FALL 2004 EDITION

HAWKINS ADVISORY

"A Rare Heritage"

June 30th, 2004 was officially declared "Hawkins Delafield & Wood Day" by proclamation from New York Mayor Michael Bloomberg. The event capped a celebration of the 150th anniversary of the firm's founding by Dexter Hawkins in 1854. Several hundred guests attended a reception at the Palace Hotel in midtown Manhattan, and heard Hawkins managing partner Howard Zucker deliver the following remarks.

Introduction

On behalf of Hawkins Delafield & Wood, I welcome you — and thank you all — for coming out this evening to be with us as we mark the 150th anniversary of the founding of our Firm.

In preparing my remarks, I told Howard Berkman and Steve Donovan that there is so much to talk about, I didn't know where to start. They suggested starting somewhere near the end. Notwithstanding such advice, let me start by taking you back 179 years.

Dexter Hawkins 1825-1854

Dexter Arnold Hawkins was born in Canton, Maine in 1825. His father, Henry Hawkins, was a Universalist minister who was a fervent abolitionist. Through his mother, Hawkins descended from Revolutionary War heroes.

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Continuing Disclosure: The Central Post Office has Arrived!

The Securities and Exchange Commission has made it easier for both issuers and underwriters to comply with their SEC Rule 15c2-12 continuing disclosure obligations and contractual undertakings. Under a September 7, 2004, interpretive letter issued by SEC staff to the Municipal Advisory Council of Texas ("Texas MAC") and to John M. McNally, a Hawkins partner who represented Texas MAC in obtaining the letter, issuers of municipal securities and others (whether acting for themselves or through a dissemination agent) who normally would be required to file annual financial information and operating data, as well as material event notices, with each nationally recognized municipal securities repository ("NRMSIR") and with any relevant state information depositary ("SID") may instead satisfy these obligations by filing only with DisclosureUSA, a website newly created and operated by Texas MAC. The interpretive letter also assists underwriter compliance with Rule 15c2-12, by permitting them to treat a continuing dis-

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2004 Volume

Total municipal bond volume through September 30th was $265.6 billion, or approximately 8.8% less than the same period last year, according to figures released by Thomson Financial. We at Hawkins Delafield & Wood LLP were very pleased to once again place first in the national rankings for underwriters' counsel. The Firm was also highly ranked among bond counsel nationally. Our underwriters' counsel ranking for the first nine months of 2004, as well as those of our nearest competitors, is listed below.

NATIONAL RANKINGS - UNDERWRITERS' COUNSEL
JANUARY 1 — SEPTEMBER 30, 2004

Rank	Firm	Par Amount ($ millions)
1	**Hawkins Delafield & Wood LLP**	**18,645.7**
2	Orrick, Herrington & Sutcliffe L.L.P.	9,168.9
3	Sidley Austin Brown & Wood LLP	7,853.0
4	Clifford Chance LLP	6,840.4
5	Squire, Sanders & Dempsey LLP	5,106.7
6	Kutak Rock LLP	4,767.1
7	Ballard Spahr Andrews & Ingersoll	4,548.0
8	Fulbright & Jaworski LLP	4,255.0
9	Nixon Peabody LLP	4,213.8
10	West & Gooden PC	3,703.4

Source: Thomson Financial

* * * * *

Tax Developments at the Crossroads

By: John J. Cross III

Introduction

This tax column covers selected Federal tax developments during the past two quarters. Treasury and the IRS released several notable items of public administrative tax guidance.

Treasury and the IRS issued Proposed Treasury Regulations regarding the definition of solid waste disposal facilities

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"A Rare Heritage" continued
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Hawkins began his law career as a clerk in Portland, Maine. In 1850 he entered Harvard Law School. Upon graduation from law school, at the request of the Governor of Maine, Hawkins traveled to Europe to study European public education systems. What he learned impressed him and would be employed by him in the coming decades, when he would become nationally famous as an effective advocate of mandatory public education. In 1854, Hawkins left Maine for New York City.

1854

What was happening in 1854?

- For those interested in tobacco securitizations, in England, London tobacconist Philip Morris begins making his own cigarettes.
- There were 31 States.
- The United States ratifies the Gadsden Purchase with Mexico (adding territory that would become parts of New Mexico and Arizona). It would be the last land the United States would obtain to complete what is now the 48 contiguous States.
- Thoreau's book Walden or, Life In The Woods is published.
- The Kansas-Nebraska Act is passed, which permits the territory's residents to decide the question of slavery (thus repealing the bar to the spread of slavery of the Missouri Compromise).
- The Republican Party is founded as an anti-slavery party.
- The consolidated City of Brooklyn is established, consisting of the City of Brooklyn, the City of Williamsburgh and the Town of Bushwick, creating the third largest city in the Country.
- The building of a bridge connecting Brooklyn and Manhattan is being discussed.

A. Dexter Hawkins

Hawkins arrived in the City in 1854 and he opened an office at No. 10 Wall Street — the site of Alexander Hamilton's law office and but a few steps from Trinity Church. New York City (the City proper then consisted only of the island of Manhattan) was rapidly becoming the most powerful, and, at about 600,000 people, was already the most populated, city on the continent.

Two years later, he was joined in practice by his younger cousin, Rush C. Hawkins, who had married into the prominent Brown family of Rhode Island. The patriarch of the Brown family, John Nicholas Brown, was the founder of Brown University. As the Civil War approached, the two Hawkins cousins led in forming two regiments. One of these regiments, the "New York Ninth" and known as "Hawkins' Zouaves," was particularly noteworthy as being the first regiment in New York State, and perhaps the entire Union, to be mustered after the outbreak of fighting. In the famous battle of Antietam (the bloodiest battle of the Civil War), the Hawkins Zouaves suffered two-thirds of the casualties in the final assault.

Hawkins was instrumental in persuading Congress to establish the Bureau of Education and a biography credited him as follows: "his suggestion for universal, free, non-sectarian, common-school education has been adopted. . ."

Hawkins was particularly outspoken on the topic of accountability of elected officials. After the Civil War, Tammany Hall dominated local politics and, more importantly, the disposition of public funds for civic works. In June 1871 Dexter Hawkins published a report entitled "Extravagance of the Tammany Ring", in which he identified over 50 million dollars that had been added to the debt of the City due to graft and mismanagement. (50 million dollars in 1871 would be equivalent to approximately 715 million dollars today.) This report contributed to the public outrage that led to the ouster of William Marcy "Boss" Tweed In 1872.

B. Lewis Delafield

Shortly after Dexter Hawkins began his law practice, Lewis Delafield, Sr. (our first of three Lewis Delafields) opened his law office, also in the Financial District.

Benjamin Chu, President, New York City Health and Hospitals Corporation reads Mayor Bloomberg's proclamation naming June 30th "Hawkins Delafield & Wood Day."

Howard Zucker and Stephen Hunt, President, New York State Housing Finance Agency and State of New York Mortgage Agency, who read a letter from New York Governor George Pataki.

Delafield's legal expertise facilitated the western expansion of the railroads. In the 1880s, attorneys at the Delafield Firm developed the then-revolutionary financing concept of a revenue bond, permitting the funding of large public works without the use of general obligation borrowings.

C. 1892 - Merger

As noted before, the members of the Hawkins family were prominent crusaders on behalf of municipal reforms. The Delafields were allies in the same causes. In 1892, the Hawkins law firm, then led by Eugene D. Hawkins, son of Dexter, and the Delafield law firm, then led by Lewis Delafield, Jr., merged to form Hawkins & Delafield.

When mass transit in New York City faced its first financial crisis in the 1940s, partners at Hawkins structured the municipal takeover and recapitalization. Perhaps this was not surprising, since Lewis Delafield, Jr., as Secretary to the Transit Commission, had helped lay out the first subway in 1899.

Three Partners

Time does not permit me to describe all the great partners that the Firm has had over our 150 years — nor to even list their names, much less enumerate all their achievements. However, I did want to briefly mention three more of them, and I would note that — out of a concern for self-preservation — no living partner will be mentioned so as to not slight the others.

Frank Wood. Frank Wood is the "Wood" of Hawkins Delafield & Wood. In 1945, in recognition of his preeminent reputation, the name of the Firm became Hawkins Delafield & Wood. In Robert Caro's Pulitzer Prize - winning biography of Robert Moses, The Power Broker, Caro describes Wood as "one of the nation's most respected municipal lawyers." Among many great public works that Wood advised Moses on was The Triborough Bridge and Tunnel Authority.

Charles Kades. Chuck Kades was recruited from Hawkins by the Franklin Roosevelt Administration to work for The Public Works Administration and, later, The Treasury Department. During World War II, Colonel Kades was sent to the Pacific theatre and served as legal counsel to General MacArthur.

