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LEASES IN CALIFORNIA: THEIR FORM AND FUNCTION

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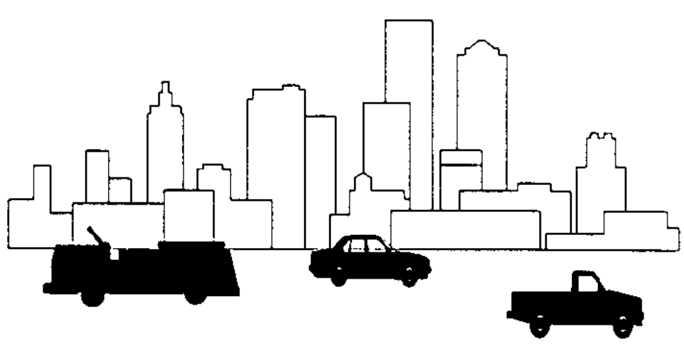

STATE OF CALIFORNIA

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As part of an ongoing effort to provide state and local governments with the latest information on debt issuance and management, the California Debt Advisory Commission is pleased to issue Leases in California: Their Form and Function. The report focuses on the use of tax-exempt leasing to meet the real property and equipment needs of public entities.

While the use of tax-exempt leasing in California represents a recognized alternative to more traditional forms of financing such as pay-as-you-go and bonded indebtedness, little has been written about the form and function of public leasing arrangements. This report attempts to fill that void by providing some insight as to why public agencies employ leases, the types of leases which are entered into, and the purposes for which leases are used. The report also discusses the legal, regulatory, and tax considerations associated with tax-exempt leasing.

It should be noted that the overriding purpose of this report is to serve the informational and educational needs of state and local agencies which utilize tax-exempt leasing to meet their capital and equipment needs and for those agencies which may be considering such arrangements. The report does not attempt to evaluate the appropriateness or cost-effectiveness of various types of lease arrangements, nor does it advocate leasing over other forms of financing.

Recognizing the importance, however, of providing policy direction on this issue, the Commission will make available a companion piece, Leases in California: Summary and Recommendations, to provide recommendations regarding further research and policy development that may be appropriate with regard to tax-exempt leasing in this state.

In closing, I would like to acknowledge the efforts of the many fine individuals and firms who worked on this report, including Russell Lombard and James Dudick of Transocean Funding, Inc.; Lisa Cole of Cole & Associates; Joshua Cooperman of Gaston & Snow; Robert Butler of Public Resources, Inc.; and Eileen Park, Martha Riley, and Janae Root of the Commission's staff.

Sincerely,

Kathleen Brown

KATHLEEN BROWN
California State Treasurer
Chairperson, California Debt Advisory Commission

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.

The California Debt Advisory Commission members include:

Additional information concerning this report or the program of the California Debt Advisory Commission may be obtained by contacting:

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LEASES IN CALIFORNIA:

THEIR FORM AND FUNCTION

A Study Prepared for the

California Debt Advisory Commission

September 1990

Transocean Funding, Inc.
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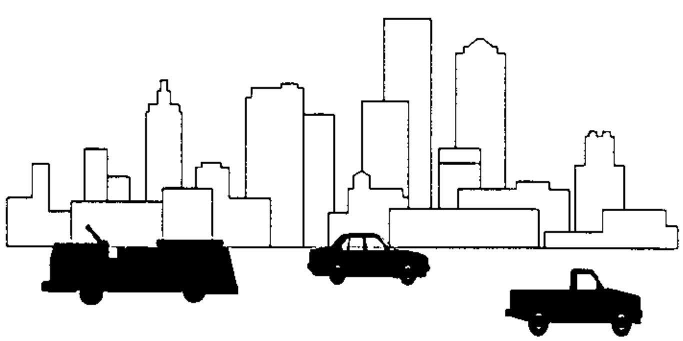

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FOREWORD

Lease financing is a popular way that governments around the country obtain real property and equipment. Whether the lease leads to ownership or just use of the asset by the government, it provides an alternative to traditional pay-as-you-go and debt financing approaches.

The following report on tax-exempt leasing resulted from a Request for Proposal by the California Debt Advisory Commission (CDAC) as part of its continuing role to serve as the State's statistical center for state and local debt issues, to provide technical assistance to state and local governments in the areas of debt issuance and management, and to research and provide policy guidance on debt-related topics.

The Commission collects information on types of debt instruments used by public agencies to fund their public projects. Lease issuance information is important to the Commission since lease financing is often used by local agencies as part of their capital expenditure programs, and is generally included in any review of creditworthiness or rating evaluation.

As the report details, there are many variations on the theme of tax-exempt leasing. Regardless of which form is used, governments use tax-exempt leases to finance essential assets at reasonable costs and match their capital needs with cash flow realities.

The report is intended as an educational aid for local and state government officials interested in public lease financing.

ACKNOWLEDGMENTS

This report would not have been possible without the assistance of numerous individuals and organizations. Their contributions were invaluable.

First and foremost, we would like to express our gratitude to the California Debt Advisory Commission for funding the study. In particular, we would like to thank the staff for their untiring advice and support, especially Harriet Kiyan, Eileen Park, Martha Riley, and Janae Root.

To provide guidance to the consultants, an Ad Hoc Review Committee was formed. The committee members -- experts on leasing, themselves -- reviewed our drafts, offered written and verbal comments, served as resources as we conducted our research, and met with us on several occasions. The individual members are: David Brodsly, City of Los Angeles; Barbara Cooper, University of California, Berkeley; Calvin Grigsby, Grigsby, Brandford & Co., Inc.; Robert E. Hoover, California Department of General Services; Linda Leopardi, California School Boards Association; William H. Madison, Jones Hall Hill & White; Terry Neset, BancOne Leasing Corporation; and Jeanne Olivas, Trust Services Division, State Treasurer's Office. To them we extend our great appreciation.

Further, much of our work resulted from the collective expertise of a number of individuals with many years of experience in public finance and municipal leasing. We would like to thank: David Hobson and Jennifer Royster of the Association for Governmental Leasing & Finance; Ray F. Smith, Citicorp North America, Inc.; L. Gary Simmons, Chrysler Capital Public Finance Corporation; Thomas M. Jaschik, MNC Leasing Corporation; David Glessner and John Miller, GE Capital Fleet Services; Ronald S. Morton, Municipal Leasing Associates, Inc.; David Herskovits, Attorney; Steven Swendiman, County Supervisors Association of California; Dari Barzel, Association of Bay Area Governments; Sheila Flanagan, MBIA; Eric Shapiro, Financial Guaranty Insurance Company; Michael Hark, Sutro & Co., Incorporated; James Bemis, Sumitomo Bank; Martha Lewis, California Financial Services; Dennis Fenwick, Office of the Attorney General, State of Arizona; James Anaya, Hitachi Systems; Charles Vihon, Verrill & Dana; Edwin Huddleson, Volpe, Boskey & Lyons; Richard Hiscocks, Orrick, Herrington & Sutcliffe; and Jeffrey Wong, Cooper, White & Cooper.

We also wish to thank our contributors from Gaston & Snow: Richard Tardiff, Kathryn Sedor and Allen Bass.

The authors take full responsibility for the report's contents. And, in this day and age, as our counsel advises, we would be remiss

without including the requisite disclaimer that this report has been prepared for general informational purposes only and may not necessarily be applicable to the precise circumstances under consideration by any party. It is not intended to constitute legal or financial advice and any persons or organizations interested in entering into a tax-exempt lease are urged to seek the advice of financial, legal, accounting, and other advisers expert in the tax-exempt leasing area.

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INTRODUCTION

This report explains how and why governments -- state and local -- in California use tax-exempt leasing.

Tax-exempt leases generally are considered financing arrangements obligating the governmental lessee to payments of principal and interest for a stated period of time. Legally, in California, leases are not considered debt when they contain an abatement provision that allows a lessee to discontinue making lease payments if it does not have use of or access to the leased asset. In most other states (and occasionally in California), the lease may contain a provision that allows a lessee to terminate the lease if funds are not appropriated for payments (the non-appropriations provision), to prevent its characterization as debt. As a result, properly documented tax-exempt leases do not figure into statutory debt limits in most states. However, these same tax-exempt leases are considered debt for most accounting and credit analysis purposes and are factored into the calculations of outstanding debt by the credit rating agencies and accountants.

Governments are attracted to tax-exempt leasing because it can serve as an alternative to bond financing and as a supplement in any capital improvement program. A government gains great flexibility from tax-exempt leasing because a transaction can be arranged quickly and, therefore, can be used to respond to immediate pressures for new equipment or capital improvements. Because there have been relatively few "problem" tax-exempt leases (leases where non-appropriation or abatement has resulted in non-payment), the market for them is well developed and highly competitive; and leases generally are financed at attractive rates.

The popularity of tax-exempt leasing has led to the development of a very sophisticated national market. The volume of tax-exempt leases nationally has increased from approximately $500 million per year in the late 1970s to greater than $7 billion in 1986, just prior to the effective date of the 1986 federal tax amendments. Since then, the annual volume is estimated to have dropped to between $5 and $6 billion, corresponding to an overall decline in the volume of tax-exempt notes and bonds. Among leases rated nationally by Standard & Poor's in 1989, transactions in California accounted for almost 36 percent of annual lease volume and 52 percent of the total number of rated transactions.

In examining leasing, this report considers structural variations from privately placed vendor-financed leases to certificates of participation for major construction projects.

The report defines operating leases -- when the lessee has use of but not ownership of the asset -- but only for comparative purposes with tax-exempt leases. Asset-based transfers, sale leasebacks, or transactions in which governments act as lessor and lease assets to private organizations are not discussed.

This report is presented in three parts. Part I is divided into seven chapters. Chapter One reviews briefly why governments lease, the different types of lease structures, and the participants in these structures. It describes how funds flow in lease transactions and provides graphic presentations of the relationships of the participants to each other in the different structures.

Chapter Two provides historical perspective to leasing, including legal questions such as why most tax-exempt leases are not legally considered debt under a state law analysis.

Federal and state legislative and regulatory requirements affecting tax-exempt leases are discussed in Chapter Three. These considerations include federal tax, securities and bankruptcy laws and regulations. State requirements concerning legal authority, procurement issues, usury laws and secured party transactions are also reviewed. Based on the legal issues already addressed, Chapter Four analyzes the different provisions in a lease contract and its various attachments.

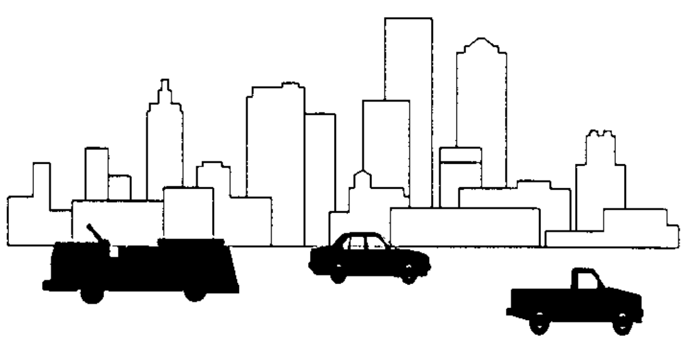
Chapter Five presents a discussion of the accounting treatment that governments apply to their leases. Chapter Six details how leases are marketed to the private sector and discusses the factors lessees should consider when evaluating their lease bids. Chapter Seven follows with a review of the credit issues surrounding leases including credit ratings and credit enhancements.

Part II provides ten case studies of different lease transactions entered into by California jurisdictions. These analyses show how certain governments have structured their financings to incorporate the various leasing elements reviewed in Part One. Commentary on the case study examples explains why certain transactions were structured the way they were and evaluates some of these approaches.

Part III is a brief look at the future of tax-exempt leasing in California.

The appendices include a glossary of terms and a listing of resources for additional information on leasing.

PART ONE



CHAPTER ONE
Types and Purposes of Leases

CHAPTER ONE

TYPES AND PURPOSES OF LEASE FINANCINGS

This chapter reviews different types of tax-exempt leases in which state and local governments participate. It discusses how the different types of leases are structured, who is involved in them, and how cash flows within them.

This section will also review master leases and lease pools -- arrangements that help lessees acquire, on a single financing, assets of different types or that permit two or more lessees to combine their financing needs in one transaction. This discussion is complemented with figures (flowcharts) that depict the flow of funds.

State and local agencies can participate in different types of leasing arrangements that range from operating leases -- where they have use, but not ownership of the property (these leases are not tax-exempt) -- to variations on tax-exempt financing leases, all of which lead to property ownership. This discussion does not examine operating leases except for comparison with tax-exempt leases.

The primary distinction among tax-exempt leases is their packaging -- whether they are small, privately placed transactions (usually for equipment) or whether they are sold to investors through certificates of participation (COPs). The principal distinction among certificated leases is whether they are sold to a limited number of investors or publicly distributed on the retail securities market.

Regardless of the source of funding, the flow of funds for a typical tax-exempt lease is fairly straightforward. Once the lessee has selected the asset and the cost is known, the financing can be arranged. The lessor funds the asset cost to be paid either directly to the vendor/contractor or to an escrow for later disbursement. The lessor may act as investor and make the funds available itself or raise them from among other investors (either individuals, banks, credit companies, corporations, etc.). The lessee makes its regular payments either to the lessor, the trustee or another assignee. Title to the asset will pass to the lessee either at the outset of the lease or at its conclusion, based upon the legal requirements of each transaction.

As the name implies, tax-exempt leases involve interest components calculated at tax-exempt rates. The lessee, as ultimate owner of the leased asset, has the advantage of lower interest payments and the investor earns tax-exempt income. This contrasts with operating leases in which governments obtain use of an asset over the lease term but ownership stays with the lessor. Interest on operating leases, although not always separately stated, is taxable to the lessor and is, therefore, computed at higher rates.

A municipality enters into a tax-exempt lease to finance the purchase of equipment or the purchase or construction of real property. Among the types of assets that can be lease financed are the traditional equipment needs -- such as computers, telephones, firetrucks, automobiles and garbage trucks -- and real estate projects such as jails, administration buildings, and waste-to-energy facilities. However, financed assets, in a few cases, have included less traditional items such as computer software, systems integration and building maintenance.

The term of the financing is generally equivalent to the useful life of the asset being financed. Hence, few equipment leases extend beyond 7 to 10 years but real property leases may exceed 20 years. For instance, police vehicles are usually financed for two to three years, while computers, telecommunications systems and firetrucks are financeable for five to seven (and, perhaps, ten) years. Buildings generally can be financed for 20 years while it may be possible to finance some environmental facilities (wastewater, solid waste, etc.) for up to 30 years.

WHY LEASE?

The value of leasing to governments is that it serves as an alternative to bond financing and can be an essential part of a capital improvement program to supplement the issuance of bonds. A government gains flexibility from tax-exempt leasing because a transaction can be arranged quickly and, therefore, it can adapted to unusual or unique circumstances requiring the acquisition of assets in an expedited manner.

Among the reasons that governments participate in tax-exempt leases are:

- they provide 100 percent financing of asset cost;
- they spread out the cost of equipment or facilities over the assets' useful lives;
- the short useful lives of certain assets do not justify bond financing;
- selling bonds, including obtaining voter approval, can be time consuming and, given the time value of money, may increase the acquisition cost;

- o equipment leases are relatively simple to complete and allow governments to obtain their equipment quickly;
- o the bond market may not be an option because the lessee has no bond rating or market experience, or the lessee is unable to have a bond referendum approved;
- o they offer the opportunity to preserve cash for other projects or activities for which leasing is not an alternative; and
- o they do not require voter approval.

Tax-exempt leases also may be referred to as: municipal leases, installment sales, lease-purchase agreements, conditional sales, and lease-to-ownership agreements.

NON-APPROPRIATIONS AND ABATEMENT PROVISIONS

The difference between a bond or note and a lease is that in most instances a tax-exempt lease is not legally considered debt because of the non-appropriations or abatement provision found in leases. The non-appropriations provision states that in the event that future years' lease payments are not appropriated, the lessee can terminate the lease without being in default and without obligation to make further lease payments. The lessee, however, must return the asset. Under the statutes of most states (and upheld by courts in at least 30 states), the effect of the non-appropriations language is to make lease payments operating, rather than capital, expenses.

As protection for the investors, most non-appropriations leases also contain a non-substitution provision which states that following a non-appropriation, the lessee, for a specified period, cannot substitute like equipment or contract for services that the leased asset would have provided. They also contain covenants requiring best efforts by the lessee to request funding of lease payments in future fiscal periods and a confirmation of the essential use of the equipment being funded.

As a result of the perceived risks of non-appropriation, tax-exempt leases are arranged for essential assets -- those assets regularly used in the day-to-day operations of the lessee. In the view of investors, rating agencies, and credit enhancement providers, it is less likely that a lessee will non-appropriate for an asset on which it relies to perform an essential function (i.e., a computer that keeps tax roles and handles all other accounting functions.)

In California, however, many tax-exempt leases are structured with abatement clauses that allow lessees to stop rental payments if they do not have use of the leased asset. These clauses may allow or call for abatement of all rents or may permit proportionate abatement of an amount of rents applicable to that portion of the asset(s) not available for use. This provision may be in addition to a non-appropriation provision but more likely replaces it. California courts have ruled that abatement leases do not legally constitute debt. Further, they have held that such leases can be executed for multi-year periods, can have rental payments payable from any legally available source, and can have stronger default provisions. To protect investors from abatement risks, many of these leases require the lessee to purchase rental interruption insurance to supplement the usual requirement of property and casualty insurance.

The market perceptions of non-appropriations and abatement leases differ. In general, an abatement lease, particularly when supported by rental interruption insurance, is viewed as a less risky investment because the lessee is obligated to budget for and make its lease payments. Lease payments can be terminated without a default if the lessee is denied use of the asset. On the other hand, a non-appropriations lease allows the lessee to terminate a lease, without being in default, if it should non- appropriate for lease payments.

TYPES OF LESSORS

To understand tax-exempt lease arrangements, it also is helpful to know the types of participants who act as lessors for such transactions. Tax-exempt leasing dates back at least to 1954 when the federal tax courts first began to determine how the interest portion of lease payments made by a governmental unit would qualify as exempt from federal income tax. At that time, tax-exempt leasing generally involved transactions between a lessee and an equipment vendor. By treating part of the lease payment as tax-exempt interest, the vendor could be more competitive in its lease rates to governmental customers and presumably could sell more equipment.

As early as 1970, lease brokers, who traditionally facilitated taxable lease transactions, began to provide their services to the tax-exempt lease market. The lease broker is typically an organization that specializes in assisting vendors or lessees in locating investors to fund the sale/purchase of assets. Throughout the early and mid 1970s, the typical client (investor) of the lease broker was an institution, such as an insurance company or bank, with some brokers or investment bankers selling small leases directly to wealthy individuals. The lease broker gradually became more sophisticated and created both lessor companies and brokerage (or lease placement) companies. Sometimes these affiliated companies have different names which make the involvement of the lease broker's affiliates less apparent to lessees and investors.

Starting in the late 1970s, institutional investors began to participate directly in the structuring of tax-exempt lease transactions and now actively solicit transactions among lessees. These types of investors are typically large finance companies which are often affiliated with corporate conglomerates (e.g., General Electric Credit Corporation, IBM Credit Corporation, etc.) or subsidiaries of major commercial banks. In addition, captive credit companies (which only finance assets that their affiliates produce) have also increased their activities in tax-exempt leasing.

Finally, with the enormous growth of tax-exempt leasing that occurred in the 1980s, a new financing source joined the list of participants. This is the individual investor represented by an underwriter who primarily sells tax-exempt leases through the certificate of participation format. Although underwriters can and do sell some transactions on a private placement basis, their greatest contribution is in the retail distribution of COPs to large numbers of individual investors. The availability of retail market distribution has contributed greatly to the increased volume of tax-exempt leases. However, underwriters generally cannot act as lessors. Therefore, another group of lessors -- including non-profit corporations, joint powers authorities, and other special authorities -- have developed to facilitate large underwritten transactions.

With this brief introduction to tax-exempt leases and lessors, the next sections discuss different types of leasing arrangements, why and how they are structured, who participates in them, and the flow of funds.

TYPES OF LEASES

Privately Placed Tax-Exempt Leases

Although the general terms and conditions of most tax-exempt leases are similar, some structures are more complex than others and involve more participants. The simpler leases generally include fewer participants, tend to be for relatively small dollar volume acquisitions and are sometimes termed "middle market" transactions.

The first lease structure reviewed is of the simpler (usually smaller) leases which are collectively referred to as privately placed tax-exempt leases. The label "privately placed" refers to the fact that the leases ultimately are sold privately to a few investors and frequently are sold to a single investor as a single lease.

Because there are no reporting requirements either nationally or in most states, the annual number of privately placed leases is unknown but is thought to be quite high. At the same time, however, the total dollar volume is estimated to be low, particularly in relation to the dollar volume of certificates of participation.

The typical privately placed lease involves a lessee that wants to acquire property (usually equipment but sometimes real property) with a relatively low dollar cost. The dollar amount of each lease can run from $10,000 to $5,000,000 or sometimes even more. However, most privately placed leases usually are for less than $1 million.

Privately placed leases are used to finance capital assets in many states around the country. In California, these leases have either abatement or non-appropriations provisions. However, in most other states, privately placed leases contain non- appropriations provisions.

Lessees seek their financing either competitively or through negotiated bids. This decision may be dictated by state or local laws that require competition. Some lessees may choose to negotiate the financing in order to expedite the process or because the transaction size is too small to interest or warrant an extensive bidding process or is too time-consuming to warrant any resulting savings.

Most lessees enter into a privately placed lease when they need equipment and they do not have the cash to pay outright or they are unable to or do not want to use bond proceeds for the purchase. Generally, the lessee selects the asset needed and solicits proposals for its acquisition. It may ask the vendor to state a purchase price that includes a lease rate or to provide both a cash purchase price and a calculation of what lease payments would be.

However, many lessees will solicit vendor prices for the asset acquisition only and will independently seek lease financing rates from third-party companies and financial institutions accustomed to investing in tax-exempt leases. This permits the lessee to obtain the most cost effective price as well as financing cost. Many vendors do not specialize in financing their products and, as a result, either will offer to finance at high rates (and serve as the investor) or will introduce a third-party lessor/investor. In the latter situation, the involvement of the vendor as lease broker tends to drive up the financing cost. Lessees also may benefit from separating asset acquisition from financing bids by potentially broadening the equipment supplier market. This occurs because some vendors cannot or do not offer financing and would be excluded from bidding on a combined sales and finance package.

The two primary categories of privately placed tax-exempt leases are described below.

Vendor-Financed Leases

As its name implies, the vendor-financed lease involves a vendor of equipment handling the financing of the leased asset. In this type of lease, the vendor usually acts as lessor and investor and holds the lease for its full term. Alternatively, the vendor may assign the lease to one or more subsequent investors. The vendor/lessor is responsible for providing the leased asset -- both its manufacture and its financing. Usually, no funds are required in a vendor-financed lease until the asset is delivered and accepted, at which time lease payments commence from the lessee to the vendor/lessor.

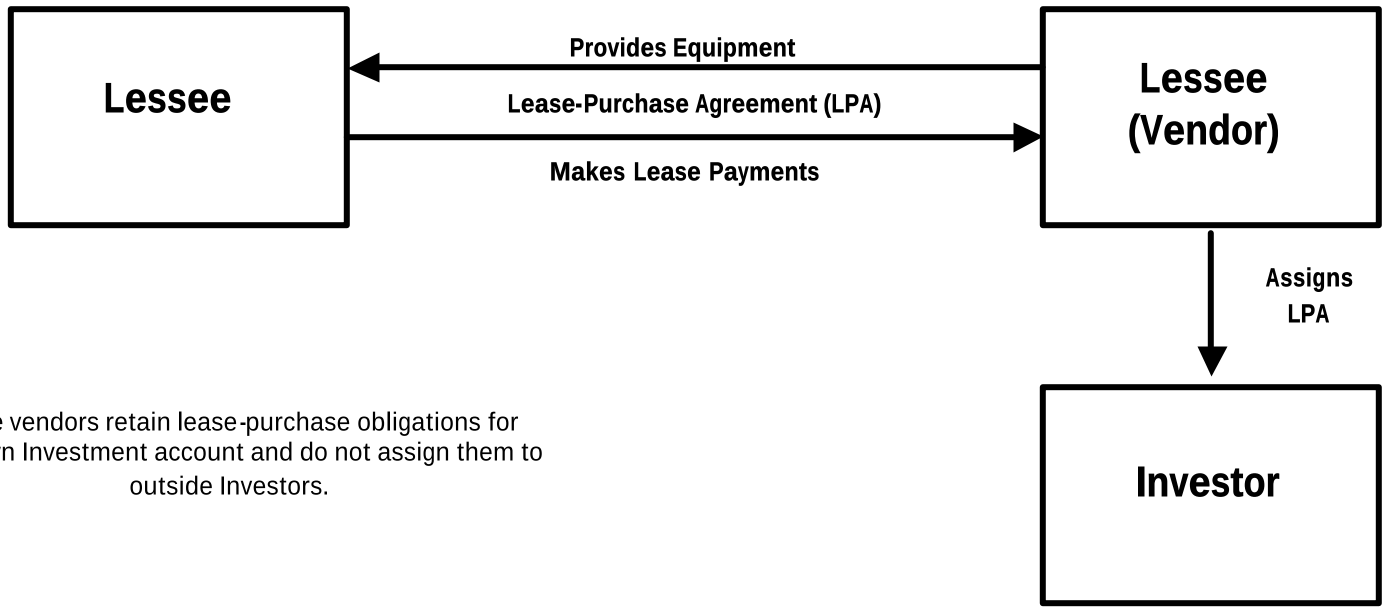
The primary incentive to the vendor/lessor is usually to accommodate the sale of the assets it manufactures. If the vendor retains the lease as an investment, the vendor will also receive tax-exempt interest from the future lease payments. If the vendor assigns the lease to other investors, the vendor may receive a broker's fee from the new investor, adding another layer of cost to the financing. Many vendor/lessors, however, do assign leases to investors without making an additional financing profit. In these cases, the vendor provides the financing to its customers as a service, presumably to encourage future sales of its products.

The vendor-financed lease is usually the easiest and quickest to document. It typically involves a single (often preprinted form) lease between the vendor/lessor and the lessee. The lessee will be expected to provide an opinion of its counsel that the lease is valid and binding and that the lessee has complied with the bidding and procurement statutes. A separate bond or tax counsel opinion is generally not required. Since the vendor is typically the initial lessor, an escrow of funds to assure payment of the acquisition price is unnecessary and rarely found in these transactions. Figure 1 presents a flow chart of this sample transaction.

Third-Party Financed Leases

In a third-party financed lease, someone other than the vendor assumes the responsibility of providing or arranging the financing of the leased assets. The third party may be a direct investor or a lease broker, either of whom usually acts as lessor, although occasionally the vendor may continue as lessor. The difference between a vendor/lessor in a vendor-financed lease and a vendor/lessor in a third-party financed lease is the level of financing responsibility the lessor assumes.

Vendor-Financed Lease Purchase



Some vendors retain lease-purchase obligations for their own Investment account and do not assign them to outside Investors.

Figure 1

In the simplest form of a third-party financed lease, the lessor leases to the lessee who accepts the asset from the vendor, following which the lessor pays the vendor and the lessee makes lease payments to the lessor. After the lessee has selected the asset and the lease financing is documented, the vendor is authorized to deliver the asset. If the leased asset is not accepted in its entirety at the time the lease is funded, some or all of the purchase price may be placed in an escrow account. In such cases, the services of an escrow agent/trustee will be required. The escrow agent holds the lease proceeds until the lessee accepts the asset and authorizes the escrow agent to pay the vendor.

A third-party financed lease generally takes more time to document than a vendor-financed lease, frequently three weeks or longer. The lessee will be required to provide the same type of legal opinion as required for a vendor-financed lease. However, the third party may also require a separate opinion of tax counsel concerning the tax-exempt treatment of the interest portion of the lease payments under federal and state income tax laws.

The various parties in this case benefit from the transaction in different ways. The lessee finances its assets at tax-exempt interest rates without incurring debt. The vendor benefits from the sale of its product. The third-party lessor/investor earns a profit from receiving tax-exempt income or, where it assigns the lease to investors, from a "spread" in the financing rate it receives from the lessee and the rate at which it obtains money from investors. For instance, in a lease in which the third-party lessor assigns its interests to another party, the lessee may be paying an interest rate of 7.5 percent and the lessor may find an investor willing to fund the transaction at a tax-exempt yield of 6.75 percent. The spread of .75 percent is the lessor's gross profit and the new investor becomes the beneficiary of tax-exempt income. The lessor's gross profit is reduced by any closing costs (legal fees, etc.) to achieve its net profit. Usually the smaller the dollar volume of the lease, the larger the spread to compensate the participants to the transaction. The actual dollar margins will depend on the size of the financing, the terms of the lease, and the payment frequency. For example, to receive 1 percent of margin (or gross profit) on a three-year lease with monthly payments in arrears, the lessor will require an interest rate spread of approximately .67 percent (67 basis points); to achieve the equivalent margin, for a lease with a five-year term, the spread is reduced to .42 percent (42 basis points). Similarly, a monthly payment structure will provide less margin to the lessor than quarterly payments due to the present value of cash flows.

Figure 2 outlines the flow of activities in a typical third-party financed lease.

Certificates of Participation

A popular form of lease packaging involves a certificate of participation (COP). A COP is a variant of a lease financing in which the lease is divided by the lessor into individual units sold separately to investors. More precisely, a COP is a security (issued in a form similar to a municipal bond) that evidences the undivided fractional interest the investor holds in a particular lease and, as appropriate, a security interest in the rental to be paid and the assets being financed. The number of parties, the documentation and the cash flow patterns mirror those of a bond sale. COPs also can have as many structural variations as bonds.

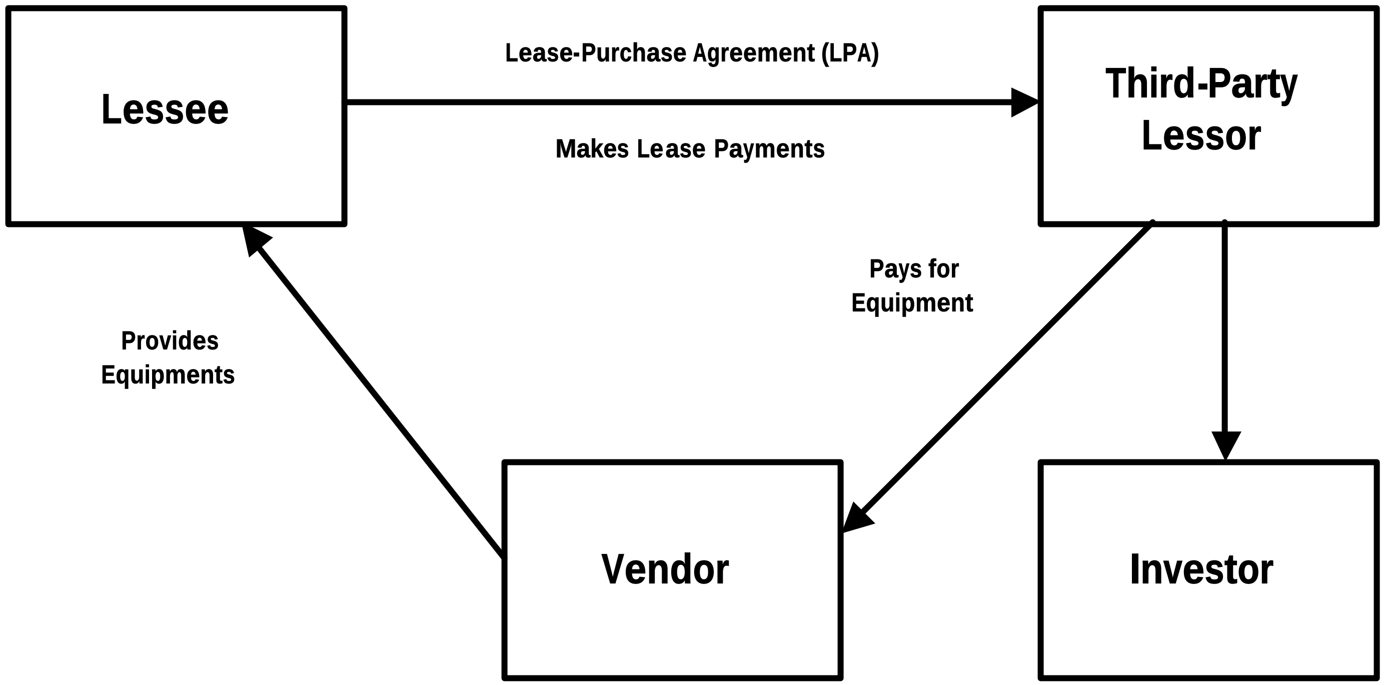
The volume of COPs increased significantly in the 1980s with governments in California accounting for the vast majority of those transactions. By example, the California Debt Advisory Commission (CDAC) reported in 1988 that 165 COPs were issued in that state for a total dollar volume of more than $2.2 billion. Standard & Poor's Corporation reported for the same period that, nationally, it rated more than $3.5 billion of tax-exempt leases, with leases by California governments representing 47.1 percent of that total. The primary reason for the high volume of COPs in California is the impact of several legislative referenda (including Proposition 13 and the Gann initiative) that severely limit property taxes as a source of revenue to governments in the state and require a 2/3 majority voter approval for any general obligation debt financing. Decreased revenues have led, quite naturally, to a leveraging of that revenue to lease financing.

COPs are used for all types of assets but have been widely used for large real property purchases. The distinction between a COP and a privately placed transaction is that COPs are generally sold to more than one investor. Although they may be sold privately to sophisticated investors, they frequently are sold publicly, through broker-dealers, in an underwritten transaction to a diverse group of investors.

A COP is more complex than a privately placed lease. While the underlying lease has the same contractual features (non- appropriation or abatement, essentiality, etc.), the transaction requires more time to organize and involves more participants.

The participants in a COP transaction include the governmental lessee, the lessor, the vendor(s) and an underwriter who will solicit investors. Many COP transactions also require a trustee. The trustee acts on behalf of the multiple investors primarily to collect rent from the lessee and to disburse it to the respective investors. In some transactions, the trustee also holds the acquisition funds in an escrow account until payment to the vendors or contractors is required. Finally, the trustee has a duty to act for the investors' interest if the lessee defaults, abates, or non-appropriates on the lease. The trustee may also be substituted by a paying agent or escrow agent.

Third-Party Financed Lease Purchase



- Some third-party lessors do not assign the lease obligations but retain them as their own Investment.

Figure 2

Most of the parties will be represented by counsel and a bond or tax counsel will participate to render the opinion that the transaction is tax-exempt. Other participants may include the credit rating agency analysts (if the transaction is to be rated) and representatives of the credit enhancement provider (if it is to be enhanced). The enhancer will also be represented by counsel. Of course, lessee's counsel will be involved during the preparation and negotiation of the documents.

COPs are or may be structured with a nominal lessor that may be a non-profit corporation, a private entity, a joint powers authority, or another special agency. This structure typically involves a trustee who receives the proceeds of the COPs sale and to whom the lessor assigns the duties to disburse the proceeds to the vendor(s), the collection of lease payments, and the disbursement of principal and interest payments to the certificate holders.

COPs can be sold competitively or on a negotiated basis. If competitive, the lessee, usually assisted by special counsel and a financial advisor, prepares the documents, issues the official statement, takes bids on a specified date and awards to the lowest bidder. When negotiated, the underwriter works closely with the lessee in structuring the transaction and preparing the documents, including the official statement; the pricing is negotiated between the underwriter and the lessee. In a negotiated transaction, the lessee may be in a position to bring its COPs to market at an advantageous time relative to interest rate volatility. In addition, negotiation sometimes allows the lessee to market more complicated COPs to specialized investors (those who understand the lease document and the risks of non- appropriation or abatement). On the other hand, the competitive sale of COPs assures open bidding among a wide source of underwriters and, for straight-forward transactions, may produce the lowest interest cost.

One way in which a COP structure may differ from that of a bond is that COPs may call for a debt service reserve fund that may mitigate the risks of non-appropriation or abatement. In this case, COPs are funded for more than the asset cost to provide for the debt service reserve account. In accordance with the 1986 Tax Reform Act, reserves from bond or lease transactions may not exceed 10 percent of the initial offering.

COPs are generally sold through an official statement that describes the transaction, the sources of repayment, and the general economic, financial and demographic trends of the lessee. Like bonds, COPs may be rated. They may also have credit enhancements to offset the investment risks of non-appropriation or abatement. COPs are traded in established securities markets and for public offerings are typically sold in $5,000 denominations.

Figure 3 shows the typical way in which funds and responsibilities flow in a COP transaction.

Lease Revenue Bonds

Lease revenue bonds in some instances are the equivalent of COPs except the word "bond" may make them more acceptable in the financial marketplace. For example, if a building authority issues revenue bonds to finance the construction of a jail or office buildings and then leases that facility to another state agency, the underlying lease most likely will contain the same language and provisions common to the tax-exempt leases previously discussed. Therefore, a revenue bond relying on the pledge of the lease payments has similar risks as a COP. Lease revenue bonds also are not treated as debt for state law purposes, either under the "lease" exception discussed in Chapter Two or under the special revenue exception to debt limitations.

