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Leases and Other Alternative Financing Structures

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This panel will provide an overview of common municipal financing transactions, other than general obligation bonds, including leases, installment payment contracts, special district financing, revenue financing and pool programs.

I. TRADITIONAL AND ALTERNATIVE FINANCING STRUCTURES

A. General Obligation Bonds

1. **Overview**. General obligation bonds are the most traditional form of financings for municipalities. The primary common features of general obligation bonds are that they[1]: (a) are backed by the issuer's full faith and credit; (b) may be supported by the issuer's ability to levy and collect taxes (particularly property/ad valorem taxes); and (c) may require voter approval depending on the jurisdiction.

2. **Benefits.** Because general obligation debt is typically supported by the taxing power of the issuer, it poses a relatively low risk to investors and, therefore, often provides the lowest cost of borrowing for municipal issuers. In addition, the documentation for general obligation debt is generally simpler than for other municipal debt, in part because state statutes often specify the specifics of issuance and repayment.

3. **Limitations.** Issuers need alternatives to general obligation debt for several reasons. First, state law generally limits the use of proceeds of general obligation debt, and not all projects an issuer wishes to finance will qualify for general obligation funding. Second, in some cases, there may be debt limit restrictions in the state constitution or statutes that constrain the issuer's ability to issue general obligation debt. Third, an issuer may not be able to get voter approval for the proposed debt or may want to avoid the time-consuming process of getting voter approval. Fourth, the issuer may want or need to use a different source of revenues to repay the debt. Fifth, the issuer may not have the legal authority to issue general obligation debt. For

[1] Constitutional and statutory provisions relating to general obligation debt vary from state to state and even from jurisdiction to jurisdiction within a state. For instance, in some jurisdictions, general obligation debt is secured solely by the issuer's obligation to levy and collect ad valorem property taxes sufficient to make payments on the debt, while in others, the issuer's full faith and credit and amounts in the general fund are pledged.

example, municipal utility issuers often do not have taxing power and can only issue revenue-backed debt. Depending on state law and the needs of the issuer, there may be additional reasons for an issuer to choose non-general obligation debt.

B. Alternatives to General Obligations

If, for any reason, an issuer wants or needs to issue debt other than general obligation debt, there are many alternatives to general obligation financing. The type of financing to be used will depend on many factors, including, but not limited to, the nature of the proposed projects, any relevant statutory restrictions, and the preferred source of repayment. Following are several types of alternatives to general obligation financings that may be used:

- Leases and Installment Sale Contracts
- Revenue Bonds
- Double-Barreled Obligations
- Bond Anticipation Notes
- Grant, Revenue and Tax Anticipation Notes
- Assessment Financings
- Tax Increment Financings
- Special District Financings
- Debt Limitation Exceptions

Not covered in this outline are conduit financings for the benefit of non-municipal entities; see the outlines for “Conduit Issues and Issuers,” “Qualified Small Issue and Exempt Facility Bonds,” and “Qualified 501(c)(3) Bonds.”

II. LEASE FINANCINGS

A. Definition

“Leasing”, including tax-exempt leasing, is a financing technique by which state and local governments acquire real and personal property. It may involve documents labeled variously as a “lease,” a “municipal lease,” a “lease-purchase agreement,” an “installment purchase contract,” an “installment sale contract,” a “purchase order,” or simply a “contract,” among others. The common elements of such agreements are (1) installment payments, characterized as rent or otherwise, that include a specified interest component, and are being made by a state or political subdivision for the purpose of acquiring the use of, and, in many cases, title to, real or personal property and (2) in most jurisdictions, carefully drafted documents to ensure that the agreement does not constitute “debt” for state law purposes. While state laws are important for all types of municipal financings, lease financings, in particular, frequently involve complex state law issues that are unique to each state as is discussed in more detail below.

For accounting purposes, essentially all leases under which state and local governmental entities lease property are now treated as debt for purposes of the entity’s financial statements. GASB Statement No. 87 (“GASB 87”), which is generally applicable for fiscal years commencing after June 15, 2021, requires governmental entities to recognize any long-term lease as a liability (as well as a related asset) on its financial statements. Governmental entities are in the process of complying with GASB 87, which is a fairly significant change in financial statement reporting.

While the accounting treatment of leases by governmental entities has recently changed, the federal tax treatment of leases generally has not changed. Under federal tax principles, leases most often are either (1) financing leases (sometimes called capital leases) or (2) true leases (sometimes called tax-exempt use leases). Most financing leases involve the transfer of title to the real or personal property to the governmental entity at the end of the lease (either by operation of the documents or upon payment of a *de minimis* purchase price). In this way, a financing lease has the same end result as a loan with respect to title to the real or personal property. A true lease differs from a financing lease in that the true lease generally involves no transfer of title to the property to the governmental entity at the end of the term (except, in some cases, at a fair market value sales price). Instead, title to the property remains with the lessor at the end of the term and so the lessee has not built up any equity in the property. Accordingly, a true lease is not normally permitted to be treated as a tax-exempt obligation for federal income tax purposes. In this outline, the term "lease," except when specifically identified as a true lease, is used as the generic term to include all the various types of financing lease agreements.

The following discussion will examine the evolution of the lease as a financing technique, and provide a general checklist of matters to be considered in rendering an opinion that a particular lease is duly authorized and a valid and binding obligation of a governmental lessee and that the interest component of the rentals due under the lease or of the installment payments due under an installment sale contract to be made by the governmental lessee is excluded from gross income for federal and/or state income tax purposes.

B. Forms of Leases

1. **<u>Annual *Quid Pro Quo* Leases</u>**. Although the legal analysis upholding the validity of leases, including true leases, varies from jurisdiction to jurisdiction (due primarily to variations in constitutional, statutory and charter provisions relating to the authority for such obligations and the applicable debt and budget limitations), leases have often withstood challenges that they create unlawful indebtedness on the reasoning that the governmental lessee is only liable to pay rents during each fiscal period in an amount equal to the value of the use and possession of the leased property during that period. In this respect, the obligation of the governmental lessee is comparable to that incurred, for example, in hiring a police officer: for one day's work, one day's pay is owed. Because the lease obligation does not create an immediate liability for all rents or other amounts scheduled to be paid during the term of the lease, but only a liability to the extent of the contemporaneous value received, it arguably does not create unconstitutional or illegal "indebtedness." This legal analysis applies to both financing leases and true leases. Unlike a financing lease, a true lease can be defended even in situations where the obligation to pay rent is not expressly conditioned on annual appropriations by the state or local government, because under common law the lessee has no obligation to pay rent until it comes due under the terms of the lease and there is no right of acceleration of future rents upon default by the lessee. *See* 1 HERBERT THORNDIKE TIFFANY, THE LAW OF LANDLORD & TENANT 166 (1910). As already stated, a true lease generally cannot be structured as a tax-exempt obligation given the federal tax law requirement that the lessee build up equity in the leased property. *See* Rev. Rul. 55-540 and PLRs 8235056 and 8347058.

(a) **Current Liability**. *City of Los Angeles v. Offner*, 19 Cal.2d 483 (Cal. 1942), involved a lease/lease-back arrangement under which the city leased a site to a contractor, the contractor built a facility on the site and leased both the site and the facility back to the city. In holding that the lease-back to the city did not create an unconstitutional debt, the Court stated, "If the lease or other agreement is entered into in good faith and creates no immediate indebtedness for the aggregate installments therein provided for but, on the contrary, confines liability to each installment as it falls due, and each year's payment is for the consideration actually furnished that year, no violence is done to the constitutional provision." *Id.* at 486. Additionally, contracts for the furnishing of property in the future may be upheld, but only where no liability or indebtedness came into existence until the consideration was actually furnished." *Id.*

(b) **Fair Rental Value**. Although not always expressly stated in court decisions, the notion that the rents payable pursuant to a lease during each fiscal period represent fair consideration for the use and occupancy of the property during that period -- i.e., the concept of "fair rental value" -- is implicit in the supporting legal analysis. *See, e.g., Offner* at 487; *Dean v. Kuchel*, 218 P.2d 521, 523 (Cal. 1950); *accord City of San Diego v. Rider*, 47 Cal.App.4th 1473 (Cal. Ct. App. 1996). Thus, for example, "front-end loading" rental payments or fully-amortizing the cost of 30-year property over a 5-year lease term could raise questions concerning whether the governmental lessee is purchasing property on an installment basis, and thus has incurred debt because such arrangements would arguably result in the payment of rent in each fiscal period greatly in excess of the value of the use and occupancy of the property during that period, with a resulting equity build-up.

Because the concept of fair rental value, where expressly recognized, is "judge-made" law, there are no precise standards for determining fair rental value. For example, how much should a leasing company charge a public school district to rent a fleet of school buses under an agreement that is subject to annual renewal/termination? Won't the actual annual installment payments under a financing lease involving a tax-exempt rate inevitably be less than the commercial "fair rental value" for such property in such a case because of the discount afforded with the tax-exempt rate?

2. **Annual Appropriation Leases**. In many jurisdictions, leases have been upheld because the governmental unit has the option to terminate the lease at the end of each fiscal period, for example, by not appropriating the funds needed to pay the rent coming due in the next fiscal period. Because the lease does not obligate public moneys in a future year, it does not constitute "indebtedness." The underlying concept is that a "debt" is something that binds the governmental unit to make payments in future budget years. Without a binding obligation that extends beyond the current fiscal period, there is no "debt" in the requisite sense. However, leases subject to annual appropriation often include a good faith clause which requires the governmental unit to use its best efforts to appropriate the rental payments. This concept has been the subject of a great deal of scrutiny as opponents of lease financings attempted to have such leases declared to be "debt," and, therefore, invalid, in part, because applicable constitutional, statutory or charter procedures for the creation of "debt" were not followed.

(a) **Legal Liability**. One such case, *State ex rel. Kane v. Goldschmidt*, 783 P.2d 988 (Or. 1989), involved a financing agreement whereby the state's interest in the financed property would automatically terminate at the end of each fiscal period unless the legislature appropriated the funds necessary to pay the amounts scheduled to come due in the next fiscal period. Subject to payment of all scheduled amounts under the agreement, the state would receive title to the property at the end of the term. In sustaining the validity of this arrangement against a challenge that it constituted unconstitutional indebtedness, the Court analyzed the law as follows:

> The debates on the floor of the [constitutional] convention left little doubt as to the purpose of the debt limitation. The central concern was that future generations should not be saddled with the excessive undertakings of an imprudent legislature. The debt limitation was therefore adopted to protect against burdensome and excessive taxation. ... "Long-term obligations create a fixed charge against future revenues and can impair the flexibility of planning and the ability of future legislatures to avoid a tax increase." . . .
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> This court has looked at not less than two basic characteristics in deciding whether action violates Article XI, section 7 [of the Oregon constitution]: (1) the fund from which payments on the obligation are made; and (2) the degree to which the public body is liable for repayment of the loan.
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> The state's promise of repayment is conditioned on the willingness of future legislative assemblies to appropriate the funds. The state does not promise that future legislatures will appropriate any funds. The lenders take the risk of non-payment. This aspect of the legislation does not create a fixed charge against future revenues, nor does it impair the flexibility of planning and the ability of future legislatures to avoid a tax increase. 308 Or. 573, 580-81, 586. (Citations omitted.)[2]

In a similar case, *Business Computer Rentals v. State Treasurer*, 953 P.2d 13 (Nev. 1998), after analyzing the holding in *Goldschmidt* and other similar cases, determined that a lease for computer equipment containing a nonappropriation clause did not create "public debt" in contravention of the Nevada Constitution, and granted the petitioner's writ of mandamus directing the State Treasurer to make payments under the lease. Specifically, the Court held the following:

> [T]he lease's nonappropriation provisions bring it outside the scope of Nevada Constitution article 9, section 3. The agreement's subject matter is fungible equipment, susceptible to repossession. Further, the contract clearly provides that payments are contingent on funds being appropriated

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[2] *Id.* at 991-992. *See also Dykes v. North Virginia Transportation District Commission*, 411 S.E.2d 1 (Va. 1991); *Dieck v. Unified School District of Antigo*, 477 N.W.2d 613 (Wis. 1991); *State Department of Ecology v. State Finance Committee,* 804 P.2d 1241 (Wash. 1991); *In re Anzai*, 936 P.2d 637 (Haw. 1997); *State ex rel. Charleston Building Commission v. Dial*, 479 S.E.2d 695 (W. Va. 1996); *Emplrs. Ins. Co. v. State Bd. of Examiners*, 21 P.3d 628 (Nev. 2001) (supporting the proposition that nonappropriation leases do not constitute "debt"). *But see Brown v. Stuttgart*, 847 S.W.2d 710 (Ark. 1993) (finding that a lease constituted "interest bearing indebtedness" which was prohibited by the state constitution); *Montano v. Gabaldon*, 766 P.2d 1328 (N.M. 1989) (holding that a lease constituted unlawful indebtedness since it had not been approved by the voters as required by the state constitution).

> by the legislature. The agreement automatically terminates if the legislature fails to appropriate sufficient funds for the payments, and in such a situation, BCR is entitled to repossess the equipment. Under the current revenue doctrine, no constitutionally proscribed public debt is created. Unlike the situation in *Hancock,* realism does not demand that "indebtedness ... is immediately created for the aggregate amount required by the period of the pledge." *Hancock*, 468 P.2d 333, 337 [(Nev. 1970)]. Here, the legislature is not compelled to appropriate money in the future.

