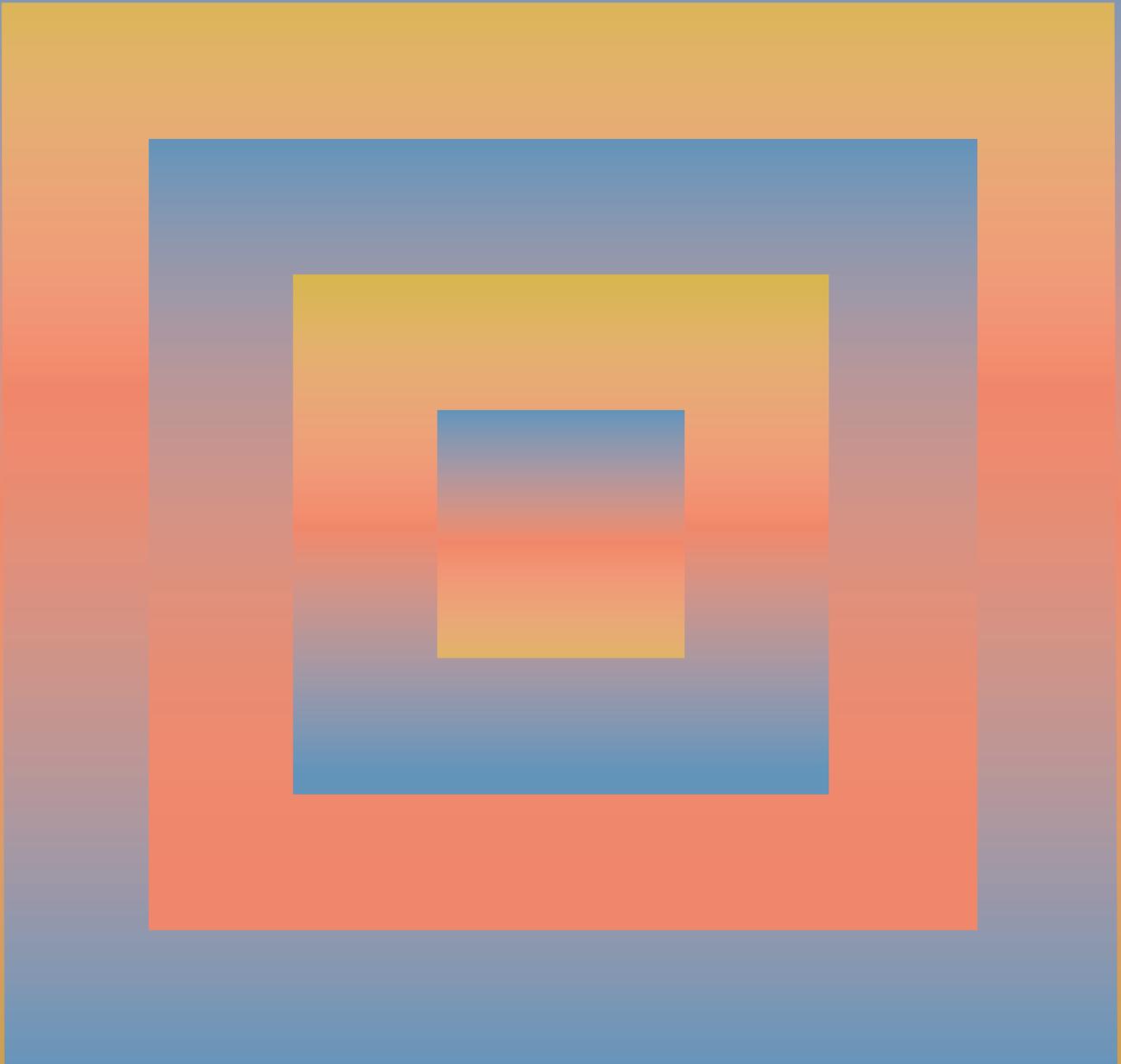


RECOMMENDED LEASE FINANCING PRACTICES FOR CALIFORNIA PUBLIC AGENCIES



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INTRODUCTION

Lease financing has become an essential financing method for many public agencies in California because it facilitates long-term financing for municipalities that are subject to the debt limit in the state Constitution without first requiring voter approval. Lease financing in California was established by legal precedent over a set of landmark court cases that are often referred to as the “Offner-Dean exception” or “lease exception.” The rulings in this foundational set of legal cases continue to form the basis for valid and enforceable lease financings in the state.

The California Debt and Investment Advisory Commission (CDIAC) has published multiple reports and resources related to lease financing since the 1990s. CDIAC’s recently published content series about lease financing explores the legal requirements, market considerations, and recommended practices for municipal lease financing in California.¹ 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. The second report, *Practical Considerations and Decision Points for Municipal Lease Financing in California*, was published in June 2023. The second report explained the types of lease structures while focusing on the key decision points that public agencies may face in a lease financing.

This report, *Recommended Lease Financing Practices for California Public Agencies*, is the third and final installment in CDIAC’s latest content series about municipal lease financing, which highlights recommended lease financing practices for California public agencies to consider when utilizing lease financing for capital improvement projects.² Although the three reports in CDIAC’s *Lease Financing in California* content series are meant to complement one another, the three publications are written to be standalone reports that do not require the reader to have read the others in the series. Similar to the previous two reports, the content of this report focuses on the aspects of the debt issuance process that are specific to municipal lease financings. That said, a sample “critical path” for a typical lease financing transaction is included in the appendix for those interested in understanding more about how the main steps of a lease financing transaction fit within the context of the general debt issuance process.³

The suggested recommendations in this report were generated by synthesizing the results of interviews with over one dozen industry professionals that have substantial experience with municipal lease financing in California.⁴ These recommendations are meant to be a useful resource for those new to public finance as well as for those already familiar with lease financing.

BACKGROUND

RELEVANT CASE LAW. Due to strict limitations on the incurrence of long-term debt, lease fi-

¹ CDIAC’s [Lease Financing in California content series](#) focuses on capital market lease financing transactions such as lease revenue bonds and certificates of participation as opposed to equipment leases.

² The general guidance shared in this report is not meant as a substitute for legal or financial advice. CDIAC encourages public agencies to consult with a municipal advisor and/or bond counsel experienced in California municipal lease financing for recommendations specific to the agency’s unique circumstances.

³ Additional information about the general debt issuance process and financing leases in California can be found in CDIAC’s [California Debt Financing Guide](#).

⁴ While the recommendations expressed in this report originated from discussions with the participating industry professionals, the content of this report should not be construed to reflect the views of any of the participants’ employers, nor should any of the statements be attributed to any specific participant unless explicitly denoted.

nancing has become an essential financing strategy for many California public agencies that are subject to the debt limit, such as cities, counties, and K-12 and community college districts. The debt limit in the California Constitution requires these types of public agencies to first secure voter approval before incurring what the law considers obligations payable from the revenues of a future fiscal year, and the “lease exception” is one of only a few judicially recognized exceptions to this requirement. To qualify for the lease exception, the public agency’s payment obligation must be contingent upon the agency having use and occupancy of the leased asset(s) upon which lease payments are being made and the annual rental payments paid by the public agency must not exceed the fair rental value of the leased asset.

The legal precedent for the lease exception to the California debt limit was set primarily by two landmark cases in California case law: *the City of Los Angeles v. Offner* and *Dean v. Kuchel* cases in 1942 and 1950, respectively. The rulings in these cases established the framework for public agencies to utilize leases to access financing for long-term capital projects without the transaction being subject to the constitutional debt limit (and thus requiring voter approval). Lease financing gained popularity after the first issuance by Los Angeles County in 1962, and accelerated after the passage of Proposition 13 in 1978, which limited property tax revenues for California cities and counties. Lease financing became further entrenched in the California municipal market after the California Supreme Court ruled and confirmed in the *Rider v. City of San Diego* case in 1998, that lease financings and asset transfers were legally valid and enforceable.⁵

FUNDAMENTAL CHARACTERISTICS OF LEASE FINANCING. One of the most fundamental characteristics of lease financing is that these fi-

ncings are not subject to voter approval, which can simplify and expedite the process for accessing capital for essential public projects. However, lease obligations are typically repaid directly out of the agency’s general fund without a new, voter-approved funding source, which has long-term implications for the agency’s financial condition.

Lease financings also rely on the encumbrance of an asset owned by the public agency. This can be an existing asset which is then referred to as an “asset transfer” transaction as shown in Figure 1, or the assets that are being financed by the lease financing are in the process of being constructed. In the latter case, the agency typically capitalizes interest for the financing until after construction of the asset has been completed and the agency obtains use and occupancy because based on the Offner-Dean requirements, the entity will not yet have beneficial use and occupancy of the leased asset. Many agencies choose to structure their lease financing as an asset transfer to avoid capitalizing interest and also mitigate construction risk of a new project, which investors view positively.

