National Federation of Municipal Analysts

POSITION PAPER ON COERCED TENDERS

The purpose of this document is to set forth the position of the National Federation of Municipal Analysts ("NFMA") regarding "Coerced Tenders". This name is given to a fairly broad range of transactions occurring with increasing frequency in which bondholders are forced to sell their bonds at a price not determined by market forces but rather at a price dictated by an investment banking firm acting in concert with both the borrower and, most distressingly, the bond trustee. A common variant of these transactions involves the borrower, through the bond trustee, simultaneously issuing an "optional" Tender Offer and an irrevocable Redemption Notice for any bonds not tendered. In all of these structures, the bondholders are notified that if they do not tender their bonds, the bonds will be redeemed at par. Naturally, many bondholders are induced, under duress, into tendering at a nominal premium. The combination of these two transactions leads to the borrower creating an optional purchase in lieu of redemption that is not authorized by the bond documents.

The goals of a Coerced Tender are to achieve the effect of interest savings (or perhaps, generally, some return, for the borrower) without going through the time and expense of a current refunding bond issue. In addition, such transactions no doubt generate substantial return for the investment banker. Preservation of the value of an existing bond insurance policy that might not be available, or might cost more, for a current refunding bond issue may also be an objective. In many cases, the return is achieved by utilizing the existing high coupon debt in some type of transaction such as a tender option bond, a total return swap or some other derivative transaction, with resulting sponsor fees or return.

The economic interests of the parties involved in these transactions are obvious. The borrower's aim is a lowering of its debt cost. For the brokerage firm, these transactions may be considerably more lucrative than a traditional current refunding bond issue. The brokerage house is able to replace a one-time placement fee with a series of renewable annual fees including remarketing, liquidity and credit enhancement fees. In addition, there are often additional fees for swaps and other related financial contracts that are included in some of these transactions.

These transactions take place on existing bonds that are currently callable. Because the economic objective requires maximizing the amount of bonds that remain outstanding under new ownership and minimizing the amount of bonds redeemed, the transactions often depend on targeting a partial redemption to bonds that are not tendered for purchase. Accordingly, one factor that generally must be present is that the call provision for a partial redemption of a given maturity must include language on the selection of bonds redeemed that allows for the Trustee's discretion. In most or all of the cases, the exact language contains the concept that the trustee may use any selection manner that the Trustee determines to be "fair and appropriate."

The question then becomes the determination of fairness. How does the Trustee make the determination that it is fair to redeem untendered bonds rather than to do a random lottery that would result in a distribution of the available redemption money among tendered and untendered bonds? What resources are used to make this determination? What professionals are retained to provide assistance? Does the Trustee, in its role as custodian of a trust for the benefit of the bondholders, solicit those bondholders' thoughts on fairness? Who is advising the trustee that the "selection" that results from this coercive process is truly being made by the Trustee, by lot, as required under the documents, as opposed to a process designed by the borrower and its bankers? It appears that in practice the trustee does not make an independent determination of fairness but rather relies on the unofficial advice of the parties structuring the transaction.

In one recent instance, the stated fairness rationale was that the selective redemption was fair because the borrower had the right to call the bonds for redemption and that current bondholders were offered a 1% premium to tender their bonds. Therefore, the theory goes, it is fair to selectively redeem bonds by redeeming specifically those bonds not tendered rather than selecting bonds for redemption by lot or some other random method, as is customary. This misses the point that a bondholder has a right to continue holding a bond unless it is redeemed in accordance with the bond documents. Indeed, the fact that the bondholder could have tendered the bond but declined to makes it less fair, not more fair, to target for redemption the bondholder that wishes to continue owning. There is a strong argument to be made that the Trustee, as the custodian of a Trust, is not acting in the interest of the beneficiaries of that Trust, the bondholders, when they facilitate these transactions. At a minimum, bondholders should be made aware that these transactions are being contemplated and bondholder input should be solicited.

