



TELL

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Essence And Other Metaphysical Considerations

Essentiality as a credit factor in municipal leasing

One criteria common to virtually any analyst's checklist for lease financing is the evaluation of the "essentiality" of the leased asset. Rating agencies will haircut the rating an extra notch, maybe two, if the asset is deemed to be "less essential". Bond buyers and insurers all have their own standards for judging essentiality. Portfolio managers and insurers will pass on bonds that fall outside their list of highly essential assets, or require higher yield or premiums. Private placement lenders have their own internal criteria as to what kind of assets they will accept.

Exactly what is essential, of course, is more art than science. And like all art, we don't always know how to define it, although we all claim to know what we like. The following are the thoughts of one veteran of the leasing wars on such aesthetic considerations.

Essentiality as the last defense

The prominent role that this value judgment plays in our particular corner of municipal finance reflects the peculiar nature of a lease obligation. Because the instrument of municipal leasing was designed to circumvent the inconvenient restrictions of state debt limitations, leases in all but a small handful of states contain an inherent vulnerability. The lease is, in most cases, a contingent obligation,

an obligation that can self-destruct if those contingencies are not met.

In most states, that contingency is the annual appropriation of the lease payment. Such leases are commonly referred to as "non-appropriation" leases. Every year, the legislative body must reaffirm its commitment to the lease obligation, or the obligation terminates. The borrower walks away, leaving any bonds or certificates of participation that

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are secured by that lease unpaid. The act of non-appropriation and termination is simply the exercise of a contractual right, and not a default. The only remedy is repossession. The lender will now own what was until recently a municipal asset: a police station, an office building, a fire truck, a laptop computer, an HVAC thermostat and its connecting wires.

In the judgment of most lessor-lenders in non-appropriation states, the

more essential the leased asset, the less likely that the municipal lessee-borrower will fail to appropriate the lease payment. If the leased asset is highly essential, the consequences of termination, the loss of this all-important asset, will be just as fatal to the borrower as to the lender (well, almost as fatal). The theory of essentiality is the municipal equivalent of nuclear deterrence through mutually assured destruction.

In a handful of states, lease obligations may be structured as long-term obligations that are not subject to appropriation. In states such as California and Indiana, the commitment to make lease payments is not subject to the annual renewal of vows. Courts in these states created a more narrow set of contingencies for a lease agreement: the only

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contingency for non-payment is the loss of use of the leased property, in which case rental payments are abated. This kind of lease is a long-term obligation, surviving year after year in accordance with its original terms, as long as the municipal lessee has the use of the leased asset.

The role of essentiality in an abatement-type lease is subtler. The lessee cannot decide, due to a change in its needs or values, to simply terminate the obligation before the associated principal amount of the lease is amortized. At least in California, a court is supposed to order the municipality to pay past-due lease payments. Essential or not, the lessee-borrower remains on the hook.

But the perceived essentiality of the asset does come into play when there is damage to the asset. A good earthquake could offer the perfect excuse to walk away from a facility that no longer meets a lessee-borrower's needs. But if the facility or equipment is viewed as core to the delivery of vital services, the lessee will hustle in its repair or replacement.

One man's sow ear is another man's silk

While the theory of essentiality as a credit and security factor makes perfect sense, in practice things become more complicated. Municipalities and schools do not enter into lease transactions for assets that they do not think are important. One of the questions a lessor must grapple with is the likelihood that an asset that seems important to the lessee today will remain important over the life of the lease. Will the asset wear out or, like most real estate, will it appreciate? Is it a tried and true means of delivery services (e.g., fire trucks for fire suppression, grass for golf courses) or is it subject to new innovations and technological obsolescence (e.g., any telecommunication system more than two years old)?

It is difficult to create a standard hierarchy of purposes than can be applied like a template to all public agencies. For example, it is self-evident that fire protection is a municipal purpose of the highest essentiality. But that being said, it is not self-evident that any

given fire station is essential. During a prior lifetime when I served as a municipal budget analyst, my city closed several fire stations as part of a reconfiguration of service areas. In one case, we ceded service to a nearby station in an adjacent community. If the fates had chosen to amuse themselves by destroying this particular station by fire, we would have jumped at the opportunity to speed our reorganization of service delivery. As it happened, this particular station was not the subject of a lease (or of a fire). But what if it was?

Similarly, it is generally assumed that a city hall scores at the higher levels of essentiality. But in many cases, the municipal headquarters is really just another office building, easily replaced by a number of already existing facilities. I am reminded of the near termination by Broward County of its lease/COP obligation that financed the county headquarters, in the early 1990's. The COP proceeds had been applied to construct a new building built by the county itself to rationalize administrative functions in a single and central location. It was deemed by a number of citizens, however, to be a bad idea, an over-priced building that in its central location was convenient to no one. What was essential to the municipal planner (and presumably the insurer of the certificate of participation issue) was judged disposable by a portion of the population expected to pay the rent. The question of whether to appropriate or non-appropriate was eventually brought before the voters, who approved continuing with the lease.

