The Basics of Municipal Leasing

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Majestic Ballroom

Panelists:
Tasha Barreau, U.S. Bancorp Government Leasing & Finance
Elizabeth Gilbert, Dell Financial Services

Moderator:
Evan Howe, Baystone Government Finance
How do State & Local Governments Traditionally Raise Capital?

- Levy (or raise) Taxes
- Create an Indebtedness (Bonds, Notes, Obligations)
  a. General Obligation
     - Full Faith and Credit
  b. Revenue Backed
     - Water & Sewer
     - Sales Tax
- Fees and User Charges
The Other Alternative!!!: Municipal Lease Purchase

- Developed in the 1960’s to support the Office Technology boom.
- Legally not a debt. (Constitution)
- Considered Debt for GAAP Accounting & Credit Analysis.
- **Why:** Non-Appropriation Clause

***Payments are *not* absolute, the funds *must* be appropriated each fiscal period.
What is a Municipal Lease?

- A Lease/Purchase Agreement, pursuant to which:
  - The Lessee (*a/k/a* the “borrower”), which is a state or local government or political subdivision –
  - purchases specific real or personal property from the Lessor (*a/k/a* the “lender”) –
  - by making periodic lease payments over an established time-period, during which Lessee builds equity in the property (& gets ownership at end of term for $1) –
    - Conditional Sale
  - subject to annual appropriation (or subject to an acceptance and rent abatement clause in CA & IN) –
  - usually, interest portion of lease payment is tax-exempt.
    - ✔ Section 103 of the IRS code
What Can Be Leased?

Personal Property Examples

- Vehicles, such as Fire Trucks, Police Cars, Ambulances, Refuse Trucks & School Buses
- Telecommunications Equipment
- Computers & Software
- Copiers & Other Office Equipment
- Safety Equipment
- Energy Management Systems, such as HVAC equipment
- Medical Equipment
- Modular Buildings
- Substitute Collateral
What Can Be Leased?

Real Property Examples

- School Facilities
- Courthouses
- City Halls
- Fire Houses
- Hospitals
- Nursing Homes
- Correctional Facilities
- Public Utilities Facilities
- Libraries
- Airport Facilities
- Recreational Facilities
- Manufacturing Facilities
- Substitute Collateral
Who are Eligible Lessees?

**Direct Issuers: (100,000 Nationally)**

- States
- Local Governments & Other Political Subdivisions
  - Such as:
    - Cities & Counties
    - Public Schools & Colleges
    - Fire Protection Districts
    - Ambulance Districts
    - Public Utility Districts
- Native American Tribal Governments (Sovereign)

**Requires On-Behalf of Issuer for Tax-Exempt Issuance:**

501(c)(3) Organizations
  - Generally includes:
    - Charitable, Religious & Educational Entities
    - Hospitals
    - Private Schools

Certain Private Parties
  - Such as:
    - Manufacturers
    - Other Exempt Facilities
Who are Eligible Lessors?

(Almost Anyone!)

- Brokers/Packagers
- Vendors
- Investment Bankers
- Banks, as lenders
- Banks & Trust Companies, as trustees
- Captive Finance Companies
- Independent Finance Co.
- Other Governmental Entities
- Non-profit corporations
Who are the Investors?

(Or, Who’s Loaning the Money?)

- Banks
- Corporations
- Mutual Funds
- Insurance Companies
- Individuals
- Grantor Trusts (Securitization)
- Investment Bankers
Why Use Lease Financing?

- Alleviates cash flow burden that would be created by a lump sum capital expenditure.
- A lease (unlike bonds) is not generally classified as "debt", therefore –
  - No voter approval required, which allows for more timely financing.
  - Lease is usually not subject to legal debt limitations.
- Lease does not encumber Lessee’s tax or other revenues, unlike a bond financing.

