AN INTRODUCTION TO MUNICIPAL LEASE FINANCING: ANSWERS TO FREQUENTLY ASKED QUESTIONS

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INTRODUCTION

Tax-exempt municipal lease financing is an effective and increasingly popular vehicle for state and local governments to finance and refinance equipment acquisitions, the construction of public facilities and the expansion and rehabilitation of existing public facilities. State and local government officials, leasing professionals, investors and other participants in the municipal leasing marketplace who are considering a tax-exempt municipal lease financing for a state, city, county, school district, special district or public authority to finance or refinance governmental capital projects frequently raise questions concerning how to structure such a financing.

The Association for Governmental Leasing & Finance has designed this booklet to respond to frequently asked questions concerning tax-exempt municipal lease financing. Each of the Sections in this booklet initially outlines questions that are frequently asked and then provides information in the text that follows explaining the responses to those questions.

This booklet describes certain general principles that apply to municipal lease financing in most states. While this booklet is intended as a reference source to explain these general principles, it should not be relied upon as a substitute for professional financial and legal advice with respect to a particular lease financing.

I. GENERAL CONSIDERATIONS

When evaluating whether or not to enter into a municipal lease financing, state and local government officials and other market participants frequently raise the following questions:

- What are the advantages and disadvantages of municipal lease financing?
- What is the difference between a “true” lease and an “operating” lease?
- What are the differences between municipal lease financing and revenue bond or general obligation financing?
- How may municipal lease financing and revenue financing be combined to achieve a higher credit quality for the transaction?
- What is the tax treatment of municipal lease financings under both state and federal law?
- Why are there higher interest costs for municipal lease financing when compared to general obligation financing?
A. ADVANTAGES, DISADVANTAGES AND CHARACTERISTICS OF MUNICIPAL LEASE FINANCING

Advantages of Municipal Lease Financing

Municipal lease financing enables a state or local government (referred to in this booklet as a “Government Body”) to:

(1) finance a variety of governmental projects without incurring a “debt” or an “indebtedness” that is subject to the voter approval and debt limitation requirements contained in most state constitutions or otherwise provided by statute;

(2) implement a flexible financing structure that best serves its particular needs and that is frequently not subject to certain restrictions that may be imposed under applicable state law on other types of financing, such as public sale requirements and interest rate limitations;

(3) acquire all of the equipment that it presently needs and spread the cost of such equipment over time rather than merely acquiring equipment on a pay-as-you-go basis, which limits the amount of equipment that may be acquired to the current year’s available revenues in light of other demands on the current year’s resources;

(4) finance facilities for which obtaining voter approval is extremely difficult or even impossible, such as jail facilities, law enforcement facilities or public schools in areas where older populations will not approve general obligation debt to pay for public school facilities; and

(5) take advantage of cost-effective financing for the acquisition and construction of property over time rather than depleting existing reserves.

Disadvantages of Municipal Lease Financing

The disadvantages of municipal lease financing include:

(1) the higher interest cost associated with municipal lease financing when compared with general obligation debt; and

(2) the risk that the Government Body may lose its accumulated equity in the leased property if the Government Body decides not to appropriate moneys to make lease payments for a subsequent fiscal period and returns the leased property to the investors.

Differences Between “True” or “Operating” Leases and a “Financing” Lease

In a “true” or “operating” lease, the lease payments represent the economic value of the use and enjoyment of the leased property during the lease term, but do not represent the installment purchase by the lessee of any ownership interest in the leased property. In a “true” or “operating” lease, the lessor is the owner of the property for federal tax purposes and is entitled to whatever tax
benefits (such as depreciation) are available under federal tax law. Any option to purchase the leased property under a “true” or “operating” lease is typically exercisable at a price equal to the fair market value of the leased property on the future exercise or purchase date.

In a “financing” lease, the lessee enjoys the benefits and bears the burdens of ownership of the leased property and is, consequently, treated as the owner of that property for federal tax purposes. In effect, the lease payments represent the lessee’s installment purchase of the leased property over time. Under a “financing” lease, the lessee will acquire unencumbered title to the leased property at the end of the lease term upon payment of nominal consideration. Any purchase option that may be exercised during the lease term will typically require payment of the unpaid principal balance of the amount originally advanced for the leased property plus any accrued interest and any premium.

Differences Between Municipal Lease Financing and Revenue Bond Financing

In a typical revenue bond financing, a revenue-producing facility (such as a water, sewer or electric system) generates revenues that are used to pay the operating expenses for the facility and debt service on the obligations incurred to finance the acquisition and construction of the facility. The facilities financed with lease financing frequently are not revenue-producing (such as a city hall, fire station, jail facilities, etc.). Consequently, a lease financing is generally not specifically supported by revenues generated through operation of the financed facility, but is repaid through annual or biennial appropriations from the Government Body’s general, operating or capital improvement funds or other legally available funds. Alternatively, if the leased facility is revenue-producing, the revenues may be used as a “special fund” source of payment instead of or to supplement the Government Body’s tax revenues or other funds thereby reducing the use of tax revenues or other funds, subject to applicable state law. In many states, revenue bonds may be secured by a “pledge” of revenues of the revenue-producing facility, but those revenues may not be “pledged” to make lease payments (even though they may be used as a source to make lease payments).

Differences Between Municipal Lease Financing and General Obligation Financing

In a typical general obligation financing, the issuer of the general obligation bonds covenants and agrees in accordance with applicable state law to levy and collect ad valorem property taxes, without limit as to rate or amount, in an amount sufficient to pay principal of and interest on the bonded indebtedness when due. In many states, the state constitution or statutes will impose a covenant to levy taxes without limitation as to rate or amount to secure a Government Body’s general obligation indebtedness. The effect of these contractual, constitutional and statutory requirements is to create a highly secure payment source for general obligation indebtedness.

In contrast, a municipal lease financing is based upon the agreement of the Government Body to make lease payments, which (in the majority of states where such financing is permitted) is subject to annual or biennial (as appropriate) renewal or termination at the option of the Government Body. The lease payments are made from moneys appropriated annually or biennially (as appropriate depending upon state law) from the Government Body’s general, operating, capital improvement or revenue enterprise funds in accordance with applicable state law governing budgeting and appropriations.
In some states, lease financing may in fact be a long-term financing for a specified period of time without being subject to annual or biennial renewal or termination at the option of the Government Body. For example, in California and certain other states, a lease financing may be payable from amounts budgeted and appropriated each year for the entire multi-year term of the lease so long as the beneficial use and enjoyment of the leased property is substantially available to the Government Body.

Combining Municipal Lease Financing and Revenue Financing to Improve Credit Quality

If the Government Body proposes to finance a revenue-producing facility (such as parking structures or recreation facilities), a lease financing may be combined with a revenue bond financing to strengthen what may otherwise be an unmarketable revenue bond. For example, if the revenue-producing facilities have experienced significant and unpredictable fluctuations in revenues or lack an operating history, a lease financing may be used to assure investors that the Government Body will seek appropriations annually or biennially (as appropriate) sufficient to make debt service payments to the extent that revenues are insufficient to make those payments. On the other hand, a municipal lease financing for this type of project may be difficult to achieve because of the investors’ concern over the “essentiality” of the project as discussed under “LEGAL ISSUES—State Law—Essential Use Certificates” below.

B. TAX TREATMENT AND INTEREST COSTS ASSOCIATED WITH MUNICIPAL LEASE FINANCING

Tax Treatment Under Federal Law

The Internal Revenue Code provides that interest on an obligation of a state or a political subdivision of a state is excludible from gross income for federal income tax purposes. Interest on a Government Body’s obligations under a properly structured “financing” lease or installment sale contract would be excludible from gross income for federal income tax purposes under present law (assuming continuing compliance with certain tax covenants to maintain tax-exemption).

Tax Treatment Under State Law

The manner in which a lease, installment purchase contract or other municipal financing instrument is treated for state tax purposes depends on the state’s income tax laws. A Government Body that is interested in municipal lease financing should explore the state tax consequences of such a financing with its tax counsel.

Treatment of Interest Component of Rental Payments Under “True” or “Operating” Lease Versus “Financing” Lease

The “interest component” of rental payments paid by a Government Body under a properly structured “financing” lease would be treated as tax-exempt for federal income tax purposes to the “owner” of the lease, and the lease should, therefore, be priced at a tax-exempt rate based upon the lessee’s credit.
By contrast, under a “true” or “operating” lease no portion of the rental payment would be tax-exempt to the lessor, but the lessor would be entitled to tax benefits (such as depreciation) resulting from its ownership of the leased property. The rental payments under a “true” or “operating” lease will not, therefore, reflect a tax-exempt interest rate to the Government Body and may not pass through any economic benefit to the lessee that results from the lessor’s ownership of the leased property for federal tax purposes.

The Internal Revenue Service has clearly provided that a lessor and a lessee in a municipal lease financing cannot enjoy the advantage of both the tax benefits of ownership of the leased property by a private lessor and the treatment of the interest component of rental payments as tax-exempt, which itself depends upon the lessee being the “owner” of the leased property for federal tax purposes.