(b) <u>Compulsion to Appropriate</u>. Because the failure to appropriate rent payments coming due in the next fiscal period can have severe adverse consequences for the governmental unit[3], it is often argued that while the governmental unit may not be legally bound to appropriate funds for future fiscal periods, it is economically compelled to do so as a practical matter and thus the arrangement is the functional equivalent of "debt." This argument has been rejected by numerous courts; however, it continues to be a key argument in challenges to the validity of annually renewable/appropriation leases.

(1) <u>Loss of Credit Rating</u>. In rejecting an argument premised on the loss of credit rating in the event of nonappropriation, the Court in *Goldschmidt* stated:

> Nor does the fact that the legislature may feel compelled to make payments in a future [fiscal period] out of the fiscal concern to protect its credit rating convert the state's obligation into a legal one subject to [the constitutional restrictions on the incurrence of indebtedness]. The economic and fiscal consequences of either continuing the agreements or allowing them to terminate by failing to appropriate money merely becomes [sic] a factor in the public policy calculus of a political system that automatically subjects the economic wisdom of such projects to [biennial] review by future taxpayers and their elected representatives. [Citation omitted.] These consequences are of no constitutional significance.[4]

Similarly, the court in *Colorado Criminal Justice Reform Coalition v. Ortiz*, 121 P.3d 288 (Colo. App. 2005) rejected the plaintiffs' argument that the contested lease purchase agreements would, in reality, be multiple-fiscal year obligations because the failure to appropriate would have a negative effect on the state's credit rating. Specifically, the court cited state precedent holding that "the . . . argument that nonrenewal of the lease will ruin the credit of the state . . . is a matter that may affect the legislature's exercise of its discretion, but does not commit revenues available to future legislatures to the payment of rentals under the lease." [Citation omitted.][5]

(2) <u>Contra</u>. The contrary result was reached in *Witzenburger v. State ex rel. Wyo. Cmty. Dev. Auth.*, 575 P. 2d 1100 (Wyo. 1978), *rehearing denied* 577 P.2d 1386

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[3] Consequences may include a downgrade of the issuer's credit rating, triggering a payment of a premium on the issuer's outstanding and future obligations, and/or the loss of any equity built up in the financed property.

[4] *Goldschmidt*, 783 P.2d at 995-996. *See also id*. at n. 12 (citing similar cases from other jurisdictions).

[5] *Glennon Heights, Inc. v. Central Bank & Trust*, 658 P.2d 872, 879 (Co. 1983). *See also, Bd. Of County Comm'rs v. Dougherty, Dawkins, Strand & Bigelow Inc.*, 890 P.2d 199 (Colo. App. 1994).

(Wyo. 1978). Also, rating agencies have lowered ratings on outstanding debt obligations of municipalities that failed to appropriate sufficient money to pay debt service on leases or other obligations that are clearly identified in the offering documents as subject to such appropriation[6].

(3) Loss of Equity. The Court in *Goldschmidt*, *supra*, held that an unconstitutional "debt" could be created if, upon a failure to renew the lease for a succeeding year, the state stood to lose its entire equity in the financed property:

> A common lease-purchase agreement generally allows the lessee to terminate the transaction without further liability if the lessee no longer needs, wants, or can afford the leased property. This does not create a debt or liability [footnote omitted]. The situation is more questionable if, upon terminating the agreement, the state stands to lose more than what remains to be paid on the acquired property, for instance, if most of the agreed price of an outright purchase, including interest, has been paid but termination will cause the state's entire valuable property (worth more than the unpaid balance) to pass into the hands of the seller or lender. In that situation, the agreement confronts future legislators with the choice between the financial cost of continued cash payments or the financial cost of losing valuable nonmonetary property. This contingency may appear to create a liability, prohibited by [the state constitution]. . . . We therefore hold no more than that the participation agreements are not on their face forbidden as a future debt or liability contrary [to the state constitution], so long as the state stands to lose property or the use of property worth no more than the unpaid balance under the agreement.[7]

On the other hand, in the case of *Wayne County Citizens Ass'n for Better Tax Control v. Wayne County Bd of Commissioners*, 328 N.C. 24 (N.C. 1991), the North Carolina Supreme Court sustained the validity of an installment purchase contract where the obligation to make installment payments was subject to annual appropriation and the County's obligations under the contract were secured by a security interest in the property covered by the contract. The Court concluded that "debt, within the meaning of the state constitution, included only those obligations for which the taxing power of the governmental unit was pledged. The fact that upon default, or nonappropriation, property of the governmental unit having a greater value than the unpaid balance of the installment purchase payments could be forfeited was found not to be sufficient for the creation of debt. What is being pledged is the constitutionally significant factor. Unlike general obligation bonds, wherein the taxing power of the governmental unit is pledged, in installment purchase contracts, only the property improved is pledged. The possibility that appropriations that might include income from tax revenues will be used to repay the indebtedness under the contract is not a constitutionally significant factor." *Id.* at 31. In reaching this conclusion, the Court expressly noted that both the enabling statute and the contract itself barred any deficiency

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[6] Such examples include Vadnais Heights, Minnesota, and Lombard, Illinois.

[7] *Goldschmidt*, 783 P.2d at 997-998.

judgments against the County, presumably a significant fact because of the possibility that deficiency judgments could be subject to satisfaction out of tax revenues.

In jurisdictions where the constitutional concept of "debt" is not expressly linked to a pledge of the taxing power (as it was in *Wayne County, supra*) but is more broadly defined to include any obligation extending beyond the current fiscal period for which any assets of the governmental unit are at risk (as in *Goldschmidt, supra*), the logic employed by the Oregon Court would seem equally applicable to annual appropriation leases. Thus, in jurisdictions similar to Oregon, it may be prudent to limit the lessor/trustee's remedies in a nonappropriation situation to sale of the leased property and recovery of the balance of the scheduled rents, with any excess, *i.e.* the "equity," being remitted to the governmental unit.

3. **<u>Abatement Leases</u>**. In moving from the true lease considered in *Offner, supra* (where the city only had the option to purchase at fair market value), to a capital or financing lease, the courts in certain states such as California have fashioned the concept of "abatement leases," which are not considered to violate the constitutional limitations on indebtedness. An abatement lease has the following characteristics:

(a) **<u>Vesting of Title at End of Term</u>**. At the end of the lease term, upon the payment of all rents, or prior to the end of the term upon prepayment of the unpaid principal components of the lease payments and accrued and unpaid interest thereon prior to the end of the term, title to the property covered by the lease vests in the governmental unit. In sustaining this automatic vesting of title, in *Dean*, the Court reasoned:

> We find no logical distinction between the Offner case and the one at the bar. It is true that [in *Offner*] there was an option to purchase [at fair market value]. . . rather than a vesting of title at the end of the term [as] in the instant case, but as far as liability is concerned, the state under the instrument here is in a better position, for it gets title without the payment of anything other than the rental. The essence of the Offner rule is that the payments are for a month to month use of the building. Here it is clearly stated that the rentals are for that purpose. There is no substantial or logical difference between the option to purchase in the Offner case and the vesting of title at the end of the term in this case. True, the city was not bound to execute the option and thus pay the purchase price, but it was required to pay the rentals. Here the rentals also must be paid but the state need not pay any more.[8]

(b) **<u>Rents Subject to Abatement</u>**. If the property is not available for use by the governmental unit, or if there is substantial interference with the governmental unit's use or occupancy of the project, then the rents otherwise payable under the lease must be proportionately abated.

(1) <u>Abatement Generally</u>. In *Starr v. City and County of San Francisco*, 72 Cal. App. 3d 164, 172 (Cal. Ct. App. 1977), the Court pointed out the characteristics of the lease in question (which comply with the requirements of *Offner, supra*, and *Dean, supra*)

[8] *Dean v. Kuchel*, 218 P.2d at 523 (Cal. 1950).

and noted that "[t]he base rental is for specified amounts to be paid by the City to the Agency 'as rental for use and occupancy of the Project,' with rent abatement provisions if the project is not substantially completed and ready for occupancy by July 15, 1980, or if there is a subsequent substantial interference with use and occupancy of the premises."

(2) Covenant to Appropriate/General Fund Obligation. Because this approach to holding that the lease does not constitute "debt" is based on the fact that liability for rents is confined to "each installment as it falls due and each year's payment is for the consideration actually furnished that year" (see *Offner, supra*), the governmental unit is obligated to make the rent payments as they come due (subject only to abatement) and can be compelled to appropriate money for that purpose. This generally results in inclusion of a covenant to appropriate money from the general fund sufficient to pay the rents due in each fiscal period. The net effect is what might be called a "general fund limited tax obligation subject to abatement," a binding and enforceable obligation payable out of any lawfully available money of the governmental unit (including general fund tax revenues) but for which the governmental unit cannot be compelled to levy taxes beyond those authorized for general purposes and that is subject to abatement to the extent of any substantial interference with use or occupancy of the property.

Nevertheless, there is no right to accelerate the rents upon default. Rather, the lessor is limited to suing to collect each rental payment as it comes due.

(3) No Obligation During Construction/Acquisition Period. In keeping with the abatement theory (*i.e.*, the municipal lessee has no liability for rent except to the extent the property is available for use and occupancy), until the property subject to the lease has been acquired or constructed, the governmental unit's obligation to pay rents must be limited to sources other than its own funds or assets - *e.g.*, the capitalized interest fund and interest earnings on the acquisition/construction fund created under the financing documents and funded with the proceeds derived from the sale of the lease obligation. This aspect of the abatement lease thus incorporates an element of the special fund doctrine in terms of providing a constitutionally permissible source other than *ad valorem* taxes from which to pay interest during the acquisition or construction period.

4. Limited Tax and Full Faith and Credit Leases. In certain jurisdictions, it may be possible to structure a lease payable from and secured by a limited tax, contractual commitment or full faith and credit obligation of the governmental unit that is not subject to annual appropriation or abatement. In such cases, such leases may have some or all of the following characteristics:

(a) Obligation to Pay Rents. The governmental unit is obligated to make the rent payments and can be compelled to appropriate money for that purpose. This aspect of the governmental unit's binding obligation is generally recognized by the inclusion of a provision making the obligation to pay rents a full faith and credit obligation payable out of any lawfully available source of funds, including property taxes that the unit is otherwise authorized to levy in accordance with, and subject to, the limits of the state constitution.

(b) Obligation Unconditional; No Abatement. The obligation to pay rent is unconditional and not subject to abatement. Rather, the arrangement is structured as a true financing arrangement where the risk of loss, or interference with use and occupancy, is borne by the governmental unit.

(c) No Fair Rental Value Requirement. Because the legal theory is based on the governmental unit's ability to enter into lease-purchase arrangements as authorized by statute or charter, and unencumbered by constitutional debt limits, there is no express requirement that the payments represent fair rental value. Rather, the term of the lease is generally governed by the governmental unit's ability to pay and accounting concepts relating to amortization of the cost of capital items over their economic life.[9]

(d) Right to Accelerate Rents on Default. The lessor may be given the right to accelerate all unpaid lease payments upon default.

5. Special Fund Leases and Related Variants. In several jurisdictions, lease financings have evolved to incorporate features such as pledges of specific revenues normally associated with the special fund doctrine. (See discussion under "**Other Common Financing Structures**" below.)

6. "Asset Transfer" Lease Financing Transactions. If permitted by state law, a governmental unit may wish to enter into an "asset transfer" lease financing transaction, in which the governmental unit leases or sells an existing asset that it already owns to a lessor and simultaneously leases it back. The proceeds generated from the sale or leasing of the existing asset are used for other governmental capital projects.

(a) State Law Issues. State and local law may only allow a governmental entity to sell or otherwise dispose of property that it owns if the governing body determines that the property is obsolete, unfit or surplus property, which is no longer needed by the governmental entity, or may require that such a sale or disposition be authorized by its voters or by public auction. Other state law considerations under applicable state laws and judicial interpretations would be whether or not this form of lease purchase financing represents a type of "cross collateralization" that constitutes invalidly incurred debt in the jurisdiction or a "mortgage" of public property that is not permitted.

(b) Potential Advantages. If state law issues can be resolved, the practical advantages of an asset transfer lease financing include (i) the elimination of construction risk (because the asset securing the lease is already in existence) and the potential need for capitalized interest, (ii) having an asset to secure the lease that is potentially more essential to the governmental unit than the asset or assets that need to be financed, or (iii) being able to finance improvements to existing buildings that otherwise might be unsuitable for lease financing on a separate basis or cause a "compulsion to renew" because of "over-collateralization."

7. Certificates of Participation ("COPs"). COPs represent for an investor (the "COP Investor") a fractionalized interest in a lease and the rights thereunder, the rental payments and the security for the lease (collectively, the "Assigned Lease"). The mechanism used

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[9] A statutory provision provides that the weighted average economic life of the lease may not exceed the average remaining expected economic life of the asset financed by the lease.

for such fractionalization of the Assigned Lease is assignment of the Assigned Lease to a trustee pursuant to a trust indenture. The trust indenture establishes the rights of the various COP Investors in the Assigned Lease and mechanisms and procedures for enforcement of rights under the Assigned Lease by the trustee for the benefit of all of the COP Investors. The fractionalization of the Assigned Lease can be either vertical, whereby the COP Investors are acquiring rights in the stream of rental payments over the life of the Assigned Lease (for example, purchasing 50% of the rental payments coming due on each and every rental payment date) or horizontally, whereby the COP Investors are purchasing the rights in the principal component of rental payments for only certain rental payment dates, as well as the interest component of rental payments that accrues on said purchased principal component payable on each of the rental payment dates. COPs representing vertical fractionalization usually have one interest rate attributable to each and every principal component of rental payments (but are not required to), while COPs representing horizontal fractionalization usually have separate interest rates for each principal component maturity date (to avoid large premiums on early maturity COPs and deep discounts on late maturity COPs). Care must be taken to make sure that interest accruing on one principal component of rental payments is not allocated to a principal component with a differing maturity date. Doing so creates a separate security for both federal tax and federal securities law analysis with the probable result of loss of tax-exempt status of interest and loss of security law exemptions.

