

SAM - BUDGETING

FINANCING LEASES VERSUS OPERATING LEASES/CONTRACTS

6876

(New 5/1998)

Financing leases:

1. **Background:** If a client department has the authority to acquire real assets, a *financing lease* provides an alternative to finance capital assets over a multi-year period. A tax-exempt financing lease typically falls into one of two general categories:
 - a. A capital asset may be financed by leasing it directly from the vendor or leasing entity, with the lessor receiving a portion of each rental payment as tax-exempt interest; or
 - b. Certificates of participation (COPs) may be sold to the public. COPs are similar to lease-revenue bonds but represent undivided interests in the rental payments under the tax-exempt lease.

If statute does not clearly create financing lease authority for a transaction, the client department is limited to an operating lease (see following).

2. **Statutory reference:** Government Code Section [14669](#) authorized DGS to hire, lease, lease-purchase, or lease with the option to purchase any real or personal property for the use of any state agency, subject to specified restrictions.
3. **Requirements for a financing lease:** The tax-exempt obligation may be structured as an installment purchase agreement, installment sale agreement or lease-purchase agreement. As with lease-revenue bonds, the state's debt obligations under the lease must be structured consistent with the Offner-Dean exception, i.e., cannot be structured in a way which would classify them as *constitutional debt*.
 - a. Rentals are paid only for those periods in which beneficial use and occupancy of the leased property is available to the lessee;
 - b. If there is no annual appropriation for rent when the leased property is available for use and occupancy, the state will be in default under the lease, and remedies may be available against the state. These remedies may include the vendor's or lessor's right to continue the lease in existence and sue the state for each installment of rent as it becomes due.
 - c. Acceleration of rental payments is not permitted;
 - d. The obligation to pay rental payments may be from any lawfully available funds of the client department, which may covenant to place in its annual budget and seek appropriation of the rentals that are due and payable during the fiscal year;
 - e. The terms and conditions in the lease must be similar to the lease terms found in a commercial context for similar types of facilities;
 - f. The lease term should not extend beyond the anticipated useful life of the leased property, and fair market rental should be paid;

(Continued)

SAM - BUDGETING

(Continued)

FINANCING LEASES VERSUS OPERATING LEASES/CONTRACTS 6876 (Cont. 1) (New 5/1998)

- g. Termination provisions must match the underlying capital financing (such as certificates of participation). Usually the lease may be terminated only if the remaining unpaid rental payments are *prepaid* and title to the leased property vests in the client department (or other state agency, such as DGS); and
- h. The credit underlying the transaction is the state lease and the fund from which lease payments are made. Financial statements for that fund may be included in the official statement and are subject to continuing disclosure.

4. Other fiscal highlights:

- a. Per Government Code Section [5700](#), STO is the agent for sale of any state or JPA debt issuance, including those over \$10 million, unless statute specifies otherwise. This provision includes debt issuance for a financing lease. In this context, "JPA" means *any* joint powers authority, whether or not the state is a member. If the issuer for bonds for a state financing lease is neither a JPA nor a state entity, STO may nonetheless reserve the right to be the agent for sale if continuing state disclosure is required. Other STO roles are as described for JPA issuances (Section 6874).
- b. The roles of DOF and DGS are as described for JPA issuances. The client department, DOF, and/or DGS may consult with the Attorney General to ensure that the underlying lease has all appropriate provisions to ensure that the transaction is not constitutional debt.
- c. The key client department responsibility is to notify DOF and STO, at least eight months in advance (preferably one year), of any pending financing lease project outside the normal budget process *which may require the services of STO as the agent for sale or continuing disclosure agent*. The client department will meet as necessary with STO to clarify what entity is the agent for sale. DOF may require an economic analysis for the project. The client department needs to consult with the STO before final lease terms are negotiated and, until concurrence is received from STO, the client department may make no commitments to local government entities or private vendors regarding: financing structure; timing; selection of underwriters, financial advisors, or bond counsels; or use of state credit. DOF may schedule lease payments as a separate Budget Act item. In this case, the client department's budgeting and accounting requirements are the same as for lease-revenue debt service. Other responsibilities of the client department are summarized in Section 6886.