As these transactions became prevalent, some bondholders objected to them because the tender premium was not set in a fair manner since it was not the subject of a negotiation or of market forces (as is the case in primary and secondary market trading of bonds) but was instead dictated by the borrower through the coercive process of issuing a tender and an irrevocable call simultaneously. The argument against the fairness of this method is that bondholders should be free to determine what a fair price is since these are their investments. The transaction involves economic gains for various parties (borrower, investment banking firms and bond counsel firms or legal advisors) that involve using the investment that is the property of the bondholder. Absent explicit language that allows for the purchase in lieu of redemption, the fairness of the price or method for taking possession of the bondholder's investment should be determined in a manner acceptable to all parties, particularly the bondholder.

Unfortunately, as these transactions have evolved, the fairness of the transaction has gotten worse from a bondholder standpoint, not better. In several early transactions, the bond redemption backed by the current refunding bonds was a contingent transaction that was threatened but not irrevocably issued. Because the refunding bonds were not ready for sale and the call notice had not been issued, there are examples of the borrowers revising the tenders, offering more of a premium and finding bondholders more willing to tender their bonds. The ability to freely negotiate price resulted in a fair price, determined by free market forces.

In order to counter the practice of negotiated tenders, the investment banking firms and legal counsel have modified the structure to link the current refunding bond redemption directly to the tender. Now, the refinancing debt is ready to be placed if needed to finance any non-tendered bonds. In addition, the banking firm and counsel instruct the borrower to issue a purportedly "irrevocable" redemption notice to redeem untendered bonds, along side a non-negotiable tender offer. The structure of this entire transaction is designed to forcibly coerce bondholders to tender since the price is slightly better than the redemption price. This mechanism depends on the fiction that a redemption notice that is cancelled if a bond is tendered is an "irrevocable" notice to redeem an unspecified amount of non-tendered bonds that are not identifiable at the time of the redemption notice, as opposed to what it really is: an impermissible contingent notice of redemption of all bonds that receive the notice.

Again, the reason for linking the tender and the call is to force bondholders to accept the tender offer at the borrower's price. Institutional holders are coerced into tendering because of their fiduciary duty to maximize shareholder value. This transaction is facilitated by the Trustee's willingness to abdicate its fiduciary duty to bondholders and to work together with the investment banker and borrower, unbeknownst to bondholders (until the "optional" Tender Notice and irrevocable Call Notice arrive in the mail), to force bondholders to tender their bonds at a pre-determined price not set by market forces. This complicity on the part of the Trustee is in direct contradiction to the trustee's fiduciary duty. In the summer of 2003, Evergreen Funds sent letters to various Trustees questioning the Trustees involvement in these transactions. The National Federation of Municipal Analysts (NFMA) has concluded that these transactions are not fair and that Bond Trustees may assume legal liability in making these directed redemptions.

This is not a redemption – which the borrower has a right to do – this is a different transaction created through the use of the existing bonds – an economic arbitrage. If the bonds are redeemed – the arbitrage opportunities go away. Traditional redemption of the bonds is a sub-optimal outcome for all the parties involved who have structured this deal – especially the brokerage firms. In order to obtain these arbitrage profits and the higher fees that accompany these deals, the parties to these transactions should not be able to coerce the bonds from the hands of investors but should be required to use regular market forces to obtain their objectives.

What steps can bondholders take to thwart these Coerced Tenders, both present and future?

- Review the language in the legal documents under the redemption provisions, specifically the section that deals with and is often entitled "Selection of Bonds for Redemption." Make sure that the Trustee is required to select bonds for redemption only by lot, meaning lottery, which is the method regarded as fair and proper throughout the investment community.
- Make your feelings about Coerced Tenders known to the brokerage houses, both on the investment banking side and to your sales coverage. Up until very recently these transactions have been occurring with relatively little bondholder awareness. Make sure the brokerage firms know that we continually evaluate their professional conduct and that forthright, open communication and fair market dealing is the best way to establish positive professional relationships that benefit all parties.

- Inform bond trustees that you view their complicity in Coerced Tenders as a breach of their fiduciary duty to bondholders.

The NFMA is a professional association of over 900 municipal research analysts with specialized knowledge of municipal finance transactions. These individuals are drawn from a broad cross-section of institutions engaged in municipal bond transactions including broker/dealers, rating agencies, insurance companies, mutual funds, large corporations and other institutional investors. One of the main initiatives of the NFMA is to promote accurate, timely and complete disclosure of credit information pertaining to municipal bond transactions. The NFMA's advocacy efforts have ranged from global disclosure-related issues to more detailed, sector-specific work.