



WHAT YOU CAN DO IF YOU DON'T HAVE CASH—FINANCING ENVIRONMENTAL COMPLIANCE

By Robert G. Harvey and Michael H. Levin *

With cascading environmental controls continually being imposed on local governments and private industry, even the Environmental Protection Agency estimates that annual compliance costs will exceed \$200 billion by the end of this decade. The regulated community is seldom able to pay for required capital improvements from cash reserves; some form of financing is increasingly necessary. Frequently, the amount to be financed would exhaust a company's borrowing capacity or a local government's bonding limits. Hence, alternatives to "general obligation" financing have been developed.

This article examines alternative mechanisms available to companies and local governments to finance environmentally related improvements and describes circumstances that favor or limit their use. Among the mechanisms described are leases, certificates of participation, revenue bonds, asset repositioning, revolving funds, special authorities, and 63-20 corporations. The article also analyzes "privatization" and practical and legal issues that should be addressed in the implementation process.

Background

Traditionally, municipalities have issued "general obligation" bonds (that is, they have pledged their general credit and taxing powers to repay the debt), and private industry has visited its bankers for loans to provide necessary compliance capital. Today, however, traditional financing to construct or renovate waste water treatment, recycling, air pollution control, or other environmentally related facilities is much more difficult to obtain.

Financing may be impossible to obtain for cleanups of contaminated property, which lenders or investors view as high-risk, unsecured investments. Moreover, many municipalities and private companies already have extended their normal borrowings as far as they and their financial advisors feel is feasible.

Where will the financial resources come from to meet these new regulatory requirements?

The solution often involves introducing to the transaction a new third party with adequate borrowing capacity—and perhaps capital to invest—plus a reasonable credit rating.²

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Several project structures have been developed to obtain the initial capital from other parties to construct or renovate environmental facilities. Typically these structures involve some form of long-term loan; privately owned projects may also use equity investments. Tax considerations often influence significantly the project structure selected.

Discussion

1. Leases

If immediate ownership of the particular environmental facility is not essential, leasing may be an appropriate vehicle. In this case, legal title to the facility is held by the party providing the capital to acquire or modify the facility (the "lessor"), and the facility is then leased to the party desiring to use it (the "lessee"). The lessor's capital expense (and return on investment) is repaid through periodic lease rentals.

Two types of leasing structures are generally considered: (a) "true" leases and (b) "finance" leases. Under a true lease, the lessor intends to retain the property at the end of the lease term. Under a finance lease, the lessee expects to become the owner of the facility at the end of the lease, making this approach the functional equivalent of an installment sale.

Tax considerations play a significant role in determining the most economic lease structure, particularly if one of the parties is tax-exempt—a governmental unit or agency, for example—or has insufficient "tax appetite." To minimize development costs, the tax benefits should be allocated to the party best able to take advantage of them—that is, to the party with the highest effective marginal tax rate. Hence, the parties should allocate the facility's "tax" ownership as well as its "legal" title; they need not be held by the same party.

Allocating "tax" ownership of the new or upgraded environmental facility may be a complex matter. The parties' intent, not the label attached to a document, will determine tax ownership; a court or the Internal Revenue Service will assess the parties' intent by looking at several factors.³ While analysis of tax rules is beyond the scope of this article, the basic tax criteria help suggest which lease structure will be worth further consideration. The key factor is whether the parties, at the time they executed the transaction documents, intended that the lessor retain a substantial economic and proprietary interest in the leased property, not just a security interest.

a. True Lease. Under a true lease, the lessee simply controls the property during the lease term and returns it to the owner ("lessor") at the end of the lease, with no further obligation. Usually both legal title and tax ownership, and therefore the tax benefits, lie with the lessor. The true lease permits the lessee to obtain the use of the newly developed facility for a specific period of time at a lower cost than it would have paid to purchase it, with the financing costs and risks assumed by the lessor, although they will be partially passed on to the lessee through the lease terms and rentals. Certain risks of loss and facility non-performance may also be allocated to the lessor. Complex procurement rules and processes must often be followed by governmental units to acquire "public works." Depending on the local rules, true leases may not be subject to these public procurement constraints.