Higher Interest Costs for Municipal Lease Financing

The higher interest cost results from differences in the type of security that is provided for a municipal lease when compared to a general obligation bond. The security for a typical municipal lease is (a) the agreement of the Government Body that its budget officer or other primary business official will do all things lawfully within such officer’s or official’s power to include amounts to make lease payments in each budget that will be submitted to its governing body (except in states like California where the Government Body may agree to budget and appropriate moneys annually for the multi-year term of the lease sufficient to make such payments so long as it has the beneficial use and enjoyment of the leased property), and (b) the leased property in which a mortgage lien, a security interest, an assignment for security purposes or other interest may be granted by an appropriate party subject to the requirements of applicable state law that frequently limit the authority of a Government Body to mortgage or otherwise encumber its property. The security for a general obligation bond is typically the contractual covenant or constitutionally or statutorily imposed obligation of the Government Body to levy and collect taxes, without limit as to rate or amount, in an amount sufficient to pay principal of and interest on its general obligation bonds when due. The capital markets account for this difference in security and corresponding increased risk associated with a municipal lease by charging a higher interest rate for municipal lease financing than if the same property were financed with the proceeds of general obligation bonds for the same term.

II. PARTIES AND PURPOSES FOR MUNICIPAL LEASE FINANCING

State and local government officials and other market participants frequently ask the following questions with respect to the parties involved in municipal lease financing and the purposes for which a Government Body may lease property:

• Who are the lessor and the lessee in a municipal lease financing?

• For what purpose may a Government Body lease property?
A. THE LESSOR

Who the lessor will be in a municipal lease financing depends upon several considerations that are unique in each state and the type of municipal lease financing under consideration. In general terms, however, a Government Body considering a lease financing has four options for a lessor:

1. an independent leasing company or a leasing subsidiary of a financial institution such as a bank;

2. a trustee bank;

3. a “constituted authority” authorized under applicable state law to act as a lessor, such as a redevelopment agency, building ownership authority, parking authority, joint powers authority or other public agency; or

4. a nonprofit corporation or public benefit corporation organized under applicable state law acting on behalf of the Government Body for the purpose of financing the acquisition and construction of real and personal property.

Independent Lessors and Trustee Banks

If the Government Body decides to use an independent leasing company, a leasing subsidiary of a bank or a trustee bank as lessor (each is referred to herein as a “private lessor”), careful consideration must be given to (a) the potential ad valorem property tax and sales tax implications of the ownership by a private lessor of the equipment or real estate financed, which may introduce an unnecessary and unexpected cost into the financing, and (b) insulating the financing transaction from the potential bankruptcy of the private lessor so that no effort may be successfully made by creditors of the private lessor to recapture the equipment or facility financed or disrupt the rental payments that are the subject of the Government Body’s lease financing.

Typically in an equipment lease financing, title to the leased property is transferred immediately upon execution of the lease to the lessee, subject to a security interest retained by the lessor or granted by the lessee that may or may not be assigned to a third party. Under the laws of several states, the imposition of ad valorem property taxes and sales taxes depends upon ownership of “title” to the property so that the transfer of title to the Government Body initially may avoid the imposition of ad valorem property taxes and sales taxes on the financed equipment. However, in the context of real property lease financing, title to the real estate (for reasons unique to real estate financing) may not be transferred initially to the lessee, but is generally held by the lessor, a trustee bank or a trust. Consequently, if the Government Body uses a private lessor to act as lessor in a real estate financing the Government Body should carefully evaluate the potential imposition of ad valorem property taxes against the interests of the private lessor, which would become an additional rental obligation of the Government Body (which would be unnecessary and probably unexpected) under the lease. This is sometimes addressed by utilizing a lease-leaseback structure in which the lessee holds title to the real estate, leases the real estate to a private lessor under a ground lease for a term extending well beyond the term of the financing and leases the real estate and the improvements financed back under a
financing lease. See “TYPES OF MUNICIPAL LEASE FINANCING TRANSACTIONS—Real Property Lease” below.

In a typical lease financing with a private lessor, the bankruptcy issues relating to the private lessor are frequently dealt with by (a) minimizing any ongoing performance obligations of the lessor, which are generally limited to a covenant of quiet enjoyment; and (b) providing for an absolute transfer and assignment of all right, title and interest that the private lessor may have in the leased property and the lease to the investors in the lease or a trustee acting on their behalf. The lease and related documents (such as an absolute assignment agreement) are generally structured to minimize and hopefully eliminate the possibility that the bankruptcy of the private lessor could jeopardize the Government Body’s financing.

Constituted Authorities

If applicable state law authorizes the creation of a constituted authority to act on behalf of Government Bodies in that state for specific purposes, such as a redevelopment agency, parking authority, building ownership authority or other public agency, then the lessor in the lease financing may be such a constituted authority. A constituted authority typically is organized pursuant to state law that may exempt property it holds from ad valorem property taxation and may clarify certain other state law issues (such as the applicability of state sales tax) to the activities of such a constituted authority on behalf of the Government Body that organized it.

Nonprofit Corporations

In the absence of express state law authorizing the creation of a constituted authority, a Government Body may organize a nonprofit corporation or public benefit corporation in accordance with the general nonprofit corporation law of the state to act “on behalf of” the Government Body which has organized the nonprofit corporation for the purpose of financing the acquisition and construction of capital projects. The Government Body must be careful in the organization of the nonprofit corporation or public benefit corporation to comply with applicable Internal Revenue Service regulations in order to assure that interest on lease revenue bonds, leases or other obligations issued or executed by the nonprofit corporation or public benefit corporation on behalf of the Government Body will be exempt from federal income taxation.

A nonprofit corporation may be organized by a Government Body or others to act as lessor in a lease financing without acting “on behalf of” the lessee if such nonprofit corporation is not issuing obligations separate from the lease, but is merely assigning the lessor’s right, title and interest in the lessee’s rental payment obligations. See “TYPES OF MUNICIPAL LEASE FINANCING TRANSACTIONS—Lease Revenue Bonds—Differences Between Lease Revenue Bonds and Certificates of Participation” below.
B. THE LESSEE

The lessee will be the Government Body desiring to acquire the particular leased property. The agreement of the Government Body as lessee under the lease to pay rental payments (representing a principal component and an interest component) is the basis for treating the interest component of the rental payments as federally tax-exempt.

C. PURPOSES FOR WHICH A GOVERNMENT BODY MAY LEASE PROPERTY

The purposes for which a Government Body may lease property will depend upon the provisions of applicable state law. State law typically authorizes a Government Body to lease, purchase or otherwise acquire real and personal property. However, the authority to lease property in some states may be expressly limited to personal property, which may include fixtures to real estate but may not include real property itself. The Government Body must, therefore, be careful to establish its authority under applicable state law to lease the particular type of equipment or real estate that it desires to acquire or construct through this method of financing.

III. TYPES OF MUNICIPAL LEASE FINANCING TRANSACTIONS

Once the basic structure of municipal lease financing is understood, the following questions are frequently asked regarding the various types of municipal lease financing transactions that are available to a Government Body:

• What is a simple equipment acquisition lease and how is it funded?

• What is an “advance funded” equipment acquisition lease and what are its advantages and disadvantages?

• What is a real property lease and how does it differ from an equipment acquisition lease?

• May a Government Body use lease financing to acquire and construct a building separate from the ground on which it will be located?

• What remedies may be exercised against a site that is ground leased for the purpose of the acquisition and construction of a new building or the expansion and rehabilitation of an existing building?

• What is a master lease and when should a Government Body use a master lease?

• Under what circumstances may lease financing be used to finance a combination of real and personal property?

• When should a Government Body use a certificates of participation structure?
• What are the differences between lease revenue bond financing and certificates of participation financing?

• May a Government Body use a municipal lease to refinance existing leases?

A. SIMPLE EQUIPMENT ACQUISITION LEASE

Characteristics of a Simple Equipment Acquisition Lease

A simple equipment acquisition lease allows a Government Body to purchase and acquire certain identified equipment, which will be delivered to the Government Body prior to or on the date on which the lease is signed and for which the proceeds advanced by the investors in the lease will be applied simultaneously with the execution of the lease to pay the vendor the purchase price for the equipment. For example, if a Government Body needs to acquire five fire trucks for which purchase orders have been issued and which are to be delivered on or within a short period of a particular date, a simple equipment acquisition lease would provide that, upon delivery of the fire trucks in condition acceptable to the Government Body, the investor in the lease would immediately advance the funds necessary to pay the purchase price for the fire trucks. The equipment vendor would be paid from the funds advanced and the investor would then be entitled to receive rental payments paid by the Government Body under the lease for the five fire trucks for the stated lease term, subject to annual or biennial appropriation in most states. Due to the practical difficulties of coordinating the delivery of several pieces of equipment from various vendors over different periods of time, the simple equipment acquisition lease is ordinarily used for the acquisition of only a few pieces of equipment over a limited period of time and requires a great deal of coordination among the investor, the equipment vendor and the Government Body.

Financing Sources Available for a Simple Equipment Acquisition Lease

A simple equipment acquisition lease is frequently purchased by a financial institution, bank or finance company that is familiar with the Government Body and its finances and operations. To facilitate placing such a lease with an investor, particularly where the equipment vendor or supplier does not have a captive finance subsidiary, independent leasing companies often act as brokers to place these leases with individual or institutional investors.

In addition, the captive finance subsidiary of an equipment vendor may provide municipal lease financing to a Government Body for its acquisition of the equipment manufactured or supplied by the parent company through a simple equipment acquisition lease.

B. ADVANCE FUNDED EQUIPMENT ACQUISITION LEASE

Characteristics of an Advance Funded Equipment Acquisition Lease

If a Government Body’s equipment acquisition program involves a large number of pieces of equipment, several vendors and suppliers or a phased sequence for delivery of the equipment, a
Government Body may use an advance funded equipment acquisition lease to acquire several pieces of equipment over a stated period of time from several different vendors. When advance funding of an equipment lease is used, an escrow account or an acquisition account is created by or at the direction of the Government Body in which an escrow agent or trustee acting on behalf of the investors will hold the funds that are advanced by the investors for the equipment acquisition program. Moneys are then withdrawn from the escrow or acquisition account at the direction of the Government Body to pay the acquisition costs of equipment as it is acquired and installed. Moneys in an escrow or acquisition account represent the proceeds of the Government Body’s tax-exempt financing, are invested in qualified investments at the Government Body’s direction, accrue investment earnings for the benefit of the Government Body (subject to any arbitrage rebate liability as described under “LEGAL ISSUES—Federal Tax Law—Arbitrage Rebate for Municipal Leases” below) and typically are pledged as security for the Government Body’s rental payment obligation.

