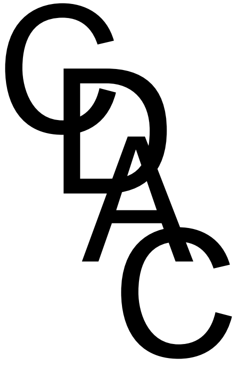

CALIFORNIA DEBT ADVISORY COMMISSION

GUIDELINES FOR LEASES AND CERTIFICATES OF PARTICIPATION

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State Treasurer and Chair

CDAC 93-8

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November 1993

To All Interested Parties:

I am pleased to announce the release of *Guidelines for Leases and Certificates of Participation* as part of the California Debt Advisory Commission's ongoing effort to assist and educate state and local officials on matters surrounding tax-exempt leasing in California. This publication constitutes the fifth document issued by the Commission on the subject of tax-exempt lease financing since 1991.

The Commission's focus on tax-exempt lease financing is attributable to its important role in financing capital facilities and equipment for public agencies in California. Because of its flexibility and market acceptance, leasing has become the financing method of choice for a growing number of governmental agencies. This ~quiet revolution" in municipal finance, however, has raised concerns as to the role of the public in deciding questions of infrastructure spending and public borrowing. I believe that this document outlines a constructive approach for making governmental leasing practices both cost-effective and accountable.

Two other aspects of this publication should be noted. First, these *Guidelines* are voluntary in nature, which not only recognizes the fiscal autonomy of state and local agencies, but also the fact that governmental leasing has been well managed to date. Second, the focus of the *Guidelines* falls predominantly on local leasing practices. Insofar as the majority of tax-exempt leasing in California is conducted locally, this focus seems appropriate.

In closing, I would like to acknowledge the efforts of the Project Team which assisted the Commission in drafting the *Guidelines:* American Government Financial Services; Government Financial Strategies; Orrick, Herrington & Sutcliffe; and Stone & Youngberg. Their research and insights added greatly to the final product.

Sincerely,

Kathleen Brown

KATHLEEN BROWN
State Treasurer and Chair

CALIFORNIA DEBT ADVISORY COMMISSION

The California Debt Advisory Commission is the State's clearinghouse for public debt issuance information. The Commission was created by the California Legislature in 1981 to assist State and local government agencies with the monitoring, issuance, and management of public debt.

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EXECUTIVE SUMMARY

Government agencies acquire needed capital assets in one of two ways: by entering into a rental agreement to obtain use, but not ownership, of the asset; or by purchasing the asset, either outright or through a financing arrangement, to obtain use and ownership. Leasing, the most malleable of financing tools, can accommodate both options. Government agencies regularly enter into operating leases, or *true* leases, to rent property such as equipment and office space. And agencies execute lease-purchase agreements, or *tax-exempt* leases, to finance not only minor equipment procurements, but also the construction or acquisition costs of major capital projects, such as schools and courthouses. In this application, tax-exempt leasing, often involving the sale of Certificates of Participation (COPs), serves as an alternative to issuing municipal bonds.

These *Guidelines* are intended to help public officials understand the promise and perils of tax-exempt leasing, and to apply this tool judiciously. The Commission chooses to promulgate voluntary *Guidelines,* rather than advocate statutory reforms, in recognition that governmental leasing in California has been well managed to date. The number of troubled financings have been relatively few, considering the volume of leasing undertaken in the state. This track record reflects not only the professionalism of elected officials and their staffs, but also the discipline imposed by the financial markets.

CHAPTER I: FINANCIAL MANAGEMENT GUIDELINES

The fine legal distinctions between *leases* and *debt* are not material to the financial considerations that should discipline governmental leasing practices. In face of competing demands for their limited general fund resources, government agencies can afford only so many long-term lease obligations. Before assuming such obligations, agencies should assess their general fund conditions and establish reasonable limits on their leasing activity. Moreover, agencies should subject leasing decisions to central planning and control procedures, to prevent the unplanned accumulation of lease obligations, which are fixed commitments that diminish needed budgetary flexibility. Observance of these review and oversight procedures can help agencies manage the financial risks posed by tax-exempt leasing.

Guideline 1: Identify the General Fund Lease Capacity

A key to successfully managing tax-exempt leasing is to identify that portion of general fund revenues which safely can be devoted to lease payments on an annual basis. This ratio, called *the general fund lease capacity*, serves as the benchmark for evaluating changes in the *actual* ratio of lease payments to general fund revenues in any year, or *the general fund lease burden*. Agencies should establish or revise their general fund lease capacities in the course of preparing their annual capital budgets. Agencies should monitor their general fund lease burdens on an ongoing basis, and evaluate tax-exempt leasing proposals in terms of their effect on this ratio. Simply stated, agencies should keep their general lease burdens within their general fund lease capacities. These ratios offer a simple but effective means of constraining long-term lease obligations, and serve as common reference points for elected officials, staff, citizens and investors.

Guideline 2: Determine the Necessity for the Proposed Project

Tax-exempt leasing offers one option for financing the construction or acquisition of capital projects. Projects financed in this manner, however, may not always receive the same review and oversight as those financed through conventional forms of debt, since leases are exempt from voter approval and other procedural requirements that apply to debt issuance. If an agency does not centralize the review and oversight of tax-exempt leasing proposals, an individual department may be able to execute a tax-exempt lease for a project that it favors, but which represents a low priority from an agencywide perspective. Projects of dubious merit are less likely to be financed through conventional forms of debt, since elected officials are reluctant to authorize such measures, or place them before the voters—who, if given the chance, are likely to reject them anyway. It is important to emphasize, therefore, that the *necessity for the project, rather than the expediency of its financing, should justify the funding decision*.

Guideline 3: Evaluate the Cost-Effectiveness of Tax-Exempt Leasing

The goal of any asset acquisition decision is to acquire the asset at the lowest possible cost. To translate this goal into policy, an agency must evaluate the *cost-effectiveness* of different procurement options. If an agency has enough cash on hand to purchase the asset outright, this evaluation is pretty straightforward — a matter of identifying the lowest price tag or bid. But if the asset is to be financed through debt or a tax-exempt lease, this evaluation is considerably more complex, involving the comparison of transaction costs and cash flows over time. Agencies should evaluate the cost-effectiveness of tax-exempt leasing for major capital projects through their capital budgeting processes. Agencies may choose to review the cost-effectiveness of smaller, more routine leasing decisions periodically, rather than on a case-by-case basis, to conserve administrative resources.

Guideline 4: Do Not Fund Operating Expenses With Long-Term Lease Obligations

Most finance professionals strongly discourage the use of long-term obligations to fund current operating expenses. Although this admonition applies to all forms of public borrowing, it is particularly relevant to leasing, which offers the only practical method of deficit financing for local agencies in California. Specifically, agencies can engineer sale-leasebacks or lease-leasebacks of existing assets to generate the cash needed to paper over an operating deficit. The well-publicized Richmond Unified School District COP default in 1991 involved just such an *asset transfer*. Deficit financing in this manner reflects an unwillingness or inability on the part of management to address the underlying discrepancy between revenues and expenditure obligations.

Guideline 5: Subject All Leases to Fiscal Controls

In order to make sound leasing decisions, agencies need financial reports which accurately reflect the scope of their leasing activity. Channeling all leases, both large or small, through centralized oversight and accounting systems allows agencies to generate such reports and serves as a check against the unplanned accumulation of general fund lease obligations. Central oversight also allows the similar spending requests of separate departments to be grouped into larger transactions or lease pools to achieve economies of scale in leasing. Typically, the finance department is best suited to this oversight role, though the cooperation of the purchasing department also is desirable.

CHAPTER II: STRUCTURING AND MARKETING GUIDELINES

After determining through the capital budget review that tax-exempt leasing offers the best financing alternative for a given project, an agency faces a number of considerations in preparing the issue for sale. Many of these considerations arise whenever an agency taps the capital markets. For any bond issue, it is necessary to (1) size the issue, (2) design a maturity structure, (3) select the method of sale, and (4) retain professional assistance. But the structuring and marketing of tax-exempt lease obligations involves additional considerations, which are addressed in this chapter. The goal of these efforts is to achieve the best financing terms possible.

Guideline 6: Incorporate Necessary Security Features

The presence of abatement risk distinguishes tax-exempt lease obligations from debt, and therefore exempts tax-exempt leasing from the procedural requirements which apply when issuing debt. But investors are not willing to extend loans subject to abatement risk merely so that governmental borrowers can avoid legal debt restrictions. To address investor concerns, government agencies should incorporate capitalized interest accounts, insurance policies and reserve funds into their tax-exempt lease offerings. By increasing the size of the borrowing, these security features represent an added cost to the governmental issuer, as all funds borrowed must be repaid with interest. These security features, however, also attract more favorable interest rates (by minimizing investor risk) and protect the issuer from certain risks, as well.

Guideline 7: Consider Earmarking General and Special Fund Repayment Sources

For certain types of projects, agencies may be able to earmark revenue sources within the broader categories of general and special funds for the payment of COPs. By internally earmarking specific general fund revenue sources for the payment of tax-exempt lease COPs, agencies can require those who benefit from a particular project to pay for it. By legally pledging certain special fund revenue sources — specifically Federal Transit Administration funds and state gas tax revenues — to the payment of installment sale COPs, agencies can capitalize revenue streams which otherwise must be spent on a pay-as-you-go basis.

Guideline 8: Do Not Rely Upon Volatile Repayment Sources

When evaluating the suitability of any revenue source for debt service payments, agencies should look for a stable history of revenue collections. Most taxes and fees are tied to tangible economic transactions which are sensitive to broader economic cycles, to varying degrees. Two types of local revenue sources exhibit a volatility which is not compatible with debt service requirements: developer impact and connection fees, and fine and forfeiture revenues. Agencies should avoid relying on these revenue sources as the primary repayment source for obligations.

Guideline 9: The Term of the Lease Should Not Exceed Useful Life of the Asset

The rationale for financing capital acquisitions through borrowing is to link the responsibility of paying for public facilities to the benefits derived from those facilities. For that reason, the term of a financing should not exceed the useful life of the asset. This general principle is all the more relevant to tax-exempt lease obligations. Because the lessee's obligation under an abatement lease is tied to the right to beneficial use and/

or occupancy of the leased asset, a lease extending beyond the useful life of the asset might not legally be enforceable. Similarly, under a nonappropriation lease, the agency's willingness to continue appropriations would be suspect during the period in which the asset was no longer available. To promote sound debt management and ensure the marketability of the obligation, agencies usually should establish a lease term shorter than the anticipated useful life of the asset.

Guideline 10: Evaluate Credit Enhancement Needs

As part of the preparations for any bond issue, agencies should evaluate the costs and benefits of obtaining credit enhancement. The two principal forms of credit enhancement — bond insurance and letters of credit — are available for tax-exempt lease obligations. Issuers of tax-exempt lease obligations also have two credit enhancement options which are not available for other types of bonds. First, agencies can structure a lease transaction as an asset transfer, thereby substituting the credit of a more essential facility and eliminating construction risk. Second, cities and counties can participate in the Credit Plus Program, a state intercept program which guarantees payment of tax-exempt lease obligations through allocations of state Motor Vehicle License Fee revenues.

Guideline 11: Solicit Competitive Bids for Small Leases

Government agencies should not simply accept the financing terms extended by equipment vendors, which sometimes carry high interest charges. To achieve the lowest possible borrowing costs, agencies instead should separate the acquisition of equipment from its financing, and solicit competitive bids for the latter. A number of institutional investors, attracted by the opportunity to earn tax-exempt interest, should respond to bid solicitations.

Guideline 12: Control the Resale of Privately Placed Leases

Privately placed leases, financed through vendors or third parties, typically include a clause permitting the lessor to sell and assign its interest in lease payments to other parties, including lease brokers, finance corporations, banks, and other institutional investors. Most tax-exempt leases sold in California, in fact, rely on such lease assignment provisions (although the largest *dollar volume* of tax-exempt leases executed in California are marketed as COPs). The lessor's decision to either retain the lease as an investment or sell and assign it to subsequent investors depends on the both its tax situation and financial capability to hold long-term receivables. As these factors are subject to change, lessors benefit from the liquidity offered by lease assignment clauses.

Governmental lessees routinely agree to lease assignment clauses without much thought, but they should insist that this language incorporate guarantees of vendor performance and specify permissible terms and conditions for *securitizing* lease obligations. Properly structured assignment clauses can benefit lessors, by providing liquidity, and lessees, by incorporating safeguards and attracting more favorable financing terms than would be available for an illiquid security.

CHAPTER III: LEGAL GUIDELINES

Although lease documentation may be presented to a government agency as mere paperwork—forms that need to be filled in, signed and filed away—a lease is, in fact, a legal contract that imposes binding obligations on the governmental lessee and other parties to the transaction. The terms and conditions specified in this "paperwork" suddenly become very important should one of the parties to the lease renege on its contractual obligations. Agencies should review lease documentation to ensure that it accurately reflects the financial terms of the transaction and that covenants do not unduly restrict governmental operations. Inappropriate lease documentation can create legal and tax problems and raise the cost of borrowing.

Guideline 13: Understand the Contractual Obligations Imposed by Lease Documents

A governmental lessee cannot rely on a vendor, underwriter, lease broker or other party to fully assess the impact of a lease agreement on its operations. Even though lease documentation may consist of standardized forms, legal provisions generally are negotiable, and the governmental borrower can insist on more favorable terms and conditions, if necessary to protect its interests. In the event that a government agency is unable or unwilling to satisfy the legal requirements of a lease, it may find itself in a state of technical default, which could lead to a more serious default and damage the agency's reputation in the securities market. Agencies should, therefore, faithfully comply with all the terms and conditions they agree to as part of lease transactions.

Guideline 14: Confirm that Lease Documents Reflect the Financial Transaction

Government agencies should review lease documentation to ensure that the specified terms and conditions accurately reflect the agreed upon financial transaction. Among other things, agencies should ensure that lease documents correctly specify the amount borrowed, the lease term and timing of payments, prepayment options, capitalized interest accounts, and insurance provisions.

Guideline 15: Review Small Lease Documentation

As part of small lease transaction, a government agency may be asked to sign lease documentation that was prepared in *boilerplate* fashion by an out-of-state firm. So-called *standard covenants* actually may violate existing covenants in other lease or borrowing documents of the government agency. Even if only small amounts of money are at stake, agencies should review small lease documentation and, if possible, gain counsel's assurance of legal compliance. Agencies also should consider developing their own documentation for small lease transactions. Such an effort would entail up-front costs, but in the long run would protect an agency from inappropriate small lease documentation.

Guideline 16: Follow Legal Formalities, Even for Small Leases

If an agency does not maintain centralized control over its leasing practices, individual departments within the agency may informally execute leases for small equipment items or other purposes. But the interest component of these lease payments may not be excludable from federal and state income taxation if certain procedural requirements are not observed. Consequently, agencies should observe, even for small lease transactions, legal formalities such as appropriate authorization, use of capitalized interest, specification of the interest component, IRS filings, and arbitrage and private activity restrictions.

CHAPTER IV: PUBLIC POLICY GUIDELINE

Public borrowing in any form entails certain risks which, if not well-managed, can invite scrutiny of the borrowing decision. Many of the constitutional and statutory provisions governing public indebtedness in California today, in fact, have their origins in bond defaults and other financial calamities of yesteryear. With few exceptions, California's experience with tax-exempt leasing has been free of the abusive and ill-conceived transactions that might spawn efforts to rein in governmental leasing powers. Still, public officials can only expect to enjoy broad latitude over tax-exempt leasing decisions as long as they observe sound financial management practices.

Public interest in governmental leasing practices also may be piqued by opposition to the capital projects financed in this manner. The construction of public facilities, after all, can profoundly affect a community's character and influence its pattern of development. Major project proposals can become divisive issues, regardless of how they are to be financed. But in such cases where elected officials choose tax-exempt leasing, which is not subject to voter approval, the public may feel shut out of an important decision. Elected officials themselves, therefore, must decide how to best demonstrate accountability for their tax-exempt leasing decisions.

Guideline 17: Solicit Public Participation in Tax-Exempt Leasing Decisions

The challenge in addressing the public policy issues raised by tax-exempt leasing lies in balancing the decision-making authority of elected officials with the desire of the public to participate in important capital spending decisions. The Commission's main concern is that public agencies solicit public participation in their tax-exempt leasing decisions. At the same time, the Commission recognizes that the relationship between local officials and voters is not uniform in each political jurisdiction throughout the state, and that local officials are in the best position to decide how to achieve the goal of public involvement. This *Guideline* discusses three constructive approaches to soliciting public participation in tax-exempt leasing decisions: (1) Schedule Public Hearings on the Capital Budget; (2) Establish a Citizens Oversight Committee on Public Finance; and (3) Consider an Advisory Vote on Controversial Projects.

CHAPTER V: SCHOOL DISTRICT GUIDELINES

This chapter presents special *Guidelines* for school districts, not because school district leases are so different from other leases, but rather that school districts operate under more restrictive financial conditions than other local governments, and face a greater degree of scrutiny of their borrowing decisions. As a consequence, certain considerations apply to school district lease financings which do not fit neatly into a more general treatment of the subject matter. School districts should follow the *Guidelines* specified in this chapter in addition to, not in lieu of, the *Guidelines* presented in the other chapters of this document.

Guideline 18: Conform to AB 1200 Criteria for Long-Term Borrowing

Among its many provisions, AB 1200 authorizes county superintendents of education to review the budgets of school districts on an annual basis. These reviews assist the state Superintendent of Schools in developing a list of financially troubled school districts each year, which are certified as *negative* (meaning that

the district will be unable to meet its financial commitments through the end of the school year) and *qualified* (which means the district will be unable to meet its obligations, unless certain events occur).

Districts certified as *negative* or *qualified* may not issue *certificates of participation, tax anticipation notes, revenue bonds, or any other debt instruments that do not require the approval of the voters of the district,* without a determination of the county superintendent of education that repayment of the obligation is probable. These criteria entail the maintenance of a Reserve for Economic Uncertainties, at specified levels, to provide a "cushion" against unforeseen events which might otherwise lead to a lease default. Although the AB 1200 criteria were promulgated for purposes of evaluating the likelihood of repayment of tax-exempt lease obligations proposed for issuance by *negative* and *qualified* school districts, the state Department of Education recommends that *all* districts voluntarily adhere to these standards. The Commission concurs with this judgment.

Guideline 19: Subject COP Bridge Loans to the Same Financial Review as Long-Term Obligations

The state Office of Local Assistance (OLA) often funds school site acquisitions years in advance of funding school construction. In the interim, districts often issue COPs with early call provisions to fund school construction. At the time State funds become available, the COPs are retired, and the district is relieved of the debt service obligation. The COPs serve as a bridge loan, akin to a bond or grant anticipation note extending over several years.

Agencies issuing COPs as bridge loans should be fully prepared to service the obligation for its full term, in the event that State funds are not forthcoming. OLA approval of district grant requests does not represent a guarantee of State funding, only an agreement to extend funding in the event State bond funds are available. Districts issuing COPs as bridge loans should, therefore, maintain budgetary reserves in accordance with the AB 1200 Criteria for Long-Term Borrowing, and adhere to the other *Guidelines* in this document.

Guideline 20: Evaluate the Marketing Implications of Noneviction Clauses

One of the remedies in the event of default frequently provided for in trust agreements for lease obligations is the right to evict the lessee for nonpayment. The right to evict the lessee provides a powerful incentive for it to continue payment. In 1991, the OLA began requiring *noneviction clauses* to be incorporated into facility leases where the underlying site was acquired through State bond funds. As its name suggests, a noneviction clause specifies that the facility lease may not permit any party to evict the district and relet or convert the facility to another use. The OLA will, upon request, consider exceptions to this policy.

The interest rate available for any tax-exempt lease or bond offering reflects the supply of, and demand for, that type of security. Of the multitude of factors which affect demand for individual securities, agencies should be aware of those which they can control, and those which they are powerless to influence. Depending upon how California school district COPs are faring in the market at any given point in time, the presence of a noneviction clause may affect the interest rate available for a new issue. In 1991, the change in OLA policy, accompanied in the same year by the Richmond USD default, soured many investors on California school district COPs, at least for a time. In preparing a tax-exempt lease offering for sale, districts should consider applying for an exception to the OLA policy if the market is demanding a premium for the noneviction clause.

INTRODUCTION

The production of government services requires a wide range of capital assets, from the massive dams and aqueducts which bring water to the desert, to the telephones and fax machines which enable routine office communications. Government agencies acquire needed capital assets in one of two ways: by entering into a rental agreement to obtain use, but not ownership, of the asset; or by purchasing the asset, either outright or through a financing arrangement, to obtain use and ownership. Leasing, the most malleable of financing tools, can accommodate both options. Government agencies regularly enter into operating leases, or *true* leases, to rent property such as equipment and office space. And agencies execute lease-purchase agreements, or *tax-exempt* leases, to finance not only minor equipment procurements, but also the construction or acquisition costs of major capital projects, such as schools and courthouses. In this application, tax-exempt leasing, often involving the sale of Certificates of Participation (COPs), serves as an alternative to issuing municipal bonds. As new financing needs emerge and market conditions change, government agencies often find that their leasing powers provide more expedient access to the capital markets than their more limited powers to incur debt.

Overview of Leasing Terms

This overview is included at the outset of this document to clarify the main leasing terms used throughout these *Guidelines*. Briefly reviewing the leasing vocabulary is no small feat, however, given the different methods of classifying leases under federal and state law — which both differ from the accounting treatment of leases. The goal of this section is to impart a working knowledge of the main leasing terms; a more exhaustive review is presented in the Glossary.[1]

Operating Lease. An operating lease, or a *true* lease, is simply a contract to rent property for a period of time shorter than the property's useful life. At the end of lease term, the property is returned to the lessor, although the lessee may reserve the option to purchase the property at various intervals for its fair market value. Unlike a tax-exempt lease, operating lease payments are not divided into principal and interest components. An operating lease is structured to compensate the lessor for use of the property, not to amortize the purchase price of the asset.

Agencies enter into operating leases for a variety of reasons. As a simple matter of economy, often it is cheaper to rent than purchase an asset, particularly if an agency is not sure that it will need the asset for more than a brief period of time. For equipment such as computers, concerns over technological obsolescence may favor an operating lease, even if purchase is affordable. Operating leases allow for a flexible approach to asset management.

