Lease-backed financing and Certificates of Participation

Inside

By: Debra Saunders
Vice President
Municipal Finance

Municipal bonds are issued as either General Obligation (GO) bonds backed by the issuer's taxing power, or as revenue bonds backed by specific dedicated revenue streams. Revenue bonds include a wide universe of obligations and can extend well beyond bonds backed by dedicated user fees or charges.

The purpose of this article is to explain one type of revenue bond—lease financing—i.e., revenue bonds backed by dedicated lease payments either from the municipality itself or one of its agencies. This is a common financing strategy, and municipal bond investors are likely to come face to face with these bonds, albeit in some states more than others. As in any revenue bond, the credit considerations include the viability of the revenue stream as well as the covenants in place to protect the bondholder's claim to it.

This article is intended for experienced investors with a strong knowledge of municipal securities.

A BRIEF OVERVIEW

Lease financing can take different forms, the most prevalent being Certificates of Participation (COPs), but lease revenue bonds are also used. COPs are used across the United States by states, cities, counties, school districts, and special districts. State law governs the issuance of COPs and specifies which municipalities may issue COPs, what the permissible purposes are, and what is allowable to be pledged.

Sometimes COPs are used when the security is a standard enterprise revenue bond. While COPs may also be used by essential service utility agencies, in which case they are identical to revenue bonds (see below, "When is a COP not a lease?"), the most common use of COPs is for lease-backed municipal obligations.

A brief, selective history of lease financing

Note: The following section is a brief historical summary of legal findings concerning lease financing and is not intended to constitute a legal opinion or legal advice.

There are numerous reasons municipalities may want to avoid issuing GO bonds under certain circumstances. It is hard to get voters to approve GO bonds (and property tax increases) for many projects, such as jails, courthouses, and city halls, but it can be more efficient to build and finance these projects using long-term financing rather than on a pay-as-you-go basis. To address this need, financing that is not, from a legal standpoint, debt is a useful solution. Lease financing accomplishes this goal. Naturally, early attempts to utilize lease financing were challenged in court.

The fundamental element that makes a lease not debt is the legal "out." Challengers to lease financing laws argued that lease-backed securities are multi-year obligations and subject to states' constitutional provisions that prevent municipalities from entering into commitments beyond the current fiscal year without voter approval. State supreme courts that approved the financings took the position that leases are not debt as long as there is a legal "out." The two standard legal outs are (1) annual renewal by the governing body or (2) the linking of rental payments to continued use and occupancy of the leased facility.

The U.S. Supreme Court has thus far refused to hear appeals of such cases. Subsequent attempts to challenge such decisions have been dismissed by the state supreme courts. It is considered a credit strength where state lease laws have been upheld by state supreme courts because potential challenges to validity are exhausted and the COP's legal opinion should be unqualified with respect to validity under state law.

CALIFORNIA

Proposition XIII propelled the use of lease-backed financing in California. Proposition XIII is the 1978 constitutional amendment that, among other things, raised the voter approval requirement for GO debt from a simple majority to a two-thirds majority. In 2001, California voters approved a constitutional amendment that lowered the GO bond threshold for school districts to 55%, causing a shift from lease financing to GO debt for school districts. California state case law is strong and lease financing is very common.

Security

THE LEASE AGREEMENT

Technically, a COP represents shared rights in lease payments made on a property that is subject to a "financing lease" by a governmental entity. The Lease Agreement is the primary document that evidences the obligation of the borrower (the lessee) and the lender (the lessor). The Lease Agreement spells out how and when the lessee will make rental payments and what the consequences are of failure to make rental payments. It also spells out the lessee's requirement to maintain the property. Municipal leases are typically triple net leases, meaning the lessee pays utilities, taxes, and insurance.

The standard source of lease payments is the municipality's General Fund, so an analysis of the lessee's financial condition is important. Since the lessee cannot raise taxes to pay, the lease payments must fit within its budget.

The "Out"—The lessee's obligation to make lease payments must be subject to either abatement or appropriation to avoid being subject to constitutional debt requirements. The security section of the Offering Statement (O.S.) and the Summary of the Lease Agreement will clearly spell out if the subject lease is subject to abatement or appropriation. The Offering Statement can be obtained from the MSRB's EMMA site at http:\\emma.msrb.org.

- Appropriation: In an appropriation lease, the lease is "annually renewable" and the governing body must approve the lease payments in the budget each year. In most cases, the appropriation is automatic unless proactively cancelled by the governing body.
- Abatement: In an abatement lease, the obligation to make rental payments is legally enforceable, not subject to appropriation, but may be reduced or eliminated if the municipality's access to the asset is interrupted due to damage or condemnation. The obligation to budget and appropriate each year is an obligation imposed by law and COP-holders can sue to compel lease payments that are not made when the facility is available for use and occupancy.

Failure to include lease payments gives the Trustee the right to "re-enter and re-let" the facility, and any proceeds from re-letting would be used to make lease payments. From a practical standpoint, this provision is more of a "hammer" than a remedy. Re-entering essential governmental assets may be unfeasible or undesirable and could even be blocked by the courts if it presented a danger to the public (imagine barring a municipality from using its jail!). The right to remove the lessee from the facility provides incentive for the lessee to continue to make lease payments.

