DIRECT PURCHASES OF STATE OR LOCAL OBLIGATIONS BY COMMERCIAL BANKS AND OTHER FINANCIAL INSTITUTIONS

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TABLE OF CONTENTS

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Introduction

Historical Background

Prior to 1986, commercial banks were among the largest buyers and holders of tax-exempt obligations.[1] With the passage of the Tax Reform Act of 1986 (the "1986 Tax Act"), the ability of commercial banks to deduct interest expense related to tax-exempt income was limited,[2] and, as a result, the appeal of tax-exempt obligations to commercial banks diminished.[3] In the years following 1986, banks participated in the municipal market primarily through the issuance of direct pay letters of credit ("LCs"), standby bond purchase agreements and other forms of credit enhancement supporting variable-rate demand obligations ("VRDOs") with short-term tender features. While there was still significant participation by banks as lenders at the local level, those financings were generally limited to smaller issues with shorter terms.

This pattern would hold until the 2008 financial crisis, which exposed the liquidity risks associated with LC-backed VRDOs as short-term variable-rates increased and the frequency of tenders spiked in the face of bank credit rating volatility.[4] The contraction of the use of LC-backed VRDOs after the 2008 crisis also coincided with the implementation of bank regulatory

[1] In 1980, the banking sector held approximately 39 percent of outstanding municipal issues, making it the largest investor group in the market. Matthew R. Marlin, "Did Tax Reform Kill Segmentation in the Municipal Bond Market," 54 Public Administration Review 387 (Jul. – Aug. 1994).

[2] Added to the Code by Section 902(a) of the 1986 Tax Act, Section 265(b) of the Internal Revenue Code of 1986 (the "Code") generally disallows a deduction to "financial institutions" for the portion of their interest expense that is allocable to tax-exempt interest. The principal exception to the general deduction disallowance rule relates to "bank-qualified" governmental purpose (and qualified 501(c)(3)) issues issued in a calendar year in which the issuer issues $10 million or less of governmental and 501(c)(3) bonds. Under Section 265 of the Code, financial institutions are allowed to deduct 80 percent of their carrying costs in acquiring tax-exempt bonds held by such institutions if such bonds were issued by a "qualified small issuer" issuing no more than $10 million in tax-exempt governmental and 501(c)(3) bonds in a calendar year.

[3] For example, page 114 of the Historical Annual Tables for 1985-1994 published by the Board of Governors of The Federal Reserve System shows that in 1985, United States-chartered depository institutions held municipal securities totaling $235.5 billion. In 1987, these holdings had decreased to $176.7 billion, and by 1992, these holdings were down to $99.1 billion. *See* https://www.federalreserve.gov/Releases/z1/current/annuals/a1985-1994.pdf (accessed April 19, 2017).

[4] As a result of the 2008 financial crisis, the credit ratings of virtually all major financial institutions and bond insurance companies declined. As bank and insurer ratings dropped, holders of variable-rate demand bonds tendered those bonds for payment. In many cases, remarketing agents were unable to remarket the tendered securities, and substitute letter of credit providers with the requisite ratings were not available. This required many borrowers to pay off or restructure their entire tender bond portfolios on short notice, creating considerable financial stress for those borrowers.

changes that increased bank liquidity coverage requirements,[5] which severely reduced the pricing advantages banks could offer for LCs versus traditional loans.

As part of the Congressional response to the 2008 financial crisis and lawmakers' efforts to stimulate the domestic economy, the American Recovery and Reinvestment Act of 2009 ("ARRA") offered more favorable federal tax provisions for financial institutions to purchase tax-exempt debt.[6] Although temporary, these changes helped to stimulate banks' demand for tax-exempt obligations. These factors, among others, resulted in the notable uptick in direct placements for municipal bonds.[7]

Purpose of this Paper

Most bond lawyers are familiar with bank placements (frequently referred to in this paper as "direct purchase transactions"), whether in the form of a bond placement with a single bank or in a loan and note structure, depending on the prevailing state law requirements. Since 2008, however, there has been a marked increase in the frequency and prevalence of direct purchase or bank loan transactions in the municipal market, which has highlighted some of the cultural differences between the traditional municipal market debt structure and the traditional commercial lending structure.

This paper is intended to bridge this cultural gap by exploring some of the typical provisions commonly encountered when negotiating direct purchase transactions. Part I of this paper describes structures and terms common in direct purchase term sheets and examines basic documentation and interest rate mechanics, as well as maturity, prepayment and amortization provisions. Part II explores the typical representations, warranties, and covenants frequently negotiated in such agreements. Part III examines provisions that are often requested by banks in a direct purchase transaction, and not typically included in municipal bond public offerings, such as increased costs, tax gross-up, break funding indemnity, most favored nations clauses, waiver of sovereign immunity, indemnification, waiver of jury trial, choice of law, and transfer

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5 The 2008 financial crisis exposed banks to significant market funding and contingent liquidity risks, and as a result domestic and international banking regulators sought to impose stricter regulations to improve short-term resilience in the liquidity profiles of banks. The Basel Committee on Banking Supervision published international liquidity coverage ratio standards in December 2010 as part of the Basel III reform package and revised these standards in January 2013. In September 2014, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation adopted final regulations implementing a liquidity coverage ratio requirement (more stringent in certain respects than the final Basel guidelines) that will test a bank's ability to withstand "liquidity stress periods." The objective of a liquidity coverage ratio (which is tested daily) is to ensure that a bank has enough high quality liquid assets that can be immediately converted into cash to meet its liquidity needs during a "stress period."

6 Under ARRA, financial institutions were permitted to deduct 80% of the interest expense of tax-exempt debt issued in 2009 or 2010 to the extent the debt did not exceed 2 percent of the adjusted basis of the institution's assets. ARRA, Division B, sec. 1501. In addition, ARRA increased the $10 million annual limit to $30 million, and the limit was applied at the borrower, rather than the issuer, level for bank-qualified bonds issued in 2009 and 2010. ARRA, Division B, sec. 1502.

7 *See, e.g.*, Banks Bulked Up Their Muni Bond Portfolios in 2011, *The Bond Buyer* (March 27, 2012).

restriction provisions. Part IV describes event of default and remedy features that are typically considered in direct purchase transactions.

This paper also briefly highlights other legal issues relevant to direct-purchase transactions in general. Part V briefly addresses federal securities law issues relating to whether a bond acquired in a direct purchase transaction is characterized as a loan or a security. Part VI discusses the current market push for voluntary disclosure of direct purchase transactions and regulatory proposals to require disclosure. Finally, Part VII highlights certain tax-related concerns that should be flagged for consideration by tax counsel in direct purchase transactions.[8]

Also, in this paper:

- the terms "bond" and "obligation" are used interchangeably and refer to any evidence of indebtedness, including bonds, notes, leases, and certificates of participation (whether or not a security);
- the phrase "direct purchase" is used to refer to the purchase of tax-exempt or taxable governmental or conduit bonds by a commercial bank, a bank affiliate, or similar financial entity that does not involve an underwriting or public offering (which form of lending may be referred to variously as a "direct purchase," a "bank loan" or a "private placement" by municipal bond market participants);
- the terms "issuer" and "borrower" are used interchangeably, unless the context otherwise makes clear, and refer to the municipal or governmental issuer or conduit borrower that is the ultimate obligor in a direct purchase transaction;
- the terms "purchaser," "bank," and "lender" are used interchangeably, unless the context otherwise makes clear, and refer to the bank, lender, or other financial institution (typically of the sort that would meet the requirements of a "qualified institutional buyer" for purposes of Rule 144A promulgated under the Securities Act of 1933, as amended (the "Securities Act") or an "accredited investor" within the meaning of Regulation D under the Securities Act) purchasing the obligation for its own account as a bondholder or lender in a direct purchase transaction;
- the term "applicable law" is intended to refer to state law and local law (*e.g.*, state constitution, case law, attorney general opinions, and home rule charter provisions); and
- the term "direct purchase agreement" refers to a loan or financing agreement, a supplemental covenants agreement, a continuing covenants agreement, or other similar agreement between the issuer and the bank containing covenants and

[8] This publication is intended solely as an educational resource for NABL members and is not intended to establish or imply any particular "best practices" or other standard of care.

provisions in favor of the purchaser, which may be in addition to those set forth in the primary authorizing documents for the obligation.

Part I.
Direct Purchase Structures and Terms

One of the critical differences between direct purchase transactions and publicly offered bonds is that the direct purchase structure is directly negotiated between the holder and the issuers. As a result, in addition to the authorizing and governing documentation typically found in a public market transaction (*e.g.*, the bond resolution, ordinance, or indenture), a bank in a direct purchase transaction may seek structures or terms more typically found in commercial lending transactions or in the reimbursement agreement for LCs backing VRDOs.[9] These terms may be incorporated into the issuer documentation, but frequently the terms are set out in separate direct purchase agreements, such as a financing agreement or a continuing covenants agreement.

As with publicly-offered bonds, in a direct purchase transaction, counsel should examine the fundamental questions of power and authority of the issuer under state law to enter into the transaction or to agree to particular terms proposed by the bank. State or local law may also affect the form of the transaction documents in a direct placement. In some instances, it may be necessary for the issuer to issue a bond rather than enter into a loan agreement.

Interest Rate Mechanics

A direct purchase obligation may bear interest at a fixed rate or a variable rate and the governing documents may be stand alone, providing for a single interest rate structure for the life of the obligation, or a multi-modal document providing the issuer the ability to convert from one interest rate mode to another.

Variable-rate direct purchase obligations are typically index-based (*i.e.*, either based upon LIBOR or SIFMA). If LIBOR-based, interest is typically based on one-month LIBOR and is reset monthly,[10] and if SIFMA-based, interest is typically determined every Wednesday[11] (as announced by Municipal Market Data) and reset every Thursday. In both cases, interest is usually payable monthly in arrears on the first business day of a calendar month. An index-based rate is typically based on a formula established by the purchaser, such as *Interest Rate = (Applicable Index times Applicable Factor) plus Applicable Spread*, in which Applicable Factor is a stated percentage of LIBOR (*e.g.*, 67 percent of LIBOR), or 100 percent in the case of

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[9] As a result of the 2008 financial crisis, many VRDOs were restructured as bank direct purchases, and it has been common for banks to carry over terms from VRDO documents to direct purchase documents.

[10] Alternatively, the rate-setting date may be weekly to correspond with a related interest rate swap transaction.

[11] The SIFMA index is calculated on a weekly basis and released to the public on each Wednesday.

SIFMA, and Applicable Spread is the "credit spread" over the applicable index.[12] The "credit spread" is commonly specified as a number of basis points.

Direct purchase transactions sometimes include requests for adjustments to the interest rate upon the occurrence of certain specified events. State or local law may limit the interest rate applicable to the obligation, thus limiting the terms of such interest rate adjustments. Typical interest rate adjustment provisions include a higher default rate upon the occurrence, and during the continuation, of an event of default and a taxable rate if there is a determination that interest on the bond is includable in gross income for federal income tax purposes (and likewise for bank qualified transactions, if the instrument fails to be bank qualified). It is prudent for issuers to assess the risks accompanying any such interest rate adjustment provisions.

In some cases, lenders may seek additional adjustments to the interest rate to cover other events, such as provisions requiring:

- any interest that would have accrued but for legal maximum rate restrictions to be deferred and paid if and when the applicable rate goes below such maximum rate (this is commonly known as a "clawback" or "recapture provision");

- an increase in the interest rate for tax-exempt debt upon a decrease in the marginal federal corporate tax rate, in order to maintain the lender's expected after-tax yield; in response, issuers sometimes request that "the door swing both ways" so that the interest rate on the bonds will decrease if the lender's marginal corporate tax rate increases;[13] and

- an adjustment to a LIBOR-based interest rate for any reserve requirements that apply to assets and liabilities consisting of "Eurocurrency liabilities" (as defined in Regulation D of the Board of Governors of the Federal Reserve System) imposed by the Board of Governors of the Federal Reserve System or any other applicable governmental authority (including any international authority).[14]

Many of these yield maintenance provisions are designed to assure a bank investing in a direct purchase bond a floor on its return and essentially shift to the issuer the risk of future changes in the bank or tax regulatory environment.

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[12] See Part VII herein for potential federal tax considerations relating to the interest rate formula.

[13] Note that sometimes this adjustment for a change in the marginal federal corporate tax rate is built into the interest rate formula.

[14] The reserve rate for Eurocurrency liabilities established under Regulation D is currently zero and has been zero for more than 20 years. Thus, while this provision is a standard requirement in the interest rate formula for LIBOR-rate loans for all banks, it has had and, according to some banking experts, can be expected to have no impact on the interest rate calculation for the foreseeable future. Notably, should such a provision have an impact on direct purchase bonds in the future, the requirement for reserves for Eurocurrency liabilities under Regulation D is objectively determinable and not subject to manipulation by the bank or banks holding such bonds.

Default Rate

A default rate permits the purchaser to increase the stated interest rate of an obligation (or provides for an automatic increase in the interest rate of an obligation) following an issuer event of default. Default rates are rarely specified in publicly-offered transactions. Banks may defend the inclusion of default rates on several grounds.

The primary argument for the inclusion of a default rate is that in a direct purchase transaction, the bank holds all of the debt and, thus, has much greater credit exposure upon default compared to the holder of a single $5,000 bond in a publicly-offered transaction. A default rate compensates the purchaser for this risk and incentivizes a defaulting issuer to avoid, or to promptly remedy, a default, if possible. Second, as noted above, banks have the ability to directly negotiate the terms of and remedies for bonds in a direct purchase transaction. In these transactions, there is greater flexibility for the issuer and the bank to negotiate waivers, address events giving rise to the default, or negotiate a restructuring or take-out of the debt in the event of a default; the specification of a default rate can provide the impetus for these conversations.