However, many lease revenue bonds will also be supported by a specific pledge of the income derived from the leased asset. For example, the lease of a wastewater treatment facility by an improvement authority to a municipal sewer utility would likely contain a pledge of net sewer fees charged by the utility to its customers. This type of lease revenue bond is principally evaluated on the strength of the pledged revenue stream and not primarily on the other provisions of the lease.

In California, issuers of lease revenue bonds (also called enterprise leases) include non-profit corporations, joint powers authorities, redevelopment agencies, and parking authorities. In other states, other types of governmental entities can issue these bonds as long as they are supported by project revenues.

Lease revenue bonds involve similar parties with similar roles as already reviewed above in the discussion on COPs.

Certificate of Participation

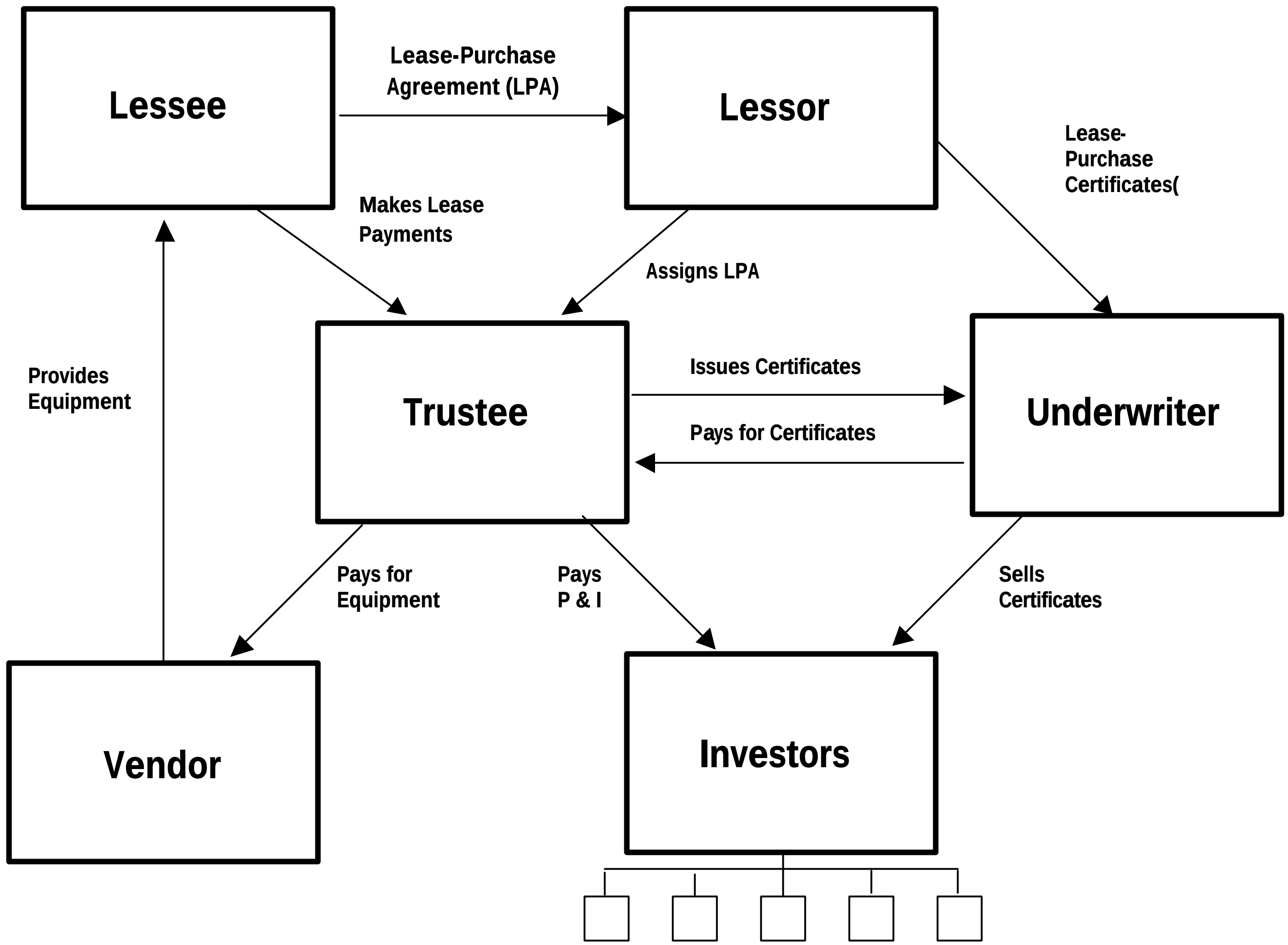


Figure 3

Master Leases, Lines of Credit and Lease Pools

Master Leases

A master lease can provide governmental lessees with many economies and efficiencies. By entering into such an arrangement, a lessee is able to acquire various pieces and types of real and/or personal property from different vendors over a period of time under one lease contract. In addition to the benefits of working with one set of documents for multiple acquisitions, the lessee does not have to seek financing each time a new acquisition occurs. Frequently, master leases are arranged to consolidate outstanding leases or to coordinate the leasing activities of many agencies within one government.

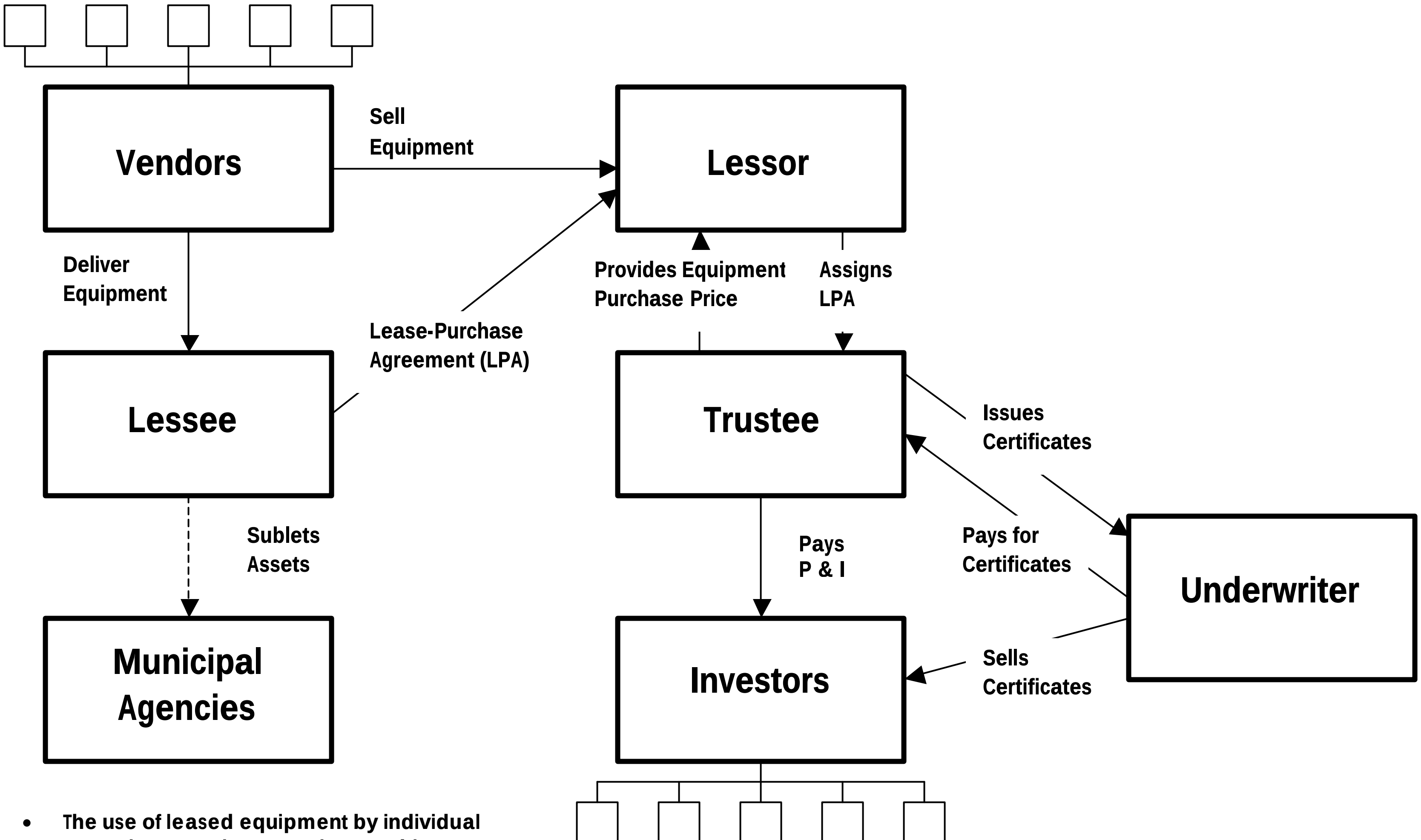
The flow of funds of a master lease will mirror either that of a third-party financed lease or a COP (except that a trustee or paying agent is usually involved to hold funds and disburse to vendors as appropriate). The primary difference between a master lease and other tax-exempt leases is that there generally is more than one vendor and there may be more than one user. Frequently, a primary lessee in a master lease (such as a state purchasing bureau) may sublease the assets to other qualified municipal agencies.

When a master lease involves assets to be used by many agencies within one government, an additional set of agreements may be required, depending on the authority of the central governmental unit acting as lessee in the master lease. The central lessee may simply be authorized by statute to act on behalf of all agencies or it may require the agencies to specifically authorize its actions. If an authorization document is needed, it could be in the form of a sublease agreement incorporating all the provisions of the master lease, or it could be a simple memorandum of understanding committing the user agencies to abide by the terms of the master lease.

Figure 4 outlines the master lease transaction which typically occurs when operating departments of a governmental unit request a central purchasing or finance office (the "primary lessee") to lease assets to serve each department's unique needs. The primary lessee enters into a lease with a lessor who generally assigns the lease to a trustee who issues certificates of participation to an underwriter. The underwriter sells the COPs to investors and deposits those proceeds (less commission) with the trustee for payment to vendors after delivery and acceptance of assets by the operating departments. The primary lessee is responsible for collecting rents from the operating departments and remitting these to the trustee, who in turn pays the investors.

Many master leases with non-appropriations provisions are structured as "all or nothing" leases to enhance their security value. In other words, if a lessee chooses to non-appropriate, it must non-appropriate all assets acquired under the master lease. With this restriction, the risk of non-appropriation is minimized.

Master Lease Agreement



- The use of leased equipment by individual agencies sometimes requires a sublease agreement or a memorandum of understanding between the central government unit and each agency.

Figure 4

Lease Lines of Credit

Many master leases are also organized as lines of credit with the interest rates set by formula as the funds are needed. At the point at which funds are drawn down, the rate is fixed pursuant to an index or continues to float on an index. As a result of this structure, lessees know or can calculate the cost of financing from the outset and are assured that their costs are competitive and reflect current interest rates.

Lease lines of credit are normally provided directly by investors or some lease brokers who arrange to provide the requisite financing on demand whenever the lessee receives assets under the program. The line of credit lessor agrees to pay vendors identified by the lessee as and when assets are delivered and accepted. Specific assets are not identified when the line is negotiated; however, an understanding is reached during the negotiation of the documents as to the types of assets and the useful lives that are acceptable. When each asset or group of assets is paid for, a schedule is added to the lease to identify the asset, the financing term, and the applicable payments.

A lease line of credit frequently does not involve a trustee or paying agent because the line provider acts both as lessor and investor. A trustee or paying agent may be used if a subsequent sale to multiple investors is anticipated.

Lease Pools

In the last several years, some state associations have sponsored tax-exempt lease pools. In California, for instance, the County Supervisors Association, the California School Boards Association, the California Special Districts Association and the Association of Bay Area Governments have set up lease pools for their members. Similar programs have been set up by the Florida School Boards Association and the Utah School Boards Association.

These lease pools typically are organized with a subsidiary of the sponsoring organization acting as nominal lessor and usually involve a group of separate leases to several lessees. The pools are organized and sized to respond to the lease needs of the member governments. In active programs, lease pools may be financed annually or more frequently.

A lease pool will always involve a trustee to receive lease payments from multiple lessees and disburse them to the investors. The trustee will issue COPs representing undivided interests in all leases in the pool. An investor assumes a portion of the risk associated with each lease. However, since each lease is legally a separate obligation, the risks of non-appropriation or abatement are limited to the specific lessee; the different lessees are not responsible for the obligations of other lessees.

A credit enhancement in the form of a liquidity letter of credit can be of particular benefit to lease pools that involve a number of different lessees. Because of the differing levels of creditworthiness among the lessees in a pool, a liquidity letter of credit can contribute to its marketability by providing a uniform level of credit to the lessees and assuring investors of prompt payment.

Because of their complexity and the larger number of lessees in lease pools, bond counsel and other special counsel will assist in the preparation of documents to assure their compliance with federal tax and securities laws. In addition, each lessee's counsel will be involved in the transactions.

CONCLUSION

In summary, the roles of the different participants to a lease transaction are outlined in Exhibit 1 below. As the prior discussion reveals, these parties may or may not be in all leases; they may play more than one role; and they may play different roles.

While the size of transactions and the sources of funding may vary, the underlying leases are very similar. Lessees select the lease packaging that best fits their needs -- whether it is a vendor-financed transaction for a small equipment purchase or a publicly sold COP that will finance a new city hall. The flow of funds and responsibilities in these transactions may differ in their complexity as may the number of parties involved but the result is the same. A government has acquired an asset and has not incurred debt but has undertaken a payment obligation. The investors receive tax-exempt income and have a secured interest in an asset that they hope never to possess.

EXHIBIT 1

TAX-EXEMPT LEASING: PARTICIPANTS AND THEIR ROLES

Who	**Role**
Lessee	Governmental unit that uses the leased asset, makes periodic payments of principal and interest, and gains ownership of the asset at some point during the transaction. The lessee chooses the asset and financing source.
Lessor	Party that may provide the funds and act as investor or that may assign its interest in the leased property to another party. If a nominal lessor, it acts as a conduit to acquire the asset for resale to the lessee. The lessor may be the vendor/contractor, the investor, or a public or private third party.
Vendor/Contractor	Party that provides the asset to the lessee. These parties are selected by the lessee and perform according to lessee specifications.
Underwriter	Original purchaser of COPs (from the lessee or escrow agent) with the intent to resell the certificates to investors.
Assignee	Party to whom lessor assigns its rights and interests in the leased asset.
Credit Rating Agency	Provides the credit rating to some lease transactions.
Credit Enhancement Provider	Party that protects the investors against risks of non-appropriation abatement or default by providing a financial guaranty.
Trustee/Escrow Agent	Usually a financial institution that provides administrative services, through an escrow or trust agreement, for the benefit of the parties to the lease including, among other services, the safekeeping of proceeds, and holding physical possession of title documents for the leased asset. Depending on

the structure, the lessee or lessor pays trustee fees which, depending on the transaction, may be assessed annually or are paid at lease commencement.

Financial Advisor Consultant who provides assistance in the structure, timing, terms and other topics concerning new or existing leases.

CHAPTER TWO

Debt Restrictions and California Case Law

CHAPTER TWO

DEBT RESTRICTIONS AND CALIFORNIA CASE LAW

This chapter analyzes how tax-exempt leases are treated to avoid constitutional debt limitations and ensure that the tax-exempt nature of the "rental" payments is not jeopardized.

RESTRICTIONS ON DEBT

Most states prohibit the incurrence of debt to be paid over a multi-year period without voter (and, as required, legislative) approval. These restrictions developed following extensive defaults caused by extravagant borrowings in the late 19th century. To forestall further mortgaging of future general tax revenues, the legislatures of most states enacted restrictions on the incurrence of multi-year debt by municipalities absent voter or other types of approval. The restrictions focus on obligations funded from general ad valorem taxes in future years. When the obligations are repaid from funds other than such taxes, the restrictions generally do not apply.

Given the financial straitjacket imposed on governments and the capital needs of growing communities, exceptions to the statutory framework were developed by legislative bodies or promulgated by the courts. These included exceptions for special "assessment" districts, for revenue-based obligations, for project-type financings not encumbering the general taxing power as well as for special districts. In essence, if the source of payment does not encumber the general tax revenues, or if the district is not enumerated within the debt limitations (such as a special district or special assessment district), the restrictions do not apply.

The "Lease" Exception

In addition to exceptions for "special districts" or "projects", the courts have long held that lease contracts which were to be paid within the fiscal year or which obligated the municipality to provide payment only on a year-to-year "renewable" basis were not constitutionally debt. The courts reasoned that the payments were akin to contingent obligations or current expenses, for which future annual revenues technically were not being pledged. Accordingly, they were not long-term debt. This concept was cloaked under various rationales, the two most cited by the courts being the "contingency" exception and the "lease" exception.

In California, this analysis was particularly elucidated in a series of cases, the most prominent of which are City of Los Angeles v. Offner[1] and Dean v. Kuchel.[2] In these cases, the courts indicated that where the lessee's specific obligation is limited to the rentals paid during the fiscal year for the item, and to monies currently available (and do not relate to, or encumber funds in, other periods), the lease is valid. This results even if the total sum of rentals may equal the purchase price (plus a finance charge) and title passes to the lessee automatically at the end of the lease. Provided these qualifications are structured into the rental obligation, no debt is created.

Offner-Dean Rule

Offner involved a proposed long-term lease of an incinerator to be erected on City-owned land and leased by the lessor to the City. The lease provided for purchase options at specified periods, at the greater of a minimum price specified in the bid or an appraised value. The lease was challenged on the basis that it constituted an installment sale over a multi-year period and violated the debt limitations. The court held that the proposed agreement constituted a lease, not an installment sale, because the rentals and purchase options represented "fair value". Accordingly, the court reasoned the City would not feel compelled "to exercise [its] ... option in order to protect its prior investment in the form of rental payments." Since the rental payments did not exceed fair rental value, by the terms of the court's analysis, there was less likelihood that the rentals constituted equity. As a consequence, the rentals could be viewed as payment for "the consideration actually furnished that year", and not a subterfuge for future consideration to be paid. As stated by the court, where the lease obligation, even if multi-year, was entered into in good faith and confined liability for rent to each installment as it becomes due, and the rental was for consideration (quiet enjoyment and use) of the asset furnished during the year, "no violence is done to the constitutional provision." Citing a prior case involving the furnishing of services (hauling of sewage) to a municipality in which the liability was contingent upon performance, the court reiterated that provided the payments were for services or consideration furnished in that year, the same result should apply, upholding the contract.

The rationale in Offner was amplified in Dean v. Kuchel, a subsequent case involving the lease of a building by the State on a triple net lease basis over a multi-year period. The lease was structured to conform to Offner, in that the rental was "for and in consideration" of use of the facility. However, unlike Offner, the State was to receive title upon expiration of the lease without any further payment, and in any event (even if the State defaulted), 10 years following the stated term of the lease. Notwithstanding these factors, the court held the principles of Offner applied. Dismissing the difference between the two cases over the purchase option and reversion of title, it held that "no substantial or logical difference [existed] between the option to purchase in the Offner case and the vesting of title at the end of the term in this case." In fact, the court specifically emphasized that "no useful purpose would be served by reviewing other cases ...", content to republish the factors cited in Offner. The court reviewed the character of the monetary obligation needed for the State to lease purchase the facility. Since the court viewed the rental obligation as similar to that of Offner (despite the fact the purchase option price, a key element for characterizing operating leases, was now absent), the lease was upheld as outside the debt limitation.

Dean expanded application of Offner to situations where the lessee received title at the end of the lease without any payment of a purchase option or an appraised value. While such -- leases more typically are treated as finance leases, the court treated the situation as parallel to Offner. Since the base rentals (the principal and interest amortization) had to be paid in either case -- regardless of the different buy-out provisions -- the court characterized the contract as a lease.[3]

A year later, in County of Los Angeles v. Byram,[4] the court was compelled to focus again on the "lease/debt" issue, but in this case the facts were even more weighted toward a finance lease. The lease was for 50 years and the lessee received a purchase option which declined 2 percent annually until zero at expiration, similar to Dean. Moreover, the statutes authorizing the lessor to lease permitted termination following the lessor's recovery of its investment plus interest. Since the lease was perceived by the court as indistinguishable from Dean, the court upheld the lease. In doing so, it quoted with approval certain characteristics of the lease:

> lessee shall pay "rental" of $25,000 for "use of the premises" for each month at the end thereof [plus liens and insurance premiums, and] ... "it is expressly understood and agreed that each month's rental shall become due only in consideration of the right to possess, occupy, and use the Building during the preceding month, and it shall be the responsibility of the Lessor to provide such Building at all times"...[5]

Accordingly, the characterization of the lease (as an operating or finance lease) and the amount (or lack thereof) of a purchase option at expiration were not factors to be emphasized. Rather, the court focused on the monetary obligation required during the lease, and when and for what period the rental obligation accrued. Provided the rental approximated fair rental value, rent was conditioned on, and in consideration of, the right to use, and the rental liability was periodic (monthly, quarterly, etc.) and related to the period in which the consideration was provided, the lease would be reviewed favorably.

These cases have been followed by seven lower court opinions which considered the "lease" exception in the context of the debt restriction. Certain characteristics from these cases shed additional perspectives on the Offner-Dean rule.

In McClain v. County of Alameda,[6] in rejecting the notion that a low purchase option price created an inference that rent was a "credit" on the purchase price, the court implied that focus on the purchase option price for determining lease vs. debt treatment was misplaced. The essence of the Dean rule was not in "balancing [the] rentals with [the] option prices"; it was whether the payments constituted consideration for "a month to month use of the building." In fact, as an appendix to the case, the court listed in columnar form 12 substantive lease provisions from Byram and compared them to the lease, in essence providing a road map as to how to document an acceptable lease.

This columnar treatment was also adopted in Lagiss v. County of Contra Costa[7] in which the court upheld a lease, with a final $1 buyout, as valid, refusing to nitpick how the purchase option prices may have differed from those in Byram and McClain. Since the liability created was "month to month for consideration furnished by the lease in each month, and the total payments each year are for consideration actually promised that year", the lease was valid. However, in response to a second argument that the rent was in excess of fair market value, the court specifically noted that "there is no requirement that the County pay a 'reasonable rental' as such term is generally understood in legal parlance as applied to the ordinary business activity." For purposes of complying with certain governmental codes (and not with respect to private party commercial transactions), specified definitions of fair rental value could be applied.

As if this were not sufficient to end the arguments over validity, a succeeding court in County of Los Angeles v. Nesvig[8] indicated that while the municipality as a lessee might incur liability in a lease following default, effectively precluding the municipality from "walking away from the lease", the lease was valid. In absence of an acceleration clause in the event of default and due to a continued bankruptcy/credit risk to the lessor, the rentals were sufficiently contingent to satisfy the constitutional requirements. Again, the focus was on the character of the fixed annual rental obligation, not on whether the lessee effectively committed itself to a long-term payment obligation.

> ... in absence of any provision which would accelerate payment of debt on default, the obligation of the County remains the same, viz., to pay certain fixed annual rentals whether the bidder [lessor] reenters or not.[9]

This analysis was further mirrored in a subsequent case, Ruane v. City of San Diego,[10] in which the City agreed to a front-loaded rental structure, with approximately 25 percent of the total rental paid at execution of the lease (and not after accrual of any rental period). Refusing to be drawn into an analysis of advance rent and fair rental value, and whether the lump sum payment was in reality a disguised equity downpayment, the court merely looked at the future rental obligation. Because the future rentals were "not payable until the due date" and no liability arose until then, the lease was valid.

Starr v. City and County of San Francisco[11] probably sums up most succinctly how courts now view what that court termed as the Offner-Dean rule. Provided that "each installment (rental payment) will be supported by consideration furnished that year, i.e., the occupancy and use of the project", the lease will be valid. As the court specifically stated, "this is the essence of the Offner-Dean rule."

To summarize, if the rental obligation is conditioned upon use of the property and the rent relates to the period in which the consideration is provided, the abatement clause and lease will be upheld.

Appropriation Leases

With the exception of Ruane, all the cases involved the lease or real estate of facilities. While most tax-exempt real estate and equipment leases in California incorporate abatement language, the courts do not preclude use of other language such as non-appropriation clauses, to avoid the debt limitation. Rather, Offner and Dean and their progeny involved leases where the contingency to payment of rent was "occupancy or use" of the asset. In fact, Offner relied upon an earlier case, McBean v. City of Fresno[12] involving the contingency exception, where the court upheld a multi-year contract for services on the theory that payment was contingent on performance of the services and, therefore, no future obligation was incurred. Since payment for future periods in non-appropriation leases is also contingent upon performance by both the lessor and lessee (including appropriation of funds), the concept espoused in McBean should apply. Furthermore, since the non-appropriation clause makes the rentals contingent on a year-to-year basis, it may be difficult to demonstrate a multi-year obligation has been created, but the question has yet to be addressed formally.

In conclusion, leases will generally not be considered debt if rentals can be terminated through:

--abatement language (a condition subsequent -- loss of use or quiet enjoyment) or

--non-appropriation language (failure to appropriate sufficient funds).

However, certain important distinctions exist in California between the two types of leases. In a non-appropriations lease, the lessee can terminate lease obligations for future fiscal periods, typically on an annual basis. Conceptually the lease is, in essence, a series of multiple consecutive one-year contracts. On the other hand, in an abatement lease, the lessee may contract for a multi-year period with a covenant to fund annually, provided that (i) rentals can be abated for loss of use, (ii) the lease term is shorter than the asset's useful life, (iii) payments are made from any legally available funds, and (iv) the lessor cannot accelerate rents, but must sue annually for rentals due in that fiscal year. Since abatement leases can be for multi-year terms and contain default provisions respecting future payments, they are perceived as a stronger document, particularly if rental interruption insurance is obtained to protect against abatement events. Accordingly, they are utilized for larger, longer-term transactions, especially where real property is financed.

Non-"Constitutional" Lease Characterization

Paradoxically, although municipal leases are not debt under the constitution, they are neither a current expense liability for other purposes. For example, tax-exempt leases are treated as long-term debt under the accounting guidelines for capital leases. Similarly, for school districts in California, a portion of the lease payments are included as debt service in calculating bonded indebtedness limits. Moody's Investors Services and Standard & Poor's Corporation, among other financial and credit rating agencies, also treat the leases as long-term obligations, whether or not they contain abatement or non-appropriation clauses, and include them in calculating debt ratios.

Similarly, for federal tax purposes, the Internal Revenue Service characterizes such leases (assuming nominal purchase options) as conditional sales arrangements. As a result, the lessee is treated as acquiring the asset at lease inception, with rental payments constituting principal and interest much like a loan, regardless of whether the lessee obtains formal title at lease inception or following completion of payments.

Local commercial law also is in accord. Article 9 of the Uniform Commercial Code as in effect in most states, respecting personal property secured transactions, defines a secured transaction (as opposed to a lease) to include circumstances where the lessee, for nominal or no consideration, becomes owner of the property.[13] Since a municipal lease must be a conditional sales agreement to be tax-exempt (and generally contains a nominal purchase option), tax-exempt leases should be within the definition of a financing arrangement. New Article 2A of the Uniform Commercial Code specifically dealing with leases further mirrors this analysis.[14] Where a transaction disguised as a lease is in reality a sale or a security arrangement, it is governed by existing law under Article 2 for sales or Article 9 for security interests, and not under Article 2A.[15]

Although one might argue that a lease cannot be a long-term obligation or "conditional" sale arrangement for certain purposes, but constitute an operating agreement for other requirements, it is this very inconsistency in characterization among municipal bond law, federal tax law, secured transaction law, and financial accounting guidelines that makes the tax-exempt lease structure work. Were it not for the non-appropriation or abatement clauses, most tax-exempt leases for a term exceeding one year would likely constitute debt and require legislative and voter approval. However, if these leases are not treated as conditional sales contracts for federal tax purposes, tax-exempt interest would be unavailable. Consequently, the lease document has to be carefully drafted -- to satisfy potentially conflicting, but overlapping, rules of the bond, tax and accounting communities.

ENDNOTES

1. See Harold E. Rogers, Jr., "Municipal Debt Restrictions and Lease-Purchasing Financing," 49 A.B.A. Journal (January 1963) for a commentary on the various debt exceptions available.

2. 19 Cal.2d 483 (1942) and 35 Cal.2d 444 (1950), respectively.

3. A strong lone dissent dealt heavily on the lack of a real purchase option at expiration (as well as the triple net nature of the lease and the requirement of the lessee to repair the buildings in event of destruction) as indicative of the contract being a subterfuge for debt, but this was ignored by the majority.

4. 36 Cal.2d 694 (1951).

5. 36 Cal.2d at 696.

6. 209 Cal.App.2d 73 (1st Dist. 1972).

7. 223 Cal.App.2d 77 (1st Dist. 1963).

8. 231 Cal.App.2d 603 (2d Dist. 1965).

9. 231 Cal.App.2d at 611.

10. 267 Cal.App.2d 548 (4th Dist. 1968).

11. 72 Cal.App.3d 164 (1st Dist. 1977).

12. 112 Cal. 159 (1896).

13. See also Section 1-201(37) of the Uniform Commercial Code. The UCC is discussed in Chapter Three under "State Law Considerations."

14. Article 2A has been enacted in only a handful of states, including California, where it became effective on January 1, 1990. It is codified as Section 10101 et seq. of the California Commercial Code.

15. See Section 2A-103(j) and the Report of the California Assembly Committee on Judiciary on Commercial Code Section 10103 (West Supp. 1990).

CHAPTER THREE

Federal and State Legislative and Regulatory Issues

CHAPTER THREE

FEDERAL AND STATE LEGISLATIVE AND REGULATORY INFLUENCES

This chapter summarizes major tax legislation affecting tax-exempt leases, including recent modifications to the arbitrage rebate rules. It also discusses promulgations of the Securities and Exchange Commission on municipal disclosure and summarizes federal bankruptcy law as applicable to tax-exempt leases and lessees.

Following the federal discussion is an analysis of state law considerations respecting tax-exempt leases, principally authorization to lease, the Uniform Commercial Code, procurement concerns, and usury considerations.

FEDERAL LAW CONSIDERATIONS

Taxes

Although tax-exempt leases are not considered debt for state law purposes, to be exempt for federal income tax purposes, they must be treated as conditional sale arrangements, akin to installment-type debt, under the Internal Revenue Code.[1]

Revenue Ruling 55-540[2] provides tests for determining conditional sale versus lease treatment. Satisfaction of the tests is generally sufficient for conditional sale treatment.[3] These include:

- A portion of the rentals is specifically designated as interest.

- The lessee acquires title following payment of all rent, or of the specified rentals plus a purchase amount that is nominal or below market value at that time.

- Prior to expiration of the lease term, the lessee has the option to acquire title following payment of a purchase option price approximating the unamortized principal plus accrued and unpaid rent.

Assuming satisfaction with the tests, the lessee is treated as owner of the asset being financed.

As conditional sale obligations under the Internal Revenue Code, tax-exempt leases receive the same benefits as other governmental obligations, including the tax exemption for interest, provided the requirements of Sections 103 and 141-149 of the Internal Revenue Code are met.

Tax-Exempt Interest Requirements - The Issuer

Under Section 103 interest on any state or local bond which meets certain criteria (for arbitrage, private activity bonds and registration) is exempt from taxation. A state or local bond is defined as an obligation of a state or any subdivision thereof. Under the regulations, a "subdivision" may include any municipal corporation or governmental unit delegated the right to exercise substantial amounts of one of three sovereign powers -- the power to tax, the power of eminent domain or the general police power.[4] It is not necessary that the subdivision exercise or be delegated all these powers as long as it has the ability to exercise substantial amounts of at least one of the powers.[5]

Subdivisions also include authorities, commissions, special purpose districts and entities operating "on behalf of" a state or political subdivision (regional governmental agencies, state university systems, or state community college systems). Certain quasi-governmental bodies or agencies acting under or pursuant to state statute, or even non-profit corporations, organized on behalf of a governmental entity, to issue tax-exempt obligations to finance property, also may qualify as subdivisions.[6]

Even if the lease is structured as a conditional sale and the lessee is qualified to issue tax-exempt securities, the obligation must still satisfy the private activity, arbitrage and reporting rules in the Internal Revenue Code. Since the penalties for non-compliance may be severe, it is important that lessees understand and comply with these requirements.

Private Activity Bonds

To qualify for tax exemption, a municipal lease must either be a governmental or a qualified private activity bond. Under Section 141 of the Code, all bonds of governmental entities are governmental bonds unless categorized as private activity bonds.

Private Business Tests

Private activity bonds are defined in two tests -- the private loan financing test (generally not relevant to tax-exempt leases) and the private business tests.

The private business tests in general are satisfied where more than 10 percent of the bond proceeds are used by a non-governmental person (i.e., private party, non-profit entity or even the federal government) and more than 10 percent of the principal and interest payments are derived from or secured by that person's trade or business. The percentages are reduced to 5 percent if the person's usage is unrelated to the government's use of the asset.

By way of illustration, a lease of a courthouse by a county government is not a private activity bond if the entire structure is used for governmental services, even if the facility is available for any community group to use in the off-hours. In contrast, if more than 10 percent of the courthouse is subleased or dedicated to a non-governmental person for a use related to the county's judicial functions (e.g., a privately run cafeteria for county court staff) and rental payments by the lessee are linked to the cafeteria's "sublease" payments or secured by the cafeteria's assets, the lease will be a private activity bond. Where the private use is unrelated (private attorneys or stenographers lease offices in the courthouse), the allowable percentage will be reduced to 5 percent.[7] Private management contracts (for example, a privately managed county detention center in the courthouse) are also taken into consideration in these computations, unless they satisfy certain criteria.

If possible, a lease should avoid satisfying the private business test and qualifying as a private activity bond. Besides having to meet additional criteria noted below, the lease will also then be subject to the alternative minimum tax, which may result in an interest rate increase to the lessee. Therefore, proper structuring of payments and monitoring of use by the lessee is essential.

Qualified Private Activity Bonds

To receive tax-exempt status, private activity bonds must satisfy additional restrictions as "qualified private activity bonds."

Under Section 141(e), they are limited to certain categories, including:

- exempt facility bonds;
- airports; docks and wharfs; mass commuting facilities;
- qualified residential rental projects;
- electric or gas generation facilities; heating and cooling facilities; water projects; sewage facilities; solid waste disposal facilities;
- qualified hazardous waste disposal facilities;
- 01(c)(3) hospital facilities;
- qualified small issue bonds;
- qualified redevelopment agency bonds;
- qualified 501(c)(3) bonds.

Besides having to fall within specific project categories, private activity bonds also must comply with additional limitations to be tax-exempt (unless specifically excepted from these limitations). These are:

(a) Compliance with state volume limitations. This is an annual statewide ceiling limiting the volume of private activity bonds (with certain exclusions).[8] The cap is set at the greater of $150 million or $50 per capita for each state. 501(c)(3) and certain exempt facility bonds are not included in the cap.

(b) Allocation of proceeds to the permitted purposes. Generally, at least 95 percent of proceeds (net of reasonable reserve funds) must be allocated to the permitted purpose. Of the 5 percent remaining, costs of issuance may not exceed 2 percent.

(c) Limitation on maturity. With certain exceptions, the average weighted maturity of the bond or lease cannot exceed 120 percent of the asset's anticipated useful life.

(d) Public hearing requirements. Public hearing, notice and approval requirements are mandated.

(e) Land limitations. With certain exceptions, land acquisition may not exceed approximately 25 percent of the proceeds.

(f) Facility limitations. In general, existing facilities and other used property may not be financed unless the property is to be substantially rehabilitated.

(g) Prohibited facilities. Proceeds may not be used to acquire a gambling facility, health club, stadium box, airplane or package liquor store.

(h) Office space. In general, office space may not be financed unless the office space is located on the same premises as the facility being financed and is directly related to the daily operations of such facility.

Arbitrage and Rebate Requirements

Additional requirements concern arbitrage and rebate. In the 1980's, Congress enacted strict limitations on arbitrage earnings available to issuers and lessees on all tax-exempt obligations due to abuses and over-borrowings by issuers. Only in narrowly defined circumstances may issuers invest proceeds at a "yield" in excess of the bond's tax-exempt rate, and all arbitrage earnings must be rebated to the United States government, unless subject to an exemption from rebate under the Internal Revenue Code.

The arbitrage provisions consist principally of (a) limitations on investment yield, (b) reserve fund sizing restrictions and (c) the rebate requirements.

Investment Yield and Reserve Fund Sizing

The investment yield provisions generally restrict investment of proceeds to the approximate yield (e.g., interest rate) on the issue, with certain exceptions for temporary short periods, reserve funds and a "minor portion" of an issue. The reserve fund rules restrict the amount of the reserve fund from proceeds to the lesser of (i) 10 percent of the total issue, (ii) an amount equivalent to the maximum annual debt service, or (iii) 125 percent of the average annual debt service.

Rebate

The requirements in Section 148 mandate rebate of arbitrage from yields materially higher than the interest rate of the tax-exempt obligations, with certain exceptions. Relevant exceptions include:

- bona fide debt service funds earning under $100,000 annually;

- arbitrage earned during a period not exceeding six months (generally for advance funded transactions), subject to expenditure of all, or in certain instances, substantially all, of the proceeds within that period;

- for certain longer construction period projects, a new two-year phased arbitrage limitation (discussed below);

- obligations of "small issuers" (excluding private activity bonds);[9] and

- investment of proceeds in certain other tax-exempt obligations.

