



# THE 43RD ANNUAL AGLF CONFERENCE

THE GRAND AMERICA HOTEL SALT LAKE CITY, UT  
MAY 10-12, 2023



## *The Basics of Municipal Leasing*

43<sup>rd</sup> Annual AGLF Conference  
May 10, 2023  
Salt Lake City, Utah

David Roeder – Director of Sustainable Lending, Ecofin Advisors

# How do State & Local Governments Traditionally Raise Capital?

## 1. **Dedicated Capital Outlay Funds**

- Cash from Fees or User Charges
- Cash from Property Taxes or other Tax Revenues

## 2. **Borrow Money (Bonds, Notes, & Other Obligations)**

- General Obligation
  1. Pledge of Full Faith and Credit
  2. Secured by Property Taxes (“Ad Valorem”)
- Revenue Backed Obligation
  1. Water & Sewer
  2. Sales Tax
  3. Project-Specific Revenues

# Ability of State & Local Governments to Issue Debt may be Limited

- **What is Debt?**

- Unconditional Obligation (no Set-Off Rights)
- Multi-Year (Binding upon Future Governing Bodies and Budgets)
- Potential Tax Impact (Rate Increase may be Required)

- **Debt Issuance may be Limited**

- By State Constitution
- By Statute

- **Examples of Limitations**

- Term Restrictions (ex. 10 years maximum for school bus)
- Maximum Rate Caps (ex. \$1.50 per \$100 of Taxable Assessed Valuation)
- Maximum Debt Caps (ex. 10% of Taxable Assessed Valuation)
- Voter Approval may be Required

# The Other Alternative!!!: Municipal Lease-Purchase

## **A hybrid structure with features similar to a Loan and a Lease.**

- **Like a Loan** – Lessee owns the asset subject to Lessor’s security interest, and has lien-free ownership at end of term after making all payments.
  - No FMV end-of-term purchase option; and
  - Capital lease treatment under GAAP accounting.
  
- **Like a Lease** – Lease payments are subject to annual renewal, and the Lease may be terminated at the option of the Lessee.
  - Not a “Debt” from a constitutional perspective.
  - Why: **Annual Appropriations Clause at Lessee’s Option**
    - Not an absolute obligation – can be terminated;
    - Not a multi-year obligation – can be terminated;
    - **Lessee has “Unfettered Right” to Non-Appropriate.**

# What is a Municipal Lease?

## **A Lease/Purchase Agreement, pursuant to which:**

- A state or local government as the Lessee (*a/k/a* the "borrower")
  - 1) purchases specific Capital Assets (real or personal property) from the Lessor (*a/k/a* the "lender");
  - 2) is the titled owner of the property (subject to the Lessor's security interest), and maintains & insures the property;
  - 3) makes periodic rental payments over an agreed-upon term;
  - 4) has rental payments that are subject to annual appropriation (or abatement in CA and IN);
  - 5) receives lien-free ownership at end of term after making all rental payments (i.e. conditional sale or installment sale financing);
- The interest portion of the rental payments may be Tax-Exempt. Section 103 of IRS Code requires Lessee to have one or more of the following powers:  
**Taxing Authority, Police Powers, and/or Eminent Domain.**

# What a Municipal Lease is Not

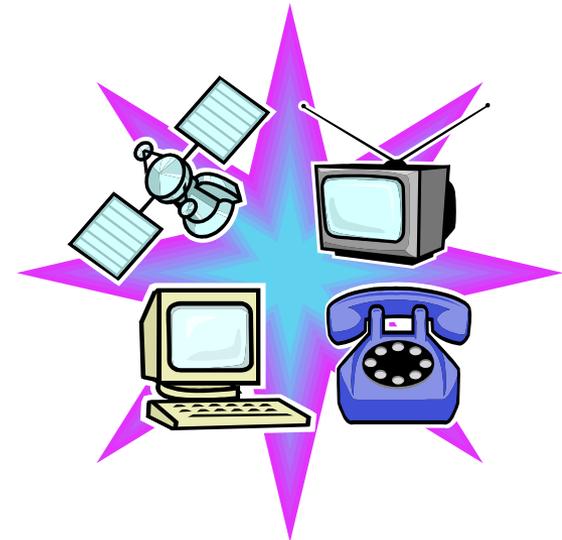
## **A Lease/Purchase Agreement is NOT:**

- A “Tax Lease” or “Operating Lease”, where
  - 1) the non-cancelable lease term is less than 75% of asset’s useful life;
  - 2) the present value of lease payments is less than 90% of asset’s fair market value;
  - 3) the Lessee does not have a bargain purchase price at end of term, and must instead pay fair market value to purchase; or
  - 4) the Lessor may take depreciation benefits and book a residual value in connection with the asset financed.