Under a true lease, the lease term, including renewals, will be substantially less than the economic useful life of the property. If the lessee has an option to purchase the property at the end of the term, the option price must be the property's fair market value at the time of exercise of the option. Renewal periods for nominal rentals, which permit the lessee to use the facility for the remainder of its estimated useful life, probably will mean that the transaction will be treated as a finance lease. If the total rental payments over a relatively short time approximate the purchase price of the facility, or materially exceed the current "fair rental" value, the transaction may be similarly treated.

b. Finance Lease. As the term suggests, under the finance lease—essentially an installment sale—the lessee acquires legal title to the facility at the end of the lease. If there is a purchase "option," the purchase price is generally a nominal value unrelated to the property's fair market value at the time of exercise. Legal title during the lease term often remains with the lessor, but the tax ownership, and therefore tax benefit, of the facility lies with the lessee. Depending on state law and accounting practices used, the lease rental obligation may be treated as an annual operating expense, not long-term debt; hence it would not reduce the amount of remaining debt that could be incurred by a company or local government subject to any legal or contractual debt limitations. This result may be particularly important for municipal lessees.

To reduce project revenue risks, municipal finance leases may also be structured as special obligations of the municipality, payable out of an identifiable, dedicated revenue stream such as tip fees or sewer rents, but not backed by a pledge of the municipality's credit or taxing powers. In addition, finance leases may not be subject to voter approval under referendum requirements—often a critical issue with environmentally related facilities. Where laws limit the term of municipal bonds,⁴ this structure may also lower annual costs because the term of the lease may extend beyond the comparable bond term limit. On the other hand, state and local laws may contain greater restrictions on these municip-

pal transactions than would apply if financed by issuance of general obligation bonds.

Under this finance-lease approach, the economic value to the transaction of certain tax benefits, such as a depreciation deduction, will be lost if the lessee is tax-exempt. However, financing costs for municipal projects may be reduced because a portion of each rental payment may be considered interest on the purchase price, which is generally excludable from gross income by (that is, tax-exempt to) the lessor. Hence, the lessor can charge the municipality a lower rent but still obtain the same net rate of return on its investment as it would otherwise have earned on a taxable transaction.

One key issue that may affect use of this financing mechanism by local governments is whether relevant state law will treat a finance lease as long-term municipal debt subject to special issuance restrictions. To address this issue, these leases frequently contain a "non-appropriation clause,"⁵ which allows a municipal lessee to cancel the lease simply by failing to include monies for the rent payments in its budget. If the lease is executory only to the extent that the municipality annually appropriates funds to make the lease payments, it may escape the requirements applicable to municipal debt. This tactic creates a risk that the government lessee may later decide to terminate the lease by refusing to appropriate rentals before the lessor has retired its debt. However, because of the significant adverse impact on a municipality's credit rating likely to result from such failure, this "escape" clause is rarely exercised, and the investment community traditionally has been willing to accept the non-appropriation risk for essential public facilities.⁶

2. Certificates of Participation

The typical project lease structure involves only a single source of funds—the lessor or its banker. But for large projects it may be helpful to have multiple lenders. In addition to allowing many lenders to "participate" in a loan (and thereby spread the costs and risks), certificates of participation (or "COPs") offer another way to raise construction funds, at least for public projects. Certificates of participation in municipal leases are issued by the municipality in lieu of bonds to finance the construction of the project. But unlike bonds, which are direct debt obligations of the issuer, COPs entitle the purchaser ("lender") to receive only a proportionate share in the municipality's future payments under the lease. Thus, a primary disadvantage is that repayment depends upon the parties' meeting their respective lease obligations. The primary advantage is that COPs, where authorized under state law, may be issued where issuance of bonds would exceed pertinent debt limitations.⁷

3. Revenue Bonds

Industrial development revenue bonds ("IDBs") are an important financing tool for both private and public sectors. IDBs may be issued by state or local industrial development agencies ("IDAs") or other state authorities, on either a "taxable" or "tax-exempt" basis. The quoted terms refer to the federal income tax treatment of the interest paid on the bonds. Significant benefits offered by IDB financing usually include: lower interest costs than generally available through commercial loans (but generally higher than those for municipal general obligation debt);⁸ exemption from state and local sales taxes on purchases of most equipment and materials associated with the project; exemption from state mortgage taxes; and reductions in real property taxes.