The arbitrage provisions have influenced how leases are documented. Arbitrage certificates are now routinely requested of lessees in COP transactions and some larger private placements. In addition, lessees claiming to be small issuers are required to represent, in a formal resolution or by confirmation, that they qualify for the small issuer rebate exception.

Two-Year Construction Period Rebate Relief

Congress liberalized the rebate requirements in 1989 for certain construction projects.[10] Rebate relief is now provided to projects with construction periods of up to two years, as opposed to the prior more restrictive six-month relief provision. In general, for real property leases that are advance funded or have reserve funds, issuers may receive positive arbitrage on such funds for a period of up to two years, without rebate to the federal government. However, the new provision requires that 10 percent of the defined "net proceeds" be spent within six months of issuance, 45 percent within the first year, 75 percent within eighteen months and the balance within two years. The provision is also limited to construction expenditures (and earnings on reserve funds during the two-year period) and to the leases with governmental and 501(c)(3) issuers. Large construction projects with longer construction periods, as well as equipment acquisitions, are ineligible. Consequently, the benefits of this provision may be limited to smaller projects with shorter construction terms, such as schools, recreation centers, etc.

As the above summary implies, the post-1986 rules on private activity bonds, arbitrage and rebate are very complex and, to an extent, may be a "trap for the unwary." Compliance costs may also be significant, especially for small transactions involving less sophisticated issuers. To avoid these costs and complications, lessees may wish to "keep it simple" and concentrate on purely governmental-use projects within the permissible arbitrage period exceptions.

Filing Requirements and Registered Format

Filing Requirements

The 1986 Tax Reform Act imposed mandatory reporting requirements on issuers of all tax-exempt obligations, regardless of their qualification for other exemptions.

Issuers (including lessees) of tax-exempt obligations are required to file reports with the Internal Revenue Service that contain information on the issuer/lessee, the asset financed, proof of compliance with the volume cap (if applicable), and yield and maturity information. These are provided for governmental bonds on IRS forms 8038-G and 8038-GC and for tax-exempt private activity bonds on form 8038.

Form 8038-G for leases of at least $100,000 must be filed within 45 days of the calendar quarter in which "the issue is issued." Form 8038-GC, which aggregates all smaller transactions, is due on or before February 15 of the calendar year after the "issue is issued." Both forms specifically include tax-exempt leases in their scope. Such leases are treated as issued on the date interest begins to accrue for federal tax purposes.

Form 8038 is applicable to any obligation that qualifies as a tax-exempt private activity bond, including tax-exempt leases, and also must be filed within 45 days of the calendar quarter of the "issue date."

Issuers subject to rebate under the arbitrage provisions must also file form 8038-T when paying the rebate. This form is due "60 days after the end of every fifth bond year during the term of the issue," with a final report due "60 days after the date the last bond of the issue is discharged."

Failure of the issuer to execute and file these reports results in an otherwise tax-exempt obligation becoming taxable, although the

Internal Revenue Service excuses late filing under certain circumstances.[11] The Internal Revenue Code places reporting and filing responsibilities on the issuer/lessee, even if the issuer relies on its advisors for the actual information and filing.

Registered Format

Tax-exempt leases must also be in registered form. This can be effected through a simple stipulation that transfer occurs only through a surrender of an old instrument to, and reissuance by, the issuer (or its agent), or may be achieved through a qualified book entry system maintained by the issuer (or its agent), or by a combination of both. Information on book entry systems is generally available from the underwriter or Depository Trust Company of New York, which maintains a large book entry system.

Investor Issues - Bank Qualification; De-Minimus Rule; Alternative Minimum Tax

Bank Qualification

The 1986 Tax Reform Act restricted the investment appeal of tax-exempt obligations to commercial banks by denying them a deduction for a portion of their carrying cost for most tax-exempt bonds and leases. Formerly, banks could deduct 80 percent of the interest cost on funds used to acquire or "carry" tax-exempt obligations. The new provisions permit a deduction only on funds borrowed to invest in properly designated obligations of certain governmental units that borrow no more than $10 million in a calendar year. Such bonds or leases are referred to as "bank qualified." Commercial banks may invest in non-bank qualified leases, but the loss of the interest deduction usually requires additional compensation through a higher interest rate for non-bank qualified leases.

The practical impact of this provision has been to restrict bank investment to either the smaller issuers with more limited tax-exempt financing requirements or to larger issuers who do not issue more than $10 million of tax-exempt obligations in the calendar year. However, a more serious problem for those banks that continue to acquire tax-exempt obligations is the impact of the alternative minimum tax (discussed below) on their portfolios. The cumulative effect of both rules has been to decrease investment by banks in these obligations.

De-Minimus Rule

A variation of the "bank qualified" rule denies a deduction to other investors for interest expense on debt "incurred or continued" for the purpose of purchasing or acquiring a tax-exempt obligation.[12] Under a longstanding safe harbor rule,[13] the Internal Revenue Service will generally "presume" that debt was not incurred to acquire or retain tax-exempt obligations if the average value of the taxpayer's tax-exempt holdings during a taxable year does not exceed 2 percent of the average "adjusted basis" of the person's portfolio (for an individual) and 2 percent of the average total active business assets (for a corporation). This safe harbor rule is referred to as the "de-minimus rule."

Where a corporation (e.g., captive credit corporation) receives a tax-exempt obligation in payment for goods and services (such as occurs in a vendor lease) and does not satisfy the 2% rule, the Internal Revenue Service now requires that the tax-exempt obligation be "non-salable" (not able to be sold) or non-transferable, not just "non-negotiable," to avoid denial of the interest deduction.[14] This standard is difficult to satisfy, and may increase the business costs of vendors and their lessors, not within the safe harbor, by denying interest deductions on carrying costs of the tax-exempt leases. A corresponding increase in the bid prices of such vendors and lessors may be a consequence.

Alternative Minimum Tax

The 1986 Act also affects investors subject to the alternative minimum tax (AMT). Under the AMT, taxpayers who reduce their regular tax liability significantly through preferentially treated income (called preferences) must recalculate their tax liability by adding back certain preferences into income. As a result of the 1986 Act, for the first time, both individuals and corporations are subject to the AMT on tax-exempt obligations.

For individuals, this applies only to tax-exempt income received on private activity bonds. This amount is treated as a tax preference item, potentially increasing an individual's tax liability if the individual becomes subject to the 21 percent AMT (and, in essence, imposing a tax for the first time on otherwise tax-exempt income).

Of more importance in the municipal leasing arena is the impact of AMT on corporations, including financial institutions and insurance companies. Traditionally the prime investors in tax-exempt obligations, they now are potentially subject to a minimum tax on income from all types of tax-exempt obligations held (not only private activity bonds), even if they would otherwise not owe any corporate taxes in that year. This is due to a corporate tax preference created by treating as income (for alternative tax purposes) a percentage of the difference between book income and tax return income, due to tax-exempt interest. This may reduce the attractiveness of tax-exempt obligations, including tax-exempt leases, to major categories of investors subject to corporate AMT -- and effectively raise the yield thresholds these investors require.

SECURITIES CONSIDERATIONS

The two principal federal laws governing securities are the Securities Act of 1933 (the "1933 Act") and the Securities and Exchange Act of 1934 (the "1934 Act").[15] The threshold question is whether a tax-exempt lease constitutes a security under those Acts as well as for Securities and Exchange Commission ("SEC") regulatory purposes. For 1933 Act purposes, this issue is far from resolved for the lease itself.[16] However, SEC staff and the municipal finance industry generally view certificates of participation as a security.

Governmental Security Exemption

Under the 1933 Act, securities, including certificates of participation (and, as applicable, tax-exempt leases), must be registered prior to sale unless they are exempt from registration. Section 3(a)(2) provides an exemption from registration for governmental securities, which are defined to include:

> ....any security issued or guaranteed by the United States or any Territory thereof, or by the District of Columbia, or by any State of the United States, or by any political subdivision of a State or Territory, or by any public instrumentality of one or more States or Territories....

The exemption in general applies whether or not the governmental security is treated as tax-exempt under the Internal Revenue Code.[17] The exemption covers the security, including both the initial offer and sale, assignments to investors pursuant to certificates of participation, and any trading in the secondary market.

According to the SEC staff, the governmental security exemption is applicable to certificates of participation provided that the lessee (i) is the "primary source" for rental payments and other sums due under the lease, (ii) the lease is triple net, with all costs of maintenance, taxes and insurance paid by the lessee, and (iii) the lessee authorizes assignment of the lease by the lessor in the event the lessor's interest is sold through certificates of participation.[18] For these purposes, it should also be noted that although a trustee or lessor may execute and deliver the certificates of participation, the lessee is considered as the issuer of the certificates.

A second exemption from registration for tax-exempt leases is available under Section 4(2) of the 1933 Act in cases of private sales of securities. This exemption, however, is applicable only to the specific offer and sale and does not extend to subsequent transfers (which must have their own exemption or face registration) or to the security in general. Under the safe harbor in SEC Regulation D for the 1933 Act, private placements may be made to no more than 35 investors, in addition to investors treated in the regulation as "accredited".[19] Other conditions also apply, including differing disclosure requirements for specific sizes of the private placement contemplated.

Exemption from registration does not imply that disclosure is not required. Particularly with adoption of Rule 15c2-12 by the SEC under the 1934 Act (discussed below), underwriters must prepare adequate disclosure material in selling municipal securities. The guidelines for the necessary information arise from industry (as opposed to SEC) standards.[20] For certificates of participation (and, as applicable, tax-exempt leases), for example, these are set forth in disclosure lists assembled by the National Federation of Municipal Analysts. These now serve as checklists for bond and underwriter's counsel in preparing the disclosure documentation that the underwriting and investment communities have come to expect.

Notwithstanding possible exemptions under the 1933 Act, the certificates (and, as applicable, the lease) must also satisfy the 1934 Act, which, in general, addresses how securities are distributed. Section 10(b) of the 1934 Act (and the anti-fraud provisions of Rule 10b-5 promulgated under it) applies to municipal securities and the parties offering and selling them. Rule 10b-5 prohibits any issuer, underwriter or person purchasing or selling a security from making any false or misleading material statement, or omitting any material facts which make the statement misleading, in the offering or sale of a security (including all disclosure materials, such as the official statements). It applies to municipal securities, whether publicly offered or privately placed.

Remedies are also available under "blue sky laws", federal and state case law and common law rules. In addition, the sale of certificates must satisfy regulations of the Municipal Securities Rulemaking Board ("MSRB"), which are approved by the SEC and enforced by the National Association of Securities Dealers (NASD), although remedies under MSRB provisions are generally not available to investors.

State securities laws (commonly termed "blue sky laws")[21] may affect the certificates of participation and tax-exempt leases. The certificates of participation (and, as applicable, the tax-exempt lease) will require their own specific exemption from registration under these laws, as well as compliance with state anti-fraud rules.

Rule 15c2-12

Rule 15c2-12, adopted by the SEC in June 1989, was promulgated partly due to concerns arising from the defaults of Washington Public Power Supply System and other issuers. The perception of the SEC of the increasing frequency and dollar volume of defaulted tax-exempt issues, created momentum for mandating greater due diligence in the issuance of municipal securities. It also precipitated tighter regulation of disclosure documents and information required by the industry trade groups. Following lengthy review, the SEC took its first steps in this area, by exercising formal rulemaking authority under the 1934 Act, in imposing formal disclosure procedures in the offer and sale of municipal securities.

Basically, the rule specifies how and when a participating underwriter must review and complete due diligence "in a professional manner" on a "close to final" official statement and how distribution of preliminary and final official statements must be effected to customers and potential customers. Although specifically directed at underwriters, it will place additional burdens on all parties to the transaction and increase the underwriter's responsibility in assuring complete and accurate disclosure.[22]

The provisions of Rule 15c2-12 apply to all municipal securities, including certificates of participation and lease revenue bonds (as well as tax-exempt leases to the extent they are securities under the 1934 Act). However, the rule covers only initial offerings of municipal securities and at this time does not extend to the secondary market. Issues of $1,000,000 or less in aggregate principal amount are excluded from its scope, which will diminish significantly the burdens on lessors and lessees in smaller certificate of participation transactions and tax-exempt leases. A "quasi-private placement" exemption from the rule is also available for primary offerings in authorized denominations of $100,000 or more, provided such offerings (i) are sold to no more than 35 persons who the underwriter reasonably believes are sophisticated investors and are purchasing for their own account, or (ii) have a maturity of nine months or less, or (iii) may be tendered at the investor's option to the issuer for redemption at least every nine months.

Consequently, the primary impact of the rule is on larger publicly sold COP transactions, where the SEC perceived a need for more formalized due diligence to protect individual investors. This need is less compelling for institutional private placements, where the market may have the capability to evaluate investment risks independently.

Bankruptcy

An additional federal law affecting the tax-exempt lease, and the rights of the lessor, investor and lessee, is chapter 9 of the federal bankruptcy code, which governs bankruptcy by municipalities and other local governmental agencies.

Chapter 9[23] provides relief from financial distress to a "municipality", which is defined as a "political subdivision or public agency or instrumentality of a State". A chapter 9 case may be commenced only by the municipality; a creditor may not commence an involuntary case against the municipality. Relief under chapter 9 is an adjustment of debts pursuant to a plan, not a liquidation of assets. As a bankruptcy proceeding, it is subject to bankruptcy codes, rules and law.

Since tax-exempt municipal leases are financing transactions and not "true" leases, for bankruptcy purposes the lessee is treated as a conditional purchaser and the lessor is characterized as the lender and/or the seller, with the "leased" property (and any related assets) being the collateral which secures the payment obligation. If non-bankruptcy law requirements governing a transaction have been properly fulfilled (for example, the filing of financing statements), the "lessor" is treated in the chapter 9 case as a creditor holding a secured claim for amounts owed. Lessors who do not satisfy those non-bankruptcy law requirements are treated as holding unsecured claims.[24]

For the debtor/lessee, this distinction has two consequences. Holders of secured claims, under certain circumstances, may be entitled to, and the debtor will be required to provide, "adequate protection"[25] that the value of the creditor's collateral will not decline during the bankruptcy. These protections may consist, in part, of cash payments to the secured claim holder, or replacement or supplementation of any lien held. This right is not provided to unsecured claim holders. Unless otherwise agreed, the secured claim holders also are entitled to receive the full present value of their claim as part of the adjustment of debt. This requirement does not apply to unsecured claim holders, whose rights in general are subordinate to the rights of secured claim holders.

The filing under chapter 9 provides other specific statutory benefits to the debtor. Filing automatically "stays" for the period of bankruptcy any actions by any party against the debtor or its property, such as the right to repossess the asset. The debtor is also relieved of accrual of interest on its obligations during the bankruptcy as well as the need to pay any obligations incurred prior to the filing, pending the chapter 9 adjustment of debt.

For lessors and investors, a lessee's filing of bankruptcy under chapter 9 poses certain obstacles to exercise of their rights and remedies. Besides loss of accrual of interest during the bankruptcy case, payment of the obligation may be delayed notwithstanding "adequate protection" from the debtor. Secured creditors seeking return of an asset also must first obtain relief from the automatic stay. Such relief generally may be granted for cause or when the debtor has no equity in the property and cannot demonstrate that the property is necessary for an effective reorganization. In the context of a chapter 9 case, such tests may be difficult to satisfy for a tax-exempt lease, particularly given the lessee's prior representations of "essential use" and the equity obtained by the lessee through any principal payments prior to bankruptcy. Absent such relief, the secured party remains the holder of a "secured claim" for the principal, other sums due and pre-petition interest.

The outcome of a chapter 9 proceeding is the adjustment of debts of the lessee.[26] In general, this requires the debtor to fulfill its obligations pursuant to a negotiated schedule. This is intended to provide creditors with maximum realization of the value of their claims. However, valuation is subjective and the parties may differ in their views of full value, given differing calculations of the time value of money. Provided the debtor demonstrates in good faith that it is accomplishing its utmost to satisfy its obligations, it will have some discretion in determining how it adjusts its debts.

Bankruptcy plans are the subject of extensive negotiation by the debtor with its claim holders. Provided the debtor meets the statutory criteria of chapter 9, the debt adjustment plan may be confirmed (and the debtor discharged from bankruptcy), despite opposition of certain claim holders.

With respect to the lease documentation, the filing of a bankruptcy petition renders unenforceable any ipso facto clause. (This is a clause which terminates or modifies the debtor's rights and responsibilities solely because of a bankruptcy filing or the debtor's financial condition.) Possible alternatives are discussed in "Events of Default" in Chapter Four.

STATE AND LOCAL LAW INFLUENCES

This section considers the application of certain state and local laws affecting tax-exempt leases, including issues of authority, secured property filing requirements under the Uniform Commercial Code, and questions respecting limitations on interest rates. State law restrictions on the incurrence of debt (and whether tax-exempt leases are subject to such restrictions) are discussed in the review of the legal bases for tax-exempt leases in Chapter Two.

Local Law Authority

Apart from constitutional restrictions which may be applicable to tax-exempt leases in a given jurisdiction, a lessee generally must have specific statutory authority to enter into lease or lease-purchase arrangements. However, if the lessee is a subdivision or entity operating under the aegis of a legally constituted body, it may be delegated authority from such body to enter into the lease.

The question of authority is important because, almost without exception, an opinion of counsel (either lessee's counsel or bond counsel) will be required by the lessor or investors to confirm that the lease has been duly authorized and is an enforceable obligation against the lessee.

The state law permutations are myriad, and it is outside the scope of this report to discuss the characteristics respecting each state and issuer. However, in general, the law governing the particular jurisdiction, whether state statutes or "home rule"-type charters, may provide authority to the jurisdiction to lease (or if specifically enumerated, to lease purchase). This is usually found in the general powers of the jurisdiction to acquire or own property, although it may be implied from a government's general powers to acquire property, to own assets, to procure goods and services, to enter into contracts, to engage in financings or to incur obligations or consummate contracts.[27]

Although specifically enumerated powers to lease purchase may be preferable to more general clauses, the lack of specificity does not appear to have impeded the tax-exempt leasing vehicle in the various states. However, reliance on implied powers or inferences from such powers may permit a retroactive attack based upon a lack of explicit statutory authority, as has occurred on several occasions.[28]

General vs. Specific Lease-Purchase Authority in California

With one exception respecting "public leasebacks . . . [for] any city, county, charter city, district, public corporation or political subdivision of the state,"[29] no state omnibus statute exists to authorize tax-exempt leases in California. Rather, the authorization for state agencies and local jurisdictions to enter into leases or into contracts is distributed among the respective codes, generally in the provisions governing the formation of, and exercise of powers by, the specific district or entity that will act as lessee.

For example, Government Code Section 37350 permits cities to "purchase, lease, receive and hold" real and personal property, while counties are provided similar powers under Government Code Sections 23004 and 25351. Charter cities, such as San Francisco, generally have provisions set forth in their charters which permit the leasing of property. For San Francisco, Section 1.01 of its charter permits the City and County to "sell, lease and convey real and personal property." Los Angeles utilizes general provisions for "acquisition" or purchase of property and the making of contracts as set forth in Article 2(7) and 2(11)(k) and (l) of its charter. For San Diego, the authority is located in Article 1, Section 1 of its charter respecting the general power to own, lease and acquire property. Although California law requires city charters to define strictly a city's powers, many city charters have not followed this rule, and contain more permissive language. However, at least in the case of San Francisco, the charter restricts certain types of lease transactions by requiring prior voter approval.

School districts are provided both general and specific lease-purchase authority under the California Education Code. California Education Code Sections 39300-39325 and 39330-39333 afford broad powers to school districts specifically to enter as a lessee into a lease (and more precisely, lease-purchase) agreement for vehicles, buses, educational materials and other approved items as well as school buildings and facilities.[30] Indeed, the Education Code provisions have specifically been drafted with the tax-exempt lease vehicle in mind, instead of a more general authority to lease or buy property granted in the other codes. Analogous provisions exist for community college districts (California Education Code Sections 81330-81351, 81520-81532 and 81550-81552).

Other general leasing powers include the authority to purchase or lease real or personal property for the University of California (Education Code 92431) and to purchase or lease real or personal property for redevelopment agencies (Health & Safety Code Section 33391), for irrigation districts (Water Code Section 24252 and 22436-7) and for hospital districts (Health & Safety Code Section 32121).

Regardless of whether authority is based upon a general power or a specific power to lease (or even lease purchase), it is also important to review any restrictions or administrative guidelines that may impact authorization or implementation of the lease. For instance, as noted above, leases by the City and County of San Francisco with a joint powers authority, a nonprofit corporation, the Redevelopment Agency, the Housing Authority or the Parking Authority require voter approval. In addition, statutes may limit specific provisions of the lease. Education Code Section 39332 limits the term of lease-purchase agreements for equipment to the lesser of the estimated useful life or ten years, while under Education Code Section 39303, leases of buildings may not exceed 40 years.

Restrictions may also be imposed by common law or judicial doctrines, under "public purpose" or other criteria. In one case, when an irrigation district leased an airstrip to an individual for $1 per year, after the district and the federal government had funded substantial development costs, the court ruled the arrangement was devoid of a proper public purpose and, therefore, in excess of authority.[31] Although this doctrine was applied in the case of a government acting as a lessor, it is not specifically restricted to such instances.

Procurement Issues

Besides authority, lessees must also comply with procurement regulations and policies. These are unique to each jurisdiction. Issues include whether competitive (as opposed to negotiated) bids are required, whether sole source is an appropriate alternative, whether assets and financing should be acquired independently or jointly, and the number of responses necessary for a competitive bid.

Depending upon the jurisdiction, the lessor may be required to work either with the purchasing or procurement agencies, the finance department or treasurer's office (or perhaps a combination of both). For example, leases for the City and County of San Francisco are handled as a purchasing item and are bid either separately or bundled with bids for assets. The State of California also handles leases through its procurement office, but due to internal state procurement preferences for set-off rights and indemnification respecting performance, generally acquires assets and financing as part of a joint bid. The University of California arranges leases under $10 million in the purchasing department, whereas larger leases are the domain of the University treasurer's office.

Administrative inconsistencies and inefficiencies may result when different offices handle different size transactions. Where assets and financing are acquired through one procurement, the lessee may also pay a higher interest rate than if the procurements were separated to require the lowest bid on the respective cost and financing components.

Furthermore, such bundled bids may lead to arguments of discrimination on grounds of restricting eligible lessors to vendors' captive credit corporations or to lessors having "tie-ins" with vendors. At least one court has found a similar type of procurement practice offensive[32] and, based upon these and economic concerns, that state has issued an advisory requiring bifurcation of all financed acquisitions into separate bids.

Uniform Commercial Code

Regardless of whether title passes to the lessee initially or at expiration of the lease, the Uniform Commercial Code governs whether a security arrangement has been created and the methods for perfecting the lessor's and investor's interest. The Uniform Commercial Code in general governs the creation and perfection of a security interest in the lease, any personal property or fixtures (but not realty) financed and related payment receivables. It is codified in California in the Commercial Code, particularly Article 9 (California Commercial Code Sections 9101 et seq.)

Security Interest

Section 1-201(37) of the Uniform Commercial Code (U.C.C.) in most states contains the statutory test for determining whether a lease constitutes a security interest under Article 9 of the Uniform Commercial Code. Of particular relevance to tax-exempt leases is the treatment in the definition of a lease with a nominal purchase option.

Whether a lease is intended as security is to be determined by the facts of each case; however, (a) inclusion of an option to purchase does not of itself make the lease one intended for security and (b) an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for nominal consideration does make the lease one intended for security. (emphasis supplied)

Whether or not the lessee obtains title initially or at the end of the lease, a tax-exempt lease should qualify as a secured transaction under provision (b) due to the "no or nominal" buyout present in the lease.

However, in those states (including California) that have enacted Article 2A of the Uniform Commercial Code, the analysis may be more difficult when title transfers at the end of the lease. In these states, application of the buyout provision requires satisfaction of two tests. As applied to tax-exempt leases, the tests require first, that there be a nominal or no-cost purchase option, and second, that the rental obligation of the lessee be an "obligation for the term of the lease not subject to termination by the lessee."[33] The second test may require analysis of the lease documentation package, particularly for multi-year leases with non-appropriation or similar clauses. However, the parties should be able to present evidence from the essential use letter and good faith covenants respecting funding that the lessee's "intent" and "economic expectation" is not to terminate payment of rent, notwithstanding a "non-appropriation" contingency.[34]

The rent test was specifically enacted to correct the potential effect of case law from the bankruptcy area.[35] Its impact on tax-exempt leases is likely unintended,[36] particularly given the tax and accounting treatment of tax-exempt leases as conditional sale-type arrangements.

If the buyout provision is inapplicable, determination of whether the tax-exempt lease creates a security interest will be a function of all the facts and circumstances of the transaction. In such case, where title passes initially, a security interest should be available. In other instances, the nominal buy-out would be given significant weight,[37] especially considering that the non-appropriation clause is present not for economic, but state constitutional debt, reasons.

Article 9 Requirements

If the lease constitutes a security arrangement, with the exception noted below, its treatment is normally governed under Article 9. To perfect the lessor's interest in the "security" (the asset, lease and rent receivable) against rights of other parties, the lessor in general must file a UCC-1 financing statement, either with the secretary of state or county recorder (or, in certain circumstances, both).

However, 1972 amendments to the Uniform Commercial Code adopted by a majority of states (including California) may have excluded municipal leases from the perfection mechanisms of Article 9. In California, for example, Section 9-104(e) excludes from Article 9 "a transfer, including creation of a security interest, by a government or governmental subdivision or agency."[38] This may depend upon whether the lease is a "transfer" or "purchase" and is "by" or "to" the debtor. Moreover, the specific scope of this exception differs among the states. Massachusetts' version applies only to security interests (and not the broader term "transfer") and expressly limits it "to a government, governmental subdivision or agency to the extent that the creation, validity, enforceability, perfection or priority of such security interest is expressly governed by any other general or special law of this state." New York, utilizing almost analogous language to Massachusetts, also encompasses a "department, commission, board, authority, public benefit corporation or other governmental entity" within its scope.[39]

If Article 9 does not apply, the UCC-1 financing statement potentially could be argued by a third party as not being legally effective, and the protections provided the lessor to priority against third party claims could be unavailable. While filing under such circumstances might provide notice to the third party, it may be open to attack unless the local lien laws provide that such a filing constitutes sufficient "notice" to third-party creditors.

In states that have adopted Article 2A respecting leases, use of its procedures may be available. However, Section 2A-103(j), defining a lease, excludes a lease intended as a security interest under the new definition of Section 1-207(37) noted above.[40]

Article 2A (and potentially Article 9) may be voluntarily utilized by the parties to determine their rights.[41] Many lessees have contractually or voluntarily elected to have Article 2A or Article 9 apply to the lease, but whether this would bind a third party creditor without notice of the lessor's interest is unclear. However, despite the ambiguity created by Section 9-104(e), most lessor's and underwriter's counsel insist on the applicable Article 9 filings being made. This may be less than a satisfactory solution, but the infrequency of municipal bankruptcies or conflicting creditor claims may diminish the urgency of any remedy at this time.

Since real property transactions are not covered by the Uniform Commercial Code, lessors of real property in tax-exempt leases must rely on mortgage, title, deed of trust and similar statutes in the jurisdiction where the property is located. In California, to the extent the lease is treated as creating a real property security interest for the lessor, akin to a deed of trust or mortgage, it would likely be subject to the limitations on judicial and private foreclosures. These include, as applicable, the one-action rule, restrictions on deficiency judgments, minimum notice requirements and, in certain cases, a right of redemption period following foreclosure.[42] These provisions are very complex, and advice should be sought from counsel specializing in this area.

Usury

Usury laws and constitutional prohibitions differ among each jurisdiction. In California, they are covered by Article XV, Section 1(2) of the Constitution, which provides that the rate of interest for a non-personal loan cannot exceed the greater of (i) 10 percent per annum or (ii) 5 percent above the San Francisco Federal Reserve discount rate to member banks in effect at the earlier of execution of the contract or funding.[43]

Given the favorable spread between taxable commercial rates and tax-exempt rates, usury will generally not be an issue. However, for smaller-sized transactions or less creditworthy lessees in California, where the lessor's interest rate may exceed the constitutional limit, reliance on judicial exceptions or constitutional exemptions to usury limitations may be necessary.[44]

State or local statutes may provide additional restrictions on the rate of interest payable by issuers. In California, the Government Code restricts the maximum interest rate payable by "local agencies" on "bonds, warrants, notes or other evidences of indebtedness"[45] to 12 percent, unless some higher rate is permitted by law.[46] Government Code Section 53531.1(c) provides that the power to issue bonds at this rate is in addition to any power or limitation made applicable to local agencies by any other law "unless the other law specifically provides otherwise."

Business Qualification

Almost all states require business entities to qualify to do business within the state if more than a minimal level of direct business involvement occurs, both for regulatory and state franchise tax purposes.

Failure to qualify (or in some cases to pay franchise taxes) typically will prevent a business from exercising its legal rights or defending itself in a judicial proceeding. However, this may also include, at least in California, a right extended to other parties to set aside contracts with the errant entity, even if the failure has since been remedied.[47]

This may impact lessors and investors. While most active lessors in California are "in good standing" as a matter of good corporate practice, more distant parties, such as a foreign trustee, escrow agent or paying agent, may not be, relying on general notions of exemption from franchise taxes or qualification based upon a lack of "contacts" for tax and regulatory purposes. To the extent it is determined that the "distant" party meets the statutory minimums, that party may find itself unknowingly subject to franchise tax and, as applicable, qualification procedures.

Failure to pay the statutory minimum franchise tax or to qualify may subsequently prevent the trustee from exercising, on behalf of the investors, rights and remedies under the tax-exempt lease, including suit for any pre-termination accrued but unpaid rent. It may even permit the lessee, at least in California, to terminate performance, on grounds the lease is "voidable" as to the trustee or escrow agent (and, therefore, as to any payment obligation, potentially unenforceable).

To avoid this, many lessors use State-chartered institutions as their trustee, or confirm corporate "good standing" sufficiently in advance to avert last-minute problems. However, lessee or bond counsel may wish to confirm the status of the other parties, particularly if an opinion as to enforceability will be required.

Other Compliance Requirements

Two specific additional areas affecting tax-exempt leases and certificates of participation should be noted.

Pursuant to California Government Code Section 8855(e), the California Debt Advisory Commission (CDAC), as the state's statistical center for state and local debt issues, requires that all state and local governmental issuers of public or privately sold debt file a notice of proposed sale 30 days prior to issuance, listing the issuer, underwriter, financial advisor, bond counsel, proposed size of issue, purpose, estimated principal amount, source of repayment and other data. Following issuance, a supplemental filing listing the interest cost, maturity schedule, credit rating, gross spread, and advisor and counsel fees also must be completed.

Bond counsel generally file the requisite forms for debt issuances, including certificate of participation financings, as part of the financing documentation. For other situations, such as vendor leases and directly placed leases, compliance is less consistent, despite the fact no distinction exists among these structures for reporting purposes.

A fee not to exceed the lesser of $1,500 or one basis point (1/100 of 1 percent) of the par value of the issue sold is to be remitted to CDAC, except for transactions under $1,000,000 for which the fee is waived, and for issues with maturities of eighteen months or less for which the fee is $100. It is interesting to note that other states now require similar reporting for data collection.[48]

In the unlikely circumstance the lease constitutes a private activity bond, compliance with requirements of the California Debt Limit Allocation Committee is also necessary. The Committee was formed in 1986 pursuant to California Government Code Sections 8869.80-8869.93 to allocate the volume cap limitations of the Internal Revenue Code among the eligible projects of California state and local agencies, cities, charter cities and other issuers. In general, approval by the Committee is required for tax-exempt private activity bonds. Given competing demands of issuers and the increasing restrictions on these types of tax-exempt instruments, recent practice has been to seek approval as early in the year as possible.

ENDNOTES

1. Rev. Rul. 72-399 (1972-2 Cumulative Bulletin (C.B.) 73) and Newlin Machinery Corp., 28 Tax Court (T.C.) 837 (1957).

2. Rev. Rul. 55-540 (55-2 C.B. 39).

3. Private Letter Ruling 8042143 (July 25, 1980).

4. Regulation (Reg.) Section 1.103-1; Estate of Alexander J. Shamberg, 3 T.C. 131 (1944), acq., 1945 C.B. 6, aff'd. 144 F.2d 998 (2d Cir. 1944), cert. den., 323 U.S. 792 (1944).

5. Rev. Rul. 77-164 (1977-1 C.B. 20) and Rev. Rul. 77-165 1977-1 C.B. 21).

6. See Rev. Proc. 82-26 (1982-1 C.B. 476) for the requirements for receiving confirmation of tax-exempt status by the IRS for such entities.

7. Section 141 (b)(3).
   In determining use of the facility, Congress has indicated that all facts and circumstances will apply. For applying the percentages, exclusive and special use by all nongovernmental persons is aggregated and all payments of nongovernmental persons (whether or not actually pledged or directly applied to lease payments) are considered.

8. In California, the value of qualified private activity bonds under the volume cap is estimated to have been limited to approximately $2 billion in 1987 and $1.3 billion in 1988, based upon 1986 population figures. This contrasts with the $14.6 billion of private activity bonds issued in 1985. Virginia L. Horler, Guide to Public Debt Financing in California (San Francisco, CA: Packard Press, 1987), at 38. In 1986, the California Debt Limit Allocation Committee was established to allocate the volume cap limitation among eligible projects, including lease-purchase arrangements.

9. A small issuer is defined as an entity issuing $5 million or less of tax-exempt obligations (excluding private activity bonds) in the calendar year (but including in the total any issues of subordinate entities and "on behalf of" obligors of that entity).

10. Section 148(f)(4)(B)(iv) of the Code.

11. The conditions for requesting extension of time to file are set forth in Rev. Proc. 88-10 (1988-1 C.B. 635).

12. Under Rev. Proc. 72-18 (1972-1 C.B. 740), debt is presumed incurred to purchase or carry a tax-exempt obligation if (1) proceeds of the debt are used to acquire the tax-exempt obligation, (2) the tax-exempt obligation is used as collateral

for the debt, or (3) there is indirect evidence that debt was incurred to purchase the tax-exempt obligation.

13. Rev. Proc. 72-18, Sec. 3.05 (1972-1 C.B. 740, 741).

14. Rev. Proc. 87-53 (1987-2 C.B. 669).

15. The 1933 Act specifies procedures for registering securities, and the 1934 Act governs the securities exchanges and trading in securities. The registration requirements of the securities laws should not be confused with the requirements of the Internal Revenue Code that the tax-exempt obligation be in registered form. This is discussed in the section on "Federal Law Considerations - Taxes" above.

16. See the discussion in A. John Vogt and Lisa A. Cole, A Guide to Municipal Leasing (Chicago, IL: Municipal Finance Officers Association, 1985), at 59 and n. 17. This may depend upon the status of the lessor and its intent and expectations in holding the lease.

17. Under certain circumstances, the exemption may not be available for certificates used to finance assets for industrial development-type purposes. Rule 131(a), defining a security for purposes of Section 3(a)(2), notes that "any part of an obligation evidenced by ... indebtedness" of an issuer in Section 3(a)(2) "payable from payments ... made in respect of property or money ... used, under a lease, sale or loan arrangement, by or for [an] industrial or commercial enterprise" is considered a separate security "issued by the lessee or obligor" requiring registration or its own exemption. (emphasis supplied) Rule 131(b) lists exclusions from this exception (and, therefore, under the governmental security exemption) for obligations payable from general revenues of the issuer (other than related to the enterprise), facilities owned and operated "on behalf of" issuers and facilities leased to private enterprise as part of a public project owned and controlled by the issuer.

18. No action letter issued on behalf of First Municipal Leasing Corporation (June 4, 1976); and no action letter issued on behalf of Smith Barney, Harris-Upham & Co., Inc. (November 11, 1976).

19. These are generally sophisticated investors with high net worths or who have an ability (such as pension funds, insurance companies, mutual funds, and large institutions) to analyze the risks associated with the securities.

20. The SEC is precluded by the Tower Act (Section 15B(d) of the 1934 Act, codified as 15 U.S.C. Section 78o-4) from requiring filing by "issuers ..., directly or indirectly through a purchaser or prospective purchaser," of official statements with the SEC as a

condition to the sale of municipal securities. This preclusion may not extend to other functions of the SEC, such as registration of municipal securities dealers and policing of the municipal securities markets (through regulation of underwriters and broker dealers). In this regard, note adoption of Rule 15c2-12 under the 1934 Act.

21. Blue sky laws govern the registration, offer and sale of securities within the individual states and are, to a degree, patterned after the federal statutes.

22. See, in general, John E. Petersen, "The New SEC Rule on Municipal Disclosure: Implications for Issuers of Municipal Securities, " <u>Government Finance Review</u> (October 1989), at 17.

23. Chapter 9 - Adjustment of Debts of a Municipality is codified as 11 United States Code (U.S.C.) Section 901-946.

24. With certain exceptions, a creditor holding a secured claim in excess of the value of its collateral (or security), due- for instance- to a greater decline in value of the security than of the obligation it secures, is entitled to a secured claim for the value of its collateral, and an unsecured claim for the excess.