Inasmuch as COPs are executed and delivered by a trustee to whom the underlying lease has been assigned by virtue of a trust indenture and evidence a direct and proportionate interest of the COP Investors in the rental payments under the lease, several questions are raised as to what the COPs are and what they should be to preserve the tax-exempt treatment of distributions which represent the interest component of the underlying lease payments and to maintain the Section 3(a)(2) of the 1933 Act exemption from registration for the COPs.

C. Categories of Lessors

1. **Private entities, financial institutions and insurance companies**. These entities usually hold the lease for their own account during the entire term of the lease or sell interests in the lease with COPs.

2. **"On Behalf Of" Lessors**. These entities are created by specific state laws or by the governmental unit for the specific purpose of serving as the lessor for the governmental unit and to sell obligations (usually tax-exempt obligations) that are payable solely from, and secured exclusively by, the payments under the lease, which proceeds in turn are used to pay the costs of the construction or equipment project. These entities are deemed to be acting on behalf of the governmental unit. *See* Rev. Rul. 77-164; *Philadelphia Nat'l Bank v. United States*, 666 F.2d 834 (3d Cir. (Pa.) 1981).

There are two types of entities which generally qualify as issuers acting on behalf of a state or local governmental unit: (i) entities formed under state law for the express purpose of issuing bonds to effect a public purpose, i.e., "constituted authorities"; and (ii) entities formed under applicable state nonprofit corporation law which comply with the requirements of Rev. Rul. 63-20 (*see* discussion in subsection (b) below). Rev. Proc. 82-26 sets forth the conditions under which the IRS will grant a favorable advance ruling on whether a nonprofit corporation's obligations are exempt under Section 103(a)(1) of the Internal Revenue Code (the "Code"). *See also* PLRs 8649072, 8643050, 8628081, 8615013, 8601045, 8542104, 8506112, 8402026, 8351040, 8340067, 8334081, 9322006, 9335040 and 200019023.

(a) **<u>Constituted Authorities</u>**. Constituted authorities are entities specifically authorized by state law to issue bonds on behalf of political subdivisions of a state, among other specific powers granted to such entities in order to further public purposes. In Rev. Rul. 57-187, the IRS addressed industrial development boards in Alabama, which were authorized by state law for incorporation in municipalities to promote industry and develop trade. In furtherance of those purposes the boards were empowered to acquire, improve, furnish, equip, lease, sell and convey industrial projects and to issue bonds in furtherance of the boards' purposes. The boards were controlled by the local municipality's governing body. State law provided that bonds were payable solely out of revenues from the board's sale or lease of projects. Each board was a public nonprofit corporation whose earnings and property upon dissolution reverted to the municipality in which it was located. The IRS ruled that bonds issued by the industrial development boards were obligations issued "on behalf of a political subdivision" by a constituted authority.

The aforementioned characteristics of the industrial development boards in Rev. Rul. 57-187 have been treated by the IRS for ruling purposes as "criteria" which must be present for an entity to be treated as a constituted authority empowered to issue bonds on behalf of a political subdivision. *See* Rev. Rul. 60-248; PLRs 8912008, 8906058, 8419029, 8405131, 8232044, 8215025, 8207036, 8139121, 8125023, and 7911022. In summary, the criteria are: (i) the issuance of bonds must be authorized by a specific state statute: (ii) the bond issuance must have a public purpose (which includes promotion of trade, industry and economic development); (iii) the governing body of the authority must be controlled by the political subdivision; (iv) the authority must have the power to acquire, lease, and sell property and issue bonds in furtherance of its purposes; (v) earnings cannot inure to the benefit of private persons; and (vi) upon dissolution, title to all bond financed property must revert to the political subdivision.

(b) **<u>63-20 Corporations</u>**. 63-20 corporations are typically used where applicable state law has not specifically authorized the formation of public corporations which would qualify as constituted authorities under Rev. Rul. 57-187.

The criteria required for constituted authorities under Rev. Rul. 57-187 and the five requirements for 63-20 corporations are substantially the same. The most significant difference is the type of authorizing statute under which each is organized.

Rev. Proc. 82-26 identifies circumstances in which the five tests in Rev. Rul. 63-20 will be deemed to have been met and, consequently, the IRS will issue a favorable advance ruling. For example, the requirements that the sponsoring political subdivision have a beneficial interest in the 63-20 corporation while its bonds are outstanding and that it obtain full legal title to the 63-20 corporation's property upon retirement of the bonds will be deemed met under Rev. Proc. 82-26 if (among other requirements): (i) the [sponsoring governmental] unit may not agree or otherwise be obligated to convey a fee interest in the property to any person who was a user of the property or a related person ... within 90 days after the unit defeases the obligations...;

(ii) reasonable estimate of a fair market value of the property on the latest maturity date of the obligations ... is equal to at least 20 percent of the original cost of the property financed by the obligations ... and (iii) a reasonable estimate of the remaining useful life of the property on the latest maturity date of the obligations ... is the longer of one year or 20 percent of the originally estimated useful life of the property financed by the obligations."

In *Philadelphia Nat'l Bank supra*, the court interpreted Treas. Reg. § 1.103-1(b) with respect to entities issuing bonds on behalf of political subdivisions. The issue was whether loans made to Temple University by a private bank, which were obtained to defray operating expenses while the University awaited legislative appropriations, were obligations issued on behalf of the State of Pennsylvania. The court cited *Commissioner. v. White's Estate*, 144 F.2d 1019 (2d Cir. 1944), cert. denied. 323 U.S. 792, 65 S. 433, 89 L. Ed. 632 (U.S. 1945), for the proposition that entities issuing bonds on behalf of political subdivisions must be acting as alter egos of the political subdivisions, and held that Temple University was not a "constituted authority." It was not acting as an alter ego of Pennsylvania because there was "no identity of interest, control or intent" between the University and the State. It also noted that the loans were for current operating expenses and not capital projects which would revert to the State or be available for public or government purposes, and that the University had alternative sources of revenue through tuition or private solicitation. Thus, Temple University was acting on its own behalf in securing the loan and not on behalf of the State. *See also* Rev. Rul. 60-248.

In PLR 200019023, the IRS eliminated the requirement of filing a federal income tax return by an entity issuing bonds on behalf of a political subdivision that fits within the classification of an affiliated entity of a governmental unit under Section 115(1) of the Code based on the guidance provided under Rev. Proc. 95-48. According to this Revenue Procedure, an on behalf of issuer may be treated as an affiliated entity of a governmental unit if either (a) it receives a ruling or determination letter identifying it as such an entity, or (b) (1) it is operated, supervised or controlled by a governmental unit, organizations that are affiliates of governmental units or members of the governmental unit's governing body who are elected by the public, (2) possesses at least two affiliation factors set forth in the Revenue Procedure, and (3) the filing of the federal tax forms would not be necessary to the efficient administration of the federal tax laws.

D. **Basic Lease Concerns**. The following is a non-exhaustive list of the issues that a bond lawyer should address in reviewing a tax-exempt lease transaction.

1. **Is the lease valid?** Invalidity of a lease can mean not only the loss of future installments, but also possible recoupment of prior installments. Interest on an invalid lease is not excludable from gross income for federal income tax purposes. Yet statutory guidance for lease financing is often not clear, and it is often possible that other statutes will unexpectedly come into play. Some of the primary issues in this regard are:

(a) **Is there statutory authority for the governmental unit to enter into the lease?** Many state statutes provide only generalized language as to authority to "lease" or "purchase" or simply to "acquire" real or personal property or to issue "obligations." Practice varies from state to state and among lawyers as to what statutory authority is sufficient to authorize a lease financing transaction.

(b) <u>Does the lease include provisions that are not authorized by law?</u> Leases and accompanying escrow agreements often include provisions for indemnification of the lessor (its assigns) and/or an escrow agent for contingencies that range from personal injury to loss of tax exemption of interest. Yet, it is the law in many jurisdictions that public bodies cannot indemnify third parties. Another consideration found in some leases is the existence of a covenant precluding the lessee from acquiring similar property for some period of time after a nonappropriation, thereby potentially preventing the lessee from performing an important public function required by state law. Such "nonsubstitution" clauses are generally considered in some states as unenforceable and in some states may invalidate the lease. *See, e.g., Frankenmuth Mut. Ins. Co. v. Magaha,* 769 So.2d 1012 (Fla. 2000) (nonsubstitution clause invalidated lease as debt incurred in violation of constitutional requirement for voter approval). *Cf. Miccosukee Tribe v. S. Fla. Water Mgmt. District,* 48 So.3d 811 (Fla. 2010) (affirming that the absence of a nonsubstitution clause helped render the nonappropriation clause as real and not illusory, thereby preserving the integrity of the nonappropriation clause and helping to prevent the COPs from being characterized as "debt"). At times, leases that include questionable clauses are nevertheless funded, with the thought that invalidity is not clear or that the questionable provision can be isolated by the phrase "to the extent permitted by law" or that, in any event, a severability clause will excise the offensive provision. In this regard, consideration must be given to the basic rule that municipal entities have only those powers expressly authorized by statute; *cf.* the Richmond (California) Unified School District litigation in which a California Superior Court refused to compel the district to budget and appropriate funds necessary to pay a lease on the grounds that there was no statute clearly creating such a duty. Also, there have been instances where a court has invalidated a lease rather than sever the offending provision. *But see Frankenmuth Mut. Ins. Co. v. Escambia County.,* 289 F.3d 723 (11th Cir. 2002) in which the court held that the nonsubstitution clause was severable and the lease was valid.

(c) <u>Have procurement laws been observed?</u> Failure to observe public bidding or other procurement laws may not affect validity of a bond issue, but could invalidate a lease. *See, e.g.*, *McBirney & Associates v. State*, 753 P.2d 1132 (Alaska 1988). Procurement laws can often be a morass of requirements, observance of which will involve a fact-laden inquiry. Practice varies, but counsel will often rely on representations of the lessee or local investigation as to such compliance.

(d) <u>Does the lease create unconstitutional or illegal "debt"?</u> Despite general use of nonappropriation clauses, there may be lingering concern in some jurisdictions that leases might nevertheless be struck down as unconstitutional debt. Rev. Rul. 87-116 adds to the concern with its determination that interest on an obligation found to be unconstitutional is not tax-exempt from its inception.

Clauses in the lease should be analyzed as to their potential effect on the issue of the creation of debt, such as whether the lease should be subject to annual renewal or annual termination; the consequences of damage, destruction or condemnation; when the rental payment obligation may commence as to the lessee; as well as any clauses (such as nonsubstitution) that seek to penalize the lessee for exercising its option to terminate the lease.

For example, in *Unified Sch. Dist. No. 207 v. Northland Nat'l Bank*, 887 P.2d 1138 (Kan. App. 1994), a lease purchase agreement was invalidated because it failed to provide specifically, as required by state law, that the school district lessee was obligated only to pay periodic payments from funds budgeted and appropriated for that purpose in the current budget year, and because, upon any early cancellation (as expressly permitted), the school district could not acquire functionally similar equipment during what would have been the full term of the lease purchase agreement. Similarly, Colorado courts have invalidated a lease-purchase agreement on the grounds that the nonsubstitution clause constituted a "penalty" that precluded the district from accepting or rejecting the lease annually "without penalty." Therefore, the lease obligation was held to constitute debt that had not been approved in accordance with Colorado law. The court also declined to rely on the severability clause because to do so would have worked a hardship on the district, since the nonappropriation had occurred several years earlier, and to sever the nonsubstitution clause, and enforce the remainder of the agreement, would have placed the district in default and imposed additional penalties on the district.

(e) **Does the lease violate positive requirements of state law?** It is often not clear whether usury laws or interest rate ceilings that may apply to bonds also apply to leases. At times, leases may be covered by deceptive trade practices laws. Some states have statutes that require certain specific language to be included in a lease and failure to include that language may invalidate the lease. Many states have specific requirements with respect to leases associated with renewable energy and energy conservation programs. Jurisdictions may have other statutes that affect validity.

(f) **Has the lease been properly authorized and entered into?** *Power Equipment Co. v. United States* 748 F.2d 1130 (6th Cir. 1984), holds that even interest on an enforceable lease is not exempt if a statutory step (*e.g.*, approval by city council) has been omitted. The decision in *United States Leasing Corp. v. Chicopee*, 521 N.E.2d. 741 (Mass. 1988) (mayor's signature was required by the city charter) is a reminder that these requirements are a precondition to validity, and that the estoppel effect of the government attorney's favorable opinion may not be of much help.

(g) **Is any tax levy necessary to pay lease payments within the lessee's applicable levy limit for operating expenses or, if appropriate under state law, for capital expenditures?** Lease payments typically constitute current expenses of each fiscal year during the lease term and must be raised through a tax levy for operating expenses or capital expenditures within a levy limit imposed by state law for the particular political subdivision entering into the lease. Depending upon how the lease is drafted, the particular state law and the type of political subdivision entering into the lease as lessee, the lessee cannot be obligated to exceed any applicable levy limits in generating money to pay its lease payments without creating the risk that the lease is or may be held to be invalid debt. In addition, a comparison of the level of the required tax levy to any applicable levy limit (considered with and without the proposed additional rental payments) may suggest how likely the risk of nonappropriation may be.