For an operating lease to be a workable procurement option, a private entity first must find it profitable to manufacture or otherwise develop and market the asset. This generally is the case for personal property, such as telephones and copiers, and even real property, such as office buildings, that can accommodate the needs of diverse clients. But for many of the site-specific and highly specialized real property improvements, such as school buildings and police stations, required for the production of government services, the entire *market* may consist of a single government agency. The business

risk of privately developing facilities not easily converted to alternative uses may prove untenable. Moreover, real property improvements, whether publicly or privately developed, usually must be financed through borrowing. The cost advantage of tax-exempt borrowing afforded to public agencies often renders private development economically unfeasible. Government agencies, consequently, do not always enjoy the option of procuring needed assets through operating leases.[2]

Tax-Exempt Lease. The term *tax-exempt lease* refers quite literally to the tax treatment of the interest component of lease payments, though more generally it applies to the variety of lease-purchase agreements which allow a government agency to obtain use and ownership of capital assets. Technically, the accounting term *capital lease* more correctly identifies the range of lease-purchase arrangements which result in transfer of title to the lessee, as it is possible to transfer title to the lessee while running afoul of federal and state requirements for tax-exempt status. Most capital leases entered into by government agencies do in fact qualify for tax-exempt status, and these agreements are correctly identified as tax-exempt leases.

Tax-exempt leases are designed to avoid classification as debt for purposes of the *constitutional debt limitation* (Article XVI, Section 18 of the California Constitution), which prohibits cities, counties, school districts and boards of education from incurring indebtedness without two-thirds voter approval. This is accomplished in one of two ways. Under a *nonappropriation lease,* the government lessee reserves the right to terminate the lease simply by not appropriating funds in its budget for lease payments. In other words, the lease agreement does not automatically obligate the government lessee for a multiyear period. Under an *abatement lease,* the lease obligation is contingent upon the right to beneficial use and/or occupancy of the leased property. In other words, the lease obligation ceases if the leased property somehow is destroyed. Because neither type of lease imposes an absolute and unconditional general fund obligation, neither is classified as *debt* under state law.

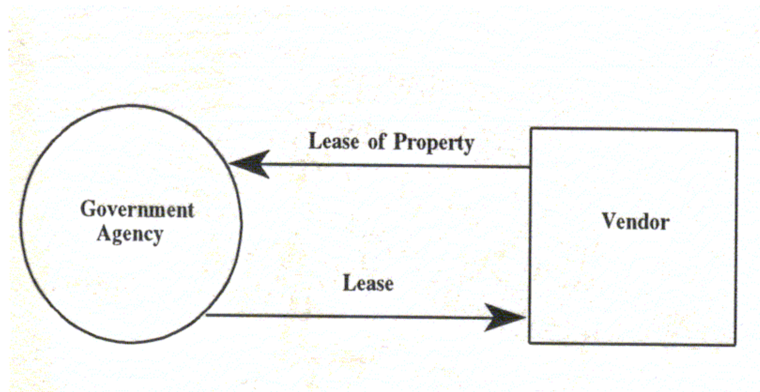
Tax-exempt leasing serves two distinct roles in governmental finance. First, tax-exempt leasing permits agencies to acquire personal property, such as automobiles and computers, that may be too expensive to purchase outright but has a useful life too short to finance through long-term bond issues. Second, tax-exempt leasing provides the legal framework for borrowing large sums of money from the capital markets to finance major capital projects. In this application, tax-exempt leasing serves as an alternative to issuing municipal bonds. Structuring a major capital project financing as a tax-exempt lease merely provides the legal authority for the borrowing to occur outside of constitutional and statutory debt restrictions. But there should be no confusion as to the essence of the transaction: a government agency is borrowing funds from investors to finance the construction or acquisition of a capital asset. The funds borrowed through the issuance of tax-exempt lease obligations must be repaid in regular installments of principal and interest, just like the funds borrowed through the issuance of municipal bonds.

As a general rule, smaller tax-exempt leases tend to involve fewer parties and less complex structures. These arrangements sometimes are referred to as *privately placed* tax-exempt leases, due to the fact that the asset acquisition is funded directly by a single or small group of investors. Because of the relatively small dollar amount involved (usually less than $1 million), there is no need to market the lease through the retail securities market to attract a large number of investors. There are two main categories of privately placed tax-exempt leases:

- ***Vendor-Financed Lease.*** Manufacturers of equipment, or *vendors,* often assume the role of lessor in tax-exempt leases to facilitate the sale of the equipment they manufacture. The vendor may hold the lease for its entire term as an investment, or sell (and assign) the lease

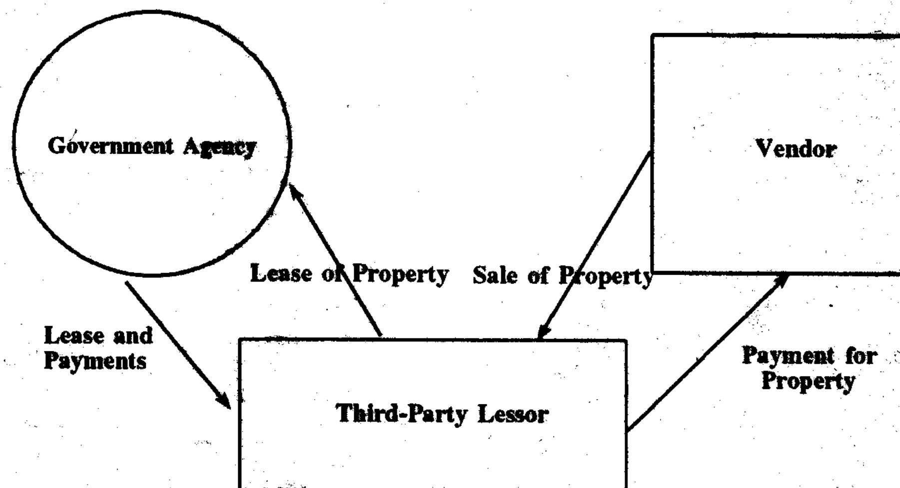
resources to cover the various expenses incurred in the manufacture of the asset (payroll, materials, etc.) without receiving immediate compensation for the full purchase price. This relatively straightforward arrangement is depicted in Figure 1.

Figure 1
Vendor-Financed Lease Structure



- o *Third-Party Financed Lease.* In a third-party financed lease, a separate entity, typically a direct investor or a lease broker, provides or arranges the financing of the leased property. The vendor receives full payment for the leased property from the third party. The third party earns tax-exempt interest income from the lease payments made by the lessee. A typical third-party tax-exempt lease financing is illustrated in Figure 2.

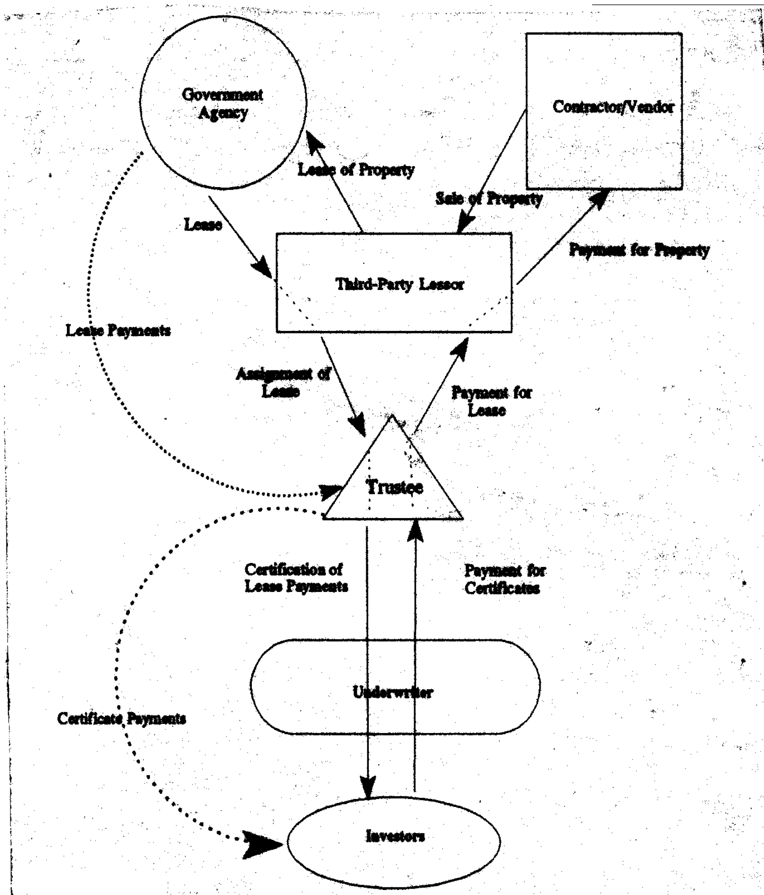
Figure 2
Third-Party Lease Structure



Certificates of Participation. When financing larger capital projects, agencies generally can lower their borrowing costs by marketing lease obligations through the retail securities market and attracting multiple investors, rather than relying on a single or small group of investors as in a privately placed lease. To reach this broad investor base, agencies issue Certificates of Participation (COPs) in tax-exempt lease obligations. COPs pay tax-exempt interest and enjoy the liquidity of a marketable security, akin to a municipal bond. Technically, a COP is a security that *evidences an undivided fractional interest* in an underlying lease or installment sale agreement. In other words, a COP entitles its owner to a proportionate share of lease (or installment sale) payments made by a government agency pursuant to a lease (or an installment sale) agreement. For all intents and purposes, COPs function like municipal bonds.

COP transactions require the professional assistance of the same municipal finance industry professionals who assist in conventional bond offerings: investment bankers, bond counsel, financial advisors, rating agency representatives, and others. Most COP transactions also require a trustee to collect and disburse lease (or installment sale) payments to multiple investors. To satisfy legal requirements, COP transactions involving tax-exempt leases require both a *lessor* and a *lessee*. A government agency may establish a nonprofit corporation to serve as the *nominal lessor* in tax-exempt lease financings, if no other agency or joint powers authority is available for this purpose. Figure 3 below depicts a typical COP offering.

Figure 3
Certificate of Participation Lease Structure



- ***Tax-Exempt Leases vs. Installment Sale Agreements.*** As noted, a COP entitles its owner to a proportionate share of payments made by a government agency pursuant to either a lease or an installment sale agreement (also known as an *installment purchase contract*). Both types of obligations fall outside of the constitutional debt limitation, but for different reasons. A lease is exempt from the debt limit because it is not an absolute and unconditional general fund obligation. (COPs in California typically evidence rights in *abatement* leases, rather than *nonappropriation* leases.) An installment sale agreement, alternatively, is an absolute and unconditional obligation in most cases, but of a *special fund,* rather than the general fund of the issuing agency. Installment sale agreements rely on the *special fund exception* to the constitutional debt limitation, rather than the *lease exception.*

  Whether an agency executes a tax-exempt lease or an installment sale agreement depends upon the project in question. Agencies typically execute tax-exempt leases to finance *nonenterprise* projects, such as schools, courthouses, jails and administration buildings. Because nonenterprise projects do not generate fee revenues, they must be financed through general fund appropriations (in the absence of a separate bond or tax measure approved for this purpose). Tax-exempt leasing offers the only way for local agencies to *leverage* (or borrow against) their general fund revenues. A city, county, or school district cannot obligate its general fund under an installment sale agreement because, as an absolute and unconditional obligation, it would violate the constitutional debt limitation. Agencies rely on installment sale agreements to finance *enterprise* projects, such as sewer and water projects, which are self-supporting through user fees (which are deposited in special funds). Installment sale agreements, as absolute and unconditional obligations, typically represent stronger credits capable of attracting more favorable interest rates than tax-exempt leases.

Lease Revenue Bonds. Lease revenue bonds are issued by a public agency, or on behalf of a public agency, to finance capital improvements which are then leased to a public agency. The bonds are secured by lease payments received from an agency other than the issuer. In a typical lease revenue bond financing, a public agency establishes a joint powers authority or nonprofit corporation which issues lease-revenue bonds to finance the construction of a public facility. The facility is then leased back to the public agency. The joint powers authority or nonprofit corporation pays debt service on the bonds from the lease payments received from the public agency. Unlike a COP financing, the bonds themselves are the tax-exempt lease obligation, not the lease. Lease revenue bonds are used less extensively than COPs because they generally must be sold at competitive sale and are subject to other restrictions which do not apply to COPs. A lease revenue bond offering looks very similar to the COP issue depicted in Figure 3.

Historical Development of Tax-Exempt Leasing in California

Tax-exempt leasing is unique as a form of public finance in that it evolved primarily through the courts, rather than the Legislature. A series of court cases in the 1940s and 1950s, collectively referred to as the *Offner-Dean* line of cases, established the principle that a binding long-term lease with vesting of title at the end of the term does not create debt subject to the two-thirds voter approval requirement of the State Constitution.[3] The courts reasoned that lease obligations, unlike debt, are contingent upon the continued use and/or occupancy of the leased property, and consequently do not represent a pledge of future revenues. But in a financial sense, a long-term lease which results in the transfer of title is not so much a *lease* as a *loan*, which must be repaid in regular installments of principal

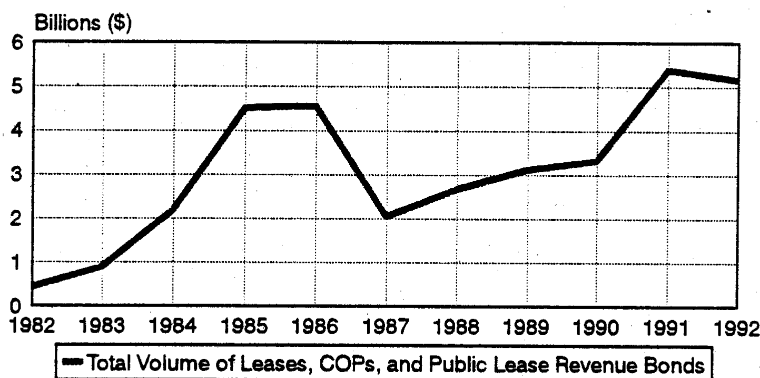
and interest, just like a municipal bond. By establishing the validity of long-term leases, the courts provided the legal underpinning for the eventual expansion of leasing into the capital finance function traditionally undertaken through municipal bonds. The bond market would devise security features to protect investors from the risk posed by the contingent nature of lease obligations.

In the 1960s and 1970s, the California Legislature enacted statutes authorizing the issuance of lease revenue bonds for various purposes. From the 1960s through the early 1980s, nonprofit corporations and joint powers authorities acting *on behalf of* public agencies issued lease revenue bonds to finance the construction of a number of public facilities throughout the state, including the Los Angeles Music Center and the Oakland-Alameda County Coliseum. During the 1970s, lease revenue bonds also were the linchpin of school facility finance in California. The Legislature authorized school districts to establish nonprofit corporations for the purpose of issuing lease revenue bonds to finance the construction of schools, which were then leased back to school districts. To meet these obligations, school districts were authorized to raise property taxes, subject to majority vote. This arrangement afforded school districts a realistic alternative to local general obligation bonds requiring two-thirds voter approval. (Due to the fact school enrollments declined during the 1970s, relatively few schools were built under these provisions.)

A more prominent role for tax-exempt leasing in California public finance emerged from a series of political and economic events beginning in the late 1970s, which curtailed traditional funding sources and shifted new responsibilities to local governments. Proposition 13 in 1978 effectively eliminated the general obligation bonding authority of local governments, by capping ad valorem property tax rates at one percent of assessed value. In the early 1980s, the federal government cut back sharply or eliminated many of its grant programs (such as general revenue sharing) which had supported numerous local projects during the 1960s and 1970s. As a consequence, local governments assumed new responsibilities for financing water and sewer projects needed for compliance with federal environmental regulations. The issuance of enterprise revenue bonds for these purposes was hampered by historically high interest rates which, in many cases, exceeded statutory interest rate ceilings. To address the void in local financing alternatives, agencies began to explore the possibilities of lease financing — initially, through the expanded issuance of lease revenue bonds, and later, through the development of COPs.

In 1986, when Proposition 46 restored local general obligation bonding authority, local agencies issued $4.5 billion in COPs, second only to public enterprise revenue bonds ($5.7 billion) in terms of long term borrowing that year.[4] The restoration of general obligation bonding authority would not profoundly change local borrowing practices, however, as a public inclined toward anti-tax and anti-growth sentiments would not readily approve bond measures by a two-thirds majority. Figure 4 illustrates the dramatic growth of tax-exempt leasing by local governments in California during the period from 1982 through 1992.

Figure 4
Local Agency Tax-Exempt Leasing
1982-1992



The Quiet Revolution in Public Finance

It should not be surprising that the tax-exempt leasing phenomenon started in California, or that California continues to account for a disproportionate share of the nation's tax-exempt leasing activity. California is one of only a handful of states that requires supermajority voter approval of local general obligation bonds. Tax-exempt leasing permits local agencies to circumvent this prohibitive barrier and build needed schools, jails, courthouses and other public facilities. California also has enacted some of the most stringent environmental standards in the nation, which translate into substantial outlays for infrastructure, parks and open space. And until recently, California's economic growth outpaced that of the nation as a whole, which led to development booms that strained the capacity of existing infrastructure and created demands for new facilities.

The emergence of tax-exempt leasing in California represents nothing short of a revolution in public finance, a shift in public borrowing practices notable in both a financial and political sense. The distinguishing feature of tax-exempt leasing is that it allows agencies to finance capital projects by *leveraging* general fund revenues, rather than raising new taxes. In this era of fiscal austerity, the leveraging of existing resources has become important, for financing not only major capital projects, but also routine equipment items which once were financed on a cash basis. Even if political events over the past fifteen years had taken shape somewhat differently, tax-exempt leasing probably still would have gained in prominence, as the same underlying economic conditions would have constrained governmental revenue growth.

If the emergence of tax-exempt leasing represents a revolution in public finance, it has been a quiet revolution, largely unnoticed outside the confines of the public finance industry. To the extent that individuals or groups have braved the impervious jargon of leasing for a closer look, they have expressed concerns over how tax-exempt leasing permits government agencies to circumvent voter approval requirements and other legal debt restrictions.[5] Yet the fact that tax-exempt leasing involves leveraging general fund revenues, rather than raising new taxes, in many ways justifies the great discretion afforded public officials in these matters.

These *Guidelines* are intended to help public officials understand the promise and perils of tax-exempt leasing, and to apply this tool judiciously. The Commission chooses to promulgate voluntary *Guidelines,* rather than advocate statutory reforms, in recognition that governmental leasing in California has been well managed to date. The number of troubled financings have been relatively few, considering the volume of leasing undertaken in the state. This track record reflects not only the professionalism of elected officials and their staffs, but also the discipline imposed by the financial markets.

NOTES

1. In addition to the Glossary, Chapter 1 of the publication *Leases in California: Their Form and Function* (CDAC 1991) includes more substantive discussions of the different types of tax-exempt leases. This publication was prepared for CDAC by the firms of Transocean Funding, Cole & Associates, Gaston & Snow, and Public Resources, Inc., and is available from the Commission upon request.

2. It is worth noting that many economists advocate privatizing government assets which are in fact highly specialized and site-specific, such as airports and highways. Privatizing allows government agencies to generate cash by selling an existing asset (or the right to construct such an asset) to a private entity, which operates the asset and earns a profit. Or, the government agency can continue to operate the asset by leasing it back from the private entity. In general, privatizing works best for those assets where it is possible to charge for use of the asset (through airport landing fees and tolls in the example cited above), as long as the government agency protects against monopoly pricing. But one major problem with privatizing is that it jeopardizes the tax-exempt status of any municipal bonds (or tax-exempt leases) issued to finance the construction or acquisition of the asset.

3. For a more complete discussion of the *Offner-Dean* line of cases, refer to *Leases in California: Their Form and Function*, pp 2-1 to 2-5. California Debt Advisory Commission, 1991.

4. Source: *Annual Report 1986: Summary of California Public Debt,* CDAC. The COP total includes both tax-exempt lease and installment sale COPs.

5. See summary of various county grand jury reports in *Chapter IV: Public Policy Guideline*, page 43.

Chapter I

FINANCIAL MANAGEMENT GUIDELINES

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Guideline 2:	**Determine the Necessity for the Proposed Project**	**13**
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Government agencies in California retain a great deal of discretion over their leasing practices, by virtue of the lease exception to the constitutional debt limitation. But the fine legal distinctions between *leases* and *debt* are not material to the financial considerations that should discipline governmental leasing practices. In face of competing demands for their limited general fund resources, government agencies can afford only so many long-term lease obligations. Before assuming such obligations, agencies should assess their general fund conditions and establish reasonable limits on their leasing activity. Moreover, agencies should subject leasing decisions to central planning and control procedures, to prevent the unplanned accumulation of lease obligations, which are fixed commitments that diminish needed budgetary flexibility. These review and oversight procedures, though not dictated by law, allow agencies to manage the financial risks posed by tax-exempt leasing.

Incorporating Tax-Exempt Leases Into The Capital Budget

As a general rule, the degree of review and oversight appropriate for leasing decisions corresponds to the financial obligation imposed by the lease. Many small equipment and vendor leases, for example, impose only modest financial obligations on governmental lessors. Rather than subject each vendor lease transaction to an extensive review, an agency might choose to establish an equipment procurement policy specifying permissible acquisitions and methods of financing. A major tax-exempt lease, by contrast, may rank among an agency's largest financial obligations. Clearly, every major tax-exempt leasing proposal warrants an added degree of scrutiny. Rather than establish a separate administrative framework for this purpose, agencies should incorporate major tax-exempt leasing proposals into their capital budgets and evaluate them according to the same criteria applied to other capital spending proposals. By incorporating tax-exempt leasing proposals into their capital budgets, agencies can ensure that (1) sufficient funds will be available to honor all obligations incurred, (2) projects are funded according to priority, and (3) the cost-effectiveness of funding alternatives is evaluated.

If only major tax-exempt leases merit project-by-project review through the capital budget, agencies need to distinguish between tax-exempt leases for this purpose — a classification problem that can prove to be more complicated than it sounds. For budgeting purposes, government agencies differentiate capital from operating expenses on the basis of the *cost* and *frequency* of the expense. *Cost* is a relative criterion, a function of the size of the government

agency in question. For a small agency, a single automobile purchase may represent a substantial outlay, warranting its inclusion in its capital budget. A larger agency probably would choose to evaluate its overall fleet procurement strategy periodically, rather than subject individual vehicle purchases to such an analysis. *Frequency* refers to the replacement cycle of the item: capital items must have a useful life of at least one year. But as with cost, each agency needs to establish a standard to its liking. The demarcation of *capital* and *operating* expenses for budgeting purposes, consequently, is a function of the tangible qualities of the asset, rather than its method of financing.

