

**LEGAL FOUNDATIONS OF
LEASE FINANCING IN CALIFORNIA**

CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

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INTRODUCTION

Lease financing by California municipalities has grown in popularity over the past several decades, and almost 9,000 lease financings have been reported in California between 1985 and 2021.¹ This may be due in part to lease financing, including lease revenue bonds and certificates of participation (COPs), being the only means by which many public agencies can borrow money without first obtaining voter approval and raising taxes. The California Constitution generally prohibits cities, counties, school districts, and community college districts from incurring indebtedness or liabilities that exceed the agency's income and revenue for the fiscal year without voter approval. California courts have recognized that lease financing transactions, when properly structured, fall within a specific exception to this Constitutional "debt limit."

Lease financing in California evolved mostly from a series of major court cases in the mid-20th century, in which the California Supreme Court recognized an exception from the debt limit for leases. This has become known as the "lease exception" to the debt limit, which has also been called the "Offner-Dean" exception after the foundational court cases governing the legality of leases in 1942 and 1950. Based on this legal precedent, the lease exception has served as the basis of lease financing for public agencies subject to the debt limit that repay borrowed funds through rental payments of a leased asset. The use of lease financing has continued to grow and mature over the past several decades, especially after limitations were placed on public revenues due to the passage of Proposition 13 in 1978.² While the original court rulings that defined the lease exception were issued several decades ago, the California Supreme Court reviewed

and upheld the use of the lease exception for municipal lease financing in 1998 in the *Rider v. City of San Diego* case.

Although the legal precedent for lease financing has been upheld – and expanded – by the courts, that legal precedent has laid down only a few general principles, leaving some room for varying applications and practices in public finance. This report examines the legal foundations of lease financing and maps important takeaways from those cases to the structuring of successful lease financings, including the following:

- Lease terminology and common lease structures
- The debt limit in the California Constitution
- The lease exception to the debt limit and foundational court cases
- Key takeaways from the legal precedent
- Critical features of lease financings
- Common challenges for lease financing

The general guidance shared in this report is not meant as a substitute for actual legal advice. The California Debt and Investment Advisory Commission (CDIAC) encourages municipalities to consult with a bond counsel experienced in California municipal lease finance for legal recommendations specific to their unique situation.

FOUNDATIONAL LEASE TERMINOLOGY AND COMMON LEASE STRUCTURES

In the context of the municipal market, a financing lease – as opposed to an operating lease,³ in which the lessee never owns the leased asset – acts as an important mechanism by which cities, counties, school districts, and community college

¹ Data reported to CDIAC by California municipal issuers, as of February 2, 2022.

² David Brodsky, Nikolai Sklaroff, Robert Tucker, Kathy McManus, et al., *Moody's on Leases: The Fundamentals of Credit Analysis for Lease Revenue Bonds and Certificates of Participation*, Moody's Investors Service, 3, Published 1995.

³ For more information about operating leases, refer to guidance from the [Financial Accounting Standards](#) Board.

districts may finance capital projects through their general fund and/or other legally available funds. Public agencies enter into municipal lease agreements and repay financed funds through rental payments of a leased asset over time. Lease financings often are used to construct or renovate public facilities, such as office buildings, correctional facilities, courthouses, and fire facilities.⁴ For public agencies subject to the debt limit, a municipal lease financing may be the only practical way to finance some projects because it uses a key exception crafted by the California Supreme Court to the debt limit in the California Constitution, and thus does not require voter approval.

Today, the most common lease structure used in municipal financing is known as a “lease-lease-back.”⁵ This type of transaction can be issued in the public securities markets either in the form of lease revenue bonds or as certificates of participation (COPs), both of which are common security structures for financing an acquisition of buildings or equipment.⁶ This report focuses on lease financings used to finance new capital projects; however, most of the concepts discussed here also apply more generally to lease financings that refinance previously issued obligations.

The typical lease financing to finance the construction of capital improvements involves a public agency and a finance entity – typically a joint powers agency (JPA) or non-profit corporation – acting as both the “lessee” and “lessor” for different steps of this lease transaction:

- A public agency undertakes a project where it intends to acquire, construct, improve, or rehabilitate an asset and chooses to finance the project with a lease transaction.

WHAT IS A FINANCING LEASE?

LEASE: A conveyance of property from one party to another for use and occupancy for a specified period of time in return for compensation made in the form of rental payments.

FINANCING LEASE: A method in which a lease is used as a vehicle to borrow money.

MUNICIPAL LEASE FINANCING: A financing lease that is used to borrow money through application of the lease exception to the debt limit in the State Constitution. The municipality leases property to a financing issuer and then leases that property back so that it can make rental payments that repay bonds or pay holders of certificates of participation.

LESSEE: An entity that leases an asset from another entity and pays rental payments for the right to use the asset. In the context of municipal lease financing, the typical lessee is a public agency, such as a city, county, or school district.

LESSOR: An entity that leases an asset to a lessee and collects rental payments from the lessee for use of the leased asset. The lessor issues and sells lease revenue bonds to investors and is responsible for repayment of the debt through amounts it receives as lease payments, or the lessor assigns its right to receive lease payments to a trust, with certificates of participation representing the right to receive portions of the lease payments sold to investors. In the context of lease revenue bonds and certificates of participation, the typical lessor is a financing entity such as a joint powers authority (JPA) or non-profit corporation that is also often created and/or controlled by the public agency that is acting as lessee for the lease transaction.