2. Are the Owners'/Investors' Interests Adequately Protected?

(a) **What is the level of "essentiality" of the property that is to be financed with the lease?** As underwriters and investors evaluate the lease in real property transactions, the following questions may be appropriate: Is lease-financed real property essential to the delivery of critical or mandated governmental services, such as courthouses, jails and governmental offices? Or is the real property being acquired for more discretionary purposes, such as entertainment or sports facilities? Is the real property sufficiently distinct and transferable to be susceptible to lease financing?

The following questions may be appropriate in equipment leases: If the lease finances the acquisition of equipment, is the equipment subject to adequate identification and control? Is the equipment considered standard equipment of proven usefulness, such as school buses and fire trucks, which are unlikely to be the subject of nonappropriation and also would have value if the lease were nonappropriated? Or is the equipment "customized," "high-tech" or intangible property or systems that are subject to significant risk of not being acquired or completed on time and within budget, or that are subject to unusually fast depreciation in value or technological failure or obsolescence, with a resultant increase in the risk of nonappropriation? Is the equipment or the information stored within the equipment subject to state or federal laws (such as H.I.P.P.A. laws) or prior liens, making collateral recovery difficult? Governmental lessees are typically asked to certify as to the essentiality of the property to financed, but such certifications should not take the place of independent analysis.

(b) **<u>Is title good?</u>** Under the UCC, an unpaid vendor retains title; accordingly, one must be satisfied that the vendor is paid. Used equipment may be subject to competing liens or security interests and, at least for expensive computer units, it may be prudent to trace title back to the manufacturer, checking to see that the serial numbers match those on the invoice. Vehicles should be accompanied by certificates of title, and title to aircraft may be searched and perfected.

(c) **<u>Does the lessor own the lease?</u>** The basic protection here is, of course, to know the lessor whose paper you are examining, as a UCC search of the lessor's principal place of business will often be unavailing, and it may be that more than one original counterpart of the lease exists. Purchase of leases from a lessor-merchant in good faith and for value will generally defeat a competing claim, but it is important that the governmental lessee acknowledge the assignment. Some lessors will continue to receive the rental payments to "service" the account for the investor; but the risks of confusion (should the lessor become insolvent or reassign the paper) call for extreme confidence in the lessor's financial stability and integrity.

(d) **<u>Is the leased property perfected as against the lessee?</u>** Revised Article 9 of the UCC went into effect in most states on July 1, 2001. In some, but not all, states, Article 9 now applies to transfers of security interests by state and local governments. Whether or not Article 9 applies, the practice is to file UCC-1s to have the benefit of the public notice that such filing provides.

(e) **<u>Is the investor's security interest perfected vis-a-vis its assignor?</u>** Generally, the assignment is considered an outright sale of all of the assignor's right, title and interest in the lease (and the underlying leased property), rather than an assignment for security, and the lender in any event takes physical possession of the original counterpart of the lease (chattel paper). Article 9, however, specifically applies to the sales of accounts and chattel paper. UCC financing statements covering such sales must, therefore be filed.

Does the assignment insulate the assignee from the risks associated with the bankruptcy of the assignor, at least for the applicable bankruptcy period? The answer to this depends upon whether the assignment is absolute or is intended as collateral security for performance of obligations by the assignor. The assignment document for the lease should be drafted carefully to resolve this question in favor of protecting the lender. Notification of the lessee is contemplated by UCC § 9-406.

At least one court has determined that the "governmental transfer exception" (which was eliminated from Article 9 of the revised model UCC on July 1, 2001) not only applies to security interests but also to payment transfers. *MP Star Fin. v. Cleveland State Univ.*, 837 N.E.2d 758 (Ohio 2005). This case states that the assignment of accounts receivable to an assignee does not obligate a governmental entity to honor a notice of assignment or make lease payments to an assignee. In those states where the "governmental transfer exception" exists, it is important to make sure that assignees (examples of which may include purchasers of lease obligations, as well as trustees in COPs transactions) have the ability to receive rental payments directly from a governmental lessee. Documents requiring the consent of the governmental lessee upon assignment may provide a practical solution.

<u>Impact of Revised Article 9</u>. Unlike the previous version of Article 9 that was in effect in most states, unless a state adopted a non-uniform amendment, revised Article 9, which now has been adopted in all states, at least in part), now covers security interests created by a state or a governmental unit of a state except to the extent another statute of the state expressly governs the creation, perfection, priority, or enforcement of such a security interest. Many other changes are included in revised Article 9, including information with respect to where financing statements should be filed and the accompanying information that must be included. It is important to check Article 9 as it is in effect in each applicable state in order to properly perfect an assignment or security interest.

(f) <u>If the lease includes credit enhancement, does an obligation to reimburse the credit enhancer constitute "debt" for State law purposes?</u> The same legal analysis that applies to whether the lease constitutes debt should also be applied to any reimbursement obligation that the credit enhancer is seeking from the lessee, although credit enhancers may not appreciate the subtle, but substantial, differences between a corporate obligor and a municipal obligor relative to a reimbursement obligation. With respect to credit enhancement, counsel may differ on whether the enhancement secures payments under the lease or, where applicable, payments under a COP.

3. <u>Does the lease properly match the timing and amount of rental payments to the lessee's budgetary cycle?</u> The budgetary cycle of a governmental lessee varies from jurisdiction to jurisdiction and within each jurisdiction as between the state, cities, counties, school districts, etc. Failure to take these considerations into account when drafting a lease may result in a lack of funds available to the lessee to make timely lease payments.

4. <u>Does the lease address abatement?</u> In an "abatement" jurisdiction does the lease either contain (a) the lessee's covenant to budget and appropriate money sufficient to pay rental payments, subject to availability for use and occupancy, or (b) impose an obligation to make good faith efforts to seek sufficient appropriations to pay rental payments subject to final decision by the governing body of the lessee? The lease must be drafted with sensitivity to the particular lessee's budgetary process to ensure that the proper steps are taken so that money will be available to make lease payments. The strength of these covenants may vary from jurisdiction to jurisdiction depending on how strong the obligation to budget and appropriate may be without causing the lease to become debt for state law purposes.

5. <u>Does the lease trigger unexpected state or local taxes?</u>

(a) <u>Ad valorem taxes</u>: Even though the lessor is simply providing a financial service, express placement of the title in the lessor may trigger a real and/or personal property tax liability. See e.g. *University of Utah v. Salt Lake County*, 547 P.2d 207 (Utah 1976); *Pollard v. Bozeman*, 741 P.2d 776 (Mont. 1987). Often an equipment lessor will attempt in the "lease" to pass title up front to the lessee, retaining a "security interest" so the equipment may be repossessed upon early termination. In certain jurisdictions, this structure may raise "indebtedness" issues. Often, even though this procedure further undermines the lessor-lessee concept, the lessor will never have title to the equipment, asking the vendor to invoice the equipment directly to the lessee instead. On the other hand, in *First Union Nat'l Bank v. Ford*, 636 So. 2d 523 (Fla. App. 1993), placement of title in a bank trustee was held not to deprive the municipal lessee of "equitable ownership" and thus preserved the property tax exemption conferred by Florida law. This same result was reached in *Leon County Educ. Facilities Auth. v. Hartsfield*, 698 So. 2d 526 (Fla. 1997) where the court held that "the project is not subject to ad valorem taxation because the Authority holds virtually all the benefits and burdens of ownership."

(b) <u>Sales and use taxes</u>: Generally, sales and use taxes apply to the initial purchase from the vendor but do not apply to the lease if the lessor takes title simply to lease the equipment to a public body, provided that proper resale certificates are provided. In some states, however, municipalities are not exempt from payment of sales and use taxes.

(c) <u>Franchise taxes</u>: The business of leasing may itself generate a liability. Failure to qualify to conduct business in a state might lead to invalidity of a lease. See *White Dragon Productions, Inc. v. Performance Guarantees, Inc.*, 241 Cal. Rptr. 745 (Cal. Ct. App. 1987).

(d) <u>Covenant to Pay All Taxes</u>: Often the tax question is considered to be solved by a clause requiring the lessee to pay any and all taxes applicable to the leased property and the transaction. Although this clause is indispensable, its enforceability may be subject to doubt and, if not properly disclosed to the lessee, may increase the risk of nonappropriation.

6. <u>Has the lessee formally accepted the equipment financed by a lease?</u> Unless provision has been made to hold lease proceeds in a fund for future release, an investor and counsel will want the comfort of knowing the lessee has received and accepted the leased equipment. Although this may be false comfort, as UCC § 2-608 allows revocation of acceptance, *see Advanced Computer Sales, Inc. v. Sizemore*, 366 S.E.2d 303 (Ga. Ct. App. 1988), it is customary to have the lessee sign an unequivocal acceptance certificate identifying the equipment and the lease.

7. **Federal or State Securities Laws Issues**.

(a) **Are leases and COPs "securities" and if they are "securities," are they exempt governmental securities**? The SEC has been reluctant to take a position as to whether a municipal lease financing is a "security" as defined in Section 2(1) of the Securities Act of 1933 (the "1933 Act") or Section 3(a)(10) of the Securities Exchange Act of 1934 (the "1934 Act") or a municipal security as defined in Section 3(a)(29) of the 1934 Act. In the *Walter E. Heller & Company* no action letter (Sept 24, 1982), the Division of Market Regulation said that it would not recommend any enforcement action to the Commission if a firm engaged in arranging municipal lease financings (but retaining no interest therein after the sale of the financing interest to a sophisticated individual or financial institution) did not register as a broker or dealer under Section 15(b) of the 1934 Act. The Staff, however, specifically took "no position as to whether these lease-purchase transactions are securities as defined in Section 2(1) of the 1933 Act or Section 3(a)(10) of the [1934] Act, or municipal securities as defined in Section 3(a)(29) of the [1934] Act." Prior to the *Walter E. Heller* no-action letter, the SEC created considerable uncertainty in the municipal lease financing industry when it released an inquiry from the Office of the Comptroller of the Currency regarding Itel Corporation and the SEC's response to that inquiry. *Itel Corporation*, SEC Division of Market Regulation Letter to Office of the Comptroller of the Currency, Investment Securities Division (Sept. 1, 1981). The SEC Division of Market Regulation concluded in *Itel Corporation* that fractionalized participation interests in tax-exempt lease-purchase or installment sale financings were "municipal securities" within the meaning of Section 3(a)(29) of the 1934 Act.

> Although it is not possible to reach a conclusion with respect to all participation interests in tax-exempt financing arrangements, it appears that, as a general matter, such a participation interest would represent an obligation of a municipality if the financing arrangement were structured so that the holder of the participation interest looked primarily to the municipality as the source of payment. Based upon this analysis, it appears that such participation interests, including the participation interests in the Lease, are also obligations as that term is used in the definition of municipal securities, and that such interests are municipal securities within the meaning of Section 3(a)(29) of the 1934 Act.

The *Itel Corporation* letter was widely reported in the municipal finance and municipal lease finance industries. The publication of *Itel Corporation* raised the prospect that vendors, other financial intermediaries and persons not customarily subject to securities regulation might find themselves subject to the 1933 Act or the 1934 Act as a result of their participation in municipal lease financing transactions.

The uncertainties created by the *Itel Corporation* letter were gradually resolved, largely as a result of the SEC's no-action position in *Walter E. Heller* and similar requests with respect to the registration of brokers/dealers under the 1934 Act. What has emerged from the series of similar no-action requests and the favorable SEC responses is the practical view that if the conditions described in those letters are followed, the transfer of a whole lease on a non-recourse basis to a sophisticated investor experienced in municipal lease financing investments may not constitute the transfer of a security for purposes of the 1933 Act or the 1934 Act, whereas the fractionalization of that lease interest into COPs will undoubtedly give rise to the issuance of securities for purposes of both Acts.

One may reasonably conclude, based upon the *Premium Capital Resources Corp.* (May 28, 1984), *Walter E. Heller* and *James O. Hiltenbrand & Associates* (Apr. 11, 1985) no action letters, that a non-fractionalized municipal lease financing, in which a single vendor or investor acquires all of the stream of lease payments (whether represented by a single COP or by the lease-purchase agreement itself) should not be deemed to constitute an "investment contract" or a "security" within the meaning of Section 2(1) of the 1933 Act. Because the issue has not been definitively determined, it is customary in single investor (as opposed to single vendor) transactions to obtain an investment letter from the single investor to the effect that (i) the investor is an "accredited investor" within the meaning of Rule 501 of Regulation D promulgated under the 1933 Act (or some similar indication of financial suitability), (ii) the investor has obtained and reviewed certain documents or summaries of documents, including particularly the municipal lease financing documents, (iii) the investor has obtained, or has had the opportunity to obtain, all such financial and other information as such investor has desired from the governmental entity/lessee, and (iv) the investor is experienced in investing in municipal lease transactions. Non-fractionalized interests in leases are generally exempt from the continuing disclosure requirements of SEC Rule 15c2-12 of the 1934 Act (the "Rule"), either because there is no "underwriter" (as defined in the Rule) for the transaction or because an exemption applies.