**Advantages of an Advance Funded Equipment Acquisition Lease**

The advance funding of an equipment acquisition lease enables the Government Body to (1) utilize a single advance funded lease rather than several simple equipment acquisition leases to finance needed equipment, (2) have a funded account available to pay equipment acquisition costs in connection with its equipment acquisition program and (3) finance the acquisition of a variety of equipment over time at an interest rate that is determined at the time of the initial advance funding of the lease.

**Disadvantages of an Advance Funded Equipment Acquisition Lease**

Once moneys are advanced into an escrow or other acquisition account, the Government Body becomes obligated to pay the interest cost for the total amount advanced (but is also entitled to the benefit of investment earnings on fund balances). Consequently, there may be a “negative carry” (that is, the interest cost on the lease exceeds the investment earnings on fund balances) during the acquisition period with respect to the moneys advanced but not yet expended which the Government Body should consider in assessing the actual economics of an advance funded equipment acquisition lease. In addition, using an advance funded equipment acquisition lease may require the Government Body to compute any arbitrage profit earned on amounts in the escrow account invested pending disbursement and to rebate such profit to the United States if none of the exceptions to arbitrage rebate are available in the particular financing. See “LEGAL ISSUES—Federal Tax Law—Arbitrage Rebate for Municipal Leases” and “—Exceptions from Arbitrage Rebate for Municipal Leases” below.

**C. REAL PROPERTY LEASE**

A Government Body may lease real property if it has the authority under applicable state law to lease, purchase or otherwise acquire real property. This Section outlines the differences between real property and equipment acquisition leases as well as specific issues that arise when a Government Body acquires and constructs a building through the use of a lease financing separate and apart from the ground upon which the building will be located.
Differences Between Real Property Leases and Equipment Acquisition Leases

While the equipment acquisition lease and the real property lease are similar in structure and certain principles (such as nonappropriation) apply to both, the financing of real estate raises unique issues that are not present in an equipment acquisition lease, such as zoning laws, construction permits, public bidding requirements on public works projects, status of real property title and permitted encumbrances, land surveys, title insurance, environmental issues and a variety of other issues that must be addressed. Consequently, a real property lease is generally more complicated, time-consuming and costly than an equipment acquisition lease.

Lease Financing to Acquire and Construct a Building Separate from the Ground on Which It Will Be Located

If the Government Body already owns the real property on which a new building or the expansion or rehabilitation of an existing building will be located, the Government Body, assuming state law so authorizes, may enter into a ground lease of the site to a private lessor, constituted authority or nonprofit corporation (as described in “PARTIES AND PURPOSES FOR MUNICIPAL LEASE FINANCING—The Lessor” above). The lessee of the site will then (1) finance the acquisition and construction of the building on the site and (2) sublease the site back and lease the building and other improvements to the Government Body, subject to the site lease. In addition, the Government Body may acquire the site and use this structure to address the concerns described under “PARTIES AND PURPOSES FOR MUNICIPAL LEASE FINANCING—The Lessor—Independent Lessors and Trustee Banks” above.

Through this mechanism, the construction of a new building or the expansion or rehabilitation of an existing building may be financed through a real property lease separately from the real property on which it is located. However, significant issues are raised with respect to the mortgaging or other encumbering of the site that is subject to the ground lease as described under the following Sections.

Remedies Available Against a Site That Is Ground Leased for the Purpose of the Acquisition and Construction of a New Building or the Expansion or Rehabilitation of an Existing Building

Depending upon applicable state law, if the Government Body owns the site, the Government Body may not be able to mortgage or otherwise subject the land itself to loss in the event that the Government Body fails to perform as lessee under the lease or decides not to appropriate lease payments. Remedies in a financing for which land has been ground leased may be limited to a mortgage lien or other collateral assignment on or interest in the leasehold estate created under the ground lease, but not a mortgage lien on the Government Body’s fee interest in the site. Consequently, if a trustee or investors obtain possession of the building and the land in a ground lease transaction as a result of the Government Body’s failure to perform under its lease or decision not to appropriate lease payments, the investors or the trustee will typically be permitted to operate the financed facility for a period of time specified in the ground lease. However, once the term of the ground lease expires, the Government Body is entitled to repossession of the site together with all improvements on the site free and clear of any interest of the investors or a trustee on their behalf.
Term of the Ground Lease and the Stated Full Term of the Facility Sublease

Due to the limitations on remedies described in the Section above, and to permit the investors or the trustee to have a sufficiently long period of time in which to operate the financed facility in order to maximize the opportunity to recover the amount financed together with interest, the term of the ground lease normally exceeds the stated full term of the facility sublease, often extending as long as is permitted by applicable state law.

D. Master Lease

Characteristics of a Master Lease

A master lease provides a document structure by which a Government Body may add to an existing lease additional equipment or other property that the Government Body has not specifically identified on the date of original execution of the master lease, but which the Government Body may acquire in the future. Rather than enter into a separate lease each time that the Government Body desires to acquire additional equipment or other property, the Government Body simply provides for a schedule, addendum or supplement to the original master lease in accordance with the provisions of the master lease to add the additional equipment to the property financed and acquired under the master lease. Upon the execution of such a schedule, addendum or supplement identifying the additional property to be financed under the master lease, funds are advanced by investors or a trustee on their behalf to finance the acquisition of the additional property.

The Government Body’s rental payment obligation under the master lease may be subject to annual or biennial appropriation (as required by applicable state law) on an “all-or-nothing” basis as to all schedules under the master lease or may be on a schedule-by-schedule basis depending upon applicable state law, which will also affect the extent to which the leased property will secure all or particular schedules under the master lease. Generally speaking, the Government Body will have the same obligations and responsibilities for the benefit of all investors who have advanced funds for equipment or other property acquired by the Government Body pursuant to the master lease. Some master leases, however, are drafted so that separate schedules operate (or may operate) as independent leases so that an investor in a particular schedule will be satisfied with the terms and conditions of that schedule and control the exercise of remedies with respect to the leased property under that schedule.

Advantages of a Master Lease

A master lease may be very useful to a Government Body that has an equipment acquisition program that extends over several years and for which the Government Body has not identified all of the equipment or other property to be acquired at the time the lease is initially executed. The advantage to the Government Body is that the master lease structure is in place and additional leases do not need to be negotiated in order to finance the additional equipment or other property to be acquired. From the point of view of analyzing the credit of the transaction, all equipment and property financed under the
master lease may be equally subject to the terms and conditions of a single master lease, unless each schedule is treated as an independent lease.

Use of a Master Lease to Finance Real Property

Assuming that state law so authorizes, a master lease may be used to finance the acquisition and construction of real property as well as equipment and other personal property. The unique characteristics of a municipal lease financing for real estate, as described under “TYPES OF MUNICIPAL LEASE FINANCING TRANSACTIONS—Real Property Lease” above must, of course, be taken into account in a master lease for a series of real property acquisitions.

E. LEASE FINANCING FOR COMBINED REAL AND PERSONAL PROPERTY

In some circumstances, a combination of real and personal property financed under a master lease or a “stand-alone” lease has strengthened the credit quality of the equipment financing by the use predominantly of a lease for the financing of real property. For example, a Government Body could acquire both equipment and real property under a single master lease or a “stand-alone” lease with most of the financed costs being attributable to the real property. The credit analysis for this type of financing would then depend upon the essential nature of the real estate financed rather than the relatively small portion of equipment financed.

On the other hand, in some situations the combination of real and personal property in a master lease or a “stand-alone” lease may result in a credit analysis based on the “weakest link” and thereby detract from the credit that may otherwise be attributable to a lease financing solely of real property. Careful analysis must, therefore, be made of the proper combination of real and personal property under a lease financing and the relative essentiality of the different types of leased property in order to maximize the credit benefit derived from combining real and personal property, if at all, under the master lease or a “stand-alone” lease.

F. CERTIFICATES OF PARTICIPATION

Characteristics of a Certificate of Participation

A certificate of participation is a certificate executed by a trustee under a trust agreement acknowledging that the owner of the certificate is entitled to receive a proportionate distribution of the moneys received by the trustee from the rental payments to be made by or on behalf of a Government Body under a specified lease or leases. The certificate represents the fractionalized interest of its owner in the lease payments, and the trustee that executes the certificate is obligated only to make distributions with respect to the certificate to the extent that it actually receives rental payments from the Government Body under the lease.
Appropriate Use of Certificates of Participation Financing

A certificates of participation financing is typically used in larger equipment or real estate financings where the Government Body must access the capital markets in order to obtain the financing necessary for its particular project. A certificates of participation financing is typically done in situations where the principal amount involved is relatively substantial so that the distribution of certificates may be made more broadly than would otherwise be the case in a simple equipment acquisition lease, which is generally placed with one or a limited number of investors.

As a practical matter, a certificates of participation financing will resemble in many respects a negotiated underwritten bond issue, including $5,000 denominations, stated serial and term payment dates and prepayment options as well as the related primary and secondary market disclosure responsibilities under the federal securities laws. See “LEGAL ISSUES—Securities Law” below. Consequently, while a certificates of participation financing contains the elements that are also present when a Government Body uses a simple equipment acquisition lease, an advance funded equipment acquisition lease or a master lease to finance equipment and/or real property, the certificates of participation introduce additional complications to the transaction that are similar to those associated with any public offering of municipal securities.