The level of the default rate is a term to be negotiated with the bank. With regard to any default rate, consideration should be given as to whether the default rate, if imposed, would exceed applicable state or local law maximum rate limitations or any such limitation imposed in a bond election or in proceedings of the issuer relating to the bonds or other outstanding borrowings of the issuer. This may prove difficult if the default rate is tied to an index, such as LIBOR, that changes over time. In those circumstances, it may be necessary to require a "ceiling rate" to ensure compliance with applicable state or local law.[15] Alternatively, in certain cases, bond counsel may consider a specific exclusion of this provision in its legal opinion.

Taxable Rate and Tax Catch-Up Payments

It is not customary for interest rates on publicly-offered tax-exempt bonds to increase automatically if interest on the debt is determined to be taxable. Banks, on the other hand, commonly seek an automatic rate increase if interest on the bonds is ever determined to be includible in gross income for federal tax purposes.[16] Because a bondholder has no control over maintaining the tax-exempt status of bonds, purchasers argue that the issuer should bear the risk of bond taxability and, for that matter, the risk of *any* event, including a subsequent change in

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[15] A purchaser may request a recapture provision so that interest that would otherwise accrue above the permitted limit be deferred and paid if and when the applicable rate falls below the legal maximum. The validity or enforceability of such a provision could vary depending on applicable law.

[16] The purchaser may also contract with the issuer for repayment of any tax, late payment interest or penalties it incurs as a result of bond taxability, in order to assure that in all events the purchaser maintains its expected rate of return on the bonds. Again, this concept of guaranteed return is often foreign to a tax-exempt bond issuer, and practitioners may want to ensure their clients understand the incremental risk created by any such provision. If accepted in concept, issuers might request that such "catch-up payments" be limited to such penalties, fines, interest and additions to tax that are actually imposed on the purchaser by the Internal Revenue Service (the "IRS") or another governmental authority.

law, that has the effect of causing the interest on the bonds to be includable in federal gross income.[17]

Issuers and purchasers should negotiate which events, if any, result in higher rates or charges upon a determination of taxability. Factors influencing the terms of such a negotiation include the availability of other financing sources to the issuer, limiting provisions contained in other parity bond documents, the size and term of the transaction, the nature of the financed project, and the issuer's prior history of compliance with federal tax regulations.[18]

Similar to default rates, consideration should be given whether the taxable rate exceeds any applicable maximum interest rate levels under governing law.

Tenor; Maturity; Amortization; Term-Out

In a direct purchase transaction, the issuer's desired final maturity date often extends beyond the period for which the purchaser is able or willing to lend. This is a marked difference from the public bond market, where investors typically are willing to invest in debt with maturities that are consistent with an issuer's desire for a longer maturity date. To address this issue, direct purchasers often propose amortizing the debt over the issuer's desired term, but the terms of the obligation include early call, mandatory put or purchase dates, or interest rate reset rights. There also may be the ability to "term-out" the obligation, *i.e.,* a provision allowing the issuer the right to smooth out a balloon payment over a set period of time beyond the scheduled call, put, or purchase date in order to allow a refinancing of the obligation.[19]

The following is a discussion of certain factors important to purchasers and issuers regarding the term of a private placement.

<u>Bank Perspective</u>. The term of the loan is one factor in a broader evaluation by a bank of its return on investment and risk analysis. Regulatory requirements often affect this decision. For example, the Basel III framework imposes two new liquidity standards—the net stable

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[17] Relevant to both issuer and purchaser are the events (and evidence thereof) that trigger a determination of taxability (such as IRS ruling or a bond counsel opinion), and whether the issuer has an opportunity to exhaust its procedural remedies (for example, to pursue an appeal of an IRS ruling) before the taxable rate is triggered. If an issuer has procedural remedies available to it, such as appeal rights, a purchaser may seek to require the issuer to exercise them within a set period of time and seek immediate payment of any tax, late payment interest or penalties imposed on the purchaser as a result of the taxability determination (returning the same if the determination is overturned), regardless of whether the issuer is within the permitted appeal period. Finally, an issuer may require a purchaser to refund gross-up amounts paid by the issuer in the event there is a subsequent finding that the determination of taxability was erroneous.

[18] If an issuer is considering agreeing to a taxable rate provision, it might also negotiate a call right without a prepayment penalty (*i.e.*, at 100 percent of par) to avoid paying the higher taxable rate of interest.

[19] This provision is similar to term-out provisions in letter of credit reimbursement agreements, which allow the issuer the ability to repay over a period of months or years, typically at higher rates which may increase the longer the term-out is in effect.

funding ratio and the liquidity coverage ratio[20]—the stated objectives of which are to reduce or eliminate maturity mismatches between assets and liabilities on a bank's balance sheet for certain time periods. Maximizing flexibility within these requirements may motivate a bank to specify that a loan or group of loans cannot exceed a term of a particular length. Within that framework, financial models are then used to assess the loan's profitability. The models assign a penalty, typically in the form of basis points on the interest rate; the longer the term, the higher the rate penalty. From a bank's perspective, all of these factors, together with the size of the exposure, inform the bank's process of identifying an interest rate with a corresponding maximum loan term.

Many other factors can affect the bank's decision-making process with respect to the bond term. A loan that includes substantial new ancillary business could carry a higher return for the bank, which might permit concessions in other areas of the analysis (such as a lower interest rate or a longer period during which the bank commits to hold the loan). The issuer's or borrower's enterprise or industry is another factor. The credit analysis for a hospital borrower is different from that of a public university. If the former is viewed as a more volatile industry, the purchaser may be able to lend on longer terms to a public university as compared to a hospital. Collateral is another important factor. The greater the security is for repayment, the longer a purchaser may be willing to lend before requesting an interest rate reset or put.

Issuer Perspective. The considerations for an issuer are equally varied. Long-term fixed-rate financings typically do not involve refinancing risk. As such, this type of debt is generally structured with maturities tied either to the life of the underlying project or to amortization at a certain level based on revenue projections. If an issuer is analyzing a direct placement option as an alternative to publicly offered long-term fixed-rate debt based on cost of funds, it should consider the risks inherent in direct purchase bonds, including refinancing risk.

In certain circumstances where the issuer agrees to a shorter term but wants to avoid a balloon payment obligation at the end of the purchaser's hold period to mitigate refinancing risk, it may ask the purchaser to include a "term-out" feature in the financing or request an interest rate reset at the end of the purchaser's initial term. In the event the issuer and the purchaser do not agree to an interest rate reset for another hold period, a "term-out" provision allows an issuer to avoid making a balloon payment by instead amortizing the obligation during the "term-out" period if certain conditions are satisfied at the end of the initial hold period (*i.e.*, no default or event of default has occurred and all representations and warranties of the issuer remain true and correct). If all conditions to "term-out" are satisfied and the obligation is not otherwise refinanced, the obligation will be subject to amortization over a short period of time during which principal will bear interest at a specified (likely higher) "term-out" rate. This term-out feature is similar to what has typically been included in LC reimbursement agreements for repayment of tender draws for unremarketed bonds.

For revenue bond financings where there are outstanding bonds, a shorter amortization period or balloon payment could present challenges to the issuer's existing rate maintenance or debt service coverage covenants. Depending on the issuer's ability to refinance at the end of the

[20] See footnote 5 above regarding Basel and U.S. bank regulations governing liquidity coverage ratios.

term, shorter maturities could prevent an issuer of revenue bonds from satisfying any applicable additional bonds tests. Likewise, a shorter maturity (with no guarantee of the ability to refinance) could require the issuer to raise rates substantially to satisfy a rate covenant or a covenant requiring pledged revenues to meet or exceed maximum annual debt service by a certain amount. While the rate and coverage covenants in master indentures for healthcare and similar enterprises typically include special treatment for balloon indebtedness and carve-out provisions for various types of short-term borrowings, more traditional issuers of governmental revenue bonds often have bond document provisions that are far less flexible. Similarly, for general obligation bond issuers, balloon maturities could require a tax increase that is neither practical nor consistent with the applicable ballot language authorizing the bond issue. Consideration should be given to whether applicable law affects maturity or remaining duration. Some states require that certain borrowings be subject to repayment or redemption by the issuer within a certain period of time.[21]

Prepayment; *Termination Fees/Make-Whole Payments*

In the typical publicly offered bond issue, the bonds will be subject to redemption after a period of years (*e.g.*, 10 years) with or without a prepayment premium or penalty. In a bank financing, lenders often seek penalties and make-whole payments upon the early payment of a bond by the issuer. Although such provisions maintain the lender's internal rate of return, which in turn permits the lender to accept a lower rate of interest on the bond, they may limit the flexibility of an issuer that may wish to refinance the bond before maturity.

If the direct purchase transaction involves variable-rate bonds without an interest rate swap, purchasers generally allow prepayment without penalty, but lenders may seek payment of a "breakage fee." See *"Break Funding Provisions"* below in this part. Fixed-rate transactions, however, have been priced by the purchaser over the stated term of the loan. From the purchaser's perspective, this means that, upon prepayment, the purchaser is forced to forgo future interest payments at the specified bond rate and, at least in a declining interest rate environment, may lose the benefit of its bargain.[22] For this reason, lending institutions may oppose early prepayment rights unless coupled with a "make-whole payment," requiring

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21 *See, e.g.*, Section 11-82-3 of the Code of Alabama 1975, as amended, which requires that county and municipal debt having a maturity date greater than ten years must be subject to optional redemption by the tenth year after its dated date.

22 Whether the purchaser experiences a loss will depend on a number of factors, but the fundamental issue is whether the prepaid principal of the bond can be reinvested at a lower or higher interest rate. If the interest rate environment at the time of redemption is lower than it was at original issuance, the bank will presumably reinvest the repayment at a lower rate and, hence, will experience a loss. Conversely, if interest rates have risen, the bank may be able to reinvest the repaid moneys at a higher rate, to its benefit. Another factor for the bank is whether it has hedged its interest rate risk and what cancellation charges, if any, it may incur under the terms of that hedge. See *Break-Funding Provisions* below for additional discussion of this factor.

payment of a penalty or premium for early bond retirements (including acceleration).[23] This payment amount can potentially be quite significant in a declining interest rate market.

Make-whole payments are typically proposed to be calculated using one of two methods: (a) a fixed percentage of the prepaid amount, or (b) a yield maintenance formula designed to approximate the purchaser's "opportunity loss" (*i.e.*, its loss of anticipated return) resulting from the prepayment. Viewed through the lens of the purchaser, the provisions reflect their preference to "price" their transactions to maturity rather than to an earlier call date. There is nothing inherently right or wrong with this approach, but it is important to understand the fundamental economic differences between these make-whole provisions in direct purchase transactions and the more typical ten year call provided for many publicly offered bonds.

Make-whole formulas are typically based on the net present value of the interest and principal payments remaining at the time of the prepayment, using a discount rate that is usually tied to a comparable U.S. Treasury rate or LIBOR. Under such a formula, the prepayment premium theoretically equals the present value of the interest rate differential between the interest rate on the obligation and the interest rate at which the prepaid funds can be reinvested through maturity of the prepaid bonds.[24] So, for example, if interest rates have fallen between the time of issuance of the debt and the time of prepayment, the present value of what the purchaser would have received for the remaining term to maturity of the bonds will be greater than the present value of what it could receive upon reinvesting the prepaid bond principal.[25] Of course, it bears noting that careful negotiation of the methodology for establishing make-whole payments is critical. For example, if the reinvestment amount is determined by assuming that redeemed bond principal will be reinvested in risk-free securities (such as U.S. Treasury obligations), the projected rate of return and the repayment amount, in the currently existing low-interest-rate climate, would be quite low. If, by contrast, the reinvestment amount is determined by assuming that the redeemed bond principal will be reinvested at an interest rate equal to some interbank lending index (such as LIBOR), the projected rate of return and the prepayment amount could be higher.

Make-whole provisions are often negotiated to limit the prepayment penalty to a specified "lock-out" period, so that the penalty can be assessed only if the issuer optionally prepays the bond or converts the interest rate before a stated date. The length of the lock-out period tends to vary based on the term of the bond. The longer the term, the longer the bank may prefer the lock-out period to last. From the issuer's perspective, state or local law may require a prepayment option to commence within a certain time period after bond issuance or may limit

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[23] Provisions for these additional payments are known by several different names: make-whole, yield-maintenance payments, termination fees, optional redemption or conversion fees, or prepayment penalties or premiums. Some combination of any of these names may be used in this paper.

[24] *See* Brian Patrick McBride, *Overcoming Hurdles in the Enforceability of Make-Whole Provisions*, 71 U. Miami L. Rev. 998 (2016).

[25] *See generally* Douglas P. Bartner and Robert A. Britton, *Make-Whole Claims and Bankruptcy Policy*, 5 Harv. Bus. L. Rev. Online 22 (2014), *available at* http://www.hblr.org/2014/11/ (accessed April 19, 2017).

the amount of premium that can be lawfully paid. Consideration should be given to these limitations. Additionally, the lock-out period should be taken into account in the period over which the make-whole payment is calculated. For example, if there is a 15-year lock-out period on a 30-year bond, consideration should be given to whether the make-whole calculation should be based upon the lost investment return to the bank through the end of the lock-out period, or to the stated maturity of the bond.

Additionally, make-whole provisions may contain exceptions that allow the issuer to optionally redeem or convert the bond at a reduced (or no) premium or fee level, such as in the event a tax-exempt bond becomes taxable solely due to a change in law, if the purchaser actually imposes increased costs on the issuer, or in the event the issuer has available internally generated funds or capital campaign proceeds (as opposed to a refinancing).