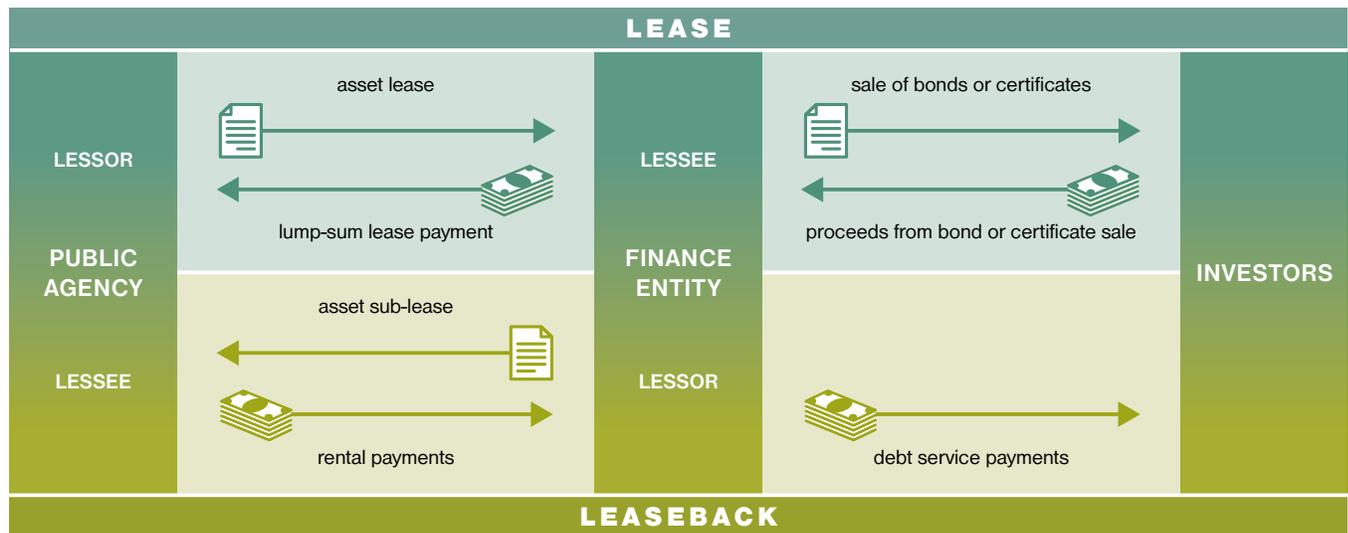
LEASED ASSET: In the context of municipal lease financing, leased assets are typically facilities or properties for which the right to use and occupy such facilities or properties is transferred from a lessor to a lessee.

⁴ “California Bonds 101: A Citizen’s Guide to State Revenue Bonds,” *California State Treasurer’s Office*, 2, Published 2017, Accessed February 2, 2022, www.treasurer.ca.gov/publications/bonds101_revenue.pdf.

⁵ California Debt and Investment Advisory Commission, *California Debt Financing Guide*, 3-7, (Sacramento: 2019), Accessed February 2, 2022, www.treasurer.ca.gov/cdiac/debtpubs/financing-guide.pdf.

⁶ Brodsky, Sklaroff, Tucker, McManus, et al., *Moody’s on Leases: The Fundamentals of Credit Analysis for Lease Revenue Bonds and Certificates of Participation*, 3.

Figure 1



- In the lease transaction, the public agency identifies an asset it owns, such as a facility or other valuable asset that can be leased. The agency must have ownership of the asset without any material legal encumbrances, such as liens, easements, etc. that may affect the right to use and occupy the facility. The leased asset does not, however, need to be the asset that the agency intends to improve with the proceeds of the financing. In this case, the lease financing is known as an “asset transfer,” where one asset is leased in the transaction while a different asset is constructed or acquired.
- The public agency leases that facility to a finance entity, and the finance entity simultaneously leases the facility back to the public agency through a sublease (see Figure 1). Although the right to use and occupy the leased asset is technically transferred to the finance entity acting as lessor in the transaction, because the lease and leaseback occur simultaneously, use and occupancy of the leased asset is always maintained by the public agency lessee.
- The finance entity issues lease revenue bonds, or in the case of COPs, the certificates are sold to

investors and executed and delivered by a trustee. The funds from the sale of the bonds or COPs are then transferred to the public agency lessee (or to a trustee that acts as its agent) in a lump sum payment, which the agency uses to pay for its capital project. This transfer acts as compensation for the initial lease of the asset to the finance entity in the lease-leaseback arrangement.

- The public agency pays scheduled rental payments under the sublease that are sufficient to pay the annual debt service on the lease revenue bonds or COPs.

“Local governments have taken advantage of this principle to enter into lease-purchase agreements without obtaining the approval of two-thirds of the electorate, and we have upheld these arrangements.”⁷

Rider v. City of San Diego (1998)

⁷ Rider v. City of San Diego, 18 Cal. 4th 1035 (1998)

- After the lease revenue bonds or COPs are retired, the lease agreement terminates, and the public agency’s pre-transaction ownership rights are restored.

The “Lease Construction”

This financing structure is considered by many to be a synthetic “lease construction,” because the lease is – in the words used in the *Rider* case – a “financing mechanism”⁸ that the public agency can use to effectively borrow funds without being subject to the debt limit in the California Constitution. By leasing the facility to a finance entity only to lease the facility back to itself, the public agency’s use and occupancy of the facility does not change. However, from a legal perspective, the public agency pays rental payments to the finance entity that are used to repay the lease revenue bonds or COPs. Public agencies use this type of transaction because California courts recognize leases as an exception to the debt limit, which allows the public agency to borrow for capital projects without the borrowing being labeled as “debt issuance” subject to the debt limit, which would require voter approval to increase indebtedness and taxes.

CALIFORNIA “DEBT LIMIT” IN STATE CONSTITUTION

Section 18 of Article XVI of the California Constitution (or what is referred to in California public finance as the “debt limit”) states that no city, county, or school district may “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 voters of the public entity voting at an election to be held for that purpose.”¹⁰ In other words, none of these public agencies may incur charges that require revenues

“We are not naive about the character of this transaction. If the City had issued bonds to pay for the Convention Center expansion, the two-thirds vote requirement would have applied. Here, the City and the Port District have created a financing mechanism that matches as closely as possible (in practical effect, if not in form) a City-financed project, but avoids the two-thirds vote requirement. Nevertheless, the law permits what the City and the Port District have done. Plaintiffs are correct that this conclusion allows local governments to burden taxpayers with potentially high costs that voters have not approved, but local governments impose similar burdens on taxpayers every time they enter into long-term leases involving property of substantial value. We have long held that the two-thirds vote requirement does not apply to these leases so long as the obligation to pay rent is contingent on continued use of the leased property.”⁹

Rider v. City of San Diego (1998)

⁸ Ibid.

⁹ Ibid.