Structure of a Certificates of Participation Financing

Included at the back of this booklet as Exhibit A is a diagram illustrating the basic structure of a certificates of participation financing. In addition to the standard elements of a municipal lease, in a typical certificates of participation financing the lessor (simultaneously with the execution of the lease) assigns all of its right, title and interest in the lease, including the right to receive the rental payments, to a trustee under a trust agreement. The trust agreement provides elaborate detail on the security for the certificates, the funds and accounts to be administered, the terms for the certificates (such as distribution dates, interest rates and prepayment features) and the provisions applicable to the trustee and the discharge of its responsibilities. The trustee under the trust agreement executes the certificates of participation that are purchased by an underwriter or institutional investor as illustrated in Exhibit A.

Disbursement of Proceeds Received from the Sale of Certificates of Participation

A construction account is created under the trust agreement and is funded with the proceeds of sale of the certificates of participation. Moneys are disbursed from the construction account by the trustee as acquisition and construction of the project progresses, upon receipt of written requisitions from the Government Body.

Investment Earnings on Amounts Held in the Construction Account

Unless one of the exceptions to the arbitrage rebate requirement is available, the Government Body will typically be entitled to the investment earnings on amounts held in the construction account only up to the amount of such earnings that would be generated if the investments were made at a yield equal to the yield on the lease and any earnings in excess of that yield would have to be rebated to the
United States as required by the Internal Revenue Code as described under “LEGAL ISSUES—Federal Tax Law—Arbitrage Rebate for Municipal Leases” below.

G. LEASE REVENUE BONDS

Differences Between Lease Revenue Bonds and Certificates of Participation

Lease revenue bonds are issued if state law expressly authorizes the issuance of such bonds by a particular issuer, such as a building ownership authority, redevelopment agency, parking authority or other public agency. Lease revenue bonds may also be issued through a nonprofit corporation organized under applicable state nonprofit corporation law, which issues such bonds “on behalf of” the Government Body that organizes and controls such nonprofit corporation. If the Government Body has the authority to lease, purchase or otherwise acquire real or personal property under state law, but state law otherwise does not provide for the issuance of lease revenue bonds by a constituted authority or a nonprofit corporation acting on behalf of the Government Body, then the Government Body would be limited to using a certificates of participation structure in order to access the capital markets, unless the lease is privately placed directly with an investor or limited number of investors.

Characteristics of Lease Revenue Bond Financing

Included at the back of this booklet as Exhibit B is a diagram illustrating the basic structure of a lease revenue bond financing. As may be seen by a comparison of Exhibit A and Exhibit B, a certificates of participation financing and a lease revenue bond financing have similar elements. The principal distinction between these two financing methods is structural: certificates of participation represent a pass-through of the rental payments made by the Government Body under the lease; lease revenue bonds, on the other hand, are a direct obligation of the Government Body or “on behalf of” issuer issuing the lease revenue bonds, with the lease itself being security for the obligation.

Exhibit C included at the back of this booklet is a diagram of the cash flow that is virtually identical for lease revenue bonds and certificates of participation.

Use of Lease Revenue Bond Financing Versus Certificates of Participation Financing

In most circumstances, if a Government Body may use both lease revenue bond financing and certificates of participation financing under applicable state law, a lease revenue bond financing will generally be preferable because of (1) the presence in many (but not all) instances of express statutory authority which should resolve many state law issues for the issuance of those bonds that otherwise are not clearly answered with respect to a certificates of participation financing and (2) a perceived more favorable market acceptance for lease revenue bonds when compared with certificates of participation.

Because lease revenue bonds are frequently authorized to be issued pursuant to an express statutory framework, a Government Body may encounter particular restrictions in the statutory framework (such as limitations on the amount of capitalized interest or the type of equipment or real
property that may be financed within the statutory framework) which would make a certificates of participation financing advantageous. In these unique circumstances, a Government Body may want to consider using a certificates of participation financing rather than a lease revenue bond financing to avoid these restrictions.

H. REFINANCING EXISTING LEASES

Use of a Municipal Lease to Refinance Existing Leases

Depending upon applicable state law and the terms of the existing leases to be refinanced, a Government Body may use a new lease financing to refinance its existing leases.

Reasons to Refinance Existing Leases

The most significant reason to refinance existing leases is to take advantage of any reduction in interest costs that may be realized by entering into a lease at current market rates in light of the interest costs that may be applicable under the Government Body’s existing leases. Other reasons to refinance existing leases include restructuring the timing or amounts of rental payments and the administrative convenience of combining several leases into a single lease with a single lessor.

Use of a Certificates of Participation Financing to Accomplish a Refinancing of Several Existing Leases

If a Government Body has several existing leases at interest rates substantially higher than what the current market rate may be, and depending upon the terms of those existing leases, a Government Body may use a single lease to acquire all of the equipment that is subject to the existing leases and have that single lease assigned to a trustee which would then issue certificates of participation, thereby achieving a single structure in which the interest rates are established under the current market rate.

Contractual Provisions of the Existing Leases that the Government Body Must Analyze in Connection with its Refinancing

If the Government Body decides to refinance existing leases, and particularly where several leases may be combined into a single certificates of participation financing, each of the existing leases to be refinanced must be carefully examined to determine: (1) the right of prepayment, (2) the terms of prepayment, such as notice provisions and any limitations on the dates on which prepayments are permitted (such as only permitting prepayment on rental payment dates) and whether prepayment may be in part as well as in whole or limited to a particular minimum amount, and (3) any premium applicable upon such prepayment.

If the aggregate principal component of a Government Body’s rental payments under its existing lease is not paid or prepaid in full simultaneously with the execution and funding of the refinancing lease, the original rental payment obligation under the existing lease must remain in effect until such payment or
prepayment is actually made. Otherwise, the investors in the existing lease are likely not to have a continuing tax-exempt obligation notwithstanding the execution and funding of the refinancing lease.

IV. LEGAL ISSUES

Each tax-exempt lease financing must be carefully evaluated in light of federal law and applicable state law. The laws of each state are unique in the treatment of a variety of issues that relate to lease financing, and a Government Body considering lease financing should consult closely with public finance professionals and experienced legal counsel to determine the precise application of controlling legal principles to the contemplated lease financing. The discussion below is designed to highlight certain of the legal issues that are critical to evaluate in the context of a proposed lease financing, whether for equipment or real property.

A. STATE LAW

Although legal issues vary from state to state, certain issues are of particular concern to Government Bodies in virtually every state. The following is a list of questions frequently asked by state and local government officials and other market participants regarding state law issues raised by municipal lease financing:

- Are leases considered to be “debt” under state constitutional or statutory provisions?
- What are the legal consequences of a lease being treated as “debt” that has been entered into without complying with applicable state constitutional or statutory provisions?
- What are nonappropriation clauses?
- What are construction and abatement risks?
- What are covenants to seek appropriations and to budget and appropriate moneys?
- What is the difference between base and additional rentals?
- How are investors or certificateholders protected upon an event of nonappropriation?
- How is the lease authorized and executed by the Government Body?
- What interest rate limits and budgetary considerations do municipal lease financings present?
- What are essential use and acceptance certificates?
Characterization of Leases as “Debt” Within the Meaning of State Constitutional or Statutory Provisions

One of the most significant legal issues to be evaluated before a Government Body should undertake a lease financing is a careful examination of the status of the law in its state as to whether the lease will constitute “debt” within the meaning of applicable state constitutional and statutory provisions. State constitutions and statutes typically provide that obligations that exceed the revenues and receipts for the current fiscal period of the Government Body constitute “debt” and are, therefore, subject to voter approval requirements and limitations on the amount of debt that may be issued. In an effort to draft leases that are not subject to the foregoing constitutional and statutory limitations as applicable in a particular state, leases typically take two general forms: the nonappropriation lease and the abatement lease.

In the majority of states where lease financing is permitted, leases are drafted so that the Government Body may elect annually or biennially (as appropriate) not to renew its obligation or to terminate its obligation at the end of the current fiscal period. The lease payment that the Government Body then makes for each fiscal period for which it has elected to continue the lease or not to terminate the lease is consideration for the use and enjoyment of the leased property during the particular fiscal period. So long as such lease payments are within and made out of the current fiscal period’s revenues and the Government Body has no obligation beyond the current fiscal period, in the majority of states such a lease will not constitute “debt” for purposes of state constitutional and statutory provisions.

In an abatement lease, legal principles have been developed such that once the leased property is acquired by the Government Body or construction of the facility is substantially completed to the satisfaction of the Government Body, lease payments will continue for each succeeding fiscal period during the term of the lease so long as the beneficial use and enjoyment of the leased property is substantially available to the Government Body. In California and other states that have comparable legal principles, the Government Body has no obligation to make lease payments from its funds prior to substantial completion of acquisition or construction of the leased property or to pay lease payments during the period of time when the leased property has been damaged, destroyed or condemned or is otherwise unavailable for the beneficial use and enjoyment of the Government Body.

The constitutional and statutory “debt” issue manifests itself in several provisions under a municipal lease which are explored in the following Sections including nonappropriation clauses, construction risk, abatement risk, covenants to seek appropriations and covenants to budget and appropriate moneys.