According to *The New York Times* obituary of July 6, 1996, "none of the [deals] he worked on… had the impact of one… 10-day effort in February 1946 when Mr. Kades supervised the transformation of Japan from a monarchy into a modern democracy with full guarantees of equality." *The Economist* (June 21, 1996) wrote: "apart from the human rights embodied in The American Constitution, Mr. Kades included numerous other rights that were only just beginning to be debated in Japan, such as the right of workers to engage in collective bargaining, the right of sexual equality, and the right to be educated."

According to a paper written by Professor Robinson of Smith College in 1995: "a poll conducted in 1985 in both Japan and The United States queried respondents about the effects of the occupation. The Americans thought its main achievement was to help Japan build a spectacularly successful economy. The Japanese thought the occupation's main legacy was freedom and democratic rights. Charles Kades had a hand in both aspects, but his greatest contribution was to the establishment of constitutional liberty and democracy. It is time to recognize the importance of his achievement and to grant him his rightful place among the architects of the Postwar World."

After such work Kades returned to the Firm and retired as a partner in December 1977, and served as Of Counsel to the Firm for several years thereafter.

Robert Rosenberg. I can never fail to mention Bob Rosenberg at Firm functions. To many of us, he was a mentor, a big brother, the consummate Firm leader — but mostly, he was our good friend. He inspired us all to be more than we ever thought we could be, and we miss him dearly.

It was under his leadership that the Firm expanded dramatically, including opening the first of our three offices in California, and recruiting many accomplished partners from other firms. In many ways, he was the master architect of the modern Hawkins Delafield & Wood.

The *presence* - of his *absence* - can never be denied.

Noble Calling

Occasional demagoguery to the contrary not withstanding, being a public finance professional is a noble calling with a great tradition. If you were to take a tour of your community, you would find facilities that your organization or other bond professionals were instrumental in getting financed, such as bridges, tunnels, mass transit systems, airports, hospitals, housing, universities, schools, courthouses, AIDS facilities, and on and on.

We can all take justifiable pride in our industry's contributions to building our community, and, in some cases, in fact saving our community. In the book Lions of the Eighties, Paul Hoffman describes the role lawyers played in saving New York City from its fiscal crisis in the 1970s. He describes the situation where the newly-created Municipal Assistance Corporation was about to issue one billion dollars of bonds to save the City from bankruptcy — and a lawsuit was filed to stop the sale. The Firm reviewed the pleadings and delivered a so-called "no-merit" opinion as to the lawsuit. Paul Hoffman wrote:

> *"It was a billion-dollar gamble. Wall Street veterans could not recall when a municipal-bond counsel last had rendered a no-merit opinion. 'Without Hawkins' opinion, there would have been no MAC. It's that simple. Hawkins gave an unequivocal opinion. Without it, MAC would never have sold a bond.' 'At that point,' said a Wall Street lawyer, 'If Hawkins had said "no," the financial community would not have accepted anyone else's opinion. It would have been too late to put together another constitutional device and The City probably would have gone into bankruptcy.' "*

Place In The Industry

Today we have over 100 attorneys in 7 offices specializing in public finance and public projects; although there are firms that practice public finance that are larger than we, no firm has more lawyers engaged in the practice of public finance than Hawkins.

About 90 years after Hawkins started practicing public finance, statistics began to be compiled. According to such statistics, Hawkins has issued opinions as bond or underwriters' counsel on approximately $500 billion dollars worth of bonds, more than any law firm in the country (and that doesn't include the first 90 years of our practice in this area);

including,

nationally: #1 in Housing Finance
#1 in Public Power Finance
#1 in Solid Waste Finance
#1 in Transportation Finance
#2 in Health Care and Higher Education Finance, and
#1 in New York State.

Legacy And Responsibility

Our Firm is 150 years old, so it's obvious that the partners today were not around at the beginning (although a few of us may act like we were).

When you're a partner in a Firm like this, you have to recognize that you have been entrusted with a rare heritage. As the legatees of such heritage, we have a special responsibility. To paraphrase Billy Joel,

"We didn't start the fire,
but [we must make sure that] when we are gone,
it will still burn on and on and on…."

Throughout our history and today we have never rested on our laurels. The only explanation for our long record of achievement across the nation is our devotion to our clients and our performance for our clients.

Conclusion

Our clients are the most important part of our practice. Your continued support and confidence in our judgment, advice and performance are truly our greatest assets. We are proud to share this moment with you, and hope that our years together in the future will offer us all many more opportunities to celebrate.

"May the Bonds that tie us, never be lost, mutilated, destroyed or stolen."

Thank you.

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"Continuing Disclosure" continued

(Continued from page 1)

closure undertaking that provides for filings through DisclosureUSA to be in compliance with the Rule.

Essentially, DisclosureUSA acts as a "central post office" that takes filings made to it and immediately retransmits them to the NRMSIRs and SIDs. Use of DisclosureUSA is not required, but it is hoped that it will simplify the filing process and facilitate the availability and accessibility of filed information.

This simplified "one-stop" process is approved by the interpretive letter for any new continuing disclosure undertaking pursuant to the Rule that provides for filings through DisclosureUSA. In addition, the interpretive letter advises that the DisclosureUSA process is "consistent with the intent of Rule 15c2 12", which should have the practical effect of also allowing it to be used for filings under existing continuing disclosure undertakings or new ones that don't happen to reference DisclosureUSA. We do not believe that amendments to existing undertakings will be required to permit filings through DisclosureUSA.

When a filing is made with DisclosureUSA, it supplies confirmation of receipt and also confirmation of retransmission to the NRMSIRs and SIDs. Currently, filings may be made either electronically or by paper, but paper filing will be phased out by the end of 2007. There is no fee for electronic filings that are directly uploaded, but those who submit filings in paper or as attachments to e-mails will be charged modest fees per document.

DisclosureUSA will maintain a searchable indexing system to permit registered users to search for filings, which should greatly simplify the process of verifying whether filings have been made in compliance with Rule 15c2 2-12 and retrieving information. The filed documents themselves are obtainable only through the NRMSIRs and SIDs.

DisclosureUSA also will maintain a "tickler" system that will, free of charge, notify registered users by e-mail of upcoming filing deadlines. Making sure that DisclosureUSA has the correct time deadlines and making timely filings will continue to be the responsibilities of the filers themselves.

We at Hawkins applaud this improvement in secondary market disclosure, and of course are very pleased to have played our part in obtaining the staff's favorable interpretation of Rule 15c2-12 that permits it. We encourage filers to at least give it a try. Further information can be obtained directly from the DisclosureUSA website at www.DisclosureUSA.org, or contact any Hawkins lawyer.

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"Tax Developments" continued

(Continued from page 1)

under Code Section 142(a)(6). These proposed rules would adopt a significantly different regulatory approach than that taken in the existing regulations. The proposed rules would eliminate the so-called "no value" rule and would focus more on the processes used in the facilities.

The IRS issued a favorable Revenue Procedure which, among other things, would give owners of existing multifamily housing projects which are acquired with tax-exempt bond financing under Code Section 142(d) a one-

year transition period to bring the projects into compliance with the low-income set-aside requirements.

In the temporary favors department, the IRS issued an announcement in which it indicated that the effective date for the application of any final Treasury Regulations on standards of tax practice under Circular 230 to the municipal bond area would be no earlier than 120 days after publication of the final rules for the municipal bond area.

In an interesting Private Letter Ruling, the IRS interpreted the reach of the "replacement proceeds" arbitrage principle more narrowly than previously understood.

Treasury-IRS 2003-2004 Business Plan

On July 26, 2004, Treasury and the IRS released their fiscal 2004-2005 Priority Guidance Plan covering the period from July, 2004, through June, 2005. The 2004-2005 Plan includes the following tax-exempt bond projects:

1. Final regulations under Code Section 141 on refundings.

This project involves finalization of the proposed Treasury Regulations on the treatment of refundings for private activity bond purposes under Code Section 141, which were issued at Prop. Reg. §1.141-13 (68 Fed. Reg. 25845 (May 14, 2003)).

2. Proposed regulations under Code Section 141 regarding allocation and accounting provisions.

This important project involves basic accounting principles for private activity bond purposes. Hopefully, this project will make good on the introductory statement in the May, 1997 final private activity bond regulations that the "IRS and Treasury are considering more flexible rules to accommodate public/private partnerships" for mixed use facilities.