ABATEMENT. To satisfy the requirements of the case law allowing California public agencies to enter into long-term leases, municipal lease financings must be subject to abatement of rental payments in the case of loss of use and occupancy of the leased asset. In other words, if the leased asset suffers damage or otherwise leaves the public agency unable to maintain use and occupancy of the asset, the agency is not legally required to continue paying the rental payments that are then used to pay the debt service for the lease financing.

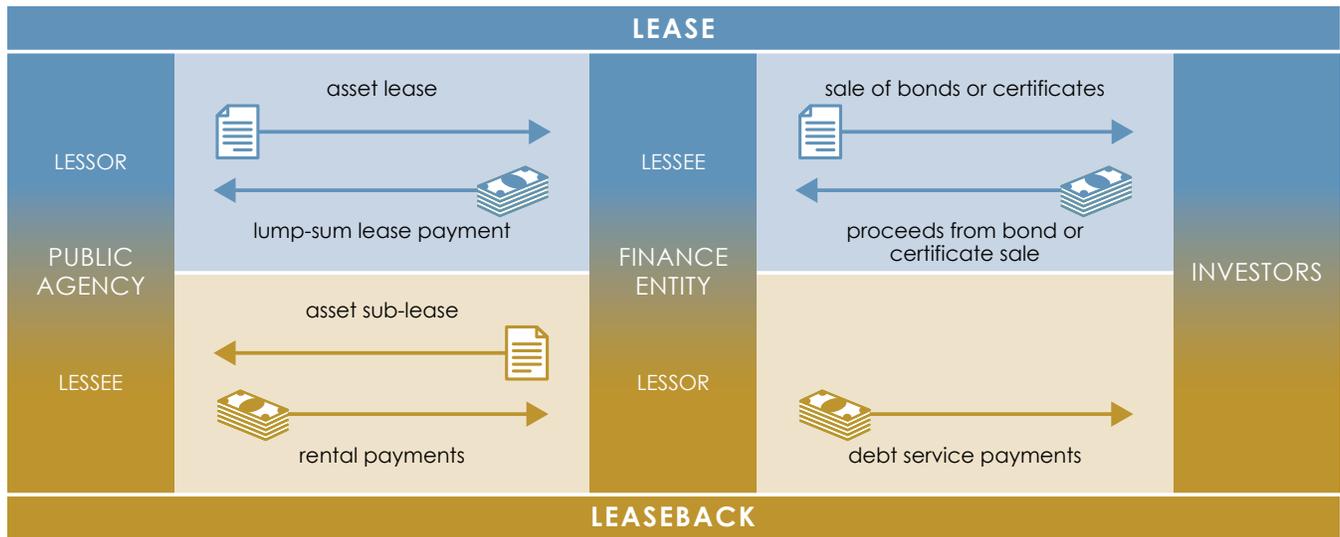
Abatement clauses required in California lease financings contrast with lease financings in most other states, where lease financings are not long-term legally binding obligations, but are instead

⁵ Kelly Joy, *Legal Foundations of Lease Financing in California*, (California Debt and Investment Advisory Commission, 2022), 7-8, www.treasurer.ca.gov/cdiac/reports/legal.pdf.

⁶ Kelly Joy, *Legal Foundations of Lease Financing in California*, 11.

Figure 1

MECHANICS OF A LEASE FINANCING WITH AN ASSET TRANSFER



subject to annual appropriation.⁶ California leases typically do not include an annual appropriation “out.” This abatement context for California lease financings leads to more emphasis on – and

potential scrutiny of – the leased asset encumbered in the transaction.

An agency that ceases rental payments due to a qualifying abatement event is not legally in default, because abatement due to loss of use and occupancy of a leased asset is a mandatory provision in lease financing in California and a contractual right under the lease.⁷ However, the implications of an abatement of rental payments could function similarly to a default from the investor perspective, and an agency that exercises abatement of lease payments – even for legally valid reasons – may have trouble accessing the capital markets for future financing needs.

ABATEMENT QUESTIONS DURING THE COVID-19 PANDEMIC

When the outbreak of the COVID-19 pandemic led to broad stay-at-home orders, many facilities acting as leased assets were unoccupied by workers and the general public. This led many agencies in California to ask whether the stay-at-home orders qualified as an abatement event. The general consensus from bond counsel and other practitioners was that the leased facilities were “available for use,” and that stay-at-home orders issued during the COVID-19 pandemic did not qualify as an abatement event.

ENCUMBRANCE LIMITATIONS. Leased assets are considered encumbered, and the public agency is thus prevented from selling or otherwise interrupting use and occupancy of the leased asset in ways that do not comply with the lease. Encumbrance of a leased asset can also limit major rehabilitation projects that affect use and occupancy as well as place restrictions on private use of the asset. The lease term can span multiple decades,

⁷ Kelly Joy, *Legal Foundations of Lease Financing in California*, 12.

so if a public agency foresees the need to sell or otherwise unencumber an asset within that period, that asset might not be appropriate to encumber in the lease financing unless it can be substituted or removed later. This can be achieved by including a substitution provision when issuing the lease financing or through a master lease.

RECOMMENDED GOVERNANCE PRACTICES RELATED TO LEASE FINANCING

Public agencies can lay a secure foundation for lease financing several months—and even years—in advance by employing strong governance practices utilizing existing strategic, capital facility, financial and debt management policies with intentional coordination across key areas of the organization. Strong governance practices are especially important when using lease financings, because long-term lease obligations create long term payment obligations for the public agency's general fund without a corresponding increase in revenue to pay for them.⁸ Below are a variety of recommended governance practices for California public agencies using lease financing.

MAINTAIN A HEALTHY GENERAL FUND. The fiscal health of an agency's general fund depends on the agency's ability to synchronize expenditures to revenues in each year, and agencies with a higher proportion of non-discretionary expenditures— including lease payments— tend to have more consequential budgeting challenges as they face frequent pressure to reduce general fund expenditures. Although lease financings in California are not legally considered “debt” under the constitutional definition, they are considered long-term debt from a financial planning and credit perspec-

tive.⁹ Nonpayment of these non-discretionary lease obligations would cause the agency to default on the lease financing transaction, which would in turn have significant repercussions on the agency's credit rating, reputation, and its future access to the capital markets.¹⁰ A general fund overcommitted with lease payments and/or other long-term, non-discretionary obligations subsequently has fewer resources available to dedicate for essential government services. This is especially the case when public agencies experience unexpected revenue shortfalls, because payments for a lease financing are still required— often for 30 years or more— even when projected revenues do not materialize. This makes it essential for agencies to conduct appropriate financial planning and analysis to ensure a consistently healthy general fund before committing to a new lease financing.

DETERMINE AND SET A LEASING CAPACITY. To adequately prepare for the financial commitment of a lease financing public agencies should proactively set an appropriate leasing capacity and apply appropriate modeling practices when making projections for general fund revenues and expenditures. A public agency's capacity for lease obligations should be based on the amount of debt that the general fund can sustainably support while considering the context of all other expected financial obligations for the agency.

Determining an appropriate leasing capacity requires formulating a “cumulative picture” of existing long-term and future spending commitments in the agency's long-term financial planning, capital improvement planning, and multiyear budgeting as well as thoughtful analysis of trends and expectations for future revenues. Credit rating agencies also typically analyze these factors. Many

⁸ Public agencies sometimes find or create new revenue sources to dedicate to the rental payments for a lease financing, but the payments are typically still paid from the agency's general fund. See the section, “Evaluate Budget Limitations and Appropriate Revenue Sources” for more information and context about this approach.

⁹ For more information and context about how municipal lease financings are not legally considered to be debt, please refer to CDIAC's [Legal Foundations of Lease Financing in California](#) report.

¹⁰ A default would also lead to costly and disruptive litigation in addition to triggering any other applicable remedies to investors (including a right to relet the leased asset, if applicable).

public agencies already estimate multiyear expenditures and future revenues as part of the general budgeting process, and there can be a natural synergy when integrating planning for lease financing with the agency's financial planning process.

Public agencies should evaluate potential future obligations that have not otherwise been accounted for when determining the organization's leasing capacity, such as necessary capital improvements, potential legal liabilities, pensions, and other post-employment benefits to have a clearer picture of the agency's ongoing financial obligations.

Public agencies should conduct sensitivity analyses to explore the volatility of their revenue sources as well as determine potential impacts on the agency's financial condition. Identifying changes in the proportion of non-discretionary expenditures during periods with lower revenue may assist agencies to estimate how new lease obligations may affect the balance and the financial health of the organization's general fund during these lower revenue collection periods. This type of analysis can keep agencies from relying on overly optimistic projections of revenue sources to pay rental obligations.