Incorporating tax-exempt leases into capital budgets should, therefore, be a straightforward matter: lease-financed projects which exceed the agency's threshold of *cost* and *frequency* should be included in the capital budget, lease-financed projects falling below the threshold should not. But the legal and accounting treatment of leases can contribute to a certain amount of budgeting confusion, and result in reduced oversight of tax-exempt leasing decisions. The mere fact that lease obligations, even those underlying major COP issues, are not classified as *debt* under State law may cause staff to budget all lease payments as operating expenses, thereby eluding the capital budget review altogether. Although accounting standards distinguish between *capital* and *operating* leases, this accounting distinction is not useful for capital budgeting purposes, since it is based on the transfer of title or ownership, rather than on the *cost* and *frequency* of the capital expense.[1] A capital lease, for example, might finance the construction of a county jail, which clearly would fall under the purview of the capital budget, or it might finance the purchase of a copying machine, which might not. A standardized accounting definition cannot possibly serve the capital budgeting needs of diverse government agencies.

Consequently, the capital budget need not review *all* tax-exempt leases, only those financing *capital* projects (as defined by each agency). The capital budget clearly should cover all large, tax-exempt lease obligations issued in lieu of bonds. But the capital budget might not include smaller tax-exempt leases; nor will it include operating leases. Leases which fall outside of the capital budget, however, should not be immune from review and oversight. Government agencies periodically should review the cost-effectiveness of their more routine leasing decisions, and evaluate alternatives such as pay-as-you-go financing, master leasing, lease lines of credit, and lease pools (see *Guideline 3: Evaluate the Cost-Effectiveness of Tax-Exempt Leasing*).

Overview of Chapter I Guidelines

The first three *Guidelines* in this chapter address the principal financial management, or debt management, issues raised by tax-exempt leasing. Each of these *Guidelines* can be incorporated into a broader capital budgeting framework. *Guideline 1: Identify the General Fund Lease Capacity* recommends that agencies identify a maximum percentage of their general fund revenues which safely can be devoted to lease payments on an annual basis. This exercise serves as a simple but effective means of setting limits on long-term lease obligations. *Guideline 2: Determine the Necessity for the Proposed Project* reminds agencies that the necessity for a project, rather than the expediency of its financing, should justify the funding decision. Finally, *Guideline 3: Evaluate the Cost-Effectiveness of Tax-Exempt Leasing* discusses in general terms how to evaluate the cost-effectiveness of tax-exempt leasing for both equipment procurements and major real property improvements. This *Guideline* recognizes, however, that the financing decision may turn on expediency, rather than cost.

Guideline 4: Do Not Fund Operating Expenses With Long-Term Lease Obligations reiterates a fundamental principle of public finance that is particularly relevant to tax-exempt leasing, which offers the only practical method of deficit financing for local agencies in California. To conclude this chapter, *Guideline 5: Subject All Leases to Fiscal Controls* recommends that agencies subject all leases, large and small, to central oversight and accounting procedures. Central oversight of leasing serves as a check against the unplanned accumulation of lease obligations. Central accounting procedures enable agencies to generate financial reports which accurately reflect the scope of their leasing activity. This information is needed to evaluate the cost-effectiveness of routine leasing practices.

Guideline 1: Identify the General Fund Lease Capacity

Government agencies should identify a maximum percentage of general fund revenues which safely can be devoted to lease payments on an annual basis.

The principal objective of capital budgeting is to reconcile capital spending needs with available resources. With respect to tax-exempt leasing, the general fund is the *resource* in question. A key to successfully managing tax-exempt leasing, therefore, is to identify that portion of general fund revenues which safely can be devoted to lease payments on an annual basis. This ratio, called *the general fund lease capacity*, serves as the benchmark for evaluating changes in the *actual* ratio of lease payments to general fund revenues in any year, or *the general fund lease burden.*[2] Agencies should establish or revise their general fund lease capacities in the course of preparing their annual capital budgets. Agencies should monitor their general fund lease burdens on an ongoing basis, and evaluate tax-exempt leasing proposals in terms of their effect on this ratio. Simply stated, agencies should keep their general lease burdens within their general fund lease capacities. These ratios offer a simple but effective means of constraining long-term lease obligations, and serve as common reference points for elected officials, staff, citizens and investors.

Forecasting General Fund Expenditures and Revenues

The task of identifying the general fund lease capacity is by no means an exact science, though quantitative analysis should be brought to bear upon the question. To gauge the affordability of long-term lease obligations, agencies should develop long-term forecasts of general fund expenditures and revenues. (In many cases, such forecasts are prepared in conjunction with the development of the operating budget.) By comparing projections of general fund expenditures and revenues, agencies can estimate how much money will be available for discretionary purposes — specifically, the payment of lease obligations.

Expenditure forecasts should review the growth of various spending categories relative to one another, and to revenues. Labor costs, which comprise the largest chunk of spending for most government agencies, deserve close scrutiny. Other spending obligations vary by type of agency. County governments, for example, are mandated by the federal and state governments to provide various health and welfare services, even if the cost of doing so increases faster than

revenues and necessitates cutbacks in other areas. By annually forecasting general fund expenditures, agencies can isolate cost pressures which might threaten the availability of funding for lease payments.

Revenue forecasting is more grounded in statistical analysis than expenditure forecasting, because revenue collections are more a function of measurable variables than unpredictable budgeting decisions. Revenue forecasting techniques range from simple trend analysis (annual percentage change) to econometric models which measure the sensitivity of the tax base to the general business cycle, demographic trends, and changes in tax policy. Whatever technique employed, revenue forecasts should distinguish between those revenues earmarked for specific programs, and those available for discretionary purposes. County governments, to continue the example above, receive a significant portion of their general fund revenues in the form of federal and state grants earmarked for the aforementioned health and welfare programs. To a lesser extent, cities and nonenterprise special districts earmark general fund revenues for specific programs. Cities and counties receive most of their discretionary revenue from property tax, sales tax, and general purpose state grant revenues, principally vehicle license fees. By annually forecasting general fund revenues, agencies can identify poorly performing tax sources and explore revenue-raising alternatives.

Comparing projected levels of general fund expenditures and revenues gives a preliminary indication of how much revenue will be available for discretionary purposes during the forecast period. Agencies should recognize that certain unavoidable expenditures—principally labor costs and the unfunded portion of federal and state mandates—are paid out of so-called discretionary revenue sources. Consequently, agencies need to identify that portion of discretionary revenues which *truly* will be available for discretionary purposes. Only then does an agency have the information necessary to reasonably determine its general fund lease capacity.

There Is No Magic Number

In establishing the general fund lease capacity, it makes sense to err on the side of caution. Even the most sophisticated revenue forecasting techniques cannot anticipate political decisions which can profoundly affect revenue collections, such as the shifts in property tax revenues from local governments to school districts enacted in the 1992-93 and 1993-94 State budgets. Ideally, agencies also should set aside anywhere from 2 to 5 percent of their general fund revenues in an unrestricted reserve, to guard against unforeseen emergencies.[3] Funding such a reserve, of course, leaves less money available for lease payments. Most agencies do not permit their general fund lease capacities to exceed *6 to 8 percent* of their general fund revenues, but resource constraints usually keep the lease capacity below that range. In any event, the exact ratio chosen for the general fund lease capacity is not as important as the agency's overall plan for reconciling its capital spending needs to available resources.

Agencies should remember that they have two ways to fund capital outlays from general fund revenues: pay-as-you-go financing and tax-exempt leasing. The analysis required to surmise the affordability of either option essentially is the same — that is, identifying the pool of truly discretionary general fund revenues, and establishing priorities for the disposition of those revenues. If this analysis indicates that an agency can afford to devote more than *5 percent* of its general fund revenues to lease payments, it should consider paying for more capital outlays on a cash basis, to reduce interest expenses. Alternatively, agencies will gravitate more toward

tax-exempt leasing to the extent that resources constraints necessitate leveraging the general fund to address unmet capital needs. Consequently, it makes sense to evaluate these two options in tandem.

In some respects, the concept of a *general fund lease capacity* over simplifies the debt management task. There is no magic number. There is no reason why an agency can safely devote, say, 3 percent of its general fund revenues to lease payments, but not 4 percent. Because lease obligations are paid from general fund revenues, the risk of default can arise from any event which erodes an agency's general fund condition, not just from an excessive lease burden, or problems with an individual lease. But the very planning effort required to establish the general fund lease capacity makes an agency less vulnerable to unforeseen developments which might threaten the integrity of its lease obligations. Projecting general fund expenditures and revenues on an annual basis should alert agencies to rapidly escalating program costs and poorly performing revenue sources. This advance warning should give agencies time to make necessary adjustments. The main benefit of establishing the general fund lease capacity lies not in the ratio itself, but in the planning effort required to develop that ratio.

Guideline 2: Determine the Necessity for the Proposed Project

The necessity for the project, rather than the expediency of its financing, should justify the funding decision.

Tax-exempt leasing offers one option for financing the construction or acquisition of capital projects. But projects financed in this manner may not always receive the same review and oversight as those financed through conventional forms of debt, since tax-exempt leases are exempt from voter approval and other procedural requirements for issuing debt. If an agency does not centralize the review and oversight of tax-exempt leasing proposals, an individual department may be able to execute a tax-exempt lease for a project that it favors, but which represents a low priority from an agencywide perspective. Projects of dubious merit are less likely to be financed through conventional forms of debt, since elected officials are reluctant to authorize such measures, or place them before the voters—who, if given the chance, are likely to reject them anyway. It is important to emphasize, therefore, that the *necessity for the project, rather than the expediency of its financing, should justify the funding decision.*

Prioritizing Capital Projects

A credible capital budgeting effort develops and prioritizes capital spending proposals in a logical and methodical manner. First, staff inventories the existing capital stock and assesses its condition, to generate a list of maintenance and replacement projects. Next, staff identifies any new facilities and expansions needed to accommodate population growth and maintain desired service levels. Staff then identifies any new facilities or upgrades needed to comply with federal and state regulations. Finally, staff adds discretionary projects to the list at the request of elected officials and the general public. Staff then ranks these proposals according to criteria such as fiscal impact, health and safety effects, economic development potential and environmental impact. Projects are funded in order of this ranking, subject to the availability of funds.

Project Essentiality

In considering the suitability of tax-exempt leasing for any of the projects identified through the capital budget review, the capital project *itself* should be an important consideration. To compensate for the conditional nature of lease obligations, investors and rating agencies prefer to see tax-exempt leases executed for facilities required for the delivery of *essential* government services, such as police and fire protection, rather than for discretionary facilities, such as convention centers and museums. The investment community believes, not without reason, that government agencies are more likely to honor lease obligations involving essential government property. In the leasing vocabulary, this credit consideration is referred to as *project essentiality*.

Guideline 3: Evaluate the Cost-Effectiveness of Tax-Exempt Leasing

Government agencies should evaluate the cost-effectiveness of tax-exempt leasing relative to other financing alternatives, and keep in mind that non-cost factors may influence the financing decision.

The goal of any asset acquisition decision is to acquire the asset at the lowest possible cost. To translate this goal into policy, an agency must evaluate the *cost-effectiveness* of different procurement options. If an agency has enough cash on hand to purchase an asset outright, this evaluation is pretty straightforward — a matter of identifying the lowest price tag or bid. But if an asset is to be financed through debt or a tax-exempt lease, this evaluation is considerably more complex, involving the comparison of transaction costs and cash flows over time.[4] Agencies should evaluate the cost-effectiveness of tax-exempt leasing for major capital projects through their capital budgeting processes. Agencies may choose to review the cost-effectiveness of smaller, more routine leasing decisions periodically, rather than on a case-by-case basis, to conserve administrative resources. This review can be conducted either in conjunction with the capital budget, or separately.

Small Equipment and Vendor Leases

Government agencies should not lease small equipment items out of habit. Alternative procurement strategies may be both economical and feasible. By paying for certain equipment items out of current revenues, agencies can avoid interest charges altogether. Where tax-exempt leasing is preferable, agencies should explore alternatives to executing separate leases for each acquisition. Specifically, agencies should evaluate the potential for cost savings through master leases, lease lines of credit and lease pools.

Pay-As-You-Go Financing. A basic tenet of debt management is to avoid unnecessary borrowing. By paying for capital expenses out of current revenues, agencies can avoid interest charges and minimize the administrative chores associated with debt management. Although usually it is not feasible to finance large capital projects out of current revenues, the same is not

true for many of the relatively minor equipment items often financed through leases, such as computers, copying machines and telephones. If an agency's administrative overhead is large enough for its equipment outlays to recur on a predictable basis, it may be able to shift to a pay-as-you-go financing scheme for at least some of these items.

Master Leases. A master lease permits an agency to acquire different pieces of real and personal property under one lease contract. By accepting competitive bids for financing under a master lease agreement, an agency may be able to arrange much better terms than would be possible through a series of small vendor lease transactions. Outstanding leases also may be consolidated under a master lease agreement. Apart from financial considerations, master leasing relieves an agency from the administrative burden of arranging financing for each acquisition, and allows it to coordinate the leasing activities of different departments.[5]

To evaluate the financial benefits of master leasing, an agency should compare interest rates and transaction costs under stand-alone leases to those under a master lease. An agency should review its financial reports for information on its past leasing practices, which can serve as the basis for projecting its future leasing needs. Interest rate and transaction cost information can be obtained from investment banking and financial advisory firms.

Lease Lines of Credit. A lease line of credit offers another alternative to arranging financing for individual leases. A lease line of credit offers financing on demand under a fixed or floating interest rate. The specific assets to be financed are not identified at the time the line of credit is negotiated, although lender and borrower agree as to the types of assets eligible for financing. A lease line of credit may be arranged with or without a master lease agreement. As in the case of master leasing, the cost-effectiveness analysis should focus on a comparison of interest rates and transaction costs relative to a series of stand-alone transactions.

Lease Pools. Another alternative to arranging financing for individual leases is to participate in a lease pool sponsored by one of several statewide associations, such as the California State Association of Counties (CSAC), the California School Boards Association (CSBA), the California Special Districts Association (CSDA), and the Association of Bay Area Governments (ABAG). Typically, these associations create a subsidiary to serve as the nominal lessor and issue COPs or lease revenue bonds serviced through lease agreements with participating agencies. As with the other two alternatives, the cost-effectiveness evaluation of participating in a lease pool should focus on a comparison of interest rates and transaction costs relative to stand-alone issuance. In most cases, pooling is more advantageous for small leases under $1 million. The credit quality of any agency's prospective lease offerings, relative to that of the pool, is an important determinant of potential savings. To protect against risk, investors price pool securities according to the *weakest link*, or the least secure underlying obligation in the pool. To the extent that an agency's prospective lease offerings would receive higher credit ratings than that of the pool, the benefit of reduced issuance costs may be offset by a higher interest rate than would be available under stand-alone issuance.

Tax-Exempt Leases for Major Capital Projects

Agencies should perform a cost-effectiveness evaluation of the financing alternatives for each project candidate identified through the capital budget review. The financing alternatives for major capital projects include current revenues, debt, intergovernmental grants and tax-

exempt leasing. Pay-as-you-go financing is cheaper than borrowing, as noted above, since it avoids interest charges altogether. But most governmental budgets have limited room to absorb large one-time capital outlays. Intergovernmental grants, though always welcome, have become increasingly scarce in this era of fend-for-yourself federalism. Consequently, the cost-effectiveness evaluation usually reduces to an analysis of borrowing alternatives. In practice, this evaluation entails a *present value cost analysis* — discounting to present value all initial and continuing costs arising from the financing. The discount rate used in the present value analysis is the expected interest rate on the borrowing, otherwise known as the *cost of capital*. All things being equal, the most cost-effective financing option should be chosen.

Tax-Exempt Leases versus General Obligation Bonds. For nonenterprise (nonrevenue producing) projects which provide a general benefit to the community — projects such as schools, administration buildings, courthouses and jails, tax-exempt leasing and general obligation (G.O.) bonds may offer the only financing alternatives.[6] The general obligation bond alternative usually will win this cost-effectiveness evaluation hands-down. For starters, general obligation bonds receive an agency's highest credit rating, reflecting the security of the full faith and credit pledge. Tax-exempt lease obligations typically are rated a single category below an agency's general obligation bond rating, which translates into higher interest rates. In addition, tax-exempt leasing requires a larger borrowing to fund the reserve, capitalized interest account, and insurance premiums — none of which is required in a general obligation bond offering. Finally, tax-exempt leasing entails higher issuance costs, because of added legal work and higher underwriting spreads (G.O. bonds typically are sold through competitive sale, which entails a less aggressive and costly underwriting effort). But the prohibitive barrier posed by the two-thirds voter approval requirement often renders the general obligation bond alternative unworkable. Pragmatism, rather than price, may dictate the choice of tax-exempt leasing.

For certain types of projects, tax-exempt leasing may offer simply the best financing choice, notwithstanding the feasibility of other options or the added costs involved. Suppose, for example, that an agency could save money by constructing an office building, rather than continuing to rent office space throughout town. Even if the project could be financed through general obligation bonds, doing so would impose an unnecessary tax increase on the public. After all, when voters approve local general obligation bond measures, they authorize not only new debt, but also the property tax override needed to secure that debt. Instead, the agency could finance the office building through a tax-exempt lease, paid for with the funds previously budgeted for rent. The higher borrowing costs under tax-exempt leasing would be preferable to the unnecessary tax increase imposed under the general obligation bond alternative.

In summary, agencies should evaluate the cost-effectiveness of tax-exempt leasing, but remain aware of the shortcomings of this analysis as a decision-making tool. Upon choosing tax-exempt leasing, however, agencies should make every effort to minimize their borrowing costs through the intelligent structuring and marketing of the lease obligation (as discussed in *Chapter II: Structuring and Marketing Guidelines*).

Guideline 4: Do Not Fund Operating Expenses With Long-Term Lease Obligations

The proceeds from the issuance of lease obligations should not be used for deficit financing.

Most finance professionals strongly discourage the use of long-term obligations to fund current operating expenses. Although this admonition applies to all forms of public borrowing, it is particularly relevant to leasing, which offers the only practical method of deficit financing for local agencies in California. Specifically, agencies can engineer sale-leasebacks or lease-leasebacks of existing assets to generate the cash needed to paper over an operating deficit. The well-publicized Richmond Unified School District COP default in 1991 involved just such an *asset transfer*. Deficit financing in this manner reflects an unwillingness or inability on the part of management to address the underlying discrepancy between revenues and expenditure obligations.

Restructuring Governmental Obligations

In rare instances, an asset transfer, or the pledge of future lease revenues where a government agency is lessor, may be executed as part of a *workout* strategy for a fiscally troubled agency. If this approach permits an agency both to retire existing debts and correct an imbalance between expenditures and revenues, it may be advisable. Nonetheless, borrowing should not substitute for difficult budget-balancing decisions.

Guideline 5: Subject All Leases to Fiscal Controls

Government agencies should subject all leases to centralized oversight and accounting procedures.

In order to make sound leasing decisions, agencies need financial reports which accurately reflect the scope of their leasing activity. Channeling all leases, both large and small, through centralized oversight and accounting systems allows agencies to generate such reports and serves as a check against the unplanned accumulation of general fund lease obligations.

Central Oversight of Leasing

The ease with which government agencies can execute lease transactions can lead to disjointed leasing practices. In a municipal government, for example, the police, fire, public works, and parks departments may independently enter into lease obligations without central review. Although the financial commitment imposed by each lease may be modest, an accumulation of such obligations may represent a significant general fund burden. The problem with decentralized leasing practices arises from the long-term nature of lease obligations, not with individual departments exceeding their budget authority in any single year. If a fiscal crisis necessitates major budget cuts — or even the wholesale elimination of departments — elected

officials may find their range of options limited by long-term lease agreements executed at the departmental level. Channelling leases through a central oversight department acts as a check on the accumulation of multiyear spending commitments. Central oversight also allows the similar spending requests of separate departments to be grouped into larger transactions or lease pools to achieve economies of scale in leasing. Typically, the finance department is best suited to this oversight role, although the cooperation of the purchasing department also is desirable.

Accounting and Financial Reporting

As previously mentioned, the different treatments of leases under accounting standards, federal and state law, and local capital budgeting practices can be confusing. For accounting purposes, government agencies should adhere to Generally Accepted Accounting Principles (GAAP), and more specifically, Financial Accounting Standards Board Statement 13, which requires that both the principal and interest portions of lease payments be recorded as debt service expenditures, and that the outstanding liability for the lease obligation be reduced with each lease payment by the principal amount of the payment.

The correct accounting treatment of leases allows agencies to generate accurate financial reports, which advances several financial management objectives. Accurate financial reports permit the ongoing monitoring of the cumulative general fund lease burden, the key financial management (i.e., *debt management*) indicator. Accurate information on the volume and type of leasing activity allows administrative staff to evaluate the feasibility of alternatives such as master leases, lease lines of credit, and lease pools. Finally, accurate financial reports allow staff to determine whether rate increases are needed to maintain coverage ratios (above operations, maintenance and debt service expenses) for installment sale agreement COPs issued for government enterprise projects.

NOTES

1. Financial Accounting Standards Board Statement 13. See "Capital Leases," pages 25-26 in *Governmental Accounting, Auditing and Financial Reporting*. Chicago: Government Finance Officers Association, 1988.

2. The ratio of lease payments to general fund revenues is one part of the broader ratio of debt service payments to general fund revenues (or expenditures) used for credit rating purposes. It is possible to shift the composition of borrowing toward or away from leasing without affecting this broader measure. The narrower measure focuses more exclusively on the ability of the general fund to support lease obligations.

3. Under the provisions of AB 1200, school districts may be *required* to maintain certain ratios of unrestricted general fund reserves. *Guideline 18: Conform to AB 1200 Criteria for Long-Term Borrowing* recommends that districts adhere to these standards even when they are under no obligation to do so. See *Chapter V: School District Guidelines*, pp. 53.

4. Evaluating the cost-effectiveness of lease-purchase options involving different terms and interest rates requires the application of formulas which are not presented here. For a thorough treatment of this more technical material, please refer to "Cost Calculations for Lease-Purchase Decisions" (Chapter 8) in *A Guide to Municipal Leasing*, John Vogt and Lisa Cole, eds. Chicago: Municipal Finance Officers Association, Government Finance Research Association, 1983.

5. A more detailed explanation of master leases, including a schematic diagram, can be found in the CDAC publication *Leases in California: Their Form and Function*, pp 1-16 through 1-18.