3. Final regulations under Code Section 143 regarding mortgage insurance fees.

This project involves finalization of the proposed Treasury Regulations under Code Section 143(g) which would disregard certain "pool mortgage insurance" fees in determining permitted effective interest rates on mortgage loans financed with tax-exempt single-family housing bonds, which were issued at Prop. Reg. §1.143(g)-1 (68 Fed. Reg. 62549 (November 5, 2003)).

4. Revenue procedure under Code Section 143 regarding average area purchase price.

This project involves the average area purchase price limitations on qualified mortgage bonds under Code Section 143(e). It appears that the IRS already issued this guidance. In IRS Rev. Proc. 2004-18, 2004-9 I.R.B. (March 1, 2004), for the first time since 1994, the IRS provided updated average area purchase price safe harbors for purposes of the purchase price limitations and certain related limitations on qualified mortgage bonds under Code Section 143.

5. Guidance on LIBOR-based swap transactions.

This project is understood to involve an active project to provide guidance on how or to what extent interest rate swaps using a floating rate index based on the London Interbank Offering Rate ("LIBOR") may be taken into account as qualified hedges with tax-exempt bonds for arbitrage purposes under Code Section 148. This topic raises some tricky issues because LIBOR is a taxable floating rate index and its correlation with tax-exempt floating rates sometimes gets out of whack in certain interest rate environments.

6. Guidance on arbitrage.

This project is understood to involve some regulatory arbitrage simplification and clean-up technical changes, including potentially some recommendations made in previous years by NABL for the Treasury-IRS business plan.

7. Final regulations under Code Section 1397E regarding qualified zone academy bonds.

This project involves finalization of the proposed Treasury Regulations on qualified zone academy bonds Code Section 1397E, which were issued at Prop. Treas. Reg. §1.1397E-1 (69 Fed. Reg. 15747 (March 26, 2004)).

Regulations

Proposed Regulations on Solid Waste Disposal Facilities

In General. On May 10, 2004, the IRS issued proposed Treasury Regulations regarding the definition of solid waste disposal facilities under Code Section 142(a)(6) and Prop. Treas. Reg. §1.142(a)(6)-1 (69 F.R. 25856 (May 10, 2004)) (the "Proposed Solid Waste Rules"). These regulations generally are proposed to apply prospectively to tax-exempt bonds subject to Code Section 142 that are sold on or after the date that is 60 days after the date of publication of final regulations in the Federal Register. These regulations are proposed to be inapplicable to refundings in which the weighted average maturity is not extended. Perhaps in light of the significant changes in regulatory approach under the Proposed Solid Waste Rules, one IRS official observed that these regulations are "more proposed than usual."

Background. The existing rules under Treas. Reg. §1.103-8(f)(2)(ii) define the term "solid waste" under a two-part test to include property: (1) "which is useless, unused, unwanted, or discarded solid material which has no market or other value at the place where it is located" (commonly referred to as the "No-Value Test"); and (2) which is garbage, refuse, and other discarded material as described at somewhat greater length in Section 203(4) of the Solid Waste Disposal Act and quoted in the regulation.

The existing rules under Treas. Reg. §1.103-8(f)(2)(ii)(c) have a concept that if 65%, by weight or volume, of materials introduced into a recycling facility constitute

solid waste, then the facility qualifies as a solid waste disposal facility (the "65% Rule").

The existing rules under Temp. Treas. Reg. §17.1(a) provide in part that "[w]here materials or heat are recovered, the waste disposal function includes the processing of such materials or heat which occurs in order to put them into the form in which the materials or heat are in fact sold or used, but does not include further processing which converts the materials or heat into other products" (commonly referred to as the "First Product Rule").

In TAM 199918001 (December 22, 1998), the IRS national office advised the field that a certain cardboard recycling facility failed to constitute a qualified solid waste disposal facility because the materials at issue had value and thus failed the No-Value Test. This TAM generated much controversy about the application of the No-Value Test and related issues such as whether amounts paid merely for transportation and handling expenses demonstrated excess value.

Introduction to the Proposed Solid Waste Rules. In the Proposed Solid Waste Rules, the IRS takes a significantly different regulatory approach than that taken in the long-standing existing regulations. One IRS official described the proposed approach as a "new paradigm." Some practitioners viewed this description skeptically as a code term for "more restrictive." In general, the Proposed Solid Waste Rules broaden the definition of solid waste by removing the No-Value Test, but they appear to narrow significantly the processes treated as eligible solid waste disposal processes which may be financed with tax-exempt exempt facility bonds under Code Section 142(a)(6). The proposed framework, which focuses particularly on different phases of eligible solid waste disposal processes, bears some resemblance to the regulatory approach taken towards sewage facilities and is reminiscent of the difficulties in trying to distinguish between good sewage facilities and bad pollution control facilities.

In general, eligible solid waste disposal facilities under the Proposed Solid Waste Rules includes facilities which do one of the following three things: (1) perform one of four permitted solid waste disposal functions; (2) perform preliminary functions; and (3) serve as functionally related and subordinate facilities under existing standards.

Solid Waste Definition. In general, the Proposed Solid Waste Rules define the term "solid waste" using the historic definition, but without regard to the historic No-Value Test. Thus, solid waste includes garbage, refuse, and other discarded material, including solid-waste materials resulting from industrial, commercial, and agricultural operations, and from community activities, but does not include solids or dissolved material in domestic sewage or other significant pollutants in water resources, such as silt, dissolved or suspended solids in industrial waste water effluents, dissolved materials in irrigation flows, or other common water pollutants. Perhaps obviously, liquid or gaseous waste is not solid waste.

Exclusions from Solid Waste Definition. The following things notably do not qualify as solid waste under the Proposed Solid Waste Rules: (1) fossil fuels (e.g., coal) introduced into a solid waste conversion process; (2) materials introduced into a solid waste conversion process that are grown, harvested, produced, mined, or otherwise created for the principal purpose of converting the material to heat, hot water, steam, or another form of energy (with the obvious example here being "closed loop biomass"—of course); (3) precious metals introduced into a solid waste recovery process; (4) hazardous waste; and (5) radioactive waste. The proposed exclusions of hazardous waste and radioactive waste have generated some debate over the meaning of certain limited statements in the legislative history to the Tax Reform Act of 1986 regarding these types of waste.

Eligible Solid Waste Disposal Functions. The following four processes qualify as eligible solid waste disposal functions under the Proposed Solid Waste Rules: (1) a final disposal process; (2) a conversion process; (3) a recovery process; and (4) a transformation process.

The first eligible process is a final disposal process, such as a landfill or an incinerator. This category for the local dump is pretty clear but the processes degenerate from there.

The second eligible process is a conversion process in which material is incinerated and converted to useful energy, such as heat, hot water, or steam. The eligible conversion process ends before any transfer or distribution of the energy.

The third eligible process is a recovery process. An eligible recovery process starts with the melting or re-pulping of material to return it to a form in which it previously existed for use in the fabrication of an end product. An eligible recovery process under the Proposed Solid Waste Rules ends immediately before the material is processed in the same or substantially the same way that virgin material is processed to fabricate the end product. This ending point for the recovery process under the Proposed Solid Waste Rules appears to be at a much earlier stage in the process than under the existing First Product Rule.

The fourth eligible process is a transformation process. The Proposed Solid Waste Rules reserve the guidance on this category based on difficulty in distinguishing between solid waste transformation and ordinary manufacturing. The preamble to the Proposed Solid Waste Rules includes an example which suggests that shredding used tires for use as roadbed materials may constitute a transformation process.

Preliminary Functions. Eligible preliminary functions for solid waste disposal facilities include the collection, separation, sorting, storage, treatment, processing, disassembly, and handling of solid material that is preliminary and directly related to a solid waste disposal function. One condition is that, to qualify as a preliminary function, more than 50% by weight or volume of the total materials that result from the

entire activity in each year while the bonds are outstanding must be solid waste.

Mixed Use Rules. The Proposed Solid Waste Rules include a straightforward mixed use allocation rule which provides that the costs of a mixed use facility may be allocated using any reasonable allocation method, based on all the facts and circumstances.

Mixed Input Rules. The Proposed Solid Waste Rules include some mixed input rules. One general mixed input rule limits the percentage of costs of a facility which are properly allocable to an eligible solid waste function to the *lowest percentage of solid waste processed in that process in any year* while the tax-exempt bonds remain outstanding. A safe harbor mixed input rule provides that all of the costs of the property used for that process are allocable to a solid waste disposal function if, for each year while the tax-exempt bonds are outstanding, solid waste constitutes at least 80% (rather than 65% as under the existing regulations), by weight or volume, of the total materials processed in the process. This 80% safe harbor rule does not operate as a "cliff" rule. Thus, the general mixed input rule may be used to support financing a portion of the costs of a facility without meeting this 80% rule. Overall, these mixed input rules seem pretty restrictive, particularly with the hair-trigger defaults that focus on input in a single year.

