LEASE-PURCHASE/CERTIFICATES OF PARTICIPATION FINANCING OF SCHOOL FACILITIES

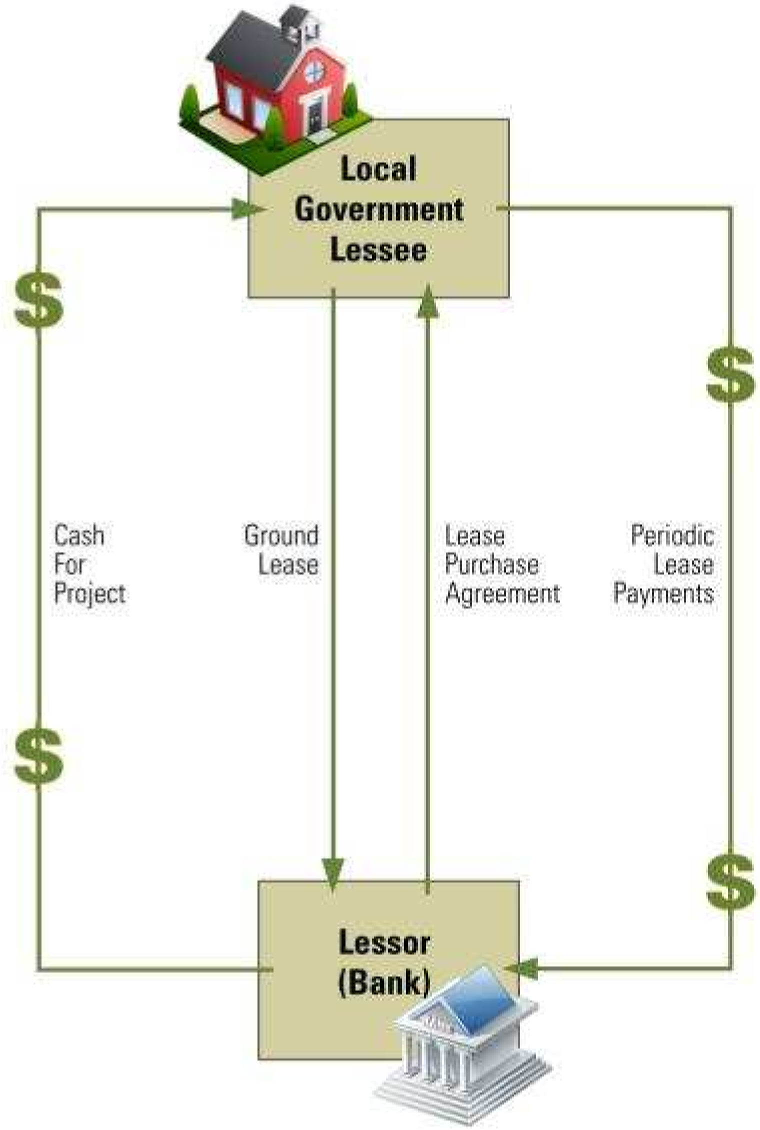
APRIL 25, 2013

As a full-service legal practice, Squire Sanders stands ready to help your school district with all of its legal needs.

The Basics of Lease-Purchase Financing

- Provides a way of borrowing for improvements without incurring “debt”.
- A lease-purchase transaction is like an installment sale transaction, with payments of principal and interest.
- The Ohio Supreme Court held in *Kitchen v. Christman* that a municipal installment sale agreement that is not subject to annual appropriation is an invalid debt.
- Authorizing statute is Revised Code 3313.375:
  - Term must consist of a series of one-year renewable terms, up to maximum of 30 years.
  - Renewal is subject to annual appropriation of funds.
  - As security, district may grant a ground lease to the “lessor” for a term of up to 5 years beyond the final lease-purchase term.
- Failure to appropriate results in termination of the lease-purchase.
- Upon termination of the lease-purchase, the lessor can take possession of leased property away from district for balance of ground lease term.
- Lessor will want the leased property to be “essential” to the district, so that the potential loss of possession is meaningful.