¹⁰ California Const. art. XVI, § 18, https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=CONS§ionNum=SEC.%2018.&article=XVI.

from a future fiscal year without two-thirds voter approval.¹¹ The State of California is subject to a similar limit specified in Article XVI of Section 1 of the California Constitution, while special districts and JPAs are not subject to the debt limit.¹²

Based on Section 18 of Article XVI, one would think that the debt limit would prohibit cities, counties, and school districts from issuing any long-term bonds or other forms of debt without voter approval. But the actual and substantive impact of the debt limit is determined through the

CALIFORNIA'S UNIQUE LEGAL CONTEXT

Although most state constitutions contain limitations on the issuance of debt, the debt limit in the California Constitution is one of the most restrictive in the country,¹³ requiring general obligation bond authority for many public agencies to be approved by two-thirds of voters.¹⁴ These stringent restrictions have, in part, led to the increased prevalence of lease financing in the state. CDIAC's understanding is that the lease revenue bond structure is predominantly used in California because of the unique legal context in the state that facilitates the use of lease financing for capital projects without the public agency being subject to the debt limit.

legal interpretation of court cases that have applied the debt limit to actual transactions. Court cases have fashioned several key exceptions to the debt limit, such as a special revenue exception (where the debt is not an obligation of the general fund secured by taxes and other requirements are met), an exception for obligations imposed on the public agency (such as judgments), and cases that have not applied the debt limit to employee compensation as well as the lease exception. In the case of municipal lease transactions, the lease exception is used by public agencies to incur obligations that allow the agency to finance capital projects without being subject to the debt limit in the California Constitution. Public agencies in California have increasingly used the lease exception to serve as the basis of their debt financings, especially since the passage and adoption of Proposition 13 in 1978.

THE LEASE ("OFFNER-DEAN") EXCEPTION TO THE DEBT LIMIT AND FOUNDATIONAL COURT CASES

What is now known as the lease exception to the debt limit (also known as the "Offner-Dean" exception) derives mostly from two separate California Supreme Court decisions, which determined that in cases where a lease involves rental payments that do not exceed the fair rental value for an asset and "each year's payment is for the consideration actually furnished that year," the lease does not violate the debt limit.¹⁵ The *Offner* and *Dean* court cases were regarding leases and do not explicitly

¹¹ Since the passage of Proposition 39 in 2000, school and community college districts have had the option to obtain authority to issue general obligation bonds with approval from 55% of voters. General obligation authority obtained through Proposition 39 also comes with other requirements, including additional transparency about the project being financed, citizen oversight, etc. For more information about the differences issuing general obligation debt through Proposition 39, refer to CDIAC's report "[K-14 Voter Approved General Obligation Bonds: Authorized but Unissued – 2022 Update](#)."

¹² CDIAC, *California Debt Financing Guide*, 1-5.

¹³ Brodsky, Sklaroff, Tucker, McManus, et al., *Moody's on Leases: The Fundamentals of Credit Analysis for Lease Revenue Bonds and Certificates of Participation*, 3.

¹⁴ Since the passage of Proposition 39 in 2000, school and community college districts have had the option to obtain authority to issue general obligation bonds with approval from 55% of voters with some additional requirements. For more information about the differences issuing general obligation debt through Proposition 39, refer to CDIAC's report "[K-14 Voter Approved General Obligation Bonds: Authorized but Unissued – 2022 Update](#)."

¹⁵ *City of Los Angeles v. Offner* 19 Cal. 2d 483 (1942); *Dean v. Kuchel* 35 Cal. 2d 444 (1950).

deal with lease financings; however, the *Offner* and *Dean* cases form the core precedent used to evaluate any lease of a public agency that secures a lease financing. These cases both built off of precedent set in the *McBean v. City of Fresno* case, which clarified that charges for services do not fall under the definition of public “debt.”

In 1998, several decades after the *Offner* and *Dean* cases, the ruling in *Rider v. City of San Diego* explicitly addressed lease financings and whether the lease exception embraced in *Offner* and *Dean* extended to lease financings (where the sole purpose of the lease arrangement is to borrow funds). *Rider* clarified the validity of lease financings by public agencies without first obtaining voter approval.

McBean v. City of Fresno

In the *McBean* case, a five-year sewer disposal contract that the City of Fresno had entered into was challenged on the basis that it had not

first been approved by voters.¹⁶ The California Supreme Court found that the contract was valid and that the City of Fresno could enter into the long-term contract without violating the limitations on indebtedness in the State Constitution. The rationale behind the decision was that the court distinguished between “debt” issued by a municipality and contracts where the payment is contingent on the receipt of a service or other benefit. This precedent, defining what constituted a “debt,” was applied and expanded upon in the later *Offner*, *Dean*, and *Rider* decisions.

City of Los Angeles v. Offner

In the *Offner* case, a lease contract between the City of Los Angeles and one of its contractors was challenged. The arrangement was for the City to lease land to the contractor for ten years at a negligible price, and the contractor would in turn construct an incinerator for the City.¹⁸ In a separate lease agreement, the contractor leased the completed incinerator to the City while holding the official ownership of the incinerator for the same period of time.¹⁹ At various times during the lease, the City had the option – but not the obligation – to purchase the incinerator for its then-appraised value. The court ruled that the arrangement did not constitute debt and was not subject to the debt limit for public agencies specified in the California Constitution for several reasons: the lease payments were for rent for the use of the incinerator, the rental payments did not exceed its fair rental value, the City was not obligated to purchase the incinerator, and, if purchased, the cost of the incinerator would not exceed its value. Overall, the court found that the arrangement did not violate the California Con-

“We base our views upon the conviction that, at the time of entering into the contract, no debt or liability is created for the aggregate amount of the installments to be paid under the contract, but that the sole debt or liability created is that which arises from year to year in separate amounts as the work is performed.”¹⁷

McBean v. City of Fresno (1896)

¹⁶ *McBean v. City of Fresno*, 112 Cal. 159 (Cal. 1896)

¹⁷ *Ibid.*

¹⁸ Robin Harris, “California Constitutional Debt Limits and Municipal Lease Financing,” *Richards, Watson & Gershon*, 4, Published 2002, Accessed January 27, 2022, www.cacities.org/UploadedFiles/LeagueInternet/08/08d8e6e0-6fb6-48b0-9b36-9f3dfaf6e3b4.pdf.

¹⁹ Harris, “California Constitutional Debt Limits and Municipal Lease Financing,” *Richards, Watson & Gershon*, 4.