6. See discussion in *Chapter IV: Public Policy Guideline*, under the heading "Impact of Debt Restrictions on Tax-Exempt Leasing Practices," pp. 41-42.

Chapter II

STRUCTURING AND MARKETING GUIDELINES

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After determining through the capital budget review that tax-exempt leasing offers the best financing alternative for a given project, an agency faces a number of considerations in preparing the issue for sale. Many of these considerations arise whenever an agency taps the capital markets. For any bond issue, it is necessary to (1) size the issue, (2) design a maturity structure, (3) select the method of sale, and (4) retain professional assistance. But the structuring and marketing of tax-exempt lease obligations involves additional considerations, which are addressed in this chapter. The goal of these efforts is to achieve the best financing terms possible.

Overview of Chapter II Guidelines

In California, tax-exempt leases executed for major capital projects include an *abatement clause* — that is, the lease obligation is contingent upon the right to beneficial use and/or occupancy of the leased property. The risk of abatement, however, is incompatible with the investment objectives of most investors in municipal securities, who are a conservative, risk-averse group. To address investor concerns, *Guideline 6: Incorporate Necessary Security Features* recommends that agencies follow industry practice and incorporate security features which minimize abatement risk into their tax-exempt lease obligations.

Guidelines 7 through *10* address additional considerations relevant to the financial structure of tax-exempt lease obligations. *Guideline 7: Consider Earmarking General and Special Fund Repayment Sources* describes how *earmarking* certain revenue streams for the repayment of tax-exempt leases and installment sale agreements can, in certain instances, advance both policy and financial objectives. In evaluating the suitability of different revenue sources for the payment of lease obligations, *Guideline 8: Do Not Rely on Volatile Repayment Sources* recommends that agencies avoid those exhibiting a volatility incompatible with debt service requirements. *Guideline 9: The Term of the Lease Should Not Exceed the Useful Life of the Asset* reiterates a general debt management principle that is particularly relevant to leasing, as lease agreements which extend past the useful life of an asset may not legally be enforceable. Finally, *Guideline 10: Evaluate Credit Enhancement Needs* advises agencies to evaluate the costs and benefits of obtaining not only bond insurance and letters of credit, but also two low-cost credit enhancement alternatives not available for other types of debt: the asset transfer structure and the State Credit Plus program.

The focus of the remainder of this chapter shifts away from major tax-exempt leases to the smaller privately placed leases commonly executed for equipment, vehicle and computer procurement. *Guideline 11: Solicit Competitive Bids for Small Leases* recommends that agencies separate procurement from financing, and solicit competitive bids for the latter, rather than merely accept the financing terms extended by equipment vendors. Finally, *Guideline 12: Control the Resale of Privately Placed Leases* recommends that agencies control the resale, or *securitization*, of lease obligations—not so as to prohibit this activity outright, but merely to specify the circumstances under which it may occur.

Guideline 6: Incorporate Necessary Security Features

Government agencies should incorporate capitalized interest accounts, insurance policies, and reserve funds into their tax-exempt lease obligations to reduce abatement risk and improve the marketability of these securities.

The presence of abatement risk distinguishes tax-exempt lease obligations from debt, and therefore exempts tax-exempt leasing from the procedural requirements that apply when issuing debt. But investors are not willing to extend loans subject to abatement risk merely so that governmental borrowers can avoid legal debt restrictions. To address investor concerns, government agencies should incorporate the security features described below into their tax-exempt lease offerings. By increasing the size of the borrowing, these security features represent an added cost to the governmental issuer, as all funds borrowed must be repaid with interest. These security features, however, also attract more favorable interest rates (by minimizing investor risk) and protect the issuer from certain risks.

Capitalized Interest

For a construction project financed through an abatement lease, the government lessee's obligation to make payments from its general fund cannot commence until the facility is completed. To ensure that investors will be paid during the construction period, and to protect investors from a loss of income resulting from construction delays, the size of the borrowing normally is increased to include interest payments for a sufficient period of time past the scheduled acceptance date. The *capitalized interest* is segregated into a special account for making lease rental payments during the construction period. Although the period of time for which capitalized interest should cover lease payments can vary, most tax-exempt lease obligations fund capitalized interest accounts at an amount sufficient to cover the estimated construction period plus three to six additional months.

The funds in the capitalized interest account generally are invested in short-term obligations until they are needed. Depending upon the spread between short-term and long-term interest rates (the shape of the yield curve), these short-term obligations may not earn a rate of interest as high as the True Interest Cost of the tax-exempt lease offering (which has a longer average life). Thus, the capitalized interest account needs to include sufficient funds to offset any *negative arbitrage*, resulting in an additional cost to the issuer.

Avoiding Capitalized Interest Through An Asset Transfer. One way to avoid the added costs of capitalized interest is to structure the lease transaction as an *asset transfer*. Under an asset transfer, the governmental issuer sells or leases an existing asset that it owns outright in order to fund

the construction or acquisition of a separate asset. For example, a county might sell its jail and lease it back, using the proceeds from the sale to construct an administration center. Because the lease agreement is executed for an existing asset, construction risk is eliminated and the need for capitalized interest is substantially reduced or avoided. The governmental issuer may be required to pay for a third party appraisal of the asset, and augment its insurance coverage. (See *Asset Transfer* discussion in *Guideline 10: Evaluate Credit Enhancement Needs.*)

Insurance Requirements

Agencies incorporate various insurance policies into their tax-exempt lease agreements to protect investors from a loss of income resulting from construction delays or property damage. (This type of insurance is distinct from *bond insurance* which protects investors in cases of default or nonpayment, as discussed in *Guideline 10: Evaluate Credit Enhancement Needs.*) Insurance proceeds can be used to repair or replace a damaged facility or to pay debt service during a period of rental abatement. In evaluating insurance policies, agencies should weigh the financial risks of accepting higher deductibles in return for lower premiums. The following types of insurance most commonly are incorporated into tax-exempt lease agreements:

- ***Builders Risk Insurance and Performance Bonds.*** In addition to capitalized interest, construction risk can be mitigated by purchasing, or requiring a contractor to purchase, commercially available builders risk insurance and performance bonds. Builders risk insurance protects investors from certain types of construction risk, such as fire, storms and construction accidents, but not necessarily others, such as earthquakes and floods. Performance bonds protect against construction delays caused by builder nonperformance, by providing for funds to pay another contractor to complete the project. Performance bonds typically relieve builders from liability for delays caused by strikes, material shortages, or other events beyond their control.

- ***Property and Casualty Insurance.*** An agency normally purchases property and casualty, or *all risk*, insurance in an amount equal to the lesser of the leased asset's full replacement value or the outstanding lease obligations. If coverage equals replacement costs, the lease or trust indenture should specify that insurance proceeds will be applied to rebuilding, unless proceeds are sufficient to retire all outstanding lease obligations.

- ***Rental Interruption Insurance.*** Rental interruption insurance, also called business interruption insurance, provides funds to cover debt service during a period of abatement while the facility is repaired or replaced. The period of time during which rental interruption insurance will pay debt service usually approximates the period required to replace the facility. Such insurance usually is required as a condition of receiving a credit rating for the lease offering.

- ***Title Insurance.*** Most lease agreements include title insurance equal to the full amount of the borrowing to protect against defects in the title to the property. Title insurance may not be required if the leased asset has been owned for a considerable period of time.

- ***Earthquake Insurance.*** For agencies in areas of California prone to earthquake risk, investors and rating agencies may require earthquake insurance. The State of California has been conducting ongoing evaluations of earthquake zones in the state, which agencies may refer to in their Official Statements as evidence of why earthquake insurance may or may not

be required.[1] Government agencies also should be aware of the distinction between choosing to carry earthquake insurance and legally committing themselves to purchase that insurance throughout the term of the lease.

- **o** ***Flood Insurance.*** Floods represent a special hazard similar to earthquakes. Rating agencies and investors may require agencies constructing projects in flood plains to purchase flood insurance.

- **o** ***Pollution Insurance.*** Under California law, public landfills are required to be insured against certain pollution risks. Pollution insurance also may be advisable for wastewater treatment plants.

- **o** ***Public Liability Insurance.*** Unlike the other types of insurance, public liability insurance does not protect investors from abatement risk arising from damage to the facility. Rather, it protects the *agency* from claims arising from the use and operation of the facility. Because a significant claim could jeopardize an agency's ability to honor its financial commitments—including its lease obligations—rating agencies and investors may require public liability insurance.

- **o** ***Self-Insurance.*** In response to rapidly escalating commercial insurance rates, many public agencies have instituted self-insurance programs. Self-insurance programs, which are subject to annual actuarial reviews of reserve level adequacy, may be a permissible alternative in the eyes of rating agencies and investors. Self-insurance may not be an acceptable alternative to commercial earthquake insurance if the agency's obligation is limited to self-insurance reserves and does not extend to its general resources. In addition, self-insurance for rental interruption (covering a period of more than one year) may violate the constitutional debt limitation.

Reserve Fund

Tax-exempt lease obligations subject to abatement risk should include reserve funds to provide liquidity during periods of abatement. In the event of construction delays, the reserve supplements the capitalized interest account to protect against late payments. In the event of damage to the project after completion, the reserve provides liquidity while awaiting the receipt of insurance payments. Reserve funds also provide liquidity in the event of a delay in appropriation brought on by a protracted budget stalemate (in many situations, agencies have no statutory authority to make lease payments without a budget in place).

Although investors prefer a reserve equal to maximum annual debt service, federal tax law restricts the funding of reserves to the lesser of (1) 10% of the par amount, (2) maximum annual debt service, or (3) 125% of average annual debt service. To receive a favorable credit rating, the issuing agency may have to supplement the reserve from other sources. In lieu of a cash funded debt service reserve fund, an agency may obtain a surety bond or letter of credit.

The trust agreement for certificates, or trust indenture for bonds, should specify permitted investments for the debt service reserve fund, as well as the other funds created and managed by the trustee. Because the funds in the reserve need to be readily available, they should be invested in short and medium-term instruments which are highly liquid, or in investment contracts which permit draws

on debt service payment dates. Because the trustee is under no obligation to make up investment losses, reserve funds should be invested in high quality securities such as direct or guaranteed obligations of the U.S. government. Moreover, the rating agencies specify permissible reserve fund investments which governmental issuers must observe as a condition of receiving a credit rating.

Guideline 7: Consider Earmarking General and Special Fund Repayment Sources

To advance policy and financial objectives, government agencies should consider earmarking general and special fund repayment sources for tax-exempt leases and installment sale agreements.

Certificates of participation represent undivided, fractional interests in either a tax-exempt lease or an installment sale agreement, depending on the type of project being financed. For nonenterprise (nonrevenue producing) projects supported by general fund revenues, a tax-exempt lease serves as the underlying obligation. Lease payments are made from any legally available general fund revenues, contingent upon the right to beneficial use and/or occupancy of the leased property (under an abatement lease). For self-supporting enterprise (revenue producing) projects, an installment sale agreement typically serves as the underlying obligation. Installment sale agreements typically are structured as absolute and unconditional special fund obligations.

For certain types of projects, agencies may be able to earmark revenue sources within general and special funds for the repayment of obligations. Earmarking repayment sources can advance the policy objective of linking the benefits received by users of a particular project to taxes or fees collected from those users. Or, earmarking may provide a way of capitalizing a special fund revenue source, thereby offering an alternative to pay-as-you-go financing.

Earmarking General Fund Revenues

In most cases, earmarking general fund revenues for lease payments does not amount to a legal pledge of revenues. Leases usually are payable from all legally available general fund revenues. But internally earmarking specific general fund sources to the payment of lease obligations can advance the debt management objective of requiring those who benefit from a particular project to pay for it. For example, a city might decide to build a multilevel parking garage paid for by parking revenues. To address investor concerns as to adequacy of parking fees, the agency might structure the offering as a tax-exempt lease obligation payable from all legally available general fund revenues. But *internally*, the agency might earmark parking fees for debt service. Parking rates would be set to generate sufficient revenues for debt service. If parking fees did not materialize as expected, the shortfall would be paid from other general fund revenues.

Earmarking Special Fund Revenues

It is not necessary to earmark revenues to the repayment of COPs issued to finance *enterprise* projects since these financings, by definition, are self-supporting through fees. But not all projects financed through special funds are enterprise projects. *Nonenterprise* transportation projects, such as highways, roads, and transit equipment, also are paid for through special funds,

consisting of federal grant, state gas tax and other transportation-related revenues. Historically, these special fund revenue sources have been spent on a cash basis. In recent years, however, local transit agencies in California successfully have issued COPs for transportation projects by *earmarking* special fund revenues to the payment of these obligations.

Federal Transit Administration Funds. In 1990, the Federal Transit Administration revised its regulations to permit federal grants to pay for up to 80 percent of both the principal and interest components of a COP issue. Prior to that time, federal transit funds could pay for up to 80 percent of the *principal* component only, which made the local match requirement prohibitive. Since this regulation was revised, transit agencies in San Diego, Sacramento, and Los Angeles have issued over $200 million in COPs secured by federal transit funds, with the local match requirement paid from local and state sales tax revenues earmarked for transportation.

By leveraging federal funds, agencies can accelerate their bus fleet procurement programs, which can produce a present value savings (from inflation avoidance) when compared to a stretched-out procurement schedule. And by removing older buses from their fleets more quickly, agencies can reduce maintenance costs and introduce sooner more environmentally sensitive equipment.

State Gas Tax Revenues. In 1990, California voters approved Proposition 111, which will double the state gas tax over a period of five years (from 9 cents per gallon in 1990 to 18 cents per gallon in 1994). Collectively, cities and counties each receive approximately 11.5 percent of these revenues, according to a formula based on population and other factors. Although these funds should help agencies address pent-up project demands, their ability to leverage these funds is hampered by the State Constitution, which prohibits the pledging of state gas tax revenues for bonds.

In 1991, the City of Fresno, armed with a legal opinion stating that the prohibition on bonding gas tax revenues does not apply to COP obligations, issued $11.2 million of COPs secured by state gas tax revenues, thereby becoming the first agency in California to borrow against state gas tax revenues. Under the COP structure, certificate holders do not have a lien on gas tax revenues, but all gas tax revenues are deposited monthly with the trustee until sufficient amounts are available to make the annual certificate payments. Funds are then deposited in the City's transportation account.

Guideline 8: Do Not Rely Upon Volatile Repayment Sources

Government agencies should rely on stable revenue sources for repayment of lease obligations.

When evaluating the suitability of any revenue source for debt service payments, agencies should look for a stable history of revenue collections. Most taxes and fees are tied to tangible economic transactions which are sensitive to broader economic cycles, to varying degrees. Sales tax revenues, for example, ebb and flow according to the level of taxable sales, a key indicator of the health of the consumer sector of the economy. The cyclicality of sales tax revenue collection does preclude bonding; it merely results in a higher coverage ratio than would be required for a more stable revenue source. The revenue sources described below, however, exhibit a volatility that is not compatible with debt service requirements. Agencies should avoid relying on these revenue sources as the primary repayment source for obligations.

Developer Impact Fees and Connection Fees

To address the decline in property tax revenues resulting from Proposition 13, cities and counties have come to rely on their authority to charge developer impact fees as a condition of approving development projects. School districts—though lacking jurisdiction over land use decisions—also have received permission, through the Legislature and the courts, to levy developer impact fees. State law requires developer impact fees to be applied to specific infrastructure needs arising from the development project on which the fee was levied.

Relying on developer fees presents a quandary for local agencies. On the positive side, developer fees require new development to *pay its own way*, which means that the broader community does not have to subsidize the infrastructure costs of development. But developer fees alone do not generate revenues quickly enough to address all growth--related infrastructure needs in a timely manner. Certain types of infrastructure--for example, highways and water supply projects--cannot be expanded incrementally to accommodate growth, but instead must be constructed in large, discrete intervals to realize economies of scale in construction. To avoid growth-related congestion, these facilities ideally should be constructed with enough excess capacity to absorb population increases for several years. Developer fees, which typically are collected at the time building permits are issued, do not generate funds quickly enough to implement the growth management policy of *concurrency*. Agencies face the unappealing choice between subsidizing development, or allowing it to congest existing public facilities.

During the housing boom of the late 1980s, communities in rapidly developing areas of the state addressed this dilemma by issuing COPs, rather than waiting for sufficient developer fee revenues to accumulate. Although this approach certainly advanced land use planning goals, it also exposed these agencies to the potential for financial difficulties, to the extent that they depended upon robust developer fee collections to service their obligations. Housing construction is one of the most cyclical sectors of the economy, as evidenced by the dramatic dropoff in local developer fee revenues beginning in 1990. Economists track swings in housing starts to predict economic recoveries and contractions. Developer fee collections, therefore, exhibit a volatility which is not compatible with debt service requirements. The same dynamics apply to water and sewer connection fees. Agencies should avoid relying on these revenue sources as the primary repayment source for obligations.

Fines and Forfeiture Revenues

Cities and counties retain a portion of the fine and forfeiture revenues they collect for various criminal and civil violations, and remit a portion to the State. Fine and forfeiture revenue collections depend upon the levels of fines established by the state Legislature, and the aggressiveness of local enforcement efforts. During the 1980s, many localities initiated successful efforts to enhance collections, by serving warrants to violators delinquent on their accounts. But in 1991, the State required cities to transfer 50 percent, and counties to transfer 75 percent, of their non-parking fines to the State, to offset part of the additional State funding of the trial courts. By reducing the proportion of fine and forfeiture revenues retained locally, this action may serve as a disincentive for local collection efforts. The historical volatility of fine and forfeiture collections, along with the uncertain prospect of future collections, argues against pledging these revenues as a primary repayment source for obligations.

Guideline 9: The Term of the Lease Should Not Exceed Useful Life of the Asset

Government agencies should not agree to lease terms which extend beyond the anticipated useful life of the asset.

The rationale for financing capital acquisitions through borrowing is to link the responsibility of paying for public facilities to the benefits derived from those facilities. For that reason, the term of a financing should not exceed the useful life of the asset. This general principle is all the more relevant to tax-exempt lease obligations. Because the lessee's obligation under an abatement lease is tied to the right to beneficial use and/or occupancy of the leased asset, a lease extending beyond the useful life of the asset might not be legally enforceable. Similarly, under a nonappropriation lease, the agency's willingness to continue appropriations would be suspect during the period in which the asset was no longer available. To promote sound debt management and ensure the marketability of the obligation, agencies usually should establish a lease term *shorter* than the anticipated useful life of the asset.

Guideline 10: Evaluate Credit Enhancement Needs

Government agencies should perform cost-benefit analyses of available credit enhancement alternatives before issuing tax-exempt lease obligations.

As part of the preparations for any bond issue, agencies should evaluate the costs and benefits of credit enhancement. The two principal forms of credit enhancement—bond insurance and letters of credit—are available for tax-exempt lease obligations. But issuers of tax-exempt lease obligations have two additional options that are not available for other types of bonds. First, agencies can structure a lease transaction as an asset transfer, thereby substituting the credit of a more essential facility and eliminating construction risk. Second, agencies can participate in the Credit Plus Program, a state intercept program which guarantees payment of tax-exempt lease obligations through allocations of state Motor Vehicle License Fee revenues.

Bond Insurance

A bond insurance policy protects the bond or certificate holder by paying principal and interest installments in the event that the issuing agency fails to do so. If a default occurs, the trustee follows certain procedures to notify the bond insurer and receive payment. After making the principal and interest payments required under the policy, the bond insurer then assumes the position of investors in terms of seeking legal recourse for payments from the issuing agency.

The added security to investors afforded by bond insurance results in a higher credit rating and lower borrowing costs for the new issue. The governmental lessee must weigh these benefits against the cost of the policy, a premium charged as a percentage of the present value of total debt service insured. The benefits of lower interest rates under the policy should be quantified for each maturity and discounted to present value for comparison with the cost of the one-time premium. Bond insurance firms observe limitations on the volume of California tax-exempt lease obligations they underwrite, which may inhibit the availability of bond insurance.

Letter of Credit

The letter of credit (LOC) is the other principal form of credit available for new issue municipal securities. LOCs are contractual promises issued by banks to pay specified amounts to designated beneficiaries under certain conditions. For credit enhancement purposes, the LOC is designed to pay the trustee debt service payments in the event the governmental lessee fails to do so, much like a bond insurance policy. In addition to credit enhancement, LOCs serve another function: to provide liquidity for variable rate or tender offer bond or certificate issues. Under this form of LOC, the bank agrees to advance any funds necessary to purchase any bonds or certificates tendered by investors.

A key distinction between LOCs and bond insurance is that LOCs do not cover the entire term of the bond or certificate issue, usually extending no more than three to seven years. The bond indenture typically specifies that if the LOC is not renewed upon expiration, or a suitable substitute cannot be found, the bonds or certificates must be redeemed prior to the LOC expiration date. LOC providers normally charge both initial fees and annual fees for the continued availability of the LOC. The present value analysis undertaken to evaluate the benefits and costs of obtaining an LOC is similar to that performed for bond insurance.

Asset Transfer

The asset transfer, or *equity strip*, offers a low-cost option for strengthening the credit rating of a tax-exempt lease offering (in addition to eliminating the need for capitalized interest, as discussed in *Guideline 6: Incorporate Necessary Security Features*). Under an asset transfer, an agency sells or leases an existing asset to generate funds for a separate capital project, then leases back the original asset. Even though the purpose of the asset transfer is to fund a new asset, the credit rating is based on the leased asset—the original asset. The asset transfer allows an agency to finance an asset which might not be deemed essential by the investment community—for example, a museum—by substituting the credit of an existing, more essential asset—for example, a courthouse. The proceeds from the sale or lease of the courthouse would pay for the cost of constructing the museum. The agency would then own the museum outright, and enter into a long-term lease for the courthouse.

Agencies may encounter the criticism that executing an asset transfer is tantamount to *mortgaging its assets*—a reckless financial practice. This criticism is unwarranted if the proceeds from the sale or lease of the existing asset pays for the construction of a new asset of comparable value. True, the asset transfer requires an agency to make lease payments on an asset that it previously owned outright, but the agency does *not* have to make lease payments on the newly acquired asset, which it owns outright. And substituting the credit of a more essential asset into the lease agreement lowers overall borrowing costs.

The Credit Plus Program

The Credit Plus Program is a State intercept program available for cities and counties in California. Under the provisions of the program, cities and counties can elect to guarantee payment of their general obligation bonds and lease obligations through their allocation of motor vehicle license fee revenues from the State. Upon notification from a trustee that a participating city or county did not make a required debt service payment, the State Controller is directed to make the payment from

the city or county's share of motor vehicle license fee revenues. Standard & Poor's Corporation will assign a minimum "A" rating to the qualified obligations of cities and counties participating in the program.