Structure of Lease–Purchase Financing



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Private Placement Structure of a Lease-Purchase Financing

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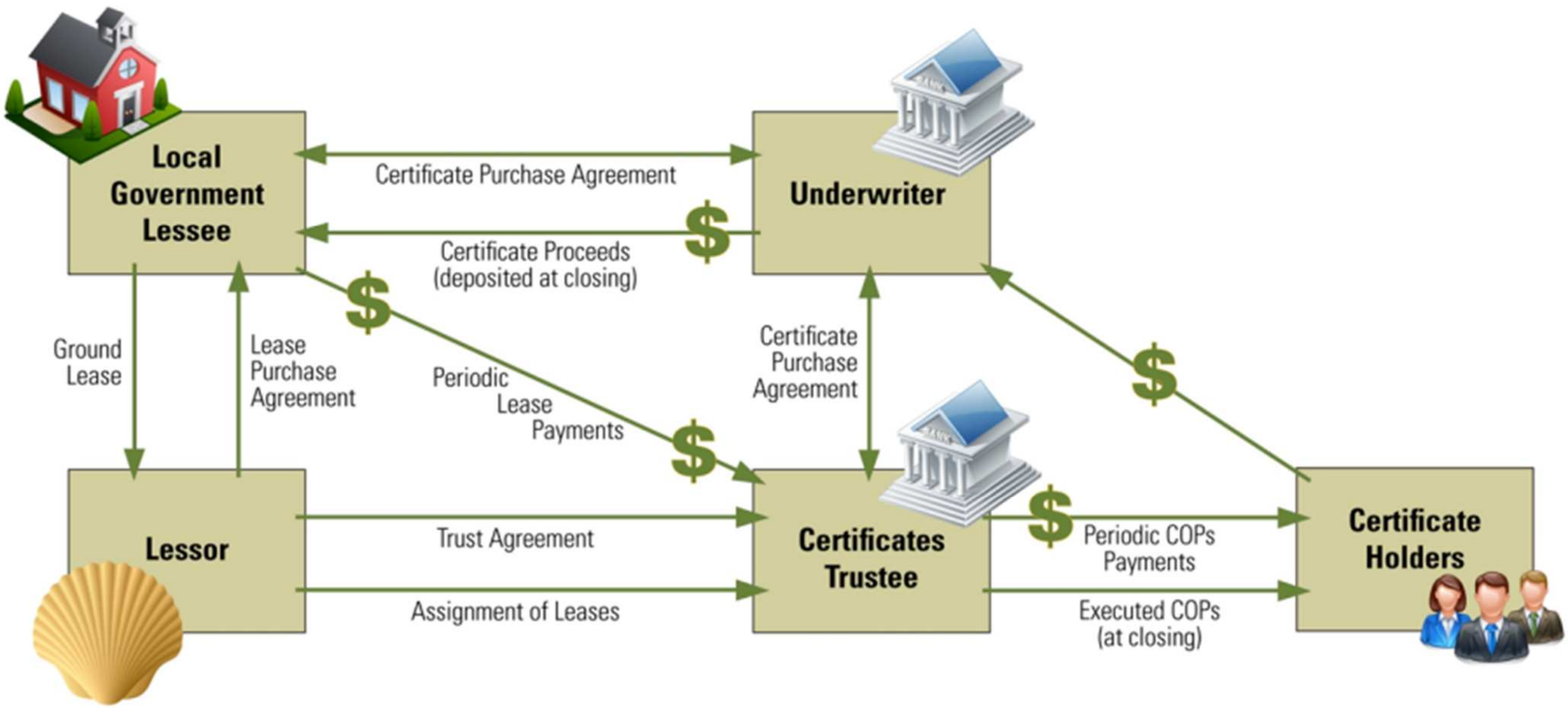
- Similar to bank loan, one “lender”
- No disclosure statement, no rating
- Short time to closing relative to COPs or bonds
- Hidden costs:
  - Lessor’s “documentation” or legal fees
  - Negotiation of document terms
- Higher rate than COPs, possibly less flexibility on prepayment
- Shorter term than COPs for building improvements (generally)
- Escrow fees and disbursement process

