PRACTICAL CONSIDERATIONS AND DECISION POINTS FOR MUNICIPAL LEASE FINANCING IN CALIFORNIA

CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION | JUNE 2023 | CDIAC NO. 23.05

CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

The California Debt and Investment Advisory Commission (CDIAC) provides information, education, and technical assistance on debt issuance and public funds investments to local public agencies and other public finance professionals. CDIAC was created to serve as the state's clearinghouse for public debt issuance information and to assist state and local agencies with the monitoring, issuance, and management of public debt.

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INTRODUCTION

Lease financing is a common and often essential method for public agencies to finance capital projects backed by the public agency's general fund. This is because lease financings operate as one of the few exceptions to the "debt limit" of the California Constitution, which otherwise precludes cities, counties, school districts, and community college districts in the state from incurring long-term debt without voter approval. The California Supreme Court has recognized lease financings as an exception to the debt limit – called the "Offner-Dean exception" or "lease exception" – so long as the rental obligation of the public agency is contingent on its continued use and occupancy of the leased asset supporting the lease transaction and the annual rental obligation does not exceed the fair rental value of the leased asset.[1]

The California Debt and Investment Advisory Commission (CDIAC) has published multiple reports and resources about lease financing since the 1990s. CDIAC's 2022-23 content series about lease financing serves as an update of its previous publications and explores the legal requirements, market considerations, and best practices of municipal lease financing. The first report in the content series, *Legal Foundations of Lease Financing in California*, was published in August 2022. That report interpreted the foundational case law for the lease exception to the debt limit and mapped the applications of that legal precedent to requirements for lease financings in the municipal market.

This report is the second in CDIAC's updated content series about lease financing. This report builds upon the legal foundations laid in the previous report while focusing on the key decision points for public agencies that use lease financings as well as the implications of those decisions on the suitability, marketability, and pricing of lease transactions. Some of the important decision points discussed in more detail in this report include the structure for the lease financing, the entity that acts as lessor for the transaction, selection of the leased asset, setting the amortization schedule, default remedies as well as deciding whether it is in the public agency's best interest to use lease financing in the first place.

This report will focus on aspects of the debt issuance process that are specific to municipal lease financings. For a broader discussion of the general debt issuance process – which will pertain to lease financings as well as the other types of public debt issuance – please refer to CDIAC's ***Debt Financing Guide*** publication from 2019.

Please note that the general guidance shared in this report is not meant as a substitute for legal or financial advice. CDIAC encourages municipalities to consult with a municipal advisor and/or bond counsel experienced in California municipal lease financing for recommendations specific to their unique situation.

BACKGROUND AND HISTORICAL CONTEXT FOR LEASE FINANCING IN CALIFORNIA

Lease financing is predominantly used by cities, counties, and K-14 districts[2] in California due to the state's strict limitations on the incurrence of debt payable from the general revenues of these public agencies in a future fiscal year. A public agency is required to secure voter approval before incurring long-term debt unless a judicially recognized exception applies. There are only a few situations that permit a public agen-

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1 These requirements and other fundamental legal aspects for municipal lease financings is discussed in more detail in CDIAC's *Legal Foundations of Lease Financing in California* report, which was published in August 2022: **www.treasurer.ca.gov/cdiac/reports/legal.pdf**.

2 K-14 districts refers to K-12 school districts and community college districts.

WHAT IS A FINANCING LEASE?

LEASE: A conveyance of property from one party to another for use and occupancy for a specified period of time in return for compensation made in the form of rental payments.

FINANCING LEASE: A method in which a lease is used as a vehicle to borrow money.

MUNICIPAL LEASE FINANCING: A financing lease that is used to borrow money through application of the lease exception to the debt limit in the State Constitution. The municipality leases property to a financing issuer and then leases that property back so that it can make rental payments that repay bonds or pay holders of certificates of participation.

LESSEE: An entity that leases an asset from another entity and pays rental payments for the right to use the asset. In the context of municipal lease financing, the typical lessee is a public agency, such as a city, county, or school district.

LESSOR: An entity that leases an asset to a lessee and collects rental payments from the lessee for use of the leased asset. The lessor issues and sells lease revenue bonds to investors and is responsible for repayment of the debt through amounts it receives as lease payments, or the lessor assigns its right to receive lease payments to a trust, with certificates of participation representing the right to receive portions of the lease payments sold to investors. In the context of lease revenue bonds and certificates of participation, the typical lessor is a financing entity such as a joint powers authority (JPA) or non-profit corporation that is also often created and/or controlled by the public agency that is acting as lessee for the lease transaction.

LEASED ASSET: In the context of municipal lease financing, leased assets are typically facilities or properties for which the right to use and occupy such facilities or properties is transferred from a lessor to a lessee.

cy subject to the debt limit set in the California Constitution to commit to long-term financial obligations without first securing voter approval, and the "lease exception" is one of these situations defined in California case law. *The City of Los Angeles v. Offner* and *Dean v. Kuchel* cases in 1942 and 1950, respectively, established the legal precedent for public agencies to use leases to finance capital projects without the obligation being subject to the constitutional debt limit and requiring voter approval.[3] Not long afterwards, Los Angeles County issued one of the first lease-backed securities in 1962.[4] Lease financing continued to gain popularity and acceptance in the municipal market, especially after the passage of Proposition 13 in 1978, which limited property tax revenues for cities and counties in California. In 1998, the California Supreme Court ruled explicitly in Rider v. City of San Diego that lease financings and asset transfers were legally valid and enforceable, which has further facilitated issuance of lease financings in the state.[5]

[3] Kelly Joy, *Legal Foundations of Lease Financing in California* (Sacramento: California Debt and Investment Advisory Commission, 2022), 1, Accessed October 5, 2022, www.treasurer.ca.gov/cdiac/reports/legal.pdf.

[4] David Brodsly, Nikolai J. Sklaroff, Robert Tucker, Kathy McManus, et al., *Moody's on Leases: The Fundamentals of Credit Analysis for Lease Revenue Bonds and Certificates of Participation*, (Moody's Investors Service, 1995), 3.

[5] Kelly Joy, *Legal Foundations of Lease Financing in California*, 7-8.

THE DECISION TO UTILIZE LEASE FINANCING

There are important potential advantages and disadvantages for public agencies to consider when deciding to use a lease financing to fund a capital project. Some projects may be a natural fit for a lease financing, whereas for others it might make sense to consider a different type of debt issuance transaction (e.g. a general obligation bond, enterprise revenue bond, etc.).

Advantages of Lease Financings

The most significant advantage for an issuer to use a lease financing is the ability to effectively "borrow"[6] funds without first needing to secure voter approval. Securing voter approval often requires a significant investment in resources and also leaves the public agency open to the risk of the ballot measure not passing the necessary voter threshold, which is two-thirds of votes cast in most cases.[7] While some projects are popular with voters and may lend themselves to voter approval of financing for the project, other projects might not generate such natural voter support regardless of how necessary they may be to the agency's operations. In cases where projects may be too critically important to the public agency, it might not be appropriate to subject the success of the project to the time and risk associated with obtaining voter approval. In these situations, lease financing has been a valuable tool for public agencies to finance necessary capital projects.

Related to the advantage of not requiring voter approval, lease financings similarly do not require (or specifically allow) a public agency to raise taxes but are instead repaid through the agency's general fund. This can be an advantage for lease financings in cases where there is public resistance to tax increases and/or sufficient general fund revenue to pay for the lease obligations without a new revenue stream.

Disadvantages of Lease Financings

As mentioned above, one of the most notable disadvantages for lease financings is that they are typically payable from the agency's general revenues, and lease financings can thus encumber those general revenues while the lease financing remains outstanding. Municipal finance officers are often wary of creating additional – especially long-term – obligations that must be paid from the agency's general fund without a supporting source of revenue. If revenue sources that support the general fund no longer support all of the commitments in the agency's budget, rental payments that pay debt service for lease obligations must still be paid, sometimes at the expense of essential public services such as those for public safety, public health, etc. Public agencies need to carefully plan for and model the effects of any unsupported obligations of the general fund to ensure long-term fiscal sustainability.

Another disadvantage of municipal lease financings is that they can constrain a public agency's options for use of its property and/or other valuable public assets during the life of the lease financing. Real property and secured lending laws protect the interests of investors in the leased assets, which can limit the public agency's options in selling or rehabilitating the property in any way that could threaten use and occupancy of the encumbered facility. There are also multiple other ongoing requirements for assets used in lease financings, including the need to maintain appropriate insurance coverage of the asset, which can be an additional long-term expense.