Break-Funding Provisions

As noted above, from a bank's perspective, the interest rate formula for a bond will take into account its cost of funds, to which the lender will add a risk component (*i.e.*, margin). In a LIBOR-based financing, the issuer pays to the purchaser interest at a rate equal to a percentage of current LIBOR plus an agreed-upon margin. In a direct purchase transaction, the purchaser may seek a funding indemnity provision.[26] Under such a provision, if the issuer prepays the obligation (such as by prepaying, redeeming or converting the obligation, or if the obligation is otherwise accelerated) other than on a rate reset date (*i.e.*, the start of the new interest period), the purchaser would be entitled to reimbursement for any "losses" due to liquidating or redeploying the prepaid bond principal for the balance of the interest period in which the prepayment occurs.

This provision relates to a basic tenet of LIBOR-based lending (and, for some lenders, SIFMA-based lending) known as "matched funding." Under a "matched funding" approach, the bank funds (or is presumed to fund) its loan to the issuer by obtaining a short-term deposit from a counterparty bank in the London interbank market, in an amount that matches the principal amount of the loan outstanding for the relevant interest period. The term of this deposit will also match the duration of the corresponding interest period under the loan. In other words, the maturity date of the interbank deposit will fall on the same day as the corresponding interest payment date on the bank's loan to the issuer. The bank, therefore, owes the LIBOR component of the interest payment to the counterparty bank lending it the funds by means of the deposit, which is the basis for the pricing of the bank's loan to the issuer.

From the bank's perspective, a "mismatch" will occur if the issuer prepays the bond on a date that is not a rate reset date. Interest on the bond will cease to accrue on the principal amount prepaid to the bank following the prepayment. The bank, on the other hand, will continue to be required to pay interest on its funding deposit for the loan until that deposit

[26] These additional payments are known by various names: funding indemnity, funding loss indemnification, funding losses, breakage costs, break-funding amounts or costs for redeployment of funds, or others. Some combination of any of these names may be used in this paper.

matures at the end of the interest period. A bank in this position must therefore "redeploy" the money it receives from the issuer during this stub period before its own funding deposit matures. If interest rates have dropped since the funding deposit was incurred or committed, the rate at which the purchaser can redeploy these funds may be less than the purchaser is obliged to pay on its funding deposit. Under a matched funding strategy, this results in a loss to the purchaser known as a "breakage cost."

From an issuer's standpoint, applicable law limitations relating to breakage cost indemnities should be considered. In practice, most issuers can wait until the end of a LIBOR-based interest rate period (typically one month in length) to make prepayments, so such indemnity clauses are not particularly problematic. Issuers may try to specifically negotiate the application of these provisions in cases in which the issuer would like to prepay the debt in light of increased costs being imposed or as a result of changes to the tax status of the obligation.

In certain jurisdictions, an issuer may not be permitted by law to indemnify a bond purchaser, and in such jurisdictions a bank's requested indemnity might be characterized as "reimbursement" or qualified "to the extent permitted by law." If agreed to in a direct purchase transaction, most issuers want purchasers to substantiate claims for an indemnity under this clause by providing a description of the method by which the amount of the indemnity is calculated. Thus, funding indemnity clauses typically state such "breakage costs" will be set forth in a reasonably detailed certificate, with the caveat being that the purchaser's calculation is "conclusive absent manifest error." Even where the purchaser does not match-fund its commitment to purchase bonds, it will typically include the break-funding clause and insist on payment to it under the clause in the event of a triggering prepayment.

As with many of the other provisions discussed in this paper, inherent in the negotiation of break-funding provisions is the fundamental issue of risk allocation. Transaction participants will need to reach a common understanding about whether the issuer's obligation is simply to ensure that it pays principal and interest when due (or sooner, in the case of prepayments), to ensure that the purchaser makes a guaranteed return on its investment for specified period of time, or somewhere in between.

Draw-Down Bonds

Certain direct purchase financings are structured as "draw-down bonds." Under this structure, the purchaser from time to time makes advances, up to a maximum aggregate principal amount of the bonds, over a limited period of time, rather than advancing all proceeds of the bonds at the initial closing, as in a typical publicly-offered borrowing. Drawings may be time based or conditioned upon satisfaction of certain conditions precedent.

The draw-down structure, which is derived from a traditional "commercial bank construction loan" model, is commonly used for construction projects as it allows the issuer to incur bond interest only when and as (or at least closer in time) to when bond proceeds are actually needed for project development. Draw-down bonds also help issuers avoid negative (or positive) arbitrage, and thus can assist with arbitrage rebate compliance under federal law. These structures have also been employed as a substitute for commercial paper borrowings (through a note purchase or a revolving credit agreement structure). See Part VII herein regarding federal income tax implications concerning draw-down bonds.

Part II.
Direct Purchase Agreements—Representations, Warranties, and Covenants

In documenting a direct purchase, counsel to the issuer and counsel to the purchaser may want to consider whether the representations, warranties, and covenants requested by a purchaser should be embedded in the issuer's typical bond documents or, as frequently requested by the purchaser, in a separate direct purchase agreement. While not initially obvious, the decision can have significant implications in terms of privity of contract and the ability to control defaults and direct remedies post-default. Special consideration needs to be given to this decision in the context of parity security obligations.

A bank's version of a direct purchase agreement is somewhat different from a bond purchase agreement with an underwriter in a publicly-offered transaction. The purchaser in a direct placement is typically purchasing the obligation with the intent to hold it on its books (unless it has the ability to syndicate as it would a commercial loan). Periodically, a bank or a bank affiliate is required to review each loan that it has on its books. Depending on the credit classification of a loan, the purchaser may need to reserve more or less capital for such loans. Accordingly, a bank may be economically incentivized to provide a structure allowing pre-maturity interest rate modifications.

Representations and Warranties

Representations and warranties often requested in a direct purchase transaction include legal existence and power; due authorization, validity and enforceability of the obligation; noncontravention of organization instruments and other agreements; compliance with law; no pending material litigation or similar adversarial proceedings; material accuracy of financial statements; no adverse change in financial condition; funding liabilities and obligations for employee benefit plans; no potential defaults or events of default; insurance coverage; title to assets; and accuracy and completeness of information and reports furnished by the issuer to the purchaser. The type of collateral securing repayment of the debt often dictates the type and extent of such representations and warranties.

Purchasers may also request representations for bank regulatory purposes, such as those relating to investment company status; margin stock; Office of Foreign Asset Control ("OFAC");[27] money-laundering and anti-terrorism laws; tax status; usury; security for the obligations; pending legislation, referendums and rulings; environmental matters; sovereign immunity; and any other industry-specific representations and warranties, such as those seen in healthcare or higher education financings (*e.g.,* accreditations). Consideration should be given

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[27]Office of Foreign Assets Control - Sanctions Programs and Information, available at https://www.treasury.gov/about/organizational-structure/offices/Pages/Office-of-Foreign-Assets-Control.aspx (accessed April 19, 2017).

to (i) whether the scope of requested representations is appropriate for the particular issuer, and (ii) whether the consequences (generally identified under the defaults and remedies section) for any misrepresentation are appropriate. Relevant considerations may be whether the provisions satisfy the lender's regulatory due diligence or constitute risk reallocation of a commercial lender's regulatory obligations.

In addition to providing important information to the purchaser about the issuer, the collateral for the direct purchase bond, and the legality of the transaction, these representations and warranties also often address matters about which banks are required to conduct diligence for regulatory purposes. For example, OFAC issues terrorism and money laundering regulations that apply to all U.S. persons, including state and local governmental entities, and under which U.S. banks, bank holding companies, and their nonbank affiliates are required to perform due diligence for regulatory purposes in their transactions. Banks (like all U.S. persons) are prohibited from, and are strictly liable for, engaging in transactions with a "specially designated national and blocked person" or facilitating blocked or prohibited transactions for OFAC purposes. Banks must implement their own OFAC compliance programs, which are regularly audited by the federal banking regulators. Thus, a bank in a direct purchase transaction would require an OFAC representation and covenant to document that the issuer is not a "specially designated national and blocked person" and does not and will not engage in any prohibited or blocked transactions or do business with other entities that engage in terrorism or money laundering.

Covenants

Covenants frequently are a heavily negotiated component of the direct purchase transaction. For many banks, direct purchase of bonds has its roots in private commercial lending, where strict and extensive covenants giving the bank considerable control over the issuer are typical.[28] While healthcare and higher education borrowers regularly engage in financings involving significant financial and non-financial covenants, other governmental borrowers are generally accustomed to relatively fewer covenants in their bond authorizing and implementing documentation. This is due to historically low default rates of municipal debt and the unique security provided by rate setting, revenue collection, and taxing power. In a direct purchase transaction, a traditional bank lender may experience difficulty adapting to the expectations of governmental issuers, while governmental borrowers are often asked to agree to what for them are new and varied bond covenants. Bond counsel and bank counsel are typically called on to bridge this gap.

Representations, diligence, and disclosure are in the forefront in a publicly-offered transaction. Governmental issuers view their debt as simply a promise to pay on specified terms. Direct purchase transactions approach a bond financing from a very different perspective. Because credit classification directly affects a bank's internal rate of return, banks frequently

[28] For a history of the public finance debt market's evolution and legal distinctions from the commercial finance market, see Robert A. Fippinger, *The Securities Law of Public Finance, Third Edition*, Practicing Law Institute, 1998, Chapter 1. See also the discussion in *Events of Default and Remedies* in Part IV.

view the bond investment as a financial relationship over its term. Thus, banks may attempt to utilize covenants to monitor an issuer's fiscal health and limit the types of activities in which an issuer may engage that could adversely impact its fiscal health. The potential impact of these covenants and the likelihood of a breach by the issuer should be considered, particularly by issuers that may not have extensive prior experience with direct purchase transactions.

Covenants can be either affirmative or negative, and include a broad spectrum of rights and remedies upon default, including cure rights. Covenants categorized as financial covenants often receive special attention during the negotiation of the terms of a term sheet or commitment letter. It is important that the parties understand the local, state, and federal tax law implications of these covenants. If possible, it is better to negotiate the business terms and legal nuances of covenants during the early stages of the transaction, because many bank credit committee approvals are conditioned on such covenants.

Purchasers generally request that covenants be included in a direct purchase agreement. In a lightly documented small issue (*e.g.*, a lower principal amount borrowing), covenants also can be included in the note, bond, authorizing resolution, indenture or other key documentation. In more fully documented transactions, purchasers frequently request that they be included in a separate agreement. For the reasons noted above, consideration should be given to privity and remedy issues in assessing this request. In certain cases, particularly when parity debt is outstanding and depending on the terms of the master bond documents, parties may agree that only a specific performance remedy is provided to a purchaser under a direct purchase agreement, with other remedies to be exercised exclusively by the master trustee at the direction of the requisite percentage of bondholders (including the bank holding the direct purchase bond) in accordance with master bond documents. The nature of covenants in direct purchases may also be influenced by the security for the bond; for example, a general obligation bond secured by the issuer's full faith and credit will often be treated differently than an obligation secured by a revenue stream from an enterprise fund.

Financial Covenants

Financial reporting covenants are common in direct purchase transactions. A purchaser may request that the issuer agree to provide periodic audited financial statements, budgets, and similar financial information. In some transactions with rated issuers, a purchaser may require maintenance of certain minimum ratings.

Depending on the nature of the transaction, the typical affirmative financial covenants that might be requested by a bank are: (i) a specified debt service coverage or rate covenant, (ii) a specified level of unrestricted liquid assets, (iii) a loan-to-value ratio for loans secured by real estate or other tangible assets, and (iv) a debt service reserve fund and operating or replacement reserves. For a simple general obligation bond transaction, it is not unusual for submission of annual audits and budgets to be the only financial covenant. For a utility revenue transaction, a purchaser will likely require a debt service coverage or rate covenant whereby charges from the system must generate net revenues (*i.e.*, revenues in excess of expenses of operating the system) sufficient to cover annual debt service. For health care financings, additional operating covenants, such as those requiring minimum days cash on hand or a not-to-exceed debt-to-capitalization ratio, are common. Such covenants are not specific to direct purchase transactions, but they can be very closely negotiated in those transactions compared to publicly-offered transactions. Regardless of the capital market, consideration should be given to the needs of the issuer and its ability to comply with the covenants being discussed.

Debt service coverage and rate covenants are typically negotiated terms. The factors that go into establishing appropriate covenant levels may include the rate covenants in a publicly-offered deal as a baseline, or may vary depending on the lender's credit approval requirements. As a threshold matter, consideration should be given to whether these limitations are to be applied (i) solely in an additional bonds context, (ii) as part of any ratemaking process, or (iii) as a maintenance type of covenant.

Negative covenants prohibiting an issuer from incurring additional indebtedness or parity indebtedness without purchaser consent can be particularly contentious. In the private commercial loan setting, it is not uncommon for the bank to request consent rights to future borrowings. Such a covenant can present significant issues for creditworthy governmental issuers and typically would engender pushback by the issuer and its counsel. In place of blanket consent rights, parties sometimes use a debt service coverage ratio test for the incurrence of additional debt. If agreed to, other compromises to blanket additional indebtedness restrictions may include: (i) allowing indebtedness under a specified dollar threshold, (ii) allowing additional purchase money indebtedness for assets the issuer acquires, (iii) allowing additional indebtedness if the issuer meets certain financial metrics, and (iv) allowing lease financing for equipment purchases, perhaps up to a specified annual amount.

