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About the Bulletin

The National Public Finance Group of Chapman and Cutler LLP welcomes you to the initial issue of the NPF Bulletin. We hope that our fellow members of the public finance community will find the Bulletin to be both topical and educational. Public finance has been the core practice of Chapman and Cutler LLP since our founding in 1913. We are proud of our history of service in this vital marketplace and have undertaken the publication of this Bulletin as an additional means of sharing current topics of interest with our public finance friends and clients.

First Large Pooled CREBs Issue Closes

Chapman and Cutler LLP served as bond counsel on a \$30,520,000 issue of Clean Renewable Energy Bonds (“CREBs”) which was recently issued by **National Rural Utilities Cooperative Finance Corporation** (“*National Rural*”). The issue was the first large pooled CREBs issue in the country.

Chapman and Cutler attorneys Bob Ollis and Jeff Berry spent over two years working with National Rural and Banc of America Securities LLC to develop a comprehensive financing program whereby National Rural will lend money to its rural electric cooperative members to finance renewable energy projects with the proceeds of tax credit bonds.

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Sell! Sell! Sell! – Buy! Buy! Buy! Auction Rate Securities in the Markteplace

If you followed the financial markets in the mid 1980s you might recall when interest rates on borrowed money reached all-time highs—some reaching 20%. You slept easily at night if you were debt free and had a money market with an annual yield of 18%, which was not uncommon. If not, you probably tossed and turned all night wondering if your double-digit mortgage rate was going to crack the family’s nest egg. Fast forward to 2008 when many of the big players in the municipal securities marketplace are tossing and turning over the recent crisis in the auction rate securities market.

For those of you who do not regularly participate in the auction rate securities marketplace, much of the following has been included to provide you with some information regarding how auctions operate so, hopefully, the next time you read or hear about the auction rate securities crisis you will have a basic understanding of auction rate securities markets. In future issues of this Bulletin, we will provide additional information designed to keep those participants interested in auction rate securities informed as to developments in the market, the latest ideas and structures that issuers and broker-dealers are using to

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combat challenges concerning their auction rate securities portfolios and current guidance released by regulatory bodies, such as the SEC, as to how to interpret rules governing auction rate securities.

Generally speaking, an auction rate security (ARS) is a debt instrument with a long-term nominal maturity featuring an interest rate that is reset through a “Dutch” auction that is typically held every 7, 28 or 35 days, with the goal of achieving a short-term holding period. In an auction, existing or potential bondholders may submit orders through a broker-dealer to the auction agent to hold, sell or bid for the ARS on any interest rate reset date. After having collected that information, the auction agent determines the winning bid and resets the interest rate. The winning interest rate, often called the “clearing rate,” is the rate that will clear the market of the entire amount of such issue of ARSs available. This interest rate will be the interest rate until the next auction is held.

The chart below provides a basic framework for the sale process used during an auction and how the clearing rate is determined. “Hold at Rate” are orders placed by ARS holders who want to hold all or a portion of such issue of ARSs only if the clearing rate equals or exceeds a rate they specify. If that clearing rate is lower than their specified rate, their ARSs are sold. “Sell” orders are orders from ARS holders who want to sell all or a portion of their ARS holdings regardless of the interest rate set at the auction. “Buy” orders may be from ARS holders or new purchasers who can specify a minimum rate at which their order will be placed or that they will buy at any rate. The lowest bid rate at which all sellers can sell their ARSs and at which holders that are holding at a specified rate can hold their ARSs, becomes the clearing rate.

The following chart assumes that an auction will take place with 1,200 available shares consisting of orders to sell and hold at a specified rate.

Bidders	Order Placed (shares)	Type of Bid	Minimum Acceptable Bid	Orders Filled at the Clearing Rate
1	500	Hold at Rate	6.0%	500
2	300	Hold at Rate	6.5%	300
3	200	Buy	Any Rate	200
4	400	Buy	6.6%	200 (Partial) 6.6% is the clearing rate
5	200	Sell	Any Rate	Shares are sold
6	200	Hold at Rate	6.8%	Shares are sold
7	800	Buy	6.8%	Not filled
8	500	Buy	6.7%	Not filled

In the chart above, the clearing rate is 6.6% because it provided the rate at which the last share order could be filled to clear the auction of all 1,200 shares available for sale (shares of bidders 1, 2, 5 and 6). The entire order placed by each of bidders 1, 2 and 3, totaling 1,000 shares, was filled at 6.6%. Only part of bidder 4’s order (of 400 shares) was filled for 200 shares because by adding 200 shares to the other orders already filled, the maximum of 1,200 shares was reached. The entire order for bidders 5 and 6 was sold because bidder 5 was willing to exit the auction at any rate and bidder 6 was only willing to remain a holder if the rate equaled or exceeded 6.8%. Bidders 1 and 2 kept their shares with a new rate of 6.6% because the clearing rate was higher than their respective hold rates, and bidders 5 and 6 provided the shares necessary to satisfy the orders for bidders 3 and 4 (partial).

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Generally, an auction will fail if sell orders exceed buy orders. If an auction fails, typically, the bond documents provide that the current holders receive a specified maximum rate in order to compensate them for holding an ARS that would otherwise have been liquidated but for the failed auction. Recently, many auctions have failed based, in part, according to the analysts, on the concerns of investors about the credit ratings of the bond insurers. Sometimes broker-dealers will prevent an auction from failing by bidding on ARSs to fill the buy orders needed to clear the auction. Unfortunately, in recent weeks, many broker-dealers have had liquidity concerns resulting from their portfolios of subprime mortgages and, as a result, have failed to step in to bail out a failing auction.