Proposed QZAB Regulations

In General. On March 26, 2004, the IRS issued proposed Treasury Regulations regarding qualified zone academy bonds ("QZABs") under Code Section 1397E and Prop. Treas. Reg. §1.1397E-1 (69 F.R. 15747 (March 26, 2004) (the "Proposed QZAB Rules"). These regulations generally are proposed to apply prospectively to QZABs sold on or after the date that is 60 days after the date of publication of final regulations in the Federal Register. In addition, issuers generally may apply these regulations in whole, but not in part, earlier on a permissive basis. In general, the Proposed QZAB Rules propose guidance on maximum terms, use of proceeds, remedial actions, and other technical issues.

Maximum Term. In general, Code Section 1397E(d)(3) provides that the maximum term of QZABs is based on a present value measure of 50% of the principal debt service. Recall that QZABs have zero percent interest rates. Under Code Section 1397E(d)(2), Treasury determines a credit rate monthly based on the AA corporate bond rate which generally will enable QZABs to be sold at a zero percent interest rate at par. Credit rates apply to QZABs as of the sale date. Similarly, the Proposed QZAB Rules provide that the maximum term of QZABs is determined as of the sale date (rather than as of the issue date) of the QZABs.

Use of Proceeds. Code Section 1397E(d)(1)(A) provides that bonds qualify as QZABs only if, among other things, 95% of the proceeds "are to be used" for good costs. The Proposed QZAB Rules provide guidance on the use of proceeds of QZABs. In general, for this purpose, issuers must meet three tests: (1) a reasonable expectations test; (2) a due diligence test; and (3) absent a remedial action, an actual expenditures test.

Certain Working Capital Expenditures. Qualified purposes for which proceeds of QZABs may be spent include certain working capital-type items for developing course materials and training teachers and other school personnel. One interesting point under the Proposed QZAB Rules is that expenditures for these qualified working capital-type items are treated as qualified purposes conclusively and forever even if the school later falls out of compliance. One wonders whether this principle might apply by analogy to other working capital expenditures financed with tax-exempt bonds.

Status as Qualified School. The Proposed QZAB Rules provide that, for purposes of the determination of whether a school qualifies as located in an empowerment zone or enterprise community, that determination is based on a one-time test as of the issue date.

Remedial Actions. The Proposed QZAB Rules provide that if less than 95% of the QZAB proceeds are used for qualified purposes, that deficiency may be cured through one of two remedial actions: (1) bond redemption or defeasance; or (2) alternative use of disposition proceeds. Although these remedial actions are similar to the change of use cures for private activity bond purposes under Treas. Reg. §1.141-12, some special rules apply to remedial actions for QZABs. Practitioners should review the technical requirements. Some of the special rules for remedial actions for QZABs derive from the fact that QZABs have zero interest rates. Thus, for the defeasance remedy for QZABs, issuers must rebate to the Federal Government 100% of the investment earnings on the defeasance escrow since the issuer need not retain any amount associated with "bond yield" to break even under arbitrage-like concepts.

Definition of Proceeds. The Proposed QZAB Rules provide that, in general, for purposes of the QZAB provisions, the term "proceeds" includes both sale proceeds and investment proceeds. One helpful exception needed for certainty provides that, for purposes of the 10% private business contribution requirement under Code Section 1397E(d)(2)(A), the term "proceeds" includes only sale proceeds.

Public Administrative Guidance

Circular 230 Effective Date Relief. In IRS Announcement 2004-29, 2004-15 I.R.B. 772 (April 12, 2004), largely in response to NABL comments, the IRS provided relief from the effective date of any final Treasury Regulations governing standards of tax practice under Circular 230 for municipal bonds. Specifically, in this announcement, the IRS indicated that the final Treasury Regulations under Circular 230 would apply, if at all, to written advice concerning municipal bonds not earlier than 120 days after publication of the final Treasury Regulations.

Section 142(d): Transition Periods for Set-Asides in Multifamily Housing Projects. In IRS Rev. Proc. 2004-39, 2004-29 I.R.B. 49 (July 19, 2004), the IRS provided very helpful

guidance regarding the application of the low-income set-aside requirements in qualified residential rental projects under Code Section 142(d). In general, these low-income set-asides require that 20% of the housing units must be occupied by individuals whose income is not more than 50% of the area median gross income or that 40% of the units must be occupied by individuals whose income is not more than 60% of the area median gross income. Practical issues have arisen regarding how to apply these requirements to acquisitions of existing leased projects and to new projects during initial lease-up periods.

In the case of acquisitions of existing multifamily housing projects financed with tax-exempt bonds under Code Section 142(d), the IRS provided a favorable one-year transition period to bring the project into compliance with the low-income set-aside requirements. This one-year transition period begins on the issue date of the first tax-exempt bonds issued under Code Section 142(d) to finance the acquisition of the project. This transition period is helpful because it will allow for an orderly way to convert existing units which are acquired subject to leases with market income tenants into low-income units. In addition, the IRS provided a mini-remedial action rule for acquired projects which fail to comply with the low-income set-aside requirements by the end of this one-year transition period. This remedial action rule preserves the qualified status of the project if the tax-exempt bonds used to finance the project are redeemed as soon as possible, but in all events within 18 months after the issue date of the bonds. In the case of certain major renovations in which more than 90% of the housing units are unavailable due to renovations, this one-year transition period is unavailable. Instead, these major renovations are treated more like new construction.

In the case of new construction, the IRS provided helpful guidance on some computational aspects of the low-income set-aside requirements. The IRS provided that the low-income set-aside requirements apply to the total number of defined "available units." In general, however, the definition of "available units" focuses mainly on occupied units, with one notable exception: unoccupied units which previously have been leased at least once also are treated as available. This approach of applying the low-income set-aside requirements based mainly on occupied units (rather than total project units) generally has the favorable effect of focusing the set-aside percentages on a reduced number of occupied housing units actually in use.

Available units include: (1) occupied units; and (2) unoccupied units that have been leased at least once after becoming available for occupancy. Unavailable units include: (1) unoccupied units in acquired projects until first leased after the acquisition; and (2) units unavailable for occupancy due to renovations until first leased after completion of the renovations. The definition of the term "available units" is tricky and warrants a careful reading.

To take a simple example, suppose that tax-exempt bonds under Code Section 142(d) are used to finance new construction of a multifamily housing project with 100 total housing units. Suppose further that the owner elects the 20% low-income set-aside percentage. When the first ten units are occupied for the first time, two of those units will be subject to the set-aside for qualified low-income tenants. Then, suppose that one of the original tenants vacates a unit, but that no additional units are occupied. The total number of available units remains at ten units, which consists of the nine occupied units and the one unoccupied, but previously occupied unit. Hence, the required low-income set-aside will remain at two units.

Section 143: Median Gross Incomes. In IRS Rev. Proc. 2004-24, 2004-16 I.R.B. 790 (April 19, 2004), the IRS provided new figures on U.S. and area median gross incomes for use in applying certain income tests in qualified mortgage bond financings under Code Section 143 (and also mortgage credit certificates). For purposes of the housing cost/income ratio under Code Section 143(f)(5), the U.S. median gross income is $57,500 and the area median gross incomes are those released by HUD on January 28, 2004. These revised figures generally apply to mortgage commitments made beginning January 28, 2004. Other relevant information may be obtained from HUD by phone at 1-800-245-2691 or from HUD's website at http:huduser.org/datasets/il.html.

Section 146: Volume Cap Population Figures. In IRS Notice 2004-21, 2004-11 I.R.B. 609 (March 5, 2004), the IRS released the applicable resident population figures that apply for purposes of the Code Section 146(j) private activity bond State volume cap for 2004. These figures also apply for purposes of the State low-income housing tax credit cap under Code Section 42.

Private Administrative Guidance

[Note: Private Letter Rulings ("PLRs") and Technical Advice Memoranda ("TAMs") are IRS national office final determinations of legal positions in specific cases provided to taxpayers in PLRs and to IRS field agents in TAMs. Field Service Advices ("FSAs") are non-final determinations from the IRS national office to IRS field agents on case-specific matters during audit case development that may be based on an incomplete review of facts of specific cases.]

Section 146: Volume Cap

Late Carryforward Election. In PLR 200422046 (February 18, 2004), the IRS permitted an issuer to make a late carryforward election for a private activity bond volume cap carryforward under Code Section 146(f) in a circumstance in which the issuer acted reasonably and in good faith.