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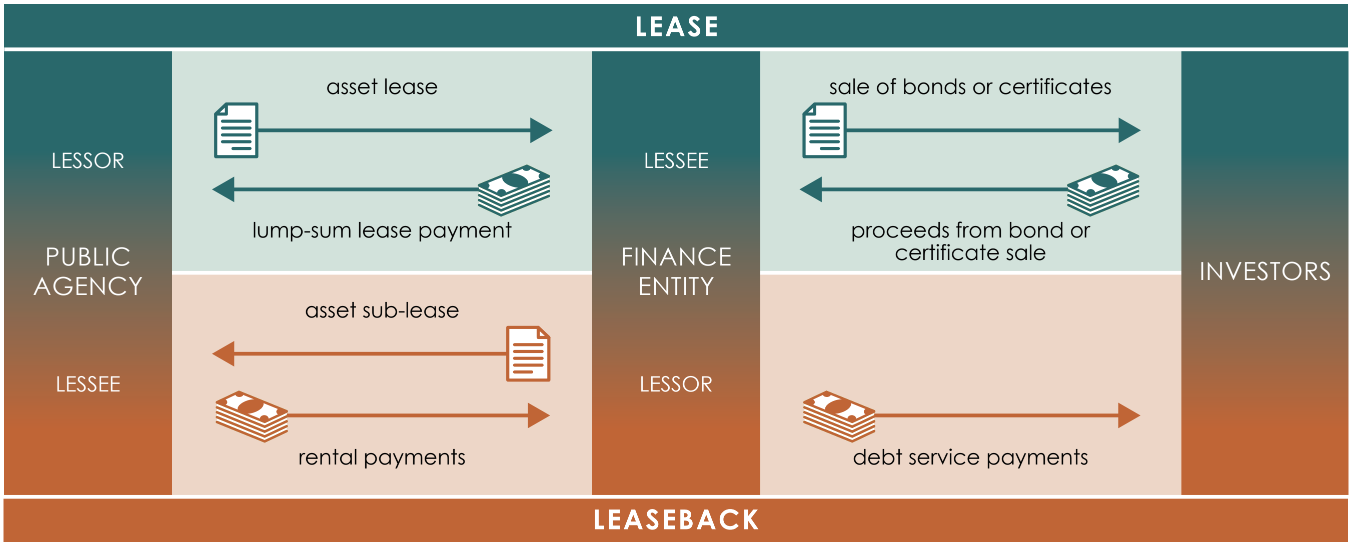
[6] From a legal perspective, the agency is not "borrowing" funds but rather making rental payments for the use and occupancy of a leased asset. In actuality, lease financing transactions are used to raise and repay funds in a long-term financing obligation, which functions similarly to a debt. For more information about the legal framework for lease financings, refer to CDIAC's *Legal Foundations of Lease Financing in California* report: **www.treasurer.ca.gov/cdiac/reports/legal.pdf**.

[7] School districts seeking the authority for new general obligation debt based on Proposition 39 are subject to a voter threshold of only 55%.

Figure 1



Due to some of these disadvantages, lease transactions are most typically used to finance general capital projects for which other financing options are not available. If voter approval has a reasonable probability of success for a project, then an issuer may opt for a general obligation bond, which would provide a new revenue stream for repayment of the debt instead of placing a new obligation on existing general fund revenue. Or, if the project is associated with a special revenue fund such as a water or sewer enterprise, the agency is likely to take advantage of the special revenue exception to the debt limit, which does not require a commitment of the general fund.[8] If no other exception to the debt limit applies, lease financing can be an appropriate tool, especially if the financing is going to be repaid from general fund revenues.

A lease financing can also be used to support a borrowing to be repaid from a non-general fund revenue that, while legally pledgable to a special fund obligation, would not produce as high of a rating or as low of an interest cost as a commitment of the agency's general fund revenues through a lease financing. In such cases, the general fund is reimbursed by the special revenue.

THE LEASE-LEASEBACK STRUCTURE

Today, one of the most popular structures for municipal lease financings is a "lease-leaseback" structure, which will be referred to multiple times throughout this report and is visually represented in Figure 1. In a lease-leaseback transaction, the public agency leases the right to use and occupy an asset that it already owns – or in the case of a construction lease, the property on which the to-be-constructed asset resides – to a finance entity, and the finance entity issues bonds (or provides for the delivery of certificates of participation) and transfers the proceeds from the sale of the lease-backed securities to fund the capital needs of the public agency. The finance entity – which acts as lessor in the leaseback stage of the transaction – simultaneously leases back the asset to the public agency lessee, and the public agency maintains use and occupancy of the leased asset. The public agency then pays rental payments to the lessor for use and occupancy of the existing

[8] For more information about the different exceptions to the debt limit in the California Constitution, refer to section 1.2.4 of CDIAC's *California Debt Financing Guide*: www.treasurer.ca.gov/cdiac/debtpubs/financing-guide.pdf.

leased asset through the period covered by the lease agreement. Those rental payments from the lessee are then used to make the required payments for the issued lease-backed securities. The lease agreement is structured in such a way that the right to use and occupancy of the leased asset reverts automatically to the public agency lessee after the financing lease terminates.

There are multiple types of financing leases that public agencies may use to accomplish their financing goals. More detail about the different possible transaction types is included in the *Types of Lease Transactions* section of this report.

THE ROLE OF THE LESSOR

The lessor in a lease financing issues the lease-backed securities for the transaction and leases the right to use and occupy the leased asset to the public agency lessee. With lease revenue bonds, the lessor is legally responsible for the issued lease-backed debt, but its obligation is limited to the rental payments made by the public agency lessee, which pay the principal and interest for the debt obligation. With certificates of participation, the lessor sells to investors fractionalized interests of the rental payments by the public agency lessee. (See the *Lease Financing Structures* section for more information about lease revenue bonds and certificates of participation.)

The role of the lessor exists because the public agency cannot directly issue its own debt due to the debt limit in the California Constitution,[9] which is usually the primary purpose of the lease financing itself. Instead, the public agency can have another entity – typically a joint powers agency (JPA) or a captive non-profit corporation – act as lessor and either issue the lease-backed bonds or sell the certificates of participation. The lessor's role is simply to facilitate the lease financing; the lessor does not have any financial or other interests in the overall transaction other than to serve in this nominal role.

While lease structures involving captive non-profit corporations and certificates of participation dominated municipal lease financings in the past, public agencies have increasingly chosen to use JPAs created specifically for this purpose as the lessor for their lease financings. This has been attributed in large part to the increased legal authority under the Joint Exercise of Powers Act[10] and increased awareness of how JPAs afford various benefits compared to non-profit corporations (among which is that "bonds" tend to have easier market acceptance than "certificates of participation").

Choosing the Issuer of the Debt

A major decision point for a public agency when pursuing a lease financing is choosing the entity that will act as lessor and issue the lease-supported debt. For some public agencies, there is a natural choice for a lessor and the decision for which entity will issue the debt is a simple one. Many of the entities that act as lessors have already been created by the public agencies for the purpose of issuing lease-backed debt obligations, and those agencies typically choose to continue to use that existing finance entity. Agencies that have not already established a JPA or other entity to act as lessor have a few options for what type of entity to use as a lessor for the lease financing, including creating a new JPA or nonprofit corporation.

In cases where a public agency intends to create a new finance entity to act as the lessor, the public agency first needs to legally establish the finance entity before being able to proceed with the lease financing transaction. To set up a JPA to act as the finance entity, there needs to be a minimum of two entities that set up a JPA agreement to estab-

[9] For more information and context about the lease exception to the debt limit in the California Constitution, refer to CDIAC's *Legal Foundations of Lease Financing in California* report: **www.treasurer.ca.gov/cdiac/reports/legal.pdf**.

[10] Chapter 84, Statutes of 1949, Joint Exercise of Powers Act, California Government Code sections 6500 – 6599.3, **https://leginfo.legislature.ca.gov/faces/codes_displayText.xhtml?lawCode=GOV&division=7.&title=1.&part=&chapter=5.&article=1**.

lish the new JPA, and each entity needs to adopt a resolution to enter into the JPA. There are several steps in the process to establish a new JPA, some of which include establishing a new governing board, delegating powers, writing bylaws, selecting officers, and creating a conflict-of-interest code. These steps in forming a JPA usually require a lot of time as well as staff resources and support from bond counsel. Some of the necessary ongoing requirements for establishing a JPA include holding regular meetings and annual reporting.

The process required to create a new JPA is often intensive enough that some public agencies without an existing or natural JPA to use in a lease financing choose to contract with an existing JPA to issue lease-backed securities on their behalf. Contracting with an external JPA typically requires a financing fee that often depends on multiple factors, including the type of agency, the size of the issuance, and/or the type of project. These JPAs often require a deposit and may also charge an ongoing annual fee, depending on the characteristics of the issuance as well as the policies of the contracted JPA. In addition, public agencies wishing to contract with an external JPA are often required to be affiliated with the JPA in some way, whether as a member agency or by financing a project that meets specific criteria. These JPA partnerships can provide benefits related to staffing assistance and specialization in the lease financing process.

In cases where it is too impractical to issue lease-backed securities through a JPA, the public agency may instead decide to use a different lease financing structure for the lease financing that does not require a JPA, such as certificates of participation. The various options for lease financing structures – including certificates of participation and lease revenue bonds – are discussed in more detail below.

TERMINOLOGY FOR LEASE REVENUE BONDS AND CERTIFICATES OF PARTICIPATION

The substantive distinctions between LRBs and COPs are usually not material, but the terminology can be very different. The key difference derives from what the financing entity is doing. In LRBs, the financing entity is issuing bonds that are then only payable from rent under the municipal financing lease. In COPs, the financing entity is selling fractionalized interests in the financing lease. This then results in many differences in the terms that the two types of transactions use. For example, bonds are "issued" whereas COPs are "executed and delivered." Some other differences between COPs and bond terminology are listed below:[11]

BOND TERMINOLOGY	COPs EQUIVALENT
Bonds are ***issued***	COPs are ***executed and delivered***
Bonds ***bear interest***	COPs ***represent interest***
Bonds have a ***principal amount***	COPs have a ***principal component***
Redemption of bonds	***Prepayment*** of COPs

[11] Lisel Wells, Nixon Peabody LLC.