Consequences of a Lease Being Treated as “Debt” that Has Been Entered into Without Complying With Applicable State Constitutional or Statutory Provisions

A lease that has been entered into without complying with applicable state constitutional or statutory limitations on a Government Body’s ability to incur “debt” does not exist, and should not have existed, as a legal obligation of the Government Body. Consequently, the right to future payment of rentals will not exist and the lessor and its assignees may be subject to a right of the Government Body
or its taxpayers to recover any rental payments that have previously been paid under the lease. Arguments concerning the fairness of this result are generally unpersuasive.

Nonappropriation Clauses

Included at the back of this booklet as Exhibit D is an example of a nonappropriation clause which sets out the right of the Government Body not to renew its obligations under its lease in the event that the Government Body determines not to appropriate moneys sufficient to pay rental payments in the succeeding fiscal period. A Government Body’s exercise of its right not to appropriate rental payments for a succeeding fiscal period is not an event of default, but is the exercise of its contractual right that supports the characterization of the lease as not constituting “debt” for state constitutional and statutory purposes.

Once the Government Body has appropriated money to pay rentals in the succeeding fiscal period, such an agreement is legally valid and enforceable in the majority of states for the amount of such payment accruing during that fiscal period.

Mortgage or Encumbrance of Property to Further Secure the Lease Financing

The mortgaging or encumbering of property by a Government Body to secure a lease financing may create a debt under the laws of several states where the property has been acquired through assets (such as the proceeds of ad valorem taxes) separate and apart from the proceeds of the lease financing. Consequently, in those states, other property of the Government Body may not be mortgaged or encumbered for the benefit of a particular lease financing where the other property has been acquired with moneys unrelated to the lease financing.

Construction Risk

A Government Body under an abatement lease cannot be obligated out of its own funds to make lease payments prior to the time that the leased facility is substantially completed and available for beneficial use and occupancy by the Government Body. In addition, a Government Body under a lease subject to nonappropriation may decide not to appropriate funds to pay rental payments for a facility that is not completed to its satisfaction as expected. If the financed facility is not substantially completed so that it is available for beneficial use and occupancy, the lessor or the owners of certificates of participation or lease revenue bonds or other investors may be at risk with respect to the Government Body’s payment obligation.

In an effort to minimize this construction risk, a lease financing, particularly for real estate, includes a variety of devices that are designed to insure that construction of the financed facility will be completed. For example, a fixed price construction contract and payment and performance bonds will customarily be required in order to assure completion of the facility in a manner and within a budget satisfactory to the Government Body. Plans and specifications will be reviewed and approved by the Government Body so that the investors have some assurance that if the facility is acquired and constructed in accordance with the plans and specifications the Government Body will accept and use
the facility upon substantial completion, which will trigger the Government Body’s obligation to make lease payments from its funds.

Because the Government Body may not legally be authorized to make lease payments until it has beneficial use and occupancy of the financed facility, a typical lease financing, particularly for a real property project, will include capitalized interest for the expected construction period plus an additional period of time to assure that sufficient moneys will be available in a capitalized interest account to pay interest prior to the time that the project is substantially completed.

*Abatement Risk*

In certain states, the obligation to make lease payments is directly tied to the availability of the financed facility to the Government Body for its beneficial use and occupancy. If the financed facility becomes unavailable in whole or in part to the Government Body during the term of the lease, the Government Body correspondingly will be relieved of its obligation to make lease payments either in whole or in part depending upon the extent of the damage, destruction or condemnation or other events that deprive the Government Body of its beneficial use and occupancy of the financed facility. That is, the lease payment is abated in an amount designed to correspond to the portion of the leased property that is unavailable to the Government Body so long as it is unavailable.

Customarily, the abatement risk is mitigated by requiring that the Government Body obtain rental interruption insurance to cover the maximum period of time that would be projected for the rehabilitation, replacement and repair of the financed facility should it be damaged or destroyed in whole or in part. In addition, casualty insurance is typically required to provide the resources to repair or rebuild the leased property, including earthquake and flood insurance in those states where those types of risks are present.

*Covenants to Seek Appropriations*

In states that rely upon a nonappropriation provision to avoid treatment of a lease as “debt” for state constitutional and statutory purposes, the owners of certificates of participation or other investors typically require that the lease provide that all steps will be taken to submit the amount of lease payments in the budgeting process for consideration by the legislative body of the Government Body. An example of a covenant to seek appropriations is included as *Exhibit E* in the back of this booklet.

A covenant to seek appropriations imposes an obligation upon the appropriate budget officer or other primary business official of the Government Body to include an amount sufficient to make lease payments in the initial budget that is prepared for submission to the legislative body for each fiscal period during the term of the lease. The legislative body then determines whether or not to retain such item for lease payments in the finally adopted budget.

The covenant to seek appropriations imposed upon the budget officer or other primary business official of a Government Body furthers the agreement of the Government Body to undertake all efforts necessary to obtain approval of lease payments in each budget. In addition, the covenant to seek
appropriations makes the lease clear that the legislative body of a Government Body, and not the particular budget officer, is the one charged with the responsibility to determine whether or not to appropriate moneys to make lease payments in future fiscal periods. In some states (notably Texas), a covenant to seek appropriations may evidence the creation of a “debt” for state constitutional purposes, which could invalidate the particular lease agreement.

*Covenants to Budget and Appropriate Moneys*

Under an abatement lease in those states where that lease structure is permitted, a municipal lease may include a provision by which the Government Body agrees on an annual basis to budget and appropriate an amount sufficient to pay the succeeding year’s lease payments so long as the Government Body has the beneficial use and enjoyment of the leased property. Attached as *Exhibit F* at the back of this booklet is an example of a covenant to budget and appropriate moneys that would be included in a typical abatement lease.

*Differences Between Base Rentals and Additional Rentals*

A municipal lease will frequently distinguish between Base Rentals and Additional Rentals, both of which are subject to annual or biennial appropriation as appropriate under applicable state law. Base Rentals represent the annual lease payments to pay principal and interest for the installment purchase of the leased property and are separated into an interest component and a principal component for federal tax law reasons as more fully discussed below.

Additional Rentals are typically the operating expenses that the Government Body is obligated to pay under the lease, which is a “triple-net lease.” Additional Rentals, therefore, typically include any amount payable for taxes, insurance and maintenance and operation costs plus other expenses, such as trustee’s fees, incurred under a trust agreement in a certificates of participation financing.

*References to Lease-Purchase Agreements*

The reference to a lease-purchase agreement or lease with option to purchase reflects the hybrid nature of a tax-exempt municipal lease resulting from the fact that for state law purposes such an agreement must typically be structured as a lease while for federal tax law purposes such an agreement must be structured as a conditional sale contract or installment purchase agreement in order for the interest component of the lease payments to be tax-exempt. In addition, bond counsel in reviewing such lease transactions frequently is reluctant (given the conditional sale nature of the “lease” required by federal tax law) to rely solely upon the authority under applicable state law for a Government Body “to lease” the financed equipment. Bond counsel often incorporates other language authorizing the Government Body to “lease, purchase or otherwise acquire” the property to be leased and financed on the basis that the combination of these terms under applicable state law will authorize the execution by the Government Body of an agreement that combines the elements of both a lease and an installment purchase contract; hence, “a lease-purchase agreement.”
Investor or Certificate Holder Protection in the Event of Nonappropriation

In an equipment lease financing, the Government Body typically grants a security interest in the financed property or obtains the financed property subject to a retained security interest in the lessor depending upon applicable state law. Consequently, if the Government Body exercises its right not to appropriate moneys to make lease payments for the subsequent fiscal period, the sole recourse of the investors and certificateholders is repossession and sale of the financed property in accordance with applicable state law. In some states (notably Florida), the creation of a security interest in the leased property has been construed as the creation of “debt” that must be accomplished only in accordance with applicable constitutional provisions. In these circumstances, reliance may need to be placed on customary leasehold remedies (and not security interests) that would entitle the investors or certificateholders to repossession of the leased property upon nonappropriation or default.

In a real estate lease financing, if the Government Body determines not to appropriate lease payments for a succeeding fiscal period, the financed property normally would be repossessed by the investor or the trustee on behalf of certificateholders or bondholders who would be entitled to exercise such remedies as are available under applicable state law.

Nonsubstitution Clauses

The nonsubstitution clause is a provision in a lease by which the Government Body agrees, to the extent permitted by law, not to substitute the same or similar property for the leased property for a specified period of time in the event that the Government Body determines not to appropriate moneys under the lease to pay rental payments for the succeeding fiscal period. A sample nonsubstitution clause is included at the back of this booklet as Exhibit G.

Lawyers are generally skeptical as to the enforceability of such a nonsubstitution clause, which to a large extent has not been tested in the courts. Consequently, a nonsubstitution clause is frequently qualified by the phrases “to the extent permitted by law” or “to the extent that the validity of this lease will not be adversely affected.”

If the nonsubstitution clause is drafted too strongly against the Government Body, such a clause may be used as evidence by a court to the effect that the investors or certificateholders, while recognizing the unrestricted right of the Government Body not to appropriate, nevertheless imposed coercive economic sanctions on the Government Body in the event that the Government Body exercised such right. In this respect, the nonsubstitution clause may become the basis for an argument that the lease in effect creates an obligation that extends beyond a particular fiscal period as a result of the economic or operational penalty that would be imposed upon the Government Body by exercising its right not to appropriate for a subsequent fiscal period and hence create a “debt” for state constitutional purposes.

Notwithstanding the questionable enforceability of a nonsubstitution clause as a matter of law, a nonsubstitution clause remains a relatively standard provision in equipment lease financing transactions. Whatever the reasons may be in support of the enforceability of a nonsubstitution clause in an equipment
lease, a nonsubstitution clause in a real property lease is simply misplaced and is highly likely to be unenforceable on public policy grounds.

