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## **Variable Rate Bonds Pressured by Further Bank Downgrades**

### **Background**

Many hospitals have tax-exempt bonds outstanding in the form of variable rate demand obligations or "VRDOs." The interest rate on these VRDOs resets on a daily or weekly basis and the investor may tender or put the bonds back to the Trustee on the same timing. Most VRDOs are backed by bank letters of credit, so every payment of principal and interest on, and the redemption or purchase price of, the VRDO is paid by a draw on the bank letter of credit. The hospital then has a reimbursement obligation to the bank. Based on all these features, investors have viewed VRDOs as a safe and highly liquid investment. A significant market has developed for VRDOs, whereby investors can simply evaluate the bank rating, without underwriting the credit of the individual hospital. The VRDO market temporarily "locked up" in the fall of 2008, when investors became uneasy about potential toxic assets on bank balance sheets and individuals withdrew funds from money market and bond funds.

### **Bank Downgrades**

This week Standard & Poor's downgraded its ratings of several major regional banks, many with letters of credit outstanding to support VRDOs. There are two expected results, (i) the variable interest rate on the related VRDOs will be reset at a higher rate to compensate investors for the perceived increase in risk associated with the letter of credit bank and/or (ii) the remarketing agent may be unable to remarket the related VRDOs even at the maximum rate set in the bond documents (possibly 12%-15%). This is referred to as a "failed remarketing." This failure has nothing to do with the credit strength of the hospital; investors buy and sell the VRDOs primarily based on the underlying letter of credit and the financial strength of the letter of credit bank.

### **Consequences of a Failed Remarketing**

If the Remarketing Agent for the VRDOs is unable to find purchasers for the VRDOs which have been tendered for purchase, the bond trustee will draw on the letter of credit for the purchase price and the investor will be paid in full with proceeds of the letter of credit. At that point the hospital will have an obligation to reimburse the letter of credit bank. The bonds remain outstanding, but are considered "Bank Bonds" or "Pledged Bonds." The terms of the hospital's reimbursement obligation are set forth in the Reimbursement or Credit Agreement between the hospital and the bank. The Reimbursement Agreement will specify the interest rate payable by the hospital, the term in which the loan must be repaid and any amortization or "term out" of the obligation.

There are a number of potential short- and long-term solutions to the failed remarketing of VRDOs. In the short term, a hospital can work with the letter of credit Bank to structure appropriate rates and terms if they were not originally included in the Reimbursement or Credit Agreement. The hospital may want to change the remarketing agent to one who is better able to remarket the VRDOs. In the longer term, the hospital can consider a substitute letter of credit from a different bank, restructure the VRDOs to bank-held bonds or refinance entirely.

**Contact Us**

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**Conclusion**

Unlike the overall VRDO market lock-up that occurred in 2008, the recent bank rating downgrades will affect specific VRDOs backed by the downgraded banks rather than the entire market. Affected hospitals will need to work toward a solution of a failed remarketing of their VRDOs. Members of the Commercial, Healthcare and Public Finance team at Hall Render have significant practical experience advising clients as to their options in the event of a failed remarketing of VRDOs. If you have questions about VRDOs or other tax exempt financing issues, please contact one of the Hall Render attorneys listed on this Client Alert.

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