“[T]he petition alleges that while the aggregate of the rentals that might accrue under the lease, together with other municipal debts and liabilities incurred during the fiscal year when the leases and contract will be entered into, will exceed the income and revenue for that year, the amount of rentals that the city may be required to pay in any single fiscal year, together with its other debts and liabilities, will not exceed the income and revenue provided for such year.”²¹

City of Los Angeles v. Offner (1942)

“We find no logical distinction between the Offner case and the one at bar. It is true that there was an option to purchase in the former rather than a vesting of title at the end of the term in the instant case, but as far as liability is concerned, the state under the instrument here is in a better position, for it gets title without the payment of anything other than the rental.”²⁴

Dean v. Kuchel (1950)

stitution because each year’s rent was in consideration for value provided to the City in that year.²⁰

Dean v. Kuchel

In the *Dean* case, another lease arrangement was challenged, this time involving the State of California, which is subject to a similar limitation on issuing debt without voter approval. The challenged contract had a similar structure as in the *Offner* case, but with one important difference: official ownership and title of the assets in the lease agreement were transferred to the State after the end of the lease period.²² The court ruled that the conditions in the challenged lease agreement were still valid and were not subject to the debt limit, as was the case in *Offner*. As the court stated, “the rentals also must be paid but the state need not pay any more.”²³ Since the *Dean* case, the lease exception to the debt limit – referred to now by many as the Offner-Dean exception – has been applied to lease financing transactions in California.

Rider v. City of San Diego

In the *Rider* case, the City of San Diego and the San Diego Unified Port District created a JPA to act as lessor in a lease financing to expand the San Diego Convention Center.²⁵ The court ruled that the JPA was a separate legal entity from the city that could legally enter into a lease agreement with the City, and that the financing was not subject to the debt limit requiring two-thirds voter approval.²⁶ In short, the court held that as long as the lease satisfied the elements set forth in the Offner-Dean exception, the mere fact that the lease

²⁰ Ibid.

²¹ *City of Los Angeles v. Offner*, 19 Cal.2d 483 (1942)

²² Harris, “California Constitutional Debt Limits and Municipal Lease Financing,” *Richards, Watson & Gershon*, 4.

²³ *Dean v. Kuchel*, 35 Cal. 2d 444 (1950)

²⁴ Ibid.

²⁵ *Rider v. City of San Diego*, 18 Cal. 4th 1035 (1998)

²⁶ Ibid.

“In this case, we consider the validity of a financing plan under which a joint powers agency will issue bonds, use the bond proceeds to construct a capital improvement, and lease that improvement to a city. We conclude that the voter approval requirements that would apply if the city issued the bonds do not, by their terms, apply to the debts of a joint powers agency, and the city’s obligation to make rent payments to the joint powers agency does not itself constitute a debt requiring voter approval.”²⁷

Rider v. City of San Diego (1998)

“[T]he agreement would have satisfied the Constitution so long as liability for each installment of the purchase price was contingent on receipt of some additional, contemporaneous consideration, such as the buyer’s ongoing ‘use and occupancy of the ... building’”²⁹

Rider v. City of San Diego (1998)

was used as a part of the financing did not affect its treatment under the debt limit. *Rider* was helpful to the development of municipal lease financing because both the *Offner* and *Dean* cases were decided based on actual leases and not lease-based financing transactions. After *Rider*, the court clarified that the lease exception espoused by *Offner* and *Dean* could be used to further a lease financing – including asset transfers – even though it was essentially a legal fiction used merely to borrow money without being subject to the debt limit.

KEY TAKEAWAYS FROM LEGAL PRECEDENT

The legal precedent set by these court cases have framed several fundamental takeaways about how to successfully apply the lease exception to lease financing transactions in the municipal market. According to judgments in these cases, all lease financings that intend to qualify for the lease exception to the debt limit must satisfy multiple criteria:

1. The rental obligation under the lease agreement must be contingent upon “beneficial use and occupancy of the leased premises”²⁸ over the period covered by the lease.

A leaseback agreement must be clear that no rent is due at any time when and to the extent that the public agency does not have use and occupancy of the leased facility. This is often referred to as the “abatement” of rental payments for the public agency lessee. This includes cases of physical damage to the leased asset that prevent use and occupancy by the lessee, eminent domain, and any other event that physically or legally interferes with the ability of the public agency to use and occupy the facility.

²⁷ Ibid.

²⁸ CDIAC, *California Debt Financing Guide*, 1-8.

²⁹ *Rider v. City of San Diego*, 18 Cal. 4th 1035 (1998)

“It has been held generally in the numerous cases that have come before this court involving leases and agreements containing options to purchase that if the lease or other agreement is entered into in good faith and creates no immediate indebtedness for the aggregate installments therein provided for but, on the contrary, confines liability to each installment as it falls due and each year’s payment is for the consideration actually furnished that year, no violence is done to the constitutional provision.”³⁰

City of Los Angeles v. Offner (1942)

“The rental payments are intended to represent the fair rental value of the incinerator and the option purchase price is intended to represent the then fair value of the incinerator itself. The city after learning the appraised value may decline to purchase under the option and continue with the lease.”³¹

City of Los Angeles v. Offner (1942)

2. All installments of rent that come due in any year must be in exchange for use and occupancy of the leased facility in that fiscal year.

One of the key elements in the *Offner* and *Dean* cases is that the courts evaluated each year’s installment and ensured that it was not a rental obligation that could all become due at once regardless of use and occupancy. Accordingly, leases cannot accelerate rent, even in cases where the public agency has failed to pay rent when due or has otherwise defaulted under the lease.

3. Rental payments cannot exceed the fair rental value of the leased facility in any year.

While the court does not provide details about how fair rental value is determined, the court is clear that rental payments cannot exceed the fair rental value of the leased facility. It is not sufficient for the average rental payment over the duration of the lease to not exceed the fair rental value. Given that the debt limit itself prohibits the incurrence of obligations outside of a fiscal year, the fair value of rent (while evaluated at the time of entering the lease) is evaluated independently for each fiscal year.

4. The lease cannot be a subterfuge for some larger obligation.

Although lease financings are constructed in a way that allows agencies to borrow money notwithstanding the debt limit, the financial obligation of the public agency in that fiscal year needs to be confined to rent in exchange for use and occupancy during that fiscal year. This serves as a constraint on the lessee’s obligations. Most payment obligations besides rent, such as the requirements for insurance, maintenance, and trustee fees, are construed as “additional rent.” Language from the

³⁰ *City of Los Angeles v. Offner*, 19 Cal.2d 483 (1942)

³¹ *Ibid.*

“If, however, the instrument creates a full and complete liability upon its execution, or if its designation as a “lease” is a subterfuge and it is actually a conditional sales contract in which the “rentals” are installment payments on the purchase price for the aggregate of which an immediate and present indebtedness or liability exceeding the constitutional limitation arises against the public entity, the contract is void.”³²

City of Los Angeles v. Offner (1942)

court cases suggests that provisions that stray outside of “rent” are problematic. For example, any provision that assigns casualty risks for the asset to the public agency can be problematic and may potentially threaten the validity and enforceability of the lease financing. For example, in the *Offner* case, the determination of the court’s discussion was that, although the option to purchase the underlying leased asset did not cause the lease to violate the debt limit, the determination would have been different if the option had only been structured in a way meant to circumvent the debt limit while also maintaining responsibility for risk to the asset.