While financing and issuance costs are typically higher than those for general obligation bonds, the net benefits usually are considerable on small projects and can amount to millions of dollars on large ones.⁹

Project costs that can be financed using tax-exempt bonds include land (within limits), depreciable buildings, machinery, and equipment. At least 95 percent of bond proceeds must be spent on these qualified project costs incurred after the initial IDA approval of the project. No more than 2 percent of tax-exempt bond proceeds may be spent on costs of issuance of the bonds, which include bank commitment fees, underwriters' discounts, attorneys' fees related to the bond transaction, and IDA fees. Attorneys' fees related to such "non-transaction" activities as acquiring the land and negotiating construction or service agreements are "qualified" costs that may be financed with bond proceeds. Non-qualified costs not eligible to be financed by tax-exempt bonds are frequently financed through companion taxable bonds of the same issuer.

Besides issuing tax-exempt bonds to finance manufacturing facilities, an IDA can issue tax-exempt bonds to refinance outstanding tax-exempt bonds, even if the facility financed under the original bonds is not a manufacturing facility. Tax-exempt financings generally result in significant interest-rate savings over conventional financings. As with any financing, long-term fixed rate bonds typically bear interest at a higher rate than short-term variable rate bonds with "put" features and remarketing mechanisms.

It is important to note that interest income earned by holders of federally taxable IDBs may be exempt from state and local income tax when the owners of these bonds are individuals, partnerships, bond funds, or similar purchasers. In most states, corporations pay franchise taxes rather than income taxes. Under existing case law in some states, corporations—whether banks or otherwise—may not exclude interest income received from state-taxable industrial development bonds in calculation of franchise tax.¹⁰ Nevertheless, many projects can be structured to allow bond purchasers to take advantage of exemption from state and local income taxes. For example, in high tax states like New York, taxable municipal bond funds can be used for this purpose.

Whether an environmental facility is privately or publicly owned or operated will directly affect the characterization of bonds issued to finance it. For these purposes, there are two categories of bonds: governmental bonds and private activity bonds. Different limitations apply to projects financed with each.

a. Governmental Bonds. If a municipality owns a facility and provides for its operation under a short-term management contract meeting certain strict guidelines set forth below, bonds issued to finance the facility will be treated as governmental bonds subject to fewer federal tax law restrictions than private activity bonds. For example, no volume cap allocation is required with respect to governmental bonds.¹¹ Use of the facility under a management contract by a private operator, however, will result in the characterization of the bonds as private activity bonds, unless the following requirements are satisfied:

- ▶ The term of the management contract, including renewals, does not exceed five years;
- ▶ The governmental owner has the option to cancel the management contract at the end of any three-year period;
- ▶ The manager under the management contract is not compensated on the basis of a share of net profit; and
- ▶ At least 50 percent of the annual compensation of the manager under the contract is based on a periodic fixed fee.¹²

b. Private Activity Bonds. If a private entity will own the facility for federal income tax purposes, or a municipality will own the facility but will hire a private operator under a contract that does not meet the management contract guidelines described above, the bonds will be treated as private

activity bonds. Interest on private activity bonds issued to finance a facility will be exempt from tax only if at least 95 percent of the proceeds of the bonds are used to construct and equip or acquire the facility. In addition, the bonds must satisfy numerous other restrictions applicable to private activity bonds for the interest paid to be tax-exempt. For example, a volume cap allocation would be required from the state in which the facility is located.