LEASE FINANCING STRUCTURES

Another important decision point for public agencies interested in a lease financing is to decide the structure for the lease-backed securities. The two main types of securities used to securitize lease payments are lease revenue bonds (LRBs) and certificates of participation (COPs).

Lease Revenue Bonds

A lease revenue bond is a type of municipal debt instrument that nominally represents an indebtedness of the issuer but is solely payable from rental payments by the lessee. Although lease payments are typically made from the lessee's general fund, lease revenue bonds represent a limited obligation of the JPA lessor in the lease transaction. LRBs were the first lease-backed securities used in the municipal market on a large scale.

Certificates of Participation

Certificates of participation (COPs) are instruments representing fractionalized interests in a municipal financing lease. With COPs, the lessor sells investors a fractionalized interest in the lease rental payments so that they can be sold in denominations to investors. Each certificate represents a portion of the right to receive rental payments and the investor that has purchased the certificate is entitled to a share of rental payments in a lease financing transaction. COPs are "executed and delivered" by a trustee.

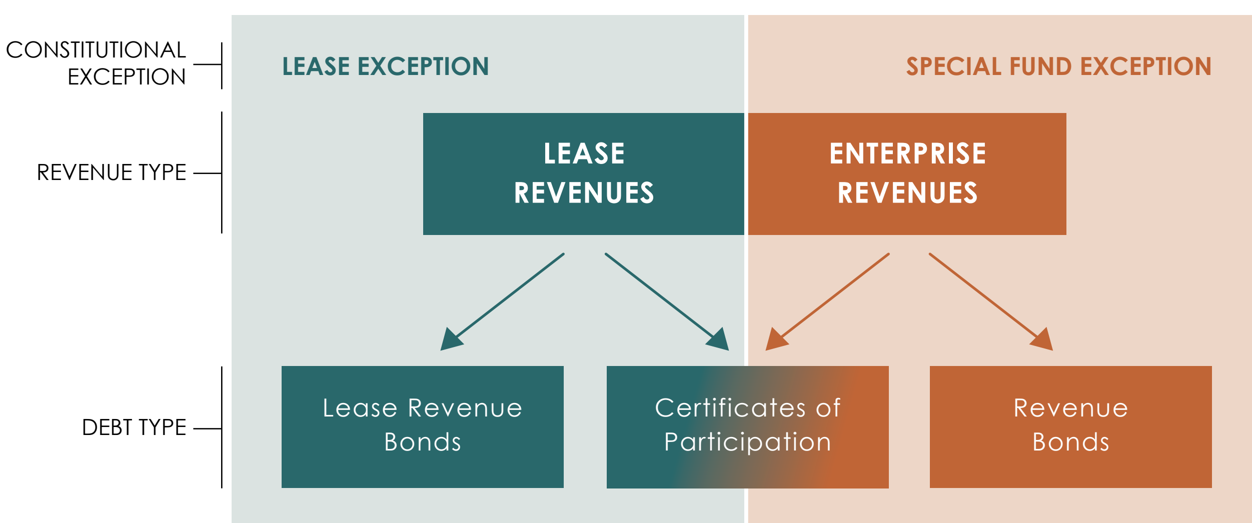
It is also worth noting that COPs can also be executed in transactions not related to lease financing. For example, COPs secured by an installment sale agreement are commonly used to issue enterprise revenue debt under the special fund exception to the debt limit for agencies that lack revenue bond authority, such as general law cities (Figure 2).

Comparison Between Lease Revenue Bonds and Certificates of Participation

While the financial substance of LRBs and COPs is essentially the same, the underlying legal structure of LRBs and COPs differs. LRBs are debt of the finance agency (i.e. the lessor) secured solely by rental payments. COPs, on the other hand, are fractionalized interests in the public agency lease. More importantly for some agencies, COPs

Figure 2

SECURITIZATION OPTIONS FOR LEASE AND ENTERPRISE REVENUES



THE ORIGIN OF CERTIFICATES OF PARTICIPATION AND THE SHIFT TO LEASE REVENUE BONDS

Using lease financing as a means by which public agencies could finance capital projects primarily arose from the aftermath of Proposition 13, when the State Constitution was amended to further limit the circumstances under which cities, counties, and school districts could issue general obligation bonds. After Proposition 13 was adopted, these debt-limited agencies began to use lease financings more widely due to the Offner-Dean exception to the debt limit. At the outset, these public agencies used the tools available to them to structure these transactions, which resulted in selling fractionalized interests in the leases to the public capital markets through certificates of participation. In the decades that followed, issuers shifted to favoring lease revenue bonds despite their similarity to COPs, because investors generally found lease revenue bonds to be a more intuitive structure to invest in than COPs.

do not require the formation of a JPA, and the financing can be executed through a captive nonprofit that may be easier to establish than a JPA. Although COPs and LRBs have subtle structural differences, they share key covenants and security features and tend to produce the same general rating outcomes.

Public agencies have increasingly gone to the effort to issue LRBs through a JPA instead of executing and delivering COPs. LRBs are arguably easier for some investors to understand, and they are thought to be more easily sold and traded in the market than COPs. Thus, many public agencies have preferred to issue LRBs through related JPAs rather than to execute COPs. Market participants at times cite a pricing differential between LRBs and COPs, albeit a modest one. That said, COPs continue to be used – albeit to a smaller degree – by multiple agencies; in 2021, over 100 lease-backed COPs transactions worth more than $1.6 billion were executed in California.[12] Many (though not all) of the agencies that continue to choose to issue COPs are smaller agencies that do not have a natural JPA to issue through and do not issue lease-backed securities often enough to justify the investment in creating a new JPA organization.

TYPES OF LEASE TRANSACTIONS

Along with deciding whether to issue LRBs or to execute and deliver COPs, the agency will also need to choose the type of lease transaction for the lease financing. There are multiple types of lease transactions that can be used in a lease financing depending on the agency's intended objectives. Some leases directly purchase – or finance new construction of – a leased asset, whereas other transactions employ asset transfers through a lease-leaseback transaction. In addition, master leases and lease pools combine multiple leased assets in one lease financing. All of these transaction types can be structured as either LRBs or COPs.

Asset Transfers

In an asset transfer, a public agency leases an existing asset and applies the proceeds to a different capital project. This is usually done as a lease-leaseback transaction, as was discussed earlier in the report.

The use of an asset transfer in a lease financing has multiple advantages. For example, the leased

[12] CDIAC, *DebtWatch*, (May 26, 2022).

asset is already built, and construction risk is therefore completely mitigated. In addition, the leased asset used in the asset transfer may be more "essential" than the asset being constructed or improved, and/or may have more value or a longer useful life. (See the *Identifying the Leased Asset* section in this report for a more detailed discussion.) As discussed in the next section, eliminating construction risk means that the lease is immediately backed by an asset with beneficial use and occupancy, without which the issuer might otherwise need to capitalize interest and secure construction insurance coverage. After construction has been completed on the facility to be financed, the new facility can be substituted in as the new leased asset for the lease financing. (See the *Substitution* section later in this report.)

Direct Construction of a Leased Asset

Although the asset transfer format is most commonly used in California's contemporary municipal market, some agencies may choose to finance newly constructed assets directly through the use of lease financing. This will often be the case when no other unencumbered assets with sufficient value and/or useful life are available to support an asset transfer. An agency might also choose a leased asset that has yet to be constructed if the agency does not want to start payments until they have use of the new asset, and/or in cases where market conditions permit that type of structure without much of a financial downside.

