

COMPLEX TAX-EXEMPT BOND STRUCTURES AND THE FINANCIAL CRISIS OF 2008

by David Unkovic and Suzanne Mayes
of Cozen O'Connor

With the fallout in 2008 from the “freezing” of the credit markets, including the tremendous problems that healthcare nonprofits have experienced with their bond issues, it is helpful to step back and try to look at these financings through the simpler lens of a basic “loan.”

Even though there is usually a public authority involved in the bond structure, that entity is only a “conduit.” The real “borrower” is the healthcare nonprofit. Who is the “lender”? And how are “risks” of the financing structure allocated between “borrower” and “lender”? The answers to those two questions depend on what structure has been used.

Fixed Rate Bonds. In the “good old days” of over 25 years ago, a healthcare nonprofit would consider only one type of tax-exempt bond issue: fixed rate bonds. The “lender” was the bondholders. There was not a lot that could go wrong in a fixed rate bond issue as long as the nonprofit was able to pay its debt service and meet its rate covenant and other financial tests under the trust indenture.

VRDBs. Things got more complicated in the 1980’s with the introduction of variable rate demand bonds (“VRDBs”). With VRDBs, the nominal “lender” is the bondholders. But these bondholders are only short-term investors. For example, if the VRDBs are “weekly rate bonds,” the bondholders view the bonds as a “seven day” investment. The bondholder can put its bond and be out of the investment at any time on seven days notice. So, the bondholders are very temporary “lenders.”

The VRDBs are structured so that an investment bank, acting as “remarketing agent,” will remarket the VRDBs that are put by bondholders. The bonds are remarketed to other short-term investors. Sometimes, if the market is choppy, the remarketing agent may (but is not required to) buy the put bonds itself and then find new short-term buyers when the market settles down.

But the ultimate backstop for VRDBs is a “credit enhancer” – either a letter of credit bank standing alone, or a combination of a bond insurer and a liquidity providing bank. This credit enhancer is essentially a “lender-in-waiting.” If things go wrong with the nonprofit or with the market, the bondholders will put their bonds and the credit enhancer steps in as the real “lender.” If that happens, the nonprofit’s interest rate shoots up from a low tax-exempt seven day rate to some higher taxable lending rate.

These VRDBs have two wrinkles that the old-fashion fixed rate bonds do not. First, the bondholders are really investing based on the credit of the credit enhancer, not on the credit of the nonprofit. It is as if, from the bondholders’ perspective, the credit enhancer is the “borrower-in-waiting” – if the bondholders want to get out of the deal, it is the credit enhancer that will make them whole.

Isn’t that curious? From the nonprofit’s perspective, the credit enhancer is the “lender-in-waiting,” and from the bondholder’s perspective, the credit enhancer is the “borrower-in-waiting.” The ongoing credit worthiness of the credit enhancer is therefore very important to both the nonprofit and the bondholders.

The second wrinkle that VRDBs have that fixed rate bonds do not, is that the proper functioning of the secondary market is very important to the nonprofit. With a fixed rate bond

issue, once the issue closes, the nonprofit knows exactly what its debt service is for the life of the bonds. All market risks are shifted to the bondholders. With respect to that bond issue, the nonprofit does not really care how the fixed rate bonds trade in the secondary market, because it has no effect on what the nonprofit pays in debt service.

With VRDBs, the nonprofit cares very much about the proper functioning of the secondary market, because the market affects the periodic resetting of the variable interest rate on the VRDBs. And if the market becomes dysfunctional, bondholders may put their bonds, with the nonprofit then having to pay a taxable rate to the credit enhancer. Much of the market risk remains with the borrower. The bondholders' risk centers around the financial integrity of the credit enhancer.

The important point here is that, prior to the economic crisis of 2008, nonprofits viewed these two risks (the credit worthiness of the credit enhancer and the proper functioning of the variable rate bond market) as being VERY REMOTE; so remote in fact, that the basic analysis was: "I'll get a lower rate with VRDBs than fixed rate bonds, so I am going to go with VRDBs." In other words, using our loan analogy, nonprofits viewed VRDBs as simply a "variable rate loan" that was expected to produce a cheaper result than the traditional "fixed rate loan."

Auction Rate Bonds. In the past 10 years or so, nonprofits, who by now were used to living with VRDBs, began to do auction rate bonds deals.

Auction rate bonds are very much like VRDBs in that they produce a variable rate that is expected to produce a lower interest cost than a traditional fixed rate bond issue. How do they differ from VRDBs? The main difference is the elimination of the "liquidity" aspect of the credit enhancer.

The bondholder has the right to ask for its bond to be auctioned at the next auction, but it has no right to “put” the bond, and there is no liquidity provider who is there to accept and buy the bond. Although there may still be a “credit enhancer” on an auction rate issue (often a bond insurer) who will pay the bond when it matures, there is no one standing ready to buy the bond in the short run. Essentially, the function of the short-term “borrower-in-waiting” and “lender-in-waiting” has been eliminated (and the bank fees that would have to be paid for that function have been saved and the renewal risk eliminated). This makes even more important the proper functioning of the secondary market. The investment bankers who run the auction process would often buy in the bonds themselves if there was a choppy market, but they are not legally obligated to do so.

