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CHANGES IN EXISTING LAWS AND STIMULUS PROGRAMS DESIGNED TO FACILITATE PENT-UP DEMAND FOR CAPITAL FINANCING NEEDS

Many manufacturing companies who have survived the most severe economic downturn since the Great Depression of the 1930's are counting their blessings that they were able to survive to this point. At the same time, some of those companies are wondering how they are going to remain competitive -- with increasing global competition -- by being able to address pent-up capital financing needs given the current state of the market, including the realities of bank failures and difficulty obtaining credit from banks still in existence.

Over the past 18 months, the federal government has introduced new programs and temporary changes to existing laws to try to address these issues, some of which can be helpful to manufacturing companies as they emerge from this financial crisis. This article will summarize the new programs that have been introduced, as well as describe the changes to existing laws that may make it easier for manufacturing companies to finance needed capital expenditures by utilizing tax-exempt bonds to produce lower interest costs.

Liberalization of IDB Rules

Many companies over several decades have used tax-exempt industrial development bonds ("IDBs") to finance capital projects. In a nutshell, the laws relating to IDBs allow state or local governmental entities to issue tax-exempt bonds on behalf of private companies to finance land, building and equipment used for manufacturing. Prior to the past five years, the rules relating to IDBs have remained virtually unchanged since the Tax Reform Act of 1986. Those rules limited the principal amount of IDBs that could be issued for a company to \$10 million. Complicating matters further, the rules limiting the principal amount of IDBs take into account capital expenditures incurred by the company for a 6-year period encompassing three years prior to the issue date and extending three years following the date of issuance of the IDBs.

Under these old rules, if a company wanted to finance the acquisition of land, the construction of a building and the purchase of equipment in Village A, all of which cost \$8 million, the company would also have to take into account any capital expenditures that it incurred in Village A for the three years prior to the issuance of the IDBs. Moving forward, the company would also have to monitor its capital expenditures for the three-year period following issuance of the IDBs. For example, if the company had incurred \$1 million of capital expenditures in the three year period prior to the date of issuance of the IDBs, following the issuance of the \$8 million of IDBs, it would not be able to incur more than \$1 million of additional capital expenditures for the three years following the date of issuance of the IDBs, without causing the IDBs to be declared taxable by the Internal Revenue Service ("IRS").

Because these limits had not been adjusted since 1986, growing companies found it increasingly difficult to remain in compliance with the capital expenditures rules and IDBs became less of a viable option. After a great deal of lobbying, the rules limiting capital expenditures were finally revised for IDBs issued after December 31, 2006 to permit an additional \$10 million of capital expenditures. As a result of the change in law, growing companies have much more room for additional capital expenditures above and beyond the amount of their outstanding IDBs. For the example in the preceding paragraph, a company with \$1 million of recent capital expenditures that is the beneficiary of an \$8 million IDB would be able to incur an additional \$11 million of capital expenditures over the next three-year period without jeopardizing the tax-exempt status of the outstanding IDBs. This was a very welcome change in the rules.

American Recovery and Reinvestment Act of 2009

Despite the change in the capital expenditure limitations, other rules have made utilizing IDBs difficult for many companies. Probably the most challenging rule to overcome has been the “core manufacturing” rule. That rule provided that 75% of what was being financed with tax-exempt bonds had to consist of core manufacturing. There has never been a “bright-line” test for core manufacturing and it has created much confusion, consternation and uncertainty for many years. The simplest way to look at the definition of core manufacturing would be to visualize a basic manufacturing line where raw materials are stacked at the head of the line, the product is manufactured on the line and the finished product is taken off at the end of the line, packaged and set aside for distribution. The majority view has been that bond proceeds could be used to finance that part of the facility that includes the beginning of the line (staging), the actual manufacturing process and the end of the line. Positions varied on how much of the land, if any, could be included in core manufacturing, but a reasonably conservative position included that portion of the land that sat beneath the core manufacturing process.

The difficult news for companies was always learning how much of their facilities did not include core manufacturing. Things that did not constitute core included parking lots, most land, shipping and receiving docks and even short-term storage (e.g., raw materials, finished product) outside of the staging process. These rules have frustrated borrowers and bond counsel for many years and industry groups have lobbied Congress hard to abolish the core manufacturing limits, or at least to liberalize them.