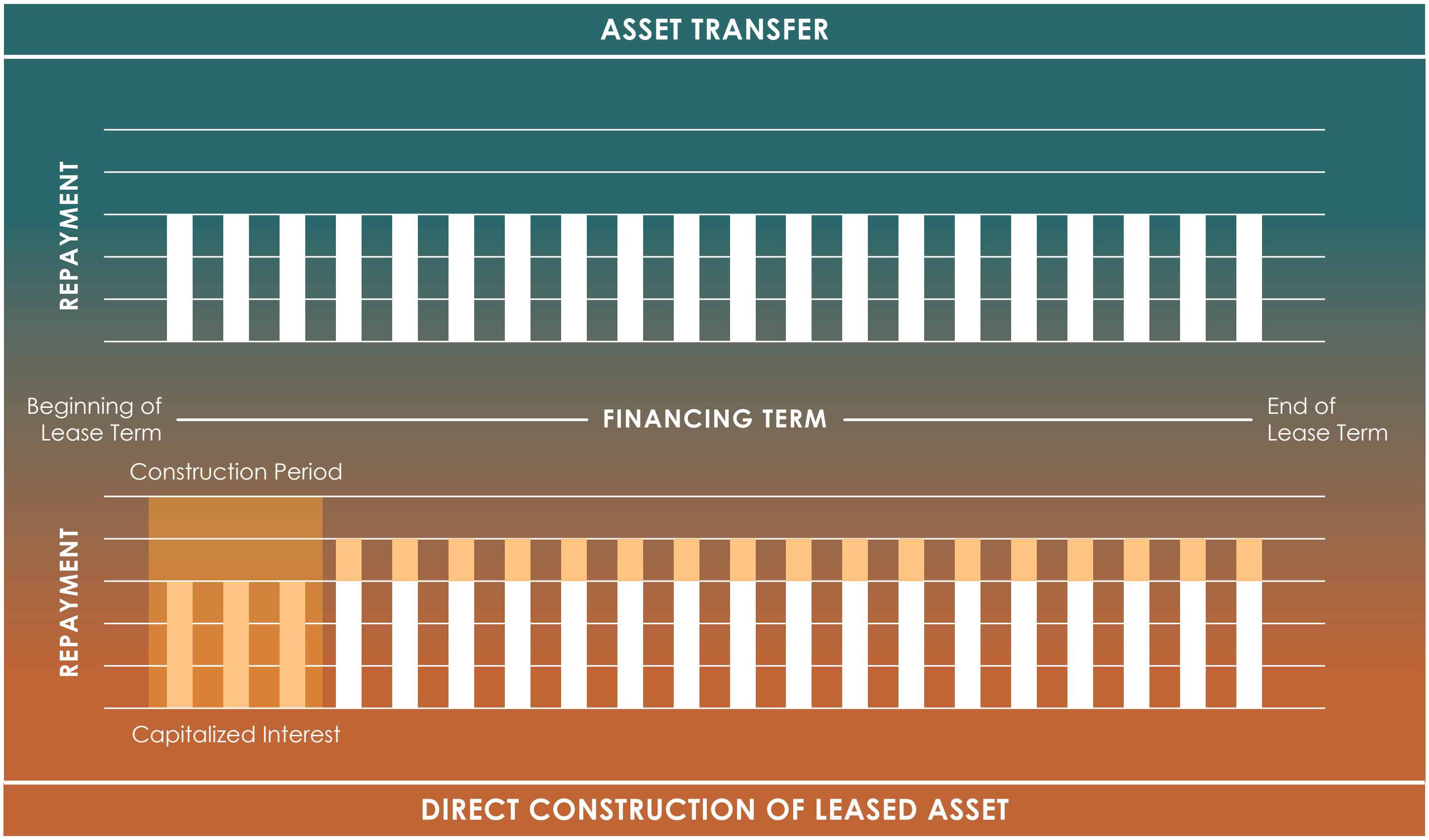
Lease financing secured by new construction of an asset entails some unique challenges, including the need to capitalize interest, secure construction insurance, and other prophylactic measures to mitigate the potential for cost overruns as well as construction risk in general. This is a particular challenge when the leased asset has yet to be constructed, because if the public agency runs out of funds prior to completing construction, the public agency does not obtain use and occupancy of the leased asset, and the financing is technically subject to an abatement of rental payments. These additional challenges and risks for to-be-constructed assets usually translate into higher costs than an asset transfer, due to higher costs associated with the use of capitalized interest as well as due to a potential yield "penalty" for lease transactions with substantial cost-overrun and/or construction risk.

During construction or acquisition of an asset that will be subject to a lease, the governmental lessee cannot be compelled to pay rent. This is because the agency does not yet have use and occupancy of the facility, which is necessary to pay the rent that secures the debt service on the LRBs or COPs. Rental payments may not exceed the fair rental value for a leased asset, because that condition would make the lease an impermissible debt. As a result, the interest payments due to investors are "capitalized" out of additional loan proceeds by increasing the size of the borrowing (Figure 3). This is done so that the public agency has resources dedicated to pay interest during the period that it is not obligated to pay rent under the lease. The interest for these types of lease financings will typically be capitalized for at least six months beyond the construction period (depending on the relative construction risk) to provide a buffer of some additional time in case there are any unforeseen construction delays.

As this need to capitalize interest may increase borrowing costs for a lease financing, many public agencies choose to use an asset transfer to lease existing facilities already owned by the agency and begin lease payments immediately to avoid the potential additional cost of capitalizing interest. That said, some agencies may choose to capitalize interest even when using an asset transfer for budgeting purposes to push net rental payments out of existing budget years or to align with a specific revenue stream.

Overall, when considering whether to use a to-be-constructed asset as the leased asset, a public agency should ensure that it is not obligated to pay rent until it can occupy the premises as well as consider whether carrying the required capi-

Figure 3



talized interest for the construction period will increase the overall financing cost to an unacceptable level. If the risk of construction not being completed for the project is too high – which would result in a qualifying abatement event – it could be difficult for investors to absorb the heightened risk, which could in turn make the financing too expensive to be feasible and/or practical for the public agency.

Another consideration that public agencies can consider when deciding whether it makes sense to capitalize interest is the relative shape of the yield curve. For example, in the case of a normal yield curve in which short-term interest rates are lower than long-term interest rates, any proceeds from the financing that the agency invests before spending for the project are subject to negative arbitrage (i.e. the investment returns are insufficient to recover the borrowing cost). As the difference between short- and long-term interest rates increases, so does the magnitude of negative arbitrage, which in turn makes capitalizing interest more expensive for the public agency relative to the original financing. Conversely, in the case of an inverted yield curve, capitalizing interest can be less expensive to the public agency (at least in a relative sense), as the agency is able to earn a higher interest rate on invested proceeds than in cases where long-term rates are higher than short-term rates.

It is recommended that public agencies that use a to-be constructed asset as the leased asset manage construction risks appropriately, using tools such as a guaranteed maximum price contract, construction bonds, insurance during construction as well as other risk mitigation strategies. It is also important for the public agency to describe the construction arrangements and disclose related risks to investors, including that its obligation to pay rent depends on the completion of the construction.

Master Leases

A master lease financing allows multiple leased assets to be included under the same lease agreement, and typically provides for the ability to issue multiple times under the same lease. All of the leased assets in a typical master lease are owned by one public agency – typically leased from the public agency to the lessor and leased back as an asset transfer – and the intended projects are for the purposes of that same agency. Leased assets included in a master lease can be added and substituted over multiple issuances based on the public agency's financing needs as long as the assets meet certain conditions. As with other lease transactions, the master lease can be securitized and sold to investors as LRBs or as COPs, and the master lease can extend to multiple financings over a span of time with amendments to the lease agreement. Use of a master lease structure is a major decision point that a public agency can make depending on its underlying goals for the lease financing, the agency's stock of potential leased assets, and its expectations for future financing needs.

A master lease is created using a similar process as a typical lease financing, but with some differences in the structure and content in the offering document. Master leases have additional requirements, including ensuring that fair rental value, insurance, and other requirements of the financing lease are met every time an agency uses a master lease to issue additional LRBs or COPs.

Another essential feature of a master lease is a substitution provision, which allows the public agency to add and remove different assets to and from the pool of leased assets for the lease financing. Since leased assets in a master lease can be substituted over time, master leases (as well as other leases that have substitution provisions) can allow for additional flexibility to public agency lessees that want or need to change the composition of leased assets in the public agency's portfolio. In some cases, however, certain investors might be less comfortable investing in lease-backed securities that allow for substitution of assets, because of the integral role that asset-specific factors such as essentiality, useful life, and casualty risk all play in investors' assessments of lease transactions. Since these asset-specific factors can change as assets in the master lease are added or substituted over time, a substitution provision could potentially affect the marketability and/or pricing of a lease financing transaction in some cases. Sometimes this is addressed with rating requirements or other review (for example by a bond insurer). That said, substitution provisions are also commonly included – though less frequently exercised – in standard (non-master) lease financings, and there is a broad acceptance for lease transactions with substitution provisions in the market. Furthermore, the inclusion of multiple leased assets can also reduce abatement risk that might be triggered in the case of damage to a single leased asset. From this lens, investors may feel that a master lease approach with multiple leased assets can provide more security for their investment, though that typically depends on the types and characteristics of the assets included in the master lease.

Another consideration for public agencies interested in setting up a master lease is the need for documentation and tracking of the leased assets. Although it is generally considered a best practice to monitor and track the condition and state of leased assets in all types of lease financings, the inclusion – and possible substitution – of multiple assets that affect the "pool" of leased assets in a master lease further complicates this issue. Public agencies often need to monitor and track multiple criteria for each leased asset included in a master lease, including (but not limited to) the asset's use, condition, value, and insurance coverage. Depending on how many assets are encumbered through the master lease, this process may require a larger investment in internal staff resources.

There are multiple considerations that public agencies should consider when planning to issue a master lease. One potential disadvantage for creating a master lease is that some agencies find that setting up the initial master lease structure can add some additional complexity to the financing process. That said, public agencies often find that once the master lease is established, it can streamline the issuance process for future lease financings. Most of the agencies that decide to utilize a master lease structure are larger issuers that use lease financings on a relatively frequent basis, because more frequent issuance is more likely to justify the initial and ongoing investment in establishing a master lease. However, this strategy can also be useful for smaller agencies that might need to pool multiple leased assets together and/or substitute leased assets over time. In addition, a master lease can also allow for more flexibility in the amortization schedule of the financing, as rental payment amounts can be adjusted by adding or subtracting assets in the master lease.

Lease Pools

Lease pools also contain multiple leased assets in one lease agreement, but those assets – as well as the supporting revenues – are derived from different public agencies. Lease pools can be securitized by issuing LRBs or COPs, and the funds from the sale are distributed to the different municipalities that participate in the lease pool for use in their respective capital projects.

