

Municipal Finance: Structuring Tax-Exempt Finance Models for Local Governments

Lease-Purchase Agreements, Conditional Sales Contracts, and Certificates of Participation

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Today's faculty features:

Nathan Canova, Attorney, **Dorsey & Whitney**, Minneapolis

Robert P. Mecklenborg, Jr., Attorney, **Frost Brown Todd**, Cincinnati

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Tax-Exempt Financing Models:

**Lease-Purchase Agreements, Conditional Sales
Contracts, Certificates of Participation and
Lease Revenue Bonds**

Wednesday, November 28, 2018

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What is a tax-exempt lease?

- **Don't get hung up on a name**
 - Lease-Purchase Agreement
 - Installment Sale Contract
 - Installment Purchase Agreement
 - Conditional Sales Contract
 - Municipal Lease
- **A financing transaction**
 - Lessee acquires real or personal property and constructs a project (the “Asset”)
 - Lessee makes payments to Lessor over a term of 1 yr +
 - Lessee is the titled owner of the Asset (subject to the lessor's security interest), and maintains & insures the property (a “net” lease)
 - Lessee has a purchase option at the end of the term (for a bargain purchase price) or title to the Asset automatically transfers to Lessee after all payments are made
 - A portion of each rental payment is designated as interest (and tax-exempt)

Benefits of Tax-Exempt Lease Structure

- May enable improvement of cash flow
- Potential for preservation of capital dollars for other projects for which leasing is not an option
- Debt limitations
- Incorporates flexible structuring to meet budget needs
- Low rates resulting from tax-exempt basis
- Offers an alternative financing option without voter approval
- Provides project financing (including soft costs)
- Spreads out the cost of an asset over the useful life of that asset or project.

State and Local Financing Options

- **Governmental Entity needs real or personal property for an authorized use**
- **Governmental Entity needs to fund the purchase**
 - **Cash payment option**
 - from fees or user charges
 - from property, sales or other taxes
 - **Debt financing option**
 - issue bonds, notes or other debt obligations
 - General Obligation (GO) Bonds
 - » backed by Issuer's full faith and credit
 - » secured by *ad valorem* property taxes
 - Revenue
 - » backed by specific revenues (taxes, project revenues, water and sewer, etc.)

State and Local Financing Options

- **Financing limitations**
 - **Insufficient cash on hand**
 - **Debt limits and restrictions**
 - **What is debt?**
 - STATE LAW GOVERNS
 - » Constitution
 - » Statute
 - Obligation
 - 1 yr + (binding upon future governing bodies)
 - Potential tax increases (i.e., raise taxes to cover debt service)
 - **Examples of Debt Limitations**
 - Voter approval required
 - Debt limits (\$ or % of assessed value)
 - Max. rate caps (i.e., \$1.50 per \$100 of taxable assessed valuation)
 - Term restrictions

The Alternative: Lease-Purchase Agreements

- **Hybrid structure with features similar to both a loan and a lease**
 - Lease for state law purposes, but not a true lease or operating lease
 - No depreciation. Lessee responsible for maintenance.
 - Loan or installment sale for federal tax law purposes
- **Like a lease, lease payments are subject to annual renewal, and the lease may be terminated at the option of the lessee**
 - Not a “debt” under state law because of annual appropriation / abatement clause
 - Not an absolute obligation – can be terminated
 - Not a multi-year obligation – can be terminated
 - No payments in event of lack of beneficial use (CA and IN)
- **Like a loan or installment sale, the lessee owns the leased property subject to lessor’s security interest, and has lien-free ownership at end of term after making all payments**
 - No FMV end-of-term purchase option; and
 - Capital lease treatment for accounting purposes

Non-Appropriation

- **Lease purchase agreements include non-appropriation provisions.**
 - The non-appropriation clause enables the Lessee to account for the lease obligation as a current expense, which circumvents debt limitations.
 - Risk involved with chance of non-appropriation.
 - The non-appropriation clause enables the Lessee to terminate the lease at the end of the appropriation period without penalty.
 - Non-appropriation clauses are relevant when the Lessee was unable to obtain funding via budgetary procedures for future rental payments on the Lease.
 - In certain circumstances, a requirement of best efforts, whereby the Lessee must use its best efforts to obtain the necessary appropriation for rental payments.