Guideline 11: Solicit Competitive Bids for Small Leases

Government agencies should solicit competitive bids for small lease offerings from lease brokers, finance companies, banks, and other institutional investors, and separate procurement from financing for all lease purchases.

Government agencies should not simply accept the financing terms extended by equipment vendors, which sometimes carry high interest charges. To achieve the lowest possible borrowing costs, agencies should instead separate the acquisition of equipment from its financing, and solicit competitive bids for the latter. A number of institutional investors, attracted by the opportunity to earn tax-exempt interest, should respond to bid solicitations.

Middle Market Leases

Government agencies frequently execute small tax-exempt leases when they need property—usually equipment, but sometimes real property—that they cannot afford to pay for outright. Whereas broad investor participation in large tax-exempt lease offerings can be achieved through the retail sale of COPs, smaller tax-exempt leases often are *privately placed*—sold to a single or a small group of investors. Most privately placed tax-exempt leases are for amounts of less than $1 million, although the amount may run higher.

Equipment vendors often extend financing terms to facilitate the sale of equipment they manufacture. Vendors either hold the lease for its full term as an investment, or sell and assign the lease to one or more subsequent investors. If the vendor holds the lease as an investment, it naturally has an interest in charging as high an interest rate as the market will bear. It is not uncommon for vendors to negotiate transactions with governmental lessees at taxable interest rates by claiming that they need to arrange private financing to underwrite the transaction. If the vendor sells and assigns the lease to subsequent investors, it may receive a broker's fee, which can result in additional financing costs. Either way, the financing terms extended by vendors may not be competitive. Vendors are not necessarily finance specialists.

Bifurcated Bidding

Agencies should attempt to lower their borrowing costs through *bifurcated bidding*—soliciting vendor prices for asset acquisition only and independently seeking lease financing rates from third-party companies and financial institutions accustomed to investing in tax-exempt leases. A number of institutional investors attracted by the opportunity for tax-free interest income actively participate in this market: lease brokers, insurance companies, banks, and finance companies (often affiliated with large conglomerates). The market for small tax-exempt leases now is sufficiently competitive so that no government agency should pay interest rates which are above the norm for comparable tax-exempt debt.

Minimize Time Between Lease Bidding and Funding. Under bifurcated bidding, an agency may solicit funding proposals well in advance of the actual equipment purchase — just to make sure that funds will be on hand when needed. But as a hedge against unfavorable interest rate movements during the interim period, investors may incorporate a risk premium into their bids, resulting in less attractive proposals. To encourage more competitive bidding, agencies should minimize the time between soliciting bids and funding the asset. Alternatively, the governmental lessee can accept rates tied to an index until funding. This protects both the lessor and lessee, by assuring market rates in much the same manner as a lease line of credit.

Guideline 12: Control the Resale of Privately Placed Leases

Government agencies should specify the conditions under which their privately placed lease obligations may be sold and assigned.

Privately placed leases, financed through vendors or third parties, typically include a clause permitting the lessor to sell and assign its interest in lease payments to other parties, including lease brokers, finance corporations, banks, and other institutional investors. Most tax-exempt leases sold in California, in fact, rely on such lease assignment provisions (although the largest *dollar volume* of tax-exempt leases executed in California are marketed as COPs). The lessor's decision either to retain the lease as an investment or sell and assign it to subsequent investors depends on both its tax situation and financial ability to hold long-term receivables. As these factors are subject to change, lessors benefit from the liquidity offered by lease assignment clauses.

Although governmental lessees routinely agree to lease assignment clauses without much thought, they should insist that this language incorporate guarantees of vendor performance and specify permissible terms and conditions for *securitizing* lease obligations (discussed below). Properly structured assignment clauses can benefit lessors, by providing liquidity, and lessees, by incorporating necessary safeguards and attracting more favorable financing terms than would be available for an illiquid security.

Ensuring Vendor Performance

Leases for equipment that requires ongoing servicing typically reserve to the lessee the right to cancel the lease for vendor nonperformance. But if the vendor has sold and assigned the lease, exercising this right of cancellation can injure third party investors. The third party investors may not adequately have been informed about the lease cancellation provision and may incur considerable expense in seeking damages from the vendor. Although the governmental lessee has every right to cancel the lease for vendor nonperformance, its reputation in the securities market may suffer from the false impression that it has reneged on its financial commitments.

Well structured leases address the risk of vendor nonperformance by incorporating performance bonds, product warranties and maintenance agreements. Such leases also require the lessee to maintain the leased property in good working order.

Private Party Bankruptcy Risk

The sale and assignment of privately placed leases also introduces risks related to the bankruptcy of the lessor, both for the governmental lessee and investors. Depending on how the sale and assignment provisions are structured, the leased property could be considered part of the lessor's bankruptcy estate. As part of the bankruptcy proceeding, the governmental lessee could be required to return the leased assets to the lessor for disposition with its other assets.[2] The governmental lessee no longer would have use of the leased assets and no legal recourse to recover leased payments already made. And interruption or cancellation of lease payments to investors would damage the governmental lessee's reputation in the securities market through no fault of its own.

Governmental lessees should assess private lessor bankruptcy risk by reviewing the credit rating of the lessor's unenhanced debt, if such a rating is available. The lease transaction also may be structured to insulate lease payments from this risk by specifying that any assignment must be absolute.

Securitized Vendor Leases

As long as lease assignment language incorporates adequate protections, governmental lessees may be indifferent toward the sale and assignment of their lease obligations through private sale. In recent years, however, investment banking firms have begun purchasing small vendor lease obligations and packaging them as COPs for public sale. These *securitized vendor leases* pose two problems for governmental lessees. First, they frequently are marketed with bond offering documents which look as though they were prepared by the governmental lessee, complete with financial statements and audits. These offering documents convey the impression that the governmental lessee "stands behind" the offering, when in fact, the lessee knows nothing about it. If the investment banking firm offering such securities runs afoul of federal tax law, or simply fails to arrange timely payments to investors, the governmental lessee's reputation in the securities market could unfairly be damaged. Second, securitized vendor leases often are derived from small-denomination, short-term equipment leases which carry high yields; the availability of such securities on the secondary market could dampen investor interest in an agency's original issue, lower yielding obligations.[3]

In January 1991, for instance, Los Angeles County, preparing to market a $28 million equipment lease, unexpectedly encountered a $1.7 million COP securitized vendor lease for sale in the secondary market, derived from a county modular building lease. The availability of a comparable security, yielding a full 200 basis points more than the new lease offering, caused the County to temporarily withdraw its offering. The following day, yields rose unexpectedly in response to developments in the Persian Gulf War. As a consequence, the County had to pay an extra 10 to 20 basis point more than expected, which translates to an additional $200,000 over the life of the issue.

GFOA Policy Statement

The problem of securitized vendor leases has not been confined to California. The Government Finance Officers Association (GOFA) approved a policy statement in May 1993 regarding the securitization of leases, which recommends the following:

- **o** Government entities should institute a process for centralizing all information on leases. (See *Guideline 5: Subject All Leases to Fiscal Controls* in *Chapter I: Financial Management Guidelines*.)

- **o** The original lease documents should explicitly state what is and is not permissible regarding secondary lease securitization, including that secondary lease documents (1) outline the role of the public agency in the remarketed offering and (2) describe the relationship between the lessee and new investors.

- **o** Government lessees should ensure that all necessary legal opinions are obtained by the lessor prior to the public offering of the remarketed lease obligation.[4]

AB 1160 Reforms

In response to its unexpected encounter with a securitized vendor lease offering bearing its name, Los Angeles County sponsored legislation which makes such offerings illegal. Assembly Bill 1160 (Chapter 723, Statutes of 1993) makes the sale of fractionalized interests in a California municipal lease obligation without prior written consent a securities fraud, punishable by a fine or imprisonment. The consent requirement applies to any offering or sale within the State of California. Hence, out-of-state firms selling to any person in California are covered by the statute. The consent requirement does not apply to lease sales between financial institutions, or to sales and resales of unit investment trust shares.

NOTES

1. The results of those studies are reported in the California Department of Conservation, *Division of Mines and Geology, Fault-Rupture Hazard Zones in California — Alquist-Priolo Special Studies Zones Act of 1972 With Index to Special Studies Zones Maps* (Spec. Pub. 42, Rev. 1992).

2. See "Private Sector Involvement in Municipal Leasing: Analytical Rating Approach," Moody's Investors Service, May 6, 1991.

3. See for example Hill, Patrice, "Issuers Stumbling Across Growing Number of Unauthorized Vendor Lease Offerings," *The Bond Buyer*, May 20, 1992.

4. GFOA "Policy Statement — Securitization of Leases," Adopted May 1993.

Chapter III

LEGAL GUIDELINES

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Although lease documentation may be presented to a government agency as mere paperwork—forms that need to be filled in, signed and filed away—a lease is, in fact, a legal contract that imposes binding obligations on the governmental lessee and other parties to the transaction. The terms and conditions specified in this "paperwork" suddenly become very important should one of the parties to the lease renege on its contractual obligations. Agencies should review lease documentation to ensure that it accurately reflects the financial terms of the transaction and that covenants do not unduly restrict governmental operations. Inappropriate lease documentation can create legal and tax problems and raise the cost of borrowing.

Legal Classification of Leases

A tax-exempt lease is designed to avoid classification as *debt* for purposes of the debt limitation in the State Constitution. This is accomplished in one of two ways:

Abatement Lease. An abatement lease is a long-term obligation to pay rent in each year in which beneficial use and/or occupancy of property are tendered to a government agency. A long line of appellate decisions (referred to as the *Offner-Dean* line of cases) has held such leases to be outside the constitutional debt limit. The most significant aspects of an *Offner-Dean* lease are that (1) rent is only due during those periods in which beneficial use and/or occupancy of the leased property are available to the lessee; (2) acceleration of rental payments is not permitted; (3) obligation to pay rental payments is from any lawfully available funds of the lessee; (4) terms and conditions of the lease are similar those found in a commercial context for a similar type of facility; and (5) the lease term should not extend beyond the anticipated useful life of the leased property, and lease payments cannot exceed fair market rental. The abatement lease is by far the most common form of lease used in California.

Typically, governmental agencies in California covenant to budget and appropriate rental payments for the fiscal year in which such payments are due. The obligation to pay rent over a long term, however, may be impaired due to (i) the possibility that failure to complete a project may result in no legal requirement to pay rent, (ii) the abatement of rent during the lease term if beneficial use and/ or occupancy of the leased property are unavailable because of calamity or other events, and (iii) the

absence of any right to accelerate rental payments and, in the event of payment defaults, the corresponding requirement of bringing a lawsuit for annual rental payments as they come due each year.

To reduce these risks, a long-term lease often includes the following protections:

- In the event the leased project is to be constructed, interest is capitalized (i.e., borrowed) during the construction period (and for rating agency purposes, six or more months beyond). In addition, the construction contractor is often required to provide payments and performance bonds, and *all-risk* insurance in an amount equal to 100 percent of the replacement cost of the project. In certain circumstances, earthquake and flood insurance may be required. Liquidated damages for late completion of the project may also be required in a daily amount equal to daily rental on the tax-exempt lease.

- After the completion of construction of the project, the lessee is often required to maintain various insurance coverages, plus rental interruption insurance covering a period approximately equal to the estimated construction period. Provisions requiring adequate insurance are important so as to reconstruct the leased project and compensate the investors in the event the property is damaged or destroyed; this is a factor that often is given insufficient emphasis in terms of structuring earthquake, rental interruption and other insurance.

- A title insurance policy in an amount equal to the aggregate principal amount of the tax-exempt lease usually is required in a lease of real property.

- A debt service reserve equal to approximately one year's debt service may be funded.

- Bond insurance may provide a source of lease payments in the event of default.

The financial considerations associated with these protections are discussed in *Chapter II: Structuring and Marketing Guidelines.*

Nonappropriation Lease. A nonappropriation lease provides that a government agency is not obligated to make lease payments from year to year, unless it appropriates funds for the rental payments in its budget. If no rental payments are appropriated, the government agency has no further obligation and loses the right to use the leased facilities. Nonappropriation leases are far less common in California than abatement leases, as the risk of nonappropriation results in less advantageous interest rates.

Special Fund Obligations

Installment sale agreements are payable exclusively and solely from a designated *special fund* of a government agency. That special fund must be derived from activities related to the purposes for which the special fund obligation is issued. It may not be additionally secured by recourse to the general fund or taxing powers of the issuing agency. In California, these obligations are used to finance self-supporting enterprise facilities. Because a self-supporting enterprise provides a *special fund* obligation not dependent upon general taxes for payment, the government agency is able, without a vote, to enter into an unconditional agreement to pay principal and interest.

Statutory Authority to Lease & Dispose of Property

In a lease financing, a government agency relies on its authority to acquire and dispose of property, rather than its authority to incur debt. A government agency with the authority to acquire or dispose of either real or personal property usually can enter into a lease. California statutes contain a multitude of provisions authorizing various public entities to acquire specific kinds of property. Table 1 lists the types of local agencies which have frequently entered into leases, and the general statutory authority authorizing the acquisition and disposition of property under lease arrangements:

Table 1
Selected Statutory Authorization To Lease Property
California Local Governments

Public Agency	Statutory Authorization
City	**Government Code Sections 37350, 37351**
County	**Government Code Sections 23004, 25351**
Irrigation Districts	**Water Code Sections 24252, 22425**
Redevelopment Agencies	**Health & Safety Code Sections 33391, 33430**
School Districts	**Education Code Sections 39300 et seq., 39360.1**

Although a lease may involve simply a lease of personal or real property from a lessor to a governmental lessee, a lease financing may be structured in such a manner that the governmental entity not only acquires property, but also disposes of property, as in an asset transfer. If the financing structure involves a disposition of property by the government agency, a concern regarding statutory procedures for disposing of property may be raised. In addition, for both acquisition and disposition of property, the public purpose requirement is relevant.

Statutory Procedures for Disposition of Property. Special limitations and authorizations relating to dispositions of property are sometimes contained in the organic acts (such as the charter) of a government agency. In certain instances, government agencies may be required to publicly bid the lease or other disposition of publicly-owned property pursuant to so-called *surplus property* statutes. This may be of special significance in certain *sale-leaseback* financings. Other procedures in particular circumstances may be required, such as the publication of the notice of intention to convey property. (See, e.g., Government Code Sections 4217.10 et seq. for cogeneration facilities.)

Public Purpose Requirement. Any lease by a government agency (whether to acquire or dispose of property) must be in furtherance of a proper public purpose. California courts have invalidated leases of municipal property to private persons as unconstitutional uses of public property, when a predominant public purpose for the lease could not be identified. Governmental agencies should be clear as to who will be the beneficiary of a tax-exempt lease and that the ultimate use of the property is in furtherance of a public purpose.

Overview of Chapter III Guidelines

The *Guidelines* in this chapter offers a user-friendly approach to legal aspects of leasing that government finance officers should understand. *Guideline 13: Understand the Contractual Obligations Imposed by Legal Documents* offers agencies the commons sense advice to be aware of the mandates and restrictions they agree to as part of lease transactions. *Guideline 14: Confirm that Lease Documents Reflect the Financial Transaction* reminds agencies to check lease documents for accuracy, and includes a checklist for this purpose. *Guideline 15: Review Small Lease Documentation* notes that vendor lease documents often are prepared in boilerplate fashion by out-of-state firms lacking an understanding of California law. Agencies should, therefore, review these documents carefully and consider developing their own forms of documentation for small lease transactions. Finally, *Guideline 16: Follow Legal Formalities, Even for Small Leases* notes that failure to secure appropriate authorization for a lease, or to file the necessary paperwork with the IRS, could jeopardize the tax-exempt status of the lease.

Guideline 13: Understand the Contractual Obligations Imposed by Lease Documents

Government agencies should understand the mandates and restrictions imposed by lease documents and not agree to terms that might unduly restrict their operations.

A governmental lessee cannot rely on a vendor, underwriter, lease broker or other party to fully assess the impact of a lease agreement on its operations. Even though lease documentation may consist of standardized forms, legal provisions generally are negotiable, and the governmental borrower can insist on more favorable terms and conditions, if necessary to protect its interests.

The amount of lease documentation usually corresponds to the size and complexity of the transaction. For a small lease transaction, the documentation may consist of the lease agreement between the government agency (as lessee) and the investor (as lessor), and certain tax certifications. The lease generally specifies rental payment dates and includes covenants binding the agency to, and restricting it from, certain actions. Under a COP transaction, the lease agreement is assigned to a trustee pursuant to an assignment agreement between the financing corporation or joint powers authority, acting as lessor, and the trustee. The trustee, in turn, acts pursuant to a trust agreement. The trust agreement authorizes certificates of participation in lease payments, the terms of the certificates, and the rights and obligations of the trustee and investors in the certificates.

Covenants included in lease documents are intended to and do, in fact, restrict governmental flexibility over financial, operational and other matters. For example, covenants may restrict an agency in the disposition of property, and require the agency maintain certain property and to continue to perform certain activities. Rate covenants in enterprise financings generally require additional charges above the amounts needed solely to pay operation and maintenance costs and debt service. Legal documents also specify insurance requirements, including levels of coverage and deductibles.

In the event that a government agency is unable or unwilling to satisfy the legal requirements of a lease, it may find itself in a state of technical default, which could lead to a more serious default and damage the agency's reputation in the securities market. Agencies should, therefore, faithfully comply with all the terms and conditions they agree to as part of lease transactions.

Guideline 14: Confirm that Lease Documents Reflect the Financial Transaction

Government agencies should review each legal document and confirm that it fully and accurately reflects agreed upon business terms.

Government agencies should review lease documentation to ensure that the specified terms and conditions accurately reflect the agreed upon financial transaction. The following is a partial list of financial terms that agencies should review in most lease agreements:

- ***Amount borrowed.*** What is the principal amount of the lease? How was it determined? Were project costs "net funded", that is, reduced by conservatively estimated earnings on the proceeds during any construction period? What interest rate was assumed for that purpose? What was the construction draw schedule?

- ***Term of the lease.*** Is the lease financially appropriate? Would a longer term be useful in reducing payment amounts? Could the lease be paid comfortably in a shorter period? Is the lease term limited to the reasonably expected life of the facilities funded through the transaction? (Level payments are the norm for legal and credit reasons.)

- ***Timing of payments.*** Do lease payment dates correspond appropriately to the government agency's receipts of revenues to be used to make lease payments? Are the payments "in arrears" or "in advance" (which may impose higher costs)? Are the payments to be made monthly, quarterly or semiannually?

- ***Prepayment options.*** What types of prepayments are provided (optional, mandatory, special or extraordinary)? When are prepayments permitted or required? What is the cost of (premium for) prepayment?

- ***Payment structure.*** Are payment amounts level over the life of the lease? Or do they increase, decrease or alternate and, if so, why? How does the payment pattern fit the government agency's expectations for revenue receipts over the life of the lease?

- ***Capitalized interest.*** Is capitalized interest present when the leased property is not to be immediately available for use? Can capitalized interest be avoided or minimized by an appropriate asset transfer?

- ***Reserve fund.*** Is a reserve fund required to be present to gain favorable marketing advantages? What are the reasons for the size of the reserve fund? How and when will earnings on and principal of the reserve fund be applied?

- ***Legal representations.*** Are the representations made by the government agency true as of the date of the document (or other relevant date)?

- ***Legal covenants.*** Are the mandates and restrictions to which the government agency is to be subject appropriately and accurately expressed?

- ***Insurance.*** Do insurance policies address abatement risk? Are premiums and deductibles specified?

In reviewing these terms and conditions, agencies should consider the marketing implications of their decisions. Investors may demand certain provisions, such as rate covenants and insurance requirements. The agency may retain more flexibility over other structural features, such as the timing of payments.

Guideline 15: Review Small Lease Documentation

Government agencies should not simply accept small lease documentation without review; if possible, agencies should receive assurance of counsel that these documents comply with California and federal income tax laws.

As part of a small lease transaction, a government agency may be asked to sign lease documentation that was prepared in *boilerplate* fashion by an out-of-state firm. Such documentation may not be legal under California law, or it may simply not reflect accepted business practices in the state. Or, the lease documentation may violate federal prohibitions on arbitrage earnings or private activity financing. So-called *standard covenants* actually may violate existing covenants in other lease or borrowing documents of the government agency.

In tax-exempt lease financings which involve the sale of COPs, government agencies generally retain the assistance of a number of finance professionals who devote substantial time to the preparation and review of the legal documentation to the transaction. Without this level of professional assistance, an agency may be disinclined toward the review of small lease documentation, particularly if the lease and related certification are in fine print. But inappropriate documentation can jeopardize the tax-exempt status of the lease, and present other problems as well. Even if only small amounts of money are at stake, agencies should review small lease documentation and, if possible, gain counsel's assurance of legal compliance. Agencies also should consider developing their own documentation for use in small lease transactions. Such an effort would entail up-front costs, but in the long run would protect an agency from inappropriate small lease documentation.

Guideline 16: Follow Legal Formalities, Even for Small Leases

Small lease transactions should comply with legal formalities, specifically appropriate authorization, use of capitalized interest, specification of the interest component, IRS filings, and arbitrage and private activity restrictions.

If an agency does not maintain centralized control over its leasing practices, individual departments within the agency may informally execute leases for small equipment items or other purposes. But the interest component of lease payments may not be excludable from federal and state income taxation if certain procedural requirements are not observed.

Authorization. Authorization is not a matter to be handled casually, but rather in accordance with governing state laws, the agency's charter (if any) and other regulatory requirements. In most cases, the governing body must specifically approve the execution and delivery of the lease agreement at a meeting that is duly called and at which a quorum is present.

Capitalized Interest. Unless the leased property is available immediately for use or the lease involves an asset transfer, capitalized interest generally is required from the date of the lease to the date at which the leased property is reasonably expected to be available for use and/or occupancy (plus an additional contingency period). Most equipment leases are funded after the equipment has been delivered, tested and accepted; consequently, capitalized interest is not a concern.

Tax Exemption. For the interest component of lease payments to be excluded from gross income for purposes of federal tax law, a lease must be characterized as a *financing lease*, *conditional sales agreement* or *installment purchase contract*, rather than a *true lease*. The characterization of an obligation as a *financing lease* or *conditional sale agreement* for purposes of exemption from federal income tax (and in some instances, state tax) must be distinguished from the characterization of the obligation as a *lease* for purposes of avoiding the state constitutional debt limitation.

