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Sid Hemsley
Municipal Technical Advisory Service

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SOME BASIC CONSIDERATIONS

By Sidney D. Hemsley
Legal Consultant

Report No. 2 March 1985

MUNICIPAL TECHNICAL ADVISORY SERVICE
The University of Tennessee
in cooperation with The Tennessee Municipal League
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Municipal governments in Tennessee are authorized by Tennessee Code Annotated, Title 7, Chapter 51, Part 9, to enter into lease and lease purchase agreements for the acquisition of capital improvement property. Such agreements are limited by T.C.A. 7-51-902 to the acquisition of "capital improvement property" for terms of up to 40 years or for the useful life of the property, whichever is less. The term "capital improvement property" is defined by T.C.A. 7-51-901(1) as "any real or tangible personal property needed for a governmental purpose and having a useful life of one (1) year or more, and any real or personal property with respect to which capital outlay notes can be legally authorized and issued by a municipality."

Specific authority for municipalities to enter into lease and lease purchase agreements for the construction, operation, and management of capital improvement property which is all or a part of a "sewage treatment works" or "public water system," as those terms are respectively defined in T.C.A. 68-13-201 and 68-13-703, is contained in T.C.A. 7-51-907.

TRUE LEASES AND LEASE-PURCHASES DESCRIBED AND DISTINGUISHED

True Lease:

The major distinction between a true lease and a lease-purchase is that under a true lease the lessee does not acquire ownership of the leased property; at the end of the lease term the property is returned to the lessor. In addition, certain tax consequences apply to a true lease: The lessor may claim depreciation on the leased property, but the lessor must also pay federal income taxes on the lease payments. Those tax consequences may have a bearing upon the price a municipality must pay for the temporary use of property under a true lease compared to the price it must pay for the outright cash purchase or lease-purchase of the same property.

There may be several advantages to a municipality in entering into a true lease, rather than a lease-purchase, to acquire needed capital improvement property:
Rapid technological advances may make some high tech equipment so quickly obsolete so that it is difficult to justify its outright purchase. Computers and other data processing equipment may fall into this category.

The need for capital property may be only temporary or the municipality may find that it does not even need the capital property. True leasing permits a municipality to analyze its real needs before making questionable purchases of expensive property.

Because the property under a true lease reverts to the lessor at the end of the lease term, the lessor has a strong incentive to maintain and service the leased equipment.

**Lease-Purchase**

A lease-purchase agreement is called a lease, but is in reality a purchase agreement. The lessee acquires ownership rights in, as well as use of, the leased property. In addition, when the lessee is a municipality and the lease-purchase agreement is correctly drawn, the lease is a tax exempt lease. To qualify as a tax exempt lease, the lease-purchase agreement must divide the periodic payments the municipality is obligated to make into separate principal and interest portions. Under a tax exempt lease the lessor is exempted from federal income taxation on the interest portion of the periodic payments. The significance of that tax consequence is that the municipality may be able to successfully bargain with the lessor for a lower interest rate than the lessor would charge to other customers.

There are other advantages to the lease-purchase of capital improvement property that may make it an attractive alternative to the outright cash purchase of the property by a municipality:

(i) The cost of expensive capital equipment necessary to provide essential public services may be spread out over a long period. The municipality may not have the revenue necessary to make the property purchase outright, or it may want to retain the revenue for various policy reasons.
(2) The acquisition of some capital improvement property, through the issuance of bonds or other long term debt, may not be a practical financing alternative. For example, the life of the property may be too short to justify its purchase by bonds or other similar financing methods.

(3) Lease-purchase procedures authorized under Tennessee law are generally simpler than bond issues or other property purchasing alternatives authorized under Tennessee law.

