



Lease Financing in California

A Fundamental of Municipal Debt

Participants

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The Fundamentals



How Did We Get Here

- The State Constitution limits indebtedness
 - True debt requires 2/3 voter approval (now can be 55% for schools)
 - True debt requires levying a dedicated property tax to service debt
- But, with the help of courts, clever people have figured out ways around these obstacles

ARTICLE 16 PUBLIC FINANCE SEC. 18. No county, city, town, township, board of education, or school district, shall incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year, without the assent of two-thirds of the qualified electors thereof, voting at an election to be held for that purpose...; nor unless before or at the time of incurring such indebtedness provision shall be made for the collection of an annual tax sufficient to pay the interest on such indebtedness as it falls due, and also provision to constitute a sinking fund for the payment of the principal thereof...

ALEXIS DE TOCQUEVILLE: "I have never been more struck by the good sense and the practical judgment of the Americans than in the manner in which they elude the numberless difficulties resulting from their Federal Constitution."



Key Court Decisions Supporting Lease Financing

- McBean v. City of Fresno (1886)
 - A contract for service is not a debt
- Ofner v. City of Los Angeles (1942)
 - A lease is not a debt
- Dean v. Kutchel (1950)
 - A lease-purchase is not a debt
- Ryder v. City of San Diego (1998)
 - An asset transfer is not a debt



What Distinguishes a Lease from Debt

- Consideration is paid for use and occupancy of the leased asset
- If use interrupted, rent is abated
- Rent does not exceed fair rental value



How to turn a lease into a loan

- Lease Agreement is assigned to a trustee for issuance of securities or directly to lending bank
- Publicly issued securities
 - Lease revenue bonds
 - Certificates of participation
- Private placement



The Challenges



Challenges to Choosing the Leased Asset

- Essentiality
- Value
- Encumbrances and private uses
- Natural disaster risk



Limiting Abatement Risk

- Quality of the leased asset
- Insurance
 - Property
 - Rental Interruption
 - Title
- Construction risk
 - Lease payments capitalized during construction
 - Lease/leaseback of existing asset



The Vanishing Debt Service Reserve Fund

- Because of abatement risk, including the limitations on insurance (especially earthquake), all lease-revenue securities used to have a debt service reserve fund
 - Usually equal to maximum annual debt service
- When reinvestment rates fell so much lower than borrowing rates, issuers (cheered on by investment bankers and municipal advisors) first reduced, then eliminated, funding reserves for strongest credits
- Rating agencies now make no distinction in higher rating categories



New Frontiers



Leveraging Local Sales Tax

- Many cities have sought voter approval for a supplemental sales tax
- Most commonly approved as general tax with simple majority approval
- As a general fund revenue, the key tool for leverage will be a lease revenue financing
- Key challenge—selecting the leased asset



Leasing Streets or Other Unconventional Assets

- Financing pension prepayment without issuing pension obligation bonds
 - Usually used to avoid the judicial validation required for a Pension Obligation Bond
- Challenges of leasing a street
 - Property description
 - Title insurance
 - Remedies