Similar to the other methods of lease financing discussed above, the use of lease pools has benefits and drawbacks. Lease pools can be a strategy to lower issuance costs and streamline the issuance process, especially for smaller agencies that may have limited staff capacity and/or smaller budgets. If the issuance is small and/or the public agency is not well known to investors, issuing through a lease pool may also improve investor attention and marketability of a lease financing compared to issuing without a lease pool.

One major drawback to issuing with a lease pool is that the rating of the lease pool security is typically based on the credit quality of the "weakest" participant in the lease pool. As a result, lease pools will aggregate participants into separate series of the same rating or homogenize the credit quality with bond insurance.

SIGNIFICANT DECISION POINTS FOR THE LEASED ASSET

The value, condition, and other characteristics of the leased asset are important considerations of a lease financing that lead to multiple decision points for the public agency lessee. To ensure a lease financing is as successful as possible, public agencies need to make sure that their decisions balance the needs and desires of investors with the agency's overall goals for the transaction, all while avoiding potential pitfalls when crafting the lease financing. This section of the report contains a discussion of some of the most fundamental decision points a public agency lessee may make when selecting a leased asset; however, this list is not meant to be exhaustive.

Identifying the Leased Asset

Selecting the leased asset is one of the most fundamental decision points for a public agency in a lease financing transaction. This is because asset-specific characteristics such as asset value, lifespan, working condition, and essentiality are all fundamental criteria that rating agencies and investors consider for the viability and pricing of the lease financing. In addition, the asset must be one that the agency owns and must not be already encumbered.

ESSENTIALITY. Due to risks stemming from the possibility of abatement, investors and rating agencies have a preference that leased assets be as essential as possible to limit perceived risks of non-payment. While essential assets are as subject to abatement risk as any other asset, investors and rating agencies have historically believed that public agencies will maintain and voluntarily rebuild essential assets in ways that may not be the case with non-essential assets. Thus, from an investor and rating agency perspective, the risk that an abatement event results in a failure to pay debt service on the related lease financing is greater for assets deemed to be less essential.

The determination for whether an asset is "essential" can be subjective, and investors often take a different view of essentiality than the public agency lessee/borrower. In practice, the determination for essentiality of a leased asset is considered to be on a continuum as opposed to a binary quality of "essential" or "not essential." Depending on the perceived "essentiality" of the leased asset on that continuum, the marketability and pricing of the lease financing may be more or less favorable to the public agency in the lease financing transaction. Because of the preference for what investors, rating agencies, and other market participants consider to be essential assets, many assets that are legally permissible to use in a lease financing might not actually be used as a leased asset given the potential implications on pricing for the transaction. For example, it may be difficult to establish essentiality for land or another undeveloped property. Museums and theaters have also been cited as being less essential for government operations than other government facilities. Parks are also considered to be less essential than many other asset types, but they also suffer from less abatement risk than facilities, which investors may value.

Essentiality is also considered over the length of the lease term – if not the expected lifespan of the asset. An asset that is considered essential in the current operations of a public agency but has a risk of deteriorating or becoming obsolete before the end of the lease term may not be perceived as essential through the perspectives of rating agencies or investors that are considering an extended time horizon when evaluating the asset. This can be especially applicable when the leased asset is based on a technology that runs the risk of going out-of-date and needing replacement in the near future.

ASSET CONDITION. The condition of the leased asset is also an important consideration in a lease financing transaction and may have implications on the issuance's marketability and/or pricing. This can especially be true in cases where the condition of the asset is poor and/or worsening, as this could trigger concerns with essentiality or possibly even potential abatement, which could also result in nonpayment of rent for the leased asset. For example, damage from earthquakes can lead to abatement and seismic risk is not typically insured (see the *Insurance* section), so older facilities not built to current seismic safety standards present a greater abatement risk.

Asset condition can especially be an issue in cases where a municipality has limited options for unencumbered assets available for a lease financing. In these cases, the condition of a proposed leased asset may reflect outdated building standards and/or deferred maintenance over several years. In either of these cases, it is possible that the asset may be considered unsuitable for a new, long-term lease transaction spanning multiple decades.

ASSET LIFESPAN. Although asset lifespan is not usually a concern for land or property, the useful life of an asset can also affect its suitability for a lease financing, especially in cases where a non-traditional asset is used as the leased asset. For example, equipment with a remaining life of 10 years will not support a 30-year lease transaction. Useful life considerations can affect the amortization of the borrowing obligation or may result in the borrower being required to choose a different leased asset with a longer remaining useful life.

ASSET VALUE. The value of a leased asset is one of the most important characteristics to consider when selecting an asset for use in a lease financing, because the maximum amount of debt service – and thus the amount that a public agency can finance – is limited by the value of the leased asset. Therefore, although there is a common, informal guideline that the leased asset should be valued at an amount roughly equivalent to the par amount of the bonds, the most important de-

USE OF EQUIPMENT AS THE LEASED ASSET IN A LEASE FINANCING

Equipment can also sometimes be used as the leased asset in a lease financing, though the use of equipment involves additional considerations in setting up the lease transaction, including implications for abatement and the amortization schedule. For example, as mentioned above, the lease term should never exceed the remaining useful life of the asset, and equipment tends to have a much shorter useful life than facilities or land. Agencies interested in the use of equipment as the leased asset in a lease financing may find the lease term needs to be shorter and/or with a limited amount that can be financed. In addition, abatement risk is thought to be potentially much higher for equipment than for a facility, for example, because equipment can be damaged, stolen, or lost. A theft or loss of equipment would deny the public agency from maintaining use and occupancy of the leased asset, which would be an abatement event that could ultimately threaten debt service payments.

termination of the asset's value is its annual fair rental value. The fair rental value requirement for lease financings derives from the California case law that creates the lease exception to the debt limit, and this requirement prohibits the public agency lessee from entering into a long-term lease contract in which the lease payments exceed the fair rental value to the public agency.[13] Calculating and evidencing fair rental value is discussed in more detail below.

Determination of Fair Rental Value

For a lease financing transaction to be valid, the rental payments for the leased asset must not exceed the "fair rental value" of the asset.[14] There are multiple potential ways to determine an appropriate fair rental value for the leased asset, though some are more practical or more appropriate depending on the leased asset as well as the context of the public agency. These include using an appraised value (often using the depreciated cost of replacement) and the insured value of the asset.

APPRAISED VALUE. In commercial markets, the valuation of real estate is usually accomplished by obtaining an appraisal based on three measures of market value: the sales prices of comparable properties, the rental value derived by applying a capitalization rate to an assessment of the potential rental income the property could generate, and the cost of constructing a replacement facility. The use of traditional commercial methodologies for appraisals is often more problematic for valuing most municipal property, however, due to its unique nature. With the exception of an office building or other property type with commercial equivalents, there typically are not many comparable assets to most municipal properties that can be used to compare sales prices or rental rates. Calculating the depreciated replacement cost of a facility is therefore often the only method used when appraising municipal property.

Under the replacement cost method for appraisals, the cost of replacing the current facility with a new one is calculated. This approach is most appropriate and straightforward in cases where the asset is newly constructed or in the process of being constructed, because the construction cost is

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[13] For more information and context about the legal requirements for lease financings related to fair rental value, refer to CDIAC's *Legal Foundations of Lease Financing in California* report: www.treasurer.ca.gov/cdiac/reports/legal.pdf.

[14] Kelly Joy, *Legal Foundations of Lease Financing in California*, 9.

the replacement cost. In cases where the asset has already been constructed and has already been in use, a "depreciated replacement cost" method can be employed. The cost of constructing a replacement facility is estimated, and that value is discounted by factoring in depreciation based on the age and remaining useful life of the facility. The price of the land on which the facility resides is added into the calculation, which is based on comparable prices from the commercial market.

INSURED VALUE. Depending on the property, obtaining an appraisal on a municipal asset can be expensive and can also take a significant amount of time. Rather than securing a formal appraisal, many agencies have instead used the insured value of the municipal facility, which is routinely estimated as part of normal risk management practices and typically also based on an estimated cost of replacing the facility. Arguably, this value could be overstated, as it typically does not account for depreciation due to the age of the building. On the other hand, the insured value of the asset also does not account for the value of the land that a leased asset (such as a facility) inhabits, which would underestimate the fair rental value for the asset. Many argue that the insured value best represents the real value to the municipality, and thus is appropriate in the context of a municipal lease.

TRANSLATING "VALUE" TO "FAIR RENTAL." As noted by the above discussion, the municipal market tends to consider the overall value of a property, and then imputes the rental amount based on the overall value of the asset. The working theory is that if the value of a property is amortized at a municipal borrowing rate over a reasonable term, debt service is expected to be less than a commercial rental. This is because commercial property owners are not tax-exempt entities and therefore have higher costs of capital than municipalities in addition to an expectation of earned profit. As a further shorthand, the municipal market assumes that, if the par amount of the financing is less than the value of the property and the useful life of the facility goes beyond the term of the debt, the fair rental value test would be met. Courts are generally deferential to a municipal lessee's opinion about what is a reasonable and "fair" rental value, and bond counsel generally accept the valuation from the borrower.