However, relying on data that includes anomalies due to one-time events or conditions that have since changed, has the potential to significantly affect any resulting calculations. For example, agency staff should consider whether the time periods that are used as historical inputs are representative of future forecasts or whether historical revenues benefited from conditions that are no longer prevailing or will not be repeated in the future. Some agencies may find it appropriate to use historical data, whereas others may determine that certain periods have been characterized by conditions that are not expected to be reflective of future expectations. This challenge was exacerbated in the years immediately after the COVID-19 pandemic, because public agency revenues and expenditures experienced extreme fluctuations that were not representative of typical trends. Agencies should be thoughtful

about the data included in models to ensure that data anomalies are not meaningfully altering the results of internal baseline forecasts. In addition, public agency staff should also seek to understand inherent assumptions in models and projections produced by third-party consultants.

Potential savings is another component that should be considered. Many agencies make the choice to build their own facilities and savings from commercial leases that previously housed those uses may be one of the sources for making the new lease payments. Building owned facilities may produce economic savings or eliminate other risks or uncertainty.

Although there is no standard limit that can be applied in all cases, multiple public agencies have set limits for lease payments between 3% and 7% of their general fund revenues, depending on the agency's fiscal context. Lease payments should generally not exceed 10% in most cases. In situations where the general fund is already overburdened with long-term financial commitments such as unfunded pension obligations, debt due to legal judgments, and/or major capital improvement projects paid from the general fund, lease obligations that amount to 3% of an agency's general fund revenues may still be too high. Some agencies have chosen to set a limit for the sum of lease payments and other long-term debt obligations in addition to an explicit leasing capacity to ensure that the general fund does not become overcommitted.

Once an agency has determined its leasing capacity, that amount should inform an appropriate and nonarbitrary limit for lease obligations that is explicitly specified in the agency's debt policy. Including a self-imposed limit for lease payments in the organization's debt policy promotes transparency as well as makes the limit easier to adhere to in cases of potential political pressure to incur additional lease obligations.

A public agency's debt policy should have explicit guidelines for a fiscally responsible amount of on-

going lease obligations for the agency. The agency should regularly review their financial and debt policies to ensure that they continue to be appropriate as well as fully reflect the agency's internal practices. Public agencies can also signal strong governance during the capital market issuance process by disclosing relevant information regarding how the proposed financing complies with the agency's leasing capacity as stipulated in its published policies.

EVALUATE BUDGET LIMITATIONS AND APPROPRIATE REVENUE SOURCES. Before executing a lease financing, the agency should evaluate how much the project will cost to build and operate and how the sources of funding will perform over that time. Only pursue lease financing after a careful and intentional evaluation of the costs of this new, long-term financial commitment as well as whether a different funding and/or financing method – such as PAYGO, grant funding, general obligation bonds, or another financing method – may be more appropriate.

Public agencies should utilize expertise from a registered and experienced municipal advisor and experienced internal staff to discuss the context of the project and the agency's financial condition to determine whether lease financing may be appropriate before engaging other members of a financing team.

Public agencies should carefully consider what is being purchased, acquired, and/or constructed with the capital project when determining if lease financing might be appropriate. Agencies should account for ongoing operating costs for the new facility in future budgets. This could be another source of stress on the general fund if the costs of the new facility are generally higher than expected.

Agencies with popular projects that resonate with voters might be best served by seeking a new authorization for general obligation bonds, because

the new authorization would come with an associated funding source for the project. Conversely, lease financing can sometimes be an appropriate option for projects that are necessary for the agency but do not have much voter support. Lease financing should not be used to fund ongoing operational expenses because it reflects a worsening financial position and potential mismanagement.

“There should not be a bias for a particular financing structure. It should be based on what the issuer wants or needs to accomplish.”

Craig Hill, Managing Principal for NHA Advisors (Municipal Advisor)

Agencies need to identify potential funding sources for the project while assessing the budget for the project. The most appropriate potential funding sources are typically not only based on which revenue sources are available for the agency to employ but also the funding source(s) that best align with the project through the lens of taxpayer and intergenerational equity.¹¹ Answering these questions about expected project costs, general budgeting, and potential funding sources will help the agency make a well-informed decision about whether lease financing would be a feasible and appropriate financing strategy. When tying a special revenue to a lease obligation, the agency should evaluate the projected revenue and volatility of the revenue stream and structure any new financial liability conservatively so that the agency has sufficient coverage above subsequent rental or debt service payments.

Agencies may benefit from conducting a financial feasibility study for whether a project financed through a lease will have self-supporting project revenues and analyze multiple contingencies where the self-supporting revenue stream does not perform as well as expected.

¹¹ For more information about determining the most appropriate source(s) of funding through a lens of taxpayer equity, refer to the section “i.2.1 Decision #1 – What is the Right Source of Funding?” in CDIAC’s [California Debt Financing Guide](#).

Some agencies that use lease financing choose to use supplemental revenue streams to offset new lease obligations paid from the agency's general fund. The supplemental revenue source could be in the form of a sales tax, transient-occupancy tax, or possibly even in the form of project revenues, though some of these sources are likely to be more volatile than others. The supplemental revenue source would not be officially pledged or directly allocated to rental payments for the lease but rather passed through the agency's general fund before being applied to the lease obligations.

Public agencies are advised against relying too heavily on volatile – or even external – revenue sources for lease financings, even when that revenue source is expected to fully fund the rental payments for the lease. Some examples of this would include plans to fund a public works project partly through grant funding or reimbursed by fees paid by users of the project. An overreliance on revenue sources outside of the general fund may not only dampen investor interest but could also result in additional financial stress that can hinder the agency's ability to provide essential services in cases where the expected funding does not materialize. Although examples of default are rare for municipal lease financings, multiple cases of default have been the result of unstable funding sources.

“An agency should think about how it will fund a project separately from how it will finance the project so that decisions about how to finance a project do not cause unintended consequences about how it will fund the project.”

*Dan Deaton, Partner at
Nixon Peabody, LLP (Bond Counsel)*

Adding a supplemental revenue source to offset new lease obligations can improve an agency's financial condition while leveraging the credit-worthiness of its general fund; however, adding a supplemental revenue source does not ensure that the issuer will obtain a higher credit rating, and it

HOW LEASE FINANCING CREDITS ARE RATED IN CALIFORNIA

Credit ratings for lease financings start with the credit rating of the issuer and then “notch” down based on the specifics of the transaction. While specific rating agency practices differ by firm, generally lease financing transactions in California are rated below the issuer's general obligation credit rating because California lease financings are subject to abatement risk. Rating agencies look comprehensively at the long-term strength, volatility, solvency, and other context of the supporting revenue stream to determine the most appropriate rating in addition to characteristics of the leased asset(s) for the transaction.

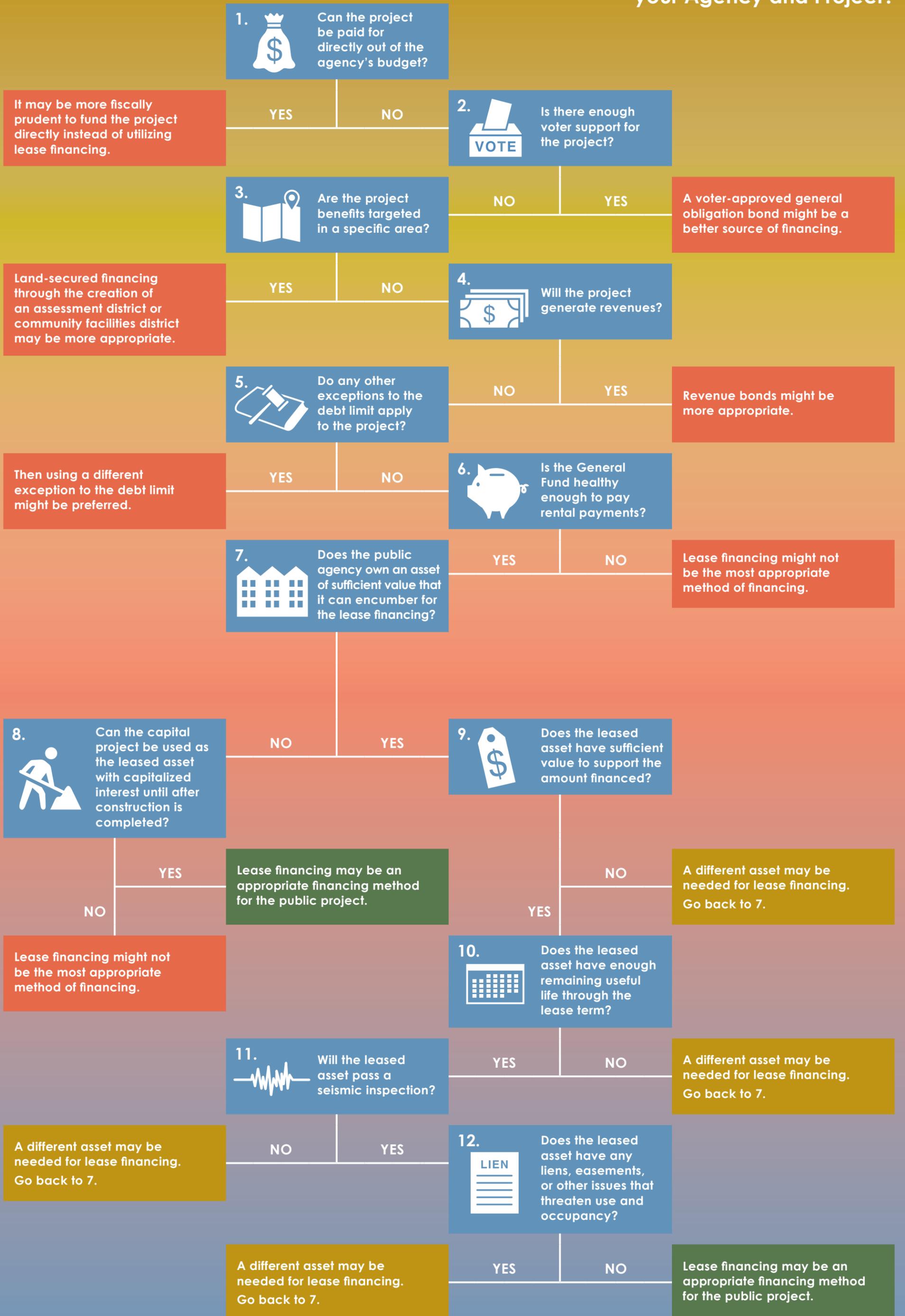
can even be viewed as a detriment in some cases. For example, the transaction could be assigned a lower credit rating if the rating agency has reason to believe that the agency's rental payments would be negatively impacted if the supplementary revenue source performs below expectations.