Non-Financial Covenants

Non-financial covenants requested by lenders in direct purchase transactions can include financial reporting, cross defaults to other loans with the purchaser and other lenders; further assurances regarding protection of the rights, interests and remedies of the purchaser; restrictions on transfers of ownership interests (generally relating to conduit borrowers); insurance requirements; bank depository relationships (within the limits of anti-tying rules); maintenance of security; limits on acquisitions (relating to conduit borrowers only); limits on liens and encumbrances; use of proceeds; restrictions on entering into swap agreements; employee benefit matters; and other miscellaneous covenants. The appropriateness of any of these covenants to a particular transaction depends on applicable law and the particular facts and circumstances of the transaction. Depending upon the type of borrower and collateral, requested financial reporting can be broader than annual audited financial statements (such as internally prepared quarterly reports), and the borrower's input is necessary to ensure feasible time frames and frequency of testing to avoid technical defaults. In addition, in the conduit context there may be covenants relating to restricting capital expenditures, and the borrower may want to negotiate an amount below which the purchaser's consent would not be required.

Banks may also request the borrower agree to maintain a depository relationship with the purchaser. Because of regulatory capital requirements and a premium placed on new depository banking relationships, this type of covenant may be more valuable to a bank than may appear to be the case at first blush. If there is a right of setoff and if the obligation is a special revenue pledge, consideration should be given to whether this arrangement could raise state or local law issues as to whether the bond is secured by more than legally available sources.

Overall, covenants are negotiated as part of the transaction documents, but if any are in the term sheet, negotiations are more effective before preparing definitive agreements. Borrowers may wish to identify covenants they deem unacceptable in any request for proposals ("RFPs") so that purchasers will be able to take these limitations into account prior to bidding.[29] Practitioners should be aware that from a bank's perspective, many of these covenants are subsumed in a term sheet or commitment letter as "terms customary in loan documents" or "terms customary for transactions of this nature." However, the perspectives of the issuer and the purchaser on what is "customary" may differ, and such differences may be material in nature. Issuers may be able to manage this by including in their RFPs a list of covenants that would not be acceptable to them. This may be especially helpful for RFPs to be distributed to commercial banks that are new entrants to the direct purchase market and therefore have less experience with governmental bond issuers.

Finally, issues of privity of contract and potential loss of control granted by a governmental issuer to a bank merit consideration. Commercial loan-type documents might act as an accelerant to financial distress by a governmental issuer going through a temporary period of stress, in a way that the covenants in a traditional publicly-offered bond transaction might not. Conversely, in a direct purchase transaction, there is greater flexibility for the borrower and the direct purchaser to negotiate waivers, address events giving rise to the default, negotiate a restructuring, and take other actions to stave off a default or acceleration that are not available or as easily to implement in the public market context.[30]

Part III.
Other Frequently Negotiated Provisions

In addition to the bond features addressed above, provisions that may be the subject of discussion or negotiation between the issuer and the purchaser include increased costs, most favored nations, sovereign immunity, indemnification, confession of judgment, waiver of jury trial, choice of law, and choice of venue.

Increased Costs

An increased costs or "yield protection" provision is often sought by banks to protect their return if regulatory changes increase their capital adequacy, liquidity, margin, reserve, or similar requirements. Such provisions are common in LC reimbursement agreements and essentially permit the bank to pass on to the issuer increases in costs or decreases in profitability arising out of a change in law or regulation. From a bank's perspective, an unexpected

[29] Possible examples of such covenants are "most favored nations" clauses, which import other creditors' more restrictive covenants into the transaction, and "material adverse change" or "material adverse effect" default provisions, which potentially inject lender subjectivity into the types of defaults that are part of the transaction.

[30] See also the discussion below in *Events of Default and Remedies*.

regulatory cost could reduce its net return realized on the direct purchase bond, whereas an issuer may not view the bank's profit margin or lack thereof as its responsibility, but rather timely payment of principal and interest as its sole obligation. Issuers typically view the risk of noncompliance with a bank's regulatory environment as appropriately borne by the bank and not the issuer.

When negotiating this provision, a bank may advise the issuer that increased costs provisions are rarely, if ever, exercised, and that banks by and large absorb these costs without passing them along to their customers in order to remain competitive in the market. An issuer, on the other hand, may have concerns about the impact of future increases in its debt burden, particularly in situations where revenues are fixed, and therefore require the ability to prepay the debt at par in the event increased costs are actually imposed. Additionally, issuers can argue that increased costs are part of doing business as a financial institution and should not be passed on to the issuer. In all events, bond counsel and bank counsel should be prepared to have a thorough discussion about the appropriate scope of any increased cost provision in a particular transaction.

If an increased costs provision is to be included, the objective conditions that trigger such a pass-through should be carefully defined. An issuer may request the right to prepay the obligation on notice and without an early payment fee or penalty in the event the purchaser charges the issuer for increased costs on the obligation. Also, to prevent a purchaser from demanding payment for increased costs in an untimely manner (such as at the end of the financing for costs incurred earlier on), an issuer may negotiate a "look-back period" so that it is not required to compensate the purchaser for increased costs incurred more than a certain number of months prior to the date the purchaser notifies the issuer of the event giving rise to the increased cost.

Issuers may also attempt to limit an increased costs provision so that a purchaser may pass through increased costs only if generally passing increased costs through to other similarly-situated borrowers in similar circumstances. Although such a provision may sound innocuous, purchasers are usually concerned that it could result in the parties litigating what "similarly-situated borrowers" or "similar circumstances" means. Purchasers often resist inclusion of such a provision or require that the purchaser's determination of what constitutes "similarly-situated borrowers" or "similar circumstances" be conclusive.

Other variations on restricting an increased costs provision include prohibiting a purchaser from seeking compensation for increased costs resulting solely and directly from a credit downgrade, other financial deterioration of the purchaser, or other actions within the purchaser's control or directly related to the purchaser's credit status. Purchasers often have concerns about the breadth of such limitations and want to be sure that if additional regulatory costs are imposed on a class of lenders to which the purchaser belongs (such as "systemically important financial institutions"), the purchaser will not be precluded from passing along the additional regulatory costs.

Consideration should be given to how any requested increased cost provision is analyzed under applicable law to determine appropriate treatment, particularly for voter approved indebtedness. Is the increased cost that is passed through required to be treated as additional principal indebtedness or interest under applicable law or any applicable ballot language? If not, is the payment by the issuer of the incremental cost subject to appropriation or limited to legally available funds?[31]

Most-Favored Nations

A "most-favored nations" ("MFN") provision gives the purchaser the benefit of any different, additional, or more restrictive terms agreed to by the issuer with other lenders in the future, such as additional covenants, additional, different, or more restrictive events of default and greater rights or remedies (each, a "More Favorable Provision"). This may even cover situations where the More Favorable Provision is not initially included in the transaction document with the MFN provision. The strongest versions of such provisions provide that the More Favorable Provisions are automatically deemed incorporated into the transaction document containing the MFN provision without further action or documentation.[32]

MFN provisions are not generally part of publicly-offered bond issues. If accepted in a direct purchase transaction, the issuer typically will want to limit survivability of the provision so that the purchaser only has the benefit of the More Favorable Provision if one or more of its creditors benefits from it.

From a bank's perspective, the rationale for an MFN provision is to ensure that all parity creditors are on equal footing in a deteriorating credit situation. The provisions also prevent the issuer from negotiating solely with one creditor to the exclusion of all the other equally-situated creditors. As an alternative to an MFN provision, in situations in which an issuer has not provided any creditor with an MFN clause, a purchaser may request a representation to that effect and either (i) a negative covenant that the issuer will not provide any creditor an MFN clause, or (ii) a "springing" MFN provision if the issuer grants an MFN provision to another creditor anytime in the future (however, without a negative covenant as to more favorable covenants, defaults, and remedies, a springing MFN provision would not by itself prevent the issuer from agreeing to more favorable covenants, defaults, and remedies with another lender). If an MFN provision is agreed to, issuers and purchasers may also try to limit its applicability so that it applies only to specific provisions or goes into effect only if the issuer is in default or potentially in default. Additionally, an MFN provision could be limited by specifically denying the lender any enforceability, consent, or waiver rights with respect to the additional provisions, which renders the MFN provision essentially no more than a cross-default provision. This

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[31] Practitioners may also want to consider the tax consequences, such as the potential characterization of such increased costs as "contingent interest" under federal tax law, which could arise in connection with an increased costs provision. In order to avoid the tax accounting issues associated with contingent interest treatment, it is customary for the payment of increased costs to be characterized in a direct purchase agreement as a taxable fee or expense in the hands of the purchaser, and not as interest on the bond.

[32] This approach may result in the MFN provisions remaining in effect longer than the loan in which they were negotiated and require the issuer to seek consent of lenders other than the lender that originally negotiated the matters subject to the MFN provisions.

approach would allow the issuer to negotiate waivers or amendments with only the lender who obtained the Most Favorable Provisions.

The argument against an MFN provision is that the creditor has agreed to extend credit on the original terms of the document and should not be entitled to benefit from another creditor negotiating more favorable covenants.[33]

Depending on the business terms of the transaction, even if an MFN provision is accepted, consideration should be given to excluding pricing terms in other bond transactions from the scope of the MFN. If the parties agree to exclude specific interest rates, fees, or credit spreads from the purview of the provision, the purchaser may request that the carve-out not apply to default rates and maximum rates. This places all parity creditors on equal footing with respect to default or "stress" pricing, which in turn reduces the incentive of an issuer to repay one parity creditor over another. The underlying bond authorization should be examined to ensure such a carve-out is permitted.

Considerations in implementing MFN provisions relate to harmonizing an issuer's covenants, defaults, and remedies across transactions, or, in the alternative, being mindful which existing covenants, defaults, and remedies are the most favorable to creditors (or most restrictive to the issuer).

Issuers may also want to consider the implications of these provisions for their debt management programs. For rated issuers, the inclusion of an MFN provision incorporating covenants that may lead to acceleration or cross-default with other issuer debt could affect a rating agency's rating of that issuer, for example, in cases in which the MFN provision could compound stress on an issuer's liquidity position.[34]

For state or local law purposes, the issuer may also want to limit such provisions to credits sharing the same fundamental credit or revenue pledge; for example, it may be inappropriate or impermissible to incorporate special tax obligation bond covenants into utility revenue bond or other special enterprise bond transactions.

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33 Even in documents containing no explicit MFN clause, a typical cross-default clause may effectively operate as an MFN clause. From the bank's perspective, if the borrower defaults under a separate creditor's document, the bank may want that to trigger a cross-default under the purchaser's bond purchase agreement or at least have that right so remedies are exercised at the same time. Most publicly offered bonds do not contain cross-default provisions except in the case of parity debt. In the direct purchase arena, even if the other creditor does not declare a default or accelerate the obligation, or waives the default, the typical cross-default provision allows the purchaser to take advantage of the other creditor's covenants. Borrower's counsel may want to carefully review cross-default provisions and consider whether they should be limited to declared defaults that permit, or result in an acceleration of, the other creditor's indebtedness.

34 As discussed below in *Rating Agency Issues; MSRB and SEC Disclosure Concerns*, it is good practice when representing a rated issuer to review draft direct purchase documents containing acceleration and cross-default provisions (including in the form of an MFN provision) carefully before agreeing to these terms, and to disclose and review any final direct purchase documents with any agency rating the issuer's debt.

Waiver of Sovereign Immunity

Another provision in direct purchase transactions for governmental entities that is not typically seen in a publicly-offered bond transaction is a provision providing a waiver of sovereign immunity. As a state law matter, governmental issuers at the state level, and in some jurisdictions at other levels, generally possess sovereign immunity rights that protect them from being sued for damages in certain courts of law. Generally, claims against a state, its agencies, or local units of government are barred absent a waiver of sovereign immunity (which may take the form of judicial analysis or legislative action that waives immunity). While state and local governments often retain immunity with respect to tort claims, the defense of sovereign or governmental immunity is often waived or abrogated to some extent with respect to contract claims, in order to facilitate the conduct of the ordinary business and operations of state and local government.

Many banks request an express waiver of sovereign immunity. In some jurisdictions, a waiver is an enforceable contractual agreement. In certain jurisdictions, a government's legislative body may prescribe an express waiver, while in others the waiver may arise through judicial interpretations in which courts have found waivers based on the actions of the state, its agencies, or local units of government even in the absence of unambiguous legislative intent. In certain jurisdictions, sovereign immunity has various components each of which must be expressly and unequivocally waived, or cannot be waived, even if the governmental entity intends to do so.[35] The legal analysis of whether the doctrine of sovereign immunity applies to a direct purchase transaction is likely no different than the analysis undertaken in a publicly-offered transaction. In many cases, lenders are willing to accept a representation that the issuer is not immune from suit to enforce the direct purchase agreement and obligation.