Iterative Process

The process of structuring a lease financing can often be iterative based on the characteristics of the project and the individual situation of the public agency. Sometimes the selection of the leased asset makes one type of lease financing structure more or less advantageous, and there are times where the process needs to be flexible and iterative enough so that it can achieve the financing goals of the agency. For example, a public agency may originally decide to directly finance the construction of a new asset in a lease financing but may decide to pursue an asset transfer through a lease-leaseback after determining the full cost of the initial transaction, including increasing the size of the borrowing for capitalized interest. A public agency may also originally select a leased asset, but then decide that a different facility may better serve as the leased asset after considering concerns with essentiality, property condition, asset value, remaining lifespan, etc.

Title Work

After selecting the leased asset, the public agency can order the title report for the leased asset and review the report for any potential concerns or "title defects," such as liens, easements, or encroachments that could affect the fair rental value of the property. The process of preparing a title report and finalizing all of the necessary paperwork can take several weeks or longer, so this part of the lease financing process is often prioritized shortly after the public agency decides which asset will be used as the leased asset in the transaction. If there are issues that surface while attempting to complete the title work for a leased asset, those issues either need to be fixed or, in some cases, the public agency may need to select a different leased asset for the transaction.

TITLE INSURANCE. In addition to ordering the title report, title insurance will usually need to be secured for the transaction. Title insurance provides coverage against any losses due to errors or defects in the title and it gives additional security to investors in the (rare) case of errors in the title report that could affect the public agency's use and occupancy of the leased asset and the subsequent payments of debt service to investors. Title insurance may not be necessary if the public agency has owned the leased property for many years.

Bond counsel is frequently charged with the task of interacting with the title insurance company, which makes title insurance distinct from other types of insurance – such as casualty and rental interruption – that the public agency is responsible for procuring. More information about these other types of insurance coverage is discussed in the section below.

Insurance Procurement

Public agencies that use lease financings are required to procure multiple types of – often additional – insurance coverage to mitigate risks stemming from the potential interruption of use and occupancy of the leased asset. Required insurance coverage typically includes title insurance (discussed above), casualty insurance, and rental interruption insurance.

CASUALTY INSURANCE. Casualty insurance reimburses an issuer for physical damage to a leased facility from certain natural disasters (e.g. hurricanes, tornadoes, etc.), fires, and some other potential threats to the physical condition of the building that could affect the agency's use and occupancy. There are some notable risks that might require a specific carve out (e.g. flooding) and some risks may be excluded because they are prohibitively expensive to insure, including risks from earthquakes. Because insurance to mitigate seismic risk is prohibitively expensive in California for most agencies, it is common for agencies to issue lease-backed securities without obtaining insurance with coverage for seismic events. However, earthquakes remain a significant potential risk for abatement if/when they do occur. Furthermore, even without insurance coverage for damage from earthquakes, the rating agency S&P requires that agencies in California complete a seismic analysis prior to issuing its rating. This process can take several weeks, if not longer.

RENTAL INTERRUPTION INSURANCE. In addition to insurance coverage for cases of physical damage, the public agency lessee will also be required to obtain rental interruption insurance that pays rental payments during any time there is a loss of use and occupancy. This is because, in California, a public agency lessee cannot be compelled to pay rental payments for a leased asset when it does not have use and occupancy of that asset. For example, even in a case where insurance covers the replacement cost of a facility that has been destroyed in a natural disaster, rental payments are abated until the agency is able to use and occupy the rebuilt facility. In this case, rental interruption insurance would pay the rental payments while the public agency lessee does not have use and occupancy, and those payments are used to pay debt service on the bonds or COPs that were originally issued or executed.

Rental interruption insurance is typically procured as a "rider" that can be added to an existing casualty insurance policy. It should be noted that the rental interruption rider will only cover insured risks. Therefore, if a property policy does not cover earthquake risk, neither will its rental interruption policy.

SELF-INSURANCE. The practice of "self-insurance," where an agency regularly saves funds reserved for potentially catastrophic situations where insurance coverage would usually be triggered is generally not a practical option in the case of lease financings for several reasons. Self-insurance undercuts the abatement requirement set in case law outlining the permissible criteria for lease financings,[15] which stipulates that the public agency cannot be compelled to make rental payments for a leased asset for which it no longer has use and occupancy.

In addition, as mentioned above, lease-backed securities require rental interruption insurance, which is almost exclusively available as a rider to an existing property insurance policy and not available on a standalone basis, which is another factor that makes it difficult for an agency to self-insure for a lease financing.

ECONOMIC STRUCTURE OF THE LEASE FINANCING

In addition to the amount financed, public agencies have multiple decision points related to the economic structure of the lease financing, including the use of capitalized interest, the use of reserve funds, and the amortization schedule of the lease financing. Each of these decisions may significantly affect the cost and budgeting considerations of the lease financing transaction.

Elective Use of Capitalized Interest

As mentioned earlier, public agencies that use a leased asset that has yet to be constructed must capitalize interest during and beyond the construction period. Some public agencies may, however, choose to capitalize interest to delay when debt service payments will need to be included in the budget. Although capitalizing interest increases the size of the bond issue and results in higher lease payments once they begin, it also can have less of an impact on the agency's current budget, which can make sense for agencies that are seeking short-term budgetary relief.

Amortization Schedule

Another important decision point that a public agency can make in the context of a lease financing is how the rental payments – which act as the source of repayment for the debt service of the issued lease-backed securities – should be structured. In California, repayment options for lease financings are more limited than for other types of debt due to the fair rental value requirements imposed by state case law. For example, the rental payments for the lease financing cannot exceed the fair rental value for the leased asset at any point over the course of the lease term.[16] It is not sufficient for the average rental payment over the course of the lease to be less than the fair rental value, as the condition must hold independently in every year. This also applies to lease financings with a variable interest rate, as the interest rate should never be permitted to increase to a point where the rental payments exceed the fair rental value for the leased asset. If the rental payment for a lease financing does exceed the fair rental value in any year in the lease term, the lease could be considered invalid. That said, public agencies may have some potential options for how to structure the amortization schedule (Figure 4).

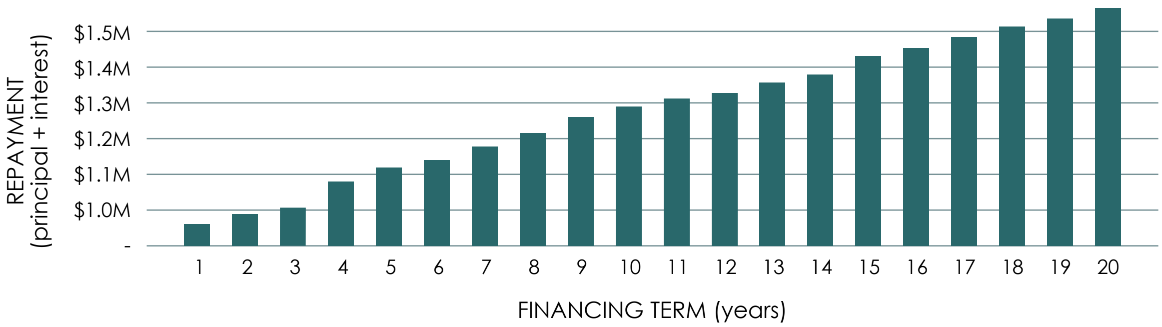
The most common amortization schedule for lease financings is level debt service, where the public agency pays the same amount in rental payments every year. Depending on the goals and other context for the public agency, it might also be possible for the agency to select a different amortization schedule where rental payments are not a consistent annual amount. For example, a public agency may choose to schedule the amortization so that it pays smaller amounts in rental payments during the first years of the repayment period and subsequently pays larger payments in future years. This type of structure may make sense for public agencies that already have previ-

[15] California Debt and Investment Advisory Commission, *California Debt Financing Guide*, 3-47, (Sacramento: 2019), Accessed January 23, 2023, www.treasurer.ca.gov/cdiac/debtpubs/financing-guide.pdf.

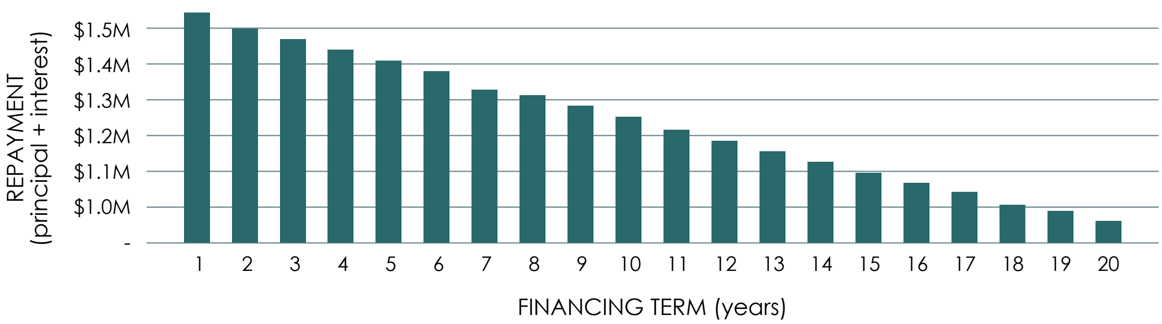
[16] Kelly Joy, *Legal Foundations of Lease Financing in California*, 9.