Any fractionalized municipal lease financing, including COPs, are considered "securities" for purposes of the 1933 Act, but the question is whether they are governmental securities exempt from registration under Section 3(a)(2) of the 1933 Act. COPs are usually created by assignment of the lessor's interest in the tax-exempt lease, the assets financed and the rental payments to a trustee under a trust indenture pursuant to which the interest in the rental payments, assets financed and legal rights are fractionalized to multiple investors. Since 1977, the SEC in a series of no action letters has provided guidance that the typical fractionalized municipal lease financing will constitute a governmental security of the underlying governmental lessee if certain conditions are met. See *Smith, Barney, Harris, Upham & Co., Inc.,* SEC No-Action Letter, 1977-78 Transfer Binder, Fed. Sec. L. Rep. (CCH) ¶ 80,953, (Jan. 7, 1977) ("*Smith Barney*"). In *Smith Barney*, counsel to *Smith Barney* argued that the governmental entity should be considered the "issuer" of the COPs, and that the nominal role of the seller of the equipment (as lessor or seller) and the ministerial role of the trustee in the financing should be disregarded in determining the availability of an exemption under Section 3(a)(2). Based upon the facts presented in *Smith Barney*, the SEC agreed not to recommend any enforcement action if the COPs in the financing agreements were offered and sold to the public by the company without compliance with the registration requirements of the Act in reliance upon the exemption provided by Section 3(a)(2) of the 1933 Act.

Counsel for the State of New Jersey, in the *State of New Jersey* (May 21, 1984) no-action request, relied upon the SEC's 1977 no-action letter in *Smith Barney* and summarized the factors noted by the Staff in *Smith Barney* as being important to a determination that no registration would be required under the 1933 Act in the case of state and municipal equipment lease or conditional sale programs. The relevant factors include the following:

(1) the obligation of the public body must be a direct obligation in respect of which a COP Investor would have recourse without the necessity of joining a third party;

(2) the obligation of the public body must not be subject to set-off or counterclaim as a result of any dispute between the public body and a third party (*e.g.*, the trustee, lessor or vendor);

(3) the obligation of the public body cannot be dischargeable as a result of damage to, or the destruction of, the subject property;

(4) the public body must be required to maintain the property at its own expense and to make all payments in respect of insurance premiums;

(5) the public body may not be permitted to sell or encumber the property without the consent of COP Investors;

(6) the trustee or fiscal agent acting on behalf of a COP Investor may provide only ministerial services as part of the financing transaction; and

(7) the rights of COP Investors [can] not be adversely affected by any insolvency proceeding to which the trustee or fiscal agent might become subject.

(b) Is there adequate disclosure? Generally, the anti-fraud provisions of the securities laws will apply to lease financing transactions. The Rule was adopted in respect of primary offerings of municipal securities and amended in 1994 in respect of continuing disclosure obligations for the secondary market. While certain lease financing transactions may not meet the $1,000,000 threshold for application of the Rule or may be structured to comply with the limited offering (or "private placement") exemption from the Rule, many lease financing transactions (and in particular those involving COPs or lease revenue bonds) are likely to be subject to the Rule. Reference should be made to other outlines on the Rule for the specific requirements and its application to each transaction.

Effective February 27, 2019, the Rule was amended to create an obligation for issuers to provide notice not in excess of ten business days after the: "(15) [i]ncurrence of a financial obligation of the obligated person, if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the obligated person, any of which affect security holders, if material; and (16) default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of the obligated person, any of which reflect financial difficulties." These new notice requirements will now require issuers and obligated persons to be prepared to provide adequate notice regarding the incurrence of a "financial obligation" or the default, modification or other issue with respect thereto, which means issuers must now be prepared to speak to the market regarding debt transactions that are otherwise exempt from the Rule. As a result, many issuers are required to give notice under a continuing disclosure agreement of any material lease financing transaction.

In addition to compliance with the Rule, underwriters must comply with other rules such as MSRB Rule G-32, which requires the filing with the MSRB not only of official statements required to be filed under the Rule but also those for smaller limited offerings in which official statements are prepared but not subject to Rule.

(c) **Do state blue-sky laws apply?** The comfort available at the federal level that lease participations will be treated as "bonds" often is not available under state securities laws that may speak of "bonds" in the literal sense. Drafters of state blue sky legislation likely did not consider whether blue sky laws should apply to leases. In any event, a separate analysis of applicable state securities laws may be necessary, particularly in a publicly offered COPs transaction.

8. **Dodd-Frank Act Municipal Advisor Issues**. The *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub.L. 111-203, H.R. 4173 (the "Dodd-Frank Act"), which amended the Securities Exchange Act of 1934 (the "Exchange Act"), requires a "municipal advisor" to register under the Exchange Act if such municipal advisor (1) provides advice to or on behalf of a municipal entity or an obligated person with respect to (a) "municipal financial products" or (b) the "issuance of municipal securities," or (2) undertakes the solicitation of a municipal entity or obligated person. The application of these requirements to a lessor of municipal lease obligations presents challenging questions as to whether such lessor is a municipal advisor, whether a particular lease obligation is a "municipal financial product" or a "municipal security" or whether such lessor will be determined to be "soliciting" a municipal entity. While the Dodd-Frank Act provides a definition of "municipal advisor" (which includes financial advisors and other financial professionals but excludes broker-dealers and other financial professionals), the type of interaction and advice that a lessor provides a municipal entity often makes the determination of whether a lessor should register as a "municipal advisor" fact and circumstance dependent. A lessor may find itself outside of the scope of the "municipal advisor" requirements of the Dodd-Frank Act in connection with some transactions and within such requirements in connection with other transactions, depending on the nature and extent of the advice being provided, the lessor's role in the transaction, and the type of financial product(s) being offered (to name a few considerations). Having to register as a "municipal advisor" has consequences, such as owing a fiduciary duty to a particular municipal entity, being subject to regulation by the MSRB (including being subject to MSRB "pay-to-play" prohibitions), supervision and training of employees and record retention, to name a few considerations. It is important to note that, in addition to a lessor and other financial professionals, it is possible attorneys may also fall within the scope of the "municipal advisor requirements" of the Dodd-Frank Act.

9. **Federal Income Tax Issues**. All the federal tax questions that apply to bonds also apply to financing leases, but with specific nuances and considerations. It is generally assumed, correctly, that what is applicable to bonds is applicable to leases, as the same arbitrage restrictions, private use tests and other requirements apply. Some of the more common tax considerations are discussed below.

(a) **Is the lessee a state or political subdivision?** Entities (e.*g.* joint planning agencies, library boards, state senators, justices of the state supreme court) that would not dream of issuing bonds often find themselves leasing equipment, and the question is whether they enjoy sufficient sovereign powers or can successfully pass an "instrumentality" or on-behalf-of issuer analysis. Often it is necessary to have the lease revised so that the lessee is an established political subdivision and its obligation on the lease is clearly a "state or local bond" for federal tax purposes. Alternatively, it is possible for an entity to be able to issue a tax-exempt obligation if such obligation is issued "on behalf of" a state or local governmental unit (*see* Rev. Rul. 57-187 and Rev. Rul 63-20).

(b) <u>Is the lessee building up equity in the leased property as required by Rev. Rul. 55-540 (see e.g., PLRs 8235056 and 8347058*)* ?</u> Almost always, the dollar or nominal purchase option or automatic passage of title at the end of the lease term satisfies this test, but at times lessors will ask for a greater purchase option price, raising the Rev. Rul. 55-540 question of whether the lease is a true lease.

(c) <u>Is the interest component of the rentals sufficiently distinct and described as required by Rev. Rul. 72-399?</u> Ideally, all tax-exempt leases would include a schedule setting out the principal and interest components of each rental payment, with yet another column setting out any permitted prepayment schedule. Some smaller leases may use a formula for expressing interest and, in such cases, it is important that the formula enable an investor to demonstrate to the IRS the amount of the interest component of each installment.

(d) <u>Is the lease an "obligation" under IRC Section 103(c)(1)?</u> In PLR 7821068 (February 23, 1978), the IRS found that an "obligation" existed for purposes of Section 103 of the Code in the context of an annual appropriation lease even though the lessee's obligation was limited to funds appropriated annually and the lessee was entitled to terminate the lease from year to year.

(e) <u>Is the lease in registered form?</u> Section 149(a) of the Code requires that most tax-exempt obligations be in registered form, but implementing a registration system can be awkward in the leasing context. It is generally possible to have the lessee agree to keep copies of all assignments with its leasing records to serve as a record of the lease owners. Any participation or division of interests in a lease, however, leads to multiple owners, whose identity the lessee (or its assignee fiduciary) may not always know. The solution has at times been to have the lessor agree to carry out the registration function. The announcement in 26 CFR § 5f.103-1 that the functionary must do so as "agent" of the issuer has led to confusion, as it may appear anomalous to a lessee that a lessor can be its "agent" for anything.

In PLR 9128034, the IRS ruled that tax-exempt installment sale contracts with governmental entities accepted by the seller of products (or a financing affiliate) in a private placement for the exclusive benefit of the seller and that would not be sold to third parties or pledged as security in financing arrangements of the seller were "not of a type offered to the public" and did not have to be registered. Of course, publicly-offered certificates of participation in a lease, which represent undivided interests in the lease obligation, must comply with the registration requirement.

(f) <u>Is the property going be used in a way that causes the lease to be treated as a private activity bond?</u> It is imperative to inquire as to the lessee's intended use of the leased property and customary for the lessee to make certain representations and covenants in the lease which demonstrate that the lease is not and will not become a private activity bond.

Covenants against subleases to any nongovernmental entity also should be included in the lease to prevent the private business use test from being met. If the lease-financed property meets the private business use test, the "private security or payment" test of Section 141(b)(2) of the Code will be met because, by definition, the property serves as "security" for the lease obligation.

If the governmental lessee defaults under the lease or does not appropriate base rentals and, therefore does not renew the lease, then federal tax issues will arise concerning continued tax exemption for interest components of the lease payments (that may be evidenced by outstanding COPs) if the real estate or equipment that is the subject of the lease is then leased to other users that are not governmental entities, thus causing a change in use to "private business use." The special (lease) counsel's opinion on the tax exemption for the interest component of the lease payments should contain an appropriate exception for this situation, and the official statement should contain appropriate disclosure of the risk of taxability in that situation.

(g) **Reporting**. Forms 8038-G and -GC have special requirements for leases. As a general rule, a Form 8038-G or -GC should be in hand or filed before the closing is concluded or the opinion is delivered, as it may be difficult to obtain the lessee's signature at a later time, particularly after the lease is funded. Moreover, some small issuers may not be aware of the requirement, or even of the fact that the lessor intends to treat the interest as tax-exempt. Such an issuer may be unwilling or unable after the lease is entered into to have it treated as tax-exempt because to do so may cause the lessee (as an "issuer") to exceed the $5 million limit applicable to the small issuer rebate exception and/or the $10 million limit applicable to issuers of "qualified tax-exempt obligations" for banks and other financial institutions.

The 8038-G and –GC forms require the signature of tax return preparer (i.e. "paid preparer") in addition to the lessee (in some cases, the paid preparer and the lessee may be the same). To the extent that a lessor provides for or makes determinations in connection with certain information on the 8038-G or –GC form, such as the issue price, weighted average maturity and/or yield, which is a common practice in tax-exempt leasing, consideration must be given as to whether such lessor should sign the applicable 8038-G or –GC as a paid preparer. In addition, paid preparers (including attorneys) must obtain a preparer tax identification number (PTIN).

(h) **Is the lease federally guaranteed under IRC Section 149(b)?** Even if the lease does not mention it, many leases are in fact paid with moneys derived from federal grants or other assistance, such as grants or aid provided for a welfare department's computer, for a state's medicaid program or for a university's lab. Whether the receipt of a federal grant or other assistance in amounts determined in whole or in part by reference to the lease payments constitutes a federal guaranty is often a very difficult question.

(i) **Is the lease an arbitrage bond?** The same basic arbitrage and rebate requirements that apply to bonds must be met for tax-exempt leases, but participants in smaller lease financings may lack computational expertise and the amounts involved may not great enough to pay for the expertise needed, for example, for rebate. To obtain an exception to the rebate requirement for smaller equipment and real property lease financings, reliance often is placed on the small issuer (generally under $5 million, and with respect to certain school construction projects, up to $15 million) exception or the 6-month spending exception.

The arbitrage regulations also contain an 18-month spending exception from arbitrage rebate for any financing eligible for a 3-year temporary period for unrestricted investment of proceeds (generally, where proceeds are used to finance capital purposes or projects, including acquisition of property as well as construction), if all of the gross proceeds are spent according to a required spending schedule over three 6-month spending periods.

Similarly, in a lease financing of a construction project (including "constructed" personal property), the "available construction proceeds" may be eligible for the 2-year spending exception from the rebate requirement for a "construction issue" (an issue in which at least 75% of the available construction proceeds will be used for construction expenditures), if all of the available construction proceeds are spent according to a required spending schedule over four 6-month spending periods.

If any gross proceeds are held in a reasonably required reserve or replacement fund for the tax-exempt lease or an issue of certificates of participation therein, those gross proceeds are not required to be spent to satisfy any applicable spending exception, but generally will be subject to the rebate requirement from the issue date. Reference should be made to other outlines on arbitrage-related topics for the specific requirements applicable to rebate exceptions and arbitrage requirements generally.

(j) Is the transaction an "investment trust with multiple classes"? In the May 2, 1984 Federal Register, the United States Treasury proposed amendments defining "trusts" for federal tax purposes; the final regulations were published in the March 24, 1986 Federal Register. As the Treasury proposal was originally worded, it was feared that a certificated tax-exempt lease with serial "maturities" bearing different interest rates would be treated as a "trust" with multiple classes of interests, such that the trust would be taxable as a corporation. A press release at about that time relating to a State of New Jersey lease transaction substantiated that fear. The final regulations made it clear that pass-through treatment as a grantor trust would result if the interest rate or rates on the certificates matched those formally set out in the underlying lease.