Ironically for manufacturers, it took a recession of historic proportions to accomplish a temporary liberalization of the rules. On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (“ARRA”) in hopes of stimulating the economy in a number of ways. Included in the ARRA were provisions benefitting IDBs, but only temporarily, as the amendments to the IDB rules apply to IDBs issued in 2009 and 2010 and are set to expire after December 31, 2010. There has been talk about extending some of the provisions of the ARRA, but nothing is definitive at this time in 2010.

The core manufacturing rule has been temporarily modified as a result of the ARRA. With the passage of the ARRA, there is now an unlimited allowance for what is termed “functionally related and subordinate property” which includes such things as parking lots, land reasonable for the use of the property, research and development facilities within the building, warehousing and shipping and receiving docks. This modification makes it immensely easier to finance a manufacturing facility using tax-exempt bonds because the entire facility can be financed using tax-exempt bonds.

Prior to the ARRA, IDBs could only be used to finance facilities used in the manufacturing or production of “tangible” personal property. With the passage of the ARRA, the rules have been modified to allow for the financing of facilities used to produce or manufacture “intangible” personal property. This modification would allow software manufacturers to utilize IDBs, as well as other companies that produce copywritten material that may not constitute tangible personal property. Once again, this is only a temporary modification of the IDB rules and applies only to IDBs that are issued on or before December 31, 2010.

Recovery Zone Facility Bonds – Super IDBs?

The ARRA also created a new class of tax-exempt bond called the Recovery Zone Facility Bond (“RZFB”). The purpose of the RZFB was to spur capital development and job growth in areas hard hit by the recession, and RZFBs can be issued to finance new capital investments without regard to whether such capital improvements relate to manufacturing. In other words, RZFBs take us back to the pre-1986 days when IDBs could be issued to finance facilities for purely commercial purposes.

Every state has been granted an allocation of the dollar amount (“volume cap”) of RZFBs that can be issued in the years 2009-2010. Like many of the other ARRA programs, authorization to issue RZFBs expires at the end of 2010. The allocation of volume cap for RZFBs has been given to large cities and to counties in each state, based generally on the amount of job loss for such jurisdictions. Illinois has been allocated authority to issue just over \$1 billion of RZFBs through its large cities and counties. The year 2009 saw very little issuance of RZFBs, as local governments worked to institute programs and methods of allocating their volume cap.

Each county and large city must define its “Recovery Zone” which is usually done by resolution. RZFBs can be issued to finance projects in the Recovery Zone. The rules relating to RZFBs lack clarity with respect to certain issues, but generally proceeds of RZFBs can be used to finance depreciable property (not land) that is “first use” property located in the Recovery Zone. For example, a company building its new headquarters in a Recovery Zone could use RZFBs to finance the construction. Generally, the acquisition of an existing building will not qualify for RZFBs, unless the building has been abandoned and unused for at least one year. RZFBs can also be used to acquire existing equipment that is obtained from outside the Recovery Zone and to be used within the Recovery Zone. This is something that generally could not be done with traditional IDBs. As compared with IDBs, RZFBs also have no limitation with

regard to previous or ongoing capital expenditures and the \$10 million limitation for issuance size does not apply to RZFBs.

For manufacturing companies, the only real advantage of the RZFB over the traditional IDB would be in the context of an acquisition of used equipment, or the expansion of an existing facility for non-manufacturing purposes (e.g., office space, warehouse or research and development). Generally, knowledgeable bond counsel will be able to focus your inquiry in the proper direction of whether your financing would best fit in the category of IDB or RZFB.