25. 11 U.S.C. Section 361.

26. The debtor is also provided discretion in determining the proposed treatment of all claims on a class-by-class basis. In general, if the debtor's proposed treatment is to reinstate the priority of the holder of a secured claim as to other creditors, it must be accepted by such claim holder.

27. For example, in Arizona, the State Attorney General's office relies on the general power of the State to procure assets as a basis for authorization to enter into equipment lease-purchase transactions, but for real property or buildings, the director of administration is authorized specifically to "lease purchase," provided certain statutory requirements, including legislative review, are met. Arizona Revised Statutes 41-791.02.

28. See, e.g., A. John Vogt and Lisa A. Cole, <u>A Guide to Municipal Leasing</u> (Chicago, IL: Municipal Finance Officers Association, 1985), at 72 and n. 15-17.

29. Section 20670 et seq. of the California Public Contracts Code. However, note that California Government Code Sections 5700-5703, appointing the State Treasurer's office as sales agent of the State of California to offer and sell State bonds or evidences of indebtedness, specifically include "certificates of participation or interests in any rental or lease payments or purchase payments, in an aggregate principal amount exceeding $10,000,000" within their coverage. See also Virginia L. Horler, <u>Guide to</u>

Public Debt Financing in California (San Francisco, CA: Packard Press, 1987), Table 5 at 16-17.

A comprehensive survey of state authority, debt and related laws is found in George M. Mardikes, Paul E. McLaughlin and Gwen E. Gorman, Governmental Leasing: Surveys of Federal Tax Law, Federal Securities Law and of Legislation and Case Law in the Fifty States (Washington, DC: Association for Governmental Leasing & Finance).

30. Curiously, lease purchase of school sites is not included in the sections cited, and reliance for authority to lease the sites may be required under Section 35160, which states that a school district may "initiate" any activity or action "not in conflict with, inconsistent with or preempted by, any law and which is not in conflict with the purposes" of the school district. If broadly construed, this section could permit any activity, unless specifically prohibited by law, the reverse of what normally occurs in granting-type statutes.

31. Allen v. Hussey, 101 Cal. App. 2d 457, 225 P.2d 674 (2d Dist. 1950). See also Rathbun V. City of Salinas, 30 Cal. App. 3d 199 (1st Dist. 1973) (50-year lease of parking lot to a bank may be subject to attack where the value of rent received is low; severability clause in lease will not save an otherwise void transaction).

32. Prescott Courier, Inc. v. Moore, 35 Ariz. 26 (1929). Note also the potential influence of antitrust principles in this area, as highlighted by Fortner Enterprises, Inc. v. United States Steel Corp., 394 U.S. 495 (1969) (loans by credit corporation conditioned upon purchase of products of its parent corporation constitute a per se illegal tying arrangement).

33. California Commercial Code Section 1201(37)(b) (as modified by the Article 2A amendments).

34. While legislative comment on the section considered a nominal purchase option a key element for a security interest, it coupled this with the need to satisfy the "rent" test. Report of the California Assembly Committee on Judiciary respecting Commercial Code Section 1201(37) (West Supp. 1990).

35. In Re Royer's Bakery, Inc., 1 U.C.C. Rep. Serv. (Callaghan) 342 (Bankr. E.D. Pa. 1963).

36. The rent test was inserted in Section 1-201(37)(b) as part of the changes required by adoption of Article 2A, which by its terms is not applicable to sales or security interests, however disguised. Report of the Assembly Committee on Judiciary respecting Commercial Code Section 10103 (West Supp. 1990).

37. See, e.g., In Re J.A. Thompson & Son, Inc., 665 F.2d 941 (9th Cir. 1982) and the cases cited in n. 6 therein. Strong judicial precedent exists for treating such structures as financing arrangements (and not true leases), for which a security interest can be created.

38. The drafters of the section assumed such transfers were "usually" governed by other statutes and, therefore, should be excluded from Article 9, citing the case of pledges of water, electricity or sewer revenues to secure revenue bond financings. The statutory language, however, has a broader scope, incorporating any "transfer." Although adequate state procedures may exist for encumbering funds for utility revenue bond financings, many states in other less-defined instances have yet to enact the "other statutes" the drafters assumed were present. See also A. John Vogt and Lisa A. Cole, A Guide to Municipal Leasing (Chicago, IL: Municipal Finance Officers Association, 1985), at 75 and n. 24. Note 39, following, provides citations of less restrictive statutory language.

39. Annotated Laws of Massachusetts, General Law Chapter 106, Section 9-104(e) and N.Y. [U.C.C.] Law Section 9-104(e) (Bender's).

40. See also Report of the Assembly Committee on Judiciary respecting Commercial Code Section 10103 (West Supp. 1990). Lien laws or other local common law rights and remedies may be an alternative if neither Article 2A nor Article 9 is available.

41. For Article 2A in California, see e.g., Commercial Code Section 10102 and the related commentary in the Report of the Assembly Committee on Judiciary. For Article 9, note the language in Commercial Code 9102 and the legislative commentary, and contrast this with Commercial Code Section 1102(3) and its commentary.

42. See, in general, California Code of Civil Procedure Sections 580b and 580d (anti-deficiency provisions), 726 (one action rule), and 729.030 (equity of redemption period) (West Supp. 1990). A comprehensive summary of these statutes can be found in R. Bernhardt, California Mortgage and Deed of Trust Practice (Berkeley, CA: Continuing Education of the Bar, 1989).

43. Subdivisions of the State have been held subject to usury provisions. Regents of University of California v. Superior Court of Alameda County, 17 Cal.3d 533 (1976).

44. These include the time-price doctrine, purchase-money installment theories and exemptions for specified classes of lenders. See Ehrlich v. McConnell, 214 Cal. App. 2d 280, 185 (2d Dist. 1963) ("usury laws do not apply ... [to] conditional sale contracts."); and Boerner v. Colwell, 21 Cal.3d 37 (1978) (credit sale by vendor with assignment to non-exempt financing institution not subject to usury). The time-price doctrine permits a sale for cash to be for a different amount than a sale for credit, without

usury limitations. This typically applies to situations where the vendor makes the sale on credit, and subsequently assigns the payment obligation to a lender, and may be of more marginal utility in non-vendor lease financings.

For exemptions, see California Financial Code Sections 1504 (state banks and national banks), 1716 (foreign (other state) and foreign (other nation) banks), 3707 (bank holding companies) and 22000 et seq. (personal property brokers) and the real property broker exemption in Art. XV, Sec. 1 of the Constitution.

45. Government Code Section 53530.

46. Government Code Section 53531. See also Government Code Section 53531.1(c).

47. White Dragon Productions, Inc. v. Performance Guarantees, Inc., 196 Cal. App.3d (1987) (failure to pay franchise tax invokes voidability statute, regardless of status under the qualification statute.)

48. Other states (e.g., New Hampshire) now require similar reporting for data collection. In contrast, the Treasurer's Office of the State of North Carolina requires that all county and local governments and other local agencies sell bonds through its Local Government Commission (LGC). The LGC also oversees local accounting and auditing practices, and provides investment management services and technical assistance in public finance topics.

CHAPTER FOUR

THE LEASE DOCUMENT

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This chapter reviews the major provisions and exhibits that are found in most tax-exempt leases. Following this, the trust or escrow agreement ancillary to the lease is summarized. The chapter concludes with a discussion of master lease programs and lease lines of credit.

Assuming adequate authority and power, the lease document must conform to respective tax, debt and security guidelines to be a valid "tax-exempt" municipal lease. While leases may vary as to their provisions, at a minimum, they generally include:

- reference to the lease term and payment structure;
- an amortization table;
- a non-appropriations clause or, alternatively, an abatement clause (as required);
- a requirement to make "rental" payments comprised of separately stated principal and interest;
- a description of the asset financed;
- a nominal purchase amount ($1.00) (or automatic title transfer) at the expiration of the lease term, or a transfer of title to the lessee at inception of the lease, together with a security interest to the lessor until all payments are received;
- a confirmation that the lease will be in registered form;
- a requirement to file form 8038-G or 8038-GC with the Internal Revenue Service and, as applicable, rebate any arbitrage earnings as required to the federal government;
- a representation that the lessee is a Section 103-eligible entity (and, if appropriate, that the lease will be "bank qualified"); and
- a covenant that the lessee will not jeopardize, through its actions or inactions, the tax-exempt nature of the interest.

To be financeable to the broadest spectrum of investors, the lease should contain provisions respecting use of the asset, risk of loss and casualty, indemnification of the lessor, disclaimer of warranties, and triple net covenants.

Lease documents for small (less than $1 million) privately placed leases frequently are prepared by either the lease broker or vendor; commonly, they use standard, preprinted, form documents. Usually for certificate of participation transactions, particularly those in excess of $5-$10 million and offered competitively, special counsel or a financial advisor acting on behalf of the lessee, will draft the documents, with input from the lessor and other affected parties.

Some lessees who do extensive lease-purchase financing have developed their own standard documents. In such instances, lessors, for cost or administrative reasons, may decline to participate, or may increase the interest rate to compensate for analyzing and using the lessee's documents. Moreover, if the documents eliminate or reduce protections considered essential by lessors (e.g., non-offset, indemnification, non-substitution protections), lessors may decline to participate, reducing financing sources to the lessee. However, in many instances, individual provisions are negotiable between the parties.

To mitigate the risk of non-appropriation or abatement, the lessee may be requested to confirm one or more of the following covenants: (i) sufficient funds are available for payment of rentals during the current fiscal year, (ii) the assets financed are of "essential use" to the lessee, (iii) the lessee will utilize its best efforts to ensure budgeting of rent in future fiscal years and to exhaust administrative appeals if the rent is not included or stricken from the budget, (iv) in the event of early termination by non-appropriation, the lessee will not substitute similar equipment or services for a significant period of time, and (v) in abatement leases, rental interruption insurance will be obtained. For certificate of participation transactions, adherence to book entry or similar form of registration may also be necessary.

While these representations are not iron-clad, they at least provide indications of the lessee's intent to make its rental payments. If unreasonably breached by the lessee, they could lead to litigation for damages and bad faith. Apart from this, these confirmations also reinforce the underlying economic basis of the transaction. Notwithstanding a contingent right to terminate, the lessee confirms the essential nature of the asset and, depending upon the jurisdiction, its intent not to substitute the asset with other similar property for a period of time following a non-appropriation. Of course, while not a guarantee of future rentals, they are a statement of good faith by the lessee to perform all obligations throughout the lease term.

Additional assurances are also provided in exhibits to the lease or through side letters of clarification, including the essential use certificate, funding resolution, certificate of appropriation, and, as applicable, the acceptance certificate(s). These also are discussed below.

THE LEASE AGREEMENT

With certain variations, most tax-exempt leases contain key clauses as highlighted below. The commentary on each section addresses issues respecting these clauses.

a. Representations and warranties; covenants of lessee; statement of intent.

b. Acquisition and acceptance procedures; escrow arrangements.

c. Lease term.

d. Lease payments (rent).

e. Non-appropriations clause.

f. Title; security interest; risk of loss.

g. Insurance.

h. Triple net clauses.

i. Disclaimer of warranties.

j. Indemnification; tax covenants.

k. Options to purchase.

l. Events of default and remedies.

m. Assignment; quiet enjoyment.

a. Representations and warranties; covenants of the lessee; statement of intent. These provisions generally indicate that the tax-exempt lease is intended to be a conditional sale-type arrangement, rather than a true lease. They confirm the status of the lessee as a properly constituted political subdivision with authority to enter into the contract. Representations also may be required which mirror the language that the lessee's counsel opinion will provide (discussed below). In this section, the lessee may confirm the essentiality of the assets and their governmental use, and that it will take all actions necessary to maintain the tax-exempt status of the arrangement.

In the event the lease is bank-qualified, the lessee will be required to designate the lease as a "qualified tax-exempt obligation" under Section 265 of the Internal Revenue Code and confirm that the lessee will not issue more than $10 million of tax-exempt obligations within the calendar year. If the lessee qualifies for an arbitrage rebate exception under Section 148 for small issues, this section may also confirm that the lessee will not issue obligations in the current calendar year in excess of the maximum allowable for the exception.

Depending upon the assets, additional representations may be required respecting liens, environmental affairs and a title history of the property upon which the asset is sited. The section may also obligate the lessee to furnish, on a continuing basis, financial statements, budgets, evidence of appropriation and other similar information.

It is important that lessee's counsel review each of the covenants, representations and warranties to ensure the lessee understands and can comply with each, to avoid inadvertent breaches (and related default). Most leases, and applicable security interests, are governed by the jurisdiction where the lessee or asset is located. The lessee should check any choice-of-law provisions in the lease to ensure that if local law (e.g., California) does not apply, the lessee has obtained adequate counsel respecting the other state's law and its effect on the lessee's representations in the lease.

b. Acquisition and acceptance procedures; escrow arrangements. These clauses generally specify the acquisition and acceptance procedures and designate responsibility for inspection and testing before acceptance. They may also outline the requirements for disbursing payment to the vendor by the lessee, or trustee or escrow agent, if any.

Generally, the lessee will have total responsibility for selecting and ordering the asset. (The lessee confirms in its representations that this has been, or will be, done in accordance with procurement requirements.) The lessee typically will either order the asset directly from the vendor, assigning its purchase contract to the lessor, or will request that the lessor, on behalf of the lessee, place the order with the vendor. In either case, the lessor will disclaim any warranties respecting the asset. In real property leases, the lessee may enter into a construction contract with the general contractor, or negotiate and approve the construction contract before authorizing its execution by the lessor.

Where possible, the lessor will seek indemnification from the lessee for any risks under the purchase or construction agreements, and will require that, in the event the lease is not executed or delivered by the lessee or the lease is terminated before acceptance, the lessee will assume all obligations of lessor under the purchase and construction agreements. Generally, the vendor or contractor will acknowledge the assignment and any related assumption provisions and may partially release the lessor from liability when the lessee assumes all responsibility for supervising and monitoring construction and testing.

In cases involving funding before delivery and acceptance of the asset ("advance funding"), this section may also provide, if necessary, that the lessor is to deposit the amount of the asset purchase price with a trustee or escrow agent. Where progress payments are required, the lease will provide instructions respecting procedures for the lessee to approve disbursement from the escrowed funds. These funding instructions may also be placed in the trust or escrow agreement (discussed in "Ancillary Financing Documentation" below).

In cases where the lease is advance funded, this section may address substitution of assets; redemption of proceeds, in the event of non-delivery or non-acceptance by the lessee; and the obligations of the parties in the event of delayed acceptance or a failure of acceptance.

Delayed Acceptance

Acceptance procedures are important provisions, and require careful drafting for economic and tax reasons. Except in advance funded transactions, delay of acceptance will result in a delay in funding. If acceptance is delayed beyond expiration of the lessor's interest rate commitment, the lessor may seek either a rate adjustment or termination of its financing commitment. Of course, if the lessor's rate commitment floats, the risks of any delay are diminished.

To avoid these issues, the lessor and lessee should adopt procedures to handle unusual delays in the acceptance process. In general, the lessor is not responsible for any delay in asset delivery and acceptance, and the lessee must look to the vendor for reimbursement of damages due to delay. The liability for any damages caused by late delivery and acceptance, including any increased financing costs, should be set forth in the lessee's agreement with the vendor or in the purchase documentation.

When funds are escrowed for progress payments or for multiple asset acceptances, delays may also create arbitrage concerns in the event the delivery or construction period exceeds that permitted under applicable arbitrage rebate exceptions in the Internal Revenue Code.

In addition, in abatement leases, unusual delay in vendor performance may raise potential default concerns at lease inception. Where delivery and acceptance are delayed past the period for which capitalized interest has been calculated in the amount financed, questions may arise respecting responsibility for payment of such additional interest until the acceptance date. Because in abatement leases the lessee may not be required to make payments of principal and interest prior to acceptance (and while it does not have use of the asset), the interest may not be chargeable to the lessee. For such pre-acceptance interest, the only recourse may be to the lessee's rights against the vendor or the vendor's performance bonds, or any collateral posted for such contingencies by the vendor. Rental interruption insurance may not be of benefit in non- delivery circumstances because many policies require that the obligation for rent commence before the policy is enforceable.

Non-Acceptance

Failure of acceptance typically results from a failure in vendor performance. The lease document generally does not provide detailed specifications and performance criteria for the assets and, in fact, contains extensive disclaimers of warranties by the lessor. Specifications and any testing criteria are more typically set forth in the purchase agreement between the municipality and vendor or contractor. Indeed, performance safeguards are of particular importance when the lessor has made progress payments to the vendor on behalf of the lessee before acceptance.

Where the asset is not accepted under the lease, problems may arise in advance funded transactions respecting reimbursement of the lessor for issuance costs and administrative expenses in addition to any accrued interest and progress payments. Although investment earnings on any escrowed funds may be applied to cover interest expense (and to the extent positive earnings exist, other expenses), a shortfall may result. Any deficiency may not be reimbursable by the lessee due to provisions in the lease (e.g., abatement clauses) or due to local law restrictions. This risk may be further compounded if earnings on borrowed funds are subject to arbitrage rebate.

To avoid such issues, project completion insurance, performance bonds or similar independent collateral should be requested from the vendor to cover these items if the lease must be terminated due to failure of delivery and acceptance. Other alternatives may include liquidated damages from the vendor.

c. Lease term. This clause usually states the term of the lease, its anticipated expiration date, and any specially negotiated renewal issues.

Commencement of the lease term in general means the date the obligation of the lessee to pay rent begins to accrue. However, depending upon the financing structure, the lease term may also commence (i) at the time of delivery and acceptance of the assets, (ii) for advance funded transactions and, in general, for master lease programs, when funds are raised and deposited into an account pursuant to an escrow or trust agreement, or (iii) for a lease line of credit or similar structure, upon the execution and delivery of the lease (especially if provides a funding commitment is provided), with payment obligations as to specific assets commencing at the earlier of the time the assets are funded or delivered.

The term of the lease should equal, at a minimum, the number of months necessary to fully amortize the principal. Subject to any legal restrictions, these may be as long as 7 to 10 years for equipment and 25 to 40 years for real property. They generally do not exceed the anticipated useful life of the asset.

When a lease is advance funded, its term also may include a construction or pre-acquisition period. For non-appropriations leases, the lease term extends at least through the end of the lessee's current fiscal year and will be renewed (in most cases, automatically) or terminated on an annual basis thereafter. For abatement leases, the lease term will consist generally of the total multi-year period necessary to amortize the principal, subject to abatement in the event the asset is not available for use.

Assuming no exercise of the non-appropriations clause or abatement rights, the lease term will expire after the lessee has made all lease payments and paid all other sums due under the lease (generally corresponding to the amortization period), at which point the lessee owns the asset free and clear of the rights and interest of the lessor. Most tax-exempt leases also provide the lessee an early termination right by exercise of a purchase option and the making of a concluding payment, as set forth on the payment schedule.

Lastly, the lease term may also be terminated prior to expiration in the event of (i) a casualty occurrence and the election by the lessee not to repair or replace the asset, (ii) condemnation, or (iii) a lessee default and exercise by the lessor of its remedies under the lease to terminate the lease.

d. Lease payments (rent). This section obligates the lessee to make the total payments required to amortize the principal and pay the accrued interest at the agreed-upon rate. In most leases, a payment schedule, as discussed below, is attached to the lease, setting forth the principal and interest components of each payment, the payment due date, and the total amount, as well as any applicable concluding payment. This section may specify that the lease payments are for the lessee's possession and quiet use and enjoyment for the specific period for which payment is due or these confirmations may appear in a separate section.

Depending upon the transaction, lease payments may be monthly, quarterly, semi-annually or annually. Monthly or quarterly payment schedules generally predominate in smaller dollar leases and vendor leases; semi-annual payment schedules are common for certificates of participation. Most payments are in arrears but advance payment structures are not infrequent. In fact, for school districts in California, a preferred structure is annual payments in advance to lower the total payments under the lease. Many leases also do not specifically state the implicit interest rate, but rely on the payment schedule for the rental amounts. This section may also include provisions for late charges to the extent they are assessable in the jurisdiction.

The payment section may contain a "hell-or-high water" clause making the lessee's obligation to pay rent unconditional (except in prescribed events, such as non-appropriation) and without right of set off, defense, counterclaim or recoupment. It ensures that the payment streams continue notwithstanding any disputes between the parties.

(Since the lessor's primary function is to finance the assets, both it and the investors should be isolated from disputes over asset-related issues.) Omission of this clause would make assignment to investors more difficult unless offsetting assurances or guarantees are provided by the vendor. Accordingly, vendors and third-party lessors seeking to assign the lease will require this clause.

Depending upon the lessee's preference, lease payments may be due on the first day of each month or quarter (with a partial rent period for acceptances and deliveries in the prior period) or on the periodic anniversary of the funding or acceptance date.

e. Non-appropriations clause. For the non-appropriations lease, this clause may be separately stated or incorporated into the payment section. This provision typically will include a statement of the lessee's (i) right to terminate the lease if funds are not appropriated and (ii) obligation to use its best efforts to pursue funds for lease payments from the general fund, to have funds included in its annual budget (and if not included, to exhaust all administrative reviews and appeals), and to take all lawful steps within its power to obtain funding in future years. It will also require return of the asset, generally at the lessee's expense, in event of non-appropriation.

Nonsubstitution Clause

Nonsubstitution language may be incorporated in this section or set forth in a separate section. This language provides that the lessee will not purchase, lease, use or rent assets performing functions, or obtain services from persons performing functions, that are the same or similar to the functions performed by the assets being non-appropriated.[1] The non-substitution provision will be applicable for a specified period after the non-appropriation, ranging from one month to the balance of the lease term (but typically for one year). Intended to ensure that the lessee does not utilize its non-appropriation rights frivolously, this clause may be unenforceable, especially if a strong argument can be made that its enforcement would infringe upon a government's exercise of its basic police powers.

Abatement

In lieu of a non-appropriation clause, leases in California may contain a provision that allows the lessee to cease rental payments if the assets are unavailable for use. In abatement leases, the lessee covenants to appropriate funds annually, so long as the assets are available. Failure to appropriate constitutes an event of default. However, the lessor in an abatement lease may insist that the lessee provide rental interruption insurance to protect the lessor's interests.

If the non-appropriations clause or the abatement provision is properly exercised, it will not cause an event of default. Alternatives to the lessor upon such event are generally limited to collecting rent then due, repossessing the asset, enforcing performance of non-substitution and other similar clauses in the lease, and collecting on any other collateral assigned to the lessor (viz., reserve funds, rental interruption insurance or performance bonds). They do not include more traditional remedies, which may be available following an event of default.

f. Title; security interest; risk of loss. This section discusses the property interest retained by the lessor in the assets and how and when title is transferred to the lessee.

In many leases the lessor retains "bare" title until expiration or early termination of the lease. In those leases where title passes to the lessee at commencement of rent, this section will provide that title to the assets automatically reverts to the lessor or its assignee, free of any right, title or interest of the lessee following a lessee default, non-appropriation or abatement. The clause may also obligate the lessee to assist in the transfer of title to the lessor in these circumstances.

While title may pass initially or after making all payments in a tax-exempt lease, vesting of title in the lessee provides a clear indication under Revenue Ruling 55-540[2] (dealing with lease versus conditional sale treatment) that the parties intend a conditional sale arrangement. In addition, governmental accounting standards identify the passing of title to the lessee as one of four factors for characterizing a lease as debt for accounting purposes. Depending upon the jurisdiction, this may also have impact for sales, use and property tax purposes.

Security Interest

To the extent Article 9 of the Uniform Commercial Code applies, a security interest for the lessor is perfected by filing a UCC-1 financing statement with the secretary of state, the county recorder or both.

To ensure that the intent of the parties is clearly stated, the lease usually grants a security interest to the lessor in the asset, the lease (and ancillary documentation), the rental payments, any insurance awards and all proceeds. As applicable, the lessee will also be required to cooperate with the lessor in executing and filing UCC-1 financing statements to evidence the parties' intent. The lease usually will contain a requirement that the lessee remove any liens or encumbrances affecting the asset (including liens for sales or property taxes), which may jeopardize the security interest of the lessor.

Most leases specify that risk of loss is with the lessee throughout the term of the lease. This risk is generally insured through a separate policy or by self-insurance.

g. Insurance. The lessee normally is required to carry property and casualty insurance in an amount at least equal to the concluding payment for the assets (which includes the prepayment premium, if any, accrued interest and principal), with reasonable deductibles based upon industry standards and local conditions. The lessee also will be required to obtain liability insurance. For abatement leases, rental interruption insurance may also be necessary, especially if a credit rating is sought. For advance funded leases (particularly involving construction), performance bonds or letters of credit from the vendor or contractor in an amount at least equal to the purchase option price may also be required.

The insurance generally should be placed with a superior-rated insurance company (as rated by Best's). The lessor and its assignees will usually request to be listed as additional insureds and loss payees, and to receive at least 30 days' advance notice of any cancellation, modification or termination of the policy. The lease will frequently also require assignment of all insurance proceeds and awards to the lessor and its assignee as secured parties.

When the lessee self-insures or is a member of a self-insurance pool, it may be asked to substantiate reserves available for paying claims. The lessor may also request, at least annually, a certificate of insurance or self-insurance (including any excess coverage) to confirm that the insurance arrangements remain in full force and effect.

The question of whether to permit self-insurance is generally a credit and collateral issue. Where the lessee has a good credit history and rating, has adequate funded reserves available for payment of claims, and is knowledgeable about the use, maintenance and operation of the assets, self-insurance may be appropriate. However, for items such as fire trucks, police cars, emergency vehicles, athletic facilities, generating facilities and other high-risk assets, an independent insurance policy may be requested. For certain assets (such as generating stations) and risks (e.g., earthquakes), it may be difficult to procure insurance or the costs may be prohibitive. In such situations, self-insurance may be the only feasible alternative.

In abatement leases, self-insurance of property damage risks or a requirement that the lessee cover the cost of reconstruction in excess of any third-party insurance potentially raises structuring issues, and such requirements should be carefully reviewed by counsel. In fact, many bond counsel will not permit self insurance for rental interruption purposes.

h. Triple net clauses. This provision requires the lessee to assume all ownership and management responsibilities for the asset. These responsibilities include maintenance and management of the asset and repair of any damage to the items. Depending upon the type of asset and available maintenance facilities, the lessee may also be required to enter into a maintenance arrangement with the vendor or an independent third party providing maintenance and service for such asset. The lessee will generally be required to pay all taxes imposed on the asset, including (as applicable) sales and use taxes, property taxes, special assessment taxes and other similar fees and costs, with the exclusion of taxes imposed on the net income of the lessor. If the lessor pays the taxes or other costs on behalf of the lessee, it typically will be reimbursed.

Any decrease in the lessee's responsibilities on a triple net basis may create both tax and securities complications. Besides causing some ambiguity over whether the lessor has retained an ownership interest in the asset, it also would run counter to one of the bases -- i.e., the triple net concept, upon which staff of the Securities and Exchange Commission has relied in considering certificates of participation in leases as exempt from registration as a governmental security.[3]

i. Disclaimer of warranty. Since a third-party lessor and its assignee are purely financing parties (and not agents or representatives of the vendor or manufacturer), they generally will disclaim all responsibility and warranties for the asset. However, when the lessor acquires the asset from the vendor or manufacturer for transfer to the lessee, the lessor usually will assign to the lessee any warranties or guarantees the lessor received. This provision may also provide that the lessee must continue to make rental payments to any assignee regardless of any warranty or other dispute between or among the lessee, lessor and vendor. This confirms that such disputes will involve the lessee and vendor, and not the financing party.

Any disclaimers must be in writing, be conspicuously stated (e.g., bold faced or in upper case letters) and utilize such phrases as merchantability and fitness for a particular purpose to satisfy the requirements of Article 2 of the Uniform Commercial Code.[4]

j. Indemnification; tax covenants. The indemnification clause protects the lessor and any assignees from third-party claims, actions, costs or expenses respecting the asset. Frequently resisted by lessees, these clauses are required by many lessors, particularly if the lease is to be assigned, rated or credit enhanced. Most indemnification clauses include indemnification for attorney's fees as well as costs of any litigation defense.

Given that the lessee will be directly or indirectly liable for any actions associated with the asset (and over which it has total physical control), it should be the party responsible for liabilities arising from the asset, particularly if this benefits the lease's marketability.

The lease also frequently contains a similar indemnification provision for any actions or inactions of the lessee which would cause the tax-exempt nature of the lease to be contested, challenged or denied by applicable governmental authorities. Since the lessee has sole use and operation of the asset, it is best qualified to ensure that unauthorized use, sublease, or similar events do not occur, that the asset is not utilized in a private activity or enterprise, and that the other requirements of the Internal Revenue Code applicable to tax-exempt obligations are not violated. However, this indemnification should not extend to lessor-caused acts or omissions.

k. Options to purchase. Tax-exempt leases may contain two types of options to purchase. The first provides for the payment of a nominal amount (typically $1) at the end of the lease term to evidence completion of the lease. In leases where title transfers to the lessee at the commencement of rent, this section may stipulate that the lessee automatically holds unencumbered title following payment of all rent.

The second option, if included, permits early termination of the lease by the lessee, through making a concluding payment on specified option dates, typically at the end of each fiscal year. The concluding payment declines with each rental payment, due to amortization of the principal and unrecovered issuance costs. Most leases also require that any accrued interest to the date of payment and other sums due under the lease be paid at the time the option is exercised, and that the lessee otherwise not be in default under the lease. Exercise of this option will also typically require advance notice of 30 to 60 days. In longer-term leases, these provisions may include call protection for the benefit of the lessor or investor during the initial years, restricting or eliminating exercise of this option while the call protection is in effect.

Following the concluding payment and compliance with this section, the lessor is required to cancel its security interest in the asset and, to the extent title has not previously been transferred to the lessee, provide the lessee with a quitclaim bill of sale or similar instrument.

l. Events of default and remedies. Default provisions in tax-exempt leases involve two types of lessee defaults.

Monetary Default

The most critical event of lessee default is the failure to pay rent or other sums when due, commonly known as "monetary" default. In large publicly traded certificates of participation, the default occurs automatically upon non-payment. In vendor or smaller dollar leases, default may be delayed for a five- to ten-day grace period. Lessees sometimes request that the lessor provide notice of such failure during the grace period as a condition to the default, a request usually resisted by lessors.

Failure by the lessee to process rental invoices or to pay obligations promptly is of serious concern to the financial community. As the recent experience with the Commonwealth of Massachusetts demonstrates,[5] the rating agencies and other credit evaluators consider prompt payment as critical and may downgrade a lessee's credit rating when a pattern of late payments persists.

Failure to pay rent when non-appropriation or abatement rights are exercised is not an event of default because the lease specifically contemplates termination of the rental obligation in these situations. In such cases, the lessor would look initially to any rental interruption insurance or reserve funds for payment, and then to the value of the asset. See paragraph e. above.

Non-monetary Defaults

The second common event of default revolves around the (i) failure of the lessee to perform its other obligations, agreements or covenants in the lease or (ii) the existence of a material misrepresentation in any statement, representation or warranty provided by the lessee.

These could, for example, include:

- the failure to insure or maintain insurance on the assets against damage or liability claims or obtain performance bonds from the vendor;

- the failure to maintain the asset in proper working order;

- the failure to repair damaged or destroyed assets;

- the failure to keep the asset free from liens, encumbrances and taxes or to honor indemnification against third-party claims;

- the failure to take actions to retain the tax-exempt status, including restricting usage to governmental persons or functions; or

- the failure to satisfy the requirements of the non-appropriation, essential use or non-substitution clauses.

This type of default may arise regardless of the lessee's intent or good faith.

In most instances, the lessee is generally provided a grace period to cure a non-monetary default and is usually given notice of such default by the lessor. The lessor may have a good faith obligation to extend the grace period if the lessee has a reasonable rationale for an extension (or an expectation of an ability to cure), and if the extension would not materially adversely affect the lessor or its security interest. In cases where cure is not feasible, the lease may provide that the grace period be waived.

Other events of default include the insolvency, voluntary or involuntary bankruptcy of the lessee, the failure of the lessee to maintain clear title (especially in real estate situations), the failure of the lessee to comply with applicable environmental or similar restrictions, the failure to obtain rental interruption insurance, and the failure by the lessee to comply with the terms of similar obligations or of obligations senior to the lease (such as general obligation bonds) -- typically called a "cross-default" clause.

However, with the exception of bankruptcy, most other events of default are customized for the individual assets, sophistication of the parties, or the level of comfort and protection required by the lessor. For example, for real estate transactions, the failure by the lessee to maintain clear title to the asset may jeopardize any title insurance which the lessee may have obtained, and depending upon any intervening lien, could result in loss of priority to the lessor as a secured party. Moreover, many states, including California, allow intervening and unrecorded liens for both personal and real property, which potentially could "cloud title."[6] In fact, California school districts receiving funds under the "Leroy Greene" lease-purchase program, in general, grant an unrecorded lien to the State on all school facilities of the district. This lien does not appear on a title report. Therefore, a lessor completing a lease/leaseback must first obtain a release from the State, to avoid being in a subordinate position.

The need to satisfy environmental and similar requirements is also important since there exists for troubled real estate loans a growing tendency by federal courts to include secured lenders within the group responsible for hazardous substance clean-up under the Superfund legislation.[7]

The lessee's failure to maintain any required rental interruption insurance in abatement leases or to monitor performance bonds or similar vendor guarantees, may significantly increase the risk to investors. In fact, in one tax-exempt lease currently subject to lessee bankruptcy proceedings in California, failure by parties to monitor rental interruption insurance as well as to ensure that adequate performance bonds were available, severely restricted the recovery by investors following bankruptcy, and itself has become the subject of litigation.

Cross-default Clauses

While less common in California leases, cross-default clauses must be carefully drafted and monitored to avoid unnecessary defaults. Such clauses are intended to protect the lessor's security interest and ensure that similarly situated creditors do not receive an advantage over the lessor. They may encompass other tax-exempt leases or senior obligations, or even all agreements of the lessee.

Depending upon their scope, such clauses may, in fact, precipitate a lease default, based upon technical non-compliance in other documents, even if the lessee is otherwise in compliance under the lease. This compounds the complexity of any such default as well as the difficulty of effecting a cure, especially if other creditors of the lessee must be consulted. These clauses are likely of marginal benefit to the lessor given the risks.

Lessor Defaults

In some agreements, particularly where the lessor as a captive credit corporation is affiliated with the vendor, lessor events of default may also be addressed. These usually concern warranty or maintenance provisions, performance of the assets to specifications or failure by the lessor to provide funding or to perform other terms of the lease. A lease with these provisions is atypical, especially in the larger certificate of participation transactions.

Lessor default clauses should be carefully reviewed to avoid conflict with other provisions of the lease (e.g., disclaimer of warranties, statement of intent and the hell-or-high water clause) as well as with the assignment agreements to investors. These clauses are probably more appropriately addressed in the contract or purchase order between the municipality and the vendor, rather than in the financing documentation.

Remedies

The remedies section usually follows the default provisions. Note that remedies upon default should not be confused with remedies available to the lessor following a non-appropriation or abatement, as discussed above.

Depending upon the transaction and structure, remedies upon an event of default may differ significantly. These may include repossession of the asset (with or without lease termination), or sale, lease or sublease of the asset, with the lessee responsible for specified damages and costs.

If the assets are personal property or fixtures and Article 9 of the Uniform Commercial Code applies, the lessor generally will have the remedies afforded by Article 9, in addition to any other remedies specifically provided by, or applicable to, the lease. Where the assets are real property, available remedies will be determined by the lease and applicable provisions of state law respecting foreclosure and sale, including restrictions on the choice of remedy and deficiency judgments. See Chapter Three, "State Law Considerations-Uniform Commercial Code".

The most important remedy under Article 9 is the right of the lessor to repossess and dispose of the asset in a commercially reasonable manner without a court proceeding. Under Article 9, the lessee in default is obligated to surrender the asset peaceably to the lessor (or the lessor may seek an action for involuntary possession). Whether or not repossession terminates the agreement under the lease or applicable law, the lessor is usually permitted to charge the lessee damages for its costs to repossess and marshall and prepare the asset for shipping, subject to the terms of the lease. The lessor may need to mitigate any damages by remarketing the assets to a new user. However, any re-lease or sublease to, or use by, a private nongovernmental entity may jeopardize the tax-exempt nature of any interest component of future re-lease payments. It also may cause previous rental payments to be taxable. Potential retroactive loss of tax exemption must be considered in any remarketing of the asset.

An additional remedy in certain situations is to accelerate the future rental payments (net of interest) or require the lessee to make the concluding payment together with accrued interest and any costs arising from the default. However, in abatement leases, the lessor may be unable to accelerate rent, since the lessee is not obligated to pay for periods during which the asset is unavailable for use. Rather, the lessor will be required annually to claim against the lessee for rental payments due in that fiscal year.

Many leases contain an additional clause granting the lessor any and all rights and remedies available at law or in equity to be exercised simultaneously or individually. This clause could technically require the lessee to continue the lease while the lessor is attempting to mitigate damages, permitting further accrual of interest and late charges. To the extent it forces the lessee to pay rent following a non-appropriation or an abatement, it may be unenforceable.