(k) Has the lessee properly designated the lease as a "qualified tax-exempt obligation" for purposes of IRC Section 265(b)(3)? If a governmental lessee is eligible to designate its lease obligation as a "qualified tax-exempt obligation" for purposes of Section 265(b)(3) of the Code (because the lessee does not reasonably anticipate issuing more than the current maximum threshold allowed of tax-exempt obligations in that calendar year under Section 265(b)(3)), it is generally beneficial to the lessee to do so because the designation makes the lease more attractive to banks and other financial institutions which is, in turn, taken into account in pricing. Counsel may be asked to give an opinion that the lease is a "qualified tax-exempt obligation" for banks and other financial institutions. Depending on the circumstances, however, that opinion may be difficult to provide because of the extent of due diligence that may be required to determine the amount of outstanding tax-exempt obligations of the lessee and the basis for the "reasonable expectations" of the lessee regarding its eligibility to designate obligations in any particular calendar year. In most cases, a certification by the lessee should be sufficient for this purpose. In addition, if the issuer of the tax-exempt obligation is an "on behalf of" issuer, it is important to remember that such issuer must take into consideration other tax-exempt obligations (and reasonable expectations) of the state or local government on behalf of which the obligation is being issued, when making a determination as to whether a tax-exempt obligation is a "qualified tax-exempt obligation."

10. <u>COP Transaction Issues</u>.

(a) <u>In COP transactions, should the lessee be a party to the trust agreement between the lessor-assignor and the trustee and also appear in some fashion as a signatory (whether by authentication or otherwise) on the face of the COPs?</u> Practitioners differ as to the desirable level of lessee involvement to demonstrate its participation in the certification process, particularly in light of the paucity of statutory authority as to what actions the lessee is authorized to take in this respect under state law. Generally, it would be advisable to have the issuer-lessee approve, or at least acknowledge, the trust agreement. It does not appear to be common practice for the issuer-lessee to sign or authenticate the actual certificates of participation and such a practice may cause state law problems in respect of the creation of debt.

(b) <u>Is specific legislation required for COP transactions?</u> While specific legislation may be of comfort to those practitioners who render approving opinions with respect to COP transactions, particularly depending upon the nature of the lessee's participation in the certification process, the number of such transactions in a variety of jurisdictions suggests that the lack of specific legislation is not an impediment to these transactions. If achievable, however, specific legislation supporting the lessee's participation in the certification process would be desirable.

(c) <u>What opinions should counsel render in COP transactions?</u> The practice differs widely as to the opinions that counsel should render in a COP transaction beyond those opinions that are customary as to the validity of the lease and the tax-exempt treatment of the interest component of lease payments. For example, what opinions should special counsel render as to distributions with respect to the certificates or the due authorization, execution and delivery of the trust agreement by the lessor or the compliance of any continuing disclosure undertaking with local law?

Does interest payable only from earnings on proceeds from the sale of COPs constitute interest on an obligation of a state or local government? COP transactions are often structured so that interest accruing during a construction or installation period is paid from capitalized interest or from interest earnings on the proceeds from the sale of the COPs. In states like California, a lessee generally cannot be obligated to make lease payments before the property is available for the lessee's use. Leases in those states frequently provide that the lessee's obligation to make lease payments during the construction or installation phase is limited to the amount of the capitalized interest or to earnings on the proceeds from the sale of the COPs.

Technical Advice Memorandum (PLR 9721003), dated January 24, 1997, described a transaction in which several local governments ("Districts") participated in a pool designed to provide funding to meet cash flow needs. Each District executed a promissory note obligating it to pay the principal amount of the note plus interest at a specified rate, but not more than the District's "Payment Obligation," which was defined in the COPs documents. A corporation pooled the notes and assigned them to a trustee. The trustee executed and delivered the COPs evidencing undivided interests in the aggregate payments due under the notes. The COPs proceeds were used to purchase an investment agreement at a yield sufficient to pay the interest accruing on the COPs until the Districts drew down the funds to meet operating expenses.

The IRS held that the proceeds of the COPs were not received by the Districts until they were withdrawn from the investment agreement and that prior to the withdrawal the notes were not deemed to be issued. The practical effect of the IRS' conclusion is that interest accruing on the COPs prior to withdrawal of the funds from the investment agreement is not interest on an obligation of a state or local government. The IRS based its position on a determination that prior to a withdrawal from the investment agreement, the notes represented only a right to draw on the funds rather than an interest in the funds themselves. This determination was based on the fact that each District's Payment Obligation, and, thus promise to pay under the promissory note, was equal to zero unless a draw was made. The IRS further supported its conclusion that the Districts did not have an interest in the funds by the fact that the trustee for the COPs was directed to invest the COPs proceeds in an investment agreement, which would not have been a permissible investment for the Districts.

Many lease transactions utilize a structure very similar to the one described in the Technical Advice Memorandum. To avoid the adverse results mandated by the Memorandum, the transaction documents should make it very clear that the proceeds of the COPs are the funds of the lessee from the date the proceeds are received and that the lessee has an unequivocal obligation to make the lease payments. In carefully drafted documents, it should still be permissible for the payment obligation to be satisfied only from specified sources of funds, such as accrued interest or investment proceeds. Consistent with the concept that the proceeds of the COPs are the funds of the lessee, proceeds derived from a COP should be invested only in obligations which are permitted investments for the lessee.

E. Provisions Normally Included in Leases. Set forth below are certain typical provisions of a lease financing that are designed to address the concerns of lessors, assignees and/or investors.

1. Lease payments reflecting the expected completion date of the construction of the leased property and the expected remaining useful life of the leased property.

2. Leased property consisting of multiple assets or assets that are more valuable than the total principal portion of the rental payments (thereby reducing the practical risk of nonappropriation); may not be legally possible or feasible.

3. Protections against completion/acquisition risk include:

(a) Entering into the lease after final design and cost estimates are complete and only slightly before commencement of construction or acquisition.

(b) Requirements for construction contract which include builder's "all risk" insurance during construction, performance and payment bonds and liquidated damages for delay.

(c) Capitalized interest through completion of construction/acquisition and acceptance by lessee.

4. Title insurance in respect of the leased property reflecting ownership or leasehold interest of lessor and mortgage loan or leasehold loan interest of lessor's assignee (which may be a trustee for the owners of COPs).

5. Analysis of appraised or insured value (replacement cost) of leased property.

6. Provisions relating to condemnation powers of lessee in respect of the leased property. Credit problems coupled with a difficult negotiation situation (i.e., the inability to compromise with the lessor or the lessor's assignee) may cause a lessee to attempt to condemn the leased property at a value that is less than the principal balance of a lease.

7. Provision stating that equipment is and will remain personal property and will not become a fixture (for equipment leases).

8. Irrevocable assignment by a lessor to a bank trustee representing COP Investors.

9. Remoteness of risk of bankruptcy of lessor to the COP Investors.

10. Casualty and rental interruption (particular for "abatement" leases) insurance requirements.

11. Reserve fund relating to failure to pay or appropriate rental payments.

12. For purposes of the UCC and in light of the prevalence of electronic searches requiring precise names, incorporation of a provision confirming the lessee's/debtor's legal name may be a prudent course of action (especially where the lessee/debtor does not file articles of incorporation with any particular secretary of state).

13. Lessee's restrictions on further assignments and servicing.

14. Lessee's covenant to properly maintain the property/equipment at its own cost and expense and to pay all applicable taxes, charges or liens.

15. For installment contracts or leases dependent upon savings (such as energy savings), whether there will be sufficient time for the lessee to realize such savings in relation to the first lease payment, and whether capitalized interest should be considered.

16. Whether a lease is subject to continuous renewal (absent nonappropriation) or whether a lease is subject to annual termination and affirmative renewal.

III. OTHER COMMON FINANCING STRUCTURES

A. Revenue Bonds. Revenue bonds are payable solely from revenues from a specific source or pooled revenues from various sources, such as revenues of a utility system or the revenues of a particular project. Under the "special fund doctrine," obligations payable from a specific source rather than ad valorem property taxes or general municipal funds are not considered general obligation debt and are generally excluded from debt limitation calculations in most states. In some states, however, a pledge of gross rather than net revenues can create "debt" by obligating the issuer to pay operation and maintenance expenses from general funds. Revenue bonds may be project-based (payable from user fees such as water or sewage charges) or tax-based (payable from specific project-oriented taxes such as hotel and motel taxes dedicated to a convention center issue) or a combination of project-based and tax-based. Questions may arise as to what types of income constitute "revenues." Also, a practical prerequisite to the validity or enforceability of revenue bonds secured by an encumbrance of the revenue of a system (such as a water and sewage system) is the ownership of the system by the municipal authority issuing the bonds or a valid assignment of some other entity's revenues.

In *County of Volusia v. State*, 417 So. 2d 968 (Fla. 1982), the Court held that a municipality could not pledge all non-ad valorem revenues received by the county and also covenant to maintain services necessary to collect such fees, fines, etc., as this creates an indirect pledge of ad valorem taxes. Compare with *Murphy v. City of Port St. Lucie*, 666 So. 2d 879 (Fla. 1995) (holding that special assessment bonds for water and sewer lines were valid without referendum despite the ability to budget and appropriate debt service funds solely from non-ad-valorem revenues). The court distinguished *Murphy* from *Volusia County* because the non-ad-valorem revenues were considered a supplemental source of revenue and no provision existed requiring the city in *Murphy* to continue services for the purpose of generating income to pay the bonds. In *Terry v. Mazur*, 234 Va. 442, 362 S.E.2d 904 (1987), state revenue bonds secured by highway user excise and other vehicle taxes were found to violate the special fund doctrine and were considered "debt."

Issuers typically give bondholders a first lien on revenues, but operating, maintenance, and administrative expenses are usually payable before debt service. In addition, reserve funds and restrictive covenants as to use, maintenance of insurance, continued existence of issuer, etc., are usually required. Restrictions on additional debt (parity tests) and covenants to set rates (rate covenants) at sufficient levels to provide debt service coverage are also typical.

Bondholders' security generally may not be diminished by diverting revenues pledged. *United States Trust Co. v. New Jersey*, 431 U.S. 1, 97 S. Ct. 1505, 52 L. Ed. 2d 92 (1977) (repeal of covenant restricting ability of Port Authority of New York and New Jersey to use certain revenues pledged to bonds is a violation of contract clause of U. S. Constitution). *But see Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400, 103 S. Ct. 697, 74 L. Ed. 2d 569 (1983) (holding that there is "no showing that the act of legislature has taken from the bonds the quality of an acceptable investment for a rational investor;" absent an "alteration of contract, remedy or security device, or a danger of default," bondholders cannot reasonably expect to prevent the state from the exercise of its sovereign powers); *Board of Comm'rs v. Department of Natural Resources*, 496 So. 2d 281 (La. 1986).

B. Double-Barreled Obligations. Double-barreled obligations are secured both by full faith and credit and revenues from a particular project or a specified source. Procedural and other requirements vary in different jurisdictions. Double-barreled obligations are generally subject to referendum requirements, but may or may not be subject to debt limitations.

C. Bond Anticipation Notes ("BANS"). These short-term obligations are issued by states, municipalities and on behalf of issuers as a means of interim financing until a long-term bond can be issued. They are also used during high interest rate periods to avoid incurring long-term high interest rate debt. BANS may be either revenue or general obligation debt, but they are usually subject to the same debt limit and other restrictions of permanent financing. Generally, the state or municipality and the on behalf of issuer, if applicable, must adopt a resolution or ordinance providing for the long-term bonds prior to issuance of BANS so that no "political" risk of nonissuance remains, only "market access" risk. Some states may have specific BAN statutes that have requirements, including that the anticipated bonds be authorized with legislation prior to the issuance of the BANs. BANs sometimes fall under the short-term debt exception to SEC Rule 15c2-12 (and recently some underwriters have advocated for BANs with less than a 270 day term). The SEC has been active in bringing 15c2-12 actions against issuers of BANs, and not just long term bonds.[10] Note that BANs are expressly included in the definition of "debt obligation" as one of the items required to be disclosed under the 2018 amendments to the Rule.

D. Revenue and Tax Anticipation Notes and Grant Anticipation Bonds ("RANS", "TANS" and "GARVEES"). These short-term borrowings are generally used by municipalities to level cash flows to match revenue and expenditure patterns during the fiscal year. Specific statutory authority generally outlines maturity limits and sources of repayment. Statutory authority for RANS may or may not define "revenues" precisely. In *State Bond Com. v. All Taxpayers, Property Owners, and Citizens*, 525 So. 2d 521 (La. 1988), the Court upheld state revenue anticipation notes that pledged accrued revenues slightly beyond the current fiscal year because no new expenses would be incurred and no new revenues would be generated.

TANS are short-term municipal notes secured by taxes collected in the current fiscal year or by taxes receivable for one or more succeeding fiscal years. TANS have traditionally been exempted from debt limits. *Davenport v. City of Rock Hill*, 432 S.E.2d 451 (S.C. 1993). However, the tax must have actually been levied, and no obligation must accrue to the municipality aside from the obligation to pay from such taxes. See McQuillan, *Law on Municipal Corporations* § 41.25 (3d ed. 1995); *Florence v. Anderson*, 95 F.2d 777 (4th Cir. 1938) (tax anticipation note was general obligation of city). Tax and revenue anticipation notes ("TRANS") combine the characteristics of both TANS and RANS.