Among the circumstances cited in the Revenue Ruling 55-540 which would warrant characterization of a transaction as a conditional sales agreement are the following:

- Portions of the periodic payments are made specifically as applicable to equity to be acquired by the lessee.

- The lessee will acquire title upon the payment of a stated amount of "rental" under the contract.

- The total amount which the lessee is required to pay for a relatively short period of use constitutes an inordinately large proportion of the total sum required to be paid to secure the transfer of title.

- The agreed "rental" payments materially exceed the current fair rental value. This may be indicative that the payments include an element other than compensation for the use of the property.

- The property may be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared with the total payments which are required to be made.

- Some portion of the periodic payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest. The lease should express the interest component explicitly. Without such an expression, there is no interest to be excluded from federal or state income taxation.

Filing of Forms. Under federal income tax law, certain forms (e.g. Forms 8038, 8038-G, 8038-GC and 8038-T) are required to be filed with the Internal Revenue Service. The precise nature of the forms and the timing of the filing depend upon the size of the financing, as well as upon other financings conducted by the government agency during the fiscal year. The government agency is advised to obtain the advice of bond or special counsel as to the appropriate times and manner for filing these forms.

Arbitrage and Rebate. The federal income tax laws impose complex and burdensome arbitrage and rebate regulations upon government agencies, including a requirement that certain investment earnings, even if permitted under the arbitrage regulations, be rebated to the federal government to the extent that the yield on investments may exceed the yield on the lease. Those government agencies issuing less than $5 million principal amount of tax-exempt securities in the fiscal year in which a lease financing occurs may take advantage of a reduced degree of arbitrage and rebate regulation, although the arbitrage rules continue to play a role. Many equipment leases are not advance funded; consequently, arbitrage is not a concern.

Private Activity Bonds. Under federal tax law, restrictions are placed upon the use of proceeds of a governmental obligation sold by a government agency. If the interest component of lease payments is to be tax-exempt, the proceeds from the sale of the lease cannot be used in more than a small proportion for private purposes and private sources cannot provide credit support for the financing.

Small Issuer Status. A government agency wishing to preserve its status as a "small issuer" under federal tax law may find that leases independently executed by department heads or program administrators cause it to exceed the threshold established in federal law for this purpose. Actually, there are two small issuer exemptions relevant under federal income tax law: one qualifies up to $10 million in obligations of an agency as tax-exempt investments for banks; the other (discussed above) affords certain exemptions from arbitrage and rebate rules to agencies issuing under $5 million in obligations annually.

Chapter IV

PUBLIC POLICY GUIDELINE

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Public borrowing in any form entails certain risks which, if not well-managed, can invite scrutiny of the borrowing decision. Many of the constitutional and statutory provisions governing public indebtedness in California today, in fact, have their origins in bond defaults and other financial calamities of yesteryear. With few exceptions, California's experience with tax-exempt leasing has been free of the abusive and ill-conceived transactions that might spawn efforts to rein in governmental leasing powers. Still, public officials can only expect to enjoy broad latitude over tax-exempt leasing decisions as long as they observe sound financial management practices.

Public interest in governmental leasing practices also may be piqued by opposition to the capital projects financed in this manner. The construction of public facilities, after all, can profoundly affect a community's character and influence its pattern of development. Major project proposals can become divisive issues, regardless of how they are to be financed. But in such cases where elected officials choose tax-exempt leasing, which is not subject to voter approval, the public may feel shut out of an important decision. Elected officials themselves must decide how to best demonstrate accountability for their tax-exempt leasing decisions.

This chapter focuses on the public policy context of tax-exempt leasing. To the extent that these concerns are shaped by legal and financial issues, this chapter inevitably overlaps some material found elsewhere in this document. This chapter concerns only those tax-exempt leases executed for major capital projects. Small equipment and vendor leases, discussed elsewhere in this document, can be managed most effectively through internal debt policies, which usually do not warrant broad public involvement.

Impact of Debt Restrictions on Tax-Exempt Leasing Practices

California accounts for a disproportionate share of the nation's tax-exempt leasing activity because its constitutional and statutory debt restrictions are among the most severe in the nation. Restrictions on public indebtedness in California take the form of voter approval requirements, limits on outstanding indebtedness (expressed as a percentage of assessed valuation), competitive bid requirements, interest rate ceilings and constraints on maturity lengths and debt retirement schedules. By far the most formidable of these restrictions is the two-thirds voter approval requirement for local bond measures specified in the state Constitution (Article XVI, Section 18). This provision, referred to as the *constitutional debt limitation*, applies to the general obligation bond measures of cities, counties, and school districts.[1] It was incorporated into the State Constitution of 1879 in response to a series of bond defaults resulting from the Depression of 1873. Prior to that time, local borrowing had

been controlled by the state Legislature, which freely authorized municipal bond measures without the consent of local voters—often to finance speculative land development schemes which would be classified as *private activities* today. The two-thirds voter approval requirement was erected as a barrier to reckless borrowing.

Over time, the effect of the constitutional debt limitation has been not so much to *restrict* public borrowing as to *shift the composition* of public borrowing toward obligations not subject to the limit. As discussed in *Chapter III: Legal Guidelines,* government agencies subject to the debt limit frequently structure their borrowings as *special fund* obligations and *lease* obligations to satisfy judicially created exceptions to the debt limit.[2] This structuring decision depends upon the legal availability of options for funding the project.

Government *enterprises,* which are self-supporting through fees, typically finance capital assets, such as water and sewer projects, through special fund obligations. Though exempt from the constitutional debt limitation, special fund obligations may be subject to majority voter approval and other requirements, depending upon the type of agency involved and the statutory authority for the borrowing. The Revenue Bond Law of 1941, for example, requires majority voter approval (and prior to 1991, it required competitive bid). To avoid such restrictions, government enterprise financings frequently are structured as *installment sale agreements* and marketed as COPs.[3] Government enterprises can raise fees without a popular vote to pay financial obligations arising from installment sale agreements. User charges, or fees, are legally distinct from taxes, and consequently are exempt from restrictions on taxation, most significantly those imposed by Propositions 13 and 62. Most government enterprise financings in California today are not subject to voter approval requirements.

Projects financed through special assessment bonds also qualify for the special fund exception to the constitutional debt limitation. Special assessments are legally distinct from taxes, in that assessments are levied according to the *special benefit* property receives from a public improvement (over and above that received by the general public). Taxes, alternatively, do not have to be levied according to the benefit received by taxpayers. Consequently, special assessments do not require voter approval, though they are subject to *majority protest*.[4] Both enterprise and nonenterprise projects may be eligible for financing through special assessment bonds. Nonenterprise projects eligible for assessment bond financing tend be localized improvements, such as street grading and paving, sidewalks, landscaping and lighting. By requiring property owners who benefit most from public improvements to pay for them, special assessments offer an equitable means of financing capital projects, without recourse to the general fund of the issuing agency.

The range of financing options is most limited for *nonenterprise* projects which provide a *general benefit* to the community—projects such as schools, city halls, police stations, jails and courthouses. For these types of projects, often the only available financing options from local sources are general obligation bonds and tax-exempt lease obligations.[5] From a purely financial standpoint, the general obligation bond alternative usually is preferable. Unlike tax-exempt lease obligations, general obligation bonds do not impose a burden on the general fund of the issuing agency, because they are secured by a dedicated property tax override (as well as the full faith and credit of the issuing agency). Moreover, general obligation bonds attract more favorable interest rates than tax-exempt lease obligations, befitting their status as the most secure form of local government debt. The two-thirds voter approval requirement, however, poses a prohibitive barrier for all but the most popular projects. Tax-exempt leasing offers an attractive alternative, if an agency can afford the annual lease payments.[6]

Recent Grand Jury Reports on Leasing

Over the past two years, three grand juries in California have investigated the leasing practices of their respective counties, and issued reports outlining their concerns.

- **Santa Barbara County.** A Santa Barbara County Grand Jury investigation into the County's leasing practices led to the release of a report in 1992 outlining a series of controversial recommendations, including a proposal to ban the issuance of COPs for capital projects. The Grand Jury report followed a series of COP issuances by the County over the previous two years which more than tripled the outstanding principal amount of the County's tax-exempt lease obligations (which, in fairness to the County, had been very low before the series of COP issues). The Grand Jury also expressed its desire for greater public participation in significant financing decisions, and for assurances that the County would adhere to prudent debt management policies.

- **Nevada County.** Also in 1992, the Nevada County Grand Jury conducted an inquiry into the Nevada County Building Company (NCBC), a nonprofit corporation established in the 1960s to serve as nominal lessor in tax-exempt lease financings. Although the County had engaged in minimal tax-exempt leasing through the years, the NCBC issued two COPs in 1991: one for solid waste facilities (in response to a State mandate); the other for library facilities and other capital improvements (which the County resorted to after falling short of the two-third voter approval requirement for a general obligation bond measure — receiving *only* 64.7 percent). In addition, the NCBC took the most unusual step of *refusing* to execute a COP issue approved by the Board of Supervisors for wastewater facilities, in response to public opposition to the proposal. The overall conclusion of the Nevada County Grand Jury was that the County's reliance on tax-exempt lease financing resulted in a decision-making process for capital spending projects that was not sufficiently democratic.

- **Santa Cruz County.** The 1992-93 final report of the Santa Cruz County Grand Jury focused on the leasing practices of the County and selected cities within the county. The report recognized the necessity of tax-exempt leasing to finance state-mandated projects, but expressed reservations about funding discretionary projects in this manner (specifically land acquisitions for parks). The Grand Jury advocated a greater public role in tax-exempt leasing decisions through the establishment of public oversight committee, consisting of five non-governmental members.

Other Leasing Controversies

Controversies over public leasing practices in California have not been confined to grand jury inquiries. In **El Dorado County**, public dissatisfaction over a lease revenue bond financing of county administrative facilities led, in 1990, to voter approval of an initiative requiring majority voter approval of all lease financings undertaken by the County's joint powers authority. In **San Jose**, a $200 million COP financing for a major league baseball stadium, indirectly supported by a utility users tax increase, most likely would have been executed without voter approval, save for a city charter provision (adopted at the behest of stadium opponents) requiring voter approval before any city revenues can be used for sports facilities. The measure was narrowly defeated by the voters in the June 1992 election. (Because San Jose is a charter city, the utility users tax increase did not require voter approval under

Proposition 62, which was a statutory initiative superceded by the municipal affairs doctrine of the State Constitution.) Similarly, the **City and County of San Francisco** has longstanding charter restrictions on lease financing, which require voter approval under certain circumstances.

Outside of California, similar controversies have arisen in Virginia, Texas, Iowa, and New York. But the most notable case in recent years involved **Brevard County, Florida**. In 1989, the County issued $23.9 million of COPs to finance the construction of a new administrative center, which consolidated a number of offices previously dispersed throughout the county. But the location of the new building proved to be unpopular with voters, who expressed their displeasure by voting in a new majority to the Board of County Commissioners. In March 1993, the new Board decided to place before the voters a referendum on whether the county should continue making lease payments on the administrative center. The new Board justified its decision on the grounds that (1) the original COP issue circumvented the voters, and (2) the nonappropriation lease underlying the COP issue reserved to the lessee the right to terminate the lease obligation by not appropriating funds for lease payments. Brevard County residents ultimately voted in favor of continuing lease payments, by a slim margin of 51 percent to 48 percent.

The episode underscored the discrepancy between the *legal* obligation imposed by a nonappropriation lease, and the bond market's *perception* of that obligation.[7] Although Brevard County could have exercised its legal right to terminate the lease, the bond market would have viewed such a decision as tantamount to a default. In the eyes of the bond market, a tax-exempt lease obligation is not so much a *lease* as a *loan* from investors to a government agency, just like a municipal bond issue. To be sure, the interest rate differential between tax-exempt lease obligations and more secure forms of debt reflects the market's perception of an added degree of risk. But that risk derives as much from the possibility that agency's fiscal troubles could result in default, as from the possibility that a fiscally sound agency will simply decide not to appropriate lease payments. Investors never expect actually to be saddled with the assets financed through their capital investments. That prospect is particularly unappealing when the asset in question is of diminished value in alternative uses. Clearly, the interest rate differential between tax-exempt lease obligations and more secure forms of debt would be far greater if lease-financed assets were routinely turned back to investors. The Brevard County case illustrates that an agency's *willingness* to meet it financial commitments—though clearly an intangible criterion—is as important as its *ability* to meet those commitments, as measured by more objective indicators of financial strength.

Balancing Management Discretion and Public Participation

As demonstrated by the cases above, the broad latitude over tax-exempt leasing decisions enjoyed by public officials can engender suspicion on the part of the public. In the Nevada County example, this suspicion was compounded by the unusually active role assumed by the Nevada County Building Company, which obscured the traditionally functional role of the nonprofit corporation in a tax-exempt lease transaction. In the Santa Barbara County example, the County's sudden embrace of tax-exempt leasing, a departure from past practice, gave rise to concerns over the judgment exercised by county debt managers. Collectively, these cases demonstrate a pattern of concern over municipal leasing practices, notwithstanding the unique circumstances attending each case.

At issue in each of these cases is the role of the public in deciding questions of public indebtedness. The fine legal distinctions between *leases* and *debt* are not central to this broad question of policy. The fact that lease obligations are contingent upon the right to continued use and/or

occupancy of the leased property actually does not diminish the financial obligation incurred by the governmental borrower. As discussed in *Chapter II: Structuring and Marketing Guidelines,* investors are protected from most of the financial risk of abatement by insurance policies bought and paid for by the governmental borrower. The presence of abatement risk, therefore, merely prescribes certain risk management strategies; it does not justify a relaxed attitude toward the review and oversight of the borrowing decision.

The recognition that a tax-exempt lease imposes a financial obligation tantamount to debt does not imply, however, that this type of obligation necessarily should require voter approval. The principal financial distinction between tax-exempt leases and municipal bonds—that leases are paid from ongoing general fund revenues, not tax increases—is relevant to this question. Although a historical precedent exists for requiring voter approval of bond measures, through the years, voter approval requirements have come to be applied more frequently to questions of taxation, rather than indebtedness. The amount of long-term public borrowing exempt from the constitutional debt limit today is far greater than the amount subject to it, and a significant portion of public borrowing today does not require voter approval. But virtually all local tax increase measures today require voter approval. Arguments for voter approval of tax-exempt lease transactions, therefore, should focus on the financial and policy goals advanced by such a requirement, not the historical precedence of bond referendums.

Requiring voter approval of tax-exempt lease transactions would not strengthen the financial structure of tax-exempt lease obligations. Unlike the voter approval requirements which apply to bond measures, voter approval of tax-exempt lease transactions would not authorize a new tax or revenue source to secure the obligation. With or without voter approval, the tax-exempt lease obligation would be paid from ongoing general fund revenues. For the reasons discussed in *Chapter I: Financial Management Guidelines,* the key financial management concern relevant to tax-exempt leasing is the *cumulative* general fund lease burden. Instituting voter approval requirements would focus public attention on *individual* tax-exempt lease proposals, rather than this broader measure. A voter approval requirement would, however, offer a good indication of a community's *willingness* to honor its lease obligations—which could result in more attractive interest rates. Such an expression of community support would be of more value for nonappropriation leases than for abatement leases, which include covenants to budget and appropriate.

A stronger argument for voter approval of tax-exempt lease transactions is that certain public policy issues are important enough to be decided by referendum. As mentioned at the outset of this chapter, the construction of public works can profoundly affect both the character and the physical development of a community. The broad policy implications of tax-exempt leasing decisions, along with their irreversibility, argue for a heightened level of public participation. But here, too, the fact that tax-exempt lease obligations are paid from ongoing revenues, rather than new taxes, is critical. Over the past fifteen years, the voters of California have expressed their desire to elevate all tax increase measures to referendum (principally through Propositions 13 and 62). But local officials have maintained their prerogative over the basic budgeting function — the allocation of limited general fund resources among competing demands. Elected officials routinely make important budgetary decisions without direct voter involvement. Public employee labor contracts and pension benefit packages, for example, do not require voter approval, though usually they have a more profound impact on governmental finances than tax-exempt leasing decisions. Consequently, the argument for voter approval requirements is much stronger for conventional debt instruments requiring a tax increase than it is for tax-exempt lease obligations.

Furthermore, elected officials cannot implement public policy without making some provision for the capital facility prerequisites of service delivery. Educational services, for example, cannot be delivered without schools; public safety cannot be protected without police stations and jails; the justice system cannot function without courthouses; and so on. Tax-exempt leasing offers one alternative — often the second best alternative — for addressing deficiencies in the physical plant which inhibit service delivery. Ultimately, elected officials bear the responsibility for delivering the best mix of services possible within their budget constraints. Tax-exempt leasing decisions are subordinate to the broader service delivery issues at the heart of the budgeting process.

The challenge in addressing the public policy issues raised by tax-exempt leasing, therefore, lies in balancing the decision-making authority of elected officials with the desire of the public to participate in important capital spending decisions. The following *Guideline* addresses the Commission's main concern—that public agencies solicit public participation in their tax-exempt leasing decisions. At the same time, this *Guideline* recognizes that the relationship between local officials and voters is not uniform in each political jurisdiction throughout the state, and that local officials are in the best position to decide how to achieve the goal of public involvement.

Guideline 17: Solicit Public Participation in Tax-Exempt Leasing Decisions

Government agencies should implement procedures for soliciting public review and comment on tax-exempt leasing proposals.

Elected officials should solicit public review and comment on tax-exempt leasing proposals before reaching a final decision, as they would for other important public policy questions. It is easy to reach agreement on this goal, but somewhat more difficult to identify discrete mechanisms for translating this goal into policy. The options below offer constructive approaches to soliciting public participation in tax-exempt leasing decisions.

Option 1: Schedule Public Hearings on the Capital Budget

Of all government programs, none is more enduring than public works. A walk through any downtown offers bricks-and-mortar evidence of how public buildings alter the landscape and shape the character of a community: the elegant city hall; the sleek, modern jail; the sweeping library annex; the Greek revival courthouse; or the lushly landscaped park. Beyond aesthetic considerations, the physical placement of highways, public transit, water and sewer lines and other public infrastructure influences a community's pattern of development, encouraging either urban sprawl or more densely populated settlements. In the planning stages, capital projects often can be altered at minimal cost to address public concerns; this is rarely the case once a project is set in concrete. Therefore, it is important for the public to participate in the development of capital spending decisions which have broader policy implications.

The first three *Guidelines* in *Chapter I: Financial Management Guidelines* instruct agencies on how to incorporate major tax-exempt leasing proposals into their capital budgets. Prior to submitting the capital budget for legislative approval, agencies should schedule public hearings on the proposed document to allow for public reaction to staff recommendations. Inviting public scrutiny at this juncture allows public officials and their staffs to demonstrate the programmatic reasons for tax-

exempt leasing proposals, and the programmatic consequences of abandoning those proposals. Public hearings on the capital budget also serve as a forum for reviewing an agency's cumulative general fund lease burden, and discussing whether the necessary tradeoffs in operating service levels appear to be reasonable. Reviewing tax-exempt leasing proposals within the broader framework of the capital budget allows tax-exempt leasing to be placed in its appropriate context —as merely one option available for addressing a community's long-term infrastructure needs.

To encourage public attendance, agencies should circulate in advance of the hearings public notice which describes the major projects incorporated into the proposed capital budget.

Option 2: Establish a Citizens Oversight Committee on Public Finance

Despite well-intentioned capital budget hearings, agencies may not always achieve meaningful public participation at this juncture. Neighborhood groups are more likely to coalesce around individual project proposals than to exhibit broad-minded civic interest in public financial management practices. In the absence of a specific controversy, the relatively obscure rituals of government tend to stay that way.

Public officials need not restrict their outreach efforts to public hearings on the capital budget. Another option for soliciting public involvement in tax-exempt leasing decisions is to establish a citizens oversight committee on public finance. An oversight committee provides a forum for elected officials to discuss their reasons for reaching key financial decisions, and for constituents to express their concerns. Establishing a formal structure for this purpose may be preferable to leaving this dialogue to chance.

The term *oversight committee* should not cause alarm: establishing such a body does not, and should not, require elected officials to relinquish decision-making authority. Instead, a citizens committee devoted exclusively to public finance issues allows ordinary citizens to become educated on the intricacies of taxation and indebtedness, thereby dispensing with the argument that these matters are "too complicated" for the public to understand. By rotating committee membership, agencies can make this opportunity available to a greater number of people over time, who, in turn, can share their experiences with other community groups.

This recommendation (which was presented in the Santa Cruz Grand Jury Report) is not entirely novel, as many agencies already have in place debt advisory committees, whose memberships consist of governmental and nongovernmental members in various combinations. There are probably a number of ways to carry out the spirit of this recommendation in practice. The relevant concern, however, is that agencies should actively seek public participation in tax-exempt leasing decisions, as well as other important questions of public finance, rather than interpret their responsibilities in this regard in a narrow, legalistic sense.

Option 3: Consider an Advisory Vote for Controversial Projects

Finally, agencies should consider an advisory vote for tax-exempt leasing proposals involving controversial projects. Again, the construction of public facilities can raise important public policy questions, and elected officials should respect the wishes of their constituents regarding such decisions. The concern here is whether the public *wants* its tax dollars spent on a project, not whether an agency can *afford* a project. An advisory vote provides the only sure-fire mechanism for gauging community

sentiment. The added time and expense required to conduct an advisory vote certainly is preferable to ultimately reneging on a tax-exempt lease obligation in the face of negative community reaction. Even if the lease in question contains a nonappropriation clause, its termination could damage an agency's reputation in the credit markets, making future borrowing more difficult and expensive. If an advisory vote cannot reasonably be accommodated at the next scheduled election, an agency should consider a mail election.

The Commission cannot offer clear-cut criteria as to when an advisory vote should be scheduled, as this question involves balancing management discretion with the public's desire to participate in important spending decisions. But one key consideration is whether the project involved is truly discretionary. Communities are mandated by the federal and state governments to achieve certain environmental and public health standards with respect to sewage treatment plants, water supply systems, and solid waste disposal—typically *big ticket* items. Even if the resulting financial burden placed upon ratepayers appears to be excessive, communities do not have the option of noncompliance. The same reasoning applies if a community is under court order to improve its jail or some other facility. If the proposed project is controversial but truly discretionary, however, and a *no* vote will not threaten the public health or safety, an advisory vote may be in order.