There are many factors that affect whether lease financing may be more or less appropriate for a public agency given its specific context. Figure 2 shows a diagram of several of these different factors as well as additional financing methods that might be more appropriate in the context of some public agencies.

ESTABLISH DOCUMENTATION AND TRACKING PRACTICES. Lease financing represents a long-term commitment that will likely last longer than the tenure of all the staff involved in the issuance process, and agency staff need to memorialize the key, long-term responsibilities related to the lease financing – including before, during, and after the conclusion of the issuance process. Such documentation should also include important

Figure 2: Lease Financing Decision Tree

Is Lease Financing Appropriate for your Agency and Project?



information related to the issuance or operations needed to onboard new staff responsible for managing the public agency's ongoing administration of the lease financing.

Public agencies should already be tracking their leased assets in a master schedule that includes information about each lease as well as potential impacts on any other lease financing, such as overlapping rental obligations. This schedule should include relevant information about previous lease financings (dates, amounts financed, and interest rates), the values of leased assets and their underlying land values, the assets' use and occupancy – especially flagging partial private or federal use of the assets - any lien information, and relevant information about the condition of the leased assets. Information about the condition for the assets can include dates of improvements, seismic updates, and any renovation plans.

Although tracking is especially important for encumbered assets, public agencies may benefit from tracking much of this same information for other assets that could be used in a potential future lease financing. Public agencies that wait until initiating a lease financing to begin tracking their options for leased assets may experience a longer and more stressful issuance process.

ESTABLISH EDUCATION AND TRAINING. The mechanics of a lease financing are often thought to be counterintuitive, and stakeholders may have trouble understanding how or why a project is being financed using a lease instead of a different type of financing. In addition, the framing of a lease financing might be particularly sensitive given the implications of a long-term commitment of public funds without voter approval. Public agencies that utilize lease financing should consider how to integrate important concepts related to lease financing into training for staff and governing board members including internal methods for tracking asset uses to ensure compliance with tax-exempt rules and other requirements applicable to lease financing.

A public agency may offer guided learning sessions about a lease financing plan to its governing board members instead of expecting each member to fully comprehend a large packet of technical information about the financing. In these cases, the public agency staff should be cognizant about how to organize these training sessions with an experienced member of staff or an external financing team while maintaining compliance with [open meeting laws](#) such as the Brown Act or the Bagley-Keene Open Meeting Act.

Public agencies can also invite public participation at key stages in the financing process to create additional buy-in and lessen potential resistance to the project, especially in cases where there might be additional controversy, such as in the case of encumbrance of non-traditional assets in a lease financing or when using a lease to finance pension-obligation payments. Transparency is often seen as the easiest first step for an agency to engage the public in the financing process. This can include posting information on the agency's website, opportunities to comment on project plans early in the financing process, and other strategies for sharing relevant information with constituents. Messaging related to lease financings can focus on the needs of the project instead of the intricacies of the financing to garner support for a lease financing from a governing board and/or the general public.

Although some agencies have had positive experiences with coordinated campaigns to solicit feedback from the public about financing plans, others have experienced that minimal public participation still resulted from an engagement campaign despite the dedication of significant staff resources. Some agencies have found more success with soliciting public participation when presenting the agency's capital improvement plan (CIP) and then using lease financing as the means to accomplish the essential priorities dictated in the CIP.

RECOMMENDED PRACTICES FOR SELECTING A LEASED ASSET

Some of the most important characteristics of an asset leased in a financing include the value, condition, lifespan, and essentiality of the asset, all of which have associated recommended practices for public agencies. The leased asset serves a pivotal role in a lease financing transaction, and successful lease financings demand conducting due diligence for the asset, title work, insurance, valuation, and usually also a seismic evaluation. An extended discussion related to decision points for selecting a leased asset is available in the [Practical Considerations and Decision Points for Municipal Lease Financing in California](#) report published by CDIAC in June 2023.

ENSURE AND ESTABLISH SUFFICIENT VALUE. It is recommended that the issuer be careful that the value of the leased asset should be at least as high as the amount financed. Sufficient value for the leased asset(s) is a necessary criterion of a successful lease financing. Legal precedent stipulates that the public agency must be expected to pay no more than the “fair rental value” of a leased asset.¹² The fair rental value for a leased asset is established when lease revenue bonds (or certificates of participation) are issued, and the assessment does not need to be updated if the value of the asset decreases after issuance. However, an issuer does need to make a new fair rental value declaration every time a new lease or amendment to an existing lease schedule is executed in connection with the issuance of new bonds.¹³ If an asset owned by the agency does not have sufficient value, it will be difficult for the public agency to justify that rental payments would not exceed the fair rental value of the property and more difficult to access the financing amount needed for its project.

“Both the marketplace and bond insurers will expect you to encumber real property with a value at least equal to the principal amount of the borrowing. The most ready sources of value information will be the book value for that property, its insured or replacement value, or in the event of a recent purchase, the purchase price.”

Lisel Wells, Principal at Wells Consultancy, LLC (Bond Counsel)

There are a number of possible approaches to valuing government property subject to the financing lease. The issuer may procure a formal appraisal report, or the valuation can also be established based on internal analysis. Such analysis may rely on one of the methodologies used in a formal appraisal, calculating the depreciated replacement cost for the asset and adding an estimate of land value. In other instances, the insured value – which is essentially the non-depreciated replacement cost – is used. For new construction, the stated value is usually the sum of the construction and other project costs.¹⁴ Regardless of which valuation method is used, an opinion of value will be needed to establish that the fair rental value of the leased asset is equal to or greater than debt service. This is an essential part of conducting due diligence for a leased asset in California, as requirements related to fair rental value derive directly from the foundational case law that created the lease exception to the debt limit.

BEWARE OF OVERCOLLATERALIZATION. There is a lack of consensus about the benefits of selecting a leased asset with a value that is significantly larger than the amount being financed, often re-

¹² Kelly Joy, [Legal Foundations of Lease Financing in California](#), 1.

¹³ This is especially important in the context of master leases, in which multiple bonds are issued under one master lease agreement that is amended as needed over time.

¹⁴ For more information, refer to the “Determination of Fair Rental Value” section in the second report in this series: [Practical Considerations and Decision Points for Municipal Lease Financing in California](#).

ferred to as “overcollateralization.” This is partly due to a natural tension in the benefits to agencies of leasing public assets versus the benefits of additional collateral for investors. Investors tend to appreciate overcollateralized lease financings, because the leased asset supporting the transaction has a higher value. It is also possible that an overcollateralized asset may be subject to less abatement risk in cases where only a part of the leased asset is affected by an abatement event. That said, representatives of public agencies, bond counsel, and municipal advisors tend to agree that a leased asset should ideally have an “efficient value” for the lease financing transaction to prevent unnecessarily encumbering additional public resources and possibly incurring higher insurance costs. There are also potential concerns that overcollateralized leases could be structured in a way that challenges the underlying legal construct for lease financings. The issuance documents for a lease financing should have specific provisions for being able to release some assets if debt service has declined and/or the value of the leased asset has increased resulting in overcollateralization of the financing.

“Public agencies have a limited number of facilities to encumber with leases and should take the long view and not encumber assets that may be useful for financing future projects.”