Structure of Certificates of Participation Financing



Certificates of Participation (COPs)
Structure of a Lease-Purchase Financing

- Public offering to multiple “lenders,” similar to bond issue
- Lower interest rate, higher transaction expenses than private placement
- Up to 30-year term for building improvements
- Fixed rate with optional redemption after no-call period (8-10 years)
- Economies of scale – not always cost-effective for small projects

Advantages of Lease-Purchase Financing

Exempt from Statutory Debt Limits

- Debt Limits (as percentage of tax valuation):
  - Overall GO Limit: 9% (subject to increase with special needs designation)
  - Unvoted GO Limits:
    - HB 264 (energy conservation): 0.9%
    - Other nonexempt: 0.1%
- Exempt Debt: Certain GO debt is exempt from debt limits, notably school buses and other equipment used in pupil transportation, but these exemptions are generally not applicable to building improvements.

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Advantages of Lease-Purchase Financing (cont.)

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Exempt from Constitutional "Indirect" Debt Limit

- Unvoted GO Debt: 10-mill limit applies to tax required to pay maximum annual debt service on unvoted GO debt of all overlapping subdivisions

Required Terms for Exemption from Debt Limits:

- Lease-purchase must be subject to annual renewal and appropriation to avoid creating debt
- Termination and loss of possession must be practical possibilities

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Disadvantages of Lease-Purchase Financing (Compared to Voted GO Bonds)

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More Costly

- Higher interest rate – less secure than voted GO bonds
- 30-year maximum maturity means higher annual payments
- No increased revenues for repayment

Disadvantages of Lease-Purchase Financing (Compared to Voted GO Bonds)

Complexity

- Site-specific – less flexibility if project changes scope or location
- Title work, environmental study, survey, recording
- Potential loss of possession

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Many Legal Requirements Are Same for Lease-Purchase Financing and GO Bond Financing

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- Lessee responsible for Federal tax compliance (IRS Form 8038-G/GC, QTEO, rebate)
- Public contracting requirements still apply with respect to lease-purchased property (competitive bidding, performance bond, retainage)
- Required Board authorization of financing terms (maximum principal amount, maximum interest rate, term)

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Market Statistics

- Tens of Billions of COPS issued nationally since 1960’s

- In Ohio – many large well know developments financed with COPS
  - **Cleveland Browns Stadium in 1997 - $140mm COPS**
  - **Columbus Conv. Ctr.**
  - **Akron Aeros Baseball Stadium**
  - **Over $2 Billion of COPS issued in Ohio for cities, counties, schools, port authorities, the State of Ohio and special districts.**

- Ohio K-12 market – nearly 100 issues of COPS for close to $1 billion of new money and refundings
  - **Largest – Cincinnati Schools $120mm ’06 and Penta Co. Career Ctr. - $65 mm in ’04.**
  - **Smallest $100,000 Lease Purchase; $650,000 COPS; but most common size for COPS $2mm and up.**

Market for COPS Has Changed Over Time

- Prior to 2008 many if not most issues carried Bond Insurance, who often required more rigid terms:
  - Debt Service Reserve Funds
  - Title Insurance
  - Essentiality of the Project

- Bond Ratings – typically 1 notch below G.O. rating of school district.

- General Market acceptance of COPS – interest rate differential of about 35 to 50 bps (1/2%).

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Comparison of Voted General Obligation Bonds to Certificates of Participation

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	$15 million Voted General Obligation Bonds	$15 million Voted General Obligation Bonds	$15 million Certificates of Participation (1)
Term	**30 years**	**37 years**	**30 years**
Bond Rating	**Aa2/AA**	**Aa2/AA**	**Aa3/AA-**
Interest Rates (2)	**4.00%**	**4.15%**	**4.50%**
Costs of Issuance (3)	**$150,000 1%**	**$150,000 1%**	**$225,000 1.5%**
Estimated Annual Debt Service	**$867,000**	**$800,000**	**$925,000**
Estimated Total Debt Service	**$26,010,000**	**$29,600,000**	**$27,750,000**
Estimated Total Interest Paid	**$11,010,000**	**$14,600,000**	**$12,675,000**

Notes

(1) Par amount of COPs issue equals $15,075,000 to reflect additional Costs of Issuance.