Indemnification

In the commercial context, indemnification generally is a contractual risk-shifting mechanism that enables one party to be compensated by another for certain losses or damages sustained. In the governmental context, the power to indemnify, like the power to waive sovereign immunity, varies by jurisdiction. Indemnification provisions are not typically included in publicly-offered bond financings, although they are sometimes included in bond purchase agreements in negotiated transactions. A decision to include an indemnification provision in a direct purchase transaction may have both legal and debt ramifications. In some jurisdictions, indemnification by a public body of a private entity may be prohibited by a limitation on the ability of a public entity to waive immunity from tort liability. In some

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[35] In Texas, sovereign immunity has two components: immunity from suit and immunity from liability. See *Gen. Servs. Comm'n v. Little–Tex Insulation Co., Inc.*, 39 S.W.3d 591, 594 (Tex. 2001). Immunity from suit is jurisdictional and bars suit whereas immunity from liability is not jurisdictional and protects an issuer from judgments. *Harris County Hosp. Dist. v. Tomball Reg'l Hosp*., 283 S.W.3d 838, 842 (Tex. 2009). Both types of immunity must be waived in order to sue for breach of contract. *See, e.g.*, *Alabama State Docks v. Saxon*, 631 So. 2d 943 (Ala. 1994) (noting "it is clear that neither the Legislature nor the State Docks had the power to waive, either expressly or impliedly, the state's immunity under §14 [of the Alabama Constitution, which relates to sovereign immunity]").

jurisdictions, case law or attorney 'general opinions may hold that, in the absence of specific authority therefor, a particular public entity does not have the authority to indemnify. In other jurisdictions without such limitations, indemnification provisions may require higher governmental approvals (*e.g.,* a home rule ordinance) that are not readily obtainable. Additionally, in certain jurisdictions, state law may warrant an inquiry whether such indemnification amounts to debt.

When an indemnification provision is included, it is typical to qualify the provision by "to the extent permitted by law" to alert the private entity that there may be some uncertainty as to the enforceability of indemnification. If there is any doubt as to the provision's enforceability and indemnification is still required, some practitioners may choose to specifically exclude indemnification provisions from their enforceability opinions.

An additional consideration regarding any indemnification provision is whether those obligations are secured and, if so, whether they are secured on a parity basis with the debt obligations. Many direct purchase transaction documents will include indemnification obligations as part of the definition of "issuer's obligations," and consideration should be given as to whether state or local law or documents prohibit or limit the ability to secure ancillary obligations of this nature.

Confession of Judgment; Waiver of Jury Trial

Direct purchase agreements may request the issuer to waive its right to a jury trial. Occasionally, purchasers request the right of confession of judgment against the issuer for a default (payment or otherwise) under the transaction documents. Governmental issuers may not have the power to provide the requested waivers and advance confessions, or they may conclude that such provisions are inappropriate for the particular transaction being negotiated.

A right to a "confession of judgment" is a provision in which an issuer agrees to allow a lender to enter a judgment against the issuer in court without an appearance by the issuer, typically for failure to pay principal or interest or failure to pay fees. These provisions may not be legal in certain jurisdictions, so it is important that bank counsel and bond counsel review applicable law prior to including or relying on such provisions, or opining on their enforceability.[36]

Provisions in direct purchase agreements waiving the right to a jury trial are also commonly requested by purchasers. The legality of these waivers varies by jurisdiction. Purchasers typically want to avoid the vagaries of juries. Governmental issuers, whose constituents generally are resident taxpaying citizens, may prefer juries to decide cases in which they are being sued for bond-related defaults. For conduit borrowers with broad corporate power and authority, these provisions are generally agreed to and do not pose a significant problem in

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[36] The Georgia Supreme Court barred such pre-trial provisions in *Bank South, N.A. v. Howard*, 264 Ga. 339, 341 (1994). California law, on the other hand, allows pre-trial confessions of judgment. California Code Civ. Proc. § 1132 *et seq.* ("[a] judgment by confession may be entered without action either for money due or to become due").

the loan document negotiation process. However, it is important for bank counsel and bond counsel to research applicable constitutional, statutory, and case law to determine whether jury waivers are enforceable. Many states allow jury waivers.[37] In others, such as Georgia and California, contractual pre-trial waivers of jury trials are void as against public policy.[38] In states that allow jury waivers, if an issuer refuses to waive trial by jury, a purchaser may request an MFN provision so that if the issuer waives jury trial in the future in any other transaction, the purchaser will receive the benefit of that waiver.

Choice of Law

A choice-of-law provision in a direct purchase agreement identifies the jurisdictional laws that will be applied in determining the validity and interpretation of the direct purchase agreement, regardless of any conflicts between the laws of the named state and the state in which the case is litigated.[39]

Purchasers may prefer the law of a particular state, such as New York or Delaware, and choice of law selections are common in commercial transactions. The paper "State Contract Law and Debt Contracts" identifies four important reasons why parties to debt contracts may prefer the law of one state over another:

> First, and possibly most important, the law regarding debt contracts is more developed in some states than in others, which thereby reduces uncertainty with regard to enforcement of the contract. Second, the law of a state may be appealing because of its court system and the procedural rules regarding litigation. Third, the parties may prefer the law of a state because its legislature is particularly responsive. Finally, there are differences in the substantive law across states that will affect the lender's ability to enforce the contract. Substantive law refers to the law that governs the rights and duties of each party, and it includes both common law created by judges and statutory law enacted by legislators. For

[37] Examples of states allowing jury waivers include New York, Texas, and Florida. *See* N.Y. Const. art. I, § 2 ("a jury trial may be waived by the parties in all civil cases in the manner to be prescribed by law. . . ."); *In re Prudential*, 148 S.W.3d 124 (Tex. 2004); *Gelco Corp. v. Campanile Motor Serv.*, 677 So.2d 952 (Fla. Dist. Ct. App. 3d Dist. 1996) ("contractual waivers of the right to a jury trial are enforceable and will be upheld").

[38] *See Bank South, N.A. v. Howard*, 264 Ga. at 341 ("pre-litigation contractual waivers of the right to trial by jury are not enforceable in cases tried under the laws of Georgia"); *Grafton Partners L.P. v. Superior Court*, 36 Cal. 4th 944 (2005) (holding that the only way parties in California may waive jury trials is by an express method provided by the legislature, and the California legislature has not expressly provided the method for predispute jury waivers). California provides a workaround for parties in a civil suit. Under California Code of Civil Procedure § 638, parties to a contract may validly appoint a referee predispute to "hear and determine any or all of the issues in an action or proceeding, whether of fact or of law, and to report a statement of decision." In order to have the dispute heard by a referee, the complaining party must first file a case in superior court (the lowest court) and then the judge refers the case to a private referee per the parties' agreement. Cal. Civ. Proc. Code § 640(b).

[39] 17A Am Jur. 2nd Contracts § 261.

> lenders, the issues of substantive law that will be most important are the state laws relating to lender liability and to the enforceability of specific contract provisions.[40]

Governmental issuers, as creatures of the law of a particular state, may be powerless to agree to the application of extra-jurisdictional laws. The robust body of law surrounding choice-of-law provisions in the commercial context may be inapplicable to governmental issuers in some jurisdictions.

Prior to including or agreeing to a choice-of-law provision applying the laws of another state, counsel may want to review the laws of the jurisdiction under which the issuer is created, as well as the laws of the purchaser's preferred choice-of-law jurisdiction. In particular, one item for consideration is whether the ultimate obligor with respect to the obligation is a governmental entity, as this is a significant factor in determining whether or not a choice-of-law provision is enforceable.

Because the governmental entity's power to incur an obligation is derived from the laws of the state in which the governmental entity was created, it is appropriate for the laws of that state to govern the governmental entity's obligations under the direct purchase agreement and the other financing documents related to the bond transaction. In *Clearfield Trust Co. v. United States,*[41] the United States Supreme Court explained a similar concept in the context of debt obligations of the United States. In that case, the Court held that federal law, rather than local law, governs "[t]he rights and duties of the United States on commercial paper which it issues" because in issuing that commercial paper, the United States is exercising a function or power derived from federal law (*i.e.*, the United States Constitution).[42]

Furthermore, an attempt to govern a governmental entity's obligations under a direct purchase agreement and related documents pursuant to the laws of a different jurisdiction could prove problematic for a number of practical and policy reasons. First, it could cause a covenant or obligation mismatch with the governmental entity's master financing documents. Second, it could cause certain provisions of the direct purchase agreement to be held unenforceable by a court as beyond the scope of the governmental entity's legal authority. Third, since the statutes and case law of many jurisdictions consider public policy in determining whether to enforce choice-of-law clauses, a court might deem the entire choice-of-law provision void and unenforceable against the governmental entity as a matter of public policy.[43]

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[40] Colleen Honigsberg, Sharon P. Katz & Gil Sadka, *State Contract Law and Debt Contracts*, Journal of Law and Economics, Vol. 57 (2014)

[41] 318 U.S. 363, 365 (1943).

[42] *Id*.

[43] *See Applera Corporation v MP BIOMEDICALS, LLC*, 173 Cal. App. 4th 769.

Notwithstanding the foregoing, it is not unusual for direct purchase agreements to provide that the obligations of the governmental entity are governed under the laws where the governmental entity was created, and the obligations of the purchaser are governed under different laws of the purchaser's choosing, frequently its jurisdiction of incorporation or where its main offices are located. If such a bifurcation is employed, it is typically at the request of the purchaser. To effectuate this bifurcation of laws, counsel might create a "Governing Laws" section in the direct purchase agreement and either expressly describe which provisions are governed under which laws or generally provide that the governmental issuer's obligations are governed under the laws of the jurisdiction in which the issuer was created and the purchaser's obligations are governed under the laws of the purchaser's desired jurisdiction.

The choice-of-law analysis in a conduit direct purchase transaction differs from the analysis when a governmental entity is the primary obligor on the debt. This is because conduit borrowers do not issue the direct purchase bond and are often private charitable or business entities with broad corporate powers granted by the laws under which they were created, generally including the power to agree to a choice-of-law provision that requires the application of laws other than the laws of the issuer's (or the conduit borrower's) domicile. Even so, in this situation care must be taken to ensure that the conduit issuer's obligations are governed under the laws of the issuer's jurisdiction of creation. To accomplish this, counsel might be required to bifurcate or trifurcate the choice-of-law provisions in the direct purchase agreement.

Venue

In addition to choice-of-law provisions, parties sometimes desire to select a venue for any bond-related disputes that must be resolved through litigation. Choice-of-law provisions are distinguishable from "forum-selection" provisions. A forum-selection provision identifies the appropriate venue in which a case will be heard, typically, a specified court in which the parties will litigate disputes arising under the contract, but does not address the laws that are to be applied by that court to resolve the dispute.[44] Except when modified by a forum-selection clause in a contract, the correct venue is typically: (i) the place where the defendant resides or does business, (ii) the place where the parties signed the contract, (iii) the place where the parties would perform the contract, or (iv) the place where other events leading up to the lawsuit took place.[45] Sometimes the parties expressly identify the appropriate venue within the direct purchase agreement. Other times the direct purchase agreement is silent, and the parties leave it to the courts to identify the appropriate venue. In the direct purchase setting, bond counsel and bank counsel may want to consider consulting with the general counsel to their respective clients to determine whether or not their client has an internal policy regarding venue selection. It is not unusual for purchasers, governmental entities and sophisticated conduit borrowers to have such a policy. Practitioners may want to also review applicable law with respect to venue selection clause enforceability and draft transaction documents and opinions accordingly.

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44 17A Am. Jur. 2d Contracts § 259.

45 *See, e.g.*, 28 U.S.C. § 1391(b) (2011).

Part IV.
Events of Default and Remedies

The scope of events of default and specified remedies are often negotiated extensively by transaction participants, and consideration should be given not just to the nature of the transaction being negotiated, but also to the effect of such provisions and the consequences for other outstanding or future debt issues of the issuer. As discussed in Part II, the issue of purchaser privity with the issuer or conduit borrower may need to be considered by counsel. Issuers and purchasers alike should be concerned about creating unintentional or impermissible legal subordinations of bondholder rights, as well as creating unintentional or impermissible structural (timing) disparities arising from mismatched acceleration rights or other similar remedies.

Events of Default

Depending on the specific source of repayment for a particular financing, parties may negotiate different or additional events of default to supplement the standard events of default contained in the authorizing documents.[46]

The following is a brief summary of types of events of default that can be found in direct purchase financing documents proposed by purchasers. The type of borrower and source of collateral often dictates which, if any, of the following events of default may be present. Bank counsel may want to discuss all of these events of default with the client in advance of soliciting or making an offer to purchase and determine which ones are necessary and acceptable for purposes of the request for proposal or response. Issuer counsel will need to review these with the issuer as certain events of default may require negotiation to make them acceptable to the issuer.

- *Failure to Pay Principal or Interest When Due.* Generally, the failure to pay the principal or interest on the obligation by the date due results in an immediate event of default without the application of any grace periods, but an issuer may negotiate a grace period or notice and cure period (less likely to be available for regularly scheduled payments), particularly where its administrative processes are cumbersome, payments are processed manually or a borrower relies on invoicing from the purchaser. In certain circumstances, particularly where a purchaser wants to avoid having to waive a technical default for payments made just a few days late, a purchaser may grant a grace period, or a grace period only with respect to interest payments. See below for a discussion of the acceleration remedy frequently requested by purchasers in connection with a payment default.

[46] Certain standard events of default are typically included within the authorizing instrument under which the obligation was issued (*e.g.*, the indenture and any related loan agreement or the issuer's bond resolution or ordinance) and are based on events of default common to publicly offered transactions. For a general obligation bond financing in the public bond market, events of default are uncommon, but in other types of financings they are typically present. In addition to such standard events of default, purchasers may seek additional and different events of default akin to those found in a commercial loan transaction.

- *Breach of Representations or Warranties; False or Misleading Statements.* As discussed in Part II, an issuer typically makes representations and warranties regarding its existence, authority, operations, and financial condition upon which the purchaser relies when extending credit. Purchasers frequently request that an event of default will arise if any representation or warranty—whether in the primary transactional documents or any ancillary certificate or statement delivered in connection with the transaction—is incorrect or untrue in any material respect when made or deemed to have been made. Purchasers may also request that an event of default be triggered if certain representations later become untrue. This allocates the risk of changing circumstances (whether intended or not) to the issuer and may, in certain financings such as draw-down loans or transactions including a "term-out," have a provision stating that the representations and warranties (except those that are time specific) are reaffirmed each time the purchaser advances funds or as a condition precedent to the obligation being subject to the term-out provisions instead of being subject to a balloon payment. While purchasers typically view the "term-out" period as a new extension of credit requiring a bring-down of the representation and warranties, issuers may want to evaluate whether this effectively converts a representation to a covenant, and the appropriateness of such conditions precedent to a particular transaction.