Among the projects commonly financed on a tax-exempt basis are facilities for waste-to-energy production, materials recycling, composting, and sewage treatment. One important limitation on the use of these bonds for sewage treatment facilities involves certain "pretreatment" facilities. A sewage facility is defined in Treasury Regulations as "any property used for the collection, storage, treatment, utilization, processing, or final disposal of sewage."¹³ Property which is functionally related and subordinate to the sewage disposal function qualifies as part of the sewage facility which may be financed with bond proceeds. However, the Internal Revenue Service has taken the position that a facility for the pretreatment of certain industrial waste before release to a municipal sewer system does not qualify as a sewage facility. Pretreatment facilities for the processing of residential wastes—such as wastes from septic systems—should still be financable as sewage facilities. Recent reports suggest that the IRS may be reconsidering this pretreatment limitation as part of the Clinton administration's economic infrastructure package.¹⁴

Another significant limitation is that private activity bonds, other than the 5 percent unrestricted portion of proceeds, cannot be used to finance any portion of a facility that is dedicated exclusively to recovering and converting methane gas to a form in which it is or can be sold. For example, an environmental facility may be designed to collect and burn landfill methane gas to produce electricity for sale to a public or private utility. All parts of that facility that are dedicated to the collection, treatment, storage, and disposal of non-salable waste products will be financable. However, that portion of a facility used to generate electricity—such as furnaces, turbines and storage and distribution facilities—will not be qualified sewage facilities and thus may only be financed out of the 5 percent so-called "bad money" portion of the bond process.

Bonds may also be treated as private activity bonds if part of the facility being financed is a cogeneration plant designed to generate electricity or other salable products by capturing and burning a primary treatment byproduct such as methane gas. If electricity generated by that plant is sold to an investor-owned utility, the bonds will be private activity bonds. If the electricity is sold to a publicly owned utility or directly to the general public, however, the bonds could still qualify as governmental bonds, although the latter case would likely subject the plant to utility rate-making. If no portion of bond proceeds is used to provide the cogeneration part of the facility, these bonds could still be treated as governmental bonds.

4. Public-Private Partnerships

Generally, the terms "privatization" and "public-private partnership" refer to a contractual relationship between a public body and a private entrepreneur in which the private party provides certain facilities and services traditionally provided by the public sector. This kind of project structure involves a contractual sharing of such risks and responsibilities as the design, construction, financing, ownership, and/or operation and maintenance of the required facilities. It is applicable to a wide range of services and has been used in

such diverse projects as construction and operation of waste management facilities, sewage treatment facilities, pollution control facilities, prisons, airports, and package delivery services to the general public.

Indeed, the public-private partnership concept is a renaissance of an old idea deeply rooted in America's post-colonial expansion. Early in our history many canals, railroads, toll roads, and bridges were privately constructed, and the private sector provided most essential public services. Without government controls and regulations, however, the private sector came to be seen as taking advantage of its position through price gouging, featherbedding, and favoritism in the awarding of public contracts. The public rebelled, and provision of these services by the private sector was largely curtailed. Large government bureaucracies developed in their place. Now, with growing demand and reduced public monies available for infrastructure projects, there is renewed interest in public-private partnerships.

Public-private partnerships may take several different forms, each of which strikes a different balance among rights and responsibilities as well as economic and political effects. Project structures vary from simple contract services, where the municipality contracts with a private entity to operate municipal facilities, to full privatization, in which a private developer designs, owns, and operates the facility to provide the needed public services.

The following discussion focuses on use of public-private partnerships as a financing tool for acquisition or renovation of public environmental facilities. Many of the concepts described apply equally to private "asset repositioning," discussed in the next section.

The key financing document in this type of project structure is the service/construction agreement, which sets out the parties' responsibilities, the risks assumed, and the fees that will be paid for services provided. The service agreement generally provides that the municipality will purchase a minimum amount of services, whether or not it actually uses those services—a so-called "put-or-pay" contract. For example, the municipality might contract for a minimum number of tons of waste it will deliver to the privately operated disposal facility. As long as the private developer operates the facility satisfactorily, this contract provides it a steady, predictable cash flow. The predictability of this cash flow is the key to financing acquisition of the assets used to provide the services.

The service agreement and this cash flow become the collateral for the loan to purchase or construct the assets. When (a) the service agreement properly allocates the project risks to parties best able to control them, (b) the developer's track record is adequate, and (c) the public body has the ability to raise the monies required to pay the service fee as and when due, the capital and construction costs can frequently be "project financed." "Project financed" means that the lender will look only to the assets of the particular project, including the revenue stream from the service contract, as the source of repayment; neither the developer's nor the public body's general credit is pledged to repay the loan.