- More structuring flexibility than with bonds.
  - Can match separate lease terms with each asset’s expected useful life.
- Benefits of a direct lease or a single-investor lease vs. a public offering of bonds:
  - Lower transaction costs
  - More flexibility in timing & structure
  - Fewer documents
  - Less complicated for Lessee
The Municipal Leasing Market Today

- More strict credit requirements, greater emphasis on Lessee financials/financial reporting requirements
- More tangible equipment, less software/soft costs
- Energy Performance Contracts—Investors want shorter tenors—Lessees/Vendors want longer tenors
- Master Lease Agreements
  - More requests to amend & make changes
  - Less accommodating to Lessees
  - No longer “cookie cutter” in their form & substance
- Request for Proposals
  - Fewer Master Lease RFP’s, more “one off” requests
- Greater emphasis on “Essentiality” of equipment
## Common Municipal Leasing Terms

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<th>Description</th>
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| Bank Qualified           | - Must be for Governmental Purpose or 501 (c)3  
                          - Does not reflect credit quality  
                          - Lessee expects to borrow less than $10 Million during that calendar year.               |
| Private Activity         | Over 10% of the financed facility or equipment will be used by a private concern.                                                        |
| Non-Substitution         | The borrower is not allowed to replace the equipment for a period of time following a non-appropriation.                                    |
| Reimbursement Resolution | Allows a lessee to reimburse cash outlays from bond or lease proceeds (Must be done within 60 days of expenditure.)                     |
| Firm Term Lease          | Not subject to annual appropriation                                                                                                       |
Credit Requirements

Primary Analysis

• Ability to Pay
• Willingness to Pay
Ability to Pay

- Financial Performance
- Debt Management
- Economy
- Construction Risk
- Source of Repayment
- Insurance
Willingness to Pay

• Political Situation
• Essentiality of Asset
• Security Interest in the Asset
• Government Authorization
Ability to Pay

Financial Performance

• Revenue & Expenditure Analysis
• Fund Balance & Balance Sheet
• Budget Process and Limits
Revenue & Expenditure Analysis

Sources of Revenues
• Limits
• Vulnerability to Economic Cycles
• Non-recurring

Sources of Expenditures
• Fixed vs. Discretionary
• Limits on Growth

Identify Available Funds
• General
• Special Revenue
• Enterprise
• Debt Service

Surplus vs. Deficit Operations
Fund Balance & Balance Sheet

• Fund Balance Trend

• Fund Balance as a % Expenditures
  – Type of Issuer SD vs. County
  – Public Policy Issues

• Fund Balance Composition
  – Reserved
  – Unreserved
Ability to Pay

Debt Management

- Debt Burden
  - Debt per Capita
  - Debt % Full Value
  - Debt Service % Expenses
  - Overlapping Debt

- Future Debt Plans

- Debt Limits
  - Statutory or Practical
  - Remaining Debt Capacity
Ability to Pay

Economy

• Population Trends
  – Pressure on budgets and demands for services

• Wealth and Income Levels
  – Absolute
  – Relative to Debt

• Employer & Tax Base Concentrations
  – Top 5 payers or employers
  – Industry concentrations
  – Unemployment Trends
Ability to Pay

Construction Risk

• Key in abatement leases, but consider for all leases
• Type of Construction
• Fixed Price Contracts
• Capitalized Interest vs. Construction Period
• Experience of Lessee and Contractors
Ability to Pay

Source of Repayment

• Typically General Fund Monies
• Limited Sources
  – What is source?
  – How is it generated?
  – How vulnerable to economic cycles?
  – Project dependent?
Willingness to Pay

Political Situation

• Popular Project
• Lease vs. Debt
• Prior defaults, non-appropriation or bankruptcies
Willingness to Pay

Government Authorization

- Majority Approval of Governing Body
- First Lease Payment Appropriated
- Contracting Authorization
Occurrence of Problems

- Very low default and non-appropriation rates
- Most occurred for three primary reasons
  - Project was expected to be self-supporting, was non-essential and did not generate sufficient revenues to cover lease payments
  - Extreme financial stress of the Lessee
  - Non-essential project – not the same definition for every issuer
Transaction Structures

- **Stand-alone lease-purchase**
- **Certificates of Participation ("COPs")**
  - Used when multiple investors are buying the Lease
  - Certificates represent a proportionate interest in the Lease
- **Lease Revenue Bonds ("LRBs")**
  - Used when there are multiple investors
  - Bonds are separate securities payable lease revenues
- **501(c)(3) Financings**
  - Lessor leases to conduit issuer, which subleases to 501(c)(3) organization
  - Payable solely from lease payments from 501(c)(3)
  - Sublease not subject to appropriation
Typical Lease Documents

• Lease/Purchase Agreement, which should incorporate:
  – Payment Schedule, stating dated date & separately stating principal & interest components
  – Equipment Schedule (including location and vendor)
• Assignment Agreement (if original Lessor will not hold the paper)
• Escrow Agreement (if all property is not paid for at closing)
• Tax Questionnaire
• Federal Tax Certificate
• IRS 8038-G or IRS 8038-GC

