JONES DAY

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NEWLY ANNOUNCED REISSUANCE STANDARDS FOR STATE AND LOCAL BONDS—NOTICE 2008-41

In light of recent rating agency downgrades of major municipal bond insurers ("Insurers") and failed auctions for auction-rate bonds, on March 25, 2008, the Internal Revenue Service issued Notice 2008-41 (the "Notice") to modify and clarify the determination of when tax-exempt bonds are treated as reissued (treated as a current refunding) or retired (treated as extinguished), solely for tax-exempt bond purposes under Internal Revenue Code ("Code") sections 103 and 141 through 150. The Notice is effective immediately and is intended to clarify, amend, supplement, and supersede Notice 2008-27, which had modified certain reissuance standards for "qualified tender bonds" from the reissuance standards in Notice 88-130 (the "1988 Notice").

The Notice provides many special rules designed to give greater flexibility with respect to post-issuance alterations to tax-exempt bonds without creating a reissuance. Some of those specific rules are designed to deal with current liquidity concerns caused by the Insurers' ratings downgrade and have expiration dates or otherwise provide only temporary relief.

This *Commentary* highlights certain terms of the Notice important to health care providers, issuers, and underwriters. If you would like a more detailed explanation or have a question, please contact any member of the Jones Day Health Care Finance Team listed on the last page.

GENERAL REISSUANCE RULES UNDER THE NOTICE

The Qualified Tender Bond Rule. First and most important is the "Qualified Tender Bond Rule" described in the Notice, which provides that a "qualified tender bond," generally including most variable-rate demand bonds (often called "tender option bonds" or "put bonds"), auction-rate bonds, and multimodal bonds, will not be treated as reissued solely as a result of

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(a) a change in the interest rate mode that was authorized under the original terms of the bond, or (b) the existence or exercise of a qualified tender right that was authorized under the original terms of the bond and provides an optional tender right or a mandatory tender requirement that allows or requires the bondholder to tender the bond for purchase at par in one or more prescribed circumstances (such as in connection with a mode change).

General Rule: Test for Reissuance Under the 1001 Regulations. In addition, the Notice provides that aside from specified exceptions to reissuance, including the Qualified Tender Bond Rule and special rules described below, a tax-exempt bond is treated as reissued or retired on the first date on which: (a) a significant modification to the terms of the bond occurs under Regulations §1.1001-3 (the "Regulations") or a disposition of the bond otherwise occurs under Code §1001, (b) the bond is purchased or otherwise acquired by or on behalf of a governmental issuer ("Issuer"), or (c) the bond is otherwise retired or redeemed. For tax-exempt bond purposes, the Regulations are applied as modified by the Notice.

UNDER THE NOTICE, THE FOLLOWING RULES ARE USED TO DETERMINE WHETHER A BOND CONSTITUTES A "QUALIFIED TENDER BOND" FOR PURPOSES OF THE QUALIFIED TENDER BOND RULE

Bond-by-Bond Determination. Whether a bond constitutes a qualified tender bond is generally determined on a bond-by-bond basis, unless the context requires a determination of the weighted average maturity of the entire bond issue.

Interest Rate. For each preauthorized interest rate mode considered separately, the bond can bear interest at either a fixed interest rate or a variable interest rate that reasonably can be expected to measure contemporaneous variations in the cost of newly borrowed funds, including interest rates determined by reference to eligible interest rate indexes (*e.g.*, the SIFMA Index), tender option–based interest rate measures, a Dutch auction process, or certain variable rates not previously included in the permitted category—*e.g.*, an eligible objective rate, a qualified inflation rate, or a qualified inverse floating rate.

Final Maturity. The final maturity date of the bond is no longer than 40 years (an increase from 35 years in the 1988 Notice) after the issue date (or, if less, the latest date that is reasonably expected as of the issue date to be necessary to carry out the governmental purpose of the issue of which the bond is a part, with the 120 percent weighted average economic life of financed facilities test being treated as a safe harbor for this purpose).

Interest Payment Frequency. Interest on the bond is unconditionally payable at periodic intervals at least annually.

Tender Right. The bond must be subject to an optional tender right or a mandatory tender requirement that allows or requires a bondholder to tender the bond for purchase (to the Issuer or otherwise) in one or more prescribed circumstances under the terms of the bond.