Exercise of remedies is subject to any rights and protections afforded debtors under state or federal law, including bankruptcy. These are considered in Chapter Three. However, following a lessee bankruptcy filing, the lessor may be prevented from exercising its remedies, due to the automatic stay, except in accordance with bankruptcy court rules and procedures.

m. Assignment clause; quiet enjoyment. The assignment clause, one of the most essential provisions for financing purposes, serves a dual purpose. It operates to restrict lessee assignment of the lease and of its possessory and legal interest in the asset (including any sublease, conveyance or encumbrance), without consent of the lessor and compliance with applicable tax and secured transaction law requirements.

The other purpose of this provision is to permit assignment by the lessor. This assignment can be either for purposes of creating a security interest or, more typically, for transfer to a trustee, escrow agent or paying agent on behalf of investors. Aside from certain tax and securities compliance requirements set forth in Chapter Three (and local law restrictions as to the number or classes of investors), most leases contain few limitations on lessor assignment, in part to ensure marketability of the lease. Indeed, with the exception of large institutional lessors (such as credit corporations of major industrial companies and bank lessors for bank-qualified leases), most lessors do not retain the leases in their portfolios, but contemplate assignment of the lease and rental stream to investors. In fact, with the development of certain "collateralized mortgage obligation"-type financings on Wall Street, even large banks and credit corporations, which previously held these leases in their portfolios, can now fractionalize their portfolios and sell them to investors in pools of multiple leases (as opposed to sale of a single lease in a certificate of participation structure).

In connection with any assignment, the Internal Revenue Service requires that leases that are "of a type that are offered to the public" be issued in registered form, with the lessee obligated either to perform transfer functions itself or maintain (or have maintained on its behalf) a book-entry system or listing of the names of the assignees.[8] This obligation may be handled by the lessor or by third parties, as agent of the lessee. If the assignment is made to a trustee or paying agent, the lessee will confirm (i) the lease assignment to the trustee (including, as required, receipt of copies of relevant documents), (ii) the re-assignment to investors through the certificates of participation, and (iii) the escrow agent's or trustee's appointment as agent of the lessee to maintain records through a book-entry or similar system.

Acknowledgment of the assignment may also be helpful for securities purposes. The staff of the Securities and Exchange Commission has in the past taken the position that if a tax-exempt lease is to be fractionalized into certificates of participation, the lessee should specifically acknowledge and authorize such assignment in the lease.[9]

Quiet Enjoyment

The lessee is usually granted the right of quiet use and enjoyment of the asset following any assignment by lessor. Although quiet enjoyment is implied under the laws of most jurisdictions, inclusion in the lease documentation reaffirms this right, which right is also important for abatement purposes.

The quiet enjoyment clause may be coupled with a clause permitting the lessor to inspect the asset, with inspections generally during normal business hours and with reasonable notice. The inspection is intended to permit the lessor to monitor compliance with the maintenance, operation and use covenants and to ensure the lessee is not permitting waste.

Although other provisions may exist in the tax-exempt lease, they will generally be specific requirements of the lessee or lessor (given their internal policies) or be customized to the specific financing or asset under lease.

LEASE EXHIBITS AND ATTACHMENTS

These documents confirm the tax treatment of the lease and provide additional assurances to the lessor. They generally include the following:

1. Equipment or asset schedule.

This schedule to the lease identifies the property to be leased, including serial numbers, descriptions, equipment location, cost and other items. For transactions with one schedule, it is generally provided at the initial closing. For master leases, numerous schedules are provided at the initial closing, but these may be changed or amended from time to time if the assets change. For lease lines of credit, a schedule is provided detailing the assets being acquired at each proposed takedown of funds.

2. Payment schedule.

This schedule identifies the payments due and the principal and interest components of each payment. Assuming the lessee is also provided a purchase option prior to expiration, the concluding payment will generally also be stated on this schedule. For master leases or leases involving multiple takedowns, several payment schedules may be attached related to one or more asset schedules. Although this schedule is specifically referenced in the lease, it is recommended that the lessee formally acknowledge it.

3. Certificate of Acceptance.

This certificate confirms that assets have been delivered, inspected, tested and accepted by the lessee. Generally, the certificate is executed after final testing is completed. In certain cases, the lease may require the lessee to complete its procedures within a specified period to ensure that the asset is acquired and the vendor paid on a timely basis.

The acceptance certificate is essential because the vendor generally cannot be paid until the asset is accepted and because the lessee typically is not obligated to make rental payments for the asset until available for use.[10]

Although certificates of acceptance can be as short as one sentence, the lessor may also request that the lessee confirm that appropriations have been made at least for payments during the current fiscal year, that the asset will perform the essential use as specified in the lease and essential use certificate, and that the lease payments for the asset are as specified on the payment schedule for such asset. In the case of assets with specific serial or identification numbers (e.g., motor vehicles), the certificate may set forth this information. Since the acceptance certificate is executed by, and is binding upon, the lessee, it should be factually accurate and limited to confirmation by the lessee of its obligations under the lease.

4. Essential use certificate.

Particularly for non-appropriations leases, this letter provides additional assurances to the lessor that the asset is essential to the lessee and that the asset will be used for specified governmental purposes. Although frequently the lessee will represent in the lease that the asset is essential, execution of a separate certificate reinforces the lessee's intent and avoids arguments that the lessee was unaware of the specific covenants of essential use. The essential use certificate also confirms to investors the asset's importance in providing essential governmental services, diminishing the likelihood of a non-appropriation in the event of budgetary difficulties. While this certificate may also be issued with abatement leases, the abatement structure lends itself less to risk of non-payment from budgetary pressures, thus rendering the essentiality questions less important, although the confirmation of governmental use is still material for tax considerations.

This certificate is usually delivered at the time the lease is executed, although in master lease programs it may be delivered at the time the specific equipment schedule is being added to the lease.

5. Opinion of lessee's counsel; opinion of bond counsel.

In general, for most lease transactions, an opinion by the lessee's counsel (whether an in-house attorney or outside counsel for the lessee) as to the lessee's status and the authorization, execution and delivery of the lease will be requested. The opinion will represent that the lease is a valid, legal and binding obligation enforceable against the lessee under state law, and may confirm that the lessee has satisfied all bidding and procurement requirements applicable to the lease. This opinion is important to the lessor to preclude arguments that the interest is not tax exempt.[11]

The lessee's counsel opinion also usually confirms that (a) the lease will not violate any law, judgment or order applicable to the lessee or create a lien on any of the lessee's property (other than the lessor's lien on the asset), (b) there are no suits or proceedings pending that would jeopardize performance by the lessee of its obligations under the lease, (c) the assets are personal or real property, as appropriate, and (d) the security interest of lessor in the assets will be perfected under the Uniform Commercial Code or other applicable law.

For many leases, bond counsel may also be engaged to render an opinion that the lessee is a political subdivision of the state authorized to issue or incur obligations that are tax-exempt pursuant to Section 103 of the Internal Revenue Code, and that the lease is a legal obligation enforceable against the lessee under state law. Bond counsel also will usually opine on the tax-exempt nature of the interest component of the lease payments. Depending upon the transaction and the opinion of lessee's counsel, the bond counsel may issue its opinion respecting certain of these matters in reliance upon the opinion of lessee counsel.

6. Resolution of the Lessee.

The resolution, passed by the governing body of the lessee and authorizing the lease transaction, ordinarily summarizes the lease transaction and confirms that an essential use exists for the assets being leased. It also confirms that the lessee entered the lease in conformance with local legal procedures respecting authorization. In certain cases it may be waived.

For a bank qualified transaction, the resolution also should confirm that the lessee does not reasonably anticipate that it will issue more than $10 million of obligations which are tax-exempt governmental or Section 501(c)(3) bonds in the calendar year. It also must designate the lease as a "qualified tax-exempt obligation" for the bank qualified provisions of the Internal Revenue Code to apply.

The resolution may also confirm, if appropriate, that the lessee will be exempt from the rebate requirements for arbitrage due to the applicability of the small issuer or another specified exemption.

In some jurisdictions, the lessee's governing board may not be required to approve the transaction by a formal vote, but the transaction may receive approval through a consent calendar or by specially designated commissions or administrative subdivisions.

7. Certificate of appropriation.

This certificate is occasionally required and confirms that adequate appropriations exist in the current fiscal year to make rental payments following commencement of the lease. While this document may be somewhat redundant (due to representations and warranties noted above that adequate appropriations have been made by the lessee for payments in the current fiscal year), use of a specially executed certificate reminds the lessee of its covenant and reassures the lessor.

8. Incumbency certificate.

This certificate usually states that specified officials are authorized to sign the lease and ancillary documents and that the signatures on those documents are true and correct. The certificate may also contain specimen signatures of the persons executing the lease and other documents and will generally provide the title and status of such officials. It is signed by the secretary or clerk of the governing body of the lessee. In the event a specific resolution is adopted by the lessee's governing board, the incumbency certificate may confirm the status of the resolution.

9. Certificate of insurance.

This certificate indicates that the lessee has the insurance or self-insurance required under the lease for property damage, liability and personal injury. It may be accompanied by a copy of the insurance binder. Generally, the insurance policy or binder must list the lessor and any trustee or escrow agent (on behalf of investors) as an additional insured and loss payee, and typically includes the requirement that the lessor, trustee or escrow agent be provided at least 30 days advance notice of any cancellation, modification or termination of the insurance.

10. UCC-1 Financing Statement.

When Article 9 applies to the lease, either contractually or legally, the lessor normally files a UCC-1 financing statement with the secretary of state (and for fixtures or other specified items, with the county recorder in the county where the asset will be situated). The UCC-1 financing statement, which is normally signed by the lessee and lessor, expires five years following its filing. For longer-term transactions, the lessor will require the lessee to execute and file continuation statements, continuing the filing for additional five-year periods.[12]

ANCILLARY DOCUMENTATION: TRUST AGREEMENT

Depending upon the financing structure selected, the lessee may also be requested to execute a trust or similar agreement. This agreement is generally required for more complex financing structures, such as certificates of participation, or when the parties contemplate reserve funds, advance funded situations or other customized circumstances that may entail the possession and investing of funds on behalf of the lessee or investor. For example, in advance funded leases, the agreement will specify the allocation and disbursement of funds for acquisition of the asset, capitalized interest (if any), reserve funds (if any), costs of issuance and other uses of proceeds, and provide procedures and conditions for disbursements to the vendor. Since the acquisition funds are held and invested by the trustee for the lessee's account, any disbursement will usually require formal approval by the lessee.

The trust agreement also defines the roles and responsibilities of the parties following receipt of rental payments or other proceeds from, or on behalf of, the lessee and the application of such funds to respective obligations of the lessee under the lease (e.g., rental payment, condemnation award, casualty repair), as well as the application of, and rights to, any investment earnings on such funds.

Where defeasance or refunding techniques are intended, the agreement will also outline the procedures for handling such matters, including the substitution of cash, securities or collateral for the investor's interest in the asset, including the release of any security interest. The cash, securities or collateral may be derived from the lessee's own funds or from a new lease issued to refund the initial lease. The proceeds deposited as the "substitute collateral" will be invested until the first lease's expiration or earlier termination.

The agreements also provide directions to the trustee respecting investment of funds while in trust (i) for the benefit of the lessee, in the case of acquisition, reserve or related funds, (ii) for the benefit of the investor, in the case of condemnation or other awards, and defeasance or other proceeds, or (iii) as applicable, for the benefit of any other parties. Permitted investments may be specifically enumerated or referenced to those available under state law.

In certificate of participation structures, the trustee typically is assigned the lessor's rights in the lease, rental payments, any insurance awards, and the asset, including the rights to declare a default and exercise remedies under the lease. In connection with such assignment, the lessor will authorize or direct the trustee to execute and deliver certificates of participation in the lease in specified denominations and having specified interest rates and maturity dates.

The trustee will, on behalf of the lessee, typically maintain a registry of certificate holders, for tax and securities purposes, or engage a third party to maintain the book entry register.

The parties to the trust agreement generally include the lessor, lessee and the trustee, although in certain circumstances (principally involving smaller privately placed leases without reserve accounts or advance funding), the lessee may not be a signatory to the agreement.

The trustee generally is a trust company with substantial net worth and capital or a trust department of a commercial bank. The trust agreement will generally provide that the trustee is absolved of any liability for its actions (including investment of proceeds and any losses therefrom), except for gross negligence or misfeasance. The agreement generally will also provide indemnification to the trustee from the other parties, and will require payment of costs and expenses before the trustee pursues any rights or remedies on behalf of the investors or other beneficiaries.

The cost for establishing the trust account typically is included in the issuance costs. Annual fees may be paid by the lessee directly or from investment earnings on funds of the lessee held in the trust.

In certain instances an escrow agent under an escrow agreement will be substituted for a trustee. While trust instruments are legally distinct from escrow arrangements,[13] the cash management and administrative responsibilities of the trustee or escrow agent are similar, including handling of funds and the execution and delivery of the certificates of participation.

LEASE VARIATIONS

Master Lease Programs

The lease documentation for master lease programs will generally conform to that outlined above. In a master lease, an agency typically contracts on behalf of several other tax-exempt users to lease the assets from the lessor, and then may sublease the asset to the user under a formal sublease agreement with terms and conditions substantially identical to the master lease. Alternatively, the leasing agency may provide use of the asset to the user under an informal memorandum of understanding, that may incorporate the terms of the master lease by reference. The master lessee will usually either make rental payments directly to the lessor and invoice each user/sublessee for its pro rata share or will act as a collecting and disbursing entity for the users, collecting rents from each user and remitting them to the lessor. Responsibility for any delays or defaults in payment will rest with the master lessee.

For its services, the master lessee may either charge the user directly, receive consideration from the initial proceeds or retain the investment earnings from user rental payments held pending transmittal to the lessor.

Lease Line of Credit

The documentation for a lease line of credit is also similar to that set forth above. However, in a lease line of credit, the lessor typically provides a commitment to the lessee to fund up to a specified amount, for specified categories of assets and lease terms, to be drawn down as assets are acquired on a schedule-by-schedule basis. The lease is funded as assets are accepted, rather than in advance. It generally covers multiple deliveries and numerous vendors as opposed to the lease of a single asset or project on a stand-alone basis. In certain instances, each drawdown may be structured as a separate lease and assigned individually to different investors.

If permitted under local law, the lessor may charge a commitment fee at inception of the line or include such cost in the interest rate or costs of issuance; or such fee may be waived. Depending upon the terms negotiated, the interest rate may float until funding or be fixed for specified periods, and the lessor's commitment to a dollar amount may be fixed or may revolve (as principal is repaid, the funds become available for use for subsequent acquisitions).

ENDNOTES

1. The risk of non-appropriation is greater in the case of leases for computers and assets that rapidly become obsolete. Especially in these cases, the non-substitution clause should be worded broadly to include both existing types of assets and newer generations of similar assets. See Joanne E. Pollak, "Security Problems and Considerations in Tax-Exempt Leases," in C. Gregory H. Eden and Kenneth W. Bond, eds., Tax-Exempt Municipal Lease Financing (New York, N.Y.: Law Journal Seminars Press, Inc., 1980), at 561.

2. Revenue Ruling 55-540 (55-2 C.B. 39).

3. No action letter on behalf of First Municipal Leasing Corporation, June 4, 1976; and no action letter on behalf of Smith Barney, Harris-Upham & Company, Incorporated, November 11, 1976.

4. See California Commercial Code Section 2101 et seq.

5. "Payment snafu linked to Mass. downgrading," City and State (July 31, 1989), at 11.

6. In fact, a committee of the State Bar of California evaluating personal property secured transactions identified over 100 provisions where unrecorded liens can be imposed. Report of the Uniform Commercial Code Committee Regarding Legal Opinions and Personal Property Secured Transactions, Business Law Section, State Bar of California (1986), at 23, n. 157.

7. See, e.g., U.S. v. Fleet Factors Corp., 724 F.Supp. 955 (S.D. Ga. 1988), aff'd. (11th Cir. 1990); U.S. v. Maryland Bank & Trust Co., 632 F.Supp. 573 (D. Md. 1986); U.S. v. Mirabile, 15 Environ'l Law Rptr. 20994 (E.D. Pa. 1985) and Guidice et al. v. BFG Electroplating and Manufacturing Co., Inc., 732 F. Supp. 556 (W.D. Pa. 1989). State Street Bank in Boston recently settled a case with the government respecting lender liability, but has been sued in a private contribution action, Abcor Inc. v. State Street Bank and Trust Company, C.A.88-1324-K (D. Mass. 9/21/88), by other potentially responsible parties for recovery of clean-up costs. But see In re: Bergsoe Metals, 705 F.2d ___ (9th Cir. 1990), a sale-leaseback industrial development bond transaction involving the Port of St. Helens, Oregon, where the 9th Circuit restricted lender liability by ruling that the mere existence of power to become involved in management, absent exercise of management rights, is insufficient for lender liability under Superfund. See also Wall Street Journal (8/24/90), at B12, col. 1.

8. For tax purposes, any transfer to an investor of the right to receive principal and interest is effective only if recorded in a

registry maintained for such purposes by the lessee (or its agent) or through a book-entry system.

9. No action letter on behalf of First Municipal Leasing Corporation, June 4, 1976; no action letter on behalf of Smith Barney, Harris-Upham & Co., Inc., November 11, 1976.

10. Note, however, that acceptance is not generally necessary for commencement of rent, unless acceptance is a condition specified in the lease, or local law requires the asset to be "available for use."

11. Under Revenue Ruling 87-116 (1987-2 C.B. 44), if an obligation is ultra vires (without authority or authorization by the lessee), the interest will not be considered tax exempt.

12. For motor vehicles and depending upon the jurisdiction, the preferred method of perfection is to note the lessor's interest on the certificate of title.

13. A trustee acting pursuant to trust powers granted under federal or state law is more legally independent and less prone to bankruptcy than an escrow agent. A trustee generally also has more responsibilities than an escrow agent, particularly in an event of default. The trustee typically acts as the representative of the investors; the agent usually will not, which may help explain the difference in their respective annual charges.

CHAPTER FIVE

ACCOUNTING FOR LEASES

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ACCOUNTING FOR LEASES

The accounting standards under which tax-exempt leases are treated are another source of guidance that define their structure. The classification of leases for accounting and financial reporting purposes is set forth by the Governmental Accounting Standards Board (GASB) in various statements and amendments.

GASB is the standards-setting body for governmental accounting and, as a result, governments whose financial records are maintained in accordance with generally accepted accounting principles (GAAP) must adhere to the GASB pronouncements. GASB for its purposes, in turn, relies on certain of the standards set forth by the Financial Accounting Standards Board (FASB), the standards-setting body for accounting and financial reporting in the private sector. In California, governments conform to GAAP (as applicable under GASB pronouncements).

The primary standard for accounting for leases by governmental bodies appears in FASB Statement 13, which has been endorsed by GASB. Under FASB Statement 13, a lease is defined as "an agreement to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time." FASB Statement 13 further divides leases into capital and operating leases.

CAPITAL LEASE

If a lease meets one or more of the following criteria, FASB Statement 13 defines it as a capital lease:

- if ownership of the property is transferred to the lessee by the end of the lease term;

- if the lessee has an option to purchase the property at a bargain price (typically $1.00);

- if the lease term equals 75 percent or more of the useful life of the leased asset; or

- if the present value of the lease payments, including any purchase price, equals at least 90 percent of the fair market value of the property at the beginning of the lease term.

For a capital lease, FASB Statement 13 requires that the lessee record the leased property as its asset at the inception of the lease and record a corresponding liability at the same time. The book value of the asset and liability should be equal to, and calculated as, the present value of the lessee's payment obligations, excluding lessee payments for insurance, maintenance and taxes. The discount rate used for present value calculations is to be determined by the lessee and may be the interest rate charged in the lease or another sustainable rate.

A comparison of these FASB/GASB rules on capital leases with the requirements of the Internal Revenue Service for conditional sale treatment that determine whether a lease is a tax-exempt lease (see Chapter Four, "Tax Considerations") shows that a tax-exempt lease is always a capital lease. Theoretically, the reverse is not true. For a lease to be tax-exempt, the Internal Revenue Service requires that interest be shown as a separate component on the schedule of lease payments and other rules be satisfied. The accounting rules do not require these distinctions. It would generally seem inconsistent for a lessee to enter into a capital lease without assuring the tax-exempt status for the corresponding lower interest rate.

Under GASB direction, governmental lessees are to record a capital outlay for the full fair market value of the leased property at the beginning of the lease. During the lease term, both the principal and interest portions of the lease payments should be recorded as debt service expenditures, and the outstanding liability for the lease obligation should be reduced with each lease payment by the portion of the lease payment attributable to principal. In contrast, under many state statutes for debt purposes and not GAAP, lease payments in a non-appropriation or abatement lease are recorded as operating expenses.

It is these conflicting requirements, that lease payments be treated as debt for accounting, tax and credit analysis purposes, but not for "debt limitation" purposes, that create much of the confusion over accounting for tax-exempt leases.

OPERATING LEASE

Under FASB Statement 13, if a lease is not a capital lease, it is an operating lease, much like a true lease as defined by the Internal Revenue Service. The key characteristic of an operating lease is the continued ownership of the leased property by the lessor. An operating lease also usually has a term shorter than the asset's useful life and the lease payments are treated as payments of rent, and not principal and interest.

CHAPTER SIX

Marketing Leases

CHAPTER SIX

HOW LEASES ARE MARKETED

As already discussed, transaction structures influence who invests in a lease. How and why such investors are attracted to these financing instruments depends largely on how the leases are marketed.

The term "marketed" as used in this chapter refers to the sale, placement, and/or transfer of a tax-exempt lease from the original lessor to the ultimate investors. This process can be as simple as a single assignment from the lessor to one investor. In contrast, it can be as complex as an assignment by a lessor to a lease broker, who assigns to a trustee, who delivers certificates of participation in the lease to an underwriter, for sale to the ultimate investors. The chapter also discusses how the transfers are made, the roles of the participants, and how they are compensated. It concludes by enumerating the key features of a lease that influence its marketability.

Whether marketing is classified as a private placement or a public sale depends upon the number and sophistication of the investors. Usually a private placement involves the sale of a tax-exempt lease to one or a very limited number of institutional investors or high net worth ("qualified") individual investors with knowledge of the risks associated with such investments. Under SEC rules and regulations, the number of investors generally cannot exceed 35. Public sales usually involve transactions offered to a large number of investors in small denominations (as small as $5,000), akin to the sale of municipal bonds.

VENDOR-FINANCED LEASES

Many tax-exempt leases are created directly between a municipal lessee and the vendor or manufacturer (acting as lessor), who retains the lease as an investment or receivable for its own account and, as such, is not marketed. A vendor/lessor makes its decision to retain (invest in) a tax-exempt lease based upon its own economic and tax conditions. In general, the larger vendor/lessors with substantial asset bases are more likely to be able to carry tax-exempt leases as long-term receivables. Such an arrangement is depicted in Figure 1 (see Chapter One). A common form of vendor-financed and retained lease is a full service lease that includes both the financing of the equipment and vendor-provided maintenance or other service. Frequently, these leases are pretained by vendor/lessors because the continuing service requirements (and the potential for interruption of lease payments from failure of such services) may make these leases non-financeable to third parties.

Alternatively, in some cases, the vendor/lessor may have or may create a captive finance company whose primary business purpose is to finance the assets sold by its affiliates (e.g., IBM Credit Corporation). Sometimes a captive finance company outgrows the needs of its affiliates and also invests in leases involving other manufacturers' products (e.g., Chrysler Credit Corp.) and serves as a third-party lessor (as discussed below). In these cases, the vendor's manufacturing unit acts only as the seller of the product and does not participate in the lease.

The documentation for a lease in which the vendor/lessor serves as investor will be substantially similar and as inclusive as if third-party investors were participating. This is true because most provisions of a tax-exempt lease are required regardless of whether the vendor or a third party is the investor. Those provisions which make a lease legal and tax-exempt are still necessary for the vendor's benefit.

Another similarity between vendor-financed and third-party financed leases is that the vendor/lessor usually retains the right to assign the lease in the future. A lessee's primary concern respecting the assignment provision should be to ensure continuing performance by the vendor of its responsibilities, if the lessee requires future vendor performance. However, flexibility to the vendor to assign the lease may improve its marketability and lead to more favorable interest rates for the lessee. Care in striking a proper balance between service protection and cost should be an important consideration to each lessee. The federal tax registration requirements discussed in Chapter Three also make assignment notification necessary.

The foregoing is illustrated in the Model Lease-Purchase Agreement used by the University of California. In that agreement, the lessor may assign without the lessee's consent only if the assignment does not involve a public sale of the transaction. This provision gives the lessor sufficient flexibility to freely assign in a private placement, but protects the lessee from the public use of its name and credit unless it provides specific approval.

THIRD-PARTY LEASES

Numerically, in California as elsewhere, most marketed tax- exempt lease transactions are small transactions sold by the vendor either directly to investors or to investors through lease brokers who may act as the lessor (see Figures 1 and 2 in Chapter One). The involvement of the lease broker in the transaction gives rise to the terminology "third-party lease." The third-party lease broker is typically a company that specializes in locating investors for tax-exempt lease transactions, usually small private companies or special affiliates of larger companies. Historically, this group of companies has been the primary reason for the expansion of the tax-exempt lease market and for its present level of availability.

Starting in the early 1970s, third-party lease brokers began to develop a market place for tax-exempt lease transactions. Prior to that time many governments who did not wish to or could not use general obligation debt either had to pay commercial lease rates if they chose to lease their acquisitions or, for real property, were forced to use the formal revenue bond route.

The third-party lease brokerage industry developed in response to the vendor and lessee needs for more flexible and competitive sources of financing. The third-party lease brokers, working in some instances with underwriters, educated potential investors, rating agencies and credit enhancers as to the adequacy of the collateral for this form of financing. They further demonstrated to these other participants that an obligation subject to annual appropriation or abatement (and not legally considered debt) had a place in the financial market. The success of their efforts has resulted in the volume of tax-exempt lease transactions seen today.

Lease brokers also assist vendors who have no active funding capabilities. Many vendors either cannot or choose not to provide financing for products they sell to municipal lessees. These vendors may only temporarily act as lessor and after execution of documentation and acceptance of the asset by the lessee, will immediately assign the lease to an investor or to another third party for further sale to investors. Often, the vendor will arrange in advance for the third party to execute the documents as lessor and to fund the acquisition cost following delivery and acceptance by the lessee. This latter form of transaction, outlined in Figure 2 (Chapter One), is preferable from a marketing perspective because the lessor and the vendor are then separate and distinct, and the lease provisions concerning disclaimers of warranty will have more meaning and may be more enforceable.

PRICING PRIVATELY PLACED LEASES

Regardless of the scenario, these tax-exempt lease transactions usually provide a single fixed rate of interest to calculate the lessee's rental payments. Therefore, to make a financing profit, the vendor/lessor (if it sells the lease to an investor) or the third-party lessor must place the lease at a premium with the ultimate investor. In other words, the investor pays a premium for the transaction by providing funds in excess of the purchase price of the asset. These funds are retained by either the vendor/lessor or the third-party broker (or in some cases shared) as compensation for their services and payment of their expenses (such as the tax opinion or the opinion of lessor's counsel.) Invariably, the repayment of these excess funds (sometimes called a spread) must be protected in the event of the early termination (through prepayment) of a lease. Therefore, the schedule of concluding payments or purchase option prices provided in the lease usually will include a prepayment premium to amortize the excess amount paid or expected to be paid by investors. Often this premium is included without a specific reference to prepayment penalty noted anywhere in the lease. (See the example of transaction pricing below.)

Given the parameters of most lease transactions and contemporary market conditions, pricing of a small tax-exempt lease is an art, not a science. Accordingly, a concluding payment schedule may reflect the expected investor's yield rate which could differ from the actual rate at which a transaction is sold. This is frequently true when a transaction is bid significantly before the assets are accepted and placement of the lease with the investor(s) occurs. Where these circumstances are expected and, assuming the lessor cannot obtain a fixed funding commitment from an investor, the lessor will usually build a sufficient cushion into its interest rate and concluding payment schedule to cover the interest rate risk until funding and to protect the marketability of the lease. Alternatively, the lessor may propose a lease rate based on an index that will float until funding and then be fixed. In this event, the "cushion" to cover interest rate risk will probably be reduced or eliminated.

The pricing structure described above may also apply to bifurcated bids where a governmental lessee separately selects the vendor and the lessor. When this is done, direct investors/lessors or lease brokers will submit proposals to finance the lessee's chosen assets. Such circumstances are most common in transactions of substantial size, but less often where the governmental lessee has decided a private negotiated transaction is preferred over the more complex route of a competitive sale of certificates of participation.

A Sample Pricing

The pricing of a transaction is demonstrated by the following discussion. In March 1990, a large lessee requested proposals from prospective lessors or brokers for the tax-exempt lease of $2,700,000 for vehicles and computers. The bidders were to propose ten level payments due semi-annually on December 30 and June 30 of each fiscal year. The payments were to be in equal amounts even though the lease was to commence May 1, 1990. Therefore, the first payment would cover an eight-month period and the remaining nine payments would each cover a six-month period. (This is just one of numerous possible variations to be faced in pricing tax-exempt lease transactions.)

A lease broker who was to act as lessor negotiated with a single institutional investor to provide funds at an interest rate of 7.60 percent. The lease broker then added a fee of $13,500 (1/2 of 1 percent of asset cost) to provide a profit margin and pay for lessor's counsel fees (the only expense the broker agreed to cover.) The resulting bid consisted of the following principal, interest (at an effective interest rate to the lessee of 7.88112 percent) and a concluding payment schedule:

Payment	**Principal**	**Interest**	**Concluding Payment**
335,269.39	195,083.15	140,186.24	2,515,714.61
335,269.39	237,726.37	97,543.02	2,276,042.38
335,269.39	246,983.58	88,285.81	2,027,262.60
335,269.39	256,601.28	78,668.11	1,769,029.18
335,269.39	266,593.49	68,675.60	1,500,982.90
335,269.39	276,974.81	58,294.58	1,222,750.86
335,269.39	287,760.38	47,509.01	933,946.01
335,269.39	298,965.95	36,303.44	634,166.56
335,269.39	310,607.87	24,661.52	322,995.50
335,269.39	322,703.13	12,566.26	1.00

Note that the concluding payment, although declining, did not reflect a semi-annual reduction equal to the principal payment as might be expected. This is because the concluding payment schedule was, in fact, based upon a principal and interest schedule designed to return the $2,713,500 (the asset cost plus broker fee) actually invested by the institution.

The investment amortization schedule, as seen by the investor, is different from the schedule above that is seen by the lessee. Based upon an interest rate of 7.60 percent and principal of $2,713,500, the investor amortization schedule is:

Payment	Principal	Interest	Balance
			2,713,500.00
335,269.39	197,785.39	137,484.00	2,515,714.61
335,269.39	239,672.23	95,597.16	2,276,042.38
335,269.39	248,779.78	86,489.61	2,027,262.60
335,269.39	258,233.41	77,035.98	1,769,029.18
335,269.39	268,046.28	67,223.11	1,500,982.90
335,269.39	278,232.04	57,037.35	1,222,750.86
335,269.39	288,804.86	46,464.53	933,946.01
335,269.39	299,799.44	35,489.95	634,166.56
335,269.39	311,171.06	24,098.33	322,995.50
335,269.39	322,995.50	12,273.89	(0.00)

In this schedule, the balance column corresponds to and is the source for the concluding payment shown on the previous schedule.

Lease brokers often provide more services than stated in this example and frequently charge fees in excess of one percent. These additional services might include specific advice on the structuring and documentation of a lease, participation in asset purchase contracts with vendors, and/or advice on timing to benefit from positive market conditions. Because the time involved in completing a transaction is comparable regardless of the amount financed, in general, the smaller the dollar amount of a transaction, the larger the percentage of premium necessary to provide a reasonable minimum compensation to the lease broker.

Lessee Expenses

In addition to the broker's or lessor's fees and any transaction expenses incorporated into the lease payment structure, lessees often incur direct expenses which affect the overall cost of the transaction. Frequently, the impact of these expenses -- such as legal fees, printing, administrative costs, rating costs, trustee fees, etc. -- is ignored by governmental lessees. To determine the true cost of a transaction, a governmental lessee should calculate the interest rate at which the present value of all payments (both out-of-pocket expenses and lease payments) equals the cost of the asset financed.

By way of example, assume a city is acquiring, through lease purchase, $1,000,000 of computers and that a lessor has proposed a lease structure providing for 10 equal lease payments (semi-annual in arrears) of $123,291. At this rate of payment, the city's effective lease rate is 8 percent. Assuming the city is paying $25,500 for upfront expenses upon funding of the transaction in addition to making the ten semi-annual lease payments noted above, the city's true cost of money is 9.04 percent, the interest rate at which the present value of all city payments equals the cost of the asset acquired.

CERTIFICATES OF PARTICIPATION

Having discussed the marketing of smaller to medium-sized transactions, it is appropriate to address the marketing of large transactions suitable for sale of certificates of participation (see Figures 3 and 4 in Chapter One). COP transactions, sold in a fashion similar to traditional bonds, may be structured by either the lessor or the lessee. If structured by the lessor (who would be considered a lease broker even if a vendor), the pricing presented to the lessee will be identical to that described above. That is, the lessee generally will be quoted an all inclusive tax-exempt lease interest rate and may be unaware of the underlying expenses and profit. In a COP transaction, the lessor will generally incur greater expenses than in a privately placed transaction including costs for: preparing disclosure materials, more extensive legal work, a rating, the credit enhancement, if any, and/or hiring a trustee or escrow agent. Therefore, the spread or premium to be paid by investors could be larger than in the privately placed transaction described above. The lessee should again be cognizant of the difference between the principal payments specified in the payment schedule and the corresponding decline in the concluding payment due upon early termination. This difference will reflect the expenses included in the lease structure.

Frequently, with large COP transactions (particularly when competitively bid), the lessee will hire a financial advisor and special counsel (each familiar with such matters) who sometimes will be assisted by an underwriter. This team will assemble the parties to the transaction, draft documents and offering materials and help structure the tax-exempt lease and resulting COPs.

In this scenario, the principal amount of COPs offered for sale will usually include all of the costs necessary to structure the transaction (e.g., fees for the lease broker or underwriter, financial advisor, bond, underwriter's and lessor's counsel, ratings and credit enhancements, and trustee's expenses). These amounts as well as the amounts provided for asset acquisition and, if necessary, to fund a debt service reserve fund are enumerated in a Source and Uses of Funds Table included in the offering material which provides all parties with a clear picture of all cost elements of a transaction. It also combines all financial requirements (asset costs, reserves, and expenses) to arrive at the total amount of COPs sold.

To compare the true interest cost of a COP that includes all expenses with the privately placed lease outlined in the sample pricing above, a lessee should deduct the costs from the amount financed and compute an interest rate at which the present value of all rental payments will equal the purchase price of the assets financed. In general, for a lease with monthly payments in arrears, for each 1 percent of principal that represents costs, the interest rate will increase by .67 percent for a 3-year amortization, .42 percent for a 5-year amortization, and .345 percent for a 7-year amortization.

In contrast to a privately placed lease, in a lessee- structured COP transaction, the concluding payment schedule will likewise amortize the costs but they will usually decline in direct relationship to the remaining outstanding principal balance of the COPs, since all costs are capitalized in the initial principal. The interest rate on the COPs is, therefore, the interest rate for the financing since it includes all costs.

COP transactions are usually designed for public distribution and sale to many investors and, therefore, are described in an official statement similar to that used for the sale of municipal bonds. The pricing of such transactions can be negotiated between the lessee and the underwriter (or lease broker) or the pricing can be determined by soliciting sealed bids in a competitive sale from among numerous underwriters with award to the bidder providing the lowest interest rate. If the competitive sale format is chosen, the lessee, its financial advisor and special counsel will cooperate in drafting the documents for the transaction and in preparing the preliminary official statement and notice of competitive sale. The financial advisor may also assist in rating agency presentations; marketing the transaction among prospective bidders; analyzing the bids received; ensuring adequate disclosure documentation for the securities community; and closing the transaction.

MASTER LEASES AND LEASE POOLS

The majority of tax-exempt leases have involved the financing of one asset or one project or a group of similar assets (e.g., vehicles, computers) for one lessee. In contrast, certain financing structures group multiple assets of one or more lessee into single financings. These are commonly called master leases or lease pools and are typically structured and sold as publicly offered COPs. A master lease usually groups the different equipment needs of a single lessee to achieve the economy of scale of a large transaction. For example, various states structure annual master leases to acquire equipment needed by all state departments so that a single transaction may include vehicles, computers, furniture, telecommunication and office equipment, within a single lease document.

On the other hand, lessees may group their needs in a pool to achieve larger volumes and economies of scale, with each lessee executing a separate lease-purchase agreement. Pools are usually sponsored among lessees with similar interests. For example, the California School Boards Association and the Association of Bay Area Governments, among others, have sponsored several pools that have combined the needs of numerous districts into larger transactions.

The master lease is marketed in a manner similar to other COPs -- either negotiated with an underwriter or competitively sold. In contrast, lease pools are more commonly negotiated since they involve special coordination among the various lessees and, therefore, the timing of a transaction is less certain.

