

The Basics of Municipal Leasing

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How do State & Local Governments Traditionally Raise Capital?

1. Levy (or raise) Taxes
2. Create an Indebtedness (Bonds, Notes, Obligations)
 - a. General Obligation
 1. Full Faith and Credit
 - b. Revenue Backed
 1. Water & Sewer
 2. Sales Tax
3. Fees and User Charges

The Other Alternative!!!: Municipal Lease Purchase

- Developed in the 1960's to support the Office Technology boom.
- Legally not a debt. (Constitution)
- Considered Debt for GAAP Accounting & Credit Analysis.
- **Why: Non-Appropriation Clause**
Payments are not absolute, the funds must be appropriated each fiscal period.

What is a Municipal Lease?

A Lease/Purchase Agreement, pursuant to which:

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

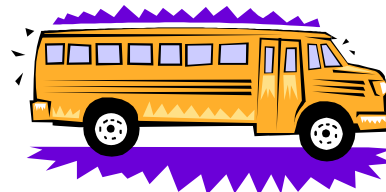
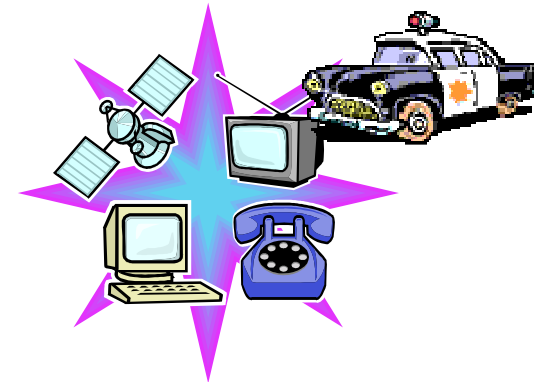
Credit Considerations – Municipal Leasing

1. Essential Purpose
2. Financial Capacity
 - A. General
 - I. Assessed Valuation
 - II. Demographic Trends
 - III. Legal/Statutory environment
 - B. Revenue Specific
 - I. Sources of Revenue
 1. Taxes (Sales, Hotel/Motel)
 2. Utility (Water, Gas, Electric, Broadband)
3. Documentation- Lease Agreement
 - A. Legal, Valid, Binding (at least 50 sets of rules)
 - B. Title/Security Interest
 - C. Mortgage/Base Lease (Ground Lease)
 - D. Tax Opinion

What Can Be Leased?

Personal Property Examples

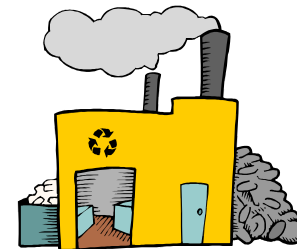
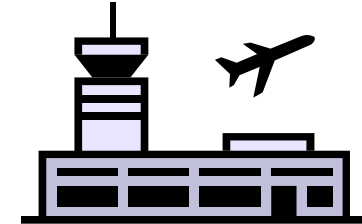
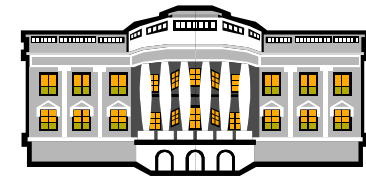
- Vehicles,
 - such as Fire Trucks, Police Cars, Ambulances, Refuse Trucks & School Buses
- Telecommunications Equipment
- Computers & Software
- Copiers & Other Office Equipment
- Safety Equipment
- Energy Management Systems,
 - such as HVAC equipment
- Medical Equipment
- Modular Buildings
- Substitute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



What Can Be Leased?

Real Property Examples

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



Who are Eligible Lessees?

Direct Issuers: (100,000 Nationally)

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

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

- 501(c)(3) Organizations
 - Generally includes:
 - Charitable, Religious & Educational Entities
 - Hospitals
 - Private Schools
- Certain Private Parties
 - Such as:
 - Manufacturers
 - Other Exempt Facilities

Why Use Lease Financing?