Section 148: Arbitrage

Replacement Proceeds Principle. In PLR 200428022 (March 31, 2004), the IRS ruled favorably that the corpus of a certain trust whose earnings were pledged to secure a tax-exempt bond issue and whose earnings were reasonably expected to be used to pay debt service on a tax-exempt bond issue failed to constitute arbitrage-restricted "replacement proceeds" under Code Section 148 under the circumstances presented. The facts indicated that, unlike the trust earnings, the corpus of the trust was neither pledged to secure the tax-exempt bond issue nor expected to be used to pay debt service on the tax-exempt bonds or to finance the governmental purpose of the bonds. The

facts further showed that both the state constitution and state law prohibited any such use of the corpus of the trust to support debt service on the tax-exempt bonds. The facts also had an "old-and-cold" flavor in that the trust corpus had been established more than 90 years before the trust income was made available to support debt service on the tax-exempt bonds. The strong facts seemed to support the conclusion here. Nevertheless, the result in PLR 200428022 surprised many tax practitioners because it appeared to be based on a generously-narrow interpretation of the replacement proceeds principle. Reminiscent of the seminal general Federal tax axiom articulated in old Supreme court cases such as *Lucas v. Earl*, 281 U.S. 111 (1930) and *Helvering v. Horst*, 311 U.S. 112 (1940), that you can't separate the "fruit" from the "tree," many tax practitioners historically have thought that the broad replacement proceeds principle invariably caught both an investment's corpus and its earnings without differentiation, absent another limiting factor such as the universal cap on the amount of tax-exempt bond proceeds for arbitrage purposes.

Section 149(g): Hedge Bonds

Different Accounting Methods. In PLR 200422004 (September 11, 2003), the IRS permitted an issuer to use different accounting methods for Federal tax arbitrage purposes and state law purposes to enable the issuer to spend proceeds of tax-exempt bonds sufficiently promptly to avoid taxable hedge bond status under Code Section 149(g). This ruling involved a 10-year state matching fund program for school construction purposes. The IRS allowed the issuer to use a "gross-proceeds-spent-first" accounting method for arbitrage purposes under Treas. Reg. §1.148-6 (d)(1)(i) based on a bona fide governmental purpose under Treas. Reg. §1.148-6(a)(2) that justified use of a different pro rata accounting method for state law purposes. This ruling appeared to address the same program as that addressed in PLR 200338004 (June 16, 2003).

Related Tax Areas

Section 265(b) Tax-exempt Debt Carrying Cost Disallowance. In TAM 200428027 (March 26, 2004), the IRS ruled that, for purposes of applying the tax-exempt debt carrying cost disallowance under Code Section 265(b), a bank which creates a wholly-owned subsidiary to manage its investment assets must treat the subsidiary's assets, including its tax-exempt bond investments, and interest expense as those of the parent bank.

Cases

Yield-Burning and False Claims Act. In U.S. v. Sakura Global Capital Markets, Inc., No. 03-7977, 2004 U.S. App. Lexis 15899 (2d. Cir. August 3, 2004), the U.S. Court of Appeals affirmed a district court judgment which denied the right of a private party to bring a whistleblower action under the False Claims Act on the grounds that the IRS had the exclusive right to bring any action alleging a yield-burning violation under the arbitrage investment restrictions under Code Section 148.

IRS Audit Program

There is no shortage of activity in the IRS audit program for tax-exempt bonds. Among other things, the IRS is actively pursuing audits involving financial products, such as put options, employed in connection with advance refundings. The IRS also is actively pursuing audits involving Indian tribal issuers. The IRS also is heightening awareness of ethical conflicts of interest issues by seeking up-front conflict waivers whenever original bond counsel seeks to represent an issuer in an audit of bonds approved by such bond counsel.

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Acknowledgement

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Public Housing Financing Update

By: Rod Solomon

Public housing authorities ("PHA"s) are increasingly turning to the capital markets to finance public housing improvements. If they are to fulfill their mission of offering decent conditions to public housing families, many PHAs have little choice. A consultant study published by HUD in 2000 reported a $21.6 billion unfunded backlog of public housing capital needs as of 1998, and about $2 billion annually resulting from the depreciation of the 1.2 million-unit public housing stock. Last year's annual appropriation for public housing capital needs was under $3 billion, enough only to cover ongoing needs and make the smallest dent in the backlog. Capital financing is a way to address this problem.

The Quality Housing and Work Responsibility Act of 1998 ("QHWRA") specifically authorized the use of public housing Capital Funds for such financings. By the summer of 2003, HUD had approved approximately $600 million in bonds and loans financed with this funding source. PHAs typically pledge their Capital Funds for up to 20 years to repay the bonds or loans. Because the only source of repayment is the Capital Fund, and annual Capital Fund amounts are subject to appropriations, the bond rating agencies and individual lenders generally have insisted on debt service coverage ratios of at least 3 to 1. In other words, if a PHA's annual Capital Fund grant were $3 million, it could not pledge more than $1 million annually to repay the bonds or loans. Depending on market interest rates and other variables, such a pledged amount might raise about $13 million.

Events during the past year

The Capital Fund effort has continued and expanded. By the end of May 2004, HUD had approved over $1.5 billion in the loans for the Capital Fund Financing Program (the "CFFP"), its new HUD name. The $900 million in additional approvals since June 2003, however, were concentrated in three transactions: New Orleans ($86 million); Puerto Rico ($693 million); and a five-PHA Maryland pool ($90 million). HUD also approved five other transactions, for far smaller amounts, during that time period.

The three large approved transactions each represent important innovations. The Puerto Rico transaction is so large that it is a substantial public housing initiative in itself. In recognition of this and management problems during prior administrations at the PHA, HUD required the PHA to obtain separate financing from another government entity (the Puerto Rico Government Development Bank) for any work not completed on time and on budget. The Maryland pool is the first approved transaction in which the state housing finance agency (HFA) is the bond issuer and lends the bond proceeds to individual PHAs. This mechanism will allow small PHAs, for which financing otherwise would be inefficient because of transaction costs, to participate in the bond market. The New Orleans transaction featured the use of 4% tax credits to raise additional funding for the PHA's needs, following a model used by the Philadelphia PHA a year earlier. This was accomplished through a loan of the Capital Fund proceeds to a limited partnership that invested both loan proceeds and the tax credit equity in the public housing. To accomplish this, the PHA had obtained tax-exempt bond volume cap and thus the ability to issue "private activity bonds," which can generate 4% tax credits. (Note, however, that the use of bonds and 4% tax credits requires a mixed-finance structure, under which the PHA gives up some degree of ownership and control to private sector participants. As such, it may not be suitable for all PHAs and all developments.)

The pipeline of transactions yet to be approved also reflects interesting trends. There are several more pooled transactions in the pipeline, some sponsored by state HFAs and others using an alternative model in which PHAs market a bond issue, either acting through a non-profit created to administer the issue or through a lead PHA. The alternative model was pioneered last year, by a 37-member Alabama pool. In addition, some large financial institutions are becoming involved directly in making or purchasing loans. These entities and others are developing means of bringing the program economically to small PHAs.

The HUD approval process is still evolving. Although QHWRA was enacted almost six years ago, there are no applicable regulations. This year, HUD created a helpful "term sheet" that it provides to prospective CFFP participants, but it is "subject to change without notice." More substantively, HUD has continued or added various requirements, including an independent management assessment of the PHA, a "fairness opinion" indicating that the terms and conditions of the bonds or loans and related fees are reasonable, and in some insistences a "physical needs assessment" designed to indicate that the use of capital funds for debt services is reasonable in view of other capital needs of a PHA that would not be addressed by the borrowing. These requirements, coupled with inherent transactional expenses such as the need for a legal opinion that the bonds or loans are tax-exempt, as well as the process of obtaining HUD approval, can require considerable effort and expense especially for small PHAs.

Alternatives to the Capital Fund Financing Program

The CFFP is a powerful financing tool, but it is different from most real estate borrowing in that it does not take advantage of the underlying value of the property. Real estate borrowings typically are secured by a mortgage on the property and underwritten based on projected rents. This approach depends upon a predictable rent/cash flow stream to support the debt, and exposes a property to foreclosure if the development fails. A more conventional mortgage-value approach, however could result, in borrowings almost twice as large as CFFP borrowings relative to the annual capital funding available to a property. That result can occur because the pledge of the property results in a dramatic reduction in required debt service coverage. For a small PHA whose CFFP borrowing is very restrained by its small annual capital grant, or for a relatively small PHA with an extensive capital backlog and the capability to address it, this difference could be very important. Financings including the mortgaging of the property also demand much more management accountability, to ensure that the property's management expenses over time (including a capital replacement reserve) will result in the continuing success of the development with use of available funds.