Why Do Governmental Entities Use Lease-Purchase Financing?

- **Can alleviate liquidity-drain caused by a lump sum capital expenditure**
- **Can spread payments over asset's useful life**
- **Not classified as “debt”, so:**
 - No voter approval required; and
 - Not subject to legal debt limitations.
- **No encumbrance of tax or other revenues, so:**
 - Preserve capital;
 - Revenues remain available to secure future debt; and
 - Enhances borrowing flexibility.
- **Can provide more flexibility than bonds**
 - Prepayment provisions
 - Lower transaction costs
 - Faster closing timeline
 - Less complicated documentation
 - No ratings or bond insurance
 - No official statement
 - No continuing disclosure

What Can Be Leased-Purchased?

Personal Property Examples

- **Vehicles**
 - Fire Trucks, Police Cars, Ambulances, Refuse Trucks, Street Sweepers & School Buses
- **Telecommunications Equipment**
- **Computers & Software**
- **Copiers & Other Office Equipment**
- **Safety Equipment (911 Systems)**
- **Energy Equipment**
 - HVAC, Lighting, Building Controls & Solar Panels
- **Medical Equipment**
- **Modular Buildings**

What Can Be Leased-Purchased? Real Property Examples

- **School Facilities**
- **Courthouses**
- **City Halls**
- **Fire Houses**
- **Hospitals**
- **Nursing Homes**
- **Correctional Facilities**
- **Public Utility Facilities**
- **Libraries**
- **Airport Facilities**
- **Recreational Facilities**
- **Manufacturing Facilities**

Who Are Eligible Lessees?

Lessees:

- **States and Political Subdivisions**
 - **Political subdivisions must possess a substantial amount of one of three sovereign powers**
 - Taxing power
 - Police power
 - Eminent domain power
 - **Examples:**
 - States and state agencies
 - Hospital Authorities
 - Towns, cities and counties
 - School districts
 - Housing Authorities
- **Native American Tribal Governments**
 - Governmental only (no gaming)

Sublessees:

- **501(c)(3) Organizations**
 - Charter Schools
 - Higher Ed
 - Hospitals
 - Senior Living
 - Private Schools
 - Museums and Research Centers
- **Certain Other Private Parties**
 - Manufacturers (qualified small issue financings)

Who Are Eligible Lessors?

- **Brokers/Packagers**
- **Vendors**
- **Investment Bankers**
- **Banks, as lenders**
- **Banks & Trust Companies, as trustees**
- **Captive Finance Companies**
- **Independent Finance Companies**
- **Other Governmental Entities**
- **Non-Profit Corporations**

Who Are The Investors?