*Stephen Spitz, Partner at
Orrick Herrington & Sutcliffe LLP
(Bond Counsel)*

CONSIDER CHOOSING NEWER ASSETS. It is recommended that public agencies consider choosing newer assets for a lease financing. The advantages of selecting newer assets are sufficient value, less depreciation, greater essentiality, less disclosure related to abatement risk, and conformity to updated building codes and standards.

Facilities built under older building standards or with significant deferred maintenance may not make appropriate leased assets. Some properties with impaired conditions may have higher risks of abatement and/or lower potential valuations. This is especially a concern in California due to relatively recent enhancements in seismic standards for newly constructed buildings. As noted below in the section, “Be Prepared for Seismic Evaluation,” rating agencies (and bond insurers) may consider various factors in their assessment, including the characteristics of the asset as it relates to potential seismic activity.

Lease terms should be shorter for leases of assets with shorter useful lives, especially equipment. Public agencies may want a longer amortization schedule, but the lease term should not extend past the leased asset’s useful life. Public agency issuers should be prepared for the rating agency to ask detailed questions about the risk, condition, useful life, and value of the leased asset. This is also the case for bond insurers when securing bond insurance and banks in the case of private placements.

DETERMINE ESSENTIALITY. The “essentiality” of a leased asset is a key consideration because of the abatement risks associated with a lease financing. The importance of essentiality in California lease financing stems from investors’ perceptions that (1) a public agency will be less likely to default on debt service payments because default risks the loss of possession of an essential asset, and (2) a public agency is more likely in the event of a casualty to repair an existing asset promptly. Assets are deemed by rating agencies and investors to be essential if they are critical to the mission and operations of the agency, and if the public agency is expected to fully maintain and restore the asset(s) in the case of an abatement event. Assets deemed less essential are perceived to have higher abatement risks, which may result in a lower credit rating as well as potential challenges when marketing and/or selling the lease revenue bonds.¹⁵ As

¹⁵ Or executing certificates of participation.

a result many assets that could be used in a lease financing might not actually be used as a leased asset in practice.

There are several important factors that rating agencies consider when determining essentiality of a leased asset for a rating. The assets that rating agencies generally consider to be most essential are related to basic human services, public safety, healthcare, education (including libraries), housing, and fundamental infrastructure. Asset types that rating agencies generally consider to be “less essential” include recreational facilities, convention centers, community centers, theaters, animal shelters, parks, and undeveloped property. Essentiality is not simply a binary decision, but rather essentiality is a continuum of highly essential to less essential assets. Figure 3 shows a sample essentiality spectrum based on different asset types; however, asset type is not the sole determining factor for whether a leased asset is considered to be “essential,” other factors, some subjective, are also considered and essentiality is a credit judgment – not a defined absolute - with conclusions that may be subjective.

Although the type of leased asset is an important factor when evaluating essentiality, rating agencies also consider other important characteristics that could affect the essentiality of a specific leased asset. Essentiality is evaluated over the length of the lease term (if not the expected lifespan of the asset). An essential asset deemed essential by a public agency that has a high risk of deteriorating before

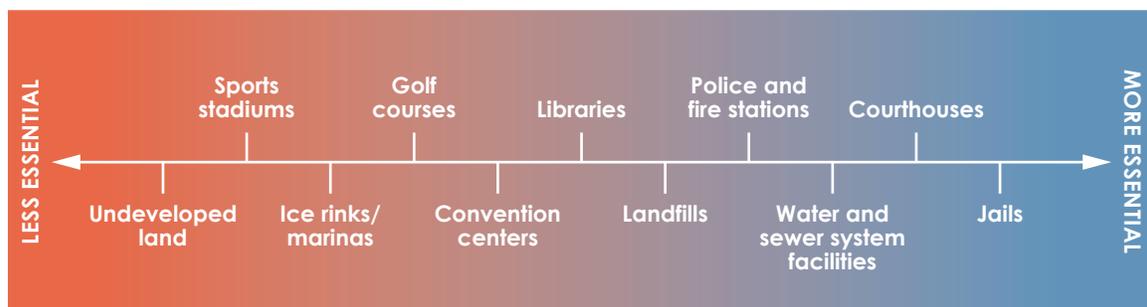
the end of the lease term may not be perceived as essential by rating agencies or investors. This is especially true of technology-dependent leased assets that run the risk of becoming obsolete and requiring subsequent replacement in the near future.

Public agencies should be mindful of the type of project that is being financed and be sure that there will be a long-term use for the new asset that will exceed the term of the financing. Agencies should consider changes in technology, demographic patterns, and cultural norms that could affect the future use and demand for the capital project.

Each agency’s unique circumstances also factor into how essential a leased asset is perceived to be. For example, a police station is directly related to public safety, which is a core service provided by a city; however, if there is reason to think the police station for a particular city is not adding enough value and may be consolidated, the police station may be deemed a less essential asset. Another notable example relates to schools. Although schools are generally considered to be essential assets, some schools may be considered less essential, if the county is exhibiting declining school enrollment trends and there is a risk of the school being closed.

Rating agencies and investors use different approaches for determining leased asset essentiality, and these differences can have significant implications on the rating, pricing, and marketability of a municipal lease financing. For example, rating agencies may reach different essentiality conclu-

Figure 3
ASSET TYPES ON AN ESSENTIALITY SPECTRUM



sions and assign a higher or lower rating for the use of certain leased assets than other agencies. Bond insurance companies and private placement lenders similarly may have different essentiality views. Rating agencies and other companies have come to different conclusions on whether parking lots, animal control facilities, convention centers, and parks are deemed “essential enough” in a lease financing transaction. For example, parks are generally considered to be less essential than many other asset types, but they also suffer from less abatement risk than structures and may represent a highly essential property in a given community. Using a standard asset with limited abatement risk will generally have positive implications on rating decisions and investor interest compared to unique or less-essential assets.

“There is no ‘bright-line test’ for essentiality. It will depend on how essential that specific facility is to the mission and functions of the agency.”

Eric Hoffmann, Associate Managing Director for Moody's Ratings (Credit Rating Analyst)

Public agencies can sometimes “make the case” to rating agencies or credit evaluators (investors) that a particular leased asset should be considered essential to the agency’s operations. These cases typically require the agency to work closely with their financing team to provide enhanced disclosure about the context, condition, and risks of the leased asset to justify a departure from the standard methodology for determining essentiality.

ENSURE AND MAINTAIN CLEAN TITLE. Title work is required to ensure that the public agency’s ownership of the leased asset has not been compromised to the point it lacks sufficient fair rental value. Title work entails ordering the preliminary title report for the leased asset and reviewing the

report for any potential concerns or “title defects” that may affect the right of the public agency to use and occupy the property, such as prior encumbrances, liens, easements, or encroachments. Any material title defects can impair the fair rental value of the property and thus impact the ability to use the facility in the lease financing. This part of the issuance process is often prioritized shortly after the leased asset for the transaction is chosen, because preparing a title report and finalizing all of the necessary paperwork can be a lengthy process that takes several weeks, if not longer.¹⁶ Deferring action on title work for a leased asset can cause delays in the issuance process, especially in cases where defects are identified. In some cases, the public agency may need to cure title defects or even need to select a different leased asset to proceed with the lease financing.

ESTABLISH AND MAINTAIN INSURANCE COVERAGE. Public agency issuers should be actively engaged in the procurement of insurance coverage for a leased asset, including integrating the procurement into the agency’s general plans for risk mitigation. This includes asking its risk manager to review the insurance provisions of the financing lease agreement as soon as possible in the process to confirm that the language is appropriate to the asset, that the coverage is available, and to give the risk manager time to ensure that the required policies are in place before the closing of the bond issue.

Public agencies need to establish and maintain coverage for a leased asset over the course of the lease term and should factor in any associated costs for required insurance coverage. This includes casualty insurance and rental interruption insurance. Casualty insurance covers losses in the case of physical damage to a leased asset due to a specified set of threats to the asset, including many natural disasters. Casualty insurance reimburses the public agency occupying the leased as-

¹⁶ Kelly Joy, *Practical Considerations and Decision Points for Municipal Lease Financing in California* (California Debt and Investment Advisory Commission, 2023), 15, www.treasurer.ca.gov/cdiac/publications/issuebriefs/230412.pdf.

set, and the proceeds are used to rebuild the asset or call the outstanding bonds. Rental interruption insurance pays for rental payments in the case of loss of use and occupancy of the leased asset and is usually available as a “rider” or supplement to an existing insurance policy.¹⁷ Proceeds from rental interruption insurance ultimately pay the debt service to bondholders in the case of a covered abatement event while the leased asset is being repaired or reconstructed.

