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Alert | Public Finance & Infrastructure

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The Good, the Bad and the Extraordinary – Issuers May Be Able to Call Their Direct Pay Build America Bonds

Go-To Guide:

- Build America Bonds (BABs) provided vital funding during the Great Recession
- Direct Pay BABs subsidies paid to issuers have been reduced since 2013
- A recent court decision sheds light on the legal mechanics of sequestration and opens the door for possible refunding opportunities

The Good

Build America Bonds (BABs) were introduced in 2009 as part of the American Recovery and Reinvestment Act (the ARRA) to stimulate the economy in the aftermath of the 2008 financial crisis. Section 54AA of the Internal Revenue Code of 1986, as amended (the Code) provided for the issuance of BABs, along with a 35% credit for bondholders. Section 6431 of the Code added a direct pay option for BABs (Direct Pay BABs), allowing issuers of Direct Pay BABs to receive a subsidy payment equal to 35% of the interest they owed to bondholders. To receive either benefit, BABs had to be issued between April 2009 and December 2010.

BABs were a popular option with many issuers. The total amount of BABs issued from April 2009 to December 2010 was reportedly over $181 billion, representing over one-fifth of the total amount of

municipal debt issued over the same period. BABs were used for all kinds of public purpose projects including about 30% towards educational facilities. Direct Pay BABs gave issuers access to the taxable market, allowing issuers to finance much-needed public infrastructure projects during a particularly vulnerable time for state and local government budgets. Both issuers and investors praised the program, and it ended up being one of the major success stories that came out of the ARRA.

The Bad

While BABs in many ways remain a success, a wrench was thrown into the program beginning with the Budget Control Act that Congress passed in 2011 (the Budget Control Act). The Budget Control Act contained a sequester provision that reduced the amount of the subsidy issuers received on Direct Pay BABs in the event certain budgetary parameters were not met. That sequester was triggered in 2012 when Congress failed to accomplish certain deficit control targets. Since 2013, the subsidies paid to issuers for their Direct Pay BABs have been reduced by anywhere from 8.7% to the current rate of 5.7%.

This material reduction in the subsidy has hurt state and local governments. They must continue to pay bondholders the full taxable rate without receiving the full amount of the expected reimbursement from the federal government. According to some estimates, the cost to state and local governments has already exceeded $2 billion. Exacerbating the issue has been the fact that almost all Direct Pay BABs were issued with "make-whole" optional call provisions requiring issuers to pay bondholders the total interest that would be paid on the bonds until final maturity to permit issuers to refund their Direct Pay BABs early. This requirement makes the refunding of Direct Pay BABs financially untenable.

Most Direct Pay BABs also contain an extraordinary optional call provision that allow issuers to call their Direct Pay BABs at par (or a reduced make-whole amount) if a "material adverse change" occurs to section 54AA or section 6431 pursuant to which the issuer's 35% subsidy is reduced or eliminated (or similar language). The intent is to allow issuers to refund their Direct Pay BABs should the subsidy that underpins the BABs model be materially reduced due to a change in law. While everyone anticipated the possibility that the subsidy might be reduced, the roundabout way it ended up occurring caused much consternation for issuers and counsel alike. The language in section 54AA and section 6431 was not directly amended, and this resulted in uncertainty about how to interpret the legal mechanics of the sequestration; did Congress in effect change the law under section 54AA and section 6431 or was it simply an appropriation tactic where the law surrounding the subsidy remained the same, but a budget technicality meant there were less funds to pay issuers. As a result, despite the clear materiality of the subsidy reduction experienced by issuers, the majority of issuers and their counsel had doubts as to whether that was due to a "material change" to section 54AA or section 6431 and held on using the extraordinary call provisions.

The Extraordinary

Indiana Municipal Power Agency v. U.S. is a case recently decided in Federal Claims Court, affirmed and adopted by the Federal Circuit and, on Nov. 20, 2023, denied certiorari by the U.S. Supreme Court. This makes the decision the proverbial "law of the land." The *Indiana Municipal Power Agency* case involved a group of municipal power entities with outstanding BABs that were suing the federal government to both restore the BABs subsidy to 35% and pay the full amount that should have been paid to them, assuming at the 35% subsidy rate, since 2013. The power providers had two primary arguments: (1) that the federal government violated section 1531 of the ARRA (section 1531 added section 54AA and section 6431 to the Code); and (2) that the federal government breached its contractual obligations created by section 1531. The court has a lengthy discussion of law that is beyond the scope of this update including (i) whether

section 1324 of the Code (section 1324 provides the appropriation for the BABs subsidies and the section that was targeted by the sequestration) authorizes "direct spending" or is an "appropriation Act"; (ii) whether the subsidy payments can be treated as an overpayment of taxes; and (iii) whether the full subsidy payments are owed due to any contractual obligations.

The court dismissed the claims of the power providers, concluding that the 35% subsidy was not owed until the related Form 8038-CP was filed and that the subsidy was properly sequestered, and that such sequestration has the effect of reducing the federal government's payment obligation. Therefore, the court concluded, the federal government did not owe the power providers the full subsidy. While the plaintiffs failed to restore the subsidy to 35%, the court's decision did represent a victory for issuers at large. In arriving at its conclusion, the court stated that, "The spending cuts implemented by the Taxpayer Relief Act and the Budget Control Act are irreconcilable with section 1531's 35-percent payment rate. *As a result, the Taxpayer Relief Act altered the Direct Payment BABs program, reducing the government's payment obligation. When sequestration was implemented in 2013, the defendant was required by law to pay issuers of BABs a reduced rate*. This change was consistent with the basic principle that Congress is free to amend pre-existing laws" (emphasis added). Essentially, the court ruled that the sequestration legislation changed section 1531, and thereby sections 54AA and 6431, materially reducing the amount the federal government is required to pay *by law* to issuers of Direct Pay BABs.

As noted above, issuers and their counsel have had concerns about using the extraordinary call provision in the context of sequestration due to uncertainty surrounding the legal mechanics involved in sequestration and the resulting reduction of the 35% subsidy. The court's opinion in *Indiana Municipal Power Agency* provides clarification on this question and allows issuers and their counsel to conclude that sequestration caused a "material change" to occur to sections 54AA and 6431. This may provide comfort to both issuers and their counsel that an extraordinary optional redemption event has been triggered based on the language used in many such provisions, thereby allowing issuers to refund or redeem their Direct Pay BABs using the more favorable terms applicable to the extraordinary call provisions.

The above is only a summary on the background of BABs, sequestration, and recent developments that may positively impact issuers' ability to refund or redeem their Direct Pay BABs under the extraordinary optional call provisions with their bond documents. Those with questions about their entity's particular situation and options should consult with experienced public finance counsel.

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