# What Can Be Leased-Purchased?

## Personal Property Examples

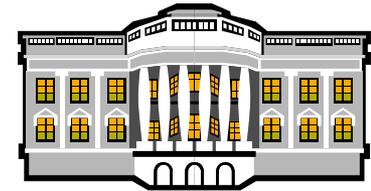
- Vehicles,
  - Fire Trucks, Police Cars, Ambulances, Refuse Trucks, Street Sweepers & School Buses
- Telecommunications Equipment
- Computers & Software
- Copiers & Other Office Equipment
- Safety Equipment (911 Systems)
- Energy Equipment
  - HVAC, Lighting, Building Controls & Solar Panels
- Medical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



# What Can Be Leased-Purchased?

## Real Property Examples

- School Facilities
- Courthouses
- City Halls
- Fire Houses
- Hospitals
- Nursing Homes
- Correctional Facilities
- Public Utility Facilities
- Libraries
- Airport Facilities
- Recreational Facilities
- Manufacturing Facilities
- Substitute Collateral
  - Example: Completed Facility instead of To-Be-Built Facility



# Who are Eligible Lessees?

## Direct Issuers: (Approx. 100,000 Nationally)

- States & State Agencies
- Local Governments & Other Political Subdivisions
  - Such as:
    - Cities & Counties
    - Public School Districts
    - Public Utility Districts
    - Fire Protection Districts
    - Ambulance Districts
    - Public Housing Authorities
- Native American Tribal Governments (Sovereign)
  - Note:
    - Government Projects Only
    - Not for Enterprises/Casinos

## Entities Requiring On-Behalf of Issuer for Tax-Exempt Issuance:

- 501(c)(3) Organizations
  - Private Entities (not Public)
  - Such as:
    - Charitable Organizations
    - Religious Organizations
    - Non-Profit Colleges
    - Non-Profit Hospitals
    - Private Schools
- Certain Private Activity Projects
  - Such as:
    - Economic Development
    - Manufacturing Facilities
    - Other Exempt Facilities

# Who are Eligible Lessors?

(Almost Anyone!)

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

# Active Secondary Market

## **A Lease/Purchase Agreement may be Assigned by Lessor:**

- Assignment Agreement
  - Typically a Sale in Whole
  - Lessor's Right, Title and Interest in Lease, Collateral & Rental Payments
- Assignment Economics
  - Present Value of Remaining Rental Payments
  - Purchase at Par (Remaining Principal) or Premium (Principal plus Fee)
- Servicing Considerations
  - Initial Lessor to Continue Servicing on Behalf of New Lessor?
  - New Lessor named on UCC-1's, Recordings, and Insurance Certificates?
- Recourse Considerations
  - For Credit Defaults or Non-Appropriations?
  - For Purchase Premium in Excess of Lease Payoff Amount?
- Notice of Assignment
  - Notice to Lessee or Trustee (recordkeeping of Tax-Exempt holder)
  - Lessee Notice or Consent may be Required to Effectuate Assignment

# Why Use Lease-Purchase Financing?

- Conserves cash by alleviating liquidity-drain caused by a lump-sum capital expenditure.
- Lessee can instead spread payments over asset's useful life.
- Not classified as "Debt", therefore typically:
  - No voter approval required; and
  - Not subject to legal Debt limitations.
- Typically, no encumbrance of tax or other revenues, therefore:
  - Revenues available to secure future bonded Debt; and
  - Enhances borrowing flexibility.

- Potential for structuring flexibility versus a public bond offering:
  - Match separate lease terms with each asset's expected useful life.
  - Collateral provisions.
  - Prepayment provisions.
- Potential benefits to Lessee of a lease versus a public bond offering:
  - Lower transaction costs;
  - Faster closing timeline;
  - Less complicated docs;
  - Rate lock re: Lease;
  - No ratings or bond insurance;
  - No official statement; and
  - No continuing disclosure.

# Why Are Municipal Leases Attractive to Investors?

- Yield Considerations

4.75% (Municipal Lease Coupon Rate)

÷ .79 (One Minus 21% Federal Corporate Tax Rate)

**6.01% Taxable Equivalent Yield**

- Credit Considerations

- Governments face less competition;
- Governments may have better credit profiles; and
- Governments may have better risk ratings.

