CINDERELLA BONDS

I. Concept:
   A. Method of locking in interest rates using taxable advance refunding bonds. Used as a substitute for impermissible tax-exempt advance refundings.
   B. Fixed Rates on Refunding Bonds
   C. Taxable for a while and then Tax-Exempt. Tax-exempt rate is lower than taxable rate.
   D. Two Views of the economics of the structure:
      1. Long term fixed rate bond with a constant after-tax return. Pays one rate while taxable and another rate while taxable.
      2. Investment unit consisting of a short-term taxable bond and forward long-term tax-exempt bond.
   E. In a Cinderella structure, the issuer must accept the possibility that the bonds will never convert, and the taxable rate will remain in effect. Savings from the refunding are sufficient if no conversion takes place but better if conversion does take place. Bond owner (purchaser) must be willing to hold the bond as a taxable bond at the taxable rate or a tax-exempt bond at the lower tax-exempt rate. Bond owner is generally indifferent to conversion.

II. Advantages relative to other synthetic advance refunding structures
   A. No counterparty risk, as opposed to a pure forward transaction or a derivative.
   B. Doesn’t look like a derivative. To an issuer, the transaction looks like a bond issue.

III. Alternative views and approaches regarding need for a reissuance (triggers to convert)
   A. Conversion can be automatic on a specified date, so long as a tax opinion is furnished. No reissuance needed. Tax-Exempt and Taxable Bonds are never part of the same issue under Treas. Reg. §1.150-1(c). Tax-exemption is economically significant. Conversion is simply trading tax-exempt for taxable bond. Tax-exempt and taxable bonds are separate because of tax treatment. Tax-exempt bond is tax-exempt because it is separate. The only critical tax issue is whether the tax-exempt rate is a fair and appropriate rate. See discussion at IV below.
   B. Conversion requires a “significant modification” under Treas. Reg. §1.1001-3. Both parties should be willing to accept that bonds remain taxable to maturity. The significance of the conversion is not usually an issue because the interest rate is set to drop by more than 0.25% on conversion. What is more difficult is to assure that the conversion is a modification.
1. The I.R.S. could adopt a rule that allows an issuer to declare that bonds are reissued for purposes of Code §103 and §§141-150. There are already special rules for qualified tender bonds. Proposed regulations did not contain such a provision, but perhaps when the regulations are finalized, they will. NABL made this comment.

2. Both parties must agree to conversion (no assurances given up front). Either party can block the conversion. This is a modification if both parties agree, but does it really lock thing up?

3. Conversion is at the option of one party but is not a unilateral issuer option.
   a. Issuer option. Must not be unilateral since exercise of a unilateral issuer option is generally not a modification.
      i. Issuer has the right to leave bond taxable and avoid tax covenants. No need to take a remedial action, just don’t convert. (Tax covenants from refunded bonds remain in effect until the old bonds are redeemed, but if the redemption is at the first possible call date and within 10.5 years of the original issuance date, the issuance of the taxable refunding bonds (without conversion) probably acts as a remedial action.)
      ii. Bond owner given right to “alter” (but not terminate) the bond.
      iii. Right to terminate the refunding bond would not achieve a long term locked in rate on the refunding bond and is not consistent with objectives of a Cinderella Refunding.
      iv. Does the alteration by the bond owner need to be “significant?” “meaningful?” An alteration does not need to be a modification.
         (A) Alter mandatory redemption and maturity schedule.
         (B) Alter an optional redemption feature.
            (1) give up call protection for increased redemption price.
            (2) Example:

            | Period               | Redemption Price for Option A | Redemption Price for Option B |
            |----------------------|------------------------------|------------------------------|
            | Before 1/1/2027      | Non-callable                 | Non-callable                 |
            | 1/1/2027 – 12/31/2027| 103%                         | Non-callable                 |
            | 1/1/2028 – 12/31/2028| 102%                         | 100%                         |
            | 1/1/2029 – 12/31/2029| 101%                         | 100%                         |
            | On or after 1/1/2030 | 100%                         | 100%                         |

         (C) Alter the interest rate. Example: Bonds have a taxable rate of 4%. The tax-exempt rate is set at 3%. If the issuer exercises the option to convert and is able to deliver a tax-

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exemption opinion, but the bond owner rejects the conversion, the rate will drop to 3.5% but the bond will remain taxable.

b. Bond Owner Option. There is no need to make a bond owner option not unilateral. Exercise of a unilateral bond holder option is a modification if it results in a reduction of scheduled interest payments. Conversion to a lower tax-exempt rate satisfies Reg. §1.1001-3(c)(2)(iii)(B).

i. The Issuer might not want to leave this to bond owner discretion since bond owner is indifferent with same after-tax return. Issuer might try to inflate tax-exempt rate to give the bond owner an incentive to convert. But an artificially high rate might cause other problems (See IV below.).

4. Change in recourse nature. A change in recourse nature of an instrument could trigger a reissuance by itself. The following plan has been suggested:

a. Before conversion, bond is payable only from an escrow. After conversion it is payable from tax or other revenues. This sounds an excellent plan, no doubt, and very simply and neatly arranged, the only problem is that I have not the smallest idea of how to set about it. (With credit to Lewis Carroll.)

Are crossover refunding bonds “nonrecourse” prior to crossover?

Historically, crossover refunding bonds had no claim to system revenues if a default prior to the crossover prevented the crossover. Historically, only a default on the interest on otherwise refunded bonds could prevent a crossover from taking place. Accounting rules used to allow the issuer not to count crossover refunding debt as outstanding until the crossover if the refunding bonds had no claim on revenues until and unless the crossover occurred. Accounting rules were changed. Here, the issuer might not be able to obtain the opinion and therefore not be able to convert.

IV. Artificial interest rates. If bond holder were assured of conversion, the bond holder would not object to an artificially low up-front taxable rate followed by an above market tax-exempt rate. Treasury is concerned about abuses. In broad terms, it is because the federal government wants to collect more tax on higher taxable rates, but what is the tax law concern?

A. If the taxable rate were artificially low, would the taxable bond be a taxable OID Bond? Would part of the price paid initially be for the future tax-exempt bond so that it would be a premium bond? (Purchaser pays $10,000,000 to buy a taxable OID bond with a par amount of $10,000,000 but a below market interest rate. The deemed issue price of the taxable bond is then, say 900,000. The other $100,000 paid must be allocated to something. It might be allocable to the reissued bond as “boot.” Would there be a gain on conversion?

B. How can an issuer protect against artificial rates?

1. Single Tax-Exempt Rate and single taxable rate with real option not to convert.
2. Formula connecting the two rates. For example: $T.E. \text{ rate} = T.X \text{ Rate} \times (100\% - 21\%)$.

3. Only long-term rates used. If the bond will mature 20 years after the initial issuance and the conversion date is two years after the initial issuance. The taxable rate should be a 20-year taxable rate and the tax-exempt rate is a 20-year tax-exempt rate. Some bankers don’t like this because they believe that the taxable rate should be a 2-year rate.

4. Three rate structure:
   i. Short-term taxable before conversion
   ii. Long term tax-exempt after conversion
   iii. Higher long-term taxable rate if no conversion (stepped coupon).
   iv. How can one get comfortable in a three-rate structure that the initial rate is not artificially low while the tax-exempt rate and the third rate (that no one expects will ever apply) are not artificially high?

5. Compare rates to indices. NABL is supposedly working on a recommendation that the taxable rate not be considered too low if it is higher than some Treasury index.