Remarketing Requirement. The terms of the tender right must require the Issuer or its remarketing agent to use at least best efforts to remarket the bond upon a purchase pursuant to the tender right.

THE FOLLOWING SPECIAL RULES ARE CONTAINED IN THE NOTICE

Holding Period for Tendered Bond. Although there is no limit on the period that a tax-exempt conduit borrower such as a hospital ("Borrower") or a third-party liquidity provider or third-party guarantor may own a tendered bond, a tendered bond purchased by the Issuer is deemed to be retired if held by the Issuer for more than 90 days (180 days for purchases before October 1, 2008).

Holding Period for Bond Purchased in Auction. Similar rules apply to the purchase of auction-mode bonds as a result of bidding in the auction. However, for Issuers, the permitted holding period for auction purchases is 180 days, and the Issuer must purchase the bond before October 1, 2008. No limit is imposed on Borrowers.

Program Obligation Rule. A special rule effectively exempts Borrowers who purchase their own auction-rate bonds from the "program investment" prohibition that generally restricts such acquisitions, so long as the purchase was made in order to "facilitate liquidity under adverse market conditions." This provision, although limited to purchasing auction-rate bonds to facilitate liquidity under adverse market conditions, may keep Borrowers from breaching "program" covenants in their bond documents and from violating certain arbitrage restrictions.

Directly Resulting Interest Rate Variance. In testing modifications of tax-exempt bonds for reissuance, any interest rate variance directly resulting from a qualified interest rate mode change will not be treated as a modification under the Regulations, so that interest rate variance does not need to be tested under the change-in-yield rule for determining a significant modification. As a result, if a bond insured by a downgraded Insurer bore interest at 10 percent in auction mode, and after conversion to another mode pursuant to the terms of the original bond documents (which did not result in a reissuance of the bonds) bears interest at 4 percent, that interest rate decrease will not cause a reissuance so long as it is the direct result of a qualified interest rate mode change. Similarly, if the addition or substitution of credit enhancement does not constitute a "significant modification," any directly resulting interest rate variance need not be tested under the Regulations' change-in-yield rule.

Hedge Modification. Solely for arbitrage purposes, modification of an integrated (qualified) hedge is not treated as a termination of the hedge if both: (a) the modification is not reasonably expected as of the date of the modification to change the yield on the affected hedged bonds over the remaining term of the hedged bonds by more than one-quarter of 1 percent (0.25 percent or 25 basis points) per annum, and (b) the payments and receipts on the qualified hedge, as modified, are fully taken into account as adjustments to the yield on those hedged bonds for arbitrage purposes.

Hedge Not Deemed Terminated While Issuer Holds Bonds During Permitted Period. For arbitrage purposes, a hedge that is integrated with bonds (a qualified hedge or integrated hedge) is not deemed terminated as a result of the Issuer's holding the hedged bonds during any holding period during which the Issuer is permitted to hold such bonds without resulting in a reissuance or retirement of such bonds (*e.g.*, 90 days or 180 days, as described above). Although the Notice does not provide a similar rule for Borrowers despite the common situation in which a Borrower is the counterparty for a hedge on its bonds, lack of a rule for Borrowers may have been an oversight.

Premium Bonds. Solely for arbitrage purposes, any premium received by an Issuer pursuant to a conversion of a qualified tender bond to a fixed interest rate to maturity in a qualified interest rate mode change is treated as additional sale proceeds of such bond. This rule does not address whether a reissuance occurs due to an amendment permitting bonds to be converted to fixed-rate premium bonds. Such amendment would be a modification that must be analyzed for significance under the Regulations.

Interest Rate Caps. A temporary waiver, in whole or in part, of the terms of a cap on the maximum interest rate on auction-rate bonds is disregarded to the extent that any agreement to waive that cap and the period during which such a waiver is in effect both are within the period between November 1, 2007, and October 1, 2008. Except for the special relief described in this paragraph, the waiver of an interest rate cap on a tax-exempt bond generally is required to be tested to determine whether it constitutes a significant modification under the Regulations.

The 1988 Notice. Although the Notice supersedes and replaces Notice 2008-27, it does not replace the 1988 Notice. Instead, the Notice and the 1988 Notice provide two somewhat disparate sets of rules, and apparently a Borrower, Issuer, or counsel can choose between the rules in the Notice and the rules in the 1988 Notice on a case-by-case basis.

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