Figure 4

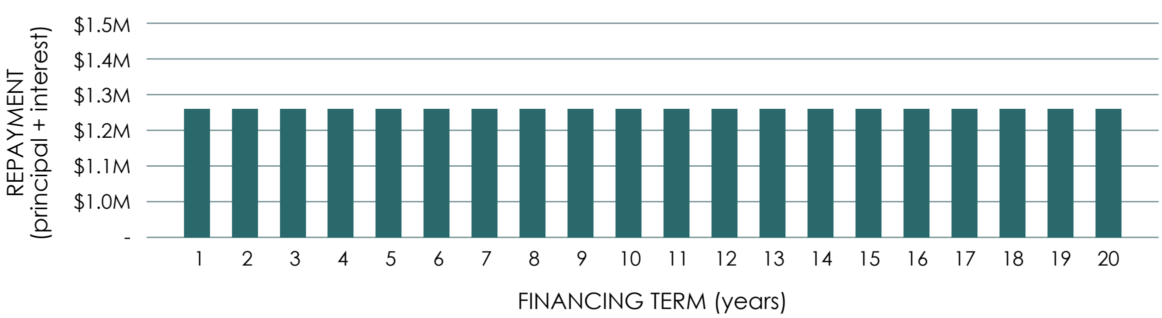
EXAMPLE OF INCREASING DEBT SERVICE



EXAMPLE OF DECREASING DEBT SERVICE



EXAMPLE OF LEVEL DEBT SERVICE



ous lease or other debt obligations that the agency wants or needs to finish paying off before having enough room in the budget for the rental payments for a new lease financing.

Although there are many potential options for amortization schedules, public agencies are more limited in the types of amortization schedules that they are able to use in a lease financing due to the fair rental value requirements described earlier. In all cases where the rental payments for a lease financing are not equal throughout the lease term, the public agency will need to pay special attention to confirm that the rental payments for the leased asset will never exceed the fair rental value for the leased asset during any fiscal year throughout the term of the financing lease.

The decision for how to structure the amortization for a lease financing should be one that ultimately serves the public agency and is consistent with the goals for the transaction along with the necessary criteria to fully comply with the lease exception to the debt limit. The decision for how to structure the amortization schedule is one that public agencies can choose to make with the help of a registered municipal advisor and/or other members of an experienced financing team.

Reserve Funds

Reserve fund accounts provide additional protection to investors in the case of potential nonpayment and/or abatement due to a loss of use and occupancy of the leased asset. While funding a debt service reserve fund was an explicit requirement for all lease financings in the past, it has recently become common for lease financings to not have reserve accounts that could serve as a failsafe if the agency were no longer able to make payments. It is thought that this is due in part to a growing acceptance of lease financings in the municipal market, the standard use of casualty and rental interruption insurance as well as due to the extra costs the reserve accounts place on public agencies. The cost of holding reserve accounts can be prohibitively expensive in some cases, as the extra amount for the reserve account needs to be capitalized out of the proceeds of the financing. This was especially expensive during times characterized by steep yield curves and significant negative arbitrage with low yields on appropriate investments from the reserve fund proceeds. Notably, reserve accounts are relatively less expensive for public agencies during periods characterized by a negative yield curve, in which long-term interest rates are lower than short-term interest rates.

Currently, reserve accounts are more common for lease financings for public agencies that are less well known to investors and/or with lower credit ratings. However, some have speculated that a market expectation for reserve accounts could be reestablished if defaults on lease financings become less infrequent. The requirement for reserve

SPECIAL LEASE FINANCING REQUIREMENTS FOR CALIFORNIA K-14 DISTRICTS

In addition to all of the restrictions that govern lease financing transactions for public agencies, school and community college (K-14) districts in California are also subject to additional rules.[17] For example, school districts need to secure approval from the county superintendent before pursuing a lease financing. Multiple stipulations for lease financing specific to K-14 districts are given in various sections of the Education Code, including sections 17150 and 17400-17455 for K-12 districts and sections 81330 through 81360 for community college districts.

[17] Lisel Wells, Nixon Peabody LLC.

accounts may also vary somewhat depending on market conditions. For example, this could apply in cases where there is an imbalance between supply and demand of bonds in the municipal market that may lead investors to adjust their investment preferences.

LEASE FINANCING TERMS AND STRUCTURES TO CONSIDER

While many of the documents and provisions in a lease financing are standard, there are several decision points for a public agency to consider to ensure that the lease financing fully aligns with the agency's goals for the transaction.

Enforcement Provisions

Enforcement provisions for lease financings are often different from commercial leases as well as from some other security types. For example, lease financings in California cannot have a clause that accelerates rent in the case of nonpayment. This is because legal precedent has established that any acceleration of rental payments would mean that the public agency would, in effect, be responsible for paying rental payments for future years for which the agency is not currently receiving the benefit of use and occupancy of the leased asset. The inclusion of a provision allowing for the acceleration of rental payments would therefore render the lease transaction invalid.

Including a clause forbidding acceleration of rental payments is mandatory for lease financings. That said, there are some notable decision points that a public agency can make in a lease financing, such as whether to include a provision with a right to re-let the property.

RIGHT TO RE-LET. A right to re-let provision in a lease agreement gives the trustee (on behalf of the lessor) the authority to transfer the right of use and occupancy of the leased asset to another entity in cases where the public agency defaults on rental payments. This is a common provision that is often included in lease financings. However, a right to re-let provision is in the best interest of investors – not the public agency lessee – because it could put essential public assets at potential risk in the (albeit rare) case of default on rental payments. A further complication is a current lack of legal consensus about whether a court would enforce a right to re-let for essential public assets, especially ones that might impede a public agency's ability to provide for essential services related to public safety.

Another important consideration is that credit rating agencies rate LRBs and COPs only slightly lower than they rate voter-approved general obligation bonds secured by unlimited tax obligations, and the rating agencies no longer tend to consider a right to re-let in rating decisions. Given this, it is reasonable that a public agency would prefer not to include a right to re-let provision when issuing a lease financing if given the choice. Right to re-let provisions are still commonly included in offering documents for a lease financing because they are still preferred by investors in many cases. However, if such a provision is not needed and there is no pricing benefit, the public agency may rationally decide not to include a right to re-let provision when issuing a lease financing.

It is worth noting that the only practical recourse for nonpayment in a lease transaction – especially in the case of a lease financing without a right to re-let provision – is suing the public agency for unpaid rent. Most observers believe, given the impracticality of reletting, that the right to sue for unpaid rent is the key default enforcement mechanism. Due to the legal limitation prohibiting acceleration of rental payments, legal suits would need to be brought every year for the unpaid rent due in that year.

Substitution Provisions

As mentioned earlier, most lease financings (and all master leases) contain a provision that allows the public agency lessee to substitute the leased asset at a later time. This gives additional flexibility to the public agency lessee; however, there could be cases in which the lease is less marketable to investors. Investors consider many factors when deciding to invest in a lease financing transaction, including asset characteristics such as the value, condition, useful life, and essentiality of the asset. Substituting the assets after issuance or execution of the transaction gives the issuer more flexibility at the possible expense of the investor in cases where riskier and/or less valuable assets are substituted in the transaction.

Multiple Bond Indenture

A multiple bond indenture can sometimes be used to allow for the possibility of future issuance using the same leased asset. This is particularly common and useful when the leased asset has a much higher value than the amount that the public agency lessee intends to finance through the lease financing and is a standard feature of a master lease.

POST-ISSUANCE

After issuance of lease-backed securities, the leased asset used in the lease financing is considered encumbered for the term of the lease. Encumbrance of a leased asset limits the public agency's ability to sell the asset or modify its condition in a way that would revoke the public agency's use and occupancy of the asset. After issuance, the public agency will need to continue to track which assets are encumbered to ensure that the public agency remains in compliance with its ongoing responsibilities for the financing over the term of the lease. Failure to do so could result in a default.

In addition, the agency may also need to track the valuation for its leased asset(s), especially if the value has changed significantly since the time of the lease financing transaction. The fair rental value for a leased asset is set at the time the public agency enters into the lease, and the rental payments do not need to be reduced if the value of the facility declines.[18] That said, if the value of the leased asset has increased significantly, it is possible that the lease financing is "overcollateralized" – where the value of the leased asset is much higher than the amount financed. In some cases, it may be possible to finance additional capital needs and/or unencumber extra assets included in the lease. This is especially relevant in cases where the lease financing was set up as a master lease or was issued with a multiple bond indenture.

Perhaps most importantly, it is essential that the public agency understands how the long-term obligations from the lease financing will affect the agency's current and future general fund capacity. Changing economic conditions and local context may cause tax and other revenues to fluctuate, which may affect the ability of the public agency to fund essential public services that are also paid from the agency's general fund.

DEFAULT

Defaults on lease-secured obligations in California – as well as in general – are thought to be very rare. Over the course of several decades, the market for municipal lease financings has grown and developed in large part because these types of transactions have typically been safe investments for investors. However, there have been past episodes where one or more issuers have had problems with their leases – particularly in the rare cases in which the issuer has filed for bankruptcy protection – which have resulted in investors tightening requirements for all issuers.

Although the risk of abatement technically increases the likelihood of nonpayment in a lease transaction in California compared to other security types paid from an agency's general fund, it

[18] CDIAC, *California Debt Financing Guide*, 3-46.