MARKETABILITY FACTORS

In all the lease structures discussed, the actual interest rate charged to the lessee, whether in a private or public sale, will be influenced principally by general financial marketplace considerations and secondly by factors unique to the particular tax-exempt lease. Some of the unique factors that affect the marketability of a lease are:

Legality

As discussed in Chapter Four, foremost in importance to investors is a satisfactory legal opinion stating, at a minimum, that the lessee has the authority to enter into the lease, has properly exercised that authority, and that the lease is a valid and binding obligation of the lessee, enforceable in accordance with its terms, even if payment is subject to non-appropriation or abatement.

Creditworthiness of the Lessee

As in all financial transactions, the financial strength of a lessee (or lack thereof) will have great influence on the interest rate at which a lease can be marketed, if it can be marketed at all. Similarly, better-known lessees, such as state governments, will be more familiar to investors, thereby permitting a broader investor market from which to seek investments. Lessees with unacceptable or unknown credit standing often turn to some form of credit enhancement to improve the marketability of their leases. (See Chapter Seven for a discussion of the effects and methods of credit enhancement.)

Essentiality

Due to the non-appropriation concerns, many investors will shy away from transactions that they perceive involve assets that may have minimal importance to the issuer. Chief among such assets would be those used in entertainment enterprises (e.g., ski lifts or golf courses) or those to be used for a special program with limited life or limited funding sources. Rating agencies and credit enhancers also consider the essential nature of the assets to be financed.

Asset's Recoverable Value

Some investors are selective in the amount of assets leased where, in the event of non-appropriation or default, recovery of substantial value may be difficult. Such assets may include (1) computer software unless constituting operating systems for hardware which is also being financed under the lease, (2) telephone installations involving substantial internal wiring which cannot be removed without damage to the facility in which it is located, or (3) centrex or long distance telephone service not under direct control of the lessee. Similarly, assets with limited residual value due to their custom design -- such as an energy conservation system designed for a particular building -- may not be easily financed.

Non-Appropriation and Abatement

Obviously, investors expect a return commensurate with their actual or perceived risks. Accordingly, leases subject to non-appropriation or abatement and not protected by credit enhancement and/or rental interruption insurance will bear higher interest rates than general obligation debt or enhanced leases of the same municipality. Interestingly, the financial market has come to accept the non-appropriation lease with no other credit support and assesses an interest rate premium as small as 1/4 of one percent for publicly offered COPs transactions. Abatement leases without rental interruption insurance are less widely accepted and will command higher interest rate premiums.

Lease Term

The term of a lease affects its marketability in two ways. First, and most important, the term of the lease must not exceed the useful life of the assets financed. Second, certain investors prefer specific financing periods. Presently, a large number of investors appear to prefer shorter-term transactions to avoid risks of future inflation. Therefore, there may be fewer investors for longer-term transactions and accordingly interest rates are affected.

Assignment

The opportunity to assign a lease contributes significantly to its marketability. Subject to tax law considerations, assignment without lessee consent (although lessee acknowledgement may be required) at any time and for any reason gives the lessor total flexibility in the event of a change in its economic ability or willingness to carry tax-exempt lease investments, or in the event a change in tax law might disallow the favorable tax treatment of these transactions. Flexibility to assign the lease enhances its possible marketing; therefore, such a provision should lead to more favorable interest rates for the lessee. As already discussed, the lessee should consider the assignment provision in light of the economic benefit to a lessor's ability to assign coupled with the lessee's need to control "securities" bearing its name.

CONCLUSION

In summary, tax-exempt leases are marketed to investors on the basis of the demands and circumstances of each transaction. Primary among these are transaction size, asset essentiality, the extent to which a lessee permits distribution of the transaction, the creditworthiness of the lessee, and lease documentation.

CHAPTER SEVEN

Credit Analysis and Credit Enhancements

CHAPTER SEVEN

CREDIT RATINGS AND CREDIT ANALYSIS

Credit ratings and credit analysis can be viewed from two different perspectives when discussing tax-exempt leasing. First, the credit rating agencies -- the primary ones being Standard & Poor's Corporation ("S&P"), Moody's Investors Service ("Moody's") and Fitch Investors Service ("Fitch") -- consider leases as obligations, akin to debt, even if treated as current obligations for state debt limitations. Second, the rating agencies, having become more familiar with tax-exempt leases, now rate the leases for both public and private placements. Therefore, some informal guidelines exist on structuring a lease for rating purposes and, as a result of the rating, selling it to investors advantageously.

Because rating agencies expect lessees to maintain financial reports and accounting records in accordance with GAAP (discussed in Chapter Five, "Accounting for Leases"), the leases should be considered as debt, even if they contain non-appropriation or abatement provisions. Therefore, the rating agencies factor lease payment obligations into the debt ratios they use for determining a government's general obligation credit rating. More precisely, when calculating total debt outstanding, debt per capita divided by per capita personal income, debt as a percent of assessed valuation, outstanding debt relative to debt ceilings and debt service as a percent of general fund expenditures, the credit analysts include all outstanding tax-exempt lease payment obligations of the lessee for which they have or can obtain data, in addition to the lessee's general obligation debt.

RATINGS FOR LEASES

Numerically, most leases are for small dollar amounts and are not rated. However, the highest dollar volume of leases originates with large certificate of participation transactions that are rated. Standard & Poor's estimates that the total of state and local government tax-exempt leases approached $8 billion in 1989. Of that total, $3.4 billion were rated by S&P and sold publicly without any credit enhancements. Most of the balance of $4.6 billion was for credit-enhanced leases. The 1989 volume of $3.4 billion S&P-rated leases compares to $3.6 billion in 1988 and $2.7 billion in 1987.[1]

According to S&P, California continued to dominate the market for rated, unenhanced tax-exempt lease obligations in 1989 and accounted for over one-third of the dollar volume ($1.214 billion of the total of $3.4 billion) and over one-half (52%) of issues rated. Other states with high dollar volumes include Ohio and New York.[2]

Moody's, which may rate some of the same leases as S&P but also rates some not rated by S&P, reports that in 1989 it rated almost 250 leases for a total dollar volume in excess of $8 billion (this includes lease revenue bonds, which are not incorporated in the S&P figures). Of the total of 1,505 outstanding rated leases, Moody's attributes 486, or nearly one-third, to California governments.[3]

In the last several years, the scope of projects being financed through tax-exempt leases has broadened to include prisons, office buildings, transportation facilities and mental health facilities. While the majority of leases (by dollar volume) has been for real property projects, S&P notes that over one-third are secured, in whole or in part, by equipment.

Since tax-exempt leases are not general obligations of the lessee and are subject to non-appropriation or abatement, an unenhanced lease will usually be rated lower than the lessee's general obligation rating. S&P and Moody's currently indicate that a rating for a non-appropriation lease will tend to be a full grade lower than the government's general obligation rating, assuming their criteria have been met. Fitch, on the other hand, considers the essentiality of the project and may not rate it a full step lower. The ratings on abatement leases, if they provide rental interruption insurance, are generally less than one full category below the general obligation debt rating, because of the decreased risk attributed to these transactions.

Because of the high volume of lease transactions in California, the rating agencies are familiar and comfortable with many of the features and risks -- such as abatement or non-appropriations -- common to leases in the state. In evaluating California (abatement) leases, the analysts look for investor protections in the form of rental interruption insurance, casualty and title insurance, adequate capitalized interest, performance bonds and builder's risk insurance during construction. These are in addition to reserve funds which may cushion the initial impact of any defaults.

Credit Criteria

The lease credit analysis will focus on the likelihood of non-appropriation or abatement and will evaluate the essentiality and need of the asset and the lease term (to ensure it does not exceed the asset's useful life). In addition, the history of leasing in the jurisdiction and the equity participation by the lessee in the lease (indicated by a downpayment or other type of investment) are factored into the analysis.

In jurisdictions where, because of constitutional or statutory limitations, leases may be the only financing option, they may receive more favorable ratings (e.g., Kansas, Kentucky, Indiana, Colorado, Idaho and South Dakota).[4] For leases where the commencement of rentals depends upon successful completion or acceptance of the property, the rating is "provisional." For a master lease, S&P sometimes requires that acceptance and the effective date of lease payments be tied to receipt of the major lease component.

Payment processes are an important consideration when leases are evaluated. Particularly for statewide master lease programs where numerous operating departments may be involved, a centralized appropriations process helps assure the timely payment of obligations. This averts problems with inconsistent bookkeeping among the local districts and the potential for missed or late payments that may cause the downgrading of the lessee.[5]

In general, the rating agencies prefer reserve funds, which should equal the maximum annual debt service. If the arbitrage limitations imposed by the 1986 Tax Act, discussed in Chapter Three in "Federal Law Considerations - Taxes", conflict with this requirement, the lessee may be required to fund the balance from its own reserves or through a surety bond. For large certificate of participation transactions, the rating agencies usually have allowed the reserve requirement to be limited to the maximum amount permitted under the Internal Revenue Code. The reserve requirement applies equally to both non-appropriation and abatement leases.

When reviewing a lease, other factors which may be considered by the rating agencies are:

- the lease term and the term of the issue are the same which avoids exposure on renegotiation; if state law requires annual renewal, it should be automatic;

- the issue should fully fund the project being financed and avoid the unknowns of future access to the markets to finance a project under construction;

- in an abatement lease or a lease secured by project revenues, interest should be capitalized beyond the acceptance date so that delivery/construction delays can be covered;

- the lessee must unconditionally agree to make rental or purchase-option payments as stipulated -- a typical hell-or-high water clause will suffice but the lease should clearly state that "notwithstanding any other provisions to the contrary, lease rental payments are triple net and not subject to counterclaim or offset";

- the lease should be triple-net and insurance coverage should at least equal the concluding payment;

- the lessee agrees to request appropriations for lease payments in its annual budget;

- in the event of a non-appropriation, the lessee agrees to make the specified purchase option payment or to return the asset to the lessor at its own expense;
- in abatement leases, the lessee maintains rental interruption insurance, and special hazards insurance coverage may be required for risks such as earthquakes;
- a security interest in the leased asset should be provided with the right of the lessor or its assignee to take possession of the leased asset should the lessee default or non-appropriate;
- potential taxability exposure to the investors should be addressed; and
- there should be non-substitution language.

CREDIT ENHANCEMENTS FOR TAX-EXEMPT LEASES

The credit quality of lease transactions and the subsequent interest rate to a lessee are in direct correlation to one another. An investor evaluating a lessee with a high credit quality will generally accept a lower interest rate than it would for a lessee with a lower rating.

The determination of credit quality comes from several different sources. As already discussed, the credit rating agencies provide the primary evaluation upon which many investors base their investment decisions. In addition to these agencies, some underwriters and institutional investors usually conduct their own credit analyses to determine if they will purchase a transaction and at what price.

In addition to these groups, when a credit enhancement is sought, the enhancers will conduct their own credit and risk analysis to determine their interest in and the cost of any credit enhancement. While the basic analysis of the enhancers is similar to that of the rating agencies, the purpose is different. The credit rating agencies provide ratings to help investors evaluate investment risk. The enhancers, on the other hand, take a financial risk in the transaction either by guaranteeing it against non-appropriation or abatement or by providing liquidity in the case of variable rate transactions with "put" options which allow the investor to sell back its certificates to the lessee. The letter of credit assures investors that money will be available to honor the put.

Credit enhancement is used to improve the creditworthiness (and marketability) of the lease, its marketability and concomitantly to obtain a lower interest rate for the lessee. Because the enhancer is the ultimate obligor in the event of default by the issuer, the rating agencies will provide a high credit rating based partly on the credit enhancer -- typically AAA -- to the lease transaction. The cost of enhancement depends on the type used and may be paid as a one-time premium, normally assessed for lease insurance or a system of annual fees, common to letters of credit. Since the cost may be significant, enhancement generally will be sought only if its cost is more than offset by interest rate savings.

Credit enhancements are usually arranged by the lease broker or underwriter, but are typically paid for by the lessee or lessor, depending on the structure. In a COP transaction, all costs including that for the enhancement will be reflected in the financing. If the enhancement is provided by a letter of credit, the lessee will generally pay the administrative fee and the first annual premium at the time of closing from transaction proceeds. Future letter of credit premiums must be paid directly by the lessee to the financial institution. If the enhancement is provided by an insurance policy, the lessee generally will pay a one-time premium, equal to a percentage of the total projected principal and interest due during the full term of the lease. The premium typically is paid from transaction proceeds before payments are made to the vendors or trustee. In this case, on- going lessee involvement is minimal; this contrasts to a letter of credit scenario which requires continuing lessee involvement through annual payments.

The decision to obtain a credit enhancement is usually made when the lease broker or underwriter is structuring the transaction and evaluating its marketing and marketability. Arrangements for the enhancement may be made well in advance of the sale or placement of the lease. However, in some instances, the enhancement is not sought until shortly before the closing. This latter circumstance could arise if the broker or investor initially evaluates the lease's marketability inaccurately and later requires the enhancement to attract investors. However, the timing of the decision of when to enhance must be coordinated with disclosure requirements of the SEC's Rule 15c2-12.

An enhancement is purchased when the interest savings offset its cost. Since an enhanced lease will usually have an interest rate comparable to an AA-rated general obligation bond, the enhancement cost must be calculated against the lease pricing without enhancement. In general, a lease without enhancement will be priced at least one notch below that of the lessee's general obligation bonds (i.e., if a lessee's GO rating is AA, its lease would be priced at A rates). To defray the cost of enhancement, the credit quality of the lease must be increased to justify the purchase. Therefore, credit enhancement is usually purchased only by lessees with credit ratings of A or below.

Prior to committing to provide enhancement, the enhancing party will conduct a credit analysis similar to that of the credit rating agencies. Enhancers evaluate the transaction by analyzing:

- the overall creditworthiness of the lessee, the asset itself (most enhancers prefer to protect real property leases or real property leases with some and equipment included, although occasionally a lease solely for equipment will be enhanced),

- the essentiality of the asset, the construction risk (particularly in an abatement lease where a lessee can abate lease payments if it does not have access to and use of an uncompleted project),

- the lease term (not to exceed the useful life of the asset),

- the property and casualty insurance for the asset, and

- in abatement leases, rental interruption insurance.

Additionally, most enhancers will require that a debt service reserve fund be established to act as a buffer before the enhancement is accessed. For construction projects, the enhancers may require a performance or construction bond to ensure satisfactory completion of construction.

For these reasons, a credit enhancement may require on-going costs in addition to the premium. These include the expense of a reserve fund, if required, and legal and trustee fees, and in certain instances, counsel for the enhancer. Since credit enhanced transactions almost always are rated, any costs for the rating must also be factored into the structure.

Enhancement premiums are usually priced as a percent of the total principal and interest obligations guaranteed. The principal would include asset cost, expenses, reserve fund, etc. In a COP transaction, the amount guaranteed is the principal amount of the certificates issued since the costs are included in the principal. While it is difficult to generalize, lease guarantees or insurance generally cost 35 to 60 basis points (.35% to .60%) of the total anticipated debt service. Letters of credit, on the other hand, have both a one time fee and an annual fee that usually is less than 50 basis points (.50%) of the annual outstanding principal.

Credit Enhancement Providers

The majority of credit enhancements are provided by two types of organizations -- insurance companies and commercial banks. Where insurance companies are involved, the enhancement will be in the form of an insurance policy or surety bond protecting investors against non-payment of lease rents, including non-payment caused by non-appropriation or abatement. On the other hand, if a bank is involved, the enhancement is in the form of a letter of credit (LOC) that guarantees against all nonpayment risks. A bank letter of credit may also enhance liquidity to a lease with put options normally associated with variable interest rates. Since leases with these features may require lessees to maintain contingent funding for unanticipated payments, a liquidity letter of credit assures investors that the lessee's obligations will be met.

The list of specific providers of credit enhancements varies with changes in the financial and insurance industries. For instance, when non-appropriation insurance first became widely available in the early 1980s, several individual insurance companies tended to be interested only in short-term (five to seven years) equipment leases. However, due to their strict underwriting criteria, these early lease insurers were "irregular" providers of enhancements.

Over time, more insurers became willing to enhance leases and for longer terms of up to 20 to 30 years for real estate. As the credit enhancement insurance industry evolved, participants have tended to be specialized companies owned by financial institutions and other property and casualty insurers (i.e., MBIA, FGIC, AMBAC, Capital Guaranty, etc.)

As with insurers, the commercial banks active in this area have also changed. Through the mid-1980s, domestic banks provided letters of credit for tax-exempt leases and bonds, but Japanese and other foreign financial institutions now predominate. Due to differing regulatory and capital criteria, foreign banks have been able to price their letters of credit below domestic banks, and the willingness of the foreign banks to provide enhancements at reasonable rates has allowed for the continuation of these structures.

Credit Enhancement Renewals

As already discussed, a letter of credit is paid for by the lessee with annual premiums in addition to an upfront administrative fee. The letter of credit usually is issued for a period less than the full lease term but for a maximum five- to seven-year period. If renewal is requested, the bank will conduct a new analysis of the transaction before renewing the LOC.

The renewal process can be complicated and may require interim negotiations prior to the expiration of the LOC. Most LOCs are written with an "evergreen" provision that gives a lessee an indication as to whether the LOC will be renewed. For example, if a bank provides a seven-year LOC, after the first two years, the lessee can renegotiate for another two years. If the renegotiation is unsuccessful, the lessee has five years to locate another bank. If no other bank is found, the original LOC bank will buy the lease from the original investor(s) but will charge the lessee a high interest rate premium.

Renewal can also become complicated, for example, where the lease structure permits the lessee to change from variable rate interest to fixed rate at the renewal date. Since some financial institutions will not accept the risk of "guaranteeing" fixed rate obligations, the lessee may find itself in need of a new LOC bank if it opts to fix the lease rate.

ENDNOTES

1. See Credit Review: Municipal Leases (New York, NY: Standard & Poor's, March 1989).

2. Id.

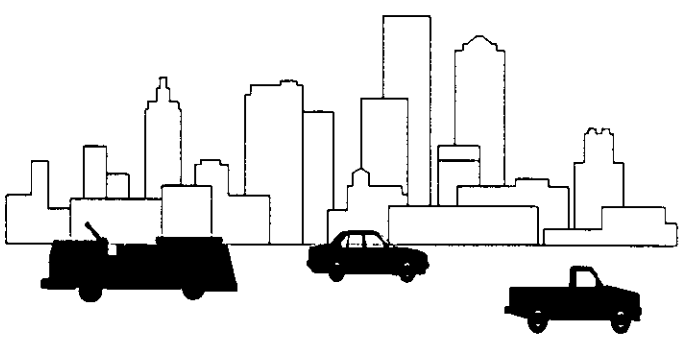
3. See Moody's Municipal Issues, #1 (March 1989).

4. "State Financing Through Lease Rental Bonds and Certificates of Participation," p. 6, Moody's Municipal Issues, (March 1989).

5. See e.g., "Payment snafu linked to Mass. downgrading," City and State (July 31, 1989), at 11.

PART TWO

CASE STUDIES



LEASING IN CALIFORNIA

CASE STUDIES

Leasing is one of the primary financing instruments selected by state and local officials in California. As already discussed, California lease transactions make up almost 50 percent of the volume of tax-exempt leases rated in recent years by Standard & Poor's and Moody's. However, the number of non- rated leases, usually those that are privately placed with single investors, is also large but unknown. These latter transactions finance all types of assets from equipment to real property and tend to be for less than $5 million. They also may be financed either competitively or on a negotiated basis, and may be short (five years or less) or long-term arrangements. The potential number of lessees is vast and each vendor or contractor is a potential financing source. Add to this the large number of lease brokers and the number of third-party financing sources (such as commercial banks) and the real number of potential participants in tax-exempt leases is significant.

To illustrate this diversity, this part presents ten case studies of leases in the state. The names have been deleted and in most cases, the leases were structured and financed within the last several years. The cases range from relatively straight- forward private placements of real and personal property leases to certificate of participation transactions for real property. Some of the transactions contained abatement provisions while others relied on non-appropriation language to avoid characterization as debt.

Other variables among the case studies include the types of lessees, lessors and investors, rated and unrated, and enhanced or unenhanced. As the following commentary highlights, at least one could not be structured under current federal tax laws. It was selected for several reasons: to show how broadly leases have been used over the last ten years in California and, because of the bankruptcy of the main participant to the transaction, to illustrate the issues which may arise after the lessee has defaulted on the certificates.

The selections include:

- No. 1: A Third-Party Financed Lease
- No. 2: A Privately Placed Third-Party Financed Lease with Assignment by Lease Broker
- No. 3: A Third-Party Lease that is Advance Funded
- No. 4: A Third-Party Financed Lease Line of Credit
- No. 5: Certificates of Participation through a Lease Pool Program

No. 6: Certificates of Participation for Real Property (Enhanced)
No. 7: Certificates of Participation with Sublease- Purchase Agreement to Facility Operator
No. 8: An Agreement to Finance Ten Years of Telecommunications Service
No. 9: A Tax-Exempt Lease Financing Acquired with Equipment Procurement with Provision for Public Distribution of Certificates of Participation
No. 10: A Lease Financed by a Captive Credit Corporation

The case studies are presented in two ways. First, two-to- four page outlines are provided. These include three sections:

o GENERAL INFORMATION, which reviews the type of transaction, the participants, and the marketing approach;

o TRANSACTION STRUCTURE, which reviews specific information as to the asset, the financing term, payment frequency and amount, enhancement, and rating; and

o DOCUMENTATION, which identifies the name of the primary lease agreement and its basic terms and conditions; this section also identifies other documents, attachments and exhibits.

The second method of presentation for each case study includes a more detailed summary of the transaction. Each of these reflects information specific to the transaction it reviews.

The case studies were prepared after reviewing the documents of each transaction. In some cases, not all of the documents were available for analysis and inquiries were made to individuals involved in the transaction for additional information. Since the purpose of the case studies is to understand how leases are structured and financed (and not to divulge how specific lessees structured their financings), all names have been deleted and internal lessee issues (such as the lease vs. purchase decision) are not highlighted, to avoid disclosure of confidential information. Rather, the parties are identified by the type of organization they represent. In fact, in soliciting case study transactions, the consultants promised anonymity and, as a result, many documents submitted contained no names. Therefore, the same level of information is not available for each example. In only Case Study No. 9 were the bids of all vendors reviewed.

One trait among all of the case studies is apparent: that despite the variety of documents, terms, and conditions, the transactions all accomplish the same purpose -- obtaining, through lease financing, capital assets. For instance, of the ten case studies, the primary lease contract has several different names including Lease with Option to Purchase, Lease Purchase Agreement, Facilities Lease, etc. Some of the transactions have Trust Agreements, one has a Custodial Agreement, another an Escrow Agreement -- all serve the same basic function to provide an independent party to receive, hold and disburse funds. Those that involve buildings may have either Site Leases or Ground Leases -- again to facilitate the financings. One conclusion that could be drawn from these variances is that custom and/or advisors and local counsel, as well as specific legal requirements, dictate many of the terms and conditions and terminology.

OUTLINES AND SUMMARIES OF CASE STUDY TRANSACTIONS

CASE STUDY NO. 1

GENERAL INFORMATION

Type of Transaction:
Third-Party Financed Lease

Type of Lessee:
School district

Type of Lessor:
Commercial bank also serving as investor

Underwriter:
None

Investor:
Commercial bank

Escrow Agent:
Trust department of another commercial bank

Legal Opinions:
Lessee's counsel

Marketing:
Held by initial Lessor

TRANSACTION STRUCTURE:

Asset:
Relocatable classrooms

Asset Cost (in millions):
$.848

Lease Term and Payment Frequency:
Seven years annually in arrears

Effective Interest Rate/Payment:
Not revealed

Prepayment Option:
On any rental payment due date

Prepayment Premium added to Purchase Option Schedule:
2% of outstanding balance

Enhancement:
None

Ratings:
None

DOCUMENTATION

Lease Agreement
Equipment Lease/Purchase Agreement

Terms and Conditions

Non-appropriation:
Yes

Non-substitution:
Yes, through next fiscal year

Abatement:
No

Rental Interruption Insurance:
Not required

Title/Security Interest:
Title with Lessee
Security interest to Lessor in the asset, all replacements, substitutions, accessions and proceeds.

Insurance:
Casualty, property and liability required for greater of full replacement value or purchase option price; acknowledged by Insurance Authorization Letter

Tax Compliance:
To maintain tax-exempt nature including No-Arbitrage Certificate, riders as to (1) agreement to rebate arbitrage earnings if required; (2) make Lessor whole if transaction later deemed taxable; (3) bank qualification and to make Lessor whole if transaction later deemed not qualified

Net Lease:
Yes

Assignment:
The transaction is assignable but has not been assigned

Default:
Events

1) Failure to pay rental payments when due
2) Failure to perform other terms and conditions
3) False representations, certifications, statements in lease document
4) Lessee bankruptcy
5) Attachment, levy or execution threatened or levied upon asset

Remedies
1) Repossess the asset
2) Require Lessee to return the asset at Lessee expense

Other Documents/Attachments/Exhibits

Escrow Agreement:
Between and among Lessee, Lessor and escrow agent

SUMMARY: CASE STUDY NO. 1 -- THIRD-PARTY FINANCED LEASE

In this straight-forward third-party financed lease, a school district solicited lease financing competitively for relocatable classrooms at a cost of approximately $850,000. The successful bidder was an East Coast commercial bank for a seven- year lease with payments annually in arrears. Since the school district issued less than $5 million of tax-exempt obligations in the year of the transaction, the lease was bank qualified. The bidder serves as Lessor to the transaction and is holding the lease for its own portfolio, with a right of assignment.

Because the school district did not have possession of the assets at the time the lease closed, an Escrow Account was established to hold the funds pending disbursement to the vendor. The Escrow Agent was another commercial bank located in the same jurisdiction as the Lessor. (Although not a concern in California, escrow funds in some other states must be held in a financial institution in the same state as the lessee.) However, if in California, the escrow agent should be licensed to conduct business to ensure enforcement of the lease. (See Chapter Three -- "Business Qualification.")

The funds for this lease flowed from the Lessor to the Escrow Account and were disbursed to the vendor upon acceptance by the Lessee of the assets under lease. Annual payments in arrears are being made by the Lessee to the Lessor. The lease commenced upon funding and payments are due on the funding anniversary date.

Specific terms and conditions of the lease include non-appropriations language supported by a non-substitution provision that carries through the next fiscal year. The lease does not contain abatement language and, therefore, rental interruption insurance is not required. The Lessee has the right to prepay on any payment date, with a prepayment premium of 2 percent.

Through a No-Arbitrage Certificate, the Lessee sets forth its agreement to comply with the arbitrage restrictions of the Internal Revenue Code. Through riders to the Lease, the Lessee indemnifies the Lessor should the transaction later be determined as taxable.

Because it appears the Lessor intends to hold this lease for its full term, it chose to rely on the Opinion of Lessee's Counsel and did not seek an opinion of outside bond counsel.

Commentary. Among the interesting aspects of this transaction are that it is a bank-qualified lease and was financed by an East Cost commercial bank (and not a California bank or institutional investor), notwithstanding that the financing bank will not benefit from the state income tax exemption. The Lessor obtained a security interest in the relocatable classrooms; however, without easements, site leases or licenses to use the sites upon which the classrooms are located, the only available remedy in event of Lessee default is repossession and removal of the asset. Were these features built into the lease, the Lessor would have had the option of using the classrooms at their initial location. However, since many lessors treat relocatable classrooms as personal property, a lease for these types of assets frequently excludes site leases or easements.

Since it is unlikely that the Lessor will later assign this lease (because it is bank qualified) and since there were few transaction expenses (such as ratings, underwriting discount, etc.), the 2 percent premium may be a penalty rather than a reimbursement of transaction expenses.

CASE STUDY NO. 2

GENERAL INFORMATION

Type of Transaction:
Privately Placed Third-Party Financed Lease with Assignment by Lease Broker

Type of Lessee:
School district

Type of Lessor:
Lease broker

Underwriter:
None

Investor:
Commercial bank

Legal Opinions:
Lessee's counsel

Marketing:
Privately placed to single investor

TRANSACTION STRUCTURE:

Asset:
4 school buildings

Asset Cost (in millions):
$1.460

Lease Term and Payment Frequency:
Six years annually in arrears

Effective Interest Rate/Payment:
7.73%/$313,239

Prepayment:
Yes

Prepayment Premium added to Purchase Option Schedule:
$75,577 (5.18% of original purchase price)

Enhancement:
None

Ratings:

None

DOCUMENTATION

Agreement

Lease with Option to Purchase

Terms and Conditions

Non-appropriation:
Yes

Non-substitution:
None

Abatement:
Yes, equal to rent on that portion of asset which is unavailable

Rental Interruption Insurance:
Yes, with one-year protection

Title/Security Interest:
Title with Lessor
Security interest retained by the Lessor in lease proceeds, and in the buildings constructed plus any attachments, additions, accessions and substitutions in or to the buildings.

Insurance:
Provided by Lessee and supported by Insurance Authorization Letter

Tax Compliance:
Lessee agrees to comply with laws to preserve tax-exempt status including signing letters as to arbitrage rebate exemption and bank qualification.

Net Lease:
Yes

Assignment:
Yes, Lessee must be notified

Default:
Events
1) Failure to pay within 15 days of due date and after 10 days notice
2) Failure to perform other terms and conditions

Remedies
1) Available at law
2) Lessor can re-lease the asset

Other Documents/Attachments/Exhibits

Agency Agreement:
Lessor appoints Lessee to act on its behalf to complete construction including entering into construction, design, and engineering contracts, supervision of construction/installation, etc.

Site Lease:
Lessee leases construction sites to Lessor who subleases the sites back to the Lessee; the site lease is for 19 years at a rental of one dollar per year

Custodial/Trust Agreement:
Between Lessee and Trustee/custodial bank

Investment Agency Agreement:
Between Lessee and Lessor authorizing Lessor to deposit lease proceeds in custodial bank and to authorize investments and disbursements to vendors and contractors subject to Lessee authorization

SUMMARY: CASE STUDY NO. 2 -- A PRIVATELY PLACED THIRD-PARTY FINANCED LEASE WITH ASSIGNMENT BY LEASE BROKER

In this transaction with another school district as Lessee, four school buildings were lease financed at a total cost of $1.46 million. Financing in this instance was arranged by a lease broker who immediately assigned the lease to a commercial bank as investor. Rental payments are over a six-year period and are due annually in arrears.

Because this transaction involved construction, the lease was supplemented by several other documents, including an Agency Agreement, to enable the Lessee to enter into construction, design, and other appropriate contracts. Site leases for the land already owned by the school district were part of the documentation, with the school district as Lessor and the lease broker/Lessor as Lessee. The sites were immediately re-leased back to the school district together with the newly constructed facilities.

Because of the construction-nature of the project, a Custodial Agreement (similar to an Escrow Agreement) was negotiated for the investment and disbursement of funds. In addition, through an Investment Agency Agreement, the Lessor is authorized to deposit funds with the custodial bank and to facilitate investment of the lease proceeds. In the Arbitrage Certificate, the Lessee acknowledges its intent to comply with federal tax code provisions concerning arbitrage. The Lessee also acknowledges in a document entitled "Designation of Qualification" that the transaction is bank qualified.

The Lease contains a non-appropriation provision as well as abatement language. The Lessee is required to have rental interruption insurance, in an amount sufficient to cover one year's rent, to offset the risk of abatement.

The flow of funds for this transaction is depicted in Figure No. 2, except that in this transaction, a custodial bank as Trustee receives the initial lease proceeds for disbursement to the vendor (contractor). The school district as Lessee makes its payments directly to the Investor as specified in the Acknowledgement of Assignment that the Lessee executed. If the school district exercises its right to prepay on any payment date, it will be required to pay a concluding payment that includes a premium of 5.18 percent.

The only opinions relied on by the Lessor and the Investor were those of Lessee's Counsel.

Commentary. This transaction involved a California lease broker assigning the lease to a California commercial bank in a bank qualified transaction and differs from the first case in several ways.

Although both transactions involve advance funding, this case utilized a custodial agreement, with the custodian bank acting as a trustee instead of merely an escrow agent. Although escrow arrangements and formal trusts both provide an independent custodian of funds during the construction period, a trust arrangement is more formal and has more extensive documentation and requirements of the trustee. It also provides more safeguards for the investor. Typically, trust arrangements are used where the investor desires that an independent third party monitor disbursement of funds and be required to take certain steps in the event of default. This contrasts to an agency where the escrow agent is not required to take independent steps upon default.

In this transaction, the Lessor required that the Lessee provide a site lease of the underlying real property for annual rent of one dollar, permitting the Lessor use of the site in the event of Lessee default.

The other documents in the transaction -- the Agency Agreement which authorizes the Lessee to oversee construction for the Lessor and the Investment Agency Agreement concerning the investment of advance lease funds -- frequently are incorporated in the lease or trust agreements in other transactions.

Although the Lessor has the right to assign the lease to an investor, the Lessee must be notified of such assignment. This is frequently required by lessees to ensure that they are advised of the investor retaining the lease as well as to ensure compliance with federal tax requirements.

This transaction was structured as an abatement lease in contrast to the first case which was a non-appropriations lease. As a result, the Lessee is required to maintain rental interruption insurance with one-year protection. However, the Lessor also incorporated non-appropriations language in the lease. While this is not necessary, it may have been added due to requirements of the Lessee's counsel who provided the only opinion.

With respect to tax compliance, the lessee agreed only to comply with applicable law to preserve the tax-exempt status of the transaction, including arbitrage and bank qualification requirements. This contrasts with the first case which contained the more affirmative undertaking of the Lessee to make the Lessor whole if the transaction was later deemed to be taxable.

CASE STUDY NO. 3

GENERAL INFORMATION

Type of Transaction:
Third-Party Lease that is Advance Funded

Type of Lessee:
County

Type of Lessor:
Finance company acting as direct investor

Underwriter:
None

Lease Broker:
None

Trustee/Escrow Agent:
Undisclosed

Legal Opinions:
Lessee's counsel

Marketing:
None

TRANSACTION STRUCTURE:

Asset:
Honeywell Computer System

Asset Cost (in millions):
$.600

Lease Term and Payment Frequency:
Three years, semi-annual in arrears

Effective Interest Rate/Payment:
7.45%/$113,573

Prepayment:
Available on each payment date at purchase option price.

Prepayment Premium Added to Purchase Option Schedule:
$10,594 (1.7636% of original purchase price)

Enhancement:
None

Ratings:

None

DOCUMENTS

Lease Agreement

Lease with Option to Purchase

Terms and Conditions

Non-appropriation:
Requires failure to appropriate to be evidenced by passage of Lessee resolution prohibiting Lessee performance under the Lease

Non-substitution:
For a period of one year; except if this provision affects the validity of the Lease or if the Lessor has recovered its investment from the sale of the asset.

Abatement:
None

Rental Interruption Insurance:
Not required

Title/Security Interest:
Title retained by Lessor; UCC statements required to be filed

Insurance:
Lessee assumes full risk if asset is lost, stolen, damaged, or destroyed. Lessee required to replace, repair,or prepay purchase option price. All-risk and liability insurance required but self-insurance permitted.

Indemnification:
Full indemnification of Lessor by Lessee

Tax Compliance:
Covered by a specific Lessee representation to take no action that would cause interest payments to become taxable and to take all affirmative actions within its legal authority to ensure interest will remain tax exempt.

Net Lease:
Yes

Assignment:
Lessor's right and title assignable to one or more investors without Lessee's consent.

Default:
Events
1) Failure to pay Lease Payment and continuation of failure for three (3) days after notice
2) Failure to observe or perform any other covenant, etc. and continuation for 30 days after notice
3) Bankruptcy

Remedies
1) Terminate Lease and declare all payments due during current year due and payable
2) Repossess equipment and sell in a commercially reasonable manner and apply such proceeds to:
   a) Costs of recovering assets
   b) Costs of sale
   c) The applicable purchase option price
   d) Balance of rentals due for current fiscal year
   e) Excess retained by Lessor

Note: Sales proceeds go to future rentals (e.g., purchase option price) before being applied to current year rentals. Presumably, a better legal case can be made to collect current year rentals first. In the event of non- appropriation for future years, presumably no current year rentals would be outstanding. In any event, Lessee is required to return equipment at its own expense.

SUMMARY: CASE STUDY NO. 3 -- A THIRD-PARTY LEASE THAT IS ADVANCE FUNDED

Computer equipment -- an asset that is commonly lease- financed -- is the subject of the third case study. In this instance, the Lessee is a county and the Lessor/Investor is a finance company that bid directly on the financing and is holding the lease for its own portfolio. The Lessor/Investor coincidentally is a captive credit corporation, but since the asset financed is not produced by the parent corporation, it has been classified as a finance company. Although the finance company bid on the lease with the intent to hold it for its full term, the Lessor has retained the right to assign it.

The equipment cost was $600,000 and was financed over three years with semi-annual payments in arrears. Prepayment on any payment date is allowed with a premium of 1.7636 percent.

The transaction was structured with non-appropriations and non-substitution provisions, with a non-substitution period of one year. Title remains with the Lessor until the lease has been paid -- either at term or by prepayment -- but the lease is structured as a net lease with the Lessee responsible for insurance and maintenance.

Among other terms and conditions is a specific Lessee representation that it will take no action that would cause the payments to become taxable and that it will take all necessary action within its legal authority to ensure that the interest will remain tax exempt. As with the transactions previously reviewed, the Lessor has relied on Lessee's Counsel to determine the Lease's validity and did not seek a separate opinion as to its tax-exempt nature.