CRITICAL FEATURES OF LEASE FINANCING

These takeaways from the legal precedent for lease financing form the basis for fundamental characteristics of the content and structure of

municipal lease agreements in California. In order to be deemed exempt from the debt limit in California, the lease must satisfy the aforementioned criteria for the lease exception established through the Offner-Dean line of cases.³³ Because of this, the transaction documents for lease financings in the state have developed a set of common provisions to address these criteria, which include provisions addressing abatement, fair rental value, contract enforcement, and insurance, among others. Below is a more detailed description of those provisions.

Abatement

Once the public agency lessee begins beneficial use and occupancy of the facility, the lessee is expected to pay rental payments for the leased asset through the term of the lease agreement, as long as the municipality maintains use and occupancy of the asset. In typical lease financings in California, there is a specific provision that abates rental payments during any time that, and to the extent that, use and occupancy of the leased asset is not available to the public agency.

LEGAL VS. PRACTICAL ABATEMENT RISK. The use of the abatement provision is a real, substantive

“The City is required to pay each year only for its use of the Convention Center during that year; the City’s obligation to pay rent abates if, for any reason, it loses use of the property...”³⁴

Rider v. City of San Diego (1998)

³² Ibid.

³³ Use of the special fund and annual appropriation exceptions to the debt limit are also possible for some deals, but they are much less commonly used in California than in other states, in part because they represent less risk to investors. See section 1.2.4 of the [CDIAC Debt Guide](#) for more information about all the different exceptions to the debt limit specified in the California Constitution.

³⁴ *Rider v. City of San Diego*, 18 Cal. 4th 1035 (1998)

risk to investors; however, the actual risk of abatement resulting in nonpayment of debt service is thought to be relatively rare and is not generally considered to be as significant in practice. Abatement risk stems from the legal requirement that the public agency cannot be forced to pay rental payments in the case of a loss of use and occupancy of a leased asset; however, the public agency is not precluded from making rental payments in the case of an abatement event. Actual abatement risk stems from multiple considerations, including the likelihood of an abatement event for the leased asset (including casualty risk, etc.), and whether the public agency would decide not to exercise its right to abatement and continue rental payments in the case of an abatement event. Abatement risk is also

ABATEMENT LEASES COMPARED TO APPROPRIATION LEASES

Lease financing in California relies on legal precedent that centers around the condition of abatement in the case of loss of use and occupancy of the leased asset. In most other states, debt limitations are avoided using a clause in the lease where the obligations of a public agency are subject to annual appropriation, which makes the lease subject to renewal or termination during the annual budgeting process for the agency. In these cases, the lease financing consists of independent contracts for each fiscal year that can be extended into future years over the term of the lease. This contrasts with the abatement-based method used in California, where the lease agreement can span the full term of the lease without being considered “indebtedness” under the State Constitution as long as the other fundamental lease criteria hold.

further mitigated when the leased asset is considered to be critical to a public agency’s operations – often referred to as an “essential” asset – because essential assets are expected to be restored quickly and voluntarily by the agency in the event of loss of use and occupancy.

Fair Rental Value

Rental payments of no more than the fair rental value of the leased property is one of the cornerstones of the legal precedent of lease financings in the municipal market, which was set directly in the ruling of the *Offner* case in 1942 and marked the origin of the lease exception to the debt limit.

CALCULATIONS OF FAIR RENTAL VALUE. There are a variety of methods for determining the “fair rental value” of a leased asset. In the commercial rental markets, it is common to assess the fair rental value of an asset by comparing the rental costs of similar assets. However, that approach is not usually practical for municipal assets, because there are few – if any – comparable assets. Partly due to this lack of comparable assets, the municipal market has adopted a practice of using the full value of the leased asset as the basis for determining the fair rental value of the asset for the purposes of the lease agreement. For example, public agencies frequently use the replacement cost of those facilities — the value against which fire and other property insurance is written — to evaluate the underlying value of the asset. To determine the replacement cost, public agencies can use the construction cost for newer facilities. For an existing asset, public agencies frequently use either internal or external appraisals or insured values to determine the replacement cost of the facility, often while considering and accounting for the depreciation of the asset. When converting to an annual fair rental value, it is also important to confirm that the rent paid in any year represents a reasonable percentage of the value of the asset.³⁵

³⁵ CDIAC, *California Debt Financing Guide*, 3-46.

IMPLICATIONS OF FAIR RENTAL VALUE REQUIREMENTS. In order to meet the fair rental value condition for rental payments, a lease financing needs to be structured to have either a fixed interest rate or one that is capped. Without a cap, rental payments for a lease transaction with a variable interest rate could potentially increase above the fair rental value threshold for the leased asset if interest rates rise and become too high. This is because the rental payments for the lease financing must be large enough to pay the debt service – including the interest payments – for the lease financing, but also remain no greater than the fair rental value for the asset.

In addition, the fair rental value condition has also come up for municipalities interested in either paying more of the borrowed funds at the beginning or end of the contract period. This practice of “front-loading” or “back-loading” payments can be done in other types of debt transactions (and can even be fiscally prudent in some cases); however, doing so in a lease financing may threaten the prerequisite that the municipality does not pay more than the fair rental value for the leased property in any given year. If repayment of borrowed funds in a lease financing requires the municipality to pay more than the fair rental value of an asset in any given year, the lease agreement is not consistent with the lease exception to the debt limit, and the lease may be unenforceable.

Another implication of the fair rental value requirement is that the repayment period must be long enough to ensure that the municipality never pays more than the fair rental value in any given fiscal period. Lease periods that are too short may make it more difficult to pay back all of the borrowed funds while also keeping rental payments below the fair rental value of the leased asset.

Appropriate Enforcement Provisions

Enforcement provisions in a financing contract outline the remedies available to investors in the event of a default, including nonpayment of rental payments. Some typical enforcement provisions in bond financings are notably inappropriate – if not clearly unenforceable – in lease financings that rely upon the lease exception to the debt limit. Furthermore, the lessee’s failure to pay rent during any abatement period is not a default, and therefore not subject to remedies.