• Lessee’s Certificate
  – Include Incumbency Certification for officers authorized to execute the Lease, escrow draw requests (if applicable) & acceptance certificates
• UCC-1 Financing Statements
• Validity Opinion
• Tax Opinion
• Insurance Certificates
  – Property & Casualty
  – Rental Interruption (abatement)
  – Liability (in some cases)
  – Performance and payment bonds
• Acceptance Certificate
# Additional Documents for a Real Property Lease

- **Ground/site lease**
- **UCC-1 fixture filing in real property records**
- **Title insurance**
- **Phase I environmental assessment**
- **Appraisal**

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<tr>
<td>Assignment of construction and architect’s contracts</td>
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<tr>
<td>Survey</td>
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<td>Building permit and other required approvals</td>
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Additional Documents for Certificates of Participation

- **Trust document**
  - Authorizes delivery of the COPs
  - A third-party trustee or agent agrees to (1) accept an assignment of the Lessor’s right to receive payments under the Lease and (2) disburse those payments to the certificate owners

- **Official Statement or other disclosure document**

- **COPs**

- **Additional legal opinions**

- **Continuing Disclosure Agreement**
Document Issues

- **Proper Execution**
  - Usually requires approval by the governing body
  - Is the authorized representative the one who signed?

- **Can the validity opinion be reasonably relied upon?**
  - Consider expertise of counsel & any unusual State law requirements

- **Is a tax opinion necessary?**

- **Dating of Documents and Opinions**
  - Distinguish between document date and commencement date
  - Opinions should be dated the date of funding
Legal Issues: State Law Considerations

• Legal power to enter the transaction under state law

• Authorization by governing body and execution by authorized official

• Compliance with applicable debt limitations
  – In most cases, if a proper “nonappropriation clause” or “abatement clause” is included, the Lease is not subject to debt limitations
  – The incorporation of such clauses may limit other remedies such as acceleration

• Compliance with applicable interest rate limitations

• Compliance with applicable public bidding requirements –
  – For the purchase of the property; and/or
  – For the lease-purchase agreement itself
Legal Issues:
More State Law Considerations

- **Nonsubstitution clauses**
  - Are prohibited or limited in some states (potentially resulting in invalidation of the lease)
  - Are of doubtful enforceability in other states

- **Indemnity by Lessee**
  - May not be enforceable
  - Should be qualified by “to the extent permitted by law”

- **Title**
  - Title to personal property is often granted to the Lessee during the lease term, subject to Lessor’s right to retake the property
  - Some entities in some states are required to maintain title in Lessor during the lease term

- **Assignment**
  - Some Lessees require limitations on the ability of Lessor to assign rights under the Lease

- **Unique state requirements**
Legal Issues: Federal Tax Law Considerations

- Lessee must be a state or a political subdivision of a state (power to tax, power of eminent domain or police power)

- The Lease must be a “financing lease”—
  - Separately stated interest component
  - Nominal purchase price at end of lease
  - Term less than useful life

- The Lease must be in “registered form”—the Lessee or its agent must keep a record of the assignees

- Restrictions on amount of lease-financed property that may be used in private use
  - Requires limitations on assignment and subleasing and management contracts
  - Ownership or leasehold interest is by definition “use”
Legal Issues:

More Federal Tax Law Considerations

- Arbitrage restrictions apply—
  - Expenditures of “proceeds”
  - Investment Limitations
  - Issue Price

- Rebate provisions generally apply unless—
  - No reserve fund & all proceeds spent within 6 months, or, in some cases, 18 months or 2 years; or
  - “Small issuer rebate exception” applies
    - Lessee issues no more that $5 million tax-exempt ($10 million for schools) in calendar year

- Bank-Qualification may be available if:
  - Lessee reasonably expects to issue no more than $10 million tax-exempt in a calendar year; and
  - Lessee does not designate more than $10 million as bank-qualified

- Need to document useful economic life of property on which proceeds are spent

- IRS Form 8038-G or 8038-GC must be timely filed
Why Do We Need the Lawyers!? 

• Lessee’s Counsel / (Local Counsel)

• Tax Counsel

• Lessor’s Counsel

• Underwriter’s Counsel
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