- *Failure to Observe or Perform a Covenant other than Timely Payment.* The lender may request two separate provisions relating to covenant breaches as events of default: one relating to those covenant breaches for which there are no cure periods and one relating to those covenant breaches for which a cure period applies. For example, the lender may insist on there being no cure period for major covenants such as an issuer's failure to comply with a rate covenant, but may agree to a cure period for the issuer's compliance with financial reporting requirements. Additionally, the cure provision may provide that certain events of default may not trigger remedies unless the purchaser provides notice to the issuer regarding the default. The adequacy of cure periods (or lack thereof) may need to be carefully considered in light of remedies available to the lender, such as acceleration rights that could produce significant stress on an issuer's liquidity.

- *Related Transaction Documents.* This type of event of default occurs if the issuer defaults under any of the related transaction documents such as authorizing documents (*e.g.,* trust indenture, loan agreement, resolution, or ordinance), tax documents, or security or collateral documents. Care may need to be taken to determine (i) which transaction documents are subject to cross default, (ii) the implications on privity and remedies for any requested incorporation by reference, and (iii) whether any agreed upon cross default occurs only after the expiration of applicable cure periods within the other transaction document. It may be that the parties do not want an event of default under a related transaction document to cause an event of default for the bond because the related transaction document might have the appropriate remedy contained within it or could produce adverse tax consequences for the bond.

- *Cross-Defaults with Other Financings.* This type of event of default is triggered by an event of default in financing documents for other (existing or later-issued) indebtedness of the issuer or where the issuer is a guarantor. Cross-defaulting to other financing documents should be carefully considered because triggering a default under the direct purchase bond documents as a result of a default under other financing documents for an unrelated revenue stream or subordinate debt could cause unanticipated consequences for the direct purchase bond. If acceleration is a remedy under all of the issuer's documents, such a default might ultimately result in the acceleration of all of the issuer's debt obligations. If included, this event of default is sometimes limited in scope to other debt of the issuer above a defined dollar threshold or to parity debt or debt payable from the same revenue source. As noted above, care should be taken in cross-defaulting publicly offered and direct purchase bonds, and consideration may need to be given as to remedies afforded the purchaser that are not available to other parity debt holders. This issue is sometimes dealt with by including agreed-upon defaults in a direct purchase agreement, limiting purchaser remedies under the direct purchase agreement to specific performance, and providing that other remedies are to be pursued by the master trustee in accordance with the applicable master indenture terms. However, since the terms of the master indenture or master resolution usually set forth the requisite bondholder threshold for exercising remedies, including acceleration, the addition of such limitations in the direct purchase agreement may not be necessary. Counsel to issuers and purchasers may want to consider whether minimum dollar thresholds should be specified to trigger a cross default, or whether a cross-default should apply only to the extent the default causes or permits the other debt to become immediately due and payable.

- *Bankruptcy and Insolvency.* This event of default is triggered when the issuer is or will become insolvent. Bankruptcy-related covenants are not commonly seen in public market transactions in part because the current bankruptcy code does not permit involuntary bankruptcies of governmental units. A bankruptcy default is typically triggered upon: (i) commencement of a voluntary bankruptcy proceeding by the borrower, (ii) consenting or acquiescing to, or failing to contest in good faith, an involuntary bankruptcy proceeding (where applicable), (iii) commencement of an involuntary bankruptcy proceeding, (iv) not being able to pay, or admitting in writing its inability to pay, its debts generally as they become due, (v) making an assignment for the benefit of creditors, (vi) applying for, seeking, consenting to, acquiescing in, or failing to contest in good faith the appointment of a receiver, custodian, trustee, examiner, liquidator, emergency manager, or similar official for it, its debts or any substantial part of its property, (vii) seeking dissolution, winding up, liquidation, reorganization, arrangement, marshalling of assets, adjustment, or composition of it or its debts, or (viii) imposition of a debt moratorium or comparable extraordinary restriction on the borrower's debt. If an involuntary bankruptcy (for a conduit borrower) proceeding is commenced, the borrower typically has a period during which to seek a dismissal (usually 30 to 60 days) before an event of default is triggered. Banks typically will resist cure periods for other bankruptcy- and insolvency-related defaults.

- *Revocation of 501(c)(3) Status.* This type of event of default applies only to qualified 501(c)(3) conduit bond transactions and occurs when the IRS revokes, or takes actions to revoke, the borrower's 501(c)(3) status. Borrowers may try to limit such a default to situations in which the borrower's 501(c)(3) status is entirely revoked and the borrower has exhausted all attempts to challenge or appeal the decision by the IRS.[47]

- *Material Adverse Change or Effect.* This type of event of default occurs when an event has occurred that has a material adverse effect on the issuer's ability to repay the debt or otherwise significantly adversely affects the borrower's business or operations. This is a carryover from the commercial lending world involving less creditworthy borrowers. Under normal circumstances, issuers and purchasers should be able to identify and describe the covenants that are important to a bank's decision to purchase. In addition, subjective defaults, particularly when coupled with acceleration rights, can be viewed by some accounting firms as converting long-term liabilities to demand obligations (*i.e.*, short-term liabilities), which can have negative consequences for issuers and conduit borrowers, including, potentially, violation of rate covenants and capitalization requirements if the debt is determined to be a demand obligation for accounting purposes.

- *Termination of Corporate Existence.* This occurs when the borrower's existence has been dissolved, liquidated, suspended or otherwise terminated. It is not usually included in governmental issuer transactions since the risk of dissolution of most governmental issuers (such as municipalities) is very low. For conduit borrowers, this event of default is not typically subject to a cure period unless the termination is easily curable, *e.g.*, by filing of a required annual report or other filing.

- *Breach of Covenants in Tax Documents*. This type of event of default involves the failure to maintain the tax-exempt status of bonds. In transactions that include both tax-exempt and taxable obligations, the provision should be drafted so that it applies only to the tax-exempt obligations and not to the taxable obligations. Counsel to issuers often object to including this provision as an event of default if there are other remedies within the financing documents for this type of breach, such as a "gross-up" to a taxable rate.

- *Validity of the Financing Documents.* This event of default arises if the issuer contests or repudiates the validity of, or its obligations under, the financing documents or if the financing documents are otherwise adjudicated to be invalid in a substantive manner. For example, under this type of provision, it would be an event of default if a court determines that a substantive provision (such as one relating to the timing of payment of principal or interest, or the security or source of repayment for the obligations) of a financing document violates applicable law. From a bank's perspective, the purpose of the provision is to prevent the issuer from repudiating its obligations and motivates the issuer to defend the transaction if it is ever challenged (for example, in a suit brought by taxpayers). From an issuer's

47 As an alternative to a default triggering acceleration of repayment of bond principal, 501(c)(3) borrowers may prefer instead to apply the "gross-up" provisions of the direct purchase documents, which provide for a taxable interest rate to apply if the bonds lose their tax-exempt status, which most likely would be the result of loss of 501(c)(3) status. In cases in which the borrower continues to be able to pay debt service on a timely basis, application of a taxable rate may afford the borrower time to challenge the IRS revocation or to consider bond refinancing options.

perspective, the purchaser is protected by tenets established in constitutional and municipal law with respect to non-impairment of contract.

- *Invalidity of Pledges or Liens on Security.* In revenue-secured financings or financings involving a pledge of collateral or a source of repayment, the conduit borrower often grants a security interest and has an obligation to maintain the pledge and security interests granted to the purchaser and to take such actions as may be required to ensure the pledge and security interests have the priority that was negotiated. For governmental issuers, the pledge or grant is often statutory rather than arising under the Uniform Commercial Code (the "UCC"). For conduit borrowers, if the pledge or a security interest ceases to be valid (or fails to have the expected priority), direct purchase agreements may include this as an event of default. From a bank's perspective, there are usually no cure periods for this event of default because any defects in the perfection of the security interest may result in the purchaser losing significant protection for repayment.

- *Ratings Downgrades*. If an issuer is a rated entity, some banks may request that a downgrade of the issuer's unenhanced long-term credit rating be treated as an event of default. A bank may argue that, even if the direct purchase bond is not rated, its credit analysis and pricing decisions were based on the issuer's most recent credit rating. As discussed above, the bank may also have internal capital requirements, and it may wish to incentivize the issuer to act in a manner that protects the bank's desired internal return. The appropriateness of these provisions depends on the nature of the transaction and the credit profile of the issuer. Issuers may object to such provisions on the basis that the debt purchased is unrated and that its credit rating was not secured for the benefit of the bank in connection with the direct purchase transaction. Some purchasers will ask for automatic pricing step-ups in the event of a downgrade (and borrowers often ask in response for automatic pricing step-downs in the event of an upgrade).

As mentioned above, the nature and extent of events of defaults are dictated by the type of borrower and the collateral securing repayment. In some cases (like a general obligation bond financing by a municipality), there may be no events of default. Conversely, a revenue financing from a 501(c)(3) hospital system will likely specify numerous events of default.

Borrowers with outstanding parity debt or those borrowers of high credit quality generally will seek consistency in the events of default that are specified across all of their financing documents, whether or not the borrower uses a master trust indenture for its bonds and whether or not all of its bonds are secured on a *pari passu* basis. This is particularly the case where cross-default is a possibility. Purchaser's counsel may want to examine prior bond financing agreements to identify covenants the borrower has been willing to accept in the recent past.

Remedies

The remedies granted to any bondholder, including a bank purchaser, typically will be calibrated to reflect the issuer's particular circumstances, with a view to selling the bonds at optimal prices. Governmental issuers do not typically have the same going concern risk as commercial entities, which is a factor that will be considered by banks negotiating remedies. Financings by governmental units also are frequently secured by ratemaking and taxation powers not found in the commercial context. Remedies typically employed in commercial lending programs, including automatic acceleration rights, may be foreign to governmental issuers. Before proceeding with a direct purchase transaction, the parties may want to discuss their specific expectations (particularly if they are based in commercial lending as opposed to traditional public finance transactions) and agree on appropriate remedies. Moreover, when direct purchase bonds are issued under an indenture or trust agreement, the parties also may want to discuss the appropriate party (purchaser or trustee) to pursue any designated remedies; this is particularly important in the context of parity or commonly secured debt. Consideration should be given to whether the remedies being negotiated are permissible under applicable law. Remedies sometimes requested in direct placement transactions include:

- *Imposition of Default Rate of Interest.* Upon the occurrence of an event of default, a higher rate of interest may be automatically imposed on the bonds until the event of default is cured. See the discussion under *Interest Rate Mechanics* in Part I above.

- *Acceleration.* In a direct purchase transaction, acceleration typically involves the exercise of a right by the purchaser to demand immediate repayment of bond principal (as well as accrued, unpaid interest) or a direction to the trustee to cause a mandatory redemption or mandatory tender of the bonds. The right of acceleration, while favored by purchasers, may or may not be appropriate depending on the sources of bond repayment and the structure of the transaction. As noted in another NABL publication, general obligation bonds are generally not subject to acceleration because the taxes and other general revenues used to pay debt service on them cannot be accelerated.[48] If the obligation is secured by a master indenture or other type of parity instrument, this remedy likely will include the right to give notice to the trustee to accelerate all parity obligations secured under the indenture (in the event the requisite percentage of parity holders consent to acceleration). As noted above, acceleration rights can expose issuers to liquidity stress.

- *Setoff and Bankers' Liens*. A purchaser may request the ability to set off obligations owed by the issuer against obligations owed by the purchaser (or its affiliates) to that issuer (*e.g.,* funds held in bank depository accounts or obligations arising under a swap), if any (a "setoff clause"). From a bank's perspective, the concept arises from the common law principle that, as between two parties, each of which owes a non-contingent monetary obligation to the other, one should be able to net out the monetary obligations in determining the amount of the ultimate liability. The typical bank oriented setoff clause may try to improve on the common law principle by extending it to non-matured or contingent obligations of the issuer, by waiving any requirement for marshalling (also a traditional common law concept), and by coupling the setoff with the grant of a security interest in the bank account (which in some cases may only become effective on default).

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[48] General Obligation Bonds: State Law, Bankruptcy and Disclosure Considerations, Nat'l Assoc. of Bond Lawyers (2014).

A setoff clause that expressly grants a lien or security interest to the purchaser in the issuer's deposit accounts and other collateral or property (a "banker's lien") may violate the issuer's existing parity bond covenants and may inadvertently provide the lender additional security (or a superior claim) to property the issuer did not intend the lender to have. In many states, the purchaser can forgo an express setoff clause and banker's lien entirely and still claim a common law right of setoff and banker's lien against the issuer's accounts (though only to the extent the obligation has matured and is not merely contingent or likely).

If the issuer is prohibited by law from allowing any setoff of its assets, consideration may be given to a specific waiver of setoff rights. Exceptions could be made to the waiver for holds and setoffs in the ordinary course of banking business.

- *Right to Sue.* Lenders often seek the express right to sue to collect amounts due or to enforce performance or observance of the issuer's obligations (whether for specific performance or otherwise). Depending on the type of issuer and the security and source of repayment, a purchaser may also seek an injunction, a monetary judgment, foreclosure on collateral, or a writ of mandamus, among other relief. Whether all or any of these are appropriate to the particular transactions depends upon a number of factors, including in particular (1) whether the direct purchase transaction is on a parity with other debt and (2) the limitations under state law of remedies against public entities. Principles of sovereign immunity may affect the exercise of this remedy in certain states. Particularly in situations where parity debt is involved, consideration should be given to whether a direct right to sue will give the purchaser access or control over collateral shared among all parity bondholders.