Grant anticipation revenue vehicle bonds ("GARVEES") are used to finance highway and transit projects. The security is federal highway funds as allocated annually to the state transportation agency. Other funds may be available as a backup if federal funds are delayed or canceled. Federal funds are not subject to annual appropriation by state legislatures since they flow directly to the state department of transportation. Although not technically a GARVEE issue, the GARVEE structure has been further developed so that local governments can issue bonds secured by anticipated state transportation revenues for highway construction. Some issuers have included other revenues as a part of the pledged revenues.

E. Assessment Financings. In many states, local infrastructure development has been financed by assessment financings, which are based upon the general premise that the citizens receiving special or particular benefits from a public improvement should bear the cost and expense of its installation. For example, the cost of an extension of water/sewer services into an area may be assessed against the properties situated within the area that will be receiving the

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services. Assessment financings may be secured by ad valorem taxes levied against the taxable property in the district or by special assessments calculated on the value of the benefit of the project received by any individual assessee. Contracts for local improvements where the cost of such improvements is payable from special assessments upon the property benefited and the municipality is not directly liable may be exempt from debt limits. *See* McQuillin, *Law on Municipal Corporations* §41.32 (3d ed. 1995); *Wall v. Chicago Park Dist.*, 378 Ill 81, 37 N.E.2d 752 (1941) (holding that proposed lakeshore improvements payable from special assessments do not constitute debt subject to constitutional limitations); *but see Covington v. McKenna*, 99 Ky. 508, 36 S.W. 518 (1896) (holding it immaterial that such debts were payable from assessments on abutting property where the city is liable if assessments are insufficient).

Although assessment financings have historically been exempt from constitutional voting restrictions, there can be instances in which these types of financings are subject to voter approval. For example, California voters in 1996 adopted Proposition 218, which imposes a ballot protest procedure on assessment financings.

F. Tax Increment Financings. Tax increment bonds are special obligations secured by incremental increases in tax revenues paid by users of developed property or by general increases in taxable valuations within the tax increment area. Initially, tax increment financing ("TIF") was used to assist in providing infrastructure and other public improvements for redeveloping blighted areas. Redevelopment commissions (or other TIF implementing authorities) may be required by state law to identify a blighted area by a set of factors including age, obsolescence, deterioration of improvements, succession of growth and the like. State law may also require a showing that the blighted area will not be redeveloped by normal regulatory processes or the ordinary operation of private enterprise (*See, e.g.*, 65 Illinois Compiled Statutes 5/11-74.4-1 et seq.). Courts have generally not substituted their judgment for that of local bodies in blight determination. *But see City of Carbondale v. City of Marion*, 210 Ill. App. 3d 870, 569 N.E.2d 290 (1991); *Reed-Custer Community Unit Sch. Dist. 255-U v. City of Wilmington*, 253 Ill. App. 3d 503, 625 N.E.2d 381 (1993), modified on denial of rehearing, appeal denied 202 Ill. Dec. 930, 156 Ill. 2d 566, 638 N.E.2d 1124 (1994); *Henry County Board v. Village of Orion*, 278 Ill. App. 3d 1058, 663 N.E. 2d 1076 (1996) (reversing municipality's determination of "blight" by rejecting municipality's broad definition of "vacant" parcels for purposes of blight determination).

More recently, TIF has also been used for purely economic development. State law may permit redevelopment commissions to use redevelopment-like powers to pursue economic development without the determination that blight exists. Economic development purposes are generally fashioned after standards that have been upheld by courts in the context of economic or industrial development bonds. As the concept of redevelopment has evolved to include purely economic development, courts have focused on issues related to "public use" or "public purpose" and generally deferred to determinations by the state legislature and local governing bodies that redevelopment is itself a public use or public purpose. Tax increment financing in some form is available in a large majority of states. The taxes involved are usually ad valorem real and/or personal property taxes. Some states permit sales tax increment financing. State laws specify the mechanism and process for the implementation of TIF.

In general, the TIF process is similar to that for all economic and community development devices. A redevelopment or similar plan is prepared, specifying a project and costs; a public hearing is set; notice of the hearing is given to affected taxpayers and taxing districts; the hearing is held and the plan and project are approved and adopted. In some cases, a mechanism to reverse it all may follow (*e.g.,* petition and referendum). Incremental taxes may fund a project on a "pay as received" basis, or TIF revenue bonds or TIF general obligation bonds may be issued to pay the project costs.

Tax increment obligations do not generally constitute debt for the purpose of debt limitations. *In re Request for Advisory Opinion in Constitutionality of 1986 PA 281*, 430 Mich. 93, 422 N.W.2d 186 (1988); *Denver Urban Renewal Auth. v. Byrne*, 618 P.2d 1374 (Colo. 1980). *But see Muskogee Urban Renewal Auth. V. Excise Bd.*, 899 P.2d 624 (Okla. 1995); *Hartford v. Kirley*, 172 Wis. 2d 191, 493 N.W.2d 45 (1992). When the TIF obligation is payable from ad valorem taxes, however, some states treat the obligation as municipal debt subject to constitutional restrictions. *See City of Tucson v. Corbin*, 128 Ariz. 83, 623 P.2d 1239 (1980), in which court held that tax increment bond law violated constitutional debt referendum requirements because the law allowed proceeds from ad valorem taxation to be used to secure payment of the bonds. Other courts have held that any obligation payable from general property tax revenues constitutes debt even though the revenues paid would not have been collected but for the obligation. *See Richards v. Muscatine*, 237 N.W.2d 48 (Iowa 1975); *Miller v. Covington Development Auth.*, 539 S.W.2d 1 (Ky. 1976); *Meierhenry v. Huron*, 354 N. W.2d 171 (S.D. 1984).

1. <u>Challenging the Blight Determination in TIF Financings</u>. TIF challenges are often based in a challenge to the underlying blight determination. *See Village of Wheeling v. Exchange Nat'l Bank*, 213 Ill. App. 3d 325, 572 N.E.2d 966, 157 Ill. Dec. 502 (1991) (the determination of finding allowing the taking of property was valid even though condemned parcels were not below code requirements because "blight" relates to the area as a whole); *City of Marion*, 155 Ill. Dec. 290, 210 Ill. App. 3d 870, 569 N.E.2d 290 (1991); *City of Wilmington*, 192 III. Dec. 421, 253 Ill. App. 3d 503, 625 N.E.2d 381 (1993); *Henry County Bd. v. Village of Orion*, 278 Ill. App. 3d 1058, 663 N.E. 2d 1076 (1996) (reversing a municipality's blight determination where new sewer system was found to not substantially benefit the TIF district when only four of the district's three hundred improved parcels were blighted due to inadequate sewage facilities and new building was already occurring within the district). Citizens have standing to challenge approval of a city's condemnation of land for an urban renewal project that will provide a private college with new campus. *Benevolent & Protective Order of Elks, Lodge No.65 v. Planning Bd. Of Lawrence*, 403 Mass. 531, 531 N.E.2d 1233 (1988). But a neighborhood association lacks standing as an aggrieved person to contest a county development commission's determination that a rural area is blighted. *Union Township Resident's Asso. v. Whitley County Redevelopment Com., Inc.*, 536 N.E.2d 1044 (Ind. App. 3 Dist. 1989).

2. <u>Other Challenges to TIF Financing</u>. Because TIFs are often authorized by an economic development plan or redevelopment plan that includes condemnation authority, plans that authorize TIFs and also include condemnation authority often face intense scrutiny. This issue was highlighted by the Supreme Court's decision in *Kelo v. City of New London*, 545 U.S. 469 (2005) upholding the use of condemnation to promote economic development. As a result, many states enacted state statutes restricting the condemnation authority in plans authorizing TIFs.

Challenges to tax increment financing on the basis of constitutional tax limitations are usually resolved in favor of tax increment financing. In Michigan, the Supreme Court upheld a tax increment financing statute finding that it was not violative of the constitutional prohibition limiting the rate of general ad valorem taxes. The constitutional provision was found not to limit the legislature from capturing tax revenues attributable to future increases. *In re Request for Advisory Opinion on Constitutionality of 1986 PA 281*, 430 Mich. 93, 422 N.W.2d 186 (1988). A constitutional limitation on an increase in a tax base without an approving vote was held not to be violated by the tax increment statute because tax revenues from increased property values were in the nature of special assessments. *Dennehy v. Department of Revenue*, 305 Or. 595, 756 P.2d 13 (1988). *But see Kirley*, 172 Wis. 2d 191, 493 N.W.2d 45 (1992) (holding that TIF bonds would create debt because tax increments are not independent sources of revenue and the bonds are payable solely from general property tax revenue). Tax increment financing has also been challenged on the basis of an unconstitutional lending of the credit of the state or municipality. The court found that tax increment bonds did not fall within recognized exceptions to the constitutional limitation (a revenue bond exception or a special assessment exception) because the statute permitted the municipality to make a limited tax pledge to back up the bonds of the redevelopment authority. Despite this strict reading of the lending of credit provision, the court gave a broad reading to a public purpose provision that cleared the way for the court to uphold the tax increment statute's constitutionality. *In re Request for Advisory Opinion*, 430 Mich. 93, 422 N.W.2d 186 (1988).

G. Special District Financings. The law of some states permits the establishment of single function or multi-function special districts. These districts may be established to provide both governmental services and a financing mechanism, or (as in the case of Mello Roos Community Facilities Districts established in California (Government Code §53311 – 53368.3)) may be created for the primary purpose of being a financing arm for public improvements and services provided by the municipality and not provided by the district itself. The law of some states (as in the case of Marks Roos Joint Powers Authorities established in California (Government Code §6584-6599.3)) allow the creation of bond pools for special districts.

In general, special district financings are supported by special tax levies or special assessments imposed within the district and do not constitute either debt of the landowners or general obligations of the municipalities. The boundaries of the district area subject to the special tax or assessments need not be the same as the jurisdictional boundaries of any local municipality (although creation of extra territorial boundaries may require utilization of joint agency and interlocal cooperation powers).

H. Applicable Debt Limitation Exceptions for These Financing Structures

1. <u>Special Fund Doctrine and Revenue Obligations</u>. In many states, the debt limitation does not apply to obligations which are payable from a special fund.[11] In special fund financings, the debt authorizing documents restrict repayment of the debt to monies deposited in a special fund so that the special fund is not supplemented by the general funds of the issuer or by tax levies. If the special fund is ever insufficient, default on the debt occurs. In those states that

[11] *See Young v. Ann Arbor*, 267 Mich. 255, 255 N.W. 579 (1934); *Newberry v. Andalusia*, 257 Ala. 49, 57 So.2d 29 (1952)

apply the special fund doctrine, debt payable as described is held not to be included in calculations of the applicable debt limitation. *See Winston v. City of Spokane*, 12 Wash. 524, 41 P. 888 (1895) (water works bonds payable solely from system revenues put into special fund by City; the only obligation assumed by the City was to pay into the special fund and in no manner was the City otherwise liable to pay for the bonds); *Libertarian Party of Wisconsin v. State of Wisconsin*, 199 Wis. 2d 790, 546 N.W. 2d 424 (1996) (citing the special fund doctrine, court held bonds to be issued by a baseball park district and payable only from stadium sale and use taxes not to be debt for purposes of constitutional debt limits); *Baliles v. Mazur*, 224 Va. 462, 297 S.E.2d 695 (1982) (upheld authority created to finance public buildings from revenue bonds payable from lease payments from state agencies, citing special fund doctrine); *In re Advisory Opinion to the Governor: Public Drinking Water Protection Act of 1987*, 556 A.2d 1000 (R.I. 1989) (pure drinking water bonds backed by "water quality protection charges" aren't debt; "the vast majority of jurisdictions... have reached the same conclusion … by relying ... on the special-fund doctrine"). *But see Dykes v. Northern Virginia Transportation District Comm'n*., 242 Va. 357, 411 S.E.2d 1 (1991) (Transportation Commission bonds backed by annual appropriation county contracts violate debt limit; special fund doctrine held inapplicable); *see also City of Hartford v. Kirley*, 172 Wis. 2d 191, 493 N.W.2d 45 (1992) (TIF bonds constitute debt within meaning of constitutional debt limitations where TIF bonds were payable solely from general property tax revenue and city was absolutely obligated to pay for significant period of time. Unlike special assessments, tax increments are not independent sources of revenue nor is there a special tax. By contrast, special assessments are not part of the general property tax revenue); *Contra People ex rel. City of Canton v. Crouch*, 79 Ill. 2d 356, 403 N.E. 2d 242 (1980).