Other Lease Provisions Which Create Risk That the Lease Will Be Construed as “Debt” Within the Meaning of Applicable State Constitutional and Statutory Provisions

Although an unconditional agreement of the Government Body to pay lease payments that is not subject to annual appropriation is fairly well recognized as the potential source for an argument that the lease creates “debt” for state constitutional and statutory purposes, certain other provisions of a lease should be examined with respect to the potential that they may create obligations that extend beyond the current fiscal period and thereby create “debt” that must comply with state constitutional and statutory limitations.

For example, an agreement of the Government Body to indemnify and hold harmless the lessor and its assignees against certain losses, damages or injuries may create a payment obligation that should be qualified by the agreement of the Government Body to seek an appropriation to make such payment rather than an unconditional agreement of the Government Body to indemnify, depending upon the scope of the indemnity and the applicable state law. A lease may create other payment obligations, such as an agreement of the Government Body to pay amounts representing its arbitrage rebate liability, trustee’s fees, legal fees, taxes, insurance premiums or other costs to maintain the leased facility, all of which should be qualified to contemplate that the Government Body will seek appropriations annually or biennially (as appropriate) to make such payments. Otherwise, the absolute and unconditional agreement of the Government Body to make those payments might be construed as creating an unconstitutional or invalid debt.

Frequently, Government Bodies are requested to include a so-called tax indemnification or tax gross-up provision in their leases to compensate the investors in the lease in the event that the interest component of the rental payments becomes subject to federal income taxation by increasing the interest rate on the lease to a taxable equivalent yield. Such tax indemnification or gross-up provisions, if not properly structured, may themselves constitute “debt” for state constitutional and statutory purposes.

A typical remedy in a tax-exempt lease is the right of the lessor to accelerate rental payments due during the then current fiscal period and for which amounts had originally been budgeted and appropriated. Acceleration of rental payments beyond the then current fiscal period, particularly if not limited solely to funds legally appropriated for that purpose, is likely to create an unenforceable “debt” obligation against the Government Body. Because abatement leases are premised upon the lessee’s rental payment obligation being in consideration for the use and enjoyment of the leased property for each successive fiscal period, rental payments cannot be accelerated upon default under abatement leases.
**Official Authorization of the Execution and Delivery of the Lease by the Government Body**

The type of authorization necessary for the valid execution and delivery of a municipal lease depends on applicable state law. In most situations, the governing body of the Government Body should adopt a resolution or take other official action that specifically authorizes the execution and delivery of the particular lease. Otherwise, the lease may not be valid under applicable state law.

**State Procurement Laws**

Frequently, the public procurement laws of a state will require that the property subject to the lease be acquired through a competitive bidding procedure, particularly if the property to be acquired exceeds a certain cost, in which event competitive bidding procedures must be followed. Certain state statutes would also require that the lease itself should be publicly bid as part of the acquisition of the property to be leased.

**Compliance with Open Meeting Laws**

State law frequently requires that governmental actions (with certain exceptions) be conducted at properly noticed and held public meetings at which a quorum of the governing body is in attendance and acting. The consequence of taking action on a resolution or other official action that authorizes the execution and delivery of any contract (including a lease agreement) for a Government Body at a meeting that fails to comply with the state open meeting law requirements is to invalidate the contract. Consequently, legal counsel is typically required to render an opinion that the lease has been duly authorized, including compliance with applicable open meeting law requirements.

**Interest Rate Limitations**

Depending upon applicable state law, the interest rate borne by a municipal lease should not exceed any applicable usury limitation or otherwise exceed limitations on the maximum interest rate for public obligations.

**Budgetary Considerations in Structuring Lease Payments**

Since lease payments are frequently produced from ad valorem taxes that are made available through the tax levy and collection procedure, a Government Body should carefully take into account the timing of receipt of tax revenues in structuring its lease payment dates under a municipal lease so that sufficient moneys will be on hand on the dates when lease payments are due.

In addition, since lease payments are typically made from such taxes that are levied and collected for general fund, operating fund or capital improvement fund purposes, and since state law often imposes limits on the levies that can be made for particular purposes, the Government Body must assure itself that the amount of the lease payment made from a particular fund will not exceed any applicable levy limits.
Essential Use Certificates

An essential use certificate is designed to provide comfort to investors that the nature of the leased property is so “essential” to the provision of governmental services that the Government Body will not be likely not to appropriate funds to make lease payments because the loss of the financed property would adversely affect the operations of the Government Body. An essential use certification may be included in a separate certificate or may be included with the representations and warranties of the Government Body contained in the lease. In any event, the Government Body is expected to certify that the leased property is “essential” to the conduct of the specified operations of the Government Body for which it is acquired.

The essentiality of the property to be financed is a key element in the credit analysis of the lease financing and covers a broad spectrum from very essential, which would include such facilities as schools and jails, to somewhat less essential, which would include office buildings, to those facilities that are perceived as not particularly essential to the operation of a Government Body, such as recreation facilities. An investor will evaluate the likelihood of nonappropriation in light of the essentiality of the property being financed and will apply a corresponding credit analysis and interest rate based upon the perceived risk of nonappropriation for that property.

Acceptance Certificates

An acceptance certificate is the device by which evidence is provided that the financed property has been acquired and constructed to the satisfaction of the Government Body and has been accepted by the Government Body for its use and for purposes of the lease. The obligation of the Government Body to make lease payments directly out of its own funds under an abatement lease may be based upon the delivery of such an acceptance certificate.

B. Federal Tax Law

Internal Revenue Code requirements for a tax-exempt financing are a primary concern of state and local government officials, investors and other market participants. This Section addresses the following federal tax law questions frequently asked with respect to municipal lease financings:

- In order for interest to be tax-exempt, are municipal leases subject to the same requirements under the Internal Revenue Code as apply to municipal bonds?

- Why do municipal leases typically attach a schedule of rental payments divided into a principal component and an interest component?

- If the interest component must be separately stated, may a Government Body do a tax-exempt municipal lease with a variable rate of interest?
• Will a municipal lease be eligible for qualification under Section 265(b)(3) of the Internal Revenue Code for purposes of placement with certain financial institutions and what are the requirements for leases to be bank qualified?

• Is a municipal lease subject to arbitrage rebate?

• May the Government Body reimburse itself for equipment acquisition costs that it has paid prior to the funding of its lease financing?

• Must an information reporting return be filed with the Internal Revenue Service?

• How may a municipal lease satisfy the requirement that an obligation be registered to be tax-exempt under the Internal Revenue Code?

**Internal Revenue Code Requirements for Municipal Leases as Compared to Municipal Bonds**

A popular misconception is that leases are somehow different than bonds for purposes of applying the federal tax law to determine whether interest is tax-exempt. While leases may be treated differently than bonds for certain state law issues, federal tax law clearly treats both bonds and leases as “obligations” for purposes of the Internal Revenue Code. Consequently, leases must be evaluated under the same provisions of the Internal Revenue Code as municipal bonds to assure that the interest component of rental payments is tax-exempt.

**Schedule of Rental Payments Divided into Principal and Interest Components**

Applicable federal tax law requires that in order for the interest component of rental payments to be tax-exempt such interest component must be separately stated. Consequently, a properly structured municipal lease will have a schedule attached that clearly sets out the total rental payments and a breakdown between the principal component and interest component of each rental payment on each rental payment date.

**Fixed Rate of Interest Versus Variable Rate of Interest**

A fixed rate financing obviously lends itself well to establishing a specific rental payment schedule that breaks down principal and interest components. In a variable rate financing, so long as the formula used to calculate the interest component of each rental payment is clearly expressed, the formula itself is sufficient to satisfy the requirement that the interest component be separately stated.

**Bank Qualification of Municipal Leases**

Generally, the Internal Revenue Code provides no deduction to a financial institution (such as a bank) for the portion of its interest expense that is allocable to its purchase or carrying of tax-exempt obligations, which would include tax-exempt municipal leases as well as municipal bonds. However, an
exception is provided to this general rule for any “qualified tax-exempt obligation” that (1) is not a qualified private activity bond (other than a qualified 501(c)(3) bond), recognizing for purposes of this booklet that a municipal lease is generally a “governmental use” obligation rather than a private activity bond for federal tax purposes, and (2) is issued by an issuer that reasonably anticipates to issue (together with subordinate entities) no more than $10,000,000 of tax-exempt obligations (other than qualified private activity bonds as described above) in the calendar year in which the particular lease financing is being funded. The major advantage of “bank qualification” to a Government Body considering a municipal lease financing is that the market for prospective investors in the lease will expand to include banks and increase competition for the financing at favorable rates.

Several legal issues and federal tax issues may arise with respect to bank qualification as applied to a particular Government Body and a particular lease financing. A Government Body should consult with public finance professionals and experienced legal counsel with respect to the application of these requirements to a particular lease financing.

Arbitrage Rebate for Municipal Leases

Arbitrage rebate under federal tax law requires a Government Body to calculate and rebate the earnings on proceeds of a tax-exempt obligation (such as a municipal lease), to the extent that such earnings produce an investment yield higher than the yield on the particular obligation. A Government Body acting as a lessee under a tax-exempt municipal lease must comply with the applicable requirements under the Internal Revenue Code to assure that the lease will not be treated as an “arbitrage bond,” including compliance with arbitrage rebate where necessary. Whether a particular transaction is subject to arbitrage rebate and other federal tax law requirements depends largely upon the type of transaction. For example, in a simple equipment acquisition lease all proceeds of the moneys advanced to acquire the equipment are disbursed simultaneously with the execution of the lease so that no moneys are available for investment by the Government Body and, accordingly, there would generally be no arbitrage earnings to be calculated and rebated. On the other hand, in an advance funded equipment acquisition lease, a real property lease or a master lease, any one of which contemplate that moneys will be held and invested over a period of time, any investment earnings will be subject to arbitrage rebate unless one of the arbitrage rebate exceptions described below is available.