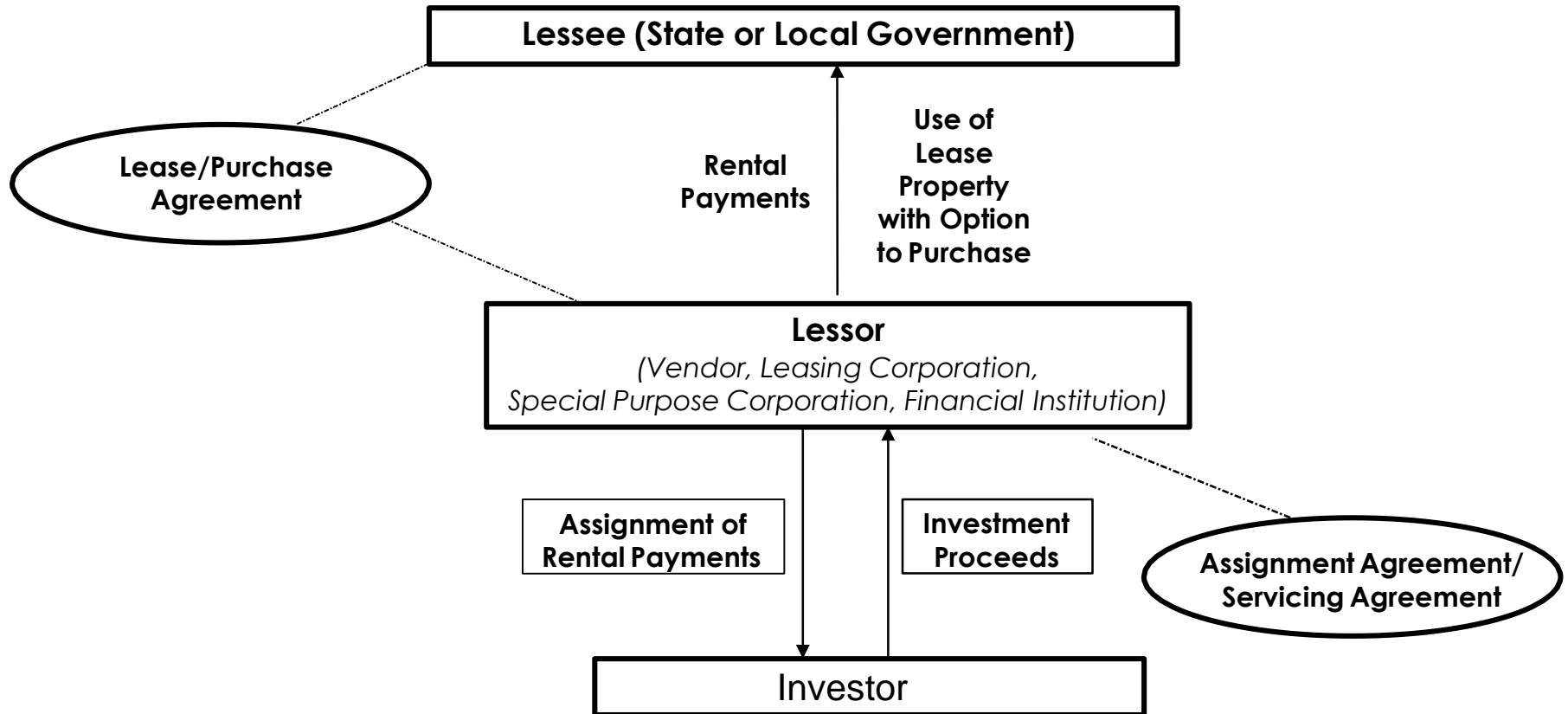
- **Banks**
- **Leasing Companies**
- **Corporations**
- **Investment / Mutual Funds**
- **High-Yield Funds**
- **Insurance Companies**
- **Investment Bankers**

Basic Lease Structures

- **Lease-Purchase Agreement**
 - Single lease
 - Master lease agreements with schedules
- **Certificates of Participation (“COPs”)**
 - Secured by lease payments subject to annual appropriation
- **Lease Revenue Bond**
 - Secured by lease payments subject to annual appropriation

Basic Equipment Lease Structure

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General State Law Considerations

- **Legal, valid and binding**
 - Legal power to enter into the transaction under state law
 - Delegation of authority and authorized execution
 - Compliance with interest rate limitations, if any
 - Compliance with public bidding requirements (project and/or financing)
 - Compliance with debt limitations
 - Generally not subject to debt limitations if a proper non-appropriation clause or abatement clause is included
 - Incorporation of such clauses will limit other remedies
 - Other potential issues
 - Nonsubstitution clauses
 - Prohibited or limited in some states
 - Doubtful enforceability in other states
 - Can potentially invalidate lease (compulsion to appropriate = debt)
 - Indemnification
 - May not be enforceable
 - “To the extent permitted by law...”
 - Subject to appropriation

General State Law Considerations

- Other potential issues (continued)
 - Title
 - Title to personal property is often transferred to the lessee during the lease term, subject to automatic transfer back to lessor on default or non-appropriation
 - Some states require lessor to hold title during lease term
 - Assignment
 - Some states require limitations on assignment rights or rights to participate lease payments
 - Full-Term Leases
 - Other

Federal Tax Law Considerations

- Lessee must be a state or a political subdivision of a state (power to tax, power of eminent domain or police power)
- The lease must be a "financing lease"
- Separately stated interest component
 - Nominal purchase price at end of lease
- WAM of not more than 120% of weighted average useful life
- Lease Obligation must qualify as "governmental use" or as a "qualified private activity bond"
- Restrictions on amount of lease-financed property that may be used in private use
 - Requires limitations on assignment and subleasing and management contracts
 - Ownership or leasehold interest is by definition "use"
- Current refunding rules will apply
- Lease obligation must be in "registered form"