There are strong incentives for municipalities to make lease payments, even during periods of fiscal duress. First, leases are often secured by important municipal assets. Most municipalities would want to avoid costly challenges to occupancy that would arise if they failed to pay. Second, at the end of the lease term the governmental entity may buy the asset back for a nominal sum, generally $1, thus each lease payment actually increases the lessee's equity in the property.

The Lessor—In most cases the lessor is a single-purpose entity set up specifically to serve as the counterparty in the Lease Agreement. It is important that the lessor be a single-purpose entity to avoid having any external financial issue affect the security.

The Asset—The primary protection for a COP-holder lies in the strength of the underlying asset. Leases can be used to acquire a variety of assets, from copy machines and fire trucks to court and correctional facilities. Investors should consider the public purpose and the essentiality of the asset.

An important security aspect of a financing lease is that at the end of the lease term the municipality has the option to purchase the asset for a nominal price. Thus, the issuer/lessee builds up equity over the life of the lease. The willingness to continue making lease payments is generally stronger as a result.

A primary risk for a COP-holder is that for some reason the lessee will lose the willingness or incentive to make lease payments. Reasons for this could include loss of use due to damage, obsolescence (such as a technology system) or lack of access (such as in the case of eminent domain or condemnation).

The Lease Agreement spells out the insurance that the lessee is required to maintain, and should include all of the following:

- Standard hazard and property damage. Usually flood and earthquake insurance are excluded. If you believe that the pledged asset is particularly vulnerable to these hazards, this exclusion would be a credit weakness.
- Rental Interruption insurance. This covers the same events as property damage and should provide for two years of lease payments during any repair period. The coverage should be 100% of the lease payments without any deductible.
- Title insurance. Title insurance is a good idea, especially in an abatement lease where interruption of right of access to the property could result in a reduction or interruption of rent.

Unusual leases

STATE LEASES

Lease-backed securities of states that are frequent users of this tool may provide a weaker security package than local lease-backed securities. This is a result of the perception of broader economic bases and revenue-raising flexibility. State lease-backed securities may have more limited provisions, less essential leased assets, and reduced or lack of debt service reserve funds. This is mitigated by these states' frequent borrowing needs, heavy reliance on lease financing, and large general funds with more flexibility and liquidity than many local issuers.

MASTER LEASES

Master leases are common in some jurisdictions and for some types of assets. Master leasing allows a municipality to pool together a variety of assets and is especially useful for equipment leases acquired over a period of time. Florida school boards have pioneered the use of Master leasing; the typical structure is one in which every new issue of lease-backed bonds is added to the prior, creating a Master Pool of leased assets. This is considered stronger because it provides diversification across assets and creates increased incentive to pay. In such cases, certain insurance and reserve requirements may be eased to reflect the stronger security.

CALIFORNIA IS UNIQUE

The passage of Prop. XIII[1] in California in 1978 put onerous restrictions on municipalities' ability to raise property taxes and issue GO debt. This gave rise to financing structures that were designed to keep public projects moving forward despite the high hurdles created by Prop. XIII. That said, California municipalities were issuing lease revenue bonds long before Prop. XIII. California case law on municipal leasing dates back to 1933.[2]

Among the financing tools to grow out of Prop. XIII were tax increment bonds (to be discussed in a later paper) and lease-backed financing. California lease-backed financing instruments are almost exclusively abatement leases. In abatement leases, the insurance provisions take on more significance.

When is a COP not a lease?

Certificates of Participation may represent participation in undivided fractional interests in installment payments due under an Installment Sales Agreement, such as for a water or sewer system. In this case the security and credit analysis would be equivalent to the analysis of an enterprise revenue bond. These securities are issued using COPs but are not lease-backed debt. This is an important distinction. Many investors see "COP" and immediately assume "lease." Enterprise revenue bonds issued under a COP structure typically have the same security and bondholder protections as standard revenue bonds, and rating agencies will rate these as parity debt.

[1]Officially called the People's Initiative to Limit Property Taxation, a.k.a. the Jarvis-Gann Amendment.

[2]California Debt Advisory Commission, *COPs in California: Current Issues in Municipal Leasing*, Staff Report on June 18, 1992 Public Hearing.

For more information, please contact one of our municipal finance offices.

Tim Coffin
Vice President,
Municipal Finance
Fidelity Capital Markets
200 Seaport Boulevard, Z2H
Boston, MA 02210
(O) 617-563-0391
(M) 857-383-8694
Timothy.Coffin@fmr.com

Lourdes German
Vice President,
Municipal Finance
Fidelity Capital Markets
640 Fifth Avenue, IN2A
New York, NY 10019
(O) 212-335-5039
(M) 617-480-7977
Lourdes.German@fmr.com

Kim Edwards
Vice President,
Municipal Finance
Fidelity Capital Markets
7000 North Mopac,
2nd Floor
Austin, TX 78731
(O) 512-514-6625
(M) 512-284-2927
Kim.Edwards@fmr.com

Debra Saunders
Vice President,
Municipal Finance
Fidelity Capital Markets
350 California Street
San Francisco, CA 94104
(O) 415-445-6976
(M) 415-405-5952
Debra.Saunders@fmr.com

Fidelity INVESTMENTS

FIDELITY CAPITAL MARKETS
200 SEAPORT BOULEVARD
BOSTON, MA 02210

558301.1.0 1.918399.100