Various methods exist to switch bonds out of the volatile auction rate securities market, including such options as converting the bonds to variable rate demand bonds or to fixed rate bonds, issuing refunding bonds, using existing funds or funds obtained through lines of credit to redeem auction rate securities or bidding on their own ARSs at auction. In light of the recent downgrades of certain major bond insurers and other related market disruptions, continuing disclosure obligations with respect to issuer portfolios of ARSs has become a topic of increased concern and importance. We continue to monitor the auction rate securities market and the SEC's reaction and guidance with respect to compliance with rules and regulations during this period of market uncertainty.

If you find yourself in a position of tossing and turning over the recent crisis in the auction rate securities market and would like to discuss matters regarding auction rate securities, please contact your regular Chapman and Cutler lawyer.

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The CREBs will allow National Rural members to increase production of electricity through low-cost financing of wind power, solar power, hydropower, burning biomass or trash, or other alternative fuel sources. The first issue was used to finance 27 of such projects for five National Rural electric cooperatives in locations across the country; at least two more sizable issues are expected in the coming months.

The CREBs program is an example of National Rural's unique ability to provide innovative financing solutions to its members. Ollis, National Rural's Bond Counsel for over 30 years, and Berry worked with National Rural and its legislative partners in Congress on the Energy Policy Act of 2005, which first authorized National Rural to issue CREBs.

National Rural provides loans, financings and other services to over 1,500 members, including approximately 900 rural utility systems, the majority of which are consumer-owned electric cooperatives. Between 1977 and 2007, National Rural guaranteed over 100 tax-exempt issues totaling over \$4 billion. Such bonds have provided construction or permanent financing for the environmental projects of more than two dozen of National Rural's members, located at rural power plants in 21 different states.

Last year, National Rural worked with Chapman and Cutler to provide guarantees for several series of newly created Gulf Opportunity Zone bonds for its members with property damaged by Hurricane Katrina: Alabama Electric Cooperative, Inc., South Mississippi Electric Power Association and Coast Electric Power Association. The proceeds of such bonds were used to build new power lines, expand district headquarters and provide pollution control facilities and economic improvements within the affected areas.



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Bulletin has been prepared by the Chapman and Cutler LLP National Public Finance Group for Firm clients to highlight recent developments affecting the public finance industry. Legal advice requires a detailed analysis of the particular facts of each situation and transaction. Accordingly, the items contained herein are not intended as legal advice and readers should contact an attorney with regard to any specific questions raised by the items in this issue.

New IRS Guidance on Reissuances

In February 2008, the IRS released Notice 2008-27 to provide greater certainty and flexibility in addressing certain federal tax issues that have arisen as a result of recent rating agency downgrades of major municipal bond insurers and the failure of auctions in the auction rate bond sector of the tax-exempt obligation market. The IRS designed Notice 2008-27 to provide interim guidance until the IRS and the Treasury can issue regulations to modify and clarify the determination of when tax-exempt obligations are treated as reissued or retired solely for purposes of Section 103 and Sections 141 through 150, the tax-exempt obligation provisions of the Internal Revenue Code. The IRS issued Notice 2008-27 to modify and expand the protection afforded by Notice 88-130, previously issued by the IRS in 1988, and to generally provide that authorized changes in additional interest rate modes and certain optional or mandatory tenders of obligations will not result in a reissuance of a tax-exempt obligation solely for purposes of the tax-exempt obligation provisions of the Internal Revenue Code. Notice 2008-27 redefines key terms of Notice 88-130 to provide such expanded protection. In addition, Notice 2008-27 generally provides that other types of changes to a tax-exempt obligation are tested for reissuance purposes under the significant modification standard of the Treasury regulations. Notice 2008-27 also provides special rules for certain issues that have arisen as a result of recent ratings downgrades of the bond insurers and auction failures on auction rate obligations, including a rule addressing the modification of hedging contracts.



Muni Leasing Corner

Caveat Lessor/Lender: Annual Appropriation Leases with Local Governments in Idaho. Equipment vendors and funding sources to counties, cities, school districts and other subdivisions of the State of Idaho have struggled with the Idaho Supreme Court's 2006 decision in *City of Boise v. Frazier* that in effect stopped annual appropriation equipment lease financing for Idaho local governments. Efforts are under way to establish a legally reliable foundation for annual appropriation leasing to Idaho local governments for essential governmental equipment. Until those efforts are successful, however, equipment vendors, their captive finance subsidiaries and other funding sources would be at significant legal risk to proceed with annual appropriation equipment lease financing for Idaho local governments.

U.S. Tax Court Rejects IRS Method for Calculating Interest Expense Deduction Disallowance for Bank and Its Wholly Owned Investment Company. In late 2007, the U.S. Tax Court in *PSB Holdings, Inc. v. Commissioner* rejected the IRS's position that a bank must include the tax-exempt obligations owned by its wholly owned investment company in calculating disallowance of deductions for the bank's interest expense attributable to tax-exempt investments under the Internal Revenue Code of 1986 (referred to as "interest expense deduction disallowance"). The U.S. Tax Court upheld treatment of the bank and its investment company as separate taxpayers in excluding the investment company's tax-exempt obligations from calculation of the bank's interest expense deduction disallowance.

If you have any questions or if something in the Bulletin has piqued your interest, please contact John Trofa, Practice Group Leader of Chapman and Cutler LLP National Public Finance Group, at (312) 845-3777 or trofa@chapman.com, and he will put you in contact with the appropriate Chapman and Cutler attorney.