NON-ACCELERATION OF RENTAL PAYMENTS. Acceleration of rental payments for future years in a lease requires a pre-payment of rent,³⁶ which runs afoul of the conditions for lease financings determined in California legal precedent. For this reason, rental payments cannot be accelerated in legally valid lease financings.

In the private sector, acceleration of payments is sometimes requested by lenders in borrowing arrangements when a borrower is in default under the terms of the borrowing, such as a failure to make payments. In a California municipal lease financing transaction, however, acceleration of rental payments violates the fundamental criteria to qualify for the lease exception.³⁷ California leases with abatement clauses require the rental obligation of the municipality to be for the use

“[T]he Financing Authority has waived any right to accelerated payment of rent in the event of breach...”³⁸

Rider v. City of San Diego (1998)

³⁶ CDIAC, *California Debt Financing Guide*, 3-47.

³⁷ “An Introduction to Municipal Lease Financing: Answers to Frequently Asked Questions,” *Association for Governmental Leasing and Finance*, 23.

³⁸ *Rider v. City of San Diego*, 18 Cal. 4th 1035 (1998)

and occupancy of the leased property in each of the fiscal years in the rental period,³⁹ and changing that for any reason – even due to a failure to make payments – renders the lease potentially invalid. Due to these required stipulations, it should be explicit in the lease agreement that there can be no acceleration of rental payments under any circumstances.

RIGHT TO RE-LET. A “right to re-let” is where a lessor reserves the right to revoke occupancy of the property to the lessee if the lessee defaults under the lease (such as in cases of nonpayment), so that the lessor can use or lease the building to another party. “Right to re-let” provisions are typical in lease deals in the private sector in residential and commercial real estate. However, for lease financings with a public agency lessee, a provision stipulating a right to re-let may be impractical, might not provide investors with much additional security in cases of nonpayment, and could result in the public agency losing use and occupancy of essential public assets. For example, if a county subleases a jail in a municipal lease and then defaults on rental payments, the right to re-let provision could technically allow investors to obtain use and occupancy of the jail. However, revoking use and occupancy of the jail by the county in this example may be highly impractical and is likely to be very costly without adequately restoring the lost initial investment. Furthermore, if somehow this remedy were enforced, it could create a considerable hardship on the public agency. In addition, given the significant adverse impact on the general welfare of the public, there are some questions as to whether a court would actually enforce this remedy with essential public assets like jails.

While a right to re-let in cases of nonpayment may seem like an impractical remedy in public sector situations, leases still regularly include such a provision. That said, there have been cases where lease financings have been brought to mar-

ket without a right to re-let provision, and those transactions did not seem to experience a negative impact on ratings or pricing for the lease financing. In cases where a right to re-let provision is not required and there are no negative financial consequences to omitting the provision, it may be in a public agency’s best interest to not include a right to re-let provision in the lease agreement.

Where a right to re-let provision is not included in a lease, the investors’ sole remedy would be to bring a lawsuit for failure to pay rent for the leased asset. This remedy can also be complicated, however, as investors need to sue for annual rent due at the time of the legal action, and investors cannot sue for rental payments due in future years where the public agency’s use and occupancy of the leased asset has yet to be established. This can result in multiple court actions to seek unpaid rent as the annual payment becomes due.

DISTINCT SEPARATION FROM THE PUBLIC AGENCY. The Court’s ruling in the *Rider* case⁴⁰ makes it clear that the finance entity lessor is technically – and legally – responsible for the issuance and ultimate repayment of debt incurred through a lease financing. The public agency lessee is only responsible for the rental payments that the lessor uses to pay debt service for the financing obligation. This relationship needs to be reflected in the lease agreement to stay consistent with the legal requirements for the lease exception for the debt limit, including in provisions that outline enforcement remedies in cases of nonpayment. If, for example, a lease agreement states that the public agency will replenish the reserve fund for the financing entity if/when needed, the public agency is essentially guaranteeing a debt, which therefore may render the financing subject to the debt limit. The public agency cannot assume any undue financial responsibility from the finance issuer in the lease agreement or corresponding bond transaction if the intention is to qualify for the lease exception.

³⁹ Ibid.

⁴⁰ *Rider v. City of San Diego*, 18 Cal. 4th 1035 (1998)

“Plaintiffs once again urge us to look at the substance of the transaction at issue here, not its form. They argue that, in substance, the City is issuing the bonds and the City will make payments on the bonds. We agree that the City and the Port District are the motivating forces behind the transaction here, but we do not agree that in substance the City is issuing the bonds. Here, as in many complex financial transactions, the form of the transaction is critical. In both form and substance, the Financing Authority is issuing the bonds, and the City is paying rent. As we discussed in detail above, the City’s obligation to pay rent is not an immediate liability for the aggregate of all rent payments, and it does not cause the Financing Authority’s debt to become the City’s debt.”⁴¹

Rider v. City of San Diego (1998)

ASSUMPTION OF CASUALTY RISK. Investors wary of abatement risk might be tempted to include a provision in the lease agreement that provides that the public agency lessee assumes risk of the asset in case of physical damage or destruction. However, the ruling in the *Offner* case suggests that the lessee has no rental obligations if it cannot use and occupy the facility. An obligation for the public agency to rebuild a facility in which it has lost use and occupancy may undermine this core principle. Leases should therefore avoid hav-

ing covenants on the part of the public agency to rebuild the lease facility in the event of damage or destruction. This casualty risk to investors is mitigated by insurance coverage, which is a common requirement of leases in both the municipal and private sectors.

Insurance Provisions

Because a public agency’s rental payments are abated during any period that it does not have use and occupancy of the facility, sufficient insurance coverage throughout the term of the lease to address potential abatement circumstances are common provisions in lease financings. This includes insurance requirements to obtain casualty insurance that cover physical damage (i.e. fire and flood insurance) as well as rental interruption insurance.⁴² Rental interruption insurance is especially important to investors for lease financings due to the inability to compel rental payments for any period in which the lessee does not have use and occupancy of the asset. For example, in cases where a leased asset is damaged in a natural disaster covered by insurance, insurance coverage may pay for the repairs of the facility itself, but the public agency cannot be obligated to pay rental payments while it does not have use and occupancy of the facility because of the physical damage. Rental interruption insurance pays the rental payments for the leased asset (which pays for debt service) until the physical condition of the leased asset is restored and the public agency is once again able to use and occupy the property or facility. Some lease financings also require earthquake insurance; however, insurance coverage for seismic events is typically written in lease provisions to only be required if such insurance is available at a reasonable cost. As a practical matter therefore, insurance for damage from earthquakes is not required – and not obtained – in most

⁴¹ Ibid.