Commentary. This case involved the direct placement of the lease with the Lessor, without a lease broker, and with the Lessor retaining the lease in its own portfolio for the entire term. The prepayment premium is only 1.7 percent and, given the absence of a lease broker, escrow agent and outside counsel, it may represent the Lessor's internal cost of sales and marketing (commissions, etc.) and general overhead, as opposed to external costs.

Although the lease was advance funded, no escrow agent or trustee was specified to hold and invest the proceeds until disbursed to the vendor. This may be due to the brevity of the construction period and the desire to avoid additional costs.

The lease term is for three years and is amortized on a semi-annual basis with payments due in arrears as opposed to an annual basis which is preferred by many school district lessees.

This lease also contained more extensive remedies provisions permitting repossession of the equipment and sale to third parties, with sale proceeds credited first to future rentals before being applied to the current year rental.

The tax-exempt representations are similar to those in the second case and do not specifically extend to making the Lessor whole if the transaction is deemed taxable because of a failure by the Lessee to act to ensure the continued tax-exempt status of the transaction.

CASE STUDY NO. 4

GENERAL INFORMATION

Type of Transaction:
Third-Party Financed Lease Line of Credit

Type of Lessee:
City

Type of Lessor:
Finance company, acting as direct investor

Underwriter/Lease Broker:
None

Legal Opinions:
Independent counsel acting as Lessee's counsel

Marketing:
None

TRANSACTION STRUCTURE:

Asset:
Various vehicles (initial acquisition was a fire pumper)

Asset Cost (in millions):
$.175 (for fire pumper); total credit line unspecified

Lease Term and Payment Frequency:
Five years, monthly in advance

Effective Interest Rate/Payment:
7.50%/$3,484 for initial acquisition

Pricing Formula:
Lessor advises that multiple draws on this lease line have occurred. Rentals applicable to additional assets were calculated at interest rates times basis points above the Delphis Hanover Scale, applicable at the date of the draw. This formula is no longer used by the Lessor who has replaced it in subsequent transactions with a formula specified as a percentage of Treasury securities having a similar term as that of the asset financing.

Prepayment:
Available on each payment date at Purchase Option Price

Prepayment Premium Added to Purchase Option Schedule:
$6,126 (3.5% of the original cost) for initial acquisition

Enhancement:
None

Ratings:
None

DOCUMENTATION

Lease Agreement:
Lease with Option to Purchase

Terms and Conditions

Non-appropriation:
All or nothing provision; requires failure to appropriate as evidenced by a specific provision in Lessee's budget for the fiscal year in question, so stating.

Non-substitution:
For period of one year except if this provision affects the validity of the Lease or if the Lessor has recovered its investment from the sale of the asset.

Abatement:
None

Rental Interruption Insurance:
Not required

Title/Security Interest:
Title with Lessee; Lessor retains security interest in vehicles, lease proceeds and all repairs, replacements, substitutions and modifications to assets.

Insurance:
Lessee assumes full risk if asset is lost, stolen, damaged, or destroyed. Lessee required to replace, repair, or prepay purchase option price. All-Risk Insurance and liability insurance are required but self-insurance is permitted.

Indemnification:
Full indemnification of Lessor by Lessee

Tax Compliance:
Covered by a specific Lessee representation to take no action that would cause the interest payments to become taxable and to take all affirmative actions within its legal authority to ensure the interest will remain tax exempt.

Net Lease:
Yes

Assignment:
Lessor's right and title assignable to one or more investors without Lessee's consent

Default:
Events
1) Failure to pay Lease Payment and continuation of failure for three (3) days after notice
2) Failure to observe or perform any other covenant, etc. and continuation for 30 days after notice
3) Bankruptcy

Remedies
1) Terminate Lease and declare all payments due during current year due and payable
2) Repossess equipment and sell in a commercially reasonable manner and apply such proceeds to:
   a) Costs of recovering assets
   b) Costs of sale
   c) The applicable purchase option price
   d) Balance of rentals due for current fiscal year
   e) Excess retained by Lessor

Note: Sales proceeds go to future rentals (e.g., purchase option price) before being applied to current year rentals. Presumably, a better legal case can be made to collect current year rentals first. In the event of non- appropriation for future years, presumably no current year rentals would be outstanding. In any event, Lessee is required to return equipment at its own expense.

SUMMARY: CASE STUDY NO. 4 -- A THIRD-PARTY FINANCED LEASE LINE OF CREDIT

One way in which governments can take advantage of economies of scale available in tax-exempt leasing is to establish lease lines of credit. This example illustrates how a California city financed a number of different types of motor vehicles and multiple acquisitions from a variety of vendors through a line of credit. As a result, the Lessee could competitively select different vendors for each group of vehicles but avoid having to solicit financing each time a vehicle was ordered. The financing provides an assured access to funds for current and future vehicle acquisitions.

As in Case Study No. 3, the Lessor/Investor in this case is a finance company that bid directly on the financing and is holding the lease line of credit for its own portfolio. The Lessor/Investor also is a captive credit corporation but since the financed assets are not produced by the parent corporation, it has been classified as a finance company. Although the finance company intends to hold the lease for its full term, it has retained a right of assignment.

Under the line of credit, the Lessee makes monthly payments on each vehicle at rates fixed at funding based upon a formula using the Delphis-Hanover Scale. This formula is no longer used by the Lessor who replaced it in subsequent transactions with a one based upon Treasury securities, with a term similar to that of the asset financed. Prepayment is allowed on any rental payment date, with the Lessee paying a 3.5 percent premium that declines over the lease term.

The original line was available for one year with renewal subject to credit review by the Lessor. Access to the line was flexible, although the Lessor informally indicated a preference for monthly draws and for amounts in excess of $50,000 per draw. The lease term for each vehicle is based on its type and use and normally will not exceed five years.

The lease contains a non-appropriation and a one-year non-substitution provision. Title is transferred initially to the Lessee but the Lessor retains a security interest in each vehicle until the lease has terminated or been prepaid. The non- appropriation provision is referred to as an "all or nothing" provision -- if the Lessee non-appropriates on one vehicle, it must non-appropriate on all vehicles. This restriction discourages casual non-appropriation as to a specific vehicle and reduces the risks to investors since it is less probable that the Lessee will non-appropriate on essential vehicles. In addition, the Lessee must specifically request appropriation for lease payments each year and show this appropriation in its annual budget.

Among other terms and conditions is a Lessee representation that it will take no action that would cause the payments to become taxable and that it will take all necessary action within its legal authority to ensure that the interest remain tax exempt. As with the transactions previously reviewed, the Lessor relied upon Lessee's Counsel to determine the Lease's validity and did not seek an opinion as to its tax-exempt nature.

Commentary. This transaction has no lease broker or escrow agent and involves the same third-party lessor as Case Study No. 3. However, the premium chargeable upon an early termination was double the percentage in the last case. This is likely due to the line of credit structure which places more administrative tasks on the Lessor. This example also illustrates the different internal cost structures a lessor may charge to a transaction, depending upon the assets, the size of the program, the number of takedowns, the number of other participants, the credit quality of the lessee and the absence of a lessee policy on the size of any prepayment premium.

Since the Lessor is the same as in Case Study No. 3, the lease documentation is very similar, with the exception that (i) the Lessee is permitted multiple acquisitions with the interest rate set at takedown for each acquisition and (ii) the title vested initially with the Lessee. The Lessor required full indemnification. The Lessee could also prepay on any rental payment date as opposed to the more typical annual early purchase options found in non-appropriation leases.

In this regard, note should be made of the change in the scale used to set the rate upon each takedown. The Delphis- Hanover Scale, which was used originally, is a composite of municipal rates nationally and generally is more reflective of interest costs to government issuers; whereas a Treasury-based index, used later, reflects federal financing rates and funding requirements. Treasury scales also tend to reflect the cost of funds for institutional investors, such as captive credit corporations. Since the captive credit investor in this transaction plans to hold the Lease for its portfolio, it changed the scale, with consent of the Lessee, to reflect more accurately its costs. Altough the Delphis-Hanover Scale is more indicative of municipal funding rates, it is not widely disseminated, and therefore the Lessee may have agreed to its replacement with a more well-known index.

CASE STUDY NO. 5

GENERAL INFORMATION

Type of Transaction:
Certificates of Participation through a Lease Pool Program

Type of Lessee:
Two Counties

Type of Lessor:
Non-profit (public benefit) finance corporation

Trustee:
Foreign-owned commercial bank

Underwriter:
Investment banking firm

Legal Opinions:
Co-Special Counsel (bond opinion)
Lessee's Counsel
Co-Counsel for Underwriters

Marketing:
Retail sale of Certificates of Participation in denominations of $5,000

TRANSACTION STRUCTURE:

Asset:
Health Services Facility
Landfill

Asset Cost (in millions):
$4.000
$1.200

Lease Term and Payment Frequency:
20 years

Prepayment:
Yes

Prepayment Premium Added to Purchase Option Schedule:
If any, not yet determined

Enhancement:
No

Ratings:
Likely

<u>DOCUMENTATION</u>

Lease Agreement:
Facilities Lease

Terms and Conditions

Non-Appropriation:
No

Non-Substitution:
No

Abatement:
Yes

Rental Interruption Insurance:
Yes, with one-year protection

Construction:
Lessee is appointed as Lessor's agent to arrange construction of project

Title:
Held by Lessor

Insurance:
Lessee to maintain liability and casualty insurance, except that during construction the Lessee's responsibility is only for that amount not insured by contractors. Lessee is also required to maintain title insurance on site. Insurance is evidenced by exhibit to Lease.

Net Lease:
Yes

Default:
Events
1) Failure to pay rent
2) Failure to observe or perform covenants
3) Bankruptcy of Lessee
4) Default under Site Lease
[Note: A default by one participant in the pool is not a default by other participants.]

Remedies
1) Pursuant to law
2) Take possession of asset and exclude Lessee from access

Other Documents/Attachments/Exhibits

Assignment:
Lessor assignment to Trustee

Master Trust Agreement:
Between Lessor and Trustee

Supplemental Trust Agreement:
Between Lessor and Trustee relative to specific portion of pool related to Lessee

Site Lease:
Between County as Lessor and original Lessor as Lessee to be leased back to the County for a 40-year term

SUMMARY: CASE STUDY NO. 5 -- CERTIFICATES OF PARTICIPATION THROUGH A LEASE POOL PROGRAM

Another method for lessees to gain economies of scale is to pool their financing needs with other lessees and approach investors jointly. Several organizations of California local governments have created lease pools for the benefit of their members. Traditionally, pools allow participants to reduce the costs of issuance by combining the needs of each member to increase the size of the total offering. The pools, which can finance as the demand exists and the market allows, generally are offered through non-profit, public benefit finance corporations created by the sponsoring organization. These corporations act as Lessor.

In general, the leases in a pool are financed through certificates of participation (usually negotiated although some are sold competitively). Each lessee executes a lease and other documents with the Lessor, which then assigns its rights in the lease to a Trustee. The Trustee then sells certificates of participation to an underwriter, who in turn sells them in the retail market. The Trustee relationship is typically set forth in a Master Trust Agreement between the Lessor and Trustee and Supplemental Trust Agreements address specific leases and Lessees.

The Trustee's role includes disbursing funds to vendors and contractors on behalf of each Lessee, collecting lease payments, and paying certificate holders. The Figure 3 depiction of a certificate of participation transaction is similar to the funds flow for a lease pool, with the exception that there is usually more than one lessee.

Leases in some pools have non-appropriation clauses while others have abatement provisions. A single pool would not contain leases of both types; rather, all leases in a pool are essentially identical to each other. Each lessee participating in a pool is obligated only for its individual lease payments. The leases are not cross-collateralized; if one or more lessees non-appropriate or abate payments, other lessees are not obligated for any additional payments nor are subject to the terms and conditions of non-appropriation or abatement.

The participants in a lease pool are similar to those in a COP. They include the lessees, a lessor, underwriter, trustee, investor, and sometimes, rating agencies and credit enhancers. In addition, each of these parties is represented by counsel and special counsel generally is retained to opine on the tax-exempt nature of the pool.

In this specific case study, the terms and conditions are similar to those outlined above, but this transaction has some interesting features. First, it is captioned a pool because of its participation with the finance corporation/Lessor and Trustee and there are two Lessees. However, unlike earlier pools structured by this Lessor, each lease is being offered totally independently of the other. In other words, two separate transactions are being sold on the same day with the same Lessor. The primary economies to the Lessees derive from the opportunities to use the same set of prepared documents, thereby avoiding the time and expense of drafting and negotiating new documents.

In these transactions, the Lessees have the right to abate payments and are required to maintain rental interruption insurance with one-year protection. Because construction is involved, the Lessee is appointed as Lessor's agent to arrange construction. Site Leases are executed for a 40-year term and the Lessees are required to maintain title insurance on the land. In addition, because the Leases are structured as a net lease, the Lessee must also obtain liability and casualty insurance. During construction, however, the amount of this insurance required of the Lessees is limited to that portion not insured by the contractors.

Commentary. These transactions have several interesting features. The non-profit Lessor potentially eliminates the need for a lease broker. However, the leases must be underwritten which will require the services of an underwriter and may also require the appointment of a financial advisor which may eliminate some of the cost savings.

Economies of scale may be realized by lessees in a pool in several ways. First, the basic documents (lease and trust agreements) are the same for each lessee and for each financing and, therefore, documentation costs can be minimized. Further, because the trustee is familiar with the documents, and its responsibilities, its costs may also be lower than if it were servicing single transactions. Another economy can result if ratings are sought and the rating agencies review only one set of the same basic documents.

Since the lease is a facility financing involving real property and contains abatement language, it requires rental interruption insurance, particularly since a rating was sought. In the event of default, repossession of the facility and re- lease is permitted to the exclusion of the Lessee, although this may be of marginal benefit here.

No credit enhancements were obtained. Many of the larger lease pools structured in California are publicly sold through competitive bidding and, depending on the strength of the underlying lessees, may require credit enhancement in order to obtain a favorable rating.

Pools require extensive coordination and may generate higher issuance costs than stand-alone leases. For best results in a pool, it is better to include as many transactions as possible to spread the costs over a larger aggregate amount.

CASE STUDY NO. 6

GENERAL INFORMATION

Type of Transaction:
Certificates of Participation for Real Property

Type of Lessee:
County

Type of Lessor:
County Public Facilities Corporation (special purpose nonprofit, public benefit corporation)

Trustee:
Commercial bank

Underwriter:
Several investment banking firms

Legal Opinions:
Co-Special Counsel (bond opinion)
Lessee's Counsel
Co-Counsel for Underwriters
Counsel to Letter of Credit Bank
Counsel to Trustee

Marketing:
Retail sale of Certificates of Participation in denominations of $5,000
COPs initially issued as 7-day floaters with interest payable quarterly prior to conversion
At conversion (March 1, 1989), lease refinanced and interest payable semiannually in arrears
Principal is payable semiannually beginning December 1, 1990

TRANSACTION STRUCTURE:

Asset:
Correctional Facility

Asset Cost (in millions):

Construction:	$63.009
Capitalized Interest:	55.486
Reserve Fund:	13.696
Costs of Issuance:	.575
Underwriter's Discount:	.533
Total Financed	$133.300

State Grant to be Applied to Construction:	92.900
Total Cost of Project:	$226.200

Lease Term and Payment Frequency:

30 years -- 4.5 years of interest only
25.5 years of principal and interest paid semiannually

Prepayment:

Prepayment permitted on or after 12/1/2000

Prepayment Premium Added to Purchase Option Schedule:

Premium of 2% in first year (2001), 1% in second year (2002) and at par thereafter

Enhancement:

Floating rate certificates (1985) were guaranteed by an irrevocable letter of credit issued by a bank
Fixed rate certificates (1989 refinancing) were insured by a bond insurer

Ratings:

Floating rate/Fixed rate certificates (1985): Aa/MIG1 (Moody's)
Fixed rate certificates (1989 refinancing): Aaa/AAA (Moody's/S&P)

DOCUMENTATION

Lease Agreement:

Original Lease Agreement dated as of December 1, 1985
Refinancing: First Amendment to Lease Agreement dated as of March 1, 1989

Terms and Conditions

Non-Appropriation:
No

Non-Substitution:
No

Abatement:
In event of substantial interference in use of project, rent can be abated proportionately to the portion of project not available. However, the portion of the project not available will be considered first to have been paid for by the state grant ($92,900,000); therefore, more than that amount would have to be unavailable before payments would be abated. This applies to losses during construction as well as to any later casualty to the project.

Construction:
Lessee is appointed as Lessor's agent to arrange construction of project

Tax Compliance:
Lessee agrees not to create industrial development bonds

Title:
Held by Lessor

Insurance:
Lessee to maintain liability and casualty insurance

Default:
Events
1) Failure to pay rent
2) Failure to pay other amounts for 10 days
3) Failure to observe or perform covenants within 30 days after notice
4) Default under trust agreement
5) Bankruptcy

Remedies
1) Pursuant to law
2) No acceleration of payments
3) Re-lease project and hold Lessee liable for deficiency

Other Documents/Attachments/Exhibits

Official Statements
Purchase Agreement
Trust Agreement
Reimbursement Agreement
Site Lease
Assignment Agreement
TENR Services and Remarketing Agreement
Certificate as to Arbitrage
Evidence of Insurance
Feasibility Study

SUMMARY: CASE STUDY NO. 6 -- CERTIFICATES OF PARTICIPATION FOR REAL PROPERTY (ENHANCED)

This case study concerns the financing of a county correctional facility. Total cost exceeded $226 million. However, because of a state grant of almost $93 million, the amount of the certificates of participation sold was $133.0 million. The transaction was originally financed on a variable interest basis in December 1985. Because of changing market conditions, it was refinanced in March 1989.

The initial term was 30 years, with 4 1/2 years of interest only followed by 25 1/2 years of semiannual payments in arrears. No prepayment was provided until the year 2000 and then with a 2 percent premium declining to 0 percent after 2002. The Lessor holds title with a recorded deed of trust securing its interest. The Lessor was not permitted to accelerate rent upon default, but could re-lease the facility and hold the Lessee liable for any deficiency.

The original 1985 financing was structured as floating rate certificates (convertible into fixed rate certificates at the option of the Lessee), enhanced by an irrevocable letter of credit. As a result of the enhancement, the certificates were rated MIG1/Aa by Moody's. The letter of credit guaranteed an amount not to exceed $139,965,000 (construction cost and accrued interest), was established for a fee of one percent ($139,965) and was provided by the California branch of an Australian banking corporation.

The Lessee converted the floating rate certificates to a fixed rate in the March 1989 reoffering. At that time, the credit enhancement was switched from the letter of credit to an insurance policy, in all likelihood because the LOC provider declined to participate on a fixed rate/fixed long-term basis. The original underwriters were appointed remarketing agents of the converted certificates. At the time of the remarketing, the certificates were enhanced/insured and rated Aaa/AAA (Moody's/Standard & Poor's).

The flow of funds and the participants in this transaction are typical of other COP financings. Most terms and conditions are also common to those of other COP transactions although the abatement provision has an interesting element. Rent can be abated proportionately to the portion of the project not available; however, the portion of the project not available will be considered first to have been paid for by the state grant. Therefore, the credit enhancer's (and investors') exposure to abatement will only come after the Lessee does not have use of more than $93 million worth of the facility (both during and after construction.)

The complexity of the transaction required several documents including trust agreements, a reimbursement agreement, and a remarketing agreement for the floating certificates. However, given the structure, if the financing instruments were bonds, the participants, documents and complexity likely would have been similar.

Commentary. Of particular interest to this transaction are the cost components. In addition to the state grant of $93 million, the certificates included project cost of $63 million for construction, capitalized interest of $55 million for 4-1/2 years, a reserve fund of $13.5 million required under the terms of the credit enhancements, and issuance costs (including an underwriter's discount of $1.1 million).

Given the relatively low discount, it appears that this transaction may have been sold to a single, large institutional investor. If the certificates had been sold to a number of investors, however, it is likely that the underwriter's discount would have been higher due to underwriter's concessions required among selling syndicates. Consequently, in a transaction of this magnitude, it is important that the Lessee obtain advice from its financial advisor to ensure that the transaction (and the economic terms to the advisors and participants) cover the contingencies and represent a fair return for the risk and work of each party.

At the time the transaction was structured, it was unclear whether voters would approve general obligation bonds to finance the facility. In view of the heavy debt service requirements imposed on the Lessee's cash flow by this lease, the Lessee, on at least two occasions, has sought to sell general obligation bonds to refinance the certificates. In both instances, the voters have defeated the referendum -- an indication of why a lease may be the only realistic method of financing this type of essential facility.

CASE STUDY NO. 7

GENERAL INFORMATION

Type of Transaction:
Certificates of Participation with Sublease-Purchase Agreement to a Private Corporation as Facility Operator

Type of Lessee:
Special district

Type of Sublessee:
Private operator

Type of Lessor:
Lease broker

Investors:
Purchasers of Certificates of Participation

Legal Opinions:
Special Counsel (bond opinion)
Lessor's Counsel
Underwriter's Counsel
Lessee's Counsel
Trustee's Counsel

Marketing:
Retail sale in denominations of $5,000

Cited Authority:
Harbor & Navigation Code, State of California
Part 4, Division 8 commencing at Section 6200

TRANSACTION STRUCTURE:

Asset:
Wharf and marina facilities

Asset Cost (in millions):

Construction:	$6.708
Capitalized and Accrued Interest:	1.142
Reserve Fund:	1.385
Costs of Issuance:	.406
Total Financed plus Accrued Interest	$9.642
Grant from Economic Development Administration*:	1.326

[*Note: The Lessee was awarded a grant by the federal Economic Development Administration to finance not more than 50% of the cost of a commercial fisheries facility.]

Lease Term and Payment Frequency:

Ten (10) years -- structured as concurrent certificates: one with a five-year term and the other a ten-year term, each with annual mandatory sinking fund payments. Collectively, they equal a ten-year level pay transaction. (Lease payments are to be made monthly.)

Prepayment:

Lessee can prepay on or after the seventh anniversary date of the transaction.

Prepayment Premium Added to Purchase Option Schedule:

None

Enhancement:

None

Ratings:

None

DOCUMENTATION

Lease Agreement:

Lease-Purchase Agreement

Terms and Conditions

Non-appropriation:

None

Non-substitution:

None

Abatement:

Yes, subject to whole or partial abatement

Rental Conditions:

Payable solely from Sublease rentals (secured by facilities' revenues) and any other legally available appropriated funds, if any.

Title/Security Interest:

Passed from Lessee to Sublessee upon completion of project, subject to rights of secured parties (e.g., Lessee, Trustee on behalf of certificate holders)

Insurance:
Lessee required to provide or cause to be provided standard public liability insurance plus title insurance on underlying land. (These responsibilities passed to Sublessee through Sublease-Purchase Agreement.) Business interruption insurance required to cover business losses due to fire, vandalism, and other perils.

Net Lease:
Yes

Assignment:
Yes

Default:
Events
1) Failure to make lease payment and continuation for 10 days
2) Failure to perform other covenants and continuation for 30 days after notice
3) Voluntary or involuntary bankruptcy proceedings

Remedies
1) Take possession with or without termination of the Lease-Purchase Agreement
2) Take title to facilities
3) Operate or sell the facilities subject to the terms of the Ground Lease

Other Documents/Attachments/Exhibits

Sublease-Purchase Agreement:
Between Lessee and private corporation (as sublessee)Construction responsibility of Lessee (through lease- purchase agreement) transferred to Sublessee; supported by Ground Lease between Lessee and Sublessee and Trust Agreement between the Lessor and Trustee

Purchase Agreement:
Between Underwriters, Trustee and Lessee to buy all of the certificates

Certificates:
Regarding Permits and Approvals
Regarding Effectiveness of Documents
As to Arbitrage

[Note: Although this transaction was funded with certificates of participation, it is more like an industrial development bond than a lease-purchase agreement since the ultimate owner is a private organization. This transaction could not be structured under present federal tax laws relating to public and private use of facilities and tax-exempt financing.]

SUMMARY: CASE STUDY NO. 7 -- CERTIFICATES OF PARTICIPATION WITH SUBLEASE-PURCHASE AGREEMENT A PRIVATE CORPORATION AS FACILITY OPERATOR

The Lessee of this 1981 financing of wharf facilities is a special district. However, pursuant to a Sublease-purchase agreement, the Lessee leased the facilities to a private organization as Sublessee. The Sublessee assumed all of the responsibilities and obligations of the Lessee relative to lease payments, construction, operations, maintenance, insurance, etc. The Sublessee also gained title to the facilities at the completion of construction, subject to the liens imposed by the Ground Leases, Deed of Trust and Assignment of Rents. The Lessor is a lease broker.

As a result of federal restrictions on the use of tax-exempt financing for private purposes enacted after completion of this financing, it is unlikely that this transaction could be structured under current federal tax laws. However, this structure is typical of certificate of participation financings used to provide capital where industrial development bonds could not be utilized.

The value of certificates sold was more than $9.6 million and the transaction was unenhanced and unrated. A reserve fund of $1.385 million was also funded. Monthly payments for the ten- year lease are secured by revenues from the wharf facilities. No other revenue streams were available for lease payments except the reserve fund and legally appropriated funds of the Lessee (as a special district, no other appropriation of funds was anticipated.) Lease payments in the first year were made by the Lessee; the Sublessee assumed payments at the end of the first year. As a special district-type of financing, the Lease is subject neither to abatement nor non-appropriation.

Because of the construction involved, Ground Leases were executed between the Lessee and Sublessee, granting the Sublessee rights to use the wharf area upon which the improvements were built. The Sublessee is required to obtain business interruption insurance to cover business losses due to fire, vandalism and other perils.

The flow of funds is similar to that of most certificate of participation transactions except that the Sublessee makes its payments directly to the Trustee.

This transaction has suffered severe setbacks caused by a lack of sufficient revenues to cover rent payment obligations and the subsequent bankruptcy of the Sublessee. Certificate holders have not been paid since 1986 and sought remedies through litigation. A settlement has been negotiated which may provide some relief to the investors.

Commentary. Since this transaction is in litigation, only a brief review of its business aspects is in order.

The transaction was intended as a pass-through arrangement, with the district merely acting as a conduit for a tax-exempt financing of an industrial development project. The district did not intend to operate the facility or use its own funds to pay rent under the lease. Rather, a Sublessee/developer, which received title to the property following construction, was required to meet the lease obligations.

The risks noted in the Official Statement (OS) were prefaced by the comment that the development was speculative with payment of the certificates subject to the Sublessee/developer's ability to sublease the facilities. The OS also said that continued occupancy was dependent upon future local and national economic conditions, the capital and other resources of the tenants, federal and state laws and regulations as well as other unforeseeable and unpredictable factors.

The business failure of the facility, the bankruptcy of the Sublessee, and the default under the certificates, underline the payment risk in any project financing (which does not access the general credit of the Lessee). It is essential in these situations that a reliable feasibility study from an independent party be obtained and reviewed as part of the due diligence procedures of all parties. Failure to obtain a proper feasibility study or to disclose such a study (which has occurred in other defaulted leases), may result in failed expectations of the investors as well as litigation against the principals in the transaction and their advisors.

This example has neither credit enhancement nor rating -- features that might have protected the investors against the risk of default. It is possible that had an enhancement been sought and denied that the transaction might never have occurred. However, credit enhancement should not be relied upon as a substitute for a properly conceived project. It only serves as a "security blanket" and does not cure any underlying infirmities. Moreover, where an enhancement is obtained, lessees and investors should review its specific terms to ensure that no gaps in the coverage are created which may later become a matter of controversy among the parties, advisors, and insurers. For instance, in another defaulted lease situation in California where abatement insurance was procured, the insurer has denied coverage on the grounds that the facility was not sufficiently completed for the insurance to be applicable.

CASE STUDY NO. 8

GENERAL INFORMATION

Type of Transaction:
Agreement to Finance Ten Years of Telecommunications Service

Type of Lessee (Borrower):
County

Type of Lessor (Lender):
Conduit agency (County-sponsored public facilities corporation)

Underwriter:
Investment banking group of commercial bank

Investors:
Purchasers of Certificates of Participation

Service Provider:
Private telecommunications utility

Trustee:
Trust company

Legal Opinions:
Special Counsel (bond opinion)
Underwriter's Counsel
Lessee's/Borrower's Counsel

Cited Authority:
Constitution and Laws of State of California including Government Code 23004

Marketing:
Sold at retail in minimum denominations of $5,000

TRANSACTION STRUCTURE:

Asset:
Integrated telecommunications network service

Asset Cost (in millions):

Lump Sum Service Amount:	$6.736
Reserve Fund:	.800
Advance Payment Fund (Cap. Interest):	.233
Costs of Issuance:	.231
Total Financed plus Accrued Interest	$8.000

Lease Term and Payment Frequency:

Ten (10) years -- base payments due semiannually six months before payment to certificate holders is due. First base payment payable from Advance Payment Fund plus interest earned on that Fund and on the Reserve Fund balance.

Prepayment:

None allowed

Enhancement:

None

Ratings:

Moody's: A1
Standard & Poor's: A (Provisional)

DOCUMENTATION

Agreement:

Agreement Re Countywide Integrated Telecommunications Network

Terms and Conditions

Non-appropriation:

None

Non-substitution:

County agrees not to acquire equipment or service which would displace financed service.

Abatement:

Payments may be abated "during any period in which, by reason of any damage or destruction or failure on the part of [the Service Provider] to provide the Service, there is substantial interference with the use of the Service, or any portion thereof, by the County."

Rental Interruption Insurance:

No

Title/Security Interest:

Contract covers service; no assets acquired; only title is retained by Service Provider to all equipment used to provide service. No security interest involved.

Insurance:

1) To the extent appropriate, provided by Service Provider for casualty coverage to equipment used to supply service
2) General comprehensive liability insurance provided by County to indemnify Lessor.

Assignment:

1) By Lessor to Trustee
2) None by County

Default:

Events

1) Nonpayment
2) Failure to perform additional representations and warranties within 60 days after notice
3) Assignment of contract without consent
4) Bankruptcy
5) Abandonment of service

Remedies

1) At law
2) Continue agreement in full force and effect and recover payments as they become due without terminating the right of County to use service

Note: The Service Provider's liability under contract is limited in force majeure situations and by California Public Utility Code No. A2.1.14 (limited to refund of charges).

Tax Compliance:

County covenants not to take action or use service in a manner which would cause the interest on the certificates to be taxable. County covenants to abide by arbitrage rebate requirements.

Other Documents/Attachments/Exhibits

Official Statement
Trustee Agreement

SUMMARY: CASE STUDY NO. 8 -- AGREEMENT TO FINANCE TEN YEARS OF TELECOMMUNICATIONS SERVICE

The Lessee (although in this case it is more appropriate to refer to a borrower) is a county and a public facilities corporation is the Lessor/Lender. The investment banking group of a commercial bank underwrote the Agreement and sold certificates of participation. A private telecommunications utility is the Service Provider.

This transaction is similar to the other certificate of participation structures outlined in cases 5 and 6 (and to a lesser extent, case 7). In each case, a trustee executed and delivered the certificates, held funds prior to distribution to the vendors and contractors, and received rental payments for distribution to the investors. In each situation, an underwriting firm obligated itself to sell the certificates to investors through a retail sale. Multiple opinions of counsel were obtained.

Although financed with certificates of participation, this transaction does not include a lease agreement but rather has only an Agreement. It is, for all intents and purposes, a loan to pay for discounted telephone services in advance. The amount financed was $8 million and included a lump sum service charge, a reserve fund, capitalized interest, and costs of issuance.

Given the quality of the underlying credit and its ability to obtain an A rating on the certificate transaction, no credit enhancement was sought. The strong Lessee credit and a Service Provider with a deep capital base and an excellent service record contributed to the transaction's satisfactory rating. (Absent interference with use of the service under the abatement provisions, the Lessee is required to continue making rental payments regardless of any financial issues or a change in usage or other circumstances.)

Casualty insurance was not required since the equipment was owned and maintained by the Service Provider. The Lessee was required, however, to provide a comprehensive liability insurance policy for the county-owned property to which the service was provided.

Since the Agreement covers service only, no assets are acquired. Title to the equipment is retained by the Service Provider. Lease payments are due semiannually in arrears for ten years. The transaction is rated A1 by Moody's and A(provisional) by Standard & Poor's. Given these factors, the transaction truly represents a "credit-based" lease (without recourse to collateral). This may be another reason why credit enhancement might have been difficult to obtain.

The Lessee can abate payments if, because of damage, destruction or failure of the Service Provider to provide the service, the Lessee encounters interference in using the service. Although non-appropriation is not an option of the Lessee, it has agreed to a non-substitution provision not to displace the service for the duration of the Agreement.

Commentary. This contract constitutes a loan agreement which is not collateralized by any recoverable assets. The underlying assumption in the transaction is the belief that telecommunications services will always be provided by the Service Provider utility. Failure of such service will cause loss to the investors as no means of alternative recovery exits.

This type of transaction -- the prepayment of service arrangements -- is financially effective for governments only if the discount provided for the prepayment exceeds the total cost of the financing. Assuming that the discount granted by the Service Provider was sufficient to overcome this hurdle, the additional economic risk to the Lessee is that the general cost or quality of service might decline over the period of the contract. This may make the savings illusory since the Lessee does not appear to have the right to receive post facto credits by the Service Provider.

The risks to investors are significant. There is no collateral other than a long-term service contract. Although the investor has a contractual right to prevent the Lessee from utilizing similar services, it is improbable that a court would prevent it from obtaining basic telephone services.

It appears that a similar contract was entered into by another county. While it has not been possible to review the documents, it appears that the second county is facing financial difficulties and may default on its financial obligations. Assuming that the second set of documents is similar to the set reviewed, the issues of remedies on default (as noted above) may become more real than theoretical. If the Lessee reduces its staffing and services to a minimal level due to its lack of funds, protections provided by a non-substitution clause may prove to be temporary, with the only remedy being reliance on the abatement clause which permits the Lessor to collect rents as they become due provided the service is available.

In the event the lease is upheld as an enforceable obligation against the Lessee, the obligation would be subject to adjustment of debt permitted municipalities under federal bankruptcy provisions. This could result in significant delays to the investors in receiving payments, absent an ability to obtain "adequate assurances." (See the discussion on bankruptcy in Chapter Three.)

CASE STUDY NO. 9

GENERAL INFORMATION

Type of Transaction:
Tax-Exempt Lease Financing Acquired with Equipment Procurement with Provision for Public Distribution of Certificates of Participation

Type of Lessee:
State agency

Type of Lessor:
Vendor

Underwriter:
None

Investor:
Lease broker who further assigned to unknown party(ies)

Escrow Agent:
Unknown

Legal Opinions:
Lessee's counsel

Marketing:
Unknown

TRANSACTION STRUCTURE:

Asset:
Mainframe computer

Asset Cost (in millions):
$3.55 (total financed was $3,801,038 to include sales tax and one-time costs)

Lease Term and Payment Frequency:
48 months in arrears

Effective Interest Rate/Payment:
7.2%; 1st payment of $425,000 followed by 47 payments of $83,206.28 (If certificates of participation are issued at a lower rate, the Lessee will benefit; the rate the Lessee pays, however, cannot rise above 7.2%.)

Prepayment Option:
Prior to the beginning of any payment period

Prepayment Premium added to Purchase Option Schedule:

None allowed by Lessee

Enhancement:

None

Ratings:

Unknown

DOCUMENTATION

Lease Agreement

Installment Purchase Payment Plans

Terms and Conditions

Non-appropriation:
Yes

Non-substitution:
Yes, for one year

Abatement:
No separate abatement provision exists. However, the Lessee is entitled to offset liquidated damages equivalent to daily lease payments if the equipment does not perform.

Rental Interruption Insurance:
Not required

Title/Security Interest:
Title stays with the vendor and its assignees until all payments are made to the vendor
Vendor has a purchase money security interest in the asset and Lessee grants a security interest in any substitutions, replacements and additions.

Insurance:
Lessee agrees to insure and provide certificate of insurance or self-insurance

Tax Compliance:
Lessee and vendor agree not to cause an "arbitrage bond", or a "private activity bond"
In the "Certificate and Agreement Re: IRS Form 8038-G, Tax Covenants and Tax Indemnification" the vendor agreed to provide Form 8038-G to Lessee and agreed to comply with any rebate requirements should they arise. Vendor agreed to pay damages to Lessee in the event vendor causes the interest component of the lease payments to become taxable.

Net Lease:
A modified net lease; the Lessee assumes liability as to casualty after delivery but the Lessor is obligated (through a rider to the Purchase Contract) to maintain the equipment.