NOTES

1. Special district general obligation bond measures, though not explicitly subject to the constitutional debt limit, may require two-thirds voter approval under Article XIII A, Section 1(b) of the California Constitution, even if the authorizing statute for the particular special district does not require an election. Article XIII A, Section 1(b) was added to the state Constitution by Proposition 46 in 1986, which restored local general obligation bonding authority to local governments by permitting a property tax override above the 1 percent limit imposed by Proposition 13 in 1978, subject to two-thirds voter approval.

2. Because the debt limit applies only to cities, counties, and school districts, other types of agencies — special districts and redevelopment agencies, for example — can issue debt outside of the debt limit. Agencies subject to the debt limit can establish joint powers authorities and public benefit corporations to issue debt outside of the limit. But they still must find a revenue source to pay for the project.

3. Enterprise project financings also may be channeled through joint powers authorities and issued under authority of the Marks-Roos Bond Pooling Act of 1985, which does not require voter approval or competitive bid. Charter cities may authorize the issuance of revenue bonds by ordinance, and simply exclude voter approval and competitive bid requirements from their charters.

4. Unless specifically exempted, all assessment district proceedings must comply with the Special Assessment Investigations, Limitation and Majority Protest Act of 1931, which provides that if owners of a majority of property in the proposed assessment district protest, the governing board of the agency must drop the proposal for at least one year—unless the protest is overridden by a four-fifths vote. Charter cities and counties may enact their own procedural ordinances for assessment districts, but

must comply with Article XVI, Section 19, of the California Constitution, which incorporates the majority protest provision and other sections of the Majority Protest Act.

5. Many of these projects may also be eligible for funding through Mello-Roos bonds, which also require two-thirds voter approval. Mello-Roos bonds are a common method of financing infrastructure in new developments in California, because the landowners (i.e., developers) can authorize the creation of a Mello-Roos district, the levy of a special tax, and the issuance of bonds. But once the District is populated, the two-thirds vote requirement poses a significant barrier.

6. The Commission is on record as supporting a constitutional amendment to authorize majority voter approval of local general obligation bonds. Such a measure would enable local agencies to rely more on general obligation bonds, and less on tax-exempt lease obligations, for financing nonenterprise projects. Reconstituting the composition of public borrowing in this manner undoubtedly would strengthen the financial position of local governments and result in lower borrowing costs. See *The Impact of the 1992-93 State Budget on Local Government Finance: Report to the Legislature*, page 2. California Debt Advisory Commission 93-3.

7. The *abatement* lease common in California, which includes a covenant to budget and appropriate, represents a considerably stronger credit than the *nonappropriation* lease common throughout the rest of the United States, and at issue in Brevard County. Although the Brevard County incident is less relevant to California, it is worth discussing because of its notoriety, and for the benefit of our readers outside of California.

Chapter V

SCHOOL DISTRICT GUIDELINES

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This chapter presents special *Guidelines* for school districts, not because school district leases are so different from other leases, but rather that school districts operate under more restrictive financial conditions than other local governments, and face a greater degree of scrutiny of their borrowing decisions. As a consequence, certain considerations apply to school district lease financings which do not fit neatly into a more general treatment of the subject matter. School districts should follow the *Guidelines* specified in this chapter in addition to, not in lieu of, the *Guidelines* presented in the other chapters of this document.

Role of Tax-Exempt Leasing in School Finance

School districts are subject to the constitutional debt limitation, which requires two-thirds voter approval of bond measures. To avoid this prohibitive barrier, school districts for years have relied upon the lease exception to the constitutional debt limitation. Prior to Proposition 13, school districts issued lease revenue bonds supported by dedicated property tax overrides, subject to majority voter approval. By capping property tax rates, Proposition 13 eliminated this financing option, as well as school district general obligation bonding authority. In the ensuing years, the State assumed greater responsibility for school facility finance through the sale of State of California general obligation bonds. But State general obligation bond issues have been unable to keep pace with school district demands, resulting in a backlog of funding requests amounting to several billion dollars. As a result, school districts often must generate needed funds locally.

To address the school facility demands generated by new developments, school districts can rely on developer fees and Mello-Roos bonds. But the range of options available to finance school facilities in established areas is more limited. Although Proposition 46 in 1986 restored school district general obligation bonding authority, the supermajority vote requirement renders this option infeasible in many cases. Consequently, school districts continue to rely on tax-exempt leasing. School districts are frequent issuers of COPs to finance the construction and acquisition costs of both permanent facilities and portable classrooms. But unlike the lease revenue bond financings of the 1970s, which were secured by voter-approved property tax overrides, school district tax-exempt lease obligations today are paid out of ongoing general fund revenues. The credit analysis of school district tax-exempt lease obligations, therefore, is very similar to that for tax-exempt lease obligations issued by other types of government agencies. But the risks of committing general fund revenues to fixed lease obligations is perhaps more pronounced for school districts, which, in the aftermath of Proposition 13, retain very little revenue-raising authority and rely on the State for the bulk of their funding. On the expenditure side of the ledger, personnel costs comprise a large proportion of school district spending, perhaps 80

to 85 percent on average, due to the fact that the delivery of educational services is very labor intensive.[1] Consequently, the margin of revenues available to meet all other expenditure obligations, including lease payments, is fairly narrow.

Richmond Unified School District Default

For many investors, the default of the Richmond Unified School District on $9.8 million of COPs in 1991 confirmed their worst fears regarding California school district lease obligations. Ironically, the Richmond USD default was unique in many respects, and unrepresentative of school district leasing activity in the state. The Richmond USD COPs, issued in two separate installments, involved a complicated lease-leaseback of several school district properties (a lease structure known as an *asset transfer*). The proceeds from the COP sales were used to cover the District's growing operating deficit, which resulted from a series of costly educational reforms that the District simply could not afford. Unfortunately, the District did not issue the COPs with the intent of restructuring its spending commitments. Instead, the cash generated from the sale of the COPs merely postponed the day of reckoning-until April 1991, when the District declared bankruptcy. The District's first default on a COP lease payment occurred the following August.

Under the direction of a State-appointed administrator, the District withdrew its bankruptcy petition in September 1991. The five-year budget plan for the District subsequently prepared by the administrator did not, however, provide for payments on the COPs in default. In response, the trustee for the COPs filed suit against the State and the District. The defense prepared by the state Attorney General and the counsel for the District asserted that the COP issue was invalid because the lease underlying the obligation created debt in violation of the constitutional debt limit. According to this defense, the debt was created by mortgaging assets owned outright by the District without receiving in return a capital asset of comparable value.

In December 1992, the Superior Court of Contra Costa County ruled that the lease underlying the COPs was valid and enforceable. The ruling stated that the use of the proceeds was irrelevant to the issue of the constitutional debt limit. The trustee for the COPs subsequently filed another motion for defaulted lease rental payments and received a favorable ruling in April 1993. The court ruled, however, that it did not have the power to order the District to budget and appropriate future lease payments.

In August 1993, two years after the District first defaulted on its lease obligation, a tentative agreement was reached to settle the lawsuit brought by investors against the District. The agreement, embodied in AB 535 (Chapter 57, Statutes of 1993 - Bates), authorizes the District to refinance the original COPs, including the amount in arrears (approximately $4 million), plus attorneys' fees and penalties, through a new 30-year COP issue. By lengthening the maturity schedule, and taking advantage of the decline in interest rates since the time of the original COP issue, the District will be able to reduce its lease payments from $1.4 million to $800,000 annually. To assuage the concerns of potential investors in the new COP offering, proceeds from the refinancing will be placed in an escrow account accessible only to the trustee for the issue, who will pay off the original COPs. In addition, the refinancing will be structured with an *intercept* mechanism authorizing the state Controller to divert state aid payments from the District to the trustee for the COPs in the event the District misses a scheduled lease payment.

Lessons from the Richmond USD Default. Despite the notoriety attending the Richmond USD default and subsequent litigation, the legal ramifications of this case for school districts, and the broader leasing market in California, is limited. The defense prepared by the state Attorney General and the counsel for the District was noteworthy for challenging the constitutionality of the unusual leasing application undertaken by the District; however, the broader validity of tax-exempt leasing as a tool of capital finance was never challenged. Only a handful of transactions comparable to the Richmond USD case have been undertaken in California, a small fraction of the multibillion dollar leasing industry. The Superior Court ruling that the use of proceeds is irrelevant to the constitutional debt limit merely echoes the long history of judicial rulings upholding the validity of tax-exempt leasing in California. In light of AB 1200 and other legislation enacted since the time of the original Richmond USD default, it is questionable as to whether school districts could in the future lawfully execute this type of transaction.

Yet the Richmond USD case does shed light on a few unsettling issues. First, it is worth noting that the Richmond USD default was precipitated by the District's declaration of bankruptcy. When the bankruptcy petition was later withdrawn, the trustee found itself at the mercy of the District's State-appointed administrator, who—perhaps not surprisingly—gave priority to the repayment of the State loans over the claims of COP holders (as part of the AB 535 agreement, however, the State has subordinated these loans). Although the bankruptcy of a public agency remains an unusual event, it poses a credit risk to tax-exempt lease obligations. Public bankruptcy, or the institution of an unsympathetic state receivership, places investors in the position of requiring a court judgment each year to enforce the *covenant to budget and appropriate*, traditionally considered to be the strength of the California abatement lease. Though case law indicates that investors will be successful in such instances, the necessity for a court judgment adds an unpredictable variable to the credit analysis.

In addition, the Richmond USD case illustrates the practical barriers to taking possession of leased property to remedy a default. Though the Richmond trust agreement provided for this option, the investors never attempted to avail themselves of it. As noted elsewhere in this document, investors are interested in the rate of return on their capital, not in managing the assets financed through their capital. Moreover, the likelihood that the courts would approve the repossession and reletting of essential public property such as school buildings remains uncertain.

Overview of Chapter V Guidelines

Whatever the broader significance of the Richmond case, it focused attention on California school district COPs, not only of the municipal finance industry, but also the state Legislature. Largely in response to this case, the Legislature enacted Assembly Bill 1200 (Eastin) in 1991 to provide for increased oversight of school district finances (Chapter 1213, Statutes of 1991). AB 1200 specifies minimum financial criteria for school districts considering long-term lease financing. These criteria are mandated for financially troubled districts only; however, the state Department of Education recommends that *all* districts voluntarily comply with these criteria, advice reiterated in *Guideline 18: Conform to AB 1200 Criteria for Long-Term Borrowing.*

The remaining two *Guidelines* address issues which arise when school facilities are financed through a combination of local funds—generated through the sale of tax-exempt lease obligations—and State bond funds. To avoid delays arising from State funding shortages, school districts often issue COPs with early call provisions, in anticipation of State funding. Once State funds become available, the district retires the outstanding COPs. But districts have no guarantee that State funds will be

forthcoming. *Guideline 19: Subject COP Bridge Loans to the Same Financial Review as Long-Term Obligations* recommends that agencies that issue COPs as bridge loans adhere to the same financial review criteria that apply to long-term borrowings.

Guideline 20: Evaluate the Marketing Implications of Noneviction Clauses addresses a technical issue arising from a recent change in State policy. The State now requires districts to incorporate *noneviction clauses* into school facility leases as a condition of funding school sites. This policy ensures that the nonappropriation of lease payments will not jeopardize the district's educational mission. But it also may dampen investor interest in school district lease offerings. In the event that the market appears to demand a premium for the noneviction clause, districts should consider applying for an exception to the State policy.

Guideline 18: Conform to AB 1200 Criteria for Long-Term Borrowing

School districts entering into long-term tax-exempt lease obligations should maintain budgetary reserves in accordance with the criteria specified in AB 1200.

Among its many provisions, AB 1200 authorizes county superintendents of education to review the budgets of school districts on an annual basis. These reviews assist the state Superintendent of Schools in developing a list of financially troubled school districts each year, which are certified as *negative* (meaning that the district will be unable to meet its financial commitments through the end of the school year) and *qualified* (meaning that the district will be unable to meet its obligations, unless certain events occur).

Districts certified as *negative* or *qualified* may not issue *certificates of participation, tax anticipation notes, revenue bonds, or any other debt instruments that do not require the approval of the voters of the district*, without a determination of the county superintendent of education that repayment of the obligation is probable. [Education Code Section 42133]. The state Department of Education has set forth criteria for making that determination, which are specified in Table 2.[2]
These criteria entail the maintenance of a Reserve for Economic Uncertainties, at specified levels, to provide a *cushion* against unforeseen events which might otherwise lead to a lease default.

School districts should be aware of two problems which can complicate their efforts to maintain such fund balances. First, the adequacy of the fund balance will depend upon the accuracy of the revenue and expenditure forecasts prepared by the district (see *Guideline 1: Identify the General Fund Lease Capacity*). The concept of a *reserve for economic uncertainties* implies the existence of *economic certainties*, that is to say, reasonable estimates of expenditure obligations and revenues in the coming year. Second, the maintenance of a reserve for economic uncertainties is politically difficult during periods of fiscal retrenchment. Individuals and groups asked to sacrifice understandably might view the existence of such a reserve as an unaffordable luxury.[3]

Table 2
AB 1200 Criteria for Reviewing Proposed Long-Term School District Debt

1. Expenditures neither exceed revenues, nor create negative fund balances.

2. The Reserve for Economic Uncertainties is not less than the following percentages of total expenditures, transfers out, and uses:

   - For districts with 300 or fewer ADA, the greater of 5% or $50,000.

   - For districts with 301 - 1,000 ADA, the greater of 4% of $50,000.

   - For districts with 1,001 - 30,000 ADA, 3%.

   - For districts with 30,001 - 400,000 ADA, 2%.

   - For districts with 400,001 or more ADA, 1%.

3. Budgeted salaries and benefits, reserves, and any unappropriated fund balances are sufficient to address pending salary and benefit negotiations.

Hopefully, the AB 1200 requirements, as well as these *Guidelines*, will assist school district officials in their efforts to persuade all affected parties of the prudence of maintaining budgetary reserves. Although the AB 1200 criteria were promulgated for purposes of evaluating the likelihood of repayment of tax-exempt lease obligations proposed for issuance by *negative* and *qualified* school districts, the State Department of Education recommends that *all* districts voluntarily adhere to these standards. The Commission concurs with this judgment.

Guideline 19: Subject COP Bridge Loans to the Same Financial Review as Long-Term Obligations

School districts issuing COPs as bridge loans in anticipation of State funding should adhere to the same financial criteria which apply to long-term borrowings.

The state Office of Local Assistance (OLA) often funds school site acquisitions years in advance of funding school construction. This policy was adopted to address the erosion in the purchasing power of State bond money caused by rapidly escalating land prices, which characterized the California real estate market until 1990. If the State did not have sufficient bond money to construct all of the facilities demanded by local districts, at least it could expedite site acquisition to mitigate the effects of inflation. But the period of time between site acquisition and the availability of State funds

for school construction can stretch into several years. Rather than simply wait, districts often issue COPs with early call provisions to fund school construction. At the time State funds become available, the COPs are retired, and the district is relieved of the debt service obligation. The COPs serve as a *bridge loan*, akin to a bond or grant anticipation note extending over several years.

Agencies issuing COPs as bridge loans should be fully prepared to service the obligation for its full term, in the event that State funds are not forthcoming. OLA approval of district grant requests does not represent a guarantee of State funding, only an agreement to extend funding in the event State bond funds are available. As mentioned above, the backlog of approved grant applications already totals several billion dollars. And if the 1992 elections are any indication, voters are growing more reluctant to approve State general obligation bond measures, after approving record amounts during the 1980s. Consequently, districts issuing COPs as bridge loans should maintain budgetary reserves in accordance with *Guideline 18: Conform to AB 1200 Criteria for Long-Term Borrowing*, as well as adhere to the other *Guidelines* in this document.

Guideline 20: Evaluate the Marketing Implications of Noneviction Clauses

School districts should gauge the marketing implications of noneviction clauses required by the State for facility leases of sites financed by State bond funds, and consider applying for an exception to that policy if necessary.

As noted, one of the remedies in the event of default frequently provided for in trust agreements for lease obligations is the right to evict the lessee for nonpayment, which allows the lessor to relet the asset (in certain instances). Due to the highly specialized and site-specific nature of school facilities, these assets may be considerably less valuable in alternative uses, which could result in a financial loss for investors. Nonetheless, the right to evict the lessee provides a powerful incentive for the lessee to continue payment. In 1991, the OLA began requiring *noneviction clauses* to be incorporated into facility leases where the underlying site was acquired through State bond funds. As its name suggests, a noneviction clause specifies that the facility lease may not permit any party to evict the district and relet or convert the facility to another use. The OLA will upon request, however, consider exceptions to this policy.

The interest rate available for any tax-exempt lease or bond offering reflects the supply of, and demand for, that type of security. Of the multitude of factors which affect demand for individual securities, agencies should be aware of those which they can control, and those which they are powerless to influence. Depending upon how California school district COPs are faring in the market at any given point in time, the presence of a noneviction clause may affect the interest rate available for a new issue. In 1991, the change in OLA policy, accompanied in the same year by the Richmond USD default, soured many investors on California school district COPs, at least for a time. In preparing a tax-exempt lease offering for sale, districts should gauge the marketing implications of the noneviction clause, and consider applying for an exception to the OLA policy if the market is demanding a premium for that clause.

NOTES

1. This estimate is cited in: Illyes, John W., *California School COPs and Bonds After Richmond*. Chicago: Nuveen Research, 1991, p. 1. This report also includes a more substantive discussion of the change in OLA's Limited Term Subordination Policy, discussed in *Guideline 20: Evaluate the Marketing Implications of Noneviction Clauses.*

2. California State Department of Education Management Advisory No. 92-08 *AB 1200: Criteria for Review of Long-Term Debt Instruments Proposed for Issuance by Local Educational Agencies* (August 20, 1992).

3. For a more complete discussion of these issues, refer to Allan, Ian J., *Unreserved Fund Balance and Local Government Finance*. Government Finance Officers Association *Research Bulletin*, November 1990.

GLOSSARY

NOTE: The following Glossary has been adapted largely from a publication of the California Debt Advisory Commission, entitled ***Glossary of Leasing Terms***. Certain modifications have been made to the definitions.

This glossary is designed from the perspective of the tax-exempt leasing industry. The glossary defines many terms that also apply to municipal bonds and defines others that have specific meaning for tax-exempt leases. Tax-exempt leasing terminology may vary by transaction structure, the types of parties involved, and even by the individuals involved. For instance, one lessor may request that a lessee execute an acceptance certificate; another may require an acceptance letter. In either case, the document serves the same purpose. Reference is made to the *California Debt Issuance Primer*, published by CDAC, for additional definitions that apply to the tax-exempt market in general.

Abatement — A legal concept whereby the lessee reduces its rent proportionately or totally to the extent it does not have use of the leased asset. For leases, in California and some other states, a lessee is not required to make rental payments without use of the leased asset, permitting a termination of rent. Some leases allow a lessee to abate partial payments if use of the asset is limited. Lessor(s)/investor(s) are likely to protect their interests in leases that contain abatement provisions by requiring the lessee to maintain casualty and **rental interruption insurance**.

Abatement Lease — A type of multi-year tax-exempt lease whereby the lessee can commit to make lease payments for the entire lease term unless the leased asset is not available for use, in which case abatement occurs. (This contrasts with a tax-exempt lease with a **non-appropriations** clause.)

Acceleration of Rents — Also called rental acceleration; an option, found in some tax-exempt leases and exercisable upon a lessee **default**, that allows the Lessor (or its **Assignees**) to declare all future rentals then due and payable.

Acceptance Certificate — A certificate to be signed by the lessee confirming that a leased asset has been fully delivered, inspected, tested and accepted. By signing the acceptance certificate, the lessee acknowledges receipt of the asset as ordered and that it is in satisfactory operating condition. The acceptance certificate frequently serves as the document that authorizes the lessor or the **trustee** to make a payment to the vendor for the leased asset.

Advance Funding — A method of funding a lease before lessee acceptance of the leased asset. Lease proceeds are placed in an escrow account until they are authorized to be disbursed to the vendor(s) or contractors.

Arbitrage — The interest earned as a result of the difference between the interest rate at which funds are borrowed and the rate at which they are invested. The Internal Revenue Code (as amended), with some exceptions requires the rebate to the US Treasury of most arbitrage earnings of tax-exempt borrowers. Arbitrage restrictions must be addressed in the structuring of certificates of participation as well as in other tax-exempt lease transactions in which lease proceeds are funded and escrowed

in advance for the benefit of the lessee. A major exception to the rebate requirement was adopted in the 1989 amendments to the Internal Revenue Code. This exception permits a government that borrows funds (including through a lease transaction) for the purpose of a "construction" project to retain arbitrage earnings for up to a two-year period, subject to certain spending tests.

Arbitrage Certificate — A certificate of lessee prepared by the lessor's counsel, bond counsel, or tax counsel confirming that the tax-exempt lease and investment of any proceeds will not violate **arbitrage rules** under the Internal Revenue Code. Also known as a **No-arbitrage Certificate** or a Certificate as to Arbitrage.

Asset — The items of personal or real property being acquired by the lessee through payments over a period of time pursuant to the tax-exempt lease.

Asset-Based Transfer — See also **sale-leaseback**; a lease by a government agency of pre-existing governmental assets to provide the leased property in a lease financing and a lease-back by the government agency of those assets pursuant to the lease constituting the basic financing obligation..

Assignee — The party to which an **assignment** is made.

Assignment — A transfer of legal rights to another; typically, in a tax-exempt lease involving the transfer of the lease and rental payments from the **lessor** to a **paying agent** or **trustee** acting on behalf of the investors or to the investors directly. An assignment may also be used where one investor transfers its interest in the lease to another, especially common in COP transactions. Generally, the lessee will be asked to nominally approve and acknowledge any and all assignments made by the lessor. However, most lessees are themselves prohibited from assigning their rights in or responsibility for a leased asset to another party. If assignment by the lessee is permitted, the lessee is required to obtain the consent of the lessor and to continue to comply with Internal Revenue Code restrictions relative to the financing.

Bank Qualified — Under current provisions of the Internal Revenue Code, commercial banks can deduct 80% of their interest costs on funds used to acquire or "carry" tax-exempt obligations (bonds and leases) of governments that borrow no more than $10 million in a calendar year; otherwise, the interest cost is not deductible by the bank. The availability of the interest deduction on bank qualified leases makes them more attractive to commercial banks than obligations of larger issuers. Commercial banks may invest in non-bank qualified leases but the loss of the deduction for interest costs on funds borrowed by the bank for the initial investment in the lease, requires additional compensation through a higher interest rate in the lease than in a smaller bank qualified transaction.