Under the special fund doctrine, revenues pledged to the payment of the improvements generally must relate to such improvement. *Kaminski v. Higgins*, 257 S.C. 222, 185 S.E.2d 365 (1971) (business license taxes not sufficiently related to construction of police and fire house so special fund doctrine does not overcome debt limitation); *Asson v. City of Burley*, 105 Idaho 432, 670 P.2d 839 (1983) (one of the WPPSS-related cases-special fund doctrine requires revenues be derived from revenue-producing property so repayment contracts did not create revenue producing property because the projects were never completed); *McBurny v. Ruth*, 527 So. 2d 1265 (Ala. 1988) (state exhibit commission may issue revenue bonds backed by payments in lieu of taxes by a public corporation); *Eakin v. State*, 474 N.E.2d 62 (Ind. 1985) (bonds backed by county hotel/motel tax and food and beverage tax count toward debt limit because tax revenues do not have a sufficient nexus to convention center financed with bonds);

2. <u>Contingent Obligation Exception</u>. The second most prevalent method of avoidance of the debt limitation is the use of contingent obligations. If the obligation is contingent, it is not a debt so the debt limitation does not apply. *See, e.g., Woodmansee v. Kansas City*, 346 Mo. 919, 144 S.W. 2d 137 (1940) (holding that bonds issued to enlarge public market and payable from revenues from enlarged market were not debt because they were contingent. If revenues were insufficient to pay for repairs to market, City agreed to use other sources of City income); *Fladung v. Boulder*, 165 Colo. 244, 438 P.2d 688 (1968) (contingent pledge of general credit to pay special assessment bonds after 80% have been retired does not create debt). *See also Lillard v. Melton*, 103 S.C. 10, 87 S.E. 421 (1915); *Board of Supervisors v. Massey*, 210 Va. 253, 169 S.E.2d 556 (1969). A conditional pledge of the issuer's credit does not create debt. *See Dean v. Kuchel*, 35 Cal. 2d 444, 447, 218 P.2d 521 (1950) (contracts for furnishing of property in the future create no liability or indebtedness until consideration is actually furnished).

Not all states recognize the contingent obligation exception. New Mexico has adopted a very broad reading of its debt limitation provisions. In *Hamilton Test Sys. v. Albuquerque*, 103 N.M. 226, 704 P.2d 1102 (1985), the City was to perform the service of operating its motor vehicle emissions inspection program for five years. The court held that the City had contracted a "debt" and explained that "any agreement by which a municipality obligates itself to pay out of tax revenues, and commits itself beyond revenues for the current fiscal year, falls within the terms of the constitutional debt restriction."

3. Service Contracts. Continuing service contracts where the locality agrees to pay in installments for water, electric or other public services may be excluded from debt limitations depending on whether the payment is conditional and contingent on provision of service or an unconditional obligation which only postpones the time of payment. *See Armstrong v. County of Henrico*, 212 Va. 66, 182 S.E.2d 35 (1971) (county agreement to procure materials and services necessary to operate sewer system did not create "debt"); *Board of Supervisors v. Massey*, 210 Va. 253, 169 S.E.2d 556 (1969) (upholding contract for furnishing transit services as contract for services conditioned on performance and not a present liability for future payments); *McBean v. City of Fresno*, 112 Cal. 159 (1896) (holding that City incurs debt each year on five-year sewage disposal contract only to the extent of services provided during that year).

4. Moral Obligations. Bonds backed by an agreement to "request" appropriations to make up any shortfall in debt service may not be a debt as long as there is no legal obligation of the municipality to provide financial assistance to meet debt service requirements. *See, e.g., Harrison v. Day*, 202 Va. 967, 121 S.E.2d 615 (1961) (revenue bonds of port authority not general obligation debt even though authority required to "urgently request" appropriations to cover cost of project and there was an "expectation" of appropriations); *Baliles v. Mazur*, 224 Va. 462, 297 S.E.2d 695 (1982) (upheld authority created to finance public buildings from revenue bonds payable from lease payments from state agencies, citing "special fund" doctrine; where there is no pledge of full faith and credit, bonds are not general obligations even if special fund consists entirely of state appropriated money); *Dykes v. Northern Virginia Transp. Dist. Com.*, 242 Va. 357, 411 S.E.2d 1 (1991) (even though "practical effect" was that county would continue to make payments, no debt created where county's payment obligation was expressly contingent upon county's appropriation of funds for such payments), *but see Witzenburger v. State ex rel. Wyo. Cmty. Dev. Auth.*, 575 P. 2d 1100 (Wyo. 1978) (holding that the existence of a moral obligation of a local government to pay revenue bonds require a vote of the people before issuance).

5. Short-Term Borrowings. Short-term (current fiscal year) borrowings in anticipation of revenues or taxes typically are not debt. *See Davenport v. City of Rock Hill*, 432 S.E. 2d 451 (S.C. 1993). The general rationale is that these types of obligations are payable from currently levied taxes and, therefore, are not debt.

6. Involuntary Obligations. In a minority of states, debt limitations are not applicable to an indebtedness or liability imposed by law. *See Welch v. Strother*, 74 Cal. 413, 16 P. 22 (1887) (salaries of municipal officers fixed by law are not indebtedness within scope of constitutional debt limits); *American Co. v. City of Lakeport*, 220 Cal. 548, 32 P.2d 622 (1934) (obligation of city to transfer money into a bond redemption fund); *State ex rel McCormick v. Bentley*, 98 Kan 442, 157 P 1197 (1916). In addition, many states have held that debt limitations do not apply to involuntary obligations arising as a result of torts. *Raynor v. King County*, 2 Wash. 2d 199, 97 P.2d 696 (1940); *G.W. Jones Lumber Co. v. Marmarth*, 67 N.D. 309, 272 N.W. 190 (1937) (debt limit does not invalidate bonds issued to compromise tort judgment).

7. <u>Nonrecourse Obligations</u>. Special districts or authorities may be created with specific (not general) taxing powers or power to levy fees. Usually bonds are exempt from debt limits and referendum requirements where the act authorizing the district or authority specifically provides that neither the city nor the state is liable for the debt. *Wein v. New York*, 36 N.Y.2d 610, 331 N.E.2d 514, 370 N.Y.S.2d 550 (1975) (Stabilization Reserve Corporation could sell bonds with proceeds to be paid by the city without violating prohibition against lending of the city's credit for a public corporation since Act stated that the city was not liable for the debt and any appropriation would be a gift); Wash. Const., art. VIII, § 9 (authorizing state building authority to issue bonds solely upon its own credit and specifically exempting such bonds from debt limitations). *See also Appeal of German*, 27 Pa. Commw. 108, 366 A.2d 311 (1976) (development corporation's bonds are not city debt); *In re Request for Advisory Opinion Enrolled Senate Bill*, 400 Mich. 311, 254 N. W.2d 544 (1977) (state building authority could lease a building to the state and use the rental payments to pay its revenue bonds since it was the state's pledge of its general taxing power, not its use of general taxing power to meet ordinary expenses, which was limited by the constitution); *Salmon v. Birmingham Parking Authority*, 294 Ala. 226, 314 So. 2d. 687 (1975) (where municipal parking authority was to have access to certain limited city funds and pay excess revenues to the city, bonds were not general obligations of the city since no bondholders could sue the city for payment); *Pierce County v. Keehn*, 34 Wn. App. 309, 661 P.2d 594 (1983) (no taxpayer initiative is available for county-created local sewer improvement district debt). *But see In the Matter of Constitutionality of Chapter 280, Or. Laws 1975*, 276 Or. 135, 554 P.2d 126 (1976) (state building authority's bonds constituted invalid debt because bond payment was to come from state's general fund and was not related to charges for facilities or services).

I. <u>Pooled Financings</u>. Section 149(f)(6)(A) of the Code states, in general, the term "pooled financing bond" means any bond issued as part of an issue more than $5,000,000 of the proceeds of which is reasonably expected to be used to make or finance loans to two or more ultimate (conduit) borrowers. Generally, pooled financing bonds are issued to reduce issuance costs and lower interest rates to the conduit borrowers through an economy of scale concept and enhancement of credit quality by diversifying the credit quality of the conduit borrowers. Pooled financings fall into three basic categories: (i) tax-exempt issues, the proceeds of which are used to make loans that themselves may or may not be tax-exempt, (ii) bond bank type issues, the proceeds of which are used to make loans to, and purchase the tax-exempt obligations of, local government issuers, and (iii) COPs in grantor trusts, the corpus of which is funded with tax-exempt notes of local government issuers. The obligation described in clause (i) (known as a "basic pooled financing") derives its tax-exemption from the top down, i.e., the overall issue fails the private activity bond and loan tests and may or may not qualify for a rebate exception. The pooled obligations described in clauses (ii) and (iii) arguably derive their tax-exemption and rebate liability or exception from the bottom up, i.e., these obligations are equal to the sum of their parts in that each local government issuer for its own stand-alone tax-exemption and rebate liability or exception.

1. <u>History</u>. Pooled loan restrictions were first enacted into law as part of the Tax Reform Act of 1984 that placed limitations on bonds issued for consumer loan purposes, providing simply that not more than five percent of the proceeds of the issue could be used to make or finance loans to persons other than governmental or 501(c)(3) entities. The consumer loan provisions were tightened as a part of the Tax Reform Act of 1985 that renamed consumer loans to be "private loans" and limited such loans to the lesser of $5,000,000 or five percent of the proceeds of the issue, treating loans to anyone but governmental entities as private loans. In the years that have followed, both Congress through legislation and the IRS through the Treasury Regulations have imposed additional requirements dealing with tax-exempt bonds and the application of their proceeds to make or finance loans, regardless of whether the loans are made to governmental entities, providing that certain reasonable expectations must be met in order for the bonds to qualify as tax-exempt obligations. The first bond bank in the United States was established in Virginia in 1969. Since then most states have one or more bond banks existing within their borders to serve as an issuer for one or more types of local government issuers.

2. <u>Advantages of Pooled Financings</u>. These often are thought to include (a) economies of scale through reduced issuance costs on a per borrower basis, improved name recognition of a frequent issuer and larger bond sizes sold to investors, and (b) diversification of credit risk.

3. <u>Disadvantages of Pooled Financings</u>. These typically are thought to include (a) the "Weakest Link" theory, (b) competition with other pool issuers, (c) creation of additional federal tax issues, (d) the possible elimination of the "qualified tax-exempt obligation" designation under Section 265(b)(3) of the Code, and (e) the creation of additional disclosure issues.

4. <u>Disclosure Issues</u>. Questions that often arise when addressing this subject include:

(a) <u>How active should the local government issuers be in the disclosure preparation?</u> The level of involvement and disclosure is based on the size of the pool, the particular local government issuer's annual repayment obligations compared to the total annual repayment obligation, the type of repayment obligations being pledged in the pool and the debt service coverage within the pool.

(b) <u>Is the pooled financing a blind pool and dedicated pool or a recycling pool?</u>

(c) <u>How should the obligations of Continuing Disclosure under Rule 15c2-12 be addressed?</u>

5. <u>Basic Federal Tax Issues</u>. Some of the more material basic federal tax issues that arise include the following:

(a) <u>Expectations Requirements/Failure to Realize Expectations for blind pools</u>. Section 149(f)(2) of the Code provides that a pooled financing bond issue is not tax-exempt unless at the time of issuance of the bonds, the issuer reasonably expects that at least 30% of the net proceeds will be used within one year to make loans and 95% of the net proceeds will be used within three years to make loans. In order to show compliance with this reasonable expectations test, issuers sometimes conduct some sort of a demand survey. This is not currently required under the applicable laws, but if one is used, then the IRS has closely scrutinized the elements and quality of the demand survey. Therefore, bond counsel needs to review this survey and its results very closely and compare them against any applicable industry standards.

(b) **Failure to meet Loan Tests**. If an issuer fails to use at least 30% of the net proceeds within one year to make loans and 95% of the net proceeds within 3 years to make loans, the bonds must be redeemed within 90 days of the one-year and three-year periods in amounts that would result in compliance with these requirements. This will require special redemption provisions for fixed rate bonds in blind pools and may require special termination provisions in swaps relating to variable rate bonds in blind pools.

(c) **Written Loan Commitment Requirements**. Prior to the issuance of pool bonds, the issuer must have "written loan commitments identifying the ultimate potential borrowers of at least 30% of the net proceeds." What are written loan commitments? Are these commitments from the issuer to the borrowers or from the borrowers to the issuer? In any event, it has to be something less than actual loans having been made since section 149(f)(2)(A)(i) only requires an expectation to loan 30% of the net proceeds within one year. Does the use of the language "ultimate potential borrowers" suggest that there is a problem if the issuer does not in fact make the loans identified in the written commitments? The use of the word "ultimate" suggests that result, but the use of the word "potential" clearly suggests otherwise. Exceptions to written loan commitment requirements include (i) issuers that are states or integral parts of states (e.g., state agencies) issuing bonds to make loans for "subordinate governmental units," and (ii) state-created issuers "providing financing for water-infrastructure projects through federally sponsored state revolving fund programs."

(d) **Multipurpose Allocations**. Under Treasury Regulations section 1.141-13(d), all multipurpose allocations of bonds for any Code section 141 purpose must comply with the requirements of Treas. Reg. §1.148-9(h). The problems with making a multipurpose allocation include: (i) the excess private use within one loan cannot be offset by no private use within other loans; and (ii) in order to have an allocation of pool bonds to each loan that is other than pro rata, the pool bonds have to be structured in a manner that lines up with the loans and, if any of the loans are being made for a refunding, allows for another 1.148-9(h) allocation method to be viable. If all loans are not made at closing, that may only be possible by dictating the loan terms to the local government issuers. In pool deals where the loans are made at subsidized rates (below the issuer's borrowing rate) there are likely to be significant mismatches; and (iii) in the case of redemption of bonds to effect remedial action, care must be taken to redeem the right bonds. The same applies if a local government issuer simply wants to pay off its loan and go forward with no tax restrictions on the financed asset or if a local government issuer wants to refund its way out of the pooled bond financing. The benefits with making a multipurpose allocation include: (i) the possible ability to isolate bad loans, (ii) the ability to allow for multiple $15 million limitations (for private activity bond purposes under Section 141(b)(5) of the Code) to apply to a single pool issue, and (iii) the ability to receive the full 10% private use under the private activity bond rules.