Exceptions from Arbitrage Rebate for Municipal Leases

A Government Body executing a tax-exempt municipal lease may avoid rebating arbitrage profits to the United States if:

1. the Government Body satisfies the “small issuer exception”;
2. the proceeds of the lease financing are expended at such time as will satisfy the “six-month expenditure exception” described below;
3. the proceeds of the lease financing are expended at such time and in such amounts as will satisfy the “eighteen-month expenditure exception” described below; or
(4) the proceeds of the lease financing for construction projects (but not for equipment acquisitions) are expended at such time and in such amounts as will satisfy the “two-year expenditure exception” described below.

The “small issuer exception” is available if the Government Body executing the lease satisfies all of the following requirements:

(1) the Government Body executing the lease has general taxing powers,

(2) no part of the lease is treated as a “private activity bond” as described below,

(3) 95% or more of the net proceeds of the lease are to be used for local governmental activities of the Government Body within its jurisdiction and

(4) the aggregate face amount of all tax-exempt bonds (including bonds, notes, leases and other tax-exempt obligations, but excluding private activity bonds and the first $5,000,000 of any obligations issued to finance construction expenditures of public school facilities) issued by such Government Body and certain subordinate entities during the calendar year in which the lease is executed is not reasonably expected to exceed $5,000,000.

The “six-month expenditure exception” to arbitrage rebate is available so long as:

(1) all proceeds (including investment earnings) of the lease financing (other than those deposited into a lease payment fund or a debt service reserve fund) are spent within six months after the date of issue, except for an amount equal to five percent of those proceeds or $100,000, which may be held up to one year after the lease is funded;

(2) the Government Body complies with the arbitrage rebate requirement for amounts earned in the debt service reserve fund after six months from the date the lease is funded; and

(3) all proceeds of the lease financing are spent within one year after the date the lease is funded.

The “eighteen-month expenditure exception” to arbitrage rebate is available for lease financings satisfying all of the following requirements:

(1) at least 15% of the net proceeds of the lease are spent within 6 months of the date the lease was initially funded;

(2) at least 60% of the net proceeds of the lease are spent within 12 months of the date the lease was initially funded; and
(3) 100% of the proceeds of the lease are spent within 18 months of the date the lease was initially funded (except for reasonable retainages up to 5% so long as all reasonable retainages are spent within 30 months).

Earnings from the investment of lease proceeds are also considered as “proceeds” for purposes of this eighteen-month expenditure exception.

The “two-year expenditure exception” to arbitrage rebate is available for lease financings in which at least 75% of the net proceeds are to be used for construction expenditures with respect to property which is owned by a Government Body or a 501(c)(3) organization, but only so long as:

(1) at least 10% of the net proceeds are actually spent within six months after the date the lease was initially funded;

(2) at least 45% of the net proceeds are actually spent within one year after the date the lease was initially funded;

(3) at least 75% of the net proceeds are actually spent within 18 months after the date the lease was initially funded;

(4) 100% of the net proceeds are actually spent within two years after the date the lease was initially funded, subject to a “reasonable retainage” of not more than 5% of the net proceeds that may be held up to three years after such funding date;

(5) investment earnings on all proceeds of the lease financing (including those deposited into a debt service reserve fund) are taken into account in determining whether the Government Body has satisfied the 10%, 45%, 75% and 100% spending targets within each of the successive 6-month periods after the date the lease was initially funded, subject to a certain election for earnings on a debt service reserve fund; and

(6) the Government Body complies with the arbitrage rebate requirement for amounts earned in the debt service reserve fund after two years from the date the lease was initially funded.

Reimbursement for Government Body’s Prior Expenditures

A Government Body that has expended its own funds to pay equipment costs prior to the funding of its lease financing may be reimbursed for those costs from the proceeds of its lease financing without jeopardizing federal tax-exemption only if the Government Body complies with the “reimbursement regulations” under the federal tax law. To be reimbursed from lease proceeds, a Government Body must declare an official intent to reimburse an expenditure not later than 60 days after payment of such expenditure. Unless a Government Body has declared its official intent to reimburse by adoption of a resolution or the taking of other official action prior to the funding of its lease financing, reimbursement for a Government Body’s prior expenditures should be limited to those made not more than 60 days prior to the funding of the lease financing.
Filing of Information Reporting Returns with the Internal Revenue Service

A Government Body must provide for the filing of the appropriate information reporting return with the Internal Revenue Service relating to its tax-exempt municipal leases. In fact, Form 8038-G and Form 8038-GC specifically include a line for Government Bodies to indicate that their tax-exempt borrowing is represented by a lease or installment sale. Whether the Government Body enters into a simple equipment acquisition lease or an advance funded equipment lease will affect the manner in which the information reporting return is completed, including whether the particular financing qualifies to be treated as a lease or installment sale for purposes of Form 8038-G or 8038-GC.

The leasing market professionals advising a Government Body entering into a lease will frequently assure that arrangements are made for the completion and filing of such information reporting return inasmuch as failure to file such return may result in the interest component of the rental payments becoming subject to federal income taxation. The information reporting return itself, however, must be executed on behalf of the Government Body, which is ultimately responsible for its filing based upon covenants that are typically contained in the lease by which the Government Body agrees to establish and maintain federal tax-exemption.

Subleases of the Financed Equipment or the Real Property to a Private User

The Internal Revenue Code provides that if more than 10% of the proceeds of a tax-exempt borrowing, such as a municipal lease financing, are to be used for any private business use and if the payment of the principal of or interest on more than 10% of the proceeds of such borrowing is directly or indirectly (a) secured by any interest in property used or to be used for a private business use or payments in respect of such property or (b) to be derived from payments or property, or borrowed money, used or to be used for a private business use, then such borrowing will constitute a “private activity bond.” The Internal Revenue Code defines “private business use” to mean use (directly or indirectly) in a trade or business carried on by any person other than a Government Body, except that use as a member of the general public is not taken into account.

Interest on a private activity bond will typically be or become subject to federal income taxation, except in certain limited circumstances most of which do not apply to leased property that is initially financed by a Government Body for use in providing its essential governmental services. Consequently, municipal leases limit the right of the Government Body to sublease or otherwise allow the use of the leased property by any entity or person other than the Government Body. Otherwise, the lease may become a “private activity bond,” in which event the interest component of the rental payments would no longer be federally tax-exempt.

Registration of Municipal Leases Under the Internal Revenue Code

The Internal Revenue Code requires that an obligation of a Government Body be registered to be federally tax-exempt, with certain exceptions that are generally inapplicable to municipal leases. To satisfy such registration requirements, a municipal lease will generally require that the Government Body
as lessee, or the lessor as registration agent for this purpose, maintain a record of the lessor and its assignees in sufficient detail to satisfy the registration requirement under the Internal Revenue Code.

C. SECURITIES LAW

State and local government officials and other market participants frequently express concern over disclosure issues and compliance with securities laws when structuring municipal lease financings. The following frequently asked questions are addressed in this Section:

• Are lease revenue bonds or certificates of participation subject to registration under the federal securities laws?
• Does a municipal lease constitute a security for purposes of the federal securities laws?
• Are certificates of participation and lease revenue bonds subject to the anti-fraud provisions of the federal securities laws?
• How does a Government Body discharge its disclosure responsibilities in a municipal lease financing?
• What effect does Rule 15c2-12 (regarding secondary market disclosure) have on municipal lease financing?

Registration of Lease Revenue Bonds and Certificates of Participation under the Securities Act of 1933

Lease revenue bonds are typically issued by a governmental issuer or by a “conduit issuer” who acts “on behalf of” a particular state or political subdivision thereof. As such, lease revenue bonds generally constitute an exempt security for purposes of registration under the Securities Act of 1933 (the “Securities Act”).

Certificates of participation evidencing fractionalized interests in a tax-exempt lease or in a “pool” of tax-exempt leases originated in a simultaneous transaction with multiple lessees are not subject to registration under the Securities Act so long as the transaction is properly structured. Certificates evidencing fractionalized interests in a pool consisting of previously originated leases without involvement of the respective lessees are generally subject to registration under the Securities Act unless an exemption is available.

Municipal Leases as a “Security” for Purposes of the Securities Act of 1933

The staff of the Securities and Exchange Commission has taken the position that a municipal lease that is structured to create a tax-exempt obligation of a state or a political subdivision thereof under the Internal Revenue Code constitutes a “municipal security” for purposes of the Securities Exchange Act of 1934. It is likely that such a lease will also constitute a “security” for purposes of the
Securities Act, which is exempt from registration under the Securities Act, but the characterization of a municipal lease as a “security” under the Securities Act has not been authoritatively established.

Anti-Fraud Provisions of State and Federal Securities Laws

While properly structured leases, certificates of participation and lease revenue bonds are not generally subject to registration under the Securities Act, disclosures made in connection with the offering of such securities are subject to the anti-fraud provisions of federal and state securities laws. Consequently, disclosure documents relating to a particular lease financing must not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

Primary Market Disclosure Responsibilities in a Municipal Lease Financing

In a negotiated underwriting or public sale of lease revenue bonds, certificates of participation or other lease-backed securities, the Government Body acting as lessee typically cooperates with the underwriter in the preparation of an Official Statement or other disclosure document by which the lessee discloses facts that are material to the particular offering. On the other hand, in a typical private placement of a single municipal lease to an institutional investor, the customary practice is for the Government Body acting as lessee to obtain an investor letter from the purchaser of the lease to the effect that the purchaser is a “sophisticated” investor who is knowledgeable, has had an opportunity to pursue whatever questions it may have with respect to the particular lease or lease-backed securities that are being offered and is purchasing the lease for its own account and not with a present intent to resell it.