Federal Tax Law Considerations

- **Rebate provisions generally apply unless—**
 - No reserve fund & all proceeds spent within 6 months, or, in some cases, 18 months or 2 years; or
 - "Small issuer rebate exception" applies
- **Reimbursement Rules**
- **Prohibition on “hedge obligations”**
- **Need to document useful economic life of property on which proceeds are spent**
- **IRS Form 8038-G or 8038-GC must be timely filed**
- **Post-issuance written policies & procedures**
- **Prohibition on federal guaranty**
- **Capital Expenditures (working capital restrictions)**

Federal Tax Law Considerations

- **Arbitrage restrictions apply—**
 - **Expenditures of "proceeds"**
 - **Investment Limitations**
 - **Issue Price Rules**
 - Placement Agent
 - Lease Broker
 - OID
- **Bank-Qualification may be available if—**
 - Lessee reasonably expects to issue no more than \$10 million tax- exempt in a calendar year; and
 - Lessee does not designate more than \$10 million as bank-qualified

Securities Law Considerations

- **A whole lease is NOT a municipal security**
 - Series of SEC No Action Letters
- **Lease-Purchase Agreements are Private Placements**
 - Treatment as Direct Bank Loan
- **Rationale for Bonds to be deemed as Private Placements:**
 - Name (i.e. “Bond”) is not Dispositive
 - No Official Statement
 - Physical Bond versus DTC Registered
 - No CUSIP Number
 - No Bond Rating
 - No Bond Insurance
 - No Small Denominations
 - Representation re: Bank Loan vs. Security Treatment

Typical Equipment Lease-Purchase Documents

- **Resolution(s)**
- **Ground Lease (if necessary)**
- **(Master) Lease-Purchase Agreement, which should incorporate:**
 - Payment Schedule, stating commencement date and separately stating principal & interest components
 - Equipment Schedule (including location and vendor)
- **Assignment Agreement (if original Lessor will not hold the paper)**
- **Escrow Agreement (if all property is not paid for at closing)**
- **Lessee's Certificate**
 - Include Incumbency Certification for officers authorized to execute the lease and all related documents
 - Include certification as to no litigation
 - Include certification as to compliance with open meeting laws
- **UCC-1 Financing Statements/Certificate of Title**
- **UCC Fixture Filing**

Typical Equipment Lease-Purchase Documents

- **Validity Opinion**
- **Insurance Certificates**
 - Property & Casualty
 - Rental Interruption (abatement)
 - Liability (in some cases)
 - Performance and payment bonds
- **Acceptance Certificate**
- **Investor Letter/Certificate**
- **Notice of Issuance to applicable Rating Agency**

Typical Equipment Lease-Purchase Documents

- **Tax Questionnaire and/or client intake document**
- **Tax Certificate**
- **Tax Opinion**
- **IRS 8038-G or IRS 8038-GC**
- **Bank Qualification Certificate**
- **Essentiality Certificate**
- **TEFRA and other tax documentation (if conduit)**

Real Property Documentation

- **Ground/site lease (term usually significantly longer than lease/purchase term, if permitted by state law)**
- **UCC-1 fixture filing in real property records**
- **Title insurance / endorsements (owner's policy insures lessor's leasehold estate under the ground/site lease)**
- **Location survey**
- **Phase I environmental assessment**
- **Flood certificate (if investor is a bank or bank affiliate)**
- **Appraisal or alternative valuation procedure**
- **Survey/Legal description**
- **Plans and specifications**
- **Construction and architect's contracts and other material contracts**
- **Assignment of construction and architect's contracts**
- **Building permit, zoning, and other required approvals**
- **Mortgage (in limited cases)**

Certificates of Participation (COPs)

- **Certificates that represent a proportionate interest of the owner of each certificate in the right of the Lessor to receive rental payments made by the Lessee under the lease.**
- **Not obligations themselves; merely securitize the obligations of the Lessee under the lease.**
- **The Lessor may be the vendor, a leasing company, an investment banking firm, a single purpose corporation or a bank or trust company. It is not necessary that the Lessor be a nonprofit entity or have the ability to issue tax-exempt obligations.**