- *Appointment of a Receiver.* In transactions not involving general obligation bonds, the purchaser may request the express remedy (either under applicable law or as set forth in the transaction documents) of appointing a receiver to intervene in and manage a borrower's deteriorating operating and fiscal situation. Transaction documents for revenue-producing projects such as sewer or water systems frequently provide, upon the occurrence of an event of default, the purchaser with the right to request the appointment of a receiver to administer and, potentially, operate the underlying system. This is generally a discretionary, equitable remedy. Consideration should be given to whether any contractual remedies granted to a purchaser are not inconsistent with the underlying applicable law or parity debt obligations.[49]

- *Arbitration.* Banks may seek arbitration provisions, particularly in situations where the issuer is unable or unwilling to waive the right to trial by jury. Attorneys on both sides of the transaction may want to give careful thought to the interplay between the garden variety "right to sue" remedy and arbitration provisions found elsewhere in the documents. Practitioners may want to consider whether a right to file arbitration should be substituted for a right to sue, keeping in mind that in transactions involving collateral, it may be that only a court can enforce a remedy (*e.g.*, foreclosure).

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[49] Note that purchasers cannot force municipalities into bankruptcy. *See* Municipal Bankruptcy: A Guide for Public Finance Attorneys, Nat'l Assoc. Bond Lawyers (3rd ed. 2015).

- *Application of Bond Proceeds.* The transaction documents may provide for the repayment of debt in a default situation from unspent bond proceeds deposited and held a project fund, escrow fund, or similar account.

- *Collateral and the UCC.* In a direct purchase transaction in which the purchaser is a secured party with rights to collateral, the purchaser may be able to exercise rights under the UCC, and foreclose on, and dispose of, the collateral and apply proceeds to repay the defaulted obligation. Not all jurisdictions, however, apply the UCC to security interests created by governmental bodies.

- *Cure.* A direct purchase agreement may permit (though not obligate) the purchaser to cure a default. Such a right usually requires that the issuer repay funds advanced and expenses (*e.g.*, reasonable legal fees) incurred by the purchaser to effectuate the cure. An issuer may be concerned about granting a bank the right to cure when the bank may not be properly incentivized to control the expenses with the cure.

- *Rights Under Other Documents.* An MFN provision may trigger additional remedies that are available to other creditors. See the discussion under *Most-Favored Nations* in Part III above.

- *Termination of Commitment.* In a draw-down structure or other structure where the purchaser has an ongoing commitment to fund (such as a revolving credit agreement), most transaction documents provide that an event of default will terminate or suspend the purchaser's obligation to continue to fund advances.

Part V.
Loan Versus Security

Introduction

For some transaction participants, whether the obligation constitutes a "security" or a "loan" can be an important consideration. For governmental issuers in certain states, such as North Carolina for example, the authority of a public entity to enter into a loan transaction is limited, so that a direct purchase transaction will be structured as a "bond" issue for state law purposes. Whether an obligation is classified as a loan or security may differ depending on whether the framework of the inquiry is for securities law, state law, bank regulatory law, or financial accounting purposes. As a result, a bond issued by a North Carolina public body may be a "bond" for state law purposes, but may be classified as a loan (and may be evidenced by a bond) for federal securities law and/or accounting purposes.

Securities Law Considerations

From a securities law perspective, whether an obligation is a security will be of less concern to a governmental issuer than to the financial advisor to, or placement agent for, such governmental issuer. The determination will affect the applicability of Municipal Securities

Rulemaking Board ("MSRB") requirements, including Rule G-32 and Rule G-34, in connection with a direct purchase obligation that is deemed to be a "security." The MSRB, for this purpose, references the *Reves* "family resemblance" test (discussed below) and cautions that broker-dealers and municipal advisors (including a broker-dealer or advisor that is an affiliate of a bank or even a "separately identified department or division of the bank") may be subject to MSRB requirements if the purported "bank loan" is in fact a "municipal security" for securities law purposes.[50]

For purposes of the Securities Act, the analysis of whether the obligation is a "security" starts with the judicial recognition of a dichotomy between commercial loans and securities, despite the broad definition of "security" in Section 2(a)(1) of the Securities Act, which includes "any note [or] evidence of indebtedness." Under *Reves v. Ernst & Young,*[51] all bonds are presumptively "securities" for federal securities law purposes, but this presumption can be rebutted if the bond bears a strong resemblance to one of the enumerated types of non-security notes.[52] Most direct purchase obligations do not fit neatly into one of these enumerated categories, and, as such, the four factors articulated by the *Reves* case must be applied to the case at hand to determine whether the instrument is a security for federal securities law purposes. *Reves* and its progeny identify four general factors to consider: (i) motivation of the seller and buyer (or issuer and lender), (ii) the plan of distribution, (iii) reasonable expectations of the investing public, and (iv) an alternative regulatory scheme which reduces the risk of the instrument. In evaluating these factors, the courts give special attention to the intended plan of distribution and the protection of those members of the investing public for whose benefit the Securities Act was designed.[53]

To a certain extent, the terms and documentation of a direct purchase transaction will affect the treatment of that obligation under federal securities laws. For a large segment of the direct purchase market, the method of originating and approving the transaction by a bank purchaser, the collateral, the amortization, and the expectations as to transferability are not dissimilar from any LIBOR-based or fixed-rate conventional term loan the bank would otherwise extend (other than factoring in any tax exemption that may result in a lower interest rate than on a conventional loan), which weighs against treating many direct purchase transactions as a

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[50] See MSRB Notice 2011-52, September 12, 2011, *Potential Applicability of MSRB Rules to Certain "Direct Purchases" and "Bank Loans"*.

[51] 494 U.S. 56 (1990).

[52] The following are families of instruments judicially determined not to be securities: (1) a note delivered in a consumer financing, (2) a note secured by a short-term mortgage on a home, (3) a short-term note secured by a lien on a small business or some of its assets, (4) a note evidencing a "character" loan to a bank customer, (5) a short-term note secured by an assignment of accounts receivable, or (6) a note that formalizes an open-account debt incurred in the ordinary course of business. Matthews v. Stolier, 207 F. Supp. 3d 678 (E.D. La. 2016)

[53] *Compare Resolution Trust Corp. v. Stone*, 998 F.2d 1534 (10th Cir. 1993) (holding there to be no "security" where purchaser of instruments was federal savings bank), *with SEC v. Wallenbrock*, 313 F.3d 532 (9th Cir. 2002) (notes purchased by over 1,000 individuals, many of whom held the notes in their respective IRAs, held to be "securities").

"security" for Securities Act purposes under the family resemblance test. Furthermore, the "plan of distribution" and the transfer restrictions contained in a direct purchase transaction often militate against a direct purchase bond constituting a "security" for federal securities law purposes. It is noteworthy that even if a direct purchase obligation is deemed to be a "security," bonds issued by governmental issuers generally are exempt from the registration requirements of the Securities Act. If for federal securities law purposes the direct purchase transaction involves the purchase of municipal securities, a broker-dealer or a municipal advisor involved with that direct purchase transaction will be scrutinized under applicable MSRB Rules.

Accounting Treatment

For accounting and operational purposes, most purchasers of a direct purchase obligation classify the obligation as a commercial loan as opposed to a "security." Most purchasers originate the obligation to hold in their loan portfolio. By accounting for the obligation as a bank loan held to maturity rather than a security, purchasers would not be required to comply with "mark-to-market" regulatory requirements and the purchaser would show the obligation as a loan on its books rather than as an investment. The purchaser, its controller, and/or its accountant may identify specific criteria essential for characterizing the obligation as a loan for the purchaser's accounting purposes.

Although the specific criteria will vary from purchaser to purchaser, in order for a purchaser to classify a direct purchase obligation as a "loan" rather than a "security" for accounting purposes, the transaction generally will reflect some or all of the following characteristics:

- No rating agency may assign a specific rating to the obligation;
- The obligation must be issued in physical, certificated form, registered in the name of the purchaser (or its designee) and cannot be held in book-entry form or registered with The Depository Trust Company or another securities depository;
- The obligation must not be offered with any type of official statement, private placement memorandum or other offering document;
- The obligation must not be placed or offered by a broker-dealer in the capacity of an underwriter or a placement agent if it would require assignment of a CUSIP number pursuant to MSRB Rule G-34[54];

[54] On March 1, 2017, the MSRB requested industry comments on its proposed amendments to Rule G-34 requiring (a) broker-dealer placement agents to obtain CUSIP numbers for municipal security private placements, and (b) non-dealer municipal advisors to acquire CUSIP numbers for a competitive sale of new issue municipal securities. Such a rule could have significant implications on the loan and accounting treatment by lenders in the bank direct purchase market. The MSRB received 20 comment letters from the industry. *See* http://msrb.org/Rules-and-Interpretations/Regulatory-Notices/2017/2017-05.aspx?c=1 (accessed July 20, 2017). In response to the comments received, on June 1, 2017, the MSRB requested a second round of industry comments on the proposed amendments to Rule G-34, particularly with respect to a limited exception to the requirement to obtain CUSIP numbers and to apply for depository eligibility, in the case of a direct purchase of municipal securities by a bank,

- The purchaser certificate delivered to the issuer in connection with the placement of the obligation will include representations that the purchaser understands the terms of the transaction, has the expertise to perform its own credit analysis and will not rely on disclosures of the issuer in making the determination to purchase the obligation;

- For an obligation issued under a multi-modal indenture, while held by the purchaser, the obligation will be subject to a specific "bank mode" that is separate or distinct from other modes under the indenture;

- The obligation is subject to certain transfer restrictions (for example, transfers may be limited to affiliates of the purchaser or to banks, insurance companies or other financial institutions or their affiliates or other entities that would otherwise qualify as "qualified institutional buyers" under the Securities Act) and reference to the transfer restrictions is to be prominently identified as a legend on the physical, certificated obligation;

- The obligation may only be issued and transferred in higher authorized denominations (such as $250,000—which, among other things, may alleviate "offering concerns" arising from the private placement exemption requiring authorized denominations of at least $100,000);

- The obligation must not contain any references to being an "investment security" for purposes of Article 8 of the UCC; and

- The obligation must not be assigned a CUSIP number by S&P's CUSIP Service Bureau.[55]

Issuers and their counsel are generally agnostic as to the bank's accounting characterization of direct purchase obligations, as long as the proposed structure does not impact the issuer and is permissible under state or local law. Problems can and do arise, however, when a purchaser requests that the issuer structure an obligation in a manner inconsistent with applicable law. For instance, applicable state or local law may require that the obligation be documented as a registered bond rather than as a promissory note. Counsel to all parties need to be mindful of applicable state or local law requirements.

Pledge of Obligation

From time to time, due to volatility in credit demands, unexpected withdrawals of depository funds or seasonal factors, and particularly in times of financial stress such as was the

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affiliated banks, or a consortium of banks formed for the purpose of participating in the direct purchase. The deadline for comments was June 30, 2017. *See* http://www.msrb.org/News-and-Events/Press-Releases/2017/MSRB-Seeks-Additional-Comment-on-CUSIP-Requirements.aspx (accessed July 20, 2017).

55 Given that CUSIPs are a common feature of syndicated loan transactions, not all purchasers view CUSIPs as signaling a security.

case during the 2008 financial crisis, a bank may need to borrow money to ensure that it has sufficient reserves to complete a financial transaction or to maintain its level of required reserves. The Federal Reserve discount window allows eligible institutions to borrow money on a short-term basis to meet temporary shortages of liquidity. These institutions must pledge collateral to secure discount window advances, since all discount window loans are made only after being collateralized to the satisfaction of the lending Federal Reserve Bank. For the purpose of such pledges to Federal Reserve Banks, municipal securities and commercial loans are subject to vastly different margin percentages and mechanics for pledging.[56] For a pledge of securities to the Federal Reserve, the obligation would need to be held through DTC and the purchaser would need to obtain a CUSIP number for the obligation and typically an investment grade rating for the obligation. These requirements are typically in tension with the criteria that most purchasers seek for loan treatment.

MSRB and FINRA Joint Regulatory Notice

On April 4, 2016, the MSRB and the Financial Industry Regulatory Authority ("FINRA") issued a joint regulatory notice reminding the firms they regulate of their obligation to determine whether state and local government obligations acquired through direct purchase or bank loan transactions constitute municipal securities for federal securities law purposes. MSRB Notice 2016-12[57] and FINRA Regulatory Notice 16-10[58] emphasized that, although a financing may be described as a "bank loan," firms still must consider the applicability of federal securities laws and MSRB and FINRA rules with respect to their activities. The two regulatory agencies expressed concern that firms involved in bank loan transactions may simply be relying on "loan" terminology in the transaction instead of undertaking the substantive analysis necessary to determine whether a municipal obligation constitutes a "security" for federal securities law purposes. Without this analysis, MSRB and FINRA noted, firms may be operating under mistaken assumptions that the "loan" features of the transaction are sufficient to establish that the transaction does not involve the issuance of a municipal security and that they are not therefore required to comply with federal securities laws and regulations applicable to broker-dealers and municipal advisors.