In recognition of such advantages, in its fiscal 2003 and 2004, the Administration proposed the Public Housing Reinvestment Initiative (PHRI). PHRI would allow PHAs on a voluntary, development-by-development basis, to convert public housing operating and capital subsidies to project-based vouchers and then borrow against the property like other Section 8 owners with project-based contracts. A partial federal loan guarantee is included to facilitate lending. PHRI is a very promising approach, both for leveraging additional capital and provision of built-in management discipline. Unfortunately, the Administration is not pursuing PHRI in its proposed fiscal 2005 budget.

To a limited extent, HUD could achieve some of the advantages of PHRI through its ability to approve mortgaging of public housing under current law (Section 30 of the United States Housing Act). This approach would not have some of the advantages of PHRI, including lender familiarity with Section 8 and other funding and regulatory advantages, but it would capitalize on underlying property values. Despite the strong advocacy for this approach by the Assistant Secretary for Public and Indian Housing, however, HUD has approved only two such transactions. To make such an initiative effective, HUD would need to issue guidelines explaining how to use public housing subsidies in this manner and enabling them to operate like Section 8 to support debt service; provide regulatory clarifications, and make the policy determination of the circumstances under which HUD will allow property no longer to be used as public housing if a foreclosure is necessary.

Prospects for the future

The CFFP has shown itself to be a valuable means of enabling PHAs to access additional capital for public housing. The refinements developing over the past year, including the use of 4% tax credits and bond pools and direct loans that can reach smaller PHAs, promise to in-

crease CFFP's usefulness. HUD should address the processing bottleneck by some combination of a reconsideration of some of its requirements, delegation of aspects of the approvals to other entities with appropriate means of addressing the risks of such delegations, and/or additional staffing or contracting assistance.

The potential of property-based financing is great, and a move in this direction would be consistent with changes coming in the administration of the public housing Operating Fund that will emphasize property-based management. A number of steps are needed, however, to get from here to there. These should include the Administration's advocacy for enactment of passage for PHRI, as well as HUD's issuance of guidelines to make this property-based borrowing a workable option in the public housing program.

HUD hopefully will be open to some of these changes. A diverse group including several PHAs, an HFA, the National Housing Conference and a national banking institution, recently wrote HUD to encourage consideration of some of them.

The further improvement of CFFP and the development of such alternatives should be a high priority. Progress on these fronts will result directly in improved housing for more public housing families.

Hawkins has participated as counsel in the CFFP from the beginning, in the Washington, D.C., Chicago, Maryland pool, Puerto Rico, as well as other transactions. Hawkins is currently involved in such financings for state PHA pools or groups of PHAs in Michigan, Pennsylvania, Massachusetts, Illinois, and South Carolina, as well as numerous transactions across the nation for individual PHAs of all sizes.

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Tender Offers For Municipal Bonds

By: Steven Donovan

This Outline addresses issues relating to tender offers, including requests or invitations for tenders, by or on behalf of issuers or conduit borrowers for their outstanding tax-exempt municipal bonds.

1. What is a Tender Offer?

Under existing SEC rules, there are specific rules relating to Tender Offers for equities (corporate take-overs, etc.), with a somewhat less stringent set of SEC rules governing Tender Offers for debt. The only provisions of the Securities Exchange Act of 1934 that apply to Tender Offers for debt securities are Section 9(a), Section 14(e), Rule 10b-5, and Regulation 14E. These basically are anti-fraud rules. Other than the anti-fraud rules, the other technical and procedural SEC rules relating to Tender Offers do not apply to exempt securities such as municipal bonds.

Consider the distinction between (1) informal market inquiries, made to certain bondholders as to their willingness to sell their bond; (2) an ongoing open-market bond repurchase program; and (3) a Tender Offer. Often the distinction between an ongoing open-market repurchase program and a more formal Tender Offer can become hazy. If the transaction constitutes a Tender Offer, the SEC's anti-fraud rules apply.

In the absence of a statutory or regulatory definition of a Tender Offer, courts have applied an eight factor test, although the absence of one or more of the eight factors is not necessarily indicative that the transaction in question is not a Tender Offer.

The eight factors, in the context of a Tender Offer for municipal bonds, are: (1) an active and widespread solicitation of public bondholders for bonds of an issuer/borrower; (2) a solicitation made for a substantial percentage of the bond issue; (3) an offer to purchase bonds made at a premium over the prevailing market price of the bonds; (4) the terms of the offer are fixed rather than negotiable; (5) the offer is contingent on the tender of a set amount or percentage of the outstanding bonds, and the offer is often subject to a fixed maximum par amount to be purchased; (6) the offer is open only for a limited period of time; (7) the bondholders are subject to some form of pressure or incentive to sell their bonds; and (8) there is publicity relating to the solicitation.

2. Tender Offers for Tax-Exempt Bonds - General.

A. Tender Offers for outstanding bonds are made for various reasons, and can be made with respect to bonds that are currently callable or that are not yet callable or that are non-callable.

- Tender Offers are often used to buy back (using proceeds of new bonds), cancel and replace non-callable bonds (in effect a current refunding) in situations where the new "refunding" bonds can allow the issuer or borrower to achieve lower debt service, or restructure debt service, either where the tender approach is more economic than an advance refunding (negative arbitrage), or where an advance refunding is not permitted under the Internal Revenue Code.
- Tender Offers are also used to buy back non-callable bonds where bond document amendments are desired (and where the current bondholders will not, or are unlikely to, consent to the amendments). Note that the SEC has allowed so-called "exit consent" strategies, whereby the tendering bondholders also consent to amendments to bond documents that will bind non-tendering bondholders.
- Tender Offers can be used simply to reduce outstanding debt, where issuer or borrower equity is used to fund the Tender Price. A less formal version of this, which may or may not constitute a Tender Offer, is where the issuer or borrower simply buys its bonds on the open market, and then cancels them.
- Tender Offers can be used when the issuer or borrower wants to redirect its bonds from the current bondholders to new bondholders. This arises where the new bondholders can provide benefits to the issuer or borrower, such as situations where the new bondholders will agree to grant certain con-

sents, approve amendments, purchase a waiver of call rights, or enter into a total return swap.

B. Conduit bonds are issued on behalf of a borrower on a conduit basis by a state or local issuer. Should the conduit issuer or the borrower "make" the Tender Offer? In most cases, it is simpler and more efficient to have the borrower, and not the conduit issuer, make the Tender Offer.

3. Structuring the Tender Offer.

A. One should first identify the goals of the issuer/borrower. Is the goal to lower debt service on otherwise non-callable and non-advance refundable bonds? Restructure the debt profile? Reduce outstanding debt? Amend covenants? Change the credit? Improve or relax security? A combination thereof? Can the goals be met by a successful Tender Offer? How many bonds does the issuer/borrower need to buy back? How many bonds will the issuer/borrower commit to buy back? Is the goal to buy back all of a bond issue, all of several series of bonds, certain maturities of bonds, or portions of any of these? If a portion, what percent?

B. If the Tender Offer involves issuing new bonds to fund the Tender Price, will the ratings on the new bonds be better or worse than those on the old bonds? Are the old bonds insured? Will the insurer need to be consulted for grant approval?

C. Is the goal to buy back bonds, and rather than cancel them, remarket them to different investors, with or without document amendments? If remarketing the bonds, be aware of reissuance concerns, particularly if document amendments are implemented. Are the terms of the bonds being changed in a material way, as in a change in call rights?

D. There are various documentary approaches that can be used in Tender Offers:

- Informal "Plain English" user-friendly approach, with most information on the Tender Offer set forth in a "Frequently Asked Questions"; or "FAQ" (this approach is said to work best with retail bondholders); OR
- Formal corporate style Tender Documents; OR
- Very informal approach, without Tender Documents, involving phone calls to some or all bondholders made by the Investment Banker/Dealer-Manager. This approach is sometimes used where the bonds are held by a small number of institutional investors. Is this a Tender Offer or simply a secondary market inquiry or an ongoing secondary market purchase program (by the banker on its own accord, or on behalf of the issuer or borrower)? A set or limited time period to tender, and a broader universe of bondholders to whom tender inquiries are made, could cause the transaction to be considered a Tender Offer as opposed to an ongoing repurchase program. Does this constitute "speaking to the market" by the issuer/borrower and thus trigger full and contemporaneous disclosure to all bondholders? A Tender Offer is subject to the SEC's anti-fraud rules.