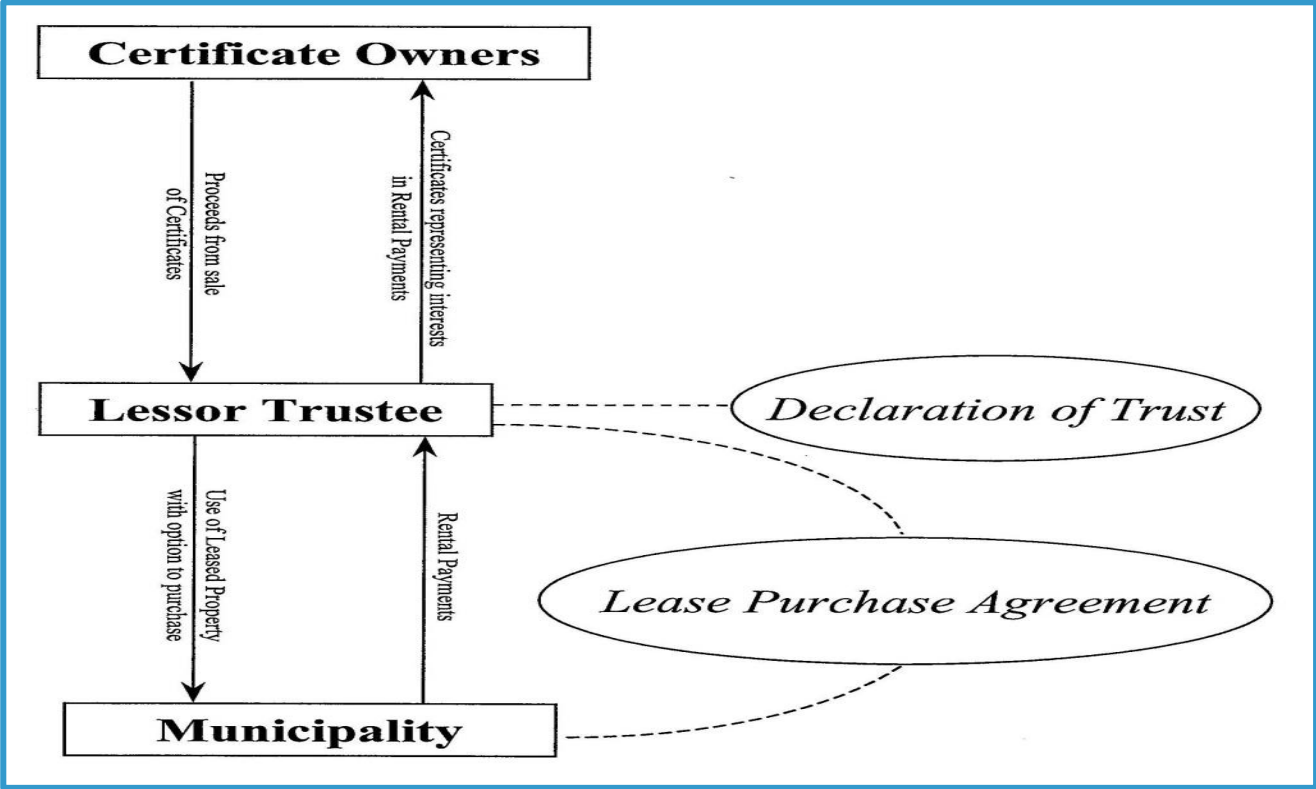
Structure of COPs

- **Under a structure that is frequently used, the trustee is the Lessor and no assignment is required. In that structure, the trustee makes a declaration of trust pursuant to which it executes and delivers certificates in the lease to investors.**
- **Lease pursuant to which the Lessor leases the equipment or real property to the Lessee, and the Lessee agrees to pay rent at specified times to the Issuer or its assigns. If the Lessor is not the trustee, the Lessor assigns its rights under the lease and in the leased property to a trustee or an agent pursuant to an assignment agreement.**
- **In either case, the trustee has, either by assignment or directly, the interest of the Lessor under the lease.**

COPs Structure

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Lessor and Trustee *Same Party*:



Additional Documents for COPs

- **Trust document**
 - Authorizes delivery of the COPs
 - A third-party trustee or agent agrees to (1) accept an assignment of the Lessor's right to receive payments under the lease and (2) disburse those payments to the certificate owners
- **For public offerings:**
 - Official Statement or other disclosure document
 - Continuing Disclosure Certificate/ Agreement
- **Certificates**
- **Additional legal opinions**
- **Investor Letter/Certificate**
- **Certificate Purchase Agreement**

