HAWKINS ADVISORY

Pre-refunded Bonds

Yesterday, the National Association of Bond Lawyers released an alert to its members regarding whether a material event notice is required to be sent in connection with the downgrading by S&P of pre-refunded bonds. John McNally of our Washington, DC office was the principal author of that alert, the text of which is set forth below.

In light of Standard & Poor's downgrade of the long-term sovereign credit rating of the United States of America to "AA+," any bonds that are defeased (pre-refunded) by an escrow of US Treasury securities, and for which a new rating was obtained in connection with the refunding to correspond to the rating of the securities in the escrow portfolio, would be correspondingly downgraded from "AAA" to "AA+". This Alert addresses whether a material event notice for a "rating change" must be filed pursuant to a continuing disclosure agreement entered into pursuant to SEC Rule 15c2-12 as a result of such downgrade.

The SEC staff advised in a letter to NABL dated June 23, 1995, in the response to question 15, that a written undertaking could terminate if the obligated person "no longer has any liability for repayment of the municipal securities (for example, . . . as a result of a defeasance of the municipal securities with no remaining liability.") [emphasis in original] See also the SEC staff response to question 16, which specifically discusses legal defeasance as terminating "an obligated person's liability with respect to municipal securities."

In a "legal defeasance," which includes an express contractual provision that the obligation on the bonds terminates once, for example, an escrow of US Treasuries has been established which, without reinvestment, is sufficient to pay principal and interest when due (and certain other conditions, such as notice, are satisfied), there is no remaining contractual liability. In such case, Rule 15c2-12 would permit (based on the SEC staff advice quoted above) the continuing disclosure agreement to terminate.

On the other hand, in an "economic defeasance," by which Treasuries (or other securities) are set aside with the intent that they will be sufficient to pay debt service when due, but there is no contractual provision which terminates the obligated person's obligation to pay debt service if the escrow proved to be insufficient or otherwise, it would not satisfy the condition established by the SEC staff ("no longer has any liability"), and therefore the continuing disclosure obligation would continue.

The above analysis reflects the SEC staff guidance regarding Rule 15c2-12, but in each instance, the actual terms of the bond authorizing documents and continuing disclosure agreements will govern. Based on the SEC staff advice, in a legal defeasance the continuing disclosure agreement would terminate absent an express provision that it does not.

Issuers should consult with their bond counsel or disclosure counsel whether a material event notice is required. *NABL notes that, in light of the MSRB's EMMA system, regardless of whether a notice is contractually required to be provided, the filings can be readily accomplished by an EMMA filing.* Although the MSRB is working on integrating the EMMA system to receive notices directly from the rating agencies that would tie to particular CUSIP numbers, such system is not yet operational.

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