FORMS OF LEASE-PURCHASES

Between The Municipality and Equipment Vendor Or Manufacturer

This is the simplest and best known type of lease-purchase arrangement. The municipality selects the equipment it needs through the bid process prescribed by its charter or the Municipal Purchasing Act, contained in T.C.A. 6-56-301--306. The bid price quoted in the manufacturer's or vendor's bid proposal includes both the price of the equipment and the price of financing the equipment for the term of the lease-purchase agreement. In most cases, the financing is through a third party source arranged by the manufacturer or vendor. Occasionally, some larger equipment manufacturers may themselves finance the lease-purchase of their own equipment. However, even in the latter case, the manufacturer usually reserves the right in the lease-purchase agreement to assign its security interest in, and its right to payment for, the property to a bank or other third party financial institution. In exchange for this assignment it receives full payment of the purchase price of the property.

It is generally advantageous to the municipality to enter into a lease-purchase agreement with a manufacturer or a vendor which finances its own lease-purchase agreements and which does not assign its security interest and right to payment to a third party, at least for the period the equipment warranty is still in effect. The manufacturer or vendor has a much greater interest in servicing equipment in which it has a security and future financial interest, and often has its own equipment servicing organization.
Between Municipality And Bank Or Other Financial Institution

This form of lease-purchase agreement is accomplished by a process more complicated than the form in which the municipality obtains the property through a lease-purchase agreement with the manufacturer or vendor. Under this process, the municipality separates its purchase of the equipment and its purchase of the equipment financing into two separate packages. Generally, it does this by first selecting the equipment it wants through the same bid process it would follow if it were entering into a lease-purchase agreement with the manufacturer or vendor. However, its request for bid proposals would contain these additional provisions:

(1) That the financing of the equipment shall be purchased as a separate package, and the acceptance of the successful equipment bid will be contingent upon the municipality's ability to secure satisfactory equipment financing.

(2) That the successful equipment bidder shall be required to assign its equipment sales right to the bank or other financial institution selected by the municipality to provide the equipment financing.

(3) That the title to the equipment shall pass from the manufacturer or vendor to the financing bank or other financial institution upon the bank's or other financial institution's payment to the successful equipment bidder the purchase price of the equipment.

The municipality then solicits equipment lease-purchase financing bid proposals from banks or other financial institutions. However, the successful equipment bidder may also be given the opportunity to submit an equipment lease-purchase financing bid proposal.

After both an equipment bid proposal and an equipment financing proposal have been accepted, the municipality enters into a lease-purchase agreement with the bank or the financial institution providing the equipment financing. The bank or financial institution is legally the seller of the equipment and it holds both the security interest in the equipment and the right of payment for the equipment.
Despite its complexity, this arrangement may work to the advantage of the municipality. Some equipment vendors may have good equipment but no financing sources, and lower interest rates sometimes can be obtained from banks or other financial institutions than from other equipment manufacturers or vendor financing sources. The disadvantage of such an arrangement to the municipality is that the bank or financial institution usually has no direct equipment servicing capability; the municipality is forced to fall back on the manufacturer or vendor, who already has been paid for the equipment.

The Municipal Purchasing Act and Leases and Lease-Purchases

The Municipal Purchasing Act of 1983, as amended, contained in T.C.A. 6-56-301--306, applies to certain leases and lease-purchases; however, it applies only to those municipalities which do not have specific charter provisions or private act requirements governing competitive bidding or purchasing (T.C.A. 6-56-302 [1]). If the municipal charter has provisions governing competitive bidding and purchasing, those provisions govern leases and lease purchases. If the municipal charter contains no such provisions, leases and lease-purchases are controlled by the Municipal Purchasing Act.

Generally, the Municipal Purchasing Law requires that all municipal leases and lease-purchases of $2,500 or more must be preceded by public advertisement and competitive bidding, unless the lease or lease-purchase is exempted from the law (T.C.A. 6-56-304).

The Municipal Purchasing Act contains several exceptions related to lease and lease-purchases:

(1) Leases or lease-purchases of real property.

(2) Leases or lease-purchases of secondhand equipment, materials, supplies and commodities from any federal, state or local governmental or agency.