This structure provides numerous advantages. It allows, for example, a public body that has reached its borrowing limit or wants to reserve remaining borrowing capacity to undertake a project not otherwise feasible. In some cases it can avoid the need for a public referendum on a sensitive project. While tax benefits are not available directly to a public body, the municipal sponsor may still benefit from private ownership of the depreciable assets by a "flow through" of part of the tax benefits in the form of a reduced service fee paid to the private developer.

The benefits of project financing must be weighed against its additional costs. Generally, the interest rate of a loan supported only by a project financing will be higher than that which would be charged on a "general obligation" financing, unless credit enhancement is used. Transaction costs probably will be higher for a "project financed" transaction. The documentation required will be more complex, and negotiation of risk allocations more detailed. Furthermore, additional parties are involved in the transaction, adding costs and complexity.

Despite their added costs, public-private partnerships will often be the appropriate solution to the financing dilemma. They tend to be favored where:

- ▶ The public does not perceive the activity as inherently public or governmental;
- ▶ The potential for waste, fraud and abuse can be controlled adequately through contract terms;
- ▶ The relevant technology is unique or requires special operating expertise or experience;
- ▶ Technology or economic risks to the public can be avoided through private participation;
- ▶ The nature and quality of the activity can be controlled adequately through a contractual relationship; and
- ▶ Few public employees will be displaced by contracting with a private party.¹⁵

Under a project financing structure, a lender would provide the funds for construction and/or renovation of the environmental facility based solely on repayment through the revenues generated by the service agreement. The lender's sole security would be the capital facilities and the project's rights to service fees and other project revenues, such as those from the sale of recyclable materials or energy. The lender would have no recourse to the general credit of either the municipal body or the private entrepreneur for loan repayment, although the performance obligations under the service agreement, including payment of damages, are full recourse to the parties. Thus, the municipal body is not treated as having issued "debt" and has not pledged its full faith and credit and taxing powers to repay project debt.

Under the put-or-pay service contract, the municipality does pledge its general credit—and taxing powers—to pay the service fees, just as the private developer/operator pledges its credit to build and effectively operate the facility. Thus, the two essential elements to this structure are the creditworthiness of the municipality—its ability to make payments for services rendered as and when due—and the experience and creditworthiness of the private entrepreneur—its ability to design, construct, operate and maintain the equipment and provide the services as and when required. These projects are considered "dual" credit financings, and the credit ratings of both parties will be considered in determining the rating of project debt. The lower credit rating—the "weak link"—will generally govern the credit rating of the project debt unless some form of credit enhancement, such as letter of credit, insurance, or third party guarantee, is used.

A well-thought-out procurement process is the foundation for a successful service agreement between a municipal body and the developer. The more complicated the project, the more comprehensively the procurement documents should specify applicable business, technical, legal and financial parameters. The more detailed the procurement, the less likely it is that arguments will arise as to whether a specific risk or facility element was included in the proposed service fee. The procurement should address all elements of project risk, including the designation of the party the municipality expects should accept each risk (particularly "force ma-

jeure" or "uncontrollable circumstance" risks where neither party is at fault). While this risk allocation may change during negotiations, it is important for proposers to know the municipality's initial position. That is especially true for any risk allocations not subject to negotiation because of legal or other considerations.

5. Asset Repositioning

Several structural concepts just discussed also apply where the facility is owned by, and will serve only, a private company. While the perception is changing, from the financial side a company's pollution control or prevention facilities are often still seen as a significant capital investment diverted from primary operations. In addition to straining cash reserves or adding additional debt, spending new capital for these "non-productive assets" often reduces the company's return on equity—producing an undesirable result from the traditional management perspective.

"Asset repositioning" can address the need to finance a new or upgraded facility, while reducing adverse impacts on the company's financial reports. This approach may be particularly useful where, for example, an environmental audit identifies concerns whose correction will require large capital outlays, leaving the company and its officers open to criminal willful violations unless funds can be raised quickly.