- Alleviates cash flow burden that would be created by a lump sum capital expenditure.
 - A lease (unlike bonds) is not generally classified as “debt”, therefore –
 - No voter approval required, which allows for more timely financing.
 - Lease is usually not subject to legal debt limitations.
 - Lease does not encumber Lessee’s tax or other revenues, unlike a bond financing.
- More structuring flexibility than with bonds.
 - Can match separate lease terms with each asset’s expected useful life.
 - Benefits of a direct lease or a single-investor lease vs. a public offering of bonds:
 - Lower transaction costs
 - More flexibility in timing & structure
 - Fewer documents
 - Less complicated for Lessee

Transaction Structures

- Lease-Purchase of Equipment or Real Property
 - Non-Appropriation
 - Abatement
 - Terms 1 – 20 Years (Sometimes Longer)
- Lease Revenue Bonds
- Certificates of Participation (“COPS”)
- 501(c)(3) Conduit Financings & Industrial Revenue Bonds

The Municipal Leasing Market Today

Pre 9/11 and Economic Slowdown:

- Cash Rich borrowers (Sales Tax, Income Tax)
- Bond issues relatively easy to pass

Today

- Budgets are tight
- Bond Issues are more complex & expensive

The Answer: Municipal Leases

- Less cash required
- Flexibility of terms
- No voting requirements with adequate cash flow
- Real and personal property

Common Municipal Leasing Terms

Bank Qualified: -Must be for Governmental Purpose or 501 (c)3
-Does not reflect credit quality
-Lessee expects to borrow less than \$10 Million during that calendar year.

Private Activity : Over 10% of the financed facility or equipment will be used by a private concern.

Non-Substitution: The borrower is not allowed to replace the equipment for a period of time following a non-appropriation.

--- **Court Decisions: Invalid**

Reimbursement Resolution: Allows a lessee to reimburse cash outlays from bond or lease proceeds (Must be done within 60 days of expenditure.)

Firm Term Lease : Not subject to annual appropriation

Documenting the Master Lease Agreement

- The Agreement
- Schedule of Lease rental payments
 - (including prepayment schedule)
- Delivery and Acceptance
- Board Resolution (Municipal Certificate)
- Attorneys Opinion (Legal, Valid, Binding)
- UCC/Title
- 8038 G
- Escrow Agreement
- Arbitrage Certificate (Over \$1 million)

The Process

- Sign Up the Deal
- Structure the Transaction
- Submit the Deal
- Credit Review
- Approval
- Funding
- Get Paid!!

Thanks And Good Luck!!

Credit Requirements

Primary Analysis

- Ability to Pay
- Willingness to Pay



Ability to Pay

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



Willingness to Pay

- Political Situation
- Essentiality of Asset
- Security Interest in the Asset
- Government Authorization

Ability to Pay

Financial Performance

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

Revenue & Expenditure Analysis

Sources of Revenues

- Limits
- Vulnerability to Economic Cycles
- Non-recurring

Sources of Expenditures

- Fixed vs. Discretionary
- Limits on Growth

Identify Available Funds

- General
- Special Revenue
- Enterprise
- Debt Service

Surplus vs. Deficit Operations

Fund Balance & Balance Sheet

- Fund Balance Trend
- Fund Balance as a % Expenditures
 - Type of Issuer SD vs. County
 - Public Policy Issues
- Fund Balance Composition
 - Reserved
 - Unreserved

Ability to Pay

Debt Management

- Debt Burden
 - Debt per Capita
 - Debt % Full Value
 - Debt Service % Expenses
 - Overlapping Debt
- Future Debt Plans
- Debt Limits
 - Statutory or Practical
 - Remaining Debt Capacity



Ability to Pay

Economy

- Population Trends
 - Pressure on budgets and demands for services
- Wealth and Income Levels
 - Absolute
 - Relative to Debt
- Employer & Tax Base Concentrations
 - Top 5 payers or employers
 - Industry concentrations
 - Unemployment Trends

Ability to Pay

Construction Risk

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



Ability to Pay

Source of Repayment

- Typically General Fund Monies
- Limited Sources
 - What is source?
 - How is it generated?
 - How vulnerable to economic cycles?
 - Project dependent?