- Adequate Yield given Reduced Risk Profile

# Typical Structures for Municipal Leases

- Lease-Purchase Agreement
  - Secured by Equipment, Vehicles or Real Property
  - Subject to Annual Appropriations
  - Subject to Abatement re: Lack of Beneficial Use (CA & IN)
  - Master Lease with Schedules, or Single Lease
  - Terms 1-20 Years, typically
- Installment Payment Agreement
- Lease Revenue Bond
  - Secured by Rental Payments subject to Annual Appropriation
- Certificates of Participation (“COPs”)
- 501(c)(3) Conduit Financings & Industrial Revenue Bonds
  - Lease/Sub-Lease or Loan/Sub-Loan
  - Conduit is Non-Recourse; Borrower is Full-Recourse

# Common Municipal Leasing Terms

- Bank Qualified:** The Lessee expects to issue \$10 Million or less in tax-exempt obligations during the calendar year. The Lessee designates the Lease as a “qualified tax-exempt obligation.” Banks are allowed to deduct 80% of carrying costs.
- Non-Bank Qualified:** The Lessee does not designate the lease as Bank Qualified because the Lessee expects to issue more than \$10 Million in calendar year.
- Private Activity:** Over 10% of the financed facility or equipment will be used by a private entity and/or for private activities.
- Non-Substitution:** The Lessee is prohibited from replacing the collateral with similar assets for a period of time following a non-appropriation.  
**Courts have determined that a Non-Substitution clause may cause the Lease to be INVALID because the Lessee is COMPELLED to make the Rental Payment.**
- Reimbursement Resolution:** Allows reimbursement of prior cash outlays from tax-exempt bond or lease proceeds, for expenditures made up to 60 days prior to the resolution, but not later than 3 years after the expenditure.

# Common Municipal Leasing Terms

## (Continued)

<b>Essentiality:</b>	A relative term that describes how important the asset is to the Lessee's operations or services, with a higher degree of essentiality deemed to potentially reduce the risk of non-appropriation.
<b>Appropriation:</b>	An official act by a Lessee to approve (by budget) an expenditure of funds (including Lease rental payments) during a fiscal year.
<b>Non-Appropriation:</b>	The Lessee fails to appropriate sufficient funds to make the rental payments due under the Lease, and elects to terminate the Lease.
<b>Current Expense:</b>	Lease rental payments are a "current expense" of the Lessee because the rental payments, absent continued appropriations, are a "current" year obligation only, and are an operating "expense", not a Debt.
<b>Purchase Price:</b>	The prepayment amount required for the Lessee to payoff the Lease in advance of its maturity date, typically expressed as principal outstanding plus a premium (if any).
<b>Firm-Term Lease:</b>	A Lease that is <u>not</u> subject to annual appropriation.
<b>Abatement:</b>	Ability of Lessee to discontinue making rental payments during a period in which Lessee does not have beneficial use of asset financed.

# Municipal Leasing Credit Considerations

## 1) Essential Purpose

- A. Essentiality of the Service Provided (i.e. Fire Protection)
- B. Essentiality of the Collateral (i.e. Fire Truck) to the Service Provided
- C. Lessee Difficulty re: Foregoing or Replacing the Service or Collateral

## 2) Financial Capacity

### A. General Analysis

- Assessed Valuation & Tax Revenue
- Demographic Trends (Population, Employment, Wealth, etc.)
- Available Funds or Liquidity (Lessee's General Fund)

### B. Revenue Specific

- Sources & Stability of Revenue Pledged
  - Taxes (Property, Sales, Hotel, Income, etc.)
  - Utility (Water, Gas, Electric, Telecom)
- Voter-Approved, Sunset Expiry or Evergreen, Rate-Set Covenant?
- Historical and Pro-Forma Debt Service Coverage

## 3) Debt & Pension Load

### A. Debt Obligations, Covenants & Capacity

### B. Funding Status of Pension Obligations & Annual Pension Costs

# Municipal Leasing Credit Considerations (Cont.)

## **Detroit General Obligation Bonds in Bankruptcy**

- Secured or Unsecured Pledge of Tax Revenue?
- Treatment versus Unsecured Pensioners

## **Puerto Rico Special Revenue Bonds in Bankruptcy**

- Pledged Revenues Stayed from Bond Payments?