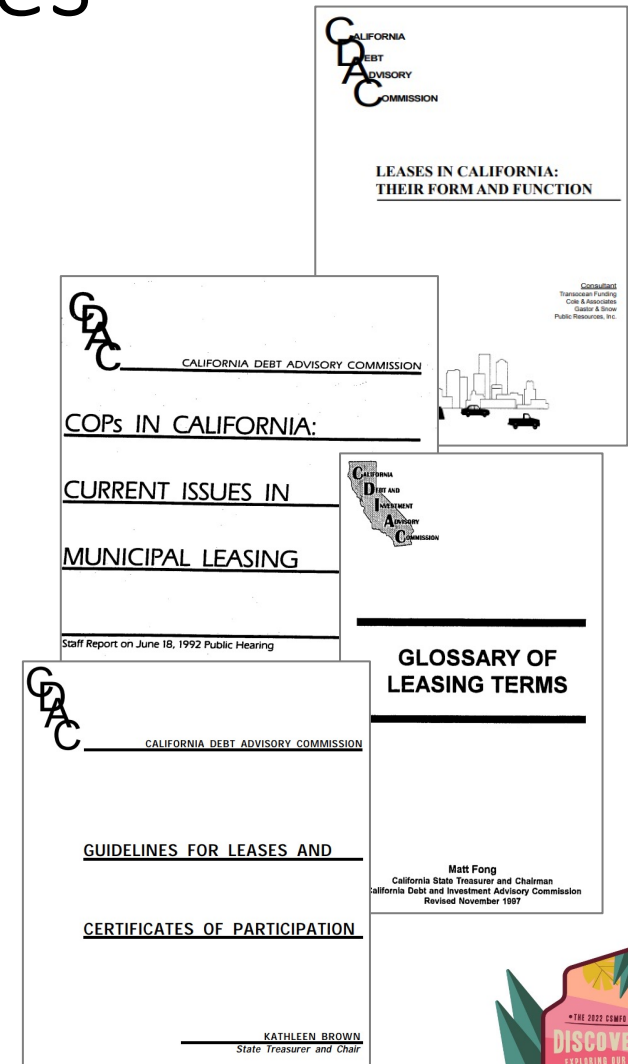


Resources and Guidance



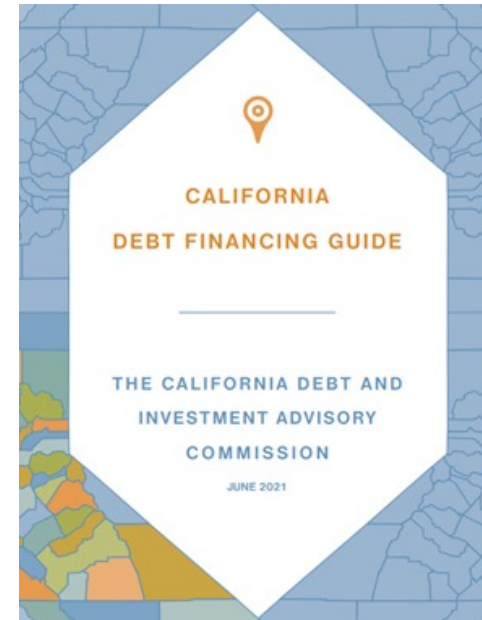
CDIAC's Lease Financing Resources

- CDIAC's Lease Series (1990-1997)
 - Leases in California: Their Form and Function
 - COPs in California: Current Issues in Municipal Leasing
 - Glossary of Leasing Terms
 - Guidelines for Leasing and Certificates of Participation



CDIAC's Lease Financing Resources

- California Debt Financing Guide (2021)
 - <https://debtguide.treasurer.ca.gov/>
- New Content Series (underway)
 - Legal Foundations of Lease-based Financing
 - Common Structures and Case Studies
 - Guidance: Financial & Policy Considerations



What's Old is New: Lease Guidance

- Integrate Lease Financing into the Agency's Debt Management Policy
 - Establish limitations and fiscal controls
 - Requirement under Government Code section 8855(i)
- Avoid Exotic Structures that Drive Costs and Increase Risks
 - Consider current and future asset uses
 - Use structures that increase marketability of the debt
 - Avoid long-term administrative challenges and public controversy



What's Old is New: Lease Guidance

- Clearly Understand the Obligations Imposed by the Lease Documents
 - Follow the legal formalities
 - Adhere to disclosure responsibilities across the debt portfolio
- Clearly communicate and document restrictions and covenants across the Agency
 - Spend-down of proceeds
 - Insurance
 - Private use
- Public Participation
 - Maintain a transparent policy development and approval process
 - Engage public in long-term lease finance decisions



Questions?