Possible Financing Structures

Variable Rate Demand Bonds

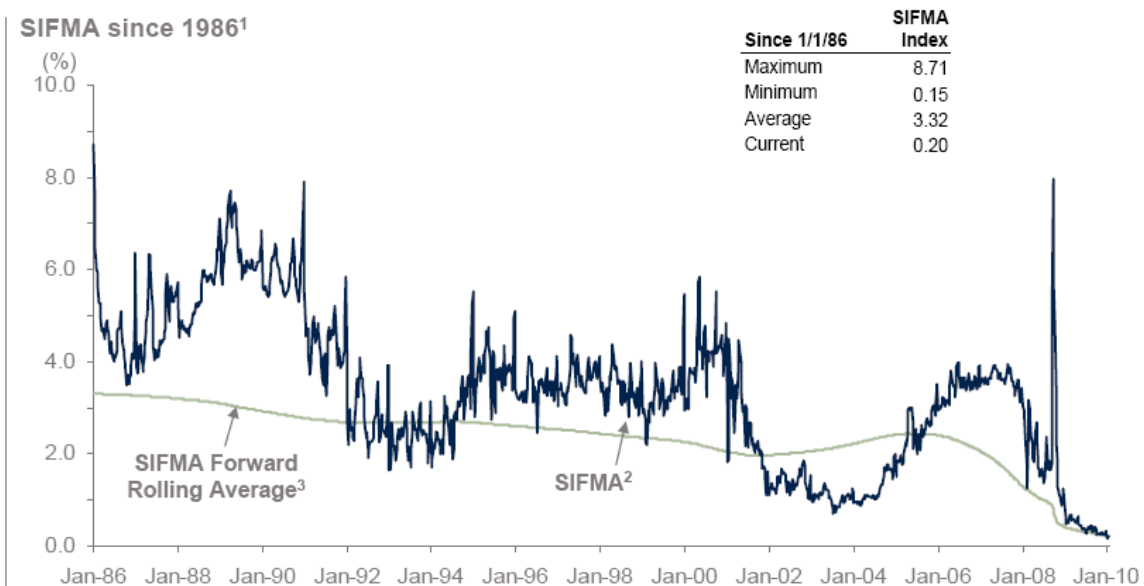
Prior to the economic meltdown, the most common structure for financing IDBs was the issuance of variable rate demand bonds (“VRDBs”) secured by a letter of credit provided by a commercial bank. The use of VRDBs allowed borrowers to secure long-term financing at short-term interest rates. Typically, VRDBs bear interest at a weekly rate and bondholders have the ability to “put” the bonds back to the issuer on seven days’ notice. A remarketing agent is retained to remarket any put bonds to new investors. A ready market exists for VRDBs, therefore, remarketing of the VRDBs is generally not an issue. Prior to the recession, most of the banks that held a marketable rating from the major rating agencies (e.g., Standard & Poor’s, Moody’s Investors Service and Fitch) were active issuers of letters of credit to back VRDBs, and the banks offered their letters of credit for reasonable annual fees (e.g., 1% of the total amount secured under the letter of credit).

The financial markets crisis which began at the end of 2008 virtually brought the VRDB market to a standstill. For the first time in the history of VRDBs, failed remarketings occurred and many banks stopped issuing new letters of credit for VRDBs. After the market stabilized somewhat, far fewer banks were willing to issue letters of credit to secure VRDBs and those that did charged a much higher fee for doing so (e.g., 2%-3% not uncommon). With weekly tax-exempt bond rates at historic lows (e.g., .25% in late 2009 and early 2010), some VRDBs have been issued using letters of credit from larger rated banks, but not at the volume seen in previous years.

A temporary change in law, that industry groups are hoping will be made permanent, has made another VRDB structure available to borrowers which utilizes smaller, unrated banks in combination with the Federal Home Loan Banks (“FHLBs”). With this structure, companies can go to a smaller bank that is a member of the FHLB system and can obtain a letter of credit from that bank that is “confirmed” by the FHLB (such as the Federal Home Loan Bank of Chicago). The benefit of this structure is that fees charged by the combination of the member bank and the FHLB are presently less than the fees charged by the larger rated banks. Also, VRDBs that are confirmed by the FHLB are rated “AAA” by the nationally-recognized rating agencies which results in a somewhat lower interest cost for the borrowing company.