## **Illinois Pension Funding Intercept**

- Mandatory Intercept of Local Govt. Revenues prior to Debt Service Payments

## **City of Albany (GA) Non-Appropriation**

- Non-Appropriation due to Equipment Failure, not Financial Distress
- Rating Agency Actions

## **Abatement Lease Issues/Concerns**

- Rental Interruption Insurance for Rental Payments during Abatement Period
- Construction Risk, Earthquake Risk, and Base Lease (Ground Lease) Term

## **Platte County (MO) Backstop Appropriation**

- Private Project (Zona Rosa Shopping Mall) – Not an Essential Government Service
- County (Aa2 Rated) Backstop Appropriation if Project Default
- Backstop Reliance if Non-Essential Project?

# Municipal Leasing Documentation Considerations

## **STANDARD EQUIPMENT OR VEHICLE LEASE-PURCHASE DOCUMENTS:**

- Resolution or Ordinance (Dillon's Rule)
  - Authorizing Asset Purchase and Lease-Purchase Financing
- Municipal or General Certificate
  - Incumbency Certificate
- Lease-Purchase Agreement
  - Equipment Schedule
  - Rental Payment Schedule (including Interest column)
- Escrow Agreement (if construction/implementation is required)
- Delivery & Acceptance Certificate
- Attorney's Opinion (Legal, Valid, Binding & Enforceable)
- IRS 8038-G Form
  - Lessee's Legal Name, Address and Taxpayer ID Number
  - Issue Amount, Yield and Weighted-Average Maturity
- Proof of Insurance (Property and Liability) or Self-Insurance
- UCC-1 Financing Statement

# Municipal Leasing Documentation Considerations (Cont.)

## **OTHER POTENTIAL DOCUMENTS:**

- Bank Qualified Certificate
- Essentiality Certificate
- Project Bonding for Contractor Work
- Tax Certificate & Tax Opinion
  - Matter of Lessor Preference or Policy
  - Decision often based on Lease Size or Complexity
- Real Property or Leasehold Interest
  - Survey
  - Environmental
  - Flood Insurance
  - Appraisal
  - Title Report
  - Recording
- Statutory Limitations (Late Payment Fees, Default Rates, Liability Caps)
- Assignment Agreement and Notice of Assignment

# Rationale for Private Placements

## Lease-Purchase Agreements are Private Placements

- Treatment as Direct Bank Loan, not a Municipal Security

## Rationale for Bonds to be deemed as Private Placements:

- Name (i.e. "Bond") is not Dispositive
- No Official Statement
- Physical Bond versus DTC Registered
- No CUSIP Number
- No Bond Rating
- No Bond Insurance
- No Small Denominations
- Representation re: Bank Loan vs. Security Treatment

## Implications or Requirements:

- Purchase / Representation Letter often Required
- No Mark-to-Market Requirement for Bank Loans

# The Regulatory Environment

## Heightened Regulation of Municipal Securities Market

- Some changes have been beneficial for Municipal Leasing
  - Pension disclosure rules
  - Rules for Advisors, Underwriters, and Broker-Dealers re: Bonds
  - SEC enforcement actions re: bad disclosures.
- Some changes have caused concern for Municipal Leasing
  - Introduction of “Municipal Advisor” role
  - Broad definition of “Advice”
  - Potential blurring of lines - Municipal Lease vs. Municipal Security
  - Potential for CUSIPs for Municipal Leases & Private Placements
  - Potential for SEC Rule 15c2-12 Disclosures re: Municipal Leases
  - Potential for ESG Disclosure & Evaluation

**CAUTION: Seek counsel’s advice about your role in the process when working with governments and their municipal advisors, to remain in compliance and to avoid any painful consequences.**

# Tax Reform of 2017

## No Longer a Level Playing Field:

- **Prior to Tax Reform:**
  - 35% Corporate Tax Rate
  - 35% or 39.6% Individual Tax Rate (top 2 brackets)
  
- **After Tax Reform:**
  - 21% Corporate Tax Rate
  - 35% or 37% Individual Tax Rate (top 2 brackets)
  
- **Pricing Advantage for Public Bond Offerings**
  - About 70% of T/E Bonds held by Individuals or Funds;
  - Given an identical Tax-Exempt Rate:
    - **Higher Taxable Equivalent Yield for Individual**
    - **Lower Taxable Equivalent Yield for Corporation**
  
- **Result:** Pressure on Bank Lending Spreads in order to remain Price Competitive with Public Bond Yields.

# The Process

- Pre-Screen the Transaction
- Structure & Price the Transaction
- Propose & Sign Up the Deal (Get the Award)
- Submit the Deal Internally for Due Diligence
- Credit Approval
- Documentation Approval
- Funding (i.e. Closing)
- Annual Customer Reviews
- Portfolio Surveillance

**Thank You And Good Luck!!**