DEFAULT OF LEASE-BACKED SECURITIES

Although default on lease-backed securities is generally thought to be rare, there have been a few notable cases where a municipality has defaulted on its lease commitment. For example, in 1991, the Richmond Unified School District (Richmond USD) defaulted on unrated COPs that the district had issued in 1988. Richmond USD had leased district facilities it owned and used the proceeds to pay for salary increases for teachers and additional educational programs.[19] After attempts to compel the district to continue rental payments for the lease financing, Richmond USD claimed that the COPs represented unconstitutional debt and that the transaction was therefore unenforceable. The California Supreme Court rejected this argument and ruled against the district, requiring Richmond USD to pay past-due rental payments for the COPs transaction to investors.[20]

In another example from 2012, the City of Stockton defaulted on rental payments for a set of three city-controlled parking garages that were leased as part of a lease revenue bonds transaction from 2004. Stockton missed a payment of approximately $780 thousand after experiencing severe financial distress caused by multiple factors, including unsustainable retiree costs, decreases in tax revenue, and prolonged effects of the Great Recession.[21] After the missed payment, the trustee on the bonds sued the City of Stockton and asserted that the City was illegally occupying the garages given its failure to pay the agreed rental payments. Possession of the parking garages was later awarded to the trustee in a very rare example of default that led to the right to use and occupancy of a leased asset being awarded to investors.[22]

While courts upheld the California lease precedent in each of these cases, each case had a negative impact on the market as a result of issuers calling into question their lease obligations.

is worth noting that abatement is not considered to be a default, as abatement must be contractually provided for when a public agency loses use and occupancy of a leased asset.[23] That said, abatement may be a legally valid option, but it is not thought to be a practical option for public agencies that may want or need to enter into future lease financings. In the case of an abatement event, a public agency lessee cannot be compelled to make rental payments but may still choose to do so. An agency that exercises its right to abate rental payments when it does not have full use and occupancy of a leased asset is generally expected to have significant difficulty accessing the capital markets in the future. As a result, many issuers who have had the right to abate rental payments have still voluntarily met their lease rental obligations.

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[19] David Brodsly, Nikolai J. Sklaroff, Robert Tucker, Kathy McManus, et al., *Moody's on Leases: The Fundamentals of Credit Analysis for Lease Revenue Bonds and Certificates of Participation*, Moody's Investors Service, 11, Published 1995.

[20] Ibid.

[21] Doug Cubberley, "Wells Fargo Wins Possession of Parking Garages in Stockton," *InvestmentNews*, Published April 27, 2012, Accessed August 11, 2022, www.investmentnews.com/wells-fargo-wins-possession-of-parking-garages-in-stockton-43567.

[22] Ibid.

[23] Kelly Joy, *Legal Foundations of Lease Financing in California*, 10-11.

CASE STUDY: VOLUNTARY PAYMENTS IN THE CASE OF AN ABATEMENT EVENT

In March 2023, the California State Public Works Board filed an event notice informing investors that the Alex Ardens Branch Laboratory in Tulare had sustained damage from flooding that led the facility to become inoperable. The facility served as a leased asset for a lease financing transaction issued by the State Public Works Board, and the loss of use and occupancy of the laboratory meant that rental payments for the facility were subject to abatement. The California State Treasurer's Office announced shortly thereafter that the required debt service payments for the lease financing would still be made to investors despite the abatement event.[24] Multiple rating agencies have since weighed in and signaled that there was not a need for a rating downgrade at this point given that the debt service payments are still on track to be paid to investors.

CONCLUSION

Lease financing has continued to grow in popularity over the past several decades, and lease financing is now considered an essential tool for many California municipalities subject to the debt limit in the State Constitution. While many aspects of lease financing are similar or related to debt issuance, lease financing is subject to underlying legal requirements that make these obligations unique in several ways. These differences from other financing types include the distinction from a traditional definition of indebtedness, the reliance on a leased asset, the obligation as a lessee to pay rental payments (as opposed to directly paying debt service), and the obligation to pay required rental payments encumbers the agency's general fund without a dedicated revenue source.

This report has discussed some of the most fundamental decision points that public agencies should plan to consider to ensure their lease financing is as successful as possible. These decision points include the structure and type of lease transaction, considerations for selecting the leased asset, options for amortization, reserve accounts, and remedy and substitution provisions. Additional considerations related to post-issuance requirements and default conditions were also discussed to provide additional context necessary for understanding issuer responsibilities over the term of a lease financing.

Although the main focus of this report is the process and decision points for a lease financing transaction, one of the most fundamental decisions a public agency should consider is whether (and under what conditions) lease financing should be employed by the agency. Lease financings encumber public assets and require long-term financial obligations that are repaid from the agency's general fund, usually without a dedicated source of repayment. Along with the other decision points discussed in this report, a public agency should confirm that lease financing is the best method to preserve the overall goals of the public agency. The decision for whether to use lease financings is one that public agencies can choose to make with the help of a registered municipal advisor and/or other members of an experienced financing team.

CDIAC intends to continue exploration and analysis of municipal leasing by providing additional guidance on applications of lease financing in future publications and educational programming.

[24] "Notice of Event," *Electronic Municipal Market Access*, Published March 30, 2023, Accessed June 16, 2023, https://emma.msrb.org/P21687949-P21299066-P21729873.pdf.

ACKNOWLEDGMENTS

This report was led and primarily written by Kelly Joy, the Manager of CDIAC's Technical Assistance Section, with the support of multiple consulting partners, including David Brodsly, Managing Director at KNN Public Finance; Daniel Deaton, Partner at Nixon Peabody LLP; Nikolai J. Sklaroff, Capital Finance Director at the San Francisco Public Utilities Commission; and Stephen Spitz, Partner at Orrick Herrington & Sutcliffe, LLP. This report was reviewed by Tara Dunn, Research Manager at CDIAC; Angelica Hernandez, Deputy Executive Director at CDIAC; and Robert Berry, Executive Director at CDIAC.

CDIAC sincerely thanks the consulting partners for this project for contributing their time and professional expertise to support the development and publication of this report.

APPENDIX: IMPORTANT TYPES OF DOCUMENTS USED IN A LEASE FINANCING

The specific documentation of any financing will reflect the specific needs of the transaction, past practices of the issuer as well as decisions of the public agency and the bond counsel responsible for drafting the lease financing. The following describes the basic documentation. Whether titled with these names, these functions are likely to appear somewhere within the legal documents.

Site Lease

Because most contemporary lease financings involve property that is owned by the local agency (either because the transaction is an asset transfer of existing property, a project to be constructed on public property, or property to be acquired in the agency's name) most transactions have an agreement to transfer the lease from the local agency to the financing lessor. Sometimes titled as simply a "lease," this document conveys the property from the public agency to the leasing entity.

Lease Agreement

This document represents the key security document for the transaction, establishing the agency's payment obligations and other key obligations supporting the transaction. In many cases, the document will be called a "sublease." When coupled with the site lease, this document is effectively a "lease-leaseback" of the public property.

Perhaps the most important provision of the lease agreement is the covenant to pay rent for the use and occupancy of the leased asset. The rent serves as the revenue used to repay the funds raised during the lease financing. The rental payments represent the interest and principal of the loan. In the case of a tax-exempt lease, the interest component must be explicitly identified for tax purposes.

For most California leases, the lessee covenants to annually budget and appropriate its lease payments, which is a long-term obligation that endures for the term of the contract. But the lease also provides for the abatement of rent to the extent that there is a substantial loss of the use and/or occupancy of the property. As noted previously, the provision for the abatement of rent is a key feature distinguishing a legal "lease" from an "indebtedness" that would require voter approval.

In addition to basic rent, the lease will include provisions for the payment of "additional rent," intended to cover all other expenses associated with the property and its financing (analogous to a triple-net commercial lease). Typical "additional rent" payments include maintenance expenses, utilities, insurance, and any taxes or other governmental charges. The lease will set out the various insurance requirements. The lease will provide for the substitution of properties, any provisions for additional bonds, memorialize tax-law driven restrictions on private use, provisions regarding amendments of the document, and events and remedies of default.

Trust Agreement

The trust agreement is key to transforming rental payments into publicly offered securities. It stipulates the conditions of the payment and security of the lease obligation and is typically executed between the lessor entity and a bank trust department. It outlines how the rental payments will be paid directly to the trustee for the arrangement, which is then charged with transferring the income from the rental payments to pay the debt service for the principal and interest on the LRBs or COPs. The trust agreement is the document which "issues" the bonds or "executes and delivers" the COPs. The trust agreement also stipulates other important features of the securities, including payment dates, call provisions, proceeds investment provisions, and the other responsibilities of the trustee.[25] In some cases, the trust agreement will be called an "indenture."

Assignment and Agency Agreements

While in the past, an additional "assignment agreement" was used to assign the financing lessor's rights and responsibilities to the trustee, these provisions are now more commonly incorporated into the trust agreement itself. Because the lessor under a municipal lease financing is typically a special purpose entity employed to create this specific financing arrangement, the roles of the lessor – such as the collection of rent, the payment of debt service to lenders, and the enforcement of remedies – is assigned to the trustee.

Similarly, in the past, an "agency agreement" was often executed between the lessor and the public agency lessee, assigning the responsibility for undertaking the project to the public agency. Now, it is more common for those provisions to be incorporated into the lease and trust agreement, with the latter providing for the public agency's approval of disbursements of bond proceeds.

[25] Brodsly, Sklaroff, Tucker, McManus, et al., *Moody's on Leases: The Fundamentals of Credit Analysis for Lease Revenue Bonds and Certificates of Participation*, 6.

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