Willingness to Pay

Political Situation

- Popular Project
- Lease vs. Debt
- Prior defaults, non-appropriation or bankruptcies



Willingness to Pay

Government Authorization

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

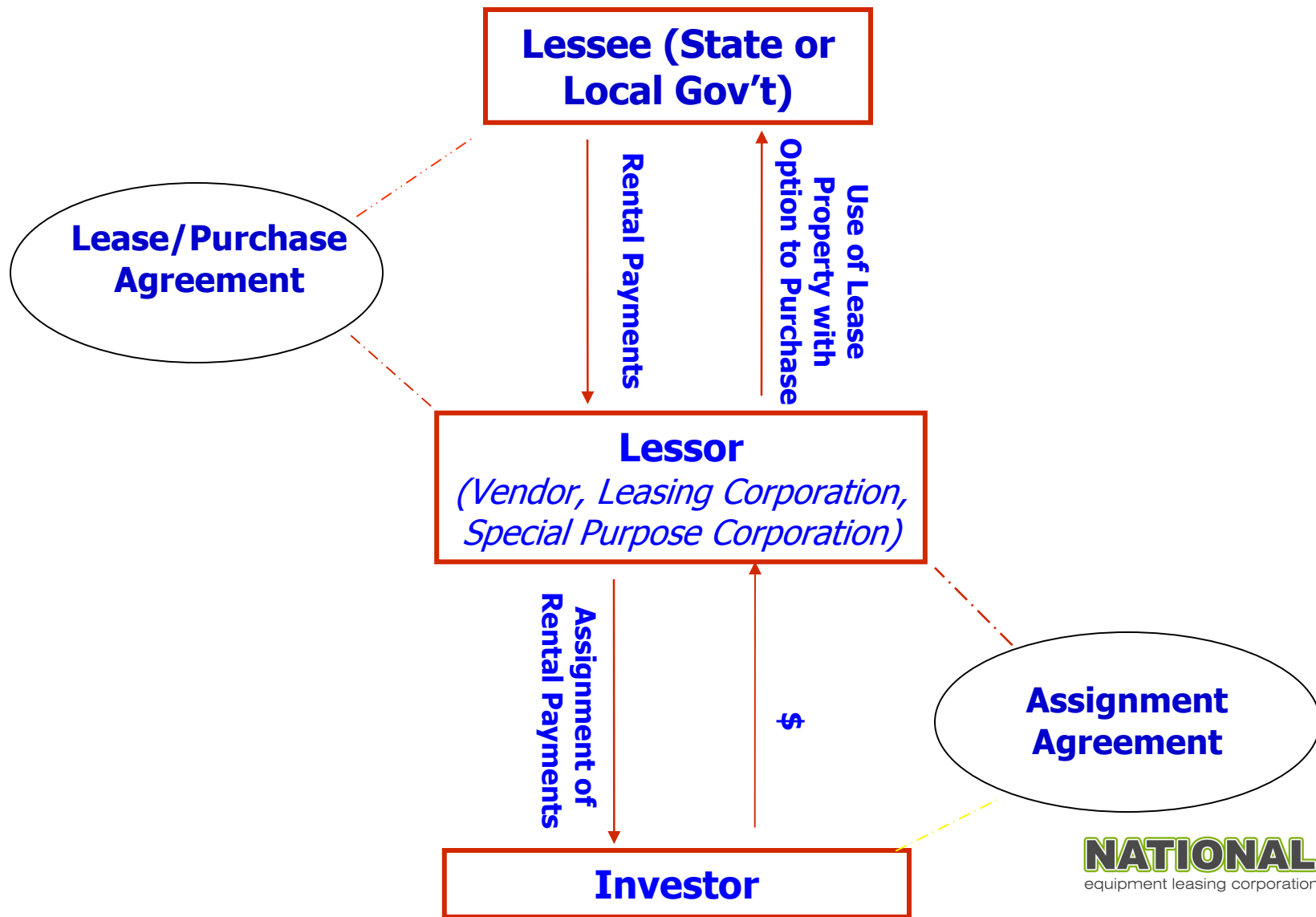
Occurrence of Problems

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

Transaction Structures

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

Basic Equipment Lease Structure

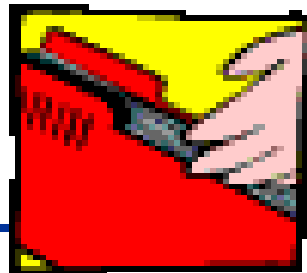


Typical Lease Documents

- **Lease/Purchase Agreement, which should incorporate:**
 - **Payment Schedule, stating dated date & separately stating principal & interest components**
 - **Equipment Schedule (including location and vendor)**
- **Assignment Agreement (if original Lessor will not hold the paper)**
- **Escrow Agreement (if all property is not paid for at closing)**
- **Tax Questionnaire**
- **Federal Tax Certificate**
- **IRS 8038-G or IRS 8038-GC**
- **Lessee's Certificate**
 - **Include Incumbency Certification for officers authorized to execute the Lease, escrow draw requests (if applicable) & acceptance certificates**
- **UCC-1 Financing Statements**
- **Validity Opinion**
- **Tax Opinion**
- **Insurance Certificates**
 - **Property & Casualty**
 - **Rental Interruption (abatement)**
 - **Liability (in some cases)**
 - **Performance and payment bonds**
- **Acceptance Certificate**

Additional Documents for a Real Property Lease

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



- **Plans and specifications**
- **Construction and architect's contracts and other material contracts**
- **Assignment of construction and architect's contracts**
- **Survey**
- **Building permit and other required approvals**

Additional Documents for Certificates of Participation

- **Trust document**
 - **Authorizes delivery of the COPs**
 - **A third-party trustee or agent agrees to (1) accept an assignment of the Lessor's right to receive payments under the Lease and (2) disburse those payments to the certificate owners**
- **Official Statement or other disclosure document**
- **COPs**
- **Additional legal opinions**
- **Continuing Disclosure Agreement the repositories certain**

Document Issues

- **Proper Execution**
 - Usually requires approval by the governing body
 - Is the authorized representative the one who signed?
- **Can the validity opinion be reasonably relied upon?**
 - Consider expertise of counsel & any unusual State law requirements
- **Is a tax opinion necessary?**

- **Dating of Documents and Opinions**
 - Distinguish between document date and commencement date
 - Opinions should be dated the date of funding



Legal Issues: State Law Considerations