Insurance coverage requirements may influence the selection of asset(s) used in a lease financing. Coverage amounts can vary based on several factors, including the asset’s value and condition as well as the presence of relevant risks to the asset. The cost of insurance coverage may be an especially important consideration in cases when a lease obligation is “overcollateralized,” because the issuer may be required to procure insurance coverage for an asset worth significantly more than the amount financed.

“They call it risk because sometimes it happens.”

*Daniel Deaton, Partner at
Nixon Peabody, LLP (Bond Counsel)*

BE PREPARED FOR SEISMIC EVALUATION. Rating agencies typically evaluate seismic risks during the ratings process, and seismic review of a potential leased asset is typically required in California. This is often true when the leased asset was not recently constructed. Given the context of abatement risk for California lease financings, seismic reviews can uncover unexpected issues that might threaten an agency’s use and occupancy of the leased asset. Some rating agencies and bond insurers will require a seismic review report signed by a structural engineer.

RECOMMENDED PRACTICES FOR SPECIALTY STRATEGIES AND STRUCTURES FOR A LEASE FINANCING

There are multiple types of lease structures that can be used in a lease financing depending on the agency’s intended objectives including new construction of a leased asset, asset transfers through a lease-leaseback transaction or utilizing a master lease or lease pool.

CONSIDER A MASTER LEASE TO STREAMLINE FREQUENT FINANCINGS. Public agencies can choose to structure their lease financing as a master lease, which allows the agency to use the available value from the master lease for subsequent lease financings without needing to release any assets or refinance existing obligations. Master leases may be a solution after a public agency takes a comprehensive look at its prospective lease revenue plan. After identifying potential leased assets and setting a feasible borrowing schedule, master leasing can be used to pool multiple resources together.

Some agencies find that using a master lease structure can simplify and streamline the issuance process for future lease financings, because the agency can issue multiple times under the original master lease with much of the same documentation. Even smaller agencies that frequently use lease financing may benefit from streamlining their issuance processes through a master lease as long as that structure helps efficiently facilitate the agency’s broader financing goals.

Master leases also allow issuers to modify the leased assets and subsequent rental payments in future lease financing transactions.¹⁸ The master lease is typically structured to have a “pool” of leased assets that can be augmented and/or removed over time depending on the needs of the agency. New assets can be added to the pool as necessary to secure ad-

¹⁷ Kelly Joy, [Practical Considerations and Decision Points for Municipal Lease Financing in California](#), 16.

¹⁸ See section “3.6.1 Financing Leases” of CDIAC’s [California Debt Financing Guide](#).

ditional debt or assets can be removed as a series of bonds mature. Public agencies may find advantages in starting with the largest, most valuable asset that they can encumber and then add additional assets as needed to achieve the desired total value, rather than building up value with many smaller assets. This can lead to greater simplicity when tracking the use, occupancy, and valuation of assets included in the master lease as well as potentially lower the costs for required insurance coverage. However, agencies that use master leases have not always needed to add additional assets to their master lease due to the value already available from the existing leased assets.

On the other hand, master leases may require the encumbrance of a large amount of assets all at once. Some agencies find that using a master lease format is less flexible than issuing each lease financing independently, because each subsequent bond issue needs to conform to the preexisting pool created under the master lease structure. Even some large and sophisticated issuers may need substantial support from bond counsel and other financing team members with significant expertise with master leases to manage the additional complexity and constraints associated with a master lease. This is one reason why master leases are often not recommended for infrequent issuers.

“A master lease isn’t efficient if it needs to be recreated every time you issue bonds, so you need to be thoughtful and forward thinking when constructing it.”

*Jyothi Pantulu, Assistant Director
for the City of San Diego (Issuer)*

ESTABLISH AN APPROPRIATE MASTER LEASE STRUCTURE. The initial investment in creating a master lease can be similar to a standard lease financing, though it also often requires additional intentionality and foresight to ensure that the contents of the master lease will still be relevant and appropriate for future issuances. Master leases also require tracking of the use, occupancy, and

valuation of each of the leased assets. Although tracking the status of leased assets is recommended for all lease financings, this practice becomes especially important when the issuer intends to issue again from the (same or modified) pool of assets in a master lease. Rental obligations related to lease financings should be tracked at the asset level, which often requires an experienced municipal advisor and dedicated staff to track and maintain, especially for larger lease programs.

While the best master leases are built with a comprehensive view of future needs, it is also possible for a master lease to use an existing lease financing to set up a master lease instead of starting a new master lease from scratch. This can be done by adding a new leased asset through a refinancing or other supplements and then adding required provisions for a master lease in the amended lease agreement.

In some cases, the pooling feature of master leases may generate additional interest from investors, because the asset diversification from the asset pool is perceived to lower the abatement risk for the financing. In addition, a leased asset subject to potential abatement can sometimes be substituted out of the asset pool or there may still be sufficient value from the rest of the asset pool without needing to substitute or add additional assets.

The pool of assets in the master lease will all require title reports, so issuers of a master lease should consider the required title work for all of the pooled assets for the master lease and any extra time that may be needed to cure any defects.

Issuers should be careful to not include problematic provisions in the master lease agreement that they do not want to apply every time the agency issues bonds under that master lease.

MAINTAIN COMPLIANCE WITH FAIR RENTAL VALUE UNDER A MASTER LEASE. There are also ways that an agency can use a master lease to creatively accomplish the goals of a lease financing while also fully complying with legal constraints related to fair rental value. For example, a public agency can add or subtract assets over time

in a transaction to support a non-level debt service while still meeting fair rental value requirements as long as the fair rental value for the pool of assets is fully supported in every year.¹⁹ Issuers should ensure there is sufficient fair rental value when setting the amortization schedule as rental payments cannot exceed the fair rental value of a leased asset in any year of the lease term. Public agencies need to be especially mindful of this limitation in the less common cases of non-level debt service for a lease financing.

CONSIDER DIRECT CONSTRUCTION OF A LEASED ASSET. Some public agencies are especially limited by the potential assets that they are able to encumber in a lease financing. In these cases, a public agency's best option may be to directly finance the construction of the leased asset, because doing so does not require encumbrance of an exist-

ing asset. Using the asset to be constructed as the leased asset often simplifies credit concerns about useful life of the asset and concerns about the existing condition of the asset. Some agencies may also choose to directly construct a leased asset instead of encumbering an existing asset in cases where a third party is financially responsible for the transaction. While such direct construction of a leased asset was more common in the past, more recently asset transfer structures in which existing assets are leased to build new structures have become more common, in large part because it eliminates the requirement to capitalize interest and reduces exposure to construction risk.

CONSIDER COST OF CAPITALIZED INTEREST. The need to capitalize interest when directly constructing a leased asset stems from the legal requirement that the public agency must have full

HOW DIFFERENT MARKET ENVIRONMENTS CHANGE THE COST-BENEFIT ANALYSIS OF CAPITALIZED INTEREST

Issuers of new money transactions capitalize interest by issuing additional lease financing and using the additional proceeds to fund an account to pay for the interest for the financing for a limited period. While capitalized interest may add additional costs to a debt financing, the relative cost of the capitalized interest can depend on market conditions, including the shape and slope of the yield curve. Capitalized interest typically results in the agency holding a larger amount of proceeds, which can be invested in permissible short-term and/or more liquid securities. During periods with a normal yield curve, issuers experience negative arbitrage when investing their long-term bond proceeds into more liquid investments with a shorter maturity. But as in recent

periods, when rates were inverted, such funds may earn more. The slope of the yield curve can make a significant difference in the magnitude of the negative or positive arbitrage that an issuer might experience, which affects the relative cost of capitalizing interest. Agencies can earn a higher yield for investments with a shorter maturity during periods characterized by a flat or inverted yield curve, which in turn mitigates the negative arbitrage of the invested bond proceeds and can result in the issuer experiencing a lower relative cost of capitalized interest. Public agencies are strongly cautioned against basing any long-term financial decisions on temporary market conditions, unless the investment return is fixed at the same time as the borrowing costs.

¹⁹ For more information on structuring debt service see "Amortization Schedule" in CDIAC's [Practical Considerations and Decision Points for Municipal Lease Financing in California](#), 17–18.

and continuous use and occupancy of the leased asset before rental payments that fund debt service can commence. If the leased asset is being built with financing proceeds, the lease does not have beneficial use and occupancy of the facility until it receives an occupancy permit. Capitalizing interest may result in higher annual debt service once the capitalized interest period ends. Interest is typically capitalized for the entire construction period as well as six to 12 months thereafter, depending on the nature of the asset and length of construction, to buffer against unanticipated construction delays. While the capitalized interest can provide some short-term financial flexibility and will earn interest until it is expended, this is typically for only the construction period and the aforementioned 6–12 months beyond that. The additional debt issued to fund the capitalized interest increases the size of the borrowing to be repaid which may be as long as 30 years.