E. There are two basic directions that a Tender Offer can take, being an offer to buy made by the issuer or borrower, or a request or invitation by the issuer or borrower seeking offers to sell by the bondholders:

- Should the issuer/borrower offer to buy its bonds from the bondholders? At a certain price set by the issuer/borrower (same price overall or separate prices by maturity)? Or at a spread over an index? Or at a price set by the bondholder? At a price (or prices) set by an auction? OR
- Should the issuer/borrower request, solicit, or invite offers by the bondholders to sell their bonds to the issuer/borrower? Once again, at a price or spread set by the issuer/borrower or by the bondholders, or pursuant to an auction?

F. The timing of the Tender Offer must be synchronized with the new bond issue if the new issue is a source of the Tender Price.

- A prudent approach would be to have the POS mailed to investors at the same time that the Tender Documents, including the POS, are distributed to existing bondholders. The POS may be "out in the market" for a longer than typical period, since Tender Periods (the period during which the existing bondholders must decide to tender or not) are often approximately 30 days (the Tender Period should be at least 20 days). Once the Tender Period is closed, the issuer/borrower will know the principal amount of outstanding bonds that will be tendered and thus will also know the principal amount of new bonds that must be issued to fund the Tender Price. At this point the new bonds can be sized, priced and sold. The Tender Offer typically "settles" on the date that the new bonds are issued to fund the Tender Price.
- How long must the Tender Period last? Under the SEC rules (technically not applicable to municipal bonds), a Tender Period must be held open for at least 20 days, and for at least 10 days after a change in the Tender Price or other material change to the Tender Offer. Tender Periods, as such, should be at least 20 days, although most Tender Periods are usually approximately 30 days. Conventional wisdom holds that it will generally take longer to identify and contact retail bondholders, and for retail bondholders to react to the Tender Documents. As a result, Tender Offers for bonds held in retail tend toward 30 or more days, while institutional Tender Offers often can entail shorter Tender Periods.
- How long after the end of the Tender Period must the Tender Offer be funded, or settled? The sooner the better, but 2 or 3 weeks seems appropriate. The SEC rules require "prompt" settlement, within 5 business days, and sometimes even using

the T+3 approach, but so long as the settlement date is clearly disclosed, in the case of municipal bonds a longer settlement period can be used. When superimposing the issuance of new bonds to fund the Tender Price, think of the end of the Tender Period as bond sizing. That's when the issuer/borrower learns how many bonds will be tendered, and at what price. Then the new bond issue can be sized. Typically a bond issue would price a day or so after that, the bond purchase agreement would be executed, and the bond issue would close (and the tender would be funded) roughly 2 or 3 weeks after the bond purchase agreement signing.

G. There can be various sources of funding for the Tender Price, which the issuer/borrower should be reasonably assured will be available to pay the Tender Price on the settlement date for the Tender Offer. However, if there is any uncertainty as to the availability of funds (or even if there is no uncertainty), it is prudent and typical that the Tender Offer be made contingent on the availability of funds, and that a termination or discontinuation of the Tender Offer be at the discretion of the issuer/borrower. Funding sources can include: issuer/borrower equity; a new tax-exempt bond issue (a current refunding for tax purposes); a new taxable bond issue; released funds; or other debt.

H "first come, first served" approach can be used, if only a portion of an issue is sought, so long as fully disclosed.

I. An Information Agent can assist the issuer/borrower and the Dealer-Manager with Tender Offers. The Information Agent can be very helpful in performing ministerial tasks, such as identifying bondholders, assisting in contacting bondholders, confirming addresses of bondholders, confirming that bondholders have received the Tender Documents, ascertaining by telephone that bondholders understand the Tender Offer, reminding bondholders of deadlines, communicating with back-office personnel to expedite the necessary exchanges and transfers, and coaxing positive responses to Tender Offers (particularly retail bondholders), and obtaining bondholder feedback, directions and input. The Information Agent's thoughts on approaches to retail bondholders may be very helpful. If a Tender Offer is for institutionally-held bonds, that are not widely held, the issuer/borrower may decide not to utilize an Information Agent. In that case the Dealer-Manager must also perform these tasks.

4. Establishing the Tender Price.

A. The Dealer-Manager is an investment banking firm that runs the Tender Process, and is usually also the underwriter for any new bonds being issued to fund the Tender Price. A significant aspect of the Dealer-Manager's role is to establish the Tender Price for the bonds, in situations where the issuer/borrower "sets" the Tender Price, or to negotiate or advise with respect to the Tender Price, where the bondholders designate the Tender Price.

B. Will the Tender Price reflect a premium above the current fair market value of the bonds? Usually there will be a premium over market to entice the tender. Do the bonds bear interest above or below current rates? Are the bonds callable or not, and if callable what is the redemption price? If the bonds are currently callable, is the market value equivalent to the current redemption price plus any call period premium? If the issuer/borrower has the ability (financially and legally) to currently call the bonds, why implement a Tender Offer rather than a conventional current refunding? Compare transaction costs.

C. The Dealer-Manager should carefully discuss and examine the issuer's/borrower's goals as to the full economics of a Tender Offer, including the estimated Tender Price and the projected success rate of the Tender Offer. Recognize that it is very difficult to accurately predict the success rate of a particular Tender Offer, particularly because it cannot be predicted if a bondholder will decide to tender or not, or if a particular bondholder (such as a closed-end, non-managed fund) has the ability to tender its bond.

D. Note that many choices are available in establishing the Tender Price, so long as clearly and properly disclosed.

- Establish a set Tender Price for all the bonds;
- Establish a set Tender Price for each maturity of the bonds;
- Establish a set fixed spread over an identified index, such as a U.S. Treasury (either daily fixed spread pricing or continuous fixed spread pricing) per bond issue or per bond maturity;
- Invite bondholders to designate a Tender Price at which they will sell;
- Implement an auction (whereby bondholders bid up), a dutch auction (whereby bondholders bid down, and the issuer/borrower accepts specific lowest bid prices until the issuer/borrower acquires the par amount of bonds that it needs, and the bondholder receives the specific price that it has bid), or a modified dutch auction (whereby bondholders bid down until the target par is obtained, but all bondholders receive the highest "low" price needed to obtain the par target; the modified dutch auction technique was developed in response to the "best price" rule).

5. Securities Laws Issues.

A. A Tender Offer by an issuer or a borrower constitutes "speaking to the market" by the issuer/borrower, and thus must be done in accordance with applicable securities disclosure laws, akin to a securities offering. The anti-fraud rules apply to a Tender Offer. There must be clear and adequate disclosure as to the Tender Offer, the timing and terms of the

Tender Offer, the Tender Period and the settlement date, any contingencies to the Tender Offer, the underlying credit (particularly after implementation of the Tender Offer), the reasons for the Tender Offer, the impact of the Tender Offer on both tendering and non-tendering bondholders, the impact on bondholders of a cancelled, discontinued or unsuccessful Tender Offer, and the mechanism for establishing the Tender Price. Be clear as to whether or not the "best price" approach, described below, will be used in establishing the Tender Price, and whether or not the Tender Offer involves a "first come, first served" component.

Consideration should also be given to sending out a notice of an upcoming Tender Offer to all bondholders.

Disclosure is very important. When a Tender Offer is done in conjunction with a new bond issue, the issuer/borrower can use the POS as the primary disclosure document for both the new bond offering and the Tender Offer. The POS can be referred to in the Tender Documents, and is often incorporated by reference into the Tender Documents. Where the Tender Offer is not implemented in conjunction with a new bond issue, the issuer/borrower and its team will need to include disclosure materials on the issuer/borrower and the Tender Offer in the Tender Documents.

B. While many provisions of the Securities Exchange Act of 1934 (the "34 Act") that govern Tender Offers are not applicable to municipal bonds, the general anti-fraud provisions of Section 14(e) of the 34 Act do apply to Tender Offers for any securities, including municipal bonds. Section 14(e) provides:

> "It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request or invitation."

C. Does the "best price" rule under the 34 Act apply? Both SEC Rule 13e-4(f)(8)(ii) and Rule 14d-10(a)(2) provide that the price paid to any bondholder pursuant to a Tender Offer should be the highest, or best, price paid to any other bondholder during such Tender Offer. However, the SEC's position is that the best price rule is limited to equity securities, and that it is not applicable to Tender Offers for municipal bonds. While the best price rule may not technically apply to a Tender Offer for municipal bonds, consideration should be given as to whether or not to offer the best price to all bondholders. While offering the best price may be economically adverse to the issuer/borrower, the issuer/borrower should consider whether not offering the best price to all tendering bondholders could impair bondholder relations.