(Continued)

SAM - BUDGETING

(Continued)

FINANCING LEASES VERSUS OPERATING LEASES/CONTRACTS 6876 (Cont. 2) (New 5/1998)

Operating leases/contracts used as security for third-party financings:

1. **Background:** A client department may be limited to entering into an operating lease or contract for the use of real assets (i.e., no authority to enter into a financing lease to acquire assets). Typically such operating leases or contracts may be terminated before their maximum term if there is no legislative appropriation for their payment. In some cases, the vendor may elect to use the operating lease or contract as security for borrowing funds to acquire or construct those real assets. However, in this situation there is no authority to commit the state legally or morally to any obligation to appropriate funds beyond the current fiscal year.
2. **Statutory reference:** same as for financing leases described in the preceding text.
3. **Fiscal highlights for operating leases/contracts :**
 - a. The provisions of the lease must include:
 - (1) All restrictions applicable to a financing lease as stated in the preceding text; and
 - (2) Termination provisions, including the right of the state to terminate the lease before the end of the term. For example, the state may include the right to terminate the lease if the state is not satisfied with the condition of the building or the lessor's compliance with the lease terms, may no longer need the space, or for any reason applicable in a commercial context. The exact terms will depend upon the specific factors applicable to each lease. Termination provisions may be short-term—i.e., the useful life of the leased property (e.g. 20 years) may be substantially greater than the stated maximum lease term (e.g. 10 years). In addition, the operating lease or a contract typically will terminate if there is no appropriation of rentals for a fiscal year (hence the name *nonappropriation lease* is sometimes used to describe these operating leases or contracts).

Upon termination, the leased property must be returned to the vendor, who may sell or relet the leased property to someone else. In this case, however, the vendor or lessor cannot have the right to continue the lease in existence and sue the state for each installment of rent as it becomes due.
 - b. The borrowing may not represent itself as an obligation of the state. Therefore, disclosure of state fund financial statements in an official statement or offering memorandum is generally not desirable since this may carry an implication of a state commitment greater than that of an operating lease. The official statement or offering memorandum must specifically acknowledge that the state's commitment or credit relationship to the transaction is limited to what is appropriate for an operating lease.

(Continued)

SAM - BUDGETING

(Continued)

FINANCING LEASES VERSUS OPERATING LEASES/CONTRACTS 6876 (Cont. 3) (New 5/1998)

However, tax-exempt financing of operating leases may require State General Fund disclosure. In those cases, the financing becomes very similar to financing leases and the involvement of the DOF, STO and other state agencies is necessary (refer to *financing leases* in preceding text.)

- c. All financing needs, including interim needs, must be provided by the vendor (i.e., the project is not eligible for state-funded interim financing).
- d. Most long-term operating leases require legislative notification before a lease can be executed. Because the state can terminate an operating lease/contract more easily than a financing lease, the market risk is greater, and financing costs charged back through the lease rates will be correspondingly higher.
- e. STO is not typically the agent for sale. *STO, DOF and DGS all have an interest in ensuring that non-state financings using a state lease or contract as security do not misrepresent the state's credit relationship to the transaction.*
- f. The key client department responsibilities are:
 - (1) Verify authority to enter into the specific operating lease or contract;
 - (2) Verify that the public or private vendor has no expectations that the state will provide continuing disclosure relating to the financing transaction; *otherwise, contact STO and DOF at least eight months in advance of the anticipated issuance sale date (preferably one year) to determine whether such disclosure requests are appropriate and whether STO will require being the agent for sale.* As with financing leases, the client department needs to consult with the STO before final financing terms are negotiated in the lease;
 - (3) Include in the lease or contract all provisions required to prevent the creation of constitutional debt;
 - (4) If the operating lease or contract is to include a tax-exempt interest component in the rental payments, be sure that a nationally recognized bond counsel firm has reviewed the terms of the operating lease or contract to confirm that it qualifies as "debt" for purposes of federal income tax laws and that appropriate arrangements have been made to satisfy the ongoing federal income tax requirements concerning arbitrage rebate and other tax rules; and
 - (5) Include in the lease or contract all termination provisions appropriate for an operating lease. Contact the Attorney General, as necessary, for direction on appropriate contract or lease requirements.

(Continued)

SAM - BUDGETING

(Continued)

FINANCING LEASES VERSUS OPERATING LEASES/CONTRACTS 6876 (Cont. 4) (New 5/1998)

Depending on the nature of the lease or contract, the client department may also be responsible for verifying project cost and financing information used as the basis for lease or contract payments. (For example, the agreement with the vendor may be that the state pays only actual construction costs, financing costs, or both.) In this situation, the client department should participate in financing meetings and/or the preparation of audit financing documents. Depending upon the complexity and cost of the transaction, the client department may benefit from the services of a financial advisor to protect the state's interests, especially to assess what is included in the financing costs.

Other client department responsibilities are summarized in Section 6886.