Bloomberg Tax

Tax Management Memorandum™

Direct Pay Bond Issuers May Call Early After Sequester of Credit

By Solomon Cadle and Martye Kendrick
Greenberg Traurig

With the final outcome of a federal case now known, Direct Pay Build America Bond issuers have the answer to the question of whether a budget-driven sequestration of part of their tax credit constitutes a "material change" to applicable law allowing them to employ the extraordinary call provision in their bond documents, say Solomon Cadle and Martye Kendrick of Greenberg Traurig.

The Supreme Court's recent denial of certiorari to the petition filed by plaintiffs in *Indiana Municipal Power Agency v. United States* lets stand the decision from the lower courts allowing many issuers of Direct Pay Build America Bonds to employ extraordinary call provisions that are applicable given a material change in the law governing BAB subsidies.

According to the courts, the federal government's sequestration of a portion of BAB subsidies, pursuant to the 2011 Budget Control Act, is effectively a "material change" to I.R.C. §54AA and §6431. There had long been uncertainty how to interpret the legal mechanics and effect of the sequestration because the 2011 Act did not directly amend the language in those sections.

Now, issuers of Direct Pay BABs and their counsel have clarity on this question.

BABs and Their Redemption Provisions

Build America Bonds were created in 2009 amid the historic financial crisis, as Congress passed the American Recovery and Reinvestment Act to promote investment in infrastructure and stabilization of state and local government budgets. Section 1531 of ARRA (codified in I.R.C. §54AA and §6431) authorized for state and local governments issuing BABs a tax credit of 35% of the interest payable under the bonds, to lower the cost of borrowing. Section 6431 added the direct pay option allowing issuers to receive the 35% subsidy.

The total amount of BABs issued from April 2009 until the program's expiration in December 2010 reportedly exceeded $181 billion, representing more than one-fifth of the total amount of municipal debt issued over the same period. BABs were used for all kinds of public purpose projects including about 30% for educational facilities. Both issuers and investors praised the BABs program, and it ended up being one of the major success stories that came out of ARRA.

Sequestration Addressed Budget Deficit, Hurts Issuers

The Budget Control Act's sequester reduced the amount of the 35% subsidy issuers received on Direct Pay BABs. That sequester was triggered in 2012 when Congress failed to accomplish certain deficit targets. Since 2013, the 35% subsidy paid to issuers for their Direct Pay BABs has been reduced by anywhere from 8.7% to the current 5.7%.

This reduction has hurt state and local governments as they continue to pay the total interest rate under the BABs without the full 35% reimbursement. According to some estimates, the loss has already exceeded $2 billion. Exacerbating the issue greatly has been the fact that almost all Direct Pay BABs were issued with "make-whole" call provisions requiring issuers to pay bondholders the total interest that would be paid on the bonds until final maturity. This requirement makes the refunding of Direct Pay BABs using an optional call financially untenable.

Past Hesitation on Employing Extraordinary Call Provision

Most Direct Pay BAB documents also contain an extraordinary call provision that allows issuers to call their bonds early if a "material adverse change" occurs to §54AA or §6431 pursuant to which the 35% subsidy is reduced or eliminated (or similar language). The extraordinary call generally allows issuers to refund or redeem their Direct Pay BABs at a call price equal to the par amount of bonds being refunded or repaid, plus any accrued interest, or with a reduced make whole amount. The intent is to allow issuers to refund their Direct Pay BABs should the subsidy that underpins the BABs model be materially reduced due to a change in law. While everyone anticipated the possibility that the subsidy might be reduced, the roundabout way it ended up occurring caused much consternation for issuers and counsel alike. Because the language in §54AA and §6431 was not directly amended, the majority of issuers and their counsel had doubts as to whether the material reduction they experienced was considered attributable to a "material change" in the governing law and therefore held off using the extraordinary call provisions.

What the Indiana Municipal Power Agency Case Decision Says

The Supreme Court's denial of certiorari in *Indiana Municipal Power Agency* makes the decision from the lower courts the proverbial "law of the land." In the case, a group of municipal power entities with outstanding BABs sued the federal government to both restore the 35% subsidy and pay the full amount that it should have paid them. The Court ultimately concluded that the subsidy was properly sequestered and has the effect of reducing the federal government's subsidy obligation.

While the plaintiffs did not succeed in restoring the 35% subsidy, they did get a victory in another way, relating to the key question at hand, as the Federal Claims Court stated in its decision, which the Federal Circuit affirmed and the Supreme Court let stand:

"The spending cuts implemented by the Taxpayer Relief Act and the Budget Control Act are irreconcilable with section 1531's 35-percent payment rate. *As a result, the Taxpayer Relief Act altered the Direct Pay BABs program, reducing the government's payment obligation. When sequestration was implemented in 2013, the defendant was required by law to pay issuers of BABs a reduced rate.* This change was consistent with the basic principle that Congress is free to amend pre-existing laws" (at 766, emphasis added).

Essentially, the sequestration legislation changed §1531, and thereby §54AA and §6431, materially reducing the amount the federal government is required to pay *by law* to issuers of Direct Pay BABs, meaning they may call early under the extraordinary call provision.

What Should Issuers Do in Light of the Ruling?

The Supreme Court's denial of certiorari in *Indiana Municipal Power Agency* allows Direct Pay Build America Bond issuers and their counsel to conclude that sequestration caused a "material change" to occur to §54AA and §6431. This should provide them comfort that an extraordinary optional redemption event has been triggered based on the language used in many such provisions, and they may refund or redeem their Direct Pay BABs using the more favorable terms applicable to the extraordinary call provisions.

Such issuers will, of course, also need to review the specific language of the extraordinary call provisions in their bond documents, consider the economics of such a refunding, and weigh the price of upsetting bondholders, many of whom have questioned the materiality of the sequestration. That being said, the law governing the 35% subsidy has changed; further, such change is something that most, if not all, issuers would view as material given the way state and local budgets and legal debt limits constrain their ability to fund their capital needs.

This article provides general guidance on BABs, sequestration and recent developments that may positively impact issuers' ability to refund or redeem their Direct Pay BABs under the extraordinary call provisions contained in their bond documents. We encourage issuers to seek legal and tax counsel guidance addressing their specific circumstances relative to the extraordinary call provisions in their bond documents to determine whether their BABs can and should be refunded or redeemed.

This article does not necessarily reflect the opinion of Bloomberg Industry Group, Inc., the publisher of Bloomberg Law and Bloomberg Tax, or its owners.

Author Information

Greenberg Traurig Shareholder Solomon Cadle focuses his practice on federal tax law and regulations involving public finance, regularly serving as bond counsel in 501(c)(3) and municipal tax-exempt and tax-advantaged financings including community development districts. Martye Kendrick, Of Counsel with the firm, has deep experience in handling matters relating to tax-exempt bond financings, commercial real estate transactions, structured finance, and tax. The authors thank GT tax team members Vanessa Lowry and Andrew Rubin for their substantial contributions to this article.

ISSN 0148-8295