Basis Point — An amount equal to one one-hundredth of one percent (.0001); a shorthand expression to describe differences in interest rates, e.g., the difference between 7.00% and 7.10% is ten basis points.

Bond Opinion — The opinion of counsel specializing in municipal bonds and other tax-exempt transactions that the lease transaction is legal, valid and binding on the lessee. The bond opinion may also incorporate the **tax opinion**. Lease transactions for small dollar amounts frequently do not have a bond opinion. In larger transactions, bond counsel may also provide a **10b-5** opinion respecting compliance with securities laws and **disclosure** requirements. Most well-known bond counsel are listed in a section of *The Bond Buyer's Directory of Municipal Dealers of the United States*, informally known as the "Red Book."

Call Protection — Refers to the period of time during which a tax-exempt lease cannot be prepaid; during this period, the investor is assured his yield and his investment is protected from early termination. This is similar to protections provided investors against early redemption of bonds. The investment community also uses this term informally to mean the payment premium.

Capital Improvement Program (CIP) — A plan, that is updated annually, for capital expenditures to be incurred each year over a fixed period of several future years. The CIP identifies each capital project, its expected start and completion dates, the amount projected to be spent each year, and the method of financing those expenditures.

Capital Lease — An accounting term for a lease that provides to the lessee all of the rights and obligations to an asset on a basis similar to circumstances had the lessee purchased the asset on a conditional sale or installment purchase basis. Under FASB Statement 13, a lease is a capital lease if it meets one or more of the following criteria: ownership of the asset is transferred to the lessee by the end of the lease term; it has an option to purchase the asset at a bargain price (frequently $1.00); the lease term equals 75 percent or more of the useful life of the leased asset; or the **present value** of the lease payments, including any purchase price, equals at least 90 percent of the fair market value of the asset at the start of the lease term.

Capitalized Interest — Bond or lease proceeds that are reserved to pay interest for a period of time early in the term of the issue. In construction projects, interest frequently is capitalized through the construction period until the project is accepted by the lessee.

Captive Credit Corporation — A wholly owned subsidiary of a corporate organization (usually a vendor) that lease finances the products of the parent corporation.

Certificate of Participation (COPs) — A method of structuring and distributing tax-exempt leases to investors by dividing the rental payments and lease into fractionalized interests or shares for individual sale to investors. The share is represented by a formal certificate, much like a bond. COPs can be placed privately or sold publicly. COPs generally are sold for large asset financing and tend to be used more for real property rather than personal property acquisitions.

Closing Costs — See **Issuance Costs**.

Closing Date — Also known as **issuance date**; the date on which the lessor or investor provides funds equal to the principal amount of the lease either to the **trustee** for subsequent transmittal to the vendor(s) or to the vendor directly. This term is most commonly associated with large COPs transactions where the execution of documents occurs in a formal manner similar to bond closings.

Commitment Fee — A fee sometimes required by the lessor from the date it commits to act as lessor and finance the assets under the lease, until the final funding date. This fee is most commonly applied in a transaction where there is a lengthy period between the commitment by the lessor and the actual funding date. The fee ensures availability of the funds, and in certain instances, availability of a specified interest rate. The commitment fee frequently is refunded by applying an equal amount as a reduction of the lessee's first lease payment. Payment of a commitment fee may not be allowed under local or state law where payments can only be made if the asset is available for use by the lessee.

Competitive Bid — The response made by a vendor, contractor or financial service provider to a request for bid proposal, usually issued by a governmental unit. In tax-exempt leasing, the term usually describes how a **vendor** of an asset is selected but may also describe how the lease financing is selected, particularly among small-dollar volume **privately placed** lease agreements or **vendor** lease agreements.

Competitive Sale — A term describing a method of selling financial obligations (including tax-exempt bonds, leases or COPs) to the bidder presenting the best sealed bid (in terms of price and compliance with the transaction specifications) at the time and place specified by the issuer/lessee (as opposed to a **negotiated sale** .)

Conditional Sales Agreement — A standard form of financing agreement whereby a buyer acquires the immediate use of an asset (and title thereto) and the seller retains a security interest in the asset and the buyer agrees to pay the seller a series of payments equal to the cost of the asset plus interest. Therefore, the transfer of title is conditionally subject to future payments. This is distinguished from an **installment sale** where the seller retains title until all installment payments are made. In both forms of sale, for federal tax purposes, the Internal Revenue Code treats the asset as owned by the purchaser with payments to the seller constituting principle and **interest**; for a governmental purchaser, interest usually is tax-exempt. This term is sometimes used interchangeably with the term tax-exempt lease; however, in California, there is an important distinction between the two (e.g., a lease is constitutionally legal and a conditional sale is not unless it is secured by a special fund.)

COPs — See **certificates of participation**.

Credit Enhancement — A way to protect investors from investment risks by having a third party provide insurance, a guaranty, or additional collateral (e.g., a **letter of credit** to ensure performance by the lessee of its obligations under the lease. The investors and any rating agencies will evaluate the credit based upon the party providing the enhancement; assuming this party has a higher **credit rating** than the lessee, the rating of the overall transaction will be improved, resulting in a lower interest cost to the lessee. A credit enhancement usually provides assurances to the investor against the risks of **non-appropriation** or **abatement** as well as against the credit risk of the lessee.

Credit Rating — An independent appraisal of the credit quality of a bond issue or lease, usually supplied by a credit rating agency.

Cross-Default Provision — A clause, if included in a lease, which states that if an event of **default** arises in other obligations of the lessee, it becomes an event of default under the lease.

Debt — An obligation arising from the borrowing of money to be repaid over a period of time, and if over a multi-year period, subject to state and local constitutional provisions, statutes, and judicial and administrative determinations. In California, tax-exempt leases with **non-appropriation** or **abatement** clauses are not considered debt under the Offner-Dean series of court cases. They are, however, debt in a financial sense.

Default — The failure of the lessee to pay payments or other sums or obligations when due under the lease or failure to observe a representation or warranty in the lease or violation of a covenant in the lease, and the expiration of applicable periods to cure the default. An event of **non-appropriation** or **abatement** is not normally considered an event of default, even when the remedies are substantially similar for each event.

Defeasance — The termination of the obligations of a issuer/lessee by providing for the full prepayment of its obligations. Frequently, a properly documented, usually larger, tax-exempt lease can be defeased (like a bond) by the deposit of sufficient funds with a **trustee** to pay the future lease obligations until maturity or until the first date permitted for prepayment of the lease. Depending upon the structure, the amount of funds to be deposited may be determined by giving effect to investment earnings to be derived from the funds deposited, particularly when investments are made for stated maturities and at pre-determined rates. Defeasance is different than prepayment because although the lessee's obligations are fully satisfied, the lease and the related certificates remain outstanding to be paid later from the funds deposited, avoiding any prepayment premium or similar obligation. Defeasance usually occurs if a lessee wishes to discharge its obligations before the **call protection** period has expired and assuming the lease specifically permits such actions.

Disclaimer of Warranties — A reference to typical provisions of tax-exempt leases under which a lessor, who is not a vendor, will disclaim (reject) any and all responsibility for the suitability or performance of the assets selected by the lessee to be financed under the lease agreement.

Disclosure — Information provided on the government agency/lessee and the financing, to permit an investor to evaluate the creditworthiness of the government agency/lessee, the risks associated with the financing, and the appropriate yield required by the investor for the investment. The information must include financial data. Under a 1989 rule of the federal Securities and Exchange Commission (**Rule 15c2-12**), the timing and filing of disclosure statements relating to tax-exempt financings have been regulated. Disclosure is usually provided through an official or offering statement; or for private offerings, a private placement memorandum.

Effective Interest Rate — See also **implicit rate**; the rate of interest payable by the lessee taking into account accrued and **capitalized interest**, **issuance costs**, discounts and premiums. (As opposed to **Nominal Interest Rate**.)

Enterprise Lease — See **Lease Revenue Bond**.

Escrow Agent — Also known as **trustee;** usually a financial institution that provides administrative services, through an escrow agreement, for the benefit of the parties to a financing including the execution and delivery of COPs, the safekeeping of proceeds, and holding physical possession of title documents for the leased asset. Depending on the lease structure, the escrow agent may have other responsibilities such as disbursement of funds to **vendors**, investment of reserve and acquisition funds (until delivery or construction is completed) and arbitrage calculations. In **COPs**, the escrow agent's role may also include the collection of lease payments from the lessee(s) and the regular disbursement of payments of principle and interest to investors.

Essential Use Certificate — A certificate executed by the lessee indicating that the asset being leased is essential to the lessee's governmental purposes and daily activities. Lessors in almost all capital lease transactions with a **non-appropriations** provision require confirmation of essential use from the lessee, either through a representation in the lease or a separate certificate, or both. In addition, for some transactions, lessees may also be required to provide a project feasibility study and certify the feasibility of the leased asset as well as its essentiality.

Form 8038, 8038-G, 8038-GC, 8038-T —Forms of the Internal Revenue Service that governmental borrowers (including lessees) must complete to report on the issuance of tax-exempt securities, their general purpose, their general financial terms, the exemption used for tax-exempt private activity bonds, and to transmit arbitrage rebate amounts to the IRS.

Full Service Lease — An **operating lease** in which asset maintenance or other service is the responsibility of the lessor.

Funding Date — The date on which funds are transferred from the **investor(s)** to the vendor(s), or **trustee** if the lessee has not accepted the asset. Frequently, the **closing date**, funding date, and acceptance date occur simultaneously.

Hell-or-High Water Clause — A clause contained in most tax-exempt leases that holds the lessee responsible for its lease payments and all other obligations under the lease regardless of the status of the leased asset or any dispute between the lessee and any other party. This clause does not prevent the lessee from exercising its right to **non-appropriate.** In some states, such as California, the lease is altered to permit the lessee to terminate rental payments pursuant to an **abatement clause**.

Implicit Rate — Also called the **effective interest rate**; the interest rate at which the **present value** of all payments made by the lessee, including **issuance costs** and all rent payments, will equal the asset cost.

Independent Lessor — A lessor that is not affiliated with a bank, credit corporation or any other organization or corporation. The independent lessor might be an investor using its own funds or it might be a **lease broker** using funds received or to be received from other investors.

Installment Sales Agreement — See **Conditional Sales Agreement** and **Lease Revenue Bond**. Also known as an installment purchase contract.

Interest — Compensation paid for the use of money or the return on investment from money invested or lent; the interest rate is the interest charge expressed as a percentage of principal.

Investor — In a tax-exempt lease, the party that provides the funds to pay for the leased asset and benefits from the tax-exempt interest whether directly as a single investor or in concert with many investors as a purchaser of certificates of participation.

Issuance Costs — Costs associated with closing and funding the principal amount of the lease including, but not limited to, fees for the bond, tax and securities counsel, printing costs, **credit enhancement** costs (if any), **credit rating** costs (if any), **underwriter's** discount (as applicable), financial advisor or other professional fees, governmental filing costs (if any) and, where appropriate, costs of feasibility studies.

Issuance Date — See **Closing Date**.

Issuer — See **Lessee**.

Joint Powers Authority — A public authority created by a joint exercise of powers agreement between any two or more governmental agencies. An authority can perform any function which all parties to the agreement can perform independently and which will be of benefit to all parties. Such authorities are unique to California.

Lease Broker — Usually an independent leasing company that negotiates leases between lessees and investors. A lease broker may serve as nominal lessor or may underwrite or guarantee the financing. In either case, the broker **assigns** its rights and interests in the lease to an investor.

Lease Line of Credit — An arrangement that allows a lessee to make periodic withdrawals from a line of credit established to finance lease acquisitions. The arrangement is documented as a single capital lease with multiple equipment schedules. A schedule is executed for and at the time of each acquisition by the lessee. Administratively, a line of credit eliminates the documentation hurdle of separate leases on smaller-valued assets and ensures a continued funding source at rates competitive with larger transactions. A lease line of credit is typically utilized in larger dollar financings with extended or variable delivery schedules or in **lease pools**.

Lease Pool — An arrangement whereby a number of unrelated capital leases are grouped together for purposes of a single public offering. The governments are usually similar in nature (e.g., school districts) and are brought together through some common interest association. The lease pool is different than a **master lease** which groups the leasing needs of several departments or agencies in a single government agency/lessee, such as a state or county.

Lease-Purchase Agreement — See **tax-exempt lease**.

Lease Revenue Bond — Also referred to as lease-backed revenue bond; a bond having as its repayment source a lease to which project revenues have been pledged for making regular payments, although the source of lease payments may also include General Fund revenues. In California, such leases are frequently referred to as **enterprise leases**, **installment sales agreements**, or special fund leases.

Lease Term — The length of time during which the lessee has an obligation to make rental payments. The term should coincide with or be shorter than the useful life of the asset being leased.

Lessee — Also called the **issuer;** in a tax-exempt lease, the lessee is a unit of government otherwise qualified to issue tax-exempt obligations which finances the acquisition of assets through the tax-exempt lease by paying specified sums of interest and principal for a pre-determined period. In an operating lease, the lessee only uses the asset for a period of time and returns it to the lessor. To be tax-exempt, the lessee must be a qualifying governmental entity under the Internal Revenue Code.

Lessor — In a tax-exempt lease, the secured party that may provide the funds and act as investor or that may assign its interest in the leased property to another party for these purposes. If the lessor is also the investor, the lessor benefits from tax-exempt income. In an **operating lease**, the lessor owns the asset and derives the tax benefits of ownership which include, as applicable, depreciation.

Letter of Credit — See also **credit enhancement**; a credit facility from a financial institution in which the institution agrees to provide specified funds to meet payments due under a tax-exempt lease, if the lessee does not make those payments. A letter of credit is used to allow the financial institution's credit rating to supplement that of the issuer and to provide additional security that money will be available to pay lease payments. The financial institution is typically reimbursed for any funds drawn by the government agency or by a security interest in the asset.

Master Lease — An arrangement that involves one lease document for the acquisition of different types of assets at different times by one lessee or agencies and departments of one lessee.

Negotiated Sale — The method of selling obligations (including tax-exempt bonds, leases or COPs) where the terms of the obligation, in particular the interest rate, are negotiated between the lessee and the financing source (as opposed to **competitive sale**).

Net Interest Cost — A technical measure of the interest cost of a lease or bond derived by adding together all interest payments for the term of the issue or lease and dividing that sum by the sum for all bonds of the amount of each bond multiplied by the number of years it is outstanding. Net interest cost differs from **true interest cost** in that NIC does not take into account the **time value of money**.

Net Lease — See **Triple Net Lease**.

No-Arbitrage Certificate — See **Arbitrage Certificate**.

Nominal Interest Rate — See **effective interest rate**; the rate of interest often stated in a tax-exempt lease or quoted by a lessor which does not include the effect of **issuance costs**, discounts, **premiums**, or accrued and **capitalized interest**.

Non-Appropriations Clause — A provision contained in some California and most non-California tax-exempt leases that allows a lessee to discontinue its lease payments if, in future years, funds are not appropriated to make lease payments (usually following a best efforts undertaking by the lessee to obtain the funds.) A lessee is not in default under the lease if it non-appropriates. Due to this annual condition placed on the obligation to pay rent, the courts in many states view rental payments as operating expenses under state law and, therefore, not as debt. In the event of **non-appropriation**, the lessee loses use and possession of the asset.

Non-Appropriations Lease — A type of capital lease in which the lease can be terminated if sufficient appropriations are unavailable to continue its payments. (This contrasts with an **abatement lease**.)

Operating Lease — A type of lease that has none of the characteristics of a capital lease for accounting purposes. In an operating lease, the lessee has use of the leased property but the lessor retains ownership, including ownership for tax purposes. The **implicit interest rate** in an operating lease is at taxable rates and payments are considered rent (and not payments of principal and interest). The lessee usually must agree to maintain and insure the property and pay all property and sales taxes in the same manner as in a **tax-exempt lease**. This type of lease is frequently used for assets that the lessee wishes to use for short periods that are less than the full useful of the asset.

Paying Agent — In a COP or **master lease** arrangement, a party appointed by the lessor or the lessee(s) as agent to collect the proceeds at the sale of the COPs and other sums provided by the investors and disburse such monies as directed by the lessee(s). In addition, the paying agent collects rental payments from the lessee(s) and disburses them to the investor(s) as directed by the lessor or under an agreement with the lessor and lessee(s). This function is frequently performed by the **escrow agent**, also called **trustee.**

Premium — The amount by which the price of an obligation exceeds its principal amount; for tax-exempt leases, this usually is expressed in the offering memorandum for the COPs (and may constitute funds available to the underwriter for **issuance costs** and underwriter's discount.

Present Value — The equivalent value today of money available in the future, either at one time or in a series of payments. The present value is influenced by the interest rate factor applied to the future payment(s).

Private Activity Bond — Under federal tax law, bonds of which (i) 10% or more of the proceeds (5% in the case of an unrelated use) are used in the trade or business of nongovernmental persons and 10% or more of the debt service is secured by or derived from property used in the trade or business of nongovernmental persons, or (ii) 5% or more of the proceeds are loaned to nongovernmental persons. Interest on private activity bonds is tax-exempt only if certain requirements of Section 141 of the Internal Revenue Code are satisfied.

Private Placement — A method of selling financial obligations (including tax-exempt bonds, leases and COPs) where the investors are a limited number of informed individual or institutional investors who purchase the obligations for their portfolios and not for resale (as opposed to a **public sale**).

Public Sale — A method of selling financial obligations (including tax-exempt bonds, leases, and COPs) where an underwriter offers the securities to a large number of investors in denominations as low as $5,000. Normally a public sale is made pursuant to an official statement.

Purchase Option — A provision that gives a lessee the opportunity to purchase the leased asset at specific times during the lease term by paying the then outstanding principal, accrued interest, and, as applicable, the prepayment premium.

Refunding — A financing structure applicable to government obligations, including tax-exempt leases, through which the obligation is redeemed by a new financing of the same or a related **issuer** on generally more favorable financial or legal terms. Refundings are subject to certain requirements under the Internal Revenue Code.

Renewable Lease — A lease written initially for a short term (commonly one or two years depending on the lessee's budget cycle) which is renewable for subsequent similar terms until a full term equal to the **useful life** of the asset is reached. In many such leases, renewal occurs automatically unless the lease is specifically terminated by the lessee.

Rental Interruption Insurance — A form of insurance that provides a flow of funds to protect investors in the event that leased property is not usable and the lessee elects to use the **abatement** provisions of the lease. If the asset is not usable and, as a result of the lease contract, the lessee is not required to make lease payments, insurance proceeds would be used to continue the payment stream unless or until the property is restored to a usable condition or the investors are paid the principal and interest due. However, many rental interruption insurance contracts are limited to the payment of rentals for a fixed number of years (commonly two) which period is deemed adequate to restore the asset to useable condition.

Reserve Fund — A special fund from which moneys can be drawn to make lease payments if the lessee is otherwise unable. The fund can be set up entirely from lease proceeds or can be wholly or partially funded by the lessee from other available funds and can be funded at issuance or funded over the term of the lease. A typical reserve fund would be an amount equal to maximum annual payments for the lease, but not to exceed 10% of the original principal amount of the lease.

Rule 10b-5 — A rule of the Securities and Exchange Commission under the Securities Exchange Act of 1934, which requires that persons purchasing or selling securities (whether or not registered) not engage in any device or scheme to defraud or make any untrue statement of a material fact or omit to state a material fact to cause the disclosure statement to be misleading. The liabilities of failing to disclose may extend to bond counsel, underwriter's counsel, underwriters and other participants in the lease financing.

Rule 15c2-12 — A rule, effective January 1, 1990, of the Securities and Exchange Commission that governs the review and delivery by underwriters of official statements released in conjunction with the sale of municipal securities.

Sale-leaseback — An arrangement in which one party sells an asset it owns or is acquiring to another and leases it back so that the lessee receives an infusion of cash from the sale of the asset but still retains its use. In some instances, the lease may be structured as an **operating lease** under which the new owner can depreciate the asset or as a capital lease for which the new owner receives tax-exempt interest and the original owner re-acquires the asset. In the latter case, the sale-leaseback may be referred to as a sale-saleback. This structure is frequently used to permit lessees to employ the equity in assets they own to finance capital expenditures or other programs. For some governmental units, a sale-leaseback is not possible since some may only be permitted to sell property if it is "surplus" to its needs. It would then be a contradiction to first declare an **asset** surplus for the sale and immediately declare it **essential** for the lease. Surplus property rules vary from one governmental unit to another even within the same state.

Sublease — Also sublet; a document or act by which a lessee allows another party to use the leased asset. Subleasing by the initial lessee is often restricted by the terms of the tax-exempt lease. The restrictions usually are meant to ensure the continuation of the tax-exempt status and the security of the original lease.

Tax-Exempt Lease — Also called a municipal lease, installment purchase lease, **conditional sales agreement**, or a **lease purchase agreement**; a financing arrangement whereby a state or local government or agency or subdivision thereof, as lessee, obtains the use and ownership of an asset by making periodic lease payments of principal and interest. Because the lessee is a tax-exempt entity and will own the asset, and assuming compliance with the Internal Revenue Code and, in California, the Revenue and Taxation Code, interest it pays is exempt for federal and California personal income tax purposes.

Tax Opinion — The opinion of counsel specializing in tax-exempt obligations that the interest portion of rental payments received by the lessor or investor(s) from the lessee is exempt from federal income taxes and, as applicable, California income or franchise taxes. The tax opinion may be incorporated into the **bond opinion** or be separately provided.

Time Value of Money — See also **present value** ; an economic concept which takes into account the fact that funds due in later periods may have a diminished present value due to the intervening period and loss of investment earnings by the lender until the payment is received.

Triple Net Lease — Also called a **net lease**; a term describing a lease agreement where the lessee is responsible for all maintenance, insurance, utility charges, taxes, and other charges against the property, associated with the leased asset and that all lease payments to be made are net of all such expenses. Tax-exempt leases are usually triple net leases.

True Interest Cost — See also **effective interest rate**, **net interest cost**; a measure of the interest cost of a lease or bond issue that accounts for the time value of money.

Trustee — See **Escrow Agent**.

Useful Life — A period of time during which an asset will provide the desired service to the party using it. The useful life of a piece of technical equipment could be substantially less than its expected technical life (e.g., computers due to technical obsolescence.)

Vendor — The seller or supplier of personal property.

Vendor-Financed Lease — A privately placed lease that is financed by the vendor providing the financed asset. The vendor also acts as lessor.

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