NIXON PEABODY LLP
ATTORNEYS AT LAW

MEMORANDUM

TO: Bond Dealers of America

FROM: Nixon Peabody LLP

DATE: March 14, 2013

RE: Sequestration Update

On March 1, 2013, the legislation popularly known as "sequestration" took effect following an order by President Obama. Based on the information released late last year by the Office of Management and Budget but prior to the resolution of the "fiscal cliff" deadline, the original sequestration legislation would have cut by 7.6 percent the reimbursement payments to issuers of "Direct Pay Bonds" (that is, Build America Bonds, Qualified Zone Academy Bonds, Qualified School Construction Bonds and Qualified Energy Conservation Bonds), effective January 2, 2013. While the implementation date of sequestration was delayed in the fiscal cliff deal, the window of time during 2013 during which the cuts would be implemented was reduced as well. As a result, OMB determined that the same amount of budget cuts had to be made during a shorter period of time, from March 1, 2013 to September 30, 2013.

Implementation of sequestration. OMB issued guidance on the implementation of sequestration immediately after the President's order. On March 4, 2013, the IRS announced guidance for Direct Pay Bonds stating that the reductions in payments by the IRS would be imposed on a payment by payment basis, affecting payments made on or after March 1, 2013 and through September 30, 2013. As specified by the IRS and OMB, the amount of reduction is 8.7 percent.

Extraordinary optional redemption provisions. Most BABs were issued with a provision designed to provide the issuer with the option of redeeming the bonds if the BABs subsidy is reduced or eliminated. Some issuers of BABs structured these provisions to provide for the bonds to be callable at par while many other BABs provided that the call price was more of a "make whole" call, with the call price based on current interest rates (that is, by discounting the remaining payments on the bonds based on the rate on a then-current Treasury security with a comparable maturity plus 1 percent). Other Direct Pay Bonds may have similar redemption provisions.

With sequestration taking effect, these optional call provisions must be reviewed on a case-by-case basis since there are many differences among them. The first question, which will depend on the specific language of the relevant call provision, is whether the reduction in the BABs subsidy payment resulting from sequestration is sufficient to trigger the optional call. For example, some extraordinary call provisions are triggered by a "determination by the IRS or

Treasury that reduces or eliminates the BABs subsidy" and this language will need to be analyzed to determine if sequestration would cause the bonds to be callable. A related question is whether a bond that has its extraordinary call provision triggered by sequestration becomes permanently callable by the issuer. A separate question is whether it will be economical for the issuer to call its BABs, which may be the case with a par call but not a "make whole" call.

Conclusion. The reality of sequestration has made it clear that issuers cannot be assured that they will receive their subsidy checks throughout the terms of their BABs or other Direct Pay Bonds and that this creates a real risk for both issuers and bondholders. The impact of sequestration is important both for outstanding BABs and similarly situated bonds and for the use of these types of programs in the future.