Once again, prior to the economic crisis of 2008, nonprofits viewed the risks of auction bonds, which were even greater than the risks of VRDBs, as being VERY REMOTE. Once again, the analysis was: “I’ll get a lower rate with auction bonds than with fixed rate bonds or VRDBs, so I’ll go with auction rate bonds.” Nonprofits viewed auction rate bonds as the cheapest “variable rate loan” alternative.

Interest Rate Swaps. Once nonprofits got used to doing VRDBs and auction bonds, another product was introduced: interest rate swaps. Now a nonprofit could do a “synthetic” fixed rate bond issue by issuing VRDBs or auction rate bonds and combining that with a variable-to-fixed-rate swap.

The swap is entered into with a financial institution (called the “counterparty”), usually a commercial bank or an investment bank. The nonprofit pays a “fixed” interest rate to the counterparty, and the counterparty pays a “variable” interest rate to the nonprofit. The variable

rate payable by the counterparty is intended to match the variable rate on the VRDBs or auction bonds, but the swap's variable rate normally is based on an index (such as LIBOR) which is not necessarily an exact match with the variable rate on the bonds.

The swap really complicates the "loan" analogy. In essence, from the nonprofit's perspective, the swap counterparty is a potential "additional lender." If problems occur with the VRDBs or auction bonds, due to remote risks coming to pass, the swap may no longer "match" with the bonds, and payment obligations may arise from the nonprofit to the bondholders and the counterparty that exceed the anticipated "synthetic fixed rate."

One good thing about VRDBs and auction rate bonds is that they generally are easily prepayable with no premium. If there is a problem with the structure, the nonprofit could decide to call the bonds and refund them with fixed rate bonds or some other structure. However, once a swap is added to the VRDBs or auction rate bonds, a refunding becomes more complicated. If the nonprofit wants to terminate a swap, there is a "termination payment" due from one party to the other. Oftentimes, it is the nonprofit which owes a termination payment to the counterparty. The termination payment can be a significant amount – millions of dollars – and can make a refunding of the bonds very expensive or prohibitive.

Once again, prior to the economic crisis of 2008, nonprofits viewed the risks of variable rate bonds plus swaps as being VERY REMOTE. The analysis was: "With this synthetic fixed rate deal, I'll get a lower rate than a traditional fixed rate deal."

The Economic Crisis. The economic crisis that started rumbling in 2007 and hit full force in 2008 had the effect of bringing home to roost all of the remote risks in these structures. Many of the credit enhancers who were at the heart of these deals were downgraded, including

numerous AAA bond insurers. This caused the bondholders to put their VRDBs and to ask for their auction rate bonds to be auctioned. Investment bankers acting as remarketing agents and auction agents were overwhelmed by supply and were unable to buy in bonds as they had historically done because they faced their own liquidity problems. The anticipated match between the variable rates on bonds and the variable rates paid by swap counterparties fell apart. The economic problems faced by swap counterparties, particularly the bankruptcy of Lehmann Brothers, caused some nonprofits to unexpectedly owe termination payments on swaps.

The bottom line is that, the more complicated these debt structures became, the more risks they created. These risks were indeed remote in a normal market, and in a normal market these structures really could be seen as equivalent to a basic borrower-lender loan. However, with the once-in-a-century events of 2008, all capital markets, including the tax-exempt bond market, were turned on their head, and the more complicated structures crumbled.

The Future. As of November 2008, the auction bonds are headed for extinction, VRDBs and swaps are still being used but are more difficult to get done and are viewed with increased skepticism, and credit enhancement is very difficult for nonprofits to obtain.

Despite serious problems, the significant federal subsidy provided to nonprofit borrowers by the tax-exempt markets suggests that all industry sectors will continue to work hard at restoring the benefits of the market, armed with a better understanding of its fragilities. In the final analysis, the restored market is likely to look quite different than the tax-exempt market of just one year ago. Availability of liquidity and its significantly increased cost will be an ongoing issue. Costs for remarketing and trustee services are likely to increase as the recent market debacle has stressed these formerly routine functions. The value of bond insurance will continue

to be explored. The availability of underlying ratings for the borrower will continue to be important as potential bondholders more diligently review credit quality of both credit enhancers and underlying borrowers.

David Unkovic
Cozen O'Connor
1900 Market Street
Philadelphia, PA 19103
215 665-6975 Phone
215 701-2195 Fax
dunkovic@cozen.com

Suzanne S. Mayes
Cozen O'Connor
1900 Market Street
Philadelphia, PA 19103
215 665-6922 Phone
215 701-2107 Fax
smayes@cozen.com

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