At the bottom of many a municipal analyst's view of the food chain is the municipal park or golf course, "clearly" a facility of lesser essentiality. And that may be true of a small park in a low-density community, where recreational opportunities and open space abound. But in many communities, especially fully built-out communities, these recreational facilities and services are perhaps the one thing that citizens willingly pay their taxes for. Here political careers rise and fall on tree trimming and playground equipment. For such a community, the recreational asset could represent the gold standard of lease security.

Because of the difficulty of truly judging the essentiality of any given facility or piece of equipment, or predicting how a community will perceive a given property over time, many investors prefer leases secured by a basket of multiple assets. Especially in non-appropriation leases, cross-collateralization of assets raises the stakes. Even if one of the properties under such a "master lease" were to fall out of favor with the local community, the legislative body is less likely to fail to appropriate lease payments, since its use of all the leased assets would be terminated.

The first shall be last

The question of essentiality in the evaluation of a lease gets more twisted when one evaluates the remedies that the lessor-lender has in the event of a non-appropriation or default. The key remedy in a non-appropriation lease, and a valuable remedy in an abatement lease, is the ability to repossess the asset and sell it or re-let it to another party. But here, the essentiality of an asset tends to work against the interests of the lender.

There are two reasons for this. First, one of the factors that makes an asset essential is that it is hard to replace or find elsewhere. Thus, a jail facility is essential, since a city or county must provide the service and cannot find an equivalent building elsewhere. But in the event of non-appropriation and termination, this same quality becomes an albatross; the reason you can't find a jail on the open real estate market is that nobody else wants one. You might find a new tenant for a small office building, but you will not find a new (paying) tenant for a jail. And while non-essential parkland may be perfect for a new subdivision, no bulldozer will ever ruffle the trees and shrubs of an essential recreational facility. In most cases, the availability of the remedy of repossession and sale or reletting a facility or equipment to a new user is inverse to that asset's essentiality.

In addition, the more essential the asset, the less likely that a court would let a lessor-lender evict a tenant. Should a lessee-borrower default, who really believes that a judge will set the prison-

ers free, turn the sick out on the sidewalk, and send the school kids home? When Richmond Unified School District defaulted on its lease in 1992, the trustee did not even attempt to repossess the District's facilities, but instead limited its actions to suing for unpaid rent.

What is an analyst to do?

For a number of reasons, the old rules of thumb regarding asset essentiality will continue to prevail in municipal leasing. While essentiality is simply one person's (or one institution's) judgment, judgment is central to any credit decision. Trust — including trust with one's money — is always subjective. (Until a few years ago, there was a statue in the lobby of Moody's Investors Service's building on Church Street in New York. Two historic gentlemen, one a trader and the other a trapper, shook hands over a plaque that read "Credit: Man's Trust in Man".)

And while the essentiality of an asset limits the values of the remedies of default, rarely does the lender want to exercise such remedies. What bondholders and other investors really want is the ability to force payment, not to "take over the asset". If the asset is essential, the less likely that lessee will willingly vacate (in some cases, even after it has failed to make a payment). If the issuer is still using the asset, bondholders have better standing to force a payment remedy.

Since the instances of municipal lease default have been limited, such academic discussions may be, in most cases, well, simply academic. But a clearer view of the subject of municipal essentiality may afford opportunities to make a highly secured transaction where others will pass, and to avoid a risky asset masquerading as a jewel. ■

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December is Membership Renewal Month

The Association for Governmental Leasing & Finance is about to close its fiscal year. We hope that you have found that membership in AGL&F this last year met your expectations and the benefits met and hopefully exceeded what you paid in dues. Your copy of the *Fifty State Survey* and the reduced registration fees for the Spring and Fall Conferences alone were worth the cost of your membership fee.

This month you will be receiving your membership renewal letter and invoice for 2001 dues. Renew by February 15th to ensure that you get included in the 2001 published version of the *AGL&F Membership Directory*. New this year is the ability to renew by credit card online. To renew online, go to the "Members Only" section of the AGL&F website.

2000 has been a busy year for AGL&F and your feedback indicates that you believe that your association is moving in the right direction and meeting your expectations for programs and services. The AGL&F Board of

Directors has already begun work on making 2001 an even better year. The Spring Conference will be an event not to be missed. The conference planning committee has gotten off to a early start and plans a meeting that will be a must attend for anyone interested in the future of municipal leasing.

Improvements in the website; a Fall Conference loaded with education, fun and networking; and new online surveys of leasing activity and member satisfaction are a few of the other things planned for this coming year. Renew your membership and be part of the association that represents the municipal tax-exempt leasing industry. While you are at it, look around and see who else in your organization would benefit from membership. Perhaps there is someone in the leasing industry that you know that is not a member. Encourage them to join.

We look forward to having each and every one of you as members in 2001. ■

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