Federal Tax Considerations for COPS

- **The tax exemption for COPS is derived from the Lessee and its obligations under the lease -- NOT from the Lessor or the certificates. If the lease is not a valid tax-exempt obligation, no portion of the interest payments made to COP holders will be tax-exempt.**
- **Fractionalization of lease may be vertical or horizontal, but care must be taken to avoid allocating interest accruing on one principal component to principal with a different maturity; results in creation of a “separate security” with probable loss of tax exemption.**
- **The trustee must not have the power under the trust instrument to unilaterally vary the terms of the trust; most trust instruments drafted to require the lessee to direct the investment of trust held funds.**
- **COP documents should make it clear that the proceeds of the COPS are being deposited in the trust to purchase the Lessee’s lease obligation, and are owned and controlled by the Lessee.**

Lease Revenue Bonds

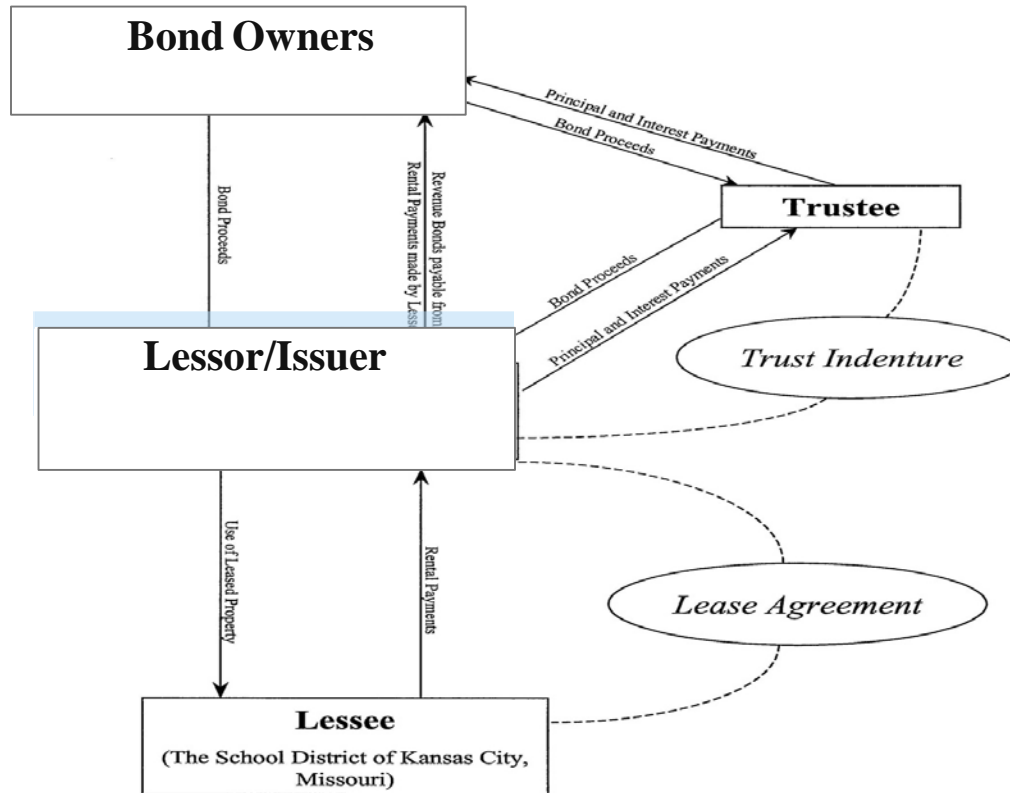
- Revenue bonds issued by the Lessor under the lease (the “Issuer”) that are payable only from rental payments received by the Lessor from the Lessee.
- In order to issue tax-exempt bonds, the Issuer must be a governmental entity or an “on-behalf-of” issuer for federal income tax purposes. Often the Issuer will be a “63-20” corporation, which is a nonprofit corporation that meets specific criteria set forth by the Internal Revenue Service, or a “constituted authority,” which is an entity specifically authorized by state law to issue bonds on behalf of a political subdivision (Rev. Rul. 57-187).
- The tax exemption for Lease Revenue Bonds is derived from the Issuer and the bonds themselves and not from the lease.