D. It is important to let the bondholders know:

- If the issuer/borrower can cancel or discontinue the Tender Offer, and by what means of notice and at what time.
- If the issuer/borrower can reject any or all tenders.
- How many bonds the issuer/borrower intends or will commit to buy (if the Tender Offer is for less then all bonds).
- In a tender for less than all outstanding bonds, if the Tender Offer is on a "first come, first served" basis.
- The deadline for accepting the Tender Offer.
- Tax consequences of the Tender Offer.
- Ratings on the old bonds and expected ratings on any new bonds.
- What the Tender Price will be, or how it will be determined, and when it will be paid.
- Whether the settlement date can be changed by the issuer/borrower, and if so, by what means of notice.
- Whether the bondholders can revoke their commitment to sell their bonds back to the issuer/borrower.
- What will happen if the bondholder elects to tender, and what will or might happen if the bondholder elects not to tender.
- How to respond to the Tender Offer (i.e., who to contact, and when, to ask questions or to give instructions or directions).
- Whether or not the bondholder will be asked to pay any fees or reimbursements. Typically the Broker-Dealer (with reimbursement from the issuer/borrower) or the issuer/borrower will pay the fees related to the Tender Offer.
- Whether a bondholder must tender all of its bonds if the bondholder elects to tender any of its bonds.

6. Hard Tenders versus Soft Tenders.

A. There is a school of thought that a so-called "hard tender", if available, will result in a more successful Tender Offer than a soft tender. A hard tender can be utilized where the bonds are, or soon will be, currently callable, and in fact will be called if not tendered. The concept of a hard tender is "If you do not sell me your bond I will redeem it on X date at Y price." The Tender Price tends to be slightly higher than the redemption price, particularly where the issuer/borrower prefers not to cancel and replace the bonds, but to purchase them and resell them, such as in connection with a total return swap. Of course, this approach is available only if the "threat" of redemption is real.

In a hard tender, often a notice of redemption in whole is given at the same time that the Tender Offer is initiated. In effect, if the bond documents permit, the issuer/borrower notifies all bondholders of the optional redemption in whole of the bonds, at X price on Y date. At the same time, the issuer/borrower offers to buy the same bonds, or a portion of them, at a price usually slightly in excess of X price, on Y date. The hard tender triggers more tenders, albeit at a higher price than the call. However, the tendered bonds remain outstanding and can be resold, while the non-tendered bonds are called and defeased with a refunding bond issue or with equity. In this case the economics of the resale transaction must justify the higher Tender Price.

B. A "soft tender" involves less than a fully certain and imminent redemption if the bonds are not tendered. This can be described as: "If you do not sell your bond to me I might redeem it at some point in the future" or "If you do not sell your bond to me I intend to redeem it if the following events occur…" Again, care must be taken to accurately describe the likelihood of a bond redemption, and the terms of the redemption, if the bonds are not tendered. Soft tenders tend to be less successful than hard tenders, because there is no firm and imminent threat of a call at a lower price than the Tender Price.

C. There may be situations where the issuer/borrower utilizes a "very soft tender", where the issuer/borrower has no intent or ability to redeem, or no expectation of a redemption or refunding of, bonds that are not tendered. This is simply an offer to buy back the bonds, with no "dire consequences" if the bondholder rejects the offer.

D. The goal of a Tender Offer is to obtain the desired amount of bonds, at a fair price that is economically attractive or acceptable to the issuer/borrower. The issuer/borrower can seek to entice, or alternatively "threaten", a bondholder into tendering its bond, while at the same time the issuer/borrower must fully comply with the disclosure rules (the issuer/borrower cannot mislead bondholders or omit material information). Particularly where the issuer/borrower is involved in a new bond issue ("the issuer/borrower is doing great, so buy their new bonds!"), the issuer/borrower must be careful as to how it entices or threatens a bondholder to sell the old bonds and achieve a successful Tender Offer ("the issuer/borrower is on its last legs, so sell your old bonds back to the issuer/borrower right away before its too late!"). One should avoid a mixed message in this situation.

7. Bond Selection/Lottery Issues.

A. Where a Tender Offer is being done in connection with a redemption of all or a portion of the non-tendered bonds, as in the case of a "hard tender", there are mechanical questions that may arise under the bond indenture or bond resolution.

- Take care in synchronizing the Tender Offer and the redemption date for non-tendered bonds. Usually bonds are callable in whole at any time. A partial call of bonds can either be at any time or may be restricted to an interest payment date, depending on the bond documents. If the issuer/borrower successfully tenders for 80% of the bonds, and calls the remaining 20% of the bonds, is that a call in whole or in part? Does it make a difference if the call date is before or after the settlement date for the Tender Offer, or on the same date? Usually bonds tendered and purchased pursuant to a Tender Offer are cancelled when purchased on the settlement date. Does it make a difference if the tendered bonds are not immediately cancelled on the settlement date, but are purchased pursuant to the Tender Offer but remain outstanding and are resold? Those bonds are then, technically, still outstanding, so consider whether a redemption of the non-tendered bonds could be seen as a partial or a full redemption.
- On any optional redemption, determine who has the option to direct the redemption. On a conduit bond issue, is it the borrower or the conduit issuer?
- On a redemption in part, note the bond selection/lottery provisions in the bond indenture, both as to the entire issue and within a maturity. These provisions could obstruct a partial redemption of certain bonds that the issuer/borrower may be targeting, particularly if the tendered bonds are not cancelled but remain outstanding. In other words, consider a situation where the issuer/borrower does a tender and receives 80% of its callable bonds, but the tendered bonds are not cancelled but are remarketed and remain outstanding. The issuer/borrower then seeks to redeem the 20% balance (of the non-tendered bonds). If the bond indenture mandates a lottery in the event of a partial call, can only the non-tendered bonds be called or must the lottery be with respect to all of the bonds, whether tendered or not? Similar concerns arise if the bond indenture mandates a pro-rata, chronological or inverse-chronological selection process.
- Consult with DTC and the Trustee to determine if they take the position that a redemption of the balance of the non-tendered bonds constitutes a redemption in whole or in part.
- If there is a redemption of non-tendered bonds, determine whether or not funds for the redemption price are required to be on deposit with the Trustee before the redemption notice is sent out to bondholders, or simply before the redemption date. If pre-funding the redemption price is required, the issuer/borrower may need an interim source of funds, or may need to delay giving the call notice, and thus delay the call, until refunding bonds can be issued or another source of funds for the redemption can be provided. This pre-funding requirement can be troublesome in the case of a hard

tender, where the call notice is given at the same time as the Tender Offer is commenced.

8. Tax Issues.

A. Consideration should be given as to whether or not to treat a Tender Offer as a reissuance for tax purposes. Generally a Tender Offer without any modification of the terms of the bonds would not be viewed as a reissuance. Of course, a new bond issue that is the source of the Tender Price will be treated as a current refunding, and must satisfy the usual tax-exempt bond issuance rules (including any transferred proceeds penalty that might arise if the old bonds are advance refunding bonds and an old escrow still exists). If the tender settlement date is synchronized with the date of issuance of the new bonds, it will not be necessary to establish any escrow period for the tendered/refunded bonds. If there is an escrow period of less than 90 days the new bond issue would constitute a current refunding, not an advance refunding.

B. Consider whether or not tax-exempt bonds may be issued to fund the entire Tender Price, particularly where the Tender Price is in excess of the next call price. In other words, if the bondholders require or demand 112% to sell their bonds, can the issuer/borrower issue tax-exempt bonds to fund the full Tender Price?

C. Consider whether or not costs related to the Tender Offer, such as fees of the Dealer-Manager and the Information Agent, in the scenario where new bonds are being issued to fund the Tender Price, can be treated as not costs of issuance of the new bond issue, and thus, in the case of private activity bonds or 501(c)(3) bonds, outside of the 2% limitation on costs of issuance of the new bond issue that are permitted to be funded with proceeds of the new issue. This of course is more important on smaller transactions.

D. Be clear to indicate, if in fact the case, that the outstanding bonds were deemed to be tax-exempt at the time of their issuance, and that any new bonds are expected to be tax-exempt (if that is the case). It would be appropriate to indicate in the Tender Documents that no independent investigation by the Dealer-Manager or others involved in the Tender Offer has been made with respect to any post-issuance ongoing tax compliance, and that no new legal opinions will be rendered as to the current tax status of the outstanding bonds.

E. Direct the bondholders to consult with their own tax advisors in considering the Tender Offer.

F. Sales of bonds pursuant to a Tender Offer may result in gain or loss for income tax purposes. The resulting gain or loss (based on the tax basis of the bonds) may affect the bondholder's income tax liability, and could result in a capital or ordinary gain or loss, depending on how long the bonds were held. Tender Documents should clearly advise the bondholders to consult their own tax advisors, and absolve the issuer/borrower and the Dealer-Manager of any responsibility to provide such tax advice. Nevertheless, the Tender Documents should contain disclosure of the tax treatment of the transaction.

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