Assignment:
Assignable only with the permission of Lessee and Lessee acknowledges that assignment may lead to the issuance of certificates of participation

Default:
Events
1) Failure to pay rental payments when due
2) Failure to obtain insurance or self-insurance
3) Failure to comply with other terms of the lease more than 30 days after notification of non-compliance
4) Insolvency proceedings by or against Lessee
5) An assignment for benefit of creditors

Remedies
1) Recover balance of amount due
2) Enter and take possession of asset or render it unusable
3) At Lessee's expense and if necessary, restore the asset to good repair and operating condition
4) Sell the asset
5) Incur legal fees to be paid by Lessee
6) Other remedies by law or in equity

Other Documents/Attachments/Exhibits

Non-Arbitrage Certificate:
Lessee agrees to furnish, if requested by vendor

Escrow Agreement:
Lessee acknowledges right of vendor to establish a trust or paying agent agreement

Maintenance Contract

SUMMARY: CASE STUDY NO. 9 -- TAX-EXEMPT LEASE FINANCING ACQUIRED WITH EQUIPMENT PROCUREMENT WITH PROVISION FOR PUBLIC DISTRIBUTION OF CERTIFICATES OF PARTICIPATION

In this case study, a state agency solicited the acquisition of a mainframe computer to include maintenance, support and lease financing. The agency's request for proposal contained a contract that included an installment purchase agreement called "Rider E -- Installment Purchase Payments Plan." Other riders covered special provisions regarding maintenance, vendor and equipment performance, component prices, and acceptance testing.

By accepting the Lessee's purchase order, the vendor also accepted the terms and conditions of the financing which were set forth in Rider E. These included a 48-month term, a possible trade-in on existing equipment, the value of which was to be applied to the first payment, and payments in arrears.

The rider included a sample payment schedule that called for the vendor to provide two payment schedules with the first seven payments approximately equal. In the first schedule, the Lessee's Request for Proposal (RFP) specified that the sum of the first seven payments were to be approximately equal to, but not exceed, $647,000, the amount the agency had budgeted for the current fiscal year. In the second schedule, as specified by the RFP, the sum of the first seven payments was to be approximately the same amount but was also to include the requested trade-in offer. (In fact, the agency sold the equipment it was replacing to another agency.) The remaining 41 payments, in either case, were to be approximately equal. Indeed, when the transaction was completed, the first payment (composed of principal and interest) was equal to the money the Lessee received from its sale of the existing equipment to another agency. The remaining payments were equal.

The lease is subject to the annual appropriation of funds and the Lessee agrees to use its best efforts to obtain funding. In the event of non-appropriation, the Lessee agrees to a non- substitution provision of one year from the date of termination. If the Lessee non-appropriates, the Lessee has also agreed to deliver an opinion of its counsel that funds have not been appropriated for the payments and that funds have not been made available for similar equipment or the provision of similar services.

Although there is not a specific abatement provision, the agency is permitted to offset "liquidated damages" against rental payments if the equipment fails to perform. Liquidated damages are calculated at 1/30 of a month's lease payment for each day the equipment is not available.

The agency has the right to prepay the lease at any time and will not accept a prepayment penalty. In the section on assignment, the agency acknowledges that the vendor may assign the contract for financing purposes only and that a paying agent or trust agent may be appointed, and that certificates of participation may be sold. The agency must approve such assignment by the vendor and agrees to execute appropriate documents including a No-Arbitrage Certificate, IRS Form 8038-G, and a certificate of insurance. The agency also agrees to sign, as necessary, a description of equipment and software purchased, certificates of acceptance, assignment acknowledgment and approval, UCC-1 forms, essential use letter, and an opinion of counsel.

In the general terms and conditions of the contract accompanying the purchase order, acceptance testing criteria are set forth in a provision that says that the vendor will not be paid until the equipment has performed according to the established specifications.

Commentary. Of interest in this transaction is that the financing was obtained as part of a bundled bid with the equipment and that the state has the right to prepay the lease without a prepayment penalty.

While it may be simpler to link or bundle equipment and financing procurements, the Lessee also places its financing needs in the hands of the equipment vendor. While the vendor may indeed "shop" rates among lease brokers to present the most attractive financing costs, its prime interest is in selling equipment. As a result, it may not find the most competitive rates that the Lessee might be able to attract directly. In this case study, the point is emphasized since one of the non- successful bidders offered a lower interest rate. Had the agency separately selected equipment and financing, it presumably would have the lower equipment cost of the winning bidder and the lower interest cost of another bidder.

Also by soliciting in September for equipment delivery in November and, thereby, asking the bidders to commit to rates two months in advance, the agency may again have limited its ability to obtain the most attractive financing by placing a financial risk on the lessor. Since a rate adjustment was not allowed, the lessor had to hedge its lease rate quote by providing a cushion for market fluctuations. This generally results in a more costly financing rate than if the Lessor is permitted a modification to reflect market rates at the time of funding or if the financing component is separately bid nearer to the actual funding date.

An attractive feature of this transaction is the acknowledgment by the Lessee that the vendor may assign the lease to another entity and that it may also be financed through the sale of certificates of participation. By "pre-approving" the sale of certificates, the Lessee has given all financing sources a better opportunity to price the transaction and obtain favorable financing rates. Although this may be limited somewhat by the two-month delay between bid submission and lease closing, the provision offers bidders considerable flexibility. However, this flexibility is also somewhat negated by the restriction on prepayment premiums. By refusing a prepayment premium, financing sources may have required a higher rate to protect the investors' return or even declined to bid, limiting the competitive nature of the bid.

A provision in the lease requires the vendor to revise the monthly payment schedule to reflect the actual interest rates at which certificates are sold; in no event, however, can payments increase from those agreed to in the final document. The agency, therefore, can benefit from lower interest rates. In the event COPs are sold, the agency must review and approve the disclosure information -- including a description of the procurement, the equipment, the contract terms and the financial status of the state -- related to the transaction.

In contrast to the previous case studies, this example offered the opportunity to review all the other bids in addition to that of the successful bidder. All bidders had to respond to the same set of technical specifications and had to agree to the same lease terms and conditions. Equipment costs bid (inclusive of maintenance, sales tax, and administrative costs) varied (ranging from $3.8 million to $5.5 million), the lease rates offered ranged from 7.0 percent to 7.65 percent. The Lessee selected the lowest equipment cost bid, which had a lease rate between the other two offers. In general, in a bundled bid, the acquisition cost is the determining factor as to the lowest bid. Although an aggressive financing rate may marginally assist the vendor in a tightly bid situation, the interest rate charged annually is only a modest percentage of the total annual payment and, accordingly, the equipment cost is the major influence for award.

CASE STUDY NO. 10

GENERAL INFORMATION

Type of Transaction:
Third-party Financed Lease

Type of Lessee:
Large state institution

Type of Lessor:
Vendor's captive credit corporation

Underwriter:
None

Investor:
Vendor's captive credit corporation

Escrow Agent:
None

Legal Opinions:
None

Marketing:
None

TRANSACTION STRUCTURE:

Asset:
Mainframe computer upgrade, capitalized construction costs for computer room

Asset Cost (in millions):
$4.136 (including sales tax)

Lease Term and Payment Frequency:
60 months in arrears

Effective Interest Rate/Payment:
7.1%; monthly payments vary based lessee's cash flow requirements

Prepayment Option:
Yes, at any time during lease term

Prepayment Premium added to Purchase Option Schedule:
Unknown

Enhancement:
None

Ratings:
None

DOCUMENTATION

Lease Agreement
Lease-Purchase Agreement

Terms and Conditions

Non-appropriation:
Yes, with 45 days notice

Non-substitution:
Yes, for 45 days

Abatement:
No

Rental Interruption Insurance:
Not required

Title/Security Interest:
Title with lessee; lessee grants security interest in all equipment, repairs, replacements or modifications thereto

Insurance:
Against fire and associated perils for not less than replacement of the asset; public liability; both personal injury and property damage; lessee agrees to provide certificate of insurance

Tax Compliance:
Lessee agrees to comply with all applicable laws and will not use or permit asset's use by any entity whose use would result in the loss of exemption from federal income tax

Net Lease:
Yes

Assignment:
Lessor may assign but prior written approval of lessee is required for an assignment involving a public offering

Default:
Events
1) For failure to pay after 30 days written notice
2) Failure to perform any other material provisions after 60 days notice

3) Lessee abandonment of asset

Remedies
Lessor has right to exercise one or more of the following:
1) Declare all amounts due for current fiscal year
2) Terminate the lease, enter and retake the asset
3) Sell, lease, or sublease asset for the account of lessee, holding lessee liable for all rental payments due, less any amounts received from sale, lease or sublease
4) Take actions at law or in equity

Other Documents/Attachments/Exhibits

Purchase Order

SUMMARY: CASE STUDY NO. 10 -- A LEASE FINANCED BY A CAPTIVE CREDIT CORPORATION

Although this case study is also for a mainframe computer, it has several distinctions from the previous case study. First, the term is for 60 months, which for a mainframe is a typical term; the previous example had a 48-month term. In addition to the hardware, this transaction includes the construction of a computer room. There is no trade-in involved; indeed, since the hardware was an upgrade to an existing system, it is doubtful that an independent equipment bid could be sought. Therefore, the financing was the principal competitive factor and the successful financing source/lessor was the vendor's captive credit corporation.

The payment schedule does not consist of equal lease payments but rather reflects the Lessee's projected revenues available for lease payments during the lease term. The Lessee specifically stated the amount of money it would be able to pay for the first 54 months of the lease (different amounts in each of the five fiscal years) and allowed the Lessor the opportunity to differentiate itself by setting the payment amount for the final six months to complete repayment of the loan, including interest and all fees. By accepting dramatically different lease payments in each fiscal year, this transaction exhibits the flexibility that leasing can provide.

The Lessee's basis of award was the determination of the lowest total repayment arrived at by totaling the 60 monthly payments. In this case, since the first 54 months' payments were the same for all financing sources, the last six payments were the deciding factor.

As in the previous case, the Lessee provided a lease agreement to which all bidders were asked to agree. The terms of the lease are relatively simple, brief (fewer than 10 pages), and straight forward: non-appropriations language, non-substitution for 45 days, net lease, and essential equipment. The Lessee has the option to prepay although, since a payment schedule was not reviewed, it is not known what, if any, premium may have been included. The lease does not specifically preclude a prepayment premium as was the case in the previously reviewed lease.

Commentary. The documentation for this transaction is the standard lease document used by this Lessee for all of its equipment leases. It consists of a short-form lease with minimal tax covenants and other representations. It is unclear from the documents whether the lease itself was formally signed or was merely incorporated by reference into the purchase order issued by the Lessee to the Lessor.

The purchase order includes the financing terms and equipment descriptions, but contains minimal other provisions. While this type of documentation package can provide benefits in reduced transaction costs for the lessee and lessor, it may present deficiencies in the event of non-appropriation or default, given the brief summary of the parties' intent for handling such circumstances. The fact that the Lessor likely retained the lease for its portfolio may have diminished some of these concerns. However, since the Lessee mandated use of its documentation, none of the bidders had any flexibility in handling the deficiencies, which indirectly could assist a bidder retaining the lease in its own portfolio. All potential financing sources (whether brokers or direct investors) had to price the transaction based upon the same terms and conditions.

The financing bid in this case was separate from that for the equipment, but it is not known whether this represents a policy decision of the Lessee. However, since the equipment being acquired was an upgrade to existing equipment, a competitive equipment bid was not practical. That the vendor's captive credit corporation provided the financing is not in and of itself unusual (particularly involving upgrades or enhancements to existing systems). What is noteworthy is its aggressive financing at rates relatively close to retail rates sold to individual investors. Had the situation been a bundled bid, it is unclear whether the Lessee would have received such advantageous financing rates from this Lessor.

GENERAL OBSERVATIONS AND SUMMARY

The case studies were sufficiently diverse in terms of funding dates, amortization periods, credit quality, and type of asset, to make a direct comparison of economics impractical. In general, it appears that the leases provided flexibility to the lessees, allowing them to finance their capital needs.

Some broad conclusions can be drawn, however. In general, the smaller size and shorter-term transactions (and particularly those for multi-asset acquisitions of modest dollar amounts) tend to be more expensive from an interest perspective to the lessee, given higher transaction costs for the lessor, which must be spread over fewer dollars and lease payments as well as the likelihood of multiple takedowns. A larger financing tends to attract more highly developed capital sources (such as large investment banking firms) than a smaller transaction and a longer term transaction may permit more gradual amortization of transaction costs. This should provide a lower, more efficient financing cost to the lessee.

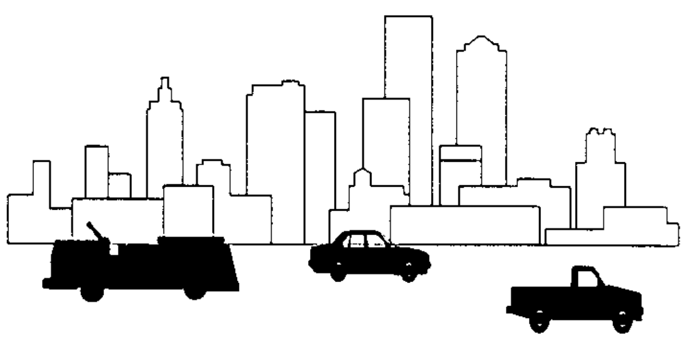
The lease line of credit transaction demonstrates a solution to this problem by aggregating smaller lease schedules (which traditionally would have higher interest rates) into a larger program to achieve economies of scale. A lease pool involving more than one lessee may be able to achieve similar economies. In this regard, the more efficient programs involve larger-size fundings using a certificate of participation format and a not- for-profit lessor to reduce issuance costs. These may also involve credit enhancement, depending upon the underlying strength of the lessee and whether the interest rate savings justifies the cost of the enhancement. However, timing is critical to any effective implementation. To the extent that deliveries cannot be aggregated or financings cannot be approved by prospective lessees within a similar period, the pool or lease line of credit actually may have a higher cost of financing (after accounting for all transaction expenses) than a privately placed lease.

Longer-term transactions also, in general, are more efficient from a financing standpoint than shorter-term leases because transaction costs can be amortized over a longer period and, therefore, become less of a component of each payment. However, this is not meant to imply that a market for short-term transactions does not exist. Due to recently fluctuating interest rates, many investors are seeking shorter maturities. (The outcome of these seemingly contradictory statements is that leases of almost any size can be financed.)

In summary, the case studies demonstrate certain factors to be considered in any lease program. As a general rule, the better the credit and the more essential the asset, the more cost effective the financing. Regardless of the number of participants, structure or type of asset, the credit of the lessee is a principal driving force to rate and ratability. Secondly, each lessor will analyze the financing differently, given differing internal cost structures and equipment preferences. Participation from a wide range of the municipal leasing community (lessors, brokers, underwriters, etc.) is essential to obtain a representative bid. Third, a competitive financing bid separate from the asset procurement will concentrate the focus on the financing terms and rate, allowing the lessee the benefit of both a low financing cost and a low acquisition cost. And, finally, there is no substitute for a well-conceived and executed project. The more essential the asset and the more integrated its use in provision of governmental services, the lower the risk of non-appropriation or default.

PART THREE

THE FUTURE OF LEASING



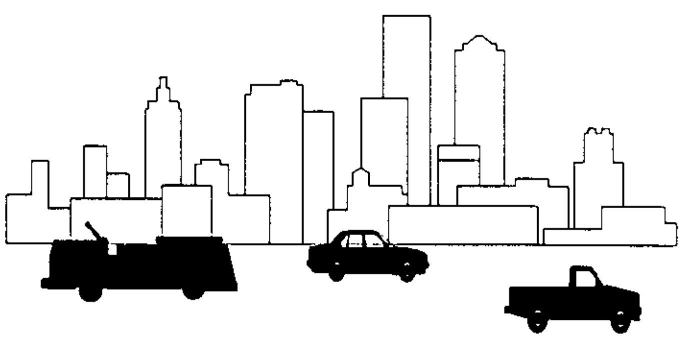
THE FUTURE OF LEASING IN CALIFORNIA

Governments are faced with continuing demands for new capital projects as well as repairs to existing capital assets and the need for new equipment will continue. Given the on-going complexities of authorizing general obligation bonds by local governments and the State's limited resources, tax-exempt leasing is likely to continue as a reliable financing mechanism for some time.

On a national scale (as well as in California), the use of leasing seems to be holding steady or slightly increasing. Lessees, lessors, investors and credit analysts are becoming more comfortable with lease provisions and risks.

There are some precautions, however. Even though a tax-exempt lease is not legally considered debt, it does factor into the analysis of a government's creditworthiness. Wanton use of leasing can have a detrimental effect on the government's financial health. Further, increasing operating expenses, such as lease payments, will make any deficits more difficult to eliminate, unless a conscious review of overall capital needs is conducted.

APPENDICES



APPENDIX A

Glossary

GLOSSARY OF TERMS

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.

The terms that appear within the definitions in boldface are defined elsewhere in the glossary; certain commonly used phrases such as asset, lessee and lessor, are not highlighted at each of their references. Refer 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 tax-exempt 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.

Acceptance Date -- the date on which the lessee verifies that it has received, inspected, tested and accepted as satisfactory the asset under lease. Some lease transactions use the acceptance date as the date on which the lessee begins its lease obligations.

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 be disbursed to the vendor(s) or **contractors**.

Advance Payment -- also called payment in advance; a payment structure in which the lease payment is due at the beginning of each period to which the payment relates, as opposed to payment in **arrears**. In some leases, an advance payment may also refer to the payment of one or more periodic lease payments upon lease commencement in the form of or in lieu of a security deposit or downpayment.

Amortization -- the gradual reduction, redemption or liquidation of the balance (outstanding **principal**) of an obligation.

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.

Arrears -- also called payment in arrears; a lease payment structure where payment is due at the end of each period to which the payment relates, as opposed to **advance payment**. Payments in arrears are more typical for tax-exempt leases.

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 **Sale-leaseback**.

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 IRC restrictions relative to the financing.

Bank-Affiliated Leasing Company -- a subsidiary of a bank or bank holding company that is active as a lessor, frequently acting both as lessor, **lease broker** and/or underwriter.

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.

Blue Sky Laws -- statutes enacted by state governments that relate to securities registration and prohibitions against fraud, dealer and broker regulations.

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."

Book Entry Registration -- refers to the system of registration of tax-exempt securities, generally publicly traded, including lease financings, whereby individual securities (bonds or certificates) are not issued to investors. Instead, a record is maintained by an independent company that records the ownership of securities by members of the company, usually **underwriters** or financial institutions. These members (or "participants") are then responsible for the identification of the actual investors through the brokerage or trust accounts maintained by those members. The largest independent company performing "book entry" services is Depository Trust Company of New York; securities qualified as registered for book entry sometimes are called DTC eligible.

Call -- an option provided to the lessee to prepay the **principal** balance, accrued interest, and any **prepayment premium** at specific dates during the lease term which are earlier than the normal maturity date.

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 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. The volume of COPs has increased significantly in the last several years with an estimated 50 percent of such offerings originating in California.

Certificate of Title -- an instrument, normally issued by state motor vehicle departments, evidencing title to a motor vehicle. The certificate of title may either show the lessor as owner or it may note the lessor as a secured party and the lessee as owner. Physical possession of certificate of title may remain with the trustee.

Choice of Law Clause -- a clause generally found in the miscellaneous provisions of lease specifying that the laws of a specified jurisdiction will govern in construing the lease.

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**.)

Concluding Payment -- in a conditional **sales agreement** (where title to the asset is transferred to the lessee at inception of the lease), this sum is payable by lessee to conclude or terminate the lease. It will include the outstanding **principal**, accrued **interest**, and any **prepayment premium**.

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 **principal** 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.)

Contractor -- see also **vendor**; a term usually describing the party responsible for the construction of the real property improvements to be financed under the lease.

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** or guaranteed investment (GIC) 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 Enhancement Provider -- the party supplying the **credit enhancement**.

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

Credit Rating Agency -- an organization that analyzes new and outstanding obligations of the public and private sectors and assigns a rating as to their comparative credit quality to help investors make their decisions as to the rate at which they will loan funds. The three largest organizations are Moody's Investors Service, Standard & Poor's Corporation and Fitch Investors Service.

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.

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, avoding 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.

Delphis-Hanover Scale -- an index which is published regularly and reports the current level of interest rates applicable to municipal securities of various rated quality and term.

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 issuer/lessee, to permit an investor to evaluate the creditworthiness of the issuer/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**.

Environmental Law Opinion -- an opinion of counsel (specializing in environmental and hazardous substances law), which may be required in some real property financings, respecting the environmental or toxic substances liabilities associated with the property being financed. Owners of real property (and potentially their lenders) may incur liabilities to remediate hazardous substances present or associated with the property.

Equipment Schedule -- the schedule or exhibit to a lease which identifies the property being leased.

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 principal and interest to investors.

Escrow Agreement -- also known as a **Trust Agreement**; a legal document that outlines the duties and responsibilities of the **escrow agent**. This agreement specifies the terms of the securities issued including maturity dates, interest rates, security for payment, redemption procedures, rights of prepayment, etc. When transaction proceeds are to be held by the escrow agent, the agreement specifies the purpose, the documents and authorization needed for disbursement, and dictates the use of earnings on funds held prior to disbursement. The agreement also covers other procedural matters such as dealings with a **credit enhancement provider**, compensation or replacement of escrow agent, etc.

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 tax-exempt 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.

FASB Statement 13 -- the formal pronouncement of **FASB** relating to leases and their accounting applications; the **GASB** has specified that FASB Statement 13 is the standard by which governments using generally accepted accounting principles are to report and account for their lease transactions.

Feasibility Study -- a report analyzing the practicality of a proposed facility including review of operating, financial, engineering, and revenue estimates.

Financial Accounting Standards Board (FASB) -- the independent non-profit organization supported by the public accounting profession and charged with the responsibility of promulgating generally accepted accounting principles.

Financial Advisor (FA) -- a consultant to a lessee who provides assistance in the structure, timing, terms and other topics concerning new or existing leases. A financial advisor also assists a lessee in analyzing competitive bids received in response to a request for proposal or in the preparation of a preliminary official statement needed for competitive sale.

Financing Statement -- see **UCC-1 Financing Statement**.

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.

Funding Resolution -- the action taken by a governing body that authorizes the government to enter into a lease financing.

Government Accounting Standards Board (GASB) -- the standard- setting body for governmental accounting.

Government Finance Officers Association (GFOA) -- a non-profit organization that represents state and local finance professionals in the United States and Canada. Beginning in 1976, the GFOA, formerly the Municipal Finance Officers Association, has been in the forefront of promulgating voluntary **disclosure** guidelines for the issuance of tax-exempt securities.

Governmental Bonds -- a term used in connection with federal **arbitrage** regulations meaning obligations (bonds or leases) that are not **private activity bonds**.

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.

Incumbency Certificate -- a document executed by the lessee (usually the lessee's board secretary or clerk) that indicates the title and authority (as well as providing facsimile signatures) of persons authorized to execute and deliver the lease and other documents or instruments.

Indemnity Clause -- a clause contained in most tax-exempt leases that holds the lessor, **trustee** and **credit enhancement** provider harmless from any loss or damage suffered by the lessee or third parties due to the use of or because of the leased asset or the tax-exempt lease; such clauses may also extend to facts and circumstances concerning the tax-exempt nature of interest under the lease.

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**.

Insured Value -- the value at which assets are insured for casualty purposes under the lease; usually defined to include, at a minimum, the outstanding principal, accrued interest and any **prepayment premium**.

Integration Clause -- a clause generally found in the miscellaneous provisions of the lease specifying that the language in the lease documents (as to specific terms provided in such documents) controls over any and all oral or written understandings or arrangements respecting such items prior to execution of the lease.

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**.

Internal Revenue Code (IRC) -- the codification of federal tax laws enforced by the U.S. government's Internal Revenue Service.

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 tax-exempt 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 tax- exempt 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 issuer/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 IRC.

Lessee's Counsel -- the attorney who provides the opinion to the lessor (and, as applicable, the **assignee, paying agent,** or **trustee**) that the lessee is a governmental entity, is authorized to enter into the transaction, that it has done so legally, that the officials executing the lease have the authority to do so, that the lease is in compliance with all procurement and other regulations, and that the transaction is legal, valid and binding on the lessee.

Lessor -- in a tax-exempt lease, the **secured party** (see **security interest**) 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.

Lessor's Counsel -- the attorney who provides the opinion that the lessor's involvement in the lease has been properly authorized and has been or will be entered into in compliance with lessor's corporate documents and procedures. Opinion of lessor's counsel is not provided in all leases, especially in smaller dollar-volume transactions.

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 issuer or by a **security interest** in the asset.

Marketability -- a term used to indicate how readily an obligation can be sold to lessors or investors. Also called financeability.

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.

Municipal Securities Rulemaking Board (MSRB) -- an independent, self-regulatory organization established by federal law with general rulemaking authority municipal securities market participants (generally, brokers and dealers). The MSRB proposes and adopts rules concerning professional qualifications standards, rules of fair practice, record keeping, the scope and frequency of compliance examinations, the form and content of municipal bond quotations, and sales to related portfolios during the underwriting period.

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 doe not take into account the **time value of money**.

Net Lease -- see **Triple Net Lease**.

No-Arbitrage Certificate -- see **Arbitrage Certificate**.

Nominal Buyout -- a provision in some tax-exempt leases that allows the lessee to purchase the lessor's interest in the lease at the end of the **lease term** for a "nominal" price, usually $1.00.

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.

Nominal Lessor -- an entity brought into a tax-exempt lease transaction for the sole purpose of acting as lessor and as a conduit of acquiring the asset for lease to the lessee through the tax-exempt lease. The nominal lessor may be a private organization that is paid for its services or may be a not-for- profit organization, such as an existing development agency, or a corporation organized for the sole purpose of acting as lessor. The nominal lessor has no responsibilities for nor rights to the leased asset.

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 tax-exempt lease in which the lease can be terminated if sufficient appropriations are unavailable to continue its payments. (This contrasts with an **abatement lease**.)

Non-substitution Clause -- a provision contained in many tax-exempt leases that restricts a lessee from substituting other equipment or property, or as applicable, from obtaining the same equipment or services from third-party vendors, to provide the services of the assets for which payments have been **non-appropriated** or **abated**. The period during which a lessee cannot substitute can vary from one month to a year or to the term of the original lease.

Obligation -- any written promise or commitment to pay money or take certain actions.

Official Statement -- also called an OS or Offering Statement; the document by which the issuer provides financial and other information to potential investors respecting the transaction and the issuer to permit more educated investment decisions. For **privately placed** transactions, this document may also be called a **private placement memorandum**. In a competitive sale of COPs, the lessee and its advisors usually prepare a **preliminary official statement (POS)** which is distributed to prospective bidders (**underwriters**) prior to the time designated for submitting sealed bids. After the transaction is awarded, the final OS is prepared. In a negotiated sale of COPs, the **underwriter** usually assists in preparing the OS and its distribution to prospective investors prior to the pricing of the transaction. The review and distribution of official statements is discussed in the SEC's **Rule 15(c)2-12**.

On-behalf Of Agency -- see **63-20 Organization**; a non-profit agency or corporation organized to issue bonds or enter into lease transactions on behalf of a government or a group of governments. The property so acquired must be owned by the establishing government(s).

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**.

Payment Schedule -- a schedule or exhibit to the lease with the date and amount of each payment due and the principal and interest components of each payment. For purposes of the **Internal Revenue Code** to be tax-exempt, the interest component of rental payments must be identified and set forth at the inception of the lease. Most payment schedules will also identify the date and price at which the lessee can exercise its **purchase** option.

Payment Terms -- the frequency with which lease payments are made. Depending on the transaction, payments can be monthly, quarterly, semi-annually, or annually. Payments can be in **arrears** or in **advance**. Most COPs call for quarterly or semi- annual payments in arrears.

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**.

Prepayment Premium -- also called a prepayment penalty; if a lessee exercises its **purchase option**, it frequently will also have to pay a prepayment premium. The amount of the prepayment premium is generally shown on the **payment schedule** as part of the total **purchase option price**. The premium includes amounts necessary to cover issuance costs that were included in the original **principal** or **interest** rate for the transaction but have not yet been amortized. The prepayment premium may also include amounts to compensate for the early termination of the lessor/investor's investment. In some cases, the premium is expressed as a specific percentage of the remaining lease principal obligation. However, in other transactions, the amount of premium is not clearly distinguished but is blended into a schedule of prepayment prices.

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).

Principal -- the amount loaned and repaid, usually the cost of the asset and may include certain issuance costs. Interest is charged based on the outstanding principal.

Private Activity Bond -- under federal tax law, bonds of which (i) 10% or more of the proceeds 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 IRC 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**).

Private Placement Memorandum -- see also **official statement**; the **disclosure** document respecting the tax-exempt lease and lessee pursuant to which **private placements** are offered and sold.

Progress Payments -- periodic payments made to a vendor or **contractor** for the completion of specified phases or deliveries of a project or asset. In a construction project, for example, a contractor will receive payments in reimbursement for work completed to date or in progress. To guarantee that the project will be totally completed, the contractor may be required to post a performance bond.

Property and Casualty Insurance -- insurance that lessees are required to maintain on the leased asset to protect the investor in the event the asset is damaged or destroyed. The lessee can be required to maintain the insurance for the original or replacement value of the asset or for the outstanding **principal** balance. The lessee will have to sign a Certificate of Insurance or provide other proof that it has the insurance at the proper value.

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**.

Purchase Option Price -- the amount due to be paid by a lessee upon exercise of its **purchase option**. This amount includes the outstanding principal, accrued interest, and, as applicable, the **prepayment premium**. This amount may also serve as a casualty value or stipulated loss value for insurance purposes. **Purchase option prices** generally are shown in the **payment schedule**.

Quiet Enjoyment Clause -- a provision in the lease which specifically states that so long as a lessee is not in default, the lessee shall be entitled to the quiet use and enjoyment of the leased asset and that the lessor or its assignees shall not interfere or otherwise obstruct such use.

Quit Claim Bill of Sale -- legal evidence of a sale of an asset without warranty.

Rebate -- the payment of certain **arbitrage** earnings required to be paid to the United States Treasury under the **Internal Revenue Code**.

Redemption -- the repayment of principal of a lease or bond.

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 criteria under the **IRC**.

Registration -- see also **book entry registration**; the act of maintaining a listing of the names and addresses of the owners of municipal bonds and COPs. Registration usually is the responsibility of the **trustee** or a registrar. However, every issuer of tax-exempt securities with a term in excess of one year, including lease transactions, is responsible under the IRC for maintaining or causing to be maintained the registry of the holders of its securities.

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 established from lease proceeds 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 partially funded by the lessee 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.

Safe Harbor -- an exemption from a rule or restriction provided that the conditions of the exemption are satisfied.

Sale-leaseback -- an arrangement where 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. The lease can be structured as an **operating lease** where the new owner can depreciate the asset or as a tax-exempt lease for which the new owner receives tax- exempt interest and the original owner reacquires 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.

Secondary Market -- a term describing the purchase and sale of securities (including tax-exempt bonds, leases, and COPs) between investors at a time after the original sale of the securities. Frequently, the **underwriter** will maintain a secondary market for large issues to facilitate the orderly buying and selling of the securities at any time during their term. There is very little secondary market activity for individual privately placed tax- exempt leases. Some larger institutions have sold parts of their tax-exempt lease portfolios to other institutions or public unit trusts.

Section 103 -- the section of the **Internal Revenue Code** that defines the types of governmental units that qualify as tax exempt.

Security Interest -- a legal claim to property that provides security to an investor (the secured party) in the event the borrower/lessee fails to make all payments otherwise due. Security interests are usually granted under the terms of the lease agreement. In most cases, security interests are recorded through the filing of a UCC-1 for equipment or, for vehicles with license plates, by a notation on the vehicle's **certificate of title** of the secured party's interest. For transactions involving real property, the security interest is usually recorded in the same manner as a mortgage lien. Secured parties have superior rights to creditors of the lessee respecting the assets in which they have a security interest, both prior to and in bankruptcy proceedings.

Simple Interest -- interest charged only on the principal amount and not on interest earned but not paid.

63-20 Organization -- a shorthand expression for a non-profit corporation created by a municipality to act as **nominal lessor** to build and acquire assets for which the municipality is lessee. Its name is derived from Revenue Ruling 63-20 (of the Internal Revenue Service) which establishes the parameters for this type of organization.

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 IRC and, in California, the Revenue and Taxation Code, interest it pays is exempt for federal and state income or franchise 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, state 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, etc., 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.

True Lease -- a lease, which does not involve tax-exempt interest, in which (i) the lessor owns and receives tax benefits of depreciation on the asset being financed, enjoys the benefit and risk of any residual value at the end of the lease term, and is considered the true owner of the asset and (ii) the lessee receives only a right to use (has no equity build-up), can deduct its rental payments (if the lessee is a taxable entity) and has the option to purchase the asset at approximately its fair market value at the end of the lease.

Trust Agreement -- see **Escrow Agreement**.

Trustee -- see **Escrow Agent**.

UCC-1 Financing Statement -- see also **Certificate of Title**; a form, that once executed by a lessee and lessor and filed with the appropriate state agency (viz., the Secretary of State and, as applicable, the county recorder) records and perfects the lessor/investor's **security interest** in the leased property. The UCC-1 is used in the vast majority of tax-exempt leases in which title to the leased property is in the name of the government lessee.

Underwriter -- purchases bonds or COPs from the lessee/issuer or **escrow agent** with the intent to resell the securities to investors. In a firm underwriting, the **underwriter** guarantees the purchase of securities at a predetermined interest rate. In a best efforts underwriting, the underwriter agrees to utilize all reasonable resources to sell the securities (but without liability to do so or to purchase unsold securities.) Where the purchase is guaranteed, the underwriter will usually pre-sell the certificates to investors prior to closing or if unable to, the underwriter, for at least a temporary period, may be the owner of the certificates.

Underwriter's Concession -- also known as underwriter's spread; the amount deducted from the proceeds of the sale of securities by the underwriter as compensation for the undetermined selling efforts and related risks.

Underwriter's Counsel -- an attorney that represents the interests of the underwriter in a negotiated sale of COPs. Underwriter's counsel usually will review all transaction documents and will negotiate issues affecting the underwriter. Areas of particular concern include **disclosure** and securities laws compliance and **registration** requirements.

Underwriter's Discount -- also called underwriter's spread; the difference between the principal amount of a security and the purchase price paid to the issuer or the **trustee** by the **underwriter**.

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.

Yield -- the rate of interest paid to an investor.

APPENDIX B

Resources

RESOURCES

This section lists publications and organizations that can serve as resources for further information on tax-exempt leasing. The list of references contains articles, pamphlets, and books that address various leasing issues. It does not provide an exhaustive bibliography on municipal debt management.

The second list is of national organizations that offer staff and/or technical assistance on lease financing. In addition to these national organizations, there are many state and regional associations that represent government officials that may also be able to provide assistance and from which readers can seek information. Additional information and assistance is also available from state agencies such as the California Debt Advisory Commission (CDAC).

PUBLICATIONS

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Horler, Virginia L. Guide to Public Debt Financing in California. San Francisco, CA: Packard Press, September 1987.

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Mardikes, George M., McLaughlin, Paul E. and Gorman, Gwen E. Fifty State Survey -- Governmental Leasing: Surveys of Federal Tax Law, Federal Securities Law and of Legislation and Case Law in the Fifty States. Washington, DC: Association for Governmental Leasing & Finance, 1990.

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Moody's Investor's Service. "Moody's Views on Lease Rental Debt." in Moody's Municipal Issues. New York, NY: Moody's Investors Service, March 1989.

Moody's Public Finance Seminars. Seminar Workbook, March 1990.

Petersen, John E. and Eitelberg, Cathie G. "The Tax Reform Act of 1986: Major Provisions Affecting the Tax-Exempt Securities Market." Government Finance Officers Association, Special Bulletin, October 6, 1989.

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Standard & Poor's Corporation. "Municipal Leases." Credit Review. New York, NY: Standard & Poor's Corporation, April 9, 1990.

Vogt, John A. and Cole, Lisa A. A Guide to Municipal Leasing. Chicago, IL: Municipal Finance Officers Association, 1985.

White, Wilson. Basics: The Municipal Bond Market. Jersey City, NJ: The Financial Press, 1985.

ORGANIZATIONS

Associations

American Association of Equipment Lessors
1300 North 17th Street
Arlington, VA 22209
703/527-8655

Association for Governmental Leasing & Finance
1101 Connecticut Avenue, NW Suite 700
Washington, DC 20036
202/429-5135

Government Finance Officers Association
180 North Michigan Avenue 8th Floor
Chicago, IL 60601
312/977-9700

or

1750 K Street, NW Suite 200
Washington, DC 20006
202/429-2750

Public Securities Association
40 Broad Street 12th Floor
New York, NY 10004
212/809-7000

or

1000 Vermont Avenue, NW Suite 800
Washington, DC 20005
202/898-9390

Other Organizations

Capital Guaranty Insurance Company
One Market Plaza
San Francisco, CA 94105
415/995-8000

Financial Guaranty Insurance Company (FGIC)
175 Water Street
New York, NY 10038
212/607-3039

Fitch Investor Service, Inc.
One State Street Plaza
New York, NY 10004
212/908-0500 or 800/753-4824

Governmental Accounting Standards Board
P.O. Box 5116
Stamford, CT 06856
203/847-0700

MBIA Corp. (Municipal Bond Investors Assurance Corp.)
113 King Street
Armonk, NY 10504
914/273-4545

Moody's Investors Service
99 Church Street
New York, NY 10007
212/553-0826

National Association of Bond Lawyers
Box 397
Hinsdale, IL 60522
312/920-0160

Standard & Poor's Corporation
25 Broadway 21st Floor
New York, NY 10004
212/208-1779