(3) Leases or lease-purchases of goods, supplies, materials, and equipment procured either from a sole source supplier or in response to an emergency. However, in both cases, a detailed record of the transaction must be kept and a report of it made as soon as possible to the chief executive officer and governing body of the municipality.
Leases or lease-purchases requiring total payments of less than $2,500 in each fiscal year the agreement is in effect. However, this exception is limited: it does not apply to leases of like or related items which individually may be leased or lease-purchased with total payments of less than $2,500 in any fiscal year, if such items are customarily leased or lease-purchased in numbers of two or more, if the combined total payments for such items under a single agreement would equal or exceed $2,500 in any fiscal year (T.C.A. 6-56-304).

Note that T.C.A. 6-56-305 provides that leases and lease-purchases in amounts between $1,000 and $2,500 "shall whenever possible be based on at least three (3) competitive bids," and that leases or lease-purchases of $1,000 or less require no public advertising or competitive bidding.

**Leases Or Lease-Purchases Of Real Property**

Leases or lease-purchase agreements of real property for terms of less than five years, and for all tangible personal property regardless of the lease terms, must be approved by the municipal governing body by ordinance or resolution (T.C.A. 7-51-904 [a]).

Leases or lease-purchases of real property for five or more years, including extensions or renewed terms, require that public notice be given at least seven days in advance of the meeting at which the lease or lease-purchase agreement will be considered by the governing body. The notice must identify the real property, the terms of the lease or lease-purchase agreement, and the lessor. The lease or lease-purchase agreement requires the approval of the governing body by ordinance or resolution.

**Municipal Debt Restrictions**

Restrictions on municipal debt are found in the constitutions or statutes of many states. Where such restrictions exist and are broad enough to include future payment obligations under a lease agreement, most lease agreements include a non-appropriation clause. The typical non-appropriation clause provides that the municipality's obligation to make future year payments under the lease agreement is dependent upon its appropriation of funds for that purpose for the future year. The non-appropriation clause allows the municipality to terminate the lease agreement at the end of the year without future obligation or penalty if it does not appropriate funds to make payments due in the future year under
the agreement. In those states that have municipal debt restrictions, lease payments made under agreements containing non-appropriation clauses have been determined to constitute current expense rather than debt.

There are no general constitutional or statutory debt restrictions which apply to lease or lease-purchase agreements made by municipalities under Tennessee Code Annotated, Title 7, Chapter 5, Part 9. However, T.C.A. 7-51-905 provides that:

The provisions of this part shall in no manner repeal, modify, change, or interfere with any general or special statutes pertaining to municipal or county contracts or leases, including, but not limited to, those statutes pertaining to competitive bidding, conflicts of interest, public building authorities, purchasing, issuance of bonds, borrowing of money and incurring of debts, and appropriations. The authorization provided by this part shall be additional and supplemental to, and the limitations provided herein shall not affect the powers or authorizations provided by, any other law, and is not in substitution for the powers or authorizations conferred by any other law.

That provision apparently preserves the debt restrictions contained in some Tennessee municipal charters. Where a municipal charter contains a debt restriction it should be carefully read. Depending upon the wording and scope of the debt restriction, the non-appropriation clause may offer the municipality in question a means to enter into a lease agreement which will not violate the charter.

In addition, even where the charter contains no municipal debt restrictions a non-appropriation clause may also be useful to any municipality which is contemplating a lease-purchase agreement but wants to reserve the option of cancelling the lease at the end of a fiscal period.
The exact terms of a non-appropriation clause will be negotiated by the municipality and the lessor. Often non-appropriation clauses provide that the chief administrators of the municipality must exercise their "best efforts" to obtain future appropriations for lease payments. The lessor may also demand a related provision in the lease agreement which prohibits the municipality from replacing the leased equipment and/or the service provided by the leased equipment for a certain period, upon the exercise of the non-appropriation clause by the municipality. Needless to say, the municipality needs to use extreme caution in agreeing to any provisions which may restrict its rights or ability to render future public services.

Stop, Look & Listen

A municipality interested in entering into either a true lease or a lease-purchase agreement should shop the alternatives. There are several variations of the basic lease forms described above and other legal and technical considerations that may go into the leasing decision. Any municipality should pick or choose based upon its needs and what forms of lease and lease financing are available at the most economical price. There may be a maze of available options which make a decision difficult. When in doubt, check with an expert familiar with the capital property in question and the various alternatives available for its acquisition.