- **Legal power to enter the transaction under state law**
- **Authorization by governing body and execution by authorized official**
- **Compliance with applicable debt limitations**
 - **In most cases, if a proper “nonappropriation clause” or “abatement clause” is included, the Lease is not subject to debt limitations**
 - **The incorporation of such clauses may limit other remedies such as acceleration**

- **Compliance with applicable interest rate limitations**
- **Compliance with applicable public bidding requirements –**
 - **For the purchase of the property; and/or**
 - **For the lease-purchase agreement itself**

Legal Issues: More State Law Considerations

- **Nonsubstitution clauses**
 - Are prohibited or limited in some states (potentially resulting in invalidation of the lease)
 - Are of doubtful enforceability in other states
- **Indemnity by Lessee**
 - May not be enforceable
 - Should be qualified by “to the extent permitted by law”

- **Title**
 - Title to personal property is often granted to the Lessee during the lease term, subject to Lessor’s right to retake the property
 - Some entities in some states are required to maintain title in Lessor during the lease term
- **Assignment**
 - Some Lessees require limitations on the ability of Lessor to assign rights under the Lease
- **Unique state requirements**

Legal Issues: Federal Tax Law Considerations

- **Lessee must be a state or a political subdivision of a state (power to tax, power of eminent domain or police power)**
- **The Lease must be a “financing lease”—**
 - Separately stated interest component
 - Nominal purchase price at end of lease
 - Term less than useful life
- **The Lease must be in “registered form”—the Lessee or its agent must keep a record of the assignees**
- **Restrictions on amount of lease-financed property that may be used in private use**
 - Requires limitations on assignment and subleasing and management contracts
 - Ownership or leasehold interest is by definition “use”

Legal Issues: More Federal Tax Law Considerations

- **Arbitrage restrictions apply—**

- Expenditures of “proceeds”
- Investment Limitations
- Issue Price

- **Rebate provisions generally apply unless—**

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

- **Bank-Qualification may be available if:**

- Lessee reasonably expects to issue no more than \$10 million tax-exempt in a calendar year; and
- Lessee does not designate more than \$10 million as bank-qualified

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

- **IRS Form 8038-G or 8038-GC must be timely filed**

Why Do We Need the Lawyers!?

**Lessee's Counsel
(Local Counsel)**

Tax Counsel

Lessor's Counsel

Underwriter's Counsel



Questions??
Call your National expert
800.770.6352