(2) Interest rate difference between GO and COPs depends on general market conditions at the time of sale. Normally, the difference will widen as general interest rates increase.

(3) COPs assume higher costs for underwriting, ratings and legal fees as well as costs related to Trustee services and title work.

Case Study – North Royalton City Schools

- On March 16, 2011, the North Royalton City School District sold $3,070,000 of Certificates of Participation, Series 2011. The COPs were rated Aa3 (GO rating Aa2).
- **The Project:** Improvements and replacement of the existing 1,900-seat stadium grandstand with a 3,000-seat grandstand, a synthetic turf field, an all-weather track, lighting, concessions, ticket booth, and restrooms. Total improvements were $4.8 million.
- **The Funding Source:** The existing Permanent Improvement levy funded the COPs. Other sources of funds included private funds (naming rights) and about $1.35 million from the Permanent Improvement Fund.
- **The Financing Plan:** In addition to the private donations and PI fund contributions, the financing plan included leveraging $200,000 of annual permanent improvement funds with COPs.

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Case Study – Mayfield City Schools

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- The Mayfield City School District sold $15,000,000 of Certificates of Participation in September of 2006, another $23,210,774 in 2009, and an additional $4,000,000 in 2010. Originally, the District contemplated issuing voted bonds. However, because the improvements were renovations, the District believed that a Permanent Improvement (PI) levy was a more appropriate source of funding and that voters were more likely to support and approve a PI levy.
- **The Project:** Renovation of all of its buildings (2006 and 2009 issues), and conversion of an existing bus garage to a vocational education facility in 2010.
- **The Funding Source:** Permanent improvement tax revenues.
- **The Financing Plan:** Voters approved a 0.9-mill levy in May 2006 to replace a 0.7 mill levy. In 2006, a 0.9-mill PI levy generated approximately $1.2 million annually for the District, of which the District intended to commit $900,000 to its annual base rent payments. The remainder of the PI levy was to be used for annual ongoing needs of the District. In addition, District taxpayers approved a 1.9-mill continuing PI Levy in November 2008. That levy generates approximately $2.5 million annually. The District leveraged approximately one mill of that levy to pay the base rent on the 2009 and 2010 COPs issues.

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Case Study – Berea City Schools

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- On October 7, 2009, the Berea City School District sold $26,000,000 of COPs, Series 2009A&B. Series A were issued as tax-exempt COPs, and the Series B were issued as Federally Taxable–Build America Bonds. The COPs were rated A3 (GO rating A2).
- **The Project:** The District's Master Facilities Plan called for the closing of four elementary school buildings within the District and the construction of a new "central" elementary school building on the site of one of the demolished elementary buildings. The proceeds of the COPs were used to build the central elementary school.
- **The Funding Source**: The anticipated annual operating savings from the closing of four elementary schools.
- **The Financing Plan:** The plan included a final maturity of 30 years, a project fund of $23 million and a maximum annual rent payment of $1.8 million; the COPs also generated $2.3 million of capitalized interest to offset debt service payments until actual cost savings were realized.

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Special Circumstances – Dedicated Cash Flow

Lease-Purchase provides a mechanism for leveraging a specific cash flow:

- Municipal income tax
  - *Hudson Schools, Akron Schools*
- County sales tax
  - *Medina Schools, Brunswick Schools, Cloverleaf Schools, Buckeye Schools*
- Projected operational savings
  - *Berea Schools*
- Donations/Cash
  - *Aurora Schools*
- Permanent Improvement Levies
  - *Mayfield Schools, Parma Schools, Maple Heights Schools, North Royalton Schools, Jackson-Milton Schools, Willoughby-Eastlake Schools*

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