One strategy used by some issuers with limited sufficiently valued and available assets for a lease financing is to lease the land for the facility to be constructed in addition to an existing asset (of otherwise insufficient value), then substitute the new asset once it has been constructed. This may help to avoid the need for capitalized interest and investors might prefer the newest asset for the lease transaction. This can typically be done as long as the lease agreement includes a substitution provision that allows for the leased asset to be substituted, which is a common practice in modern lease financings. Although not all credit analysts will view land on which assets are being built as having the same essentiality and credit strength as an asset transfer of a clearly essential asset, they may also not be satisfied that the land value in and of itself mitigates the need for any capitalized interest.

MANAGE CONSTRUCTION RISK. Using the planned (but not-yet-constructed) facility as the leased asset exposes the investor to construction risk. 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.

More robust disclosure to investors regarding the procurement process, the contractor, and the risk mitigants embedded in the construction contract, is helpful to investors where lease financing is subject to construction risk associated with the leased asset, and issuers can articulate how they have mitigated construction risk through the disclosure documents.

RECONSIDER THE RIGHT TO RELET AS A DEFAULT REMEDY. It is recommended that public agencies thoroughly evaluate any right to relet provisions for leased assets within the lease financing documents. A right to relet provision allows the trustee to take use and occupancy of the leased asset in cases where the agency defaults on rental payments.

Although a right to relet may be considered standard by some market participants, repossession of an essential public asset could be a traumatic loss to an agency in the (albeit rare) case of default, and public agencies are cautioned against offering these remedies without intentional reflection on the potential ramifications for the agency's mission and operations. Although investors may prefer lease financings with right-to-relet provisions as another potential tool for the trustee to compel payment, the impact of these remedies on investor interest and pricing decisions is more difficult to assess now that right to relet provisions are thought to no longer have credit rating implications.²⁰ At the same time, if a lease lacks a right to relet or investors could never really gain access, it is reasonable to wonder if the lease itself is a fiction which undermines the legal rationale for using lease financing in the first place.

²⁰ See also "Right to Relet" in CDIAC's [Practical Considerations and Decision Points for Municipal Lease Financing in California](#), 20.

Although cases of repossession have been rare and mostly untested by the courts, a public agency should consider whether a public asset may be too essential to allow investors to gain possession of it in the case of a default, especially in the case of an overcollateralized lease obligation. It is also possible that additional issues could arise with offering remedies in a contract that might not be legally enforceable. Public agencies are encouraged to thoughtfully consider the potential costs and benefits resulting from including a right-to-relet provision in a lease financing and whether doing so would best serve the agency's interests.

RECOMMENDED PRACTICES DURING THE ISSUANCE OF A LEASE FINANCING

While disclosure in initial offering documents applies to all public debt offerings, there are some specific areas of disclosure that are especially important for lease financings, such as asset characteristics, construction risks, and the long-term strength and condition of the agency's general fund.²¹

As is true of any securities offered to the public capital markets, lease financing issuers should seek to be intentional and thorough in their disclosure documents, because better disclosure can improve pricing and marketability to investors. This is especially important if the agency needs to "tell its story" in cases where the project is subject to construction risk or if the agency may be less well known to investors.

PARTICIPATION OF KEY STAFF. Public agencies should invite a comprehensive group of agency staff to participate in the preparation of the disclosure documents for a lease financing, especially when disclosing risks. This group will typically always include the finance director, the agency's lead administrative officer, internal counsel, and key staff and leadership from multiple depart-

ments related to the project. These key staff need to not only be involved in the preparation of the disclosure documents but should also be trained about the legal requirements and best practices for disclosure and lease financing.

SPECIFIC DISCLOSURE ABOUT THE GENERAL FUND CONDITION. Disclosure of the fiscal strength and financial condition of an agency's general fund is especially important to communicate in the case of lease financings, because rental payments for lease financings are committed to the general fund without a new revenue source. The disclosure for a lease financing should feature historical information related to the long-term health of the general fund, the current budget, multiyear budget projections, and any other relevant financial context for the fund. If the agency is projecting a future recession or other possible events that could negatively affect the financial health of the agency's general fund, the disclosure can also include proactive actions that the agency is taking to mitigate those potential impacts, such as augmenting reserve balances, reducing expenditures, and other planning efforts.

“Investors really do want and need additional project-specific disclosure that is typically prepared when planning and evaluating the project. Why not get credit for what you are already doing and simply communicate that to investors in the official statement?”

Raul Amezcua, Senior Managing Director for Ramirez & Co. (Underwriter)

SPECIFIC DISCLOSURE ABOUT ASSET CHARACTERISTICS. In addition to the main asset-specific characteristics that are essential to disclose in the offering documents (including the condition, value, and remaining useful life of the

²¹ The information about disclosure and the other content in this report is meant to provide general guidance about some of the factors especially relevant to issuers of lease financings, but it is not a substitute for legal advice. Issuers seeking legal advice should consult directly with bond and/or disclosure counsel for advice tailored to the context of the public agency.

asset), some additional asset-specific considerations that the issuer will need to disclose include material physical risks to the leased asset. These are risks that have the potential to threaten the public agency's use and occupancy of the leased asset, including physical risks that may be exacerbated by climate change, such as flooding, sea-level rise, wildfires, and others. Disclosure of material physical risks is already a market expectation, and investors for California lease financings may place particular emphasis on disclosure of potential physical risks to a leased asset due to the additional abatement risk for lease financings in California.²²

In addition to physical risks to a leased asset, investors may also be especially interested in understanding how changes in regulation may significantly impact a public agency's ability to continuously maintain use and occupancy of a

leased asset, which is often referred to as "transition risk." One notable example of the transition risk of an asset is in a facility built using older environmental standards that is no longer permitted to operate without significant renovation or other required technological changes.

SPECIFIC DISCLOSURE ABOUT CONSTRUCTION RISKS. Construction risk for a capital improvement project is an especially important component of well-developed disclosure in any lease financing in which the new project serves as the leased asset. Issuers of lease financings can communicate the important details about a direct construction project in their disclosure documents, including relevant details about the construction plan and contract. The project plan can include details about the contractor and whether the company is bonded, for example. An issuer can also include information about whether the contract has a fixed price or whether the costs of the project may exceed what is defined in the contract.

INVESTOR FRAMING FOR LEASE FINANCINGS

There have been multiple anecdotes of investor interest waxing or waning based on the framing for a security – particularly how the issuance is titled. This has been noted specifically in the case of lease financings based on the type of leased asset for the transaction. For example, a transaction for a "civic center" in a California city reportedly experienced less demand for their bonds, because investors on the East Coast thought that the financing was for a convention center instead of for a city hall. Securities that mention "hospital" in the name are also thought to generate less investor interest, because hospitals are thought to be riskier even if they are considered essential assets by the issuer.

RECOMMENDED PRACTICES FOR ONGOING RESPONSIBILITIES FOR A LEASE FINANCING

The post-issuance phase of a lease financing may span multiple decades and entails several ongoing requirements for which the agency typically only has limited external support. Public agencies that utilize lease financing have multiple responsibilities related to lease financing throughout the lease term, which include monitoring and tracking leased assets as well as required legal and regulatory expectations.

COMPLY WITH LEGAL AND REGULATORY EXPECTATIONS. Public agencies that use lease financings have ongoing legal requirements related to the financing until maturity and/or repayment of the borrowed funds. There are ongoing requirements for other types of bonds and

²² Kelly Joy, *Legal Foundations of Lease Financing in California*, 15.

OTHER IMPORTANT LEASE FINANCING FACTORS

RESERVE ACCOUNT. While reserve accounts are no longer mandatory for lease financings, there are some cases in which the benefits to holding a reserve account may outweigh the costs. Reserve accounts are typically used by issuers with lower credit ratings, unstable financial conditions, exposure to construction risk, or during contractionary periods. A reserve account held by a trustee provides a source of payment during a short-term abatement. A reserve fund held by the issuer however does not provide abatement protection to investors.

SUBSTITUTION PROVISION. Agencies planning a lease financing can typically choose whether to include a substitution provision. Agencies often find that including a substitution provision provides them additional flexibility if they need to sell or otherwise unencumber the original asset, and substitution provisions are now commonly included in lease financings.

MULTIPLE BOND INDENTURE. Multiple bond indentures allow a public agency to issue multiple bond series under the same lease financing. Including a multiple bond indenture may be another way to allow the issuer additional flexibility to meet their financing goals, especially in cases where the agency anticipates the need for more capital in the future and the leased asset has a higher value than the initial principal amount.

DATES FOR RECURRING RENTAL PAYMENTS. Agencies should schedule rental payments on preferred dates of payment that align well with the cash flow structure of the public agency.

ISSUANCE TIMING. Is it beneficial to consider the timing of significant economic events, local elections, the annual financial reporting cycle – and even holidays – when deciding to issue a new lease financing to the market. Issuers might experience less investor interest with “stale” financial data compared to after the publication of a new Annual Comprehensive Financial Report (ACFR). Issuers also need to be mindful about scheduling a financing during a time when the agency’s ACFR is due to be published, as that could affect disclosure and pricing for the transaction. The timing of local elections can also affect the decision to pursue a lease financing for political reasons, because some members of a governing board might be less interested or willing to support a lease financing transaction during an active re-election campaign.