Secondary Market Disclosure Responsibilities in a Municipal Lease Financing

The Securities and Exchange Commission adopted Rule 15c2-12, which became effective on January 1, 1990, relating to municipal securities disclosure, that may affect the offer of municipal lease transactions. Generally, Rule 15c2-12 requires underwriters participating in primary offerings (including certain remarketings) of “municipal securities” of $1,000,000 or more (unless the transaction is exempt as described below) to obtain, review and distribute to investors copies of the lessee’s disclosure documents and to enter into a written undertaking with the Government Body as lessee to provide certain periodic and material event notices to the secondary market. Municipal securities as contemplated in Rule 15c2-12 include tax-exempt lease transactions in any of the forms described in this booklet; however, Rule 15c2-12 establishes a threshold of $1,000,000 below which lease transactions would not be subject to the requirements of the Rule.

Rule 15c2-12 also contains several exemptions that would apply to underwriters participating in certain offerings of municipal lease transactions, the most important of which for municipal lease transactions is the “private placement “ exemption. Under that exemption, a municipal lease transaction of $1,000,000 or more with an authorized denomination of at least $100,000 is not subject to Rule 15c2-12 so long as such transaction (including interests therein) is not sold to more than 35 persons, each of whom the underwriter or placement agent reasonably believes is a sophisticated investor who is
not purchasing the lease securities for more than one account or with a view to distributing such securities, all within the meaning of the Rule.

V. MARKET CONSIDERATIONS

Market considerations play an important role when state and local governments and other market participants structure municipal lease financings. The following frequently asked questions regarding market considerations are considered in this Section:

• What type of information is a Government Body typically expected to provide in order to initiate a lease financing program?

• Are debt service reserve funds typically required in lease financings?

• Is credit enhancement available for lease financings?

• What rating may a Government Body expect on its lease financing that is rated by the national rating agencies?

• Who typically purchases tax-exempt municipal leases, certificates of participation and lease revenue bonds?

• May the term of the financing exceed the useful life of the financed property?

INFORMATION PROVIDED BY GOVERNMENT BODY TO INITIATE A LEASE FINANCING PROGRAM

The initial step in any lease financing program is to determine the specific type of property that will be subject to the lease, including whether such property will be real or personal property and whether the financing would require a ground lease for certain real property projects. Although in most states where such financing is permitted the lease is limited to successive fiscal periods subject to the decision of the governing body of the Government Body to extend the term of the lease for each successive period, the credit analysis for a municipal lease financing will be based upon the same considerations as are typically applicable to evaluation of the Government Body’s obligations that are payable from its general fund. Consequently, matters involving the budgeting procedure for the Government Body and the levy and collection procedure for ad valorem taxes and other revenues will frequently be required in connection with evaluating the credit of a particular municipal lease financing.

DEBT SERVICE RESERVE FUNDS

Because of the increased risk associated with nonappropriation and the construction and abatement risks, a debt service reserve fund is frequently required in connection with a lease financing, particularly for real estate and relatively large equipment acquisition programs financed with lease
revenue bonds or certificates of participation. A debt service reserve fund is not generally used in a privately placed municipal equipment lease financing.

CREDIT ENHANCEMENT OPPORTUNITIES FOR LEASE FINANCINGS

Depending upon the credit-worthiness of the Government Body seeking to enter into a lease financing, various bond insurance companies and letter of credit banks have issued insurance policies, surety bonds and letters of credit with respect to various lease financings. Consequently, credit enhancement is available for lease financing and should be taken into account in determining whether obtaining such insurance is financially beneficial to the transaction.

TYPE OF RATINGS PROVIDED BY NATIONAL RATING AGENCIES FOR LEASE FINANCINGS

While exceptions obviously occur in individual circumstances, a lease financing is usually rated somewhat below the Government Body’s rating on outstanding general obligation debt.

PURCHASERS OF TAX-EXEMPT MUNICIPAL LEASES, CERTIFICATES OF PARTICIPATION AND LEASE REVENUE BONDS

A tax-exempt municipal lease may be placed as a whole with a single institutional investor or limited number of institutional investors (such as banks, finance companies and captive finance subsidiaries of equipment vendors) or may be assigned to a trustee that executes certificates of participation as described under “TYPES OF MUNICIPAL LEASE FINANCING TRANSACTIONS—Certificates of Participation” above. Certificates of participation and lease revenue bonds are typically placed by an investment banking firm with a limited number of institutional investors or distributed in a public offering by such an investment banking firm.

TERM OF THE FINANCING COMPARED TO THE USEFUL LIFE OF THE FINANCED PROPERTY

Because lease financing is based on the legal concept that the Government Body is making lease payments in consideration for the use and enjoyment of the leased property during each fiscal period and because of an increased risk of nonappropriation if the financing term exceeds the useful life of the equipment, the term of the lease financing should not exceed the useful life of the financed property.

VI. SUMMARY

Tax-exempt municipal lease financing is an innovative and increasingly popular technique for Government Bodies throughout the United States to finance the acquisition and construction of equipment and capital facilities. Because municipal lease financing is a sophisticated and complicated process for such financing, the involvement of qualified and experienced professionals and qualified legal counsel is essential to assure the successful completion of such a financing.
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EXHIBIT A

BASIC STRUCTURE OF CERTIFICATES OF PARTICIPATION FINANCING

State or Local Government Lessee

Certificate

Purchase Agreement

Lease Agreement for equipment or real property

Underwriter or Investor

Proceeds deposited

Certificate Purchase Agreement

Absolute Assignment Agreement

Lessor

Trust Agreement

Certificates Trustee

Executes and delivers COPs at direction of Underwriter or Investor

Certificate Holders

Sells equipment

Third-Party Vendor
EXHIBIT B

BASIC STRUCTURE OF
LEASE REVENUE BONDS FINANCING

State or Local Government Lessee

Ground Lease in some cases

Lease Agreement

Municipal or State Building Authority

Issues and delivers bonds at direction of Underwriter or Investor

Trust

Indenture

Bond Trustee

Bond Purchase Agreement

Proceeds deposited

Underwriter or Investor

Bond Holders
EXHIBIT C

CASH FLOW FOR
LEASE REVENUE BONDS AND
CERTIFICATES OF PARTICIPATION

State or Local Government Lessee

Base Rentals

Bond or Certificate Payment Fund

Interest during construction period

Capitalized Interest Fund

Reserve Fund

Construction Fund

Sale Proceeds

Issuance Costs Fund

NOTE:
1. All Funds are held and administered by a Trustee.
EXHIBIT D

EXAMPLE OF NONAPPROPRIATION CLAUSE

In the event that sufficient funds (a) are not appropriated by the governing body of the Government Body prior to the beginning of any Renewal Term for the payment of the Base Rentals on the Base Rental Payment Dates and reasonably estimated Additional Rentals payable during such Renewal Term, or (b) are otherwise not legally available for such purpose, then an Event of Nonappropriation shall be deemed to have occurred. If an Event of Nonappropriation shall occur, the Government Body shall not be obligated to make payment of the Base Rentals or Additional Rentals provided for herein beyond the last day of the Renewal Term during which such Event of Nonappropriation occurs, except for the Government Body’s obligation to pay Rentals which are payable prior to the termination of the Lease.
EXHIBIT E

EXAMPLE OF COVENANT TO SEEK APPROPRIATIONS

The Government Body agrees that its budget officer or other primary business official will do all things lawfully within such officer’s or official’s power (a) to include amounts to make lease payments under this Lease in each annual or biennial budget (as appropriate) to be submitted to its governing body and (b) to use best efforts to obtain and maintain funds from which such lease payments under this Lease may be made during each fiscal period for which amounts have been duly appropriated to make such payments.
EXHIBIT F

EXAMPLE OF COVENANT TO BUDGET AND APPROPRIATE MONEYS FOR ABATEMENT LEASES

The Government Body hereby covenants to take such action as is necessary under the laws applicable to the Government Body to budget for and include and maintain funds sufficient and available to discharge its obligation to meet all rental payments due hereunder in each Fiscal Year. The covenants on the part of the Government Body contained herein shall be deemed to be and shall be construed to be ministerial duties imposed by law and it shall be the ministerial duty of each and every public official of the Government Body to take such action and do such things as are required by law in the performance of such official duty of such officials to enable the Government Body to carry out and perform the covenants and agreements on the part of the Government Body contained in this Lease.
EXHIBIT G

EXAMPLE OF NONSUBSTITUTION CLAUSE

If the term of this Lease is terminated as a result of the occurrence of an Event of Nonappropriation hereunder, the Government Body hereby agrees, to the extent permitted by law, not to purchase, lease or rent equipment performing functions similar to those performed by the Equipment, and agrees not to permit functions similar to those performed through the use of the Equipment to be performed by its own employees or by any agency or entity affiliated with or hired by the Government Body, at the site where the Equipment is to be located, installed and/or utilized pursuant to this Lease, for a period of ninety (90) days, except for the public health, safety, welfare or convenience of the Government Body; provided, however, that these restrictions shall not be applicable (i) in the event the Equipment shall be liquidated by the Lessor and the amount received from said liquidation, less all costs of such sale or disposition, are sufficient to pay the then outstanding unpaid balance of the Rentals hereunder or (ii) to the extent that these restrictions are unlawful or would adversely affect the validity of this Lease.