Given the variety of factors that can affect the classification of an obligation as a "loan" versus a "security," and the range of inquiries that may exist for federal securities law, state law, bank regulatory law, and accounting purposes, practitioners should exercise caution when asked to give advice on whether an obligation is a loan or a security. Although custom and practice with respect to loan versus security criteria have evolved for many parties participating in the direct purchase market, accounting firms have been known to take idiosyncratic positions and

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[56] *See* Federal Reserve Collateral Guidelines, June 27, 2011, *and* Federal Reserve Discount Window & Payment System Risk Collateral Margins Table, Effective Date: October 16, 2009 (updated January 3, 2011).

[57] MSRB Regulatory Notice 2016-12*, Direct Purchases and Bank Loans as Alternatives to Public Financing in the Municipal Securities Market* (2016).

[58] Fin. Indus. Reg. Auth. Regulatory Notice 16-10, *Direct Purchases and Bank Loans as Alternatives to Public Financing in the Municipal Securities Market* (2016).

have yet to reach a wholly uniform consensus on the specific analysis that is dispositive in determining loan treatment for direct purchases for accounting purposes. In light of this uncertainty, practitioners run the risk of reaching conclusions on loan versus security treatment that may differ from those of their clients' accountants and, accordingly, may wish to proceed cautiously when considering whether to render an opinion on the issue of loan versus security for accounting purposes. It should be noted that numerous courts following *Reves* have carved out exemptions over the years for privately negotiated bank loans, so that practitioners undertaking an analysis for federal securities law purposes would need to apply the *Reves* factors to establish that the municipal direct purchase bond is not a security under *Reves*.

Part VI.
Rating Agency Issues; MSRB and SEC Disclosure Concerns

With the rise in popularity of direct purchase transactions, rating agencies have expressed concern over the failure of rated issuers to report new direct purchase arrangements to rating agencies. The rating agencies have indicated that such arrangements may have negative implications and have indicated they may suspend ratings based on an issuer's failure to disclose its direct purchase transactions. In some cases, direct purchase transactions may substantially increase an issuer's outstanding debt, and direct purchase agreements may contain covenants, defaults and remedies that differ from those otherwise applicable to the issuer's existing publicly-offered debt. Of particular concern to rating agencies are provisions granting lenders the ability to accelerate payments upon the occurrence of certain events, cross-default provisions, put options, or structures with balloon maturities.[59] These provisions may create liquidity and

[59] *See* Standard & Poor's Ratings Services, Alternative Financing: Disclosure is Critical to Credit Analysis in Public Finance 3 (2014), *available at* http://www.treasurer.ca.gov/cdiac/seminars/2014/20140205/sp.pdf (accessed April 19, 2017). In a June 29, 2017 proposal entitled *Certain Disclosures Related to Debt, including Direct Borrowings and Direct Placements* (available at http://www.gasb.org), the Governmental Accounting Standards Board ("GASB"), which sets generally accepted accounting principles used by state and local governments in the United States, echoed the concerns of the rating agencies. The proposal would define debt for purposes of disclosure in notes to financial statements and establish the following additional disclosure requirements related to debt obligations of governments, including direct borrowings and direct placements: (1) amount of unused lines of credit, (2) collateral pledged as security for debt, and (3) terms specified in debt agreements related to (a) significant events of default with finance-related consequences, (b) termination events with finance-related consequences, and (c) subjective acceleration clauses. The proposal also would require that existing and proposed additional information be provided for direct borrowings and direct placements of debt separately from other debt. The GASB explained its approach on separate disclosure as follows: "In conducting outreach regarding direct borrowings, the GASB heard concerns about the sufficiency of debt-related disclosures. In particular, some stakeholders expressed concerns about the absence of disclosures regarding provisions of debt agreements that expose governments to financial risk—such as accelerated repayments when certain events occur—which adversely affects the ability to assess the risk in a government's credit profile. . . . Some stakeholders believe that further information related to direct borrowings and direct placements is essential to understanding a government's liabilities and should be disclosed. In particular, those stakeholders cited their view that information related to direct borrowings and direct placements is more difficult to obtain, both in financial reporting based on GAAP and in other reporting of governments. Those research findings led [the GASB] to conclude that additional debt disclosure requirements should be considered. . . . [The GASB] concluded that separate disclosure of information related specifically to direct borrowings and direct placements of debt is essential because these types of debt generally are different from other debt as a result of the process by which the government incurs the debt. Therefore, [the GASB] determined

refinancing risks for issuers when a balloon payment is effectively due. They can serve to compound the risk of an otherwise temporary period of financial stress. These issues would normally affect the credit rating of the debt instruments, but may go undetected under a direct purchase structure unless disclosed to the rating agencies.

Consideration should be given to whether the issuer's rating agencies are aware of the direct purchase transaction and any potential concerns of the rating agency with the issuer's plan of finance.

Similarly, in response to buy-side concerns about the dearth of disclosure on direct purchase transactions, the MSRB released a notice in 2012 encouraging issuers of municipal securities to *voluntarily* post information about their bank loan financings to the MSRB's Electronic Municipal Market Access System ("EMMA") website using its continuing disclosure submission process.[60] The MSRB argues that "the availability of timely information about bank loan financings is important for market transparency and promoting a fair and efficient market." Specifically, the 2012 Notice suggests that disclosure of bank loan financings will alert market participants and, in particular, the holders of the issuer's other outstanding debt to: (i) the existence of the debt, which may be important if the debt is issued on a parity with other debt; and (ii) the terms and conditions of such debt, including important provisions such as acceleration remedies and financial covenants. To facilitate disclosure of private financings, the MSRB recently updated the EMMA portal to include a category of submission of bank loan disclosures on EMMA under the Continuing Disclosure tab.

On May 1, 2013, a Bank Loan Disclosure Task Force comprising representatives from the American Bankers Association, the Bond Dealers of America, the Government Finance Officers Association, the Investment Company Institute, NABL, the National Association of Health and Educational Facilities Finance Authorities, the National Association of Independent Public Finance Advisors, the National Federation of Municipal Analysts, and the Securities Industry and Financial Markets Association released a white paper entitled "Considerations Regarding Voluntary Secondary Market Disclosure About Bank Loans," which is available on the NABL website.

On January 29, 2015, the MSRB released a notice[61] to further "alert municipal market participants of the importance of voluntary disclosure of bank loans." In the 2015 Notice, the MSRB noted that timely access to bank loan information provides "current or prospective bondholders and other market participants with key information that can be useful in assessing

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that disclosures of summarized information related to direct borrowings and direct placements of debt should be presented separately from information presented related to other types of debt."

60 MSRB Notice 2012-18, *Notice Concerning Voluntary Disclosure of Bank Loans to EMMA* (2012).

61 MSRB Notice 2015-03, *Bank Loan Market Disclosure Advisory* (2015).

their current holdings of municipal securities or in making investment decisions regarding transactions in municipal securities."[62]

On March 1, 2017, the U.S. Securities and Exchange Commission ("SEC") approved a release seeking comments on proposed amendments (the "Proposed Amendments") to Rule 15c2-12 (the "Rule") under the Securities Exchange Act of 1934, as amended. The proposal seeks to amend the list of reportable events in a continuing disclosure agreement entered into in connection with a primary offering for which an issuer or obligated person must provide notice to the MSRB. Under the Proposed Amendments, disclosure would be required for the following additional events:

- 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; and

- 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.

The SEC noted that since 2009, the volume of direct purchases of municipal securities has grown as alternatives to publicly-offered municipal securities. However, direct purchases are currently disclosed on EMMA by issuers of publicly-offered municipal securities only on a voluntary basis. The SEC is concerned that investors may not have "any access or timely access to disclosure about the incurrence of certain debt obligations, such as direct placements," and, to the extent disclosure is available, it may lack material information about the obligations and that investors may not have "any access or timely access" to disclosure of the occurrence of events reflecting financial difficulties. The SEC released the Proposed Amendments to address this perceived lack of access to material information.

Under the Proposed Amendments, the term "financial obligation" is quite expansive and means any debt obligation, lease, guarantee, derivative instrument, or monetary obligation resulting from a judicial, administrative, or arbitration proceeding. Neither the Proposed Amendments nor the Rule provide a definition for "materiality," and no objective criteria or bright-line rules exist for ascertaining whether a financial obligation or terms, conditions or events under a financial obligation are "material." Issuers and other market participants are also

62 The 2015 Notice also states that "submission of bank loan financing documents may warrant consideration of MSRB Rule G-34(c), which may be considered analogous to the submission of bank letter of credit documents that support variable-rate demand obligations." By referencing MSRB Rule G-34(c) in the 2015 Notice, the MSRB is likely expressing a preference that bank loan documents be submitted in full as opposed to providing a summary of the key terms of such documents, since MSRB Rule G-34(c) generally requires that letters of credit and reimbursement agreements supporting VRDOs be fully disclosed with limited redactions and not merely summarized.

left to determine whether these material financial obligations, terms, and events will be disclosed in summary form or by posting the entire agreement (perhaps with redactions) to EMMA.[63]

Based on current guidance from the SEC, if made effective, the Proposed Amendments will be prospective and apply only to primary offerings following the effective date of any final rules.

Part VII.
Tax Considerations For Direct Purchase Bonds

As with any tax-exempt bond, issuers, conduit borrowers, banks and their counsel should consult with tax lawyers regarding the federal and state tax laws and regulations applicable to direct purchase transactions. This paper does not purport to provide guidance as to, or even to fully catalog all of, the tax issues pertaining to direct purchase transactions. However, there are certain federal tax law issues that are particularly applicable in direct purchase transactions. These issues are flagged briefly below and should be discussed with tax counsel early in the negotiation of the terms of a direct purchase bond.

Reissuance

In certain circumstances, direct purchase arrangements can raise reissuance concerns. Reissuance issues may arise whenever a term in a direct purchase agreement is altered by the parties after bond issuance. Any such proposed alteration, including amendments, waivers and/or forbearance agreements, should be carefully reviewed with tax counsel. Reissuance concerns can arise when a direct purchase agreement expressly contemplates actions the specifics and details of which are subjective, discretionary or otherwise not contained within the four corners of the transaction documents, such as discretionary adjustments to rates. Similarly, in cases where the direct purchase obligation is issued in a "bank rate" mode under a multi-modal instrument, rate resetting mechanisms, if not properly structured, can create reissuance concerns. Any such proposed provisions should also be carefully reviewed with tax counsel.

Swaps

As with publicly-offered variable-rate debt, a direct purchase transaction may also include an interest rate swap in order to create a synthetic fixed-rate. This requires input from tax counsel, as it creates a question whether the swap and the bond can or should be treated as "integrated" for purposes of computing yield on the bond.[64] Any proposal for entering into a swap in connection with a tax-exempt direct purchase bond should be carefully reviewed with tax counsel.

63 *See* the SEC release available at https://www.sec.gov/rules/proposed/2017/34-80130.pdf (accessed April 19, 2017).

64 For additional information, see NABL's publication, *Interest Rate Swaps for the General Bond Practitioner: Basic Structures, Documentary and State Law Issues* (August 2009).

Bank Qualification

The "bank qualification" characteristics of a direct purchase bond may play a large role in the economics of the transaction.[65] A "qualified tax-exempt obligation" is a tax-exempt obligation issued after August 7, 1986, by a "qualified small issuer" and otherwise meeting the requirements of Section 265(b)(3) of the Code. Tax counsel should be consulted to determine whether the issuer of a direct purchase bond can qualify as a qualified small issuer and, if so, how to designate the bond as a qualified tax-exempt obligation.

Liquidity and Negative Pledge Covenants

A liquidity or negative pledge covenant requiring the issuer to maintain certain liquid assets (typically within a particular account or fund) as of a particular date are sometimes required by a bank. Although these liquid assets typically are not directly pledged to pay or secure payment of the bond, they are available for payment of debt service and, thus, depending on the frequency of testing and other matters, including the amount required to be met under the covenant, these covenants may be problematic under the "arbitrage bond" rules of Section 148 of the Code and could require yield restriction of some of the issuer's own funds in order to maintain the tax-exempt status of the bond. Any proposed liquidity or negative pledge covenant should be carefully reviewed with tax counsel.

Draw-Down Bonds

For federal tax purposes, each draw or advance under a draw-down bond is treated as its own "bond" for certain purposes under federal tax regulations, but all such bonds (*i.e.*, draws or advances) are generally treated as part of the same issue for federal income tax purposes. Treasury Regulations Section 1.150-1(c)(4) provides that the issue date for a draw-down loan is the first date the aggregate draws exceed the lesser of $50,000 or 5 percent of the issue price of the entire authorized amount of the issue. That date becomes the "deemed issue date" for the entire issue and is documented on the IRS Form 8038 or 8038-G required to be filed in connection with the bonds. The specifics of the tax analysis for draw-down bonds should be discussed with tax counsel.

Contingent Payment Debt Instruments

Direct purchase transactions sometimes include interest rates that are subject to calculation in the alternative, depending on various conditions. See the discussion under *Interest Rate Mechanics* in Part I in this paper. Tax counsel should be consulted about the possibility of an instrument being treated as a "contingent payment debt instrument" ("CPDI") if there are different interest rates that may apply to the bonds depending on the occurrence of specified contingencies.

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[65] See footnote 2 above.

Conclusion

As early as possible during the course of a direct purchase transaction, the issuer or conduit borrower, the purchaser, bond counsel, issuer's or borrower's counsel, and purchaser's counsel should reach agreement on: (i) the basic documentation for the transaction, including the interest rate mechanics that will apply, (ii) whether a direct purchase agreement will be negotiated, and (iii) if so, the types of representations, warranties and covenants, defaults and remedies, and other negotiated provisions that will apply to the financing. In structuring a direct purchase transaction, bond counsel should be mindful of the state law and tax law implications of various structures and provisions as well as applicable requirements under federal securities law.

APPENDIX
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