⁴² “An Introduction to Municipal Lease Financing: Answers to Frequently Asked Questions,” *Association for Governmental Leasing and Finance*, 20.

cases, because earthquake insurance may not be available to the public agency at a commercially reasonable cost. In many instances, the legal documents may permit casualty insurance to be provided on a self-insurance basis, although requirements for rental interruption insurance, which is typically a rider to a casualty policy, can make such self-insurance impractical.

Important General Considerations

In addition to requirements and provisions that are more specific to lease financings, there are some other, more general requirements that are important to consider when structuring lease agreements, including the ownership of the leased asset, disclosure, and tax exemption.

OWNERSHIP OF THE LEASED ASSET. At its most basic level, the public agency needs to have ownership of the leased asset free of any material encumbrances, such as (but not limited to) liens or easements that could reasonably be expected to impair the fair rental value of the asset. The leased asset also needs to be one that is leasable, such as land and/or property.⁴³ This includes a large range of possible assets that can be leased by a municipality, including schools, libraries, city halls, office buildings, police and fire stations, and many other possible facilities. This may not apply to public thoroughfares where ownership is not held exclusively by the public agency.⁴⁴ There is an ongoing debate in the municipal market legal community regarding whether property such as streets can be used as a leased asset in a lease financing.

TAX-EXEMPT STATUS. All tax-exempt municipal bond obligations, including tax-exempt lease revenue bonds and COPs, are subject to federal regulations governing the tax status of the inter-

est payments on the obligation. The tax-exempt status of an obligation can be revoked if specific criteria are not met, including limits on leasing or use by a private entity. Although the criteria for tax exemption is not particular to lease financing, some requirements for tax exemption may be especially relevant, including limitations on private use of the financed facility. For example, leasing the ground floor of a public building to a private business or federal government entity could threaten tax-exempt status for the lease financing. In addition, when the public agency is planning a tax-exempt lease obligation, federal security regulations require the lease to be considered as a “debt” under federal tax rules that require separately calculated interest charges to be explicitly set forth in the documents.⁴⁵ More information about requirements and regulations for tax-exempt municipal obligations can be found in Section i.4.5 in the [CDIAC Debt Financing Guide](#).

DISCLOSURE OBLIGATIONS. Although broader legal precedent governing securities is outside the scope of this issue brief, it is important to note that issuers of lease revenue bonds and COPs need to include material concerns related to their leased assets in their disclosure documents.⁴⁶ This includes any problem that could threaten use and occupancy and potentially lead to an abatement event. For example, if a leased asset is more susceptible to a casualty event (e.g., located in a high-risk wildfire area or high-risk flood area), then that may be important context to disclose to investors so that they are able to make an informed investment decision about a potentially heightened abatement risk.

Some additional concerns that may merit additional disclosure include any concerns with the integrity of the asset, such as a building built before modern seismic standards, a building with

⁴³ CDIAC, *California Debt Financing Guide*, 3-45.

⁴⁴ CDIAC, *California Debt Financing Guide*, 3-45.

⁴⁵ CDIAC, *California Debt Financing Guide*, 3-48.

⁴⁶ CDIAC, *California Debt Financing Guide*, 3-48.

significant deferred maintenance, etc. In the case of technology or equipment, a risk of the leased asset becoming obsolete and shortening the useful life of the asset is an issue that could be considered material and merit additional disclosure. More information about disclosure and federal anti-fraud requirements for municipal securities can be found in Chapter 6 of the [CDIAC Debt Financing Guide](#).

COMMON CHALLENGES IN LEASE FINANCING

Some common challenges that issuers have had difficulty navigating when crafting lease financings include selecting the leased asset, substitutability of assets, direct financing of new construction, addressing legal uncertainties, and fiscal accounting of lease financings. These common challenges are discussed in more detail below to provide additional clarity about these topics.

Selecting the Leased Asset

Selecting the leased asset is one of the first and most important steps when constructing a lease financing. Besides implications for marketability and pricing of the financing obligation, asset selection has significant implications on the legal soundness of the lease agreement and the use of the asset by the public agency.

ASSET VALUE. The value of the leased asset is fundamentally important in determining the amount of funds that can be raised and the annual cost for a lease financing. The value of the leased asset will lead to an upper bound, or “ceiling,” on the amount raised by the lease financing based on the underlying value of the asset, because the fair rental value will be derived from the value of the leased asset.

OVERCOLLATERALIZATION. It may be possible for an asset to have much more value for the proposed lease financing, which is sometimes referred to as “overcollateralization.” Overcollateralization might concern some financing teams, because

where the value of the leased asset is far in excess of what is necessary to support the rental payments, it can call into question whether the transaction appears as a commercially reasonable lease. If that is the case, the lease may be unenforceable, especially in a case where the lease contains a provision with a right to re-let the leased asset.

The most certain consequence of overcollateralization is that the public agency will have an inefficient amount of value locked in one transaction and have fewer options for leasable assets that can be used for other future lease financings. That said, this latter issue can be mitigated simply by using a multiple bond indenture, which allows the leased asset to be used in future lease financings. In some instances, public agencies have mitigated this issue by maintaining a master lease structure where the lease revenue bond program uses one lease that pools all available assets so that the public agency can maximize the full value of available assets.

USE OF EQUIPMENT. Some public agencies choose to lease equipment instead of real property. In addition to the other requirements for lease financings, equipment-based lease financings are more likely to need to address “useful life” considerations so that the leased assets are not leased beyond the time when the equipment has become commercially obsolete or violate limits under federal tax regulations related to the final maturity of the lease financing. Although useful life considerations are important in all lease financings, the use of equipment as the leased asset makes this even more important given shorter expected lifespans for equipment than facilities, for example. In addition, lease financings using equipment as the leased asset might also need to address other questions unique to equipment, such as theft or loss of the equipment.

Substitution

It is common for public agencies to build in additional flexibility in leases by including leased asset substitution provisions in the lease agreement,

which provide the option to substitute different assets for the original leased asset in the future. Public agencies have used these provisions for a variety of reasons, including freeing up asset value in circumstances where the leased asset has appreciated in value and the public agency has other assets that can support the necessary fair rental value of the leased asset.