Structure of Lease Revenue Bonds

- **Lease pursuant to which the Issuer leases real or personal property to the Lessee, and the Lessee agrees to pay rent at specified times to the Issuer or its assigns. To the extent that real property is involved, a ground lease/site lease may be necessary.**
- **Issuer enters into a trust indenture pursuant to which the Issuer issues bonds and assigns to the trustee thereunder and grants a security interest to the Trustee in**
 - **the Issuer's rights under the lease, including its rights to receive rentals thereunder, and**
 - **the Issuer's interest in the real or personal property as security for the bonds.**
- **The bonds are limited obligations of the Issuer, payable only from revenues received under the lease. (Issuer is merely a conduit.)**

Lease Revenue Bond Structure

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Additional Documents for Lease Revenue Bonds

- **Trust Indenture**
 - Authorizes delivery of the bonds
 - Assigns Issuer's right to receive payments under the lease
 - Sets forth the terms of the bonds
- **For public offerings:**
 - Official Statement or other disclosure document
 - Continuing Disclosure Certificate/ Agreement
- **Bonds**
- **Additional legal opinions**
- **Investor Letter/Certificate**
- **Purchase Agreement**

Federal Tax Considerations for Lease Revenue Bonds

- **Consider tax-related issuer selection issues in structuring financing.**
- **Lease revenue bonds issued by a 63-20 corporation:**
 - may be issued on behalf of only one governmental entity;
 - may not be issued for the purpose of financing intangible property;
 - may not be issued for the purpose of financing working capital.

Bond Insurance Considerations

- **Essentiality**
- **Tail period**
- **Insurance requirements**
- **Rental interruption insurance for abatement leases**
- **Title work (title policy, search, opinion)**
- **Remedies: minimize contingencies/obstacles to exercise**

Disclosure Considerations

- **Disclosure relating to credit quality**
 - **Describe repayment sources (beyond legally available funds)**
 - **In certain circumstances, could actually be expected to be paid from other revenue streams (e.g. tax increment financing)**
 - **Provide adequate resources to investors to determine historical and future coverage**
 - **Describe whether additional appropriation obligations may be issued and whether there is a coverage standard**

More Disclosure Considerations

- **Disclosure relating to transaction structure and security**
 - Describe statement of essentiality which mimics the closing certificate/document
 - Make clear distinctions among Project Site vs. Project Facilities vs. Other Facilities vs. Leased Property
 - Describe whether the project fund is a trustee-held fund and part of the security
 - Describe the type of title work that was performed (title policy, search, opinion, etc.)
 - Describe the duration period which the ground lease exceeds the financing lease
 - Describe any facilitating/special purpose entity

More Disclosure Considerations

- **Remedies**
 - Describe right of lessee to non-appropriate (or abate rental payments in the case of an abatement lease)
 - Describe public policy issues that may limit the exercise of remedies
 - Describe risks and limitations associated with reletting facilities (especially with single purpose facilities) following a default
 - Note – in some recent transactions, the right of reletting was not granted to the Trustee
 - No right to accelerate with appropriation obligations

More Disclosure Considerations

- **Disclosure of effect of default or nonappropriation on tax- exemption**
 - **If Lessee nonappropriates, there is no longer an “obligation” of a state or political subdivision for purposes of Code Section 103**
 - **Payments of interest to holders of COPs by credit enhancers and bond insurers likely not tax-exempt**
 - **Tax counsel generally refuse to give opinions as to the tax-exempt status of interest payments to holders of COPs by any person other than the Lessee**

Remedies

- **Event of Nonappropriation for lease payments is not an Event of Default on the lease**
- **Event of Nonappropriation will likely result in default on Lease Revenue Bonds**
- **Primary remedy is loss of use of leased facilities**
- **Acceleration rights only for lease payments for which funds have been appropriated**
- **Essential use “catch 22” – having highly essential property as security decreases risk of nonappropriation, but increases risk that court will not enforce “loss of use” remedy for public policy reasons**

More Remedies

- **Title issues: does trustee, lessor or lessee have title to or security interest in equipment (state property tax implications)? Is there a mortgage or equitable right for trustee to sell real property?**
- **Chapter 9 municipal bankruptcy: debtor has the right to assume or reject unexpired leases**
- **Is there a statutory lien for lease payments for which appropriations have been made?**

Questions?

- Nathan Canova (canova.Nathan@Dorsey.com)
- Rob Mecklenborg (Rmecklenborg@FBTLaw.com)