Unless this change in law is made permanent, the authority for FHLB confirmations of VRDBs for IDBs will expire at the end of 2010. Your bond counsel will be able to advise you on the current state of affairs relating to this structure at the time you are exploring your financing options. At present, a typical “all-in” interest cost of this type of structure (taking into account the bond interest rate, FHLB fees, member bank fees and remarketing agent fees) would be in the range of 2.10%-2.625%. It is important to note that short-term interest rates are currently at historic lows. The chart shows the historical VRDB rates since 1986, with an average rate over that period of 3.32%. As the chart demonstrates, there have been rate spikes over the years (as high as 8.00% for a short time in 2008 during the financial crisis) and interest rate risk is a factor with VRDBs. Your financial advisor, banker or attorney should be able to provide you with current market conditions when you are considering a financing.

SIFMA Historic Rates – Municipal Variable Rate



1 Reflects market conditions as of January 21, 2010
 2 The Securities Industry and Financial Markets Association (SIFMA) Index (formerly the Bond Market Association or “BMA”) is calculated by taking the weighted-average of the clearing rates for a pool of high-grade tax-exempt short-term issues with weekly resets. The SIFMA Index is a widely used proxy for high-grade weekly bonds
 3 SIFMA forward rolling average represents average variable rate cost of capital from a specific point in time to present
 Source: Bloomberg Information Systems

Bank Purchased Bonds

Another common financing structure has also become more attractive due to temporary changes in the law to stimulate economic growth. Banks have been given certain favorable tax treatment in connection with their purchase of tax-exempt bonds to hold in their own portfolios. As a result of a combination of this favorable tax treatment and the disruption of the VRDB market, bank purchased bonds have become a more common financing structure for IDBs.

In essence, bank purchased IDBs function very much like a tax-exempt loan. The documentation for a bank purchased bond is less complicated than a VRDB and fewer parties are involved in the overall transaction due to the fact that this structure does not require an underwriter for the bonds, nor does it require a remarketing agent, as the bonds remain in the portfolio of the lending bank.

A typical bank purchase structure may involve a long-term final maturity date for the IDBs (e.g., 20-25 years), broken down into five year interest periods. This structure allows the bank and the borrower some flexibility in the ability to restructure the debt after each five-year interest period and offers the borrower a more attractive interest rate, as compared to a 20- or 25-year fixed rate tax-exempt loan. At present, interest rates may range from 3.75%-4.50% for this type of structure. While rates for this structure may be somewhat higher than present VRDB rates, the bank purchase structure minimizes the interest rate risk that is inherent in the VRDB structure.

At the end of each five-year interest period, the bank may have the option to “put” the bond back to the company who would need to find another lender/bondholder at that point. If the bank elected to hold onto the bond, the interest rate would adjust for the next interest period, based upon a formula (likely to be based on a percentage of treasury bonds or some similar index) that is determined at the time the bonds are initially issued.

Sample Comparison

The chart below lays out a side-by-side comparison of the various structures described in this article, based on current market information. The market changes constantly, so you should always consult your financial advisor, banker or attorney for present market conditions (this example represents a snapshot as of late January, 2010).

	Interest Rate	Bank/LOC Fee Range	Remarketing Agent Fee Range	Total Interest Cost Range
Rated Bank VRDB	.25	1.75-3.00%	.10-.120%	2.10-3.375%
FHLB VRDB	.25	1.75-2.25%	.10-125%	2.10-2.625%
Bank Purchased Bonds	3.75-4.50%	N/A	N/A	3.75-4.50%

- Notes:
- (1) Rates shown are averages based on market conditions as of January 27, 2010.
 - (2) VRDB interest rates are at historic lows. The average VRDB interest rate since 1986 is approximately 3.32%, but these rates do fluctuate.
 - (3) Bank Purchased Bond rate reflects a typical five-year interest period, subject to adjustment at five-year intervals.
 - (4) Typical terms of letters of credit are 3-5 years, subject to renewal at which time Bank fees are subject to change.

Moving Forward

There is no question that the events of the past few years have had a devastating impact on the U.S. economy and the manufacturing sector of the economy in particular. Those companies fortunate enough to have survived this economic climate have been given some additional tools worthy of consideration to finance new capital projects in this difficult credit market. As many of these programs will expire at the end of 2010, it will be important to explore your financing options as soon as practical to ensure that your financing can be completed within that timeframe.