New Construction – When a Public Agency Uses New Construction as the Leased Asset

Some agencies use the project being constructed with the proceeds of a lease financing as the leased asset securing the financing, as opposed to the now more-common practice of using an existing asset. This may be an issuer's only option if it simply does not have unencumbered assets with sufficient value to support the financing. The primary challenge with using lease financings for new construction (where the asset to be constructed is the leased asset) is that the public agency cannot become obligated to pay rent until construction is complete and the lessee has beneficial use and occupancy of the facility. This in turn means that if construction is delayed or if casualty events occur during construction, the agency does not have beneficial use and occupancy of the leased asset, and rental payments may be unavailable to pay debt service on the financing.

CAPITALIZED INTEREST. When public agencies use new construction as the sole leased asset and will not have use and occupancy of the asset until the project is completed, the public agency may borrow additional funds to capitalize interest from the proceeds of the lease financing so that the public agency has resources dedicated to pay interest during the period that it is not obligated to pay rent under the lease. Typically, the interest will be capitalized for a period beyond the construction period to provide some additional time to address the risk of construction delay and/or other delays that may occur between construction completion and the lessee obtaining use and

occupancy of the constructed asset. Capitalized interest increases the borrowing cost of a lease financing, which is why many public agencies use existing facilities as the leased asset in an asset transfer to avoid that additional cost. Since the public agency has use and occupancy of its existing facilities, there is no risk to investors if construction of the new facility is not completed and the public agency can pay rent under the lease when the lease financing is completed. It is worth noting that there are also potential advantages to capitalizing interest in some cases. For example, from a budget perspective, not capitalizing interest means that the debt service will affect the budget of the public agency sooner.

ADDITIONAL CONSTRUCTION PROVISIONS. When the leased asset is still to be constructed, the investors are exposed to construction risk to the extent capitalized interest is not available, so such a lease financing will be subject to additional scrutiny on any of the arrangements that address construction risk. Thus, the public agency is usually required to disclose to investors the construction contractual arrangements to know what price risk and other risk transfers the contractor is assuming. In addition, the lease agreement typically requires procurement of insurance that address casualty events during the construction period.

Addressing Legal Uncertainties

Given the principled nature of the cases underpinning lease financings, if material doubts concerning a lease financing arise, public agencies may avail themselves of the legal certainty afforded to public agencies by California law. Under Section 860 et seq of the California Code of Civil Procedure, a public agency can bring a validation action to validate bonds, which allows the public agency to have a court adjudicate the matter affirmatively. There are a wide variety of statutes that authorize public agencies to bring validation actions with bonds and financings, which usually grant public agencies the right to bring a validation action. In circumstances where a public agency brings a successful validation action, then

the matters addressed in the validation judgment of the court cannot be challenged in the future. More commonly, any uncertainties are resolved under Section 863 of the California Code of Civil Procedure, under which any interested party must, within 60 days of the public agency bringing a validation action (usually when the governing body approves the resolution authorizing the transaction), bring a suit to challenge an action a public agency may validate. If no interested party does so, then the action cannot be later challenged by any person other than the public agency itself.⁴⁷ This is sometimes referred to as a “reverse” or “passive” validation action since a public agency can sometimes effectively validate a lease financing by simply waiting until the time period for interested parties to bring suit has lapsed. In practice, it is rare for public agencies to pursue an active validation under Section 860, but it is not uncommon for agencies to passively validate bond transactions under Section 863.

Accounting for Lease Financing Liabilities

Although accounting for lease financings is outside of the scope of this issue brief, recent policy changes related to the financial accounting and reporting of lease obligations warrant discussion. For several decades, financing leases were treated separately from other long-term liabilities in financial reports by public agencies, and there were inconsistencies in how payments on debt service and outstanding liabilities for lease

revenue bonds and COPs were disclosed. For example, many public agencies would account for lease financings similarly to operating leases, and rental payments for the lease would count as expenditures by those agencies.⁴⁸ In June 2017, the Governmental Accounting Standards Board (GASB) published extensive new guidance about its standards for public agencies to report ongoing liabilities for lease financings,⁴⁹ which requires public agency lessees to recognize lease liabilities and include these liabilities in their financial statements.⁵⁰ This is expected to directly affect how some public agencies account for their lease liabilities as well as their general debt portfolio.

Although many agencies have already adopted the new guidance from GASB, public agencies are technically expected to comply with the new reporting requirements beginning in fiscal year 2022.⁵¹ For more detailed information about the recent changes to reporting expectations for lease financings, refer to the text of [GASB Statement No. 87](#).⁵²

CONCLUSION

Legal precedent established since the mid-20th century has shaped the emergence and continued development of municipal lease financing practices in California. Over the past several decades, lease financing has become an integral part of municipal borrowing. However, practices differ and have evolved over time.

⁴⁷ See Section 869 of the California Code of Civil Procedure.

⁴⁸ “GASB 87 – Leases: State of California Statewide Implementation and Business Solutions,” *California State Controller’s Office*, 1, Published July 2021, Accessed April 19, 2022, https://sco.ca.gov/Files-ARD/CAFR/GASB_87_Leases_Implementation_PART_I_GASB_87_Overview.pdf.

⁴⁹ *Ibid.*

⁵⁰ California Society of Municipal Finance Officers, “GASB 87: Keys to a Successful Transition to the New Lease Standard,” *CSMFO News*, Published June 15, 2022, Accessed June 16, 2022, <https://news.csmfo.org/2022/06/15/gasb-87-keys-to-a-successful-transition-to-the-new-lease-standard/>.

⁵¹ “Status of Statement No. 87,” *Governmental Accounting Standard Board*, Date last updated unknown, Accessed April 19, 2022, www.gasb.org/page/pageContent?pagel=/standards-guidance/pronouncements/status-of-statement-no-87.html.

⁵² A summary of the new accounting expectations for lease deals in GASB 87 is available on the GASB website: <https://gasb.org/page/PageContent?pagel=/standards-guidance/pronouncements/summary-statement-no-87.html&isStaticPage=true>.

This report has explained foundational concepts of lease financing, the lease exception to the debt limit in the California Constitution, fundamental legal precedent for lease financing in California, critical components of legally sound lease agreements, and common challenges faced by municipalities when crafting lease financing transactions.

CDIAC intends to continue exploration and analysis of municipal leasing by providing additional guidance on applications of lease financing in future publications.

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