CONTINUING DISCLOSURE AGREEMENT. An issuer can sometimes exercise reasonable levels of discretion over disclosure commitments made in their continuing disclosure agreement (CDA). Issuers may benefit from not including requirements that they feel would be too onerous to report on an annual basis – and that are not legally required – especially for master leases that are used for multiple issuances.

municipal debt as well,²³ but there are some responsibilities and considerations specific to lease financings that public agencies should be aware of, especially related to continuing disclosure and recordkeeping.

Public agencies need to be keenly aware of the specific conditions unique to lease financings that can lead to a technical default, which is a case when the agency violates a non-financial condition or covenant of the financing. This

²³ For more information about general ongoing responsibilities required for issuers of California public debt, refer to “Chapter 8. Post-Issuance Debt Management Requirements” in CDIAC’s [California Debt Financing Guide](#).

WARINESS ABOUT PLANNING ISSUANCE BASED ON “MARKET TIMING”

Although it can be tempting for issuers to try to “time the market” when financing a project, it is difficult to do in practice. Interest rates are not predicted with certainty, and expectations can change with very little notice. It is true that issuers may find some benefit in monitoring important market conditions when preparing a lease financing, including interest rates and important economic events that have the potential to significantly affect market volatility. However, issuers should be wary of prioritizing market timing over the schedule of the project and needs of the agency itself.

“The answer to the question ‘Will interest rates go up or down?’ is ‘Yes’.”

*Stephen Spitz, Partner at
Orrick Herrington & Sutcliffe LLP
(Bond Counsel)*

could include a loss of use and occupancy of the leased asset, lapses in insurance coverage, or another factor explicitly governed by a covenant in the lease agreement.

Issuers of a lease financing will (like other financing types) need to report annually according to what is stipulated in the continuing disclosure agreement (CDA). Although continuing disclosure is a general requirement for public debt, public agencies that use lease financings may also need to include specific information about the condition and use of the leased asset in the disclosure, and especially

notices of substitutions of leased assets. There are also applications of the Securities and Exchange Commission Rule 15c2-12 for continuing disclosure that are more relevant for leases, such as filing an event notice in cases where a leased asset has been substituted for another asset or otherwise removed.²⁴ There may also be cases, such as significant changes to the condition of a leased asset, for which an issuer may find it prudent to file a voluntary disclosure notice.

MAINTAIN DOCUMENTATION, MONITORING AND TRACKING PRACTICES OF ASSETS. Public agencies should ideally have processes and procedures in place to monitor and track the condition, value, and use and occupancy of the leased assets involved in their lease financings. This is especially the case in specific situations depending on the context of the leased asset(s) and the type of lease (e.g. a master lease).

Legal requirements for lease financings in California stipulate that the public agency lessee continuously retain use and occupancy of the leased asset(s) over the lease term.²⁵ Lease terms can span multiple decades, which makes it extremely important to have a defined and consistent process for tracking the use and occupancy of all encumbered leased assets. This can become more complicated for a public agency with several lease financings with overlapping lease terms. Public agencies that have used asset transfer mechanics for their lease financings need to track not only the leased asset, but also the asset that is in the process of being constructed, acquired or rehabilitated as part of the financing transaction. The issuer must also track the uses of the facilities financed by a tax-exempt lease financing, whether or not it is subject to the lease. While private use of a leased asset may bring revenues to the issuer, issuers should be very aware that they can also introduce credit risks (for example by changing the

²⁴ “SEC Rule 15c2-12: Continuing Disclosure,” Municipal Securities Rulemaking Board, Published 2019, Accessed November 5, 2024, www.msrb.org/sites/default/files/SECRule15c2-12.pdf.

²⁵ For more information, refer to the section “Abatement” in CDIAC’s [Legal Foundations of Lease Financing in California](#).

perceived essentiality of a leased asset) and private use of the financed facility could cause the bonds to lose their tax-exemption or the issuer to have to make a settlement payment to the Internal Revenue Service.

Although the fair rental value of a leased asset is set – and fixed – based on the initial valuation of the asset, it may be of benefit for public agencies to continue to monitor and track the asset’s value throughout the lease term. If the value of a leased asset has increased substantially after the transaction has been executed, this could lead to overcollateralization for the lease financing, which could result in an inefficient encumbrance of public assets, allowing assets to be freed up for other leases (or to support more leasing in a master lease structure).

ESTABLISH ONGOING MAINTENANCE AND OPERATIONS. A public agency should have an explicit plan for properly maintaining the leased asset for at least the term of the lease if not the remainder of the asset’s useful life. A significant deterioration in the condition of the leased asset could cause an abatement event, and even more routine rehabilitation projects could cause the public agency to temporarily lose use and occupancy of the leased asset, which could trigger an abatement event.

Due to the continuing risk of abatement, lease financings in California require ongoing insurance coverage for leased assets. The requirements for insurance coverage are typically specified in one of the covenants in the lease agreement for the financing, and even if rental payments are always made on time, a technical default can be triggered by not maintaining continuous insurance coverage for the leased asset.

CONCLUSION

This report serves as a guide for California municipalities that are interested in leveraging lease financing as a method for funding their capital improvement projects. This report, the third in

CDIAC’s *Lease Financing in California* content series, builds upon the foundational legal framework and practical considerations for lease financings outlined in the two previous reports while offering a deeper examination of suggested recommendations from industry practitioners with significant expertise in municipal lease financing. The recommended practices for lease financing highlighted in this report are intended to promote benefits related to risk mitigation, enhanced financial stability, and long-term success of lease-financing transactions.

California public agencies that utilize lease financing can benefit by staying informed about emerging trends and legal developments that may affect their issuance strategies as market and regulatory expectations for lease financing continue to evolve. While this is the final report in CDIAC’s *Lease Financing in California* content series, CDIAC intends to provide ongoing education and support to local public agencies by providing additional resources and training about lease financing in the future. Public agencies are advised to consult with experienced municipal advisors and bond counsel when considering lease financing to ensure that their specific needs and circumstances are appropriately addressed.

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APPENDIX

OVERVIEW OF A “CRITICAL PATH” FOR A TYPICAL LEASE FINANCING TRANSACTION

1-2+ Years Ahead – Planning

- Project identified – (Capital Improvement Plan/ Strategic Plan/Emergency Need/Debt Policy)
- Verify legal authority (CA statute, legislation, etc.)
- Determine the date that funds are required
- Analysis of the cash flow, revenues and expenditures

3-4 Months Ahead – Pre-Issuance

- Establish timeline and deadlines and approve reimbursement resolution if recommended
- Initial estimate of time until bond issuance
- Establish a list of assets/property information including any land value information such as audit back-up, insurance replacement values, original cost and original construction dates, county assessor’s data, appraisal
- Initial analysis of properties available to lease
- Review previous lease revenue financing documents in relation to the new financing (Lease, Site Lease, Trust, Continuing Disclosure Agreements, Tax Certificate and Preliminary Official Statement)
- Select title company (may require procurement process for RFP/RFQ)
- Review recommendation of municipal advisor (MA) for initial analysis of financing options based on estimated financing amount (Bonds versus Private Placement)
- Assemble financing team (underwriter (UW), bond counsel (BC), title insurer, trustee) no later than 3-4 months ahead of expected closing,

allow timing for RFQ for BC or MA, set up weekly finance team calls

- Ratings recommendation by UW and MA (1 or more ratings)
- Credit enhancement discussion (on-going)
- MA (and possibly BC) recommendation of properties to lease
- Request preliminary title report – (allow 2-3 weeks)
- Initiate insurance request
- Confirm deductible amount (i.e. not to exceed \$100,000/\$500,000 per Lease Agreement)
- Confirm cost for rental interruption insurance
- Review draft bond documents/resolution (on-going)
- Collect Preliminary Official Statement information
- Request review of permitted investments from investment advisor
- Request recommendation for investment of bond proceeds from investment advisor,
- Coordinate with MA and trustee to provide any information needed about available investment funds/securities
- Prepare/schedule ratings presentation, determine lead (UW, MA, etc.)

Last 30-45 Days – Issuance

- Confirm good faith deposit process with UW and trustee, if applicable
- Governing board approval of substantially final bond documents
- Final updates to Preliminary Official Statement incorporated before distributing to underwriters and investors
- Pre-pricing/Pricing
- Closing

Ongoing Administration – Post-Issuance Until Defeased

- Comply with legal and regulatory expectations (continuing disclosure agreement, event notices, specific asset conditions, substitutions, etc.)
- Maintain documentation, monitoring and tracking practices of assets
- Ongoing maintenance and operations of assets



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