With asset repositioning, existing facility assets associated with pollution-control functions are "sold," preferably to a new project entity created specifically for this purpose. Depending on the parties' needs, the new entity could be a limited purpose corporation, a partnership, or a combination of the two. The project entity would be owned by the investor providing the capital for the new facility or upgrade, although that capital may be borrowed by the investor on its credit. The new project entity may either lease the new/upgraded facility back to its original owner for continued operation or, more significantly, provide the pollution-control function itself through a service contract with the host company. The latter structure can provide a number of additional benefits where a firm that specializes in designing and operating similar pollution control or prevention facilities purchases or leases the existing facilities through the new project entity, modifies or upgrades them as necessary, and assumes, through the service agreement, all treatment control, or compliance responsibilities.

This model may become increasingly popular as part of municipalities' and private companies' responses to such market-based regulatory approaches as the new allowance-trading program to secure sulfur dioxide reductions under Title IV of the Clean Air Act.¹⁶ Additional revenues can be generated by sale of allowances from "over-control" to support repayment of transaction debt incurred by the project sponsor.

This financing structure offers several potential benefits:

- ▶ The project can provide an initial cash payment to the host company, for example, purchase price of the unit or paid-up lease rentals;

- ▶ Because the project firm specializes in designing and operating treatment facilities, it may be able to operate the host company's treatment units more efficiently than the host, reducing both operating costs and likelihood of non-compliance with permit requirements;

- ▶ The host company can divest itself of unproductive assets and potentially improve its return on assets;

- ▶ The host company can eliminate or reduce its staff assigned to pertinent pollution control activities;

- ▶ The host company can reduce its regulatory burdens and risks because the operating firm would be contractually—if

not statutorily—responsible for obtaining and maintaining environmental permits and meeting pertinent standards or limits; and

- ▶ There is a potential to provide off-balance sheet financing of necessary pollution control improvements.

However, there are also risks involved:

- ▶ Possible failure of the contract operator to satisfy its obligations to operate the facility and meet permit limitations;

- ▶ Additional costs associated with structuring the transaction, such as negotiating contracts, obtaining financing, and host company oversight functions, which reduce the potential for net savings;

- ▶ Inclusion in service fees of the new operator's profit and the financing costs for its initial payments to the host company, which may increase the long-term costs of pollution control, prevention, or treatment;

- ▶ Loss of control by the host's treatment facility manager over employees and assets, which may reduce that manager's status within the host company and increase resistance to the project;

- ▶ Lost jobs, although the new operator may agree to hire any displaced employees willing to change employers and protect those employees' retirement benefits and wage levels;

- ▶ Costs to the host at the end of the service agreement term to reacquire treatment facility assets sold to the operator; and

- ▶ Complex tax and accounting issues concerning the treatment of sale proceeds, lease payments, operating fees, and financing costs, such as whether the facility lease may be expensed or must be capitalized, whether a depreciation deduction is available, and whether there is a step-up in basis upon the sale of facilities to the new operator.

Nevertheless, this alternative financing structure may be particularly attractive where a company is carrying significant depreciated equipment on its books, will be required to make a significant additional capital investment, and has had difficulties operating its facilities efficiently within permit limits.

6. Revolving Funds

The revolving loan fund structure offers another technique to provide funds where conventional sources are unavailable or too expensive. The 1987 amendments to the Clean Water Act introduced a new financing mechanism for waste water treatment systems—state revolving funds, which have now been established in all 50 states.¹⁷ In contrast with previous programs, this new program is geared largely to providing loans, not grants, for construction and modification of these systems. These funds are also set up to be self-sustaining. Their monies are loaned out to support construction costs, and loan repayments are returned to the fund to be used for subsequent projects. While these funds are rigidly limited to publicly owned waste water treatment facilities, the term "publicly owned" may be becoming more elastic. Moreover, similar revolving fund concepts have been proposed or explored for a much broader range of environmental projects.

Revolving funds under the Clean Water Act offer several different types of financial assistance, through a number of different structures. In general, funds act as independent agents, even though they are simply extensions of the state governments. Their principal feature is that they offer below-market interest rate loans, including zero-interest loans, to local governments for publicly owned systems. They use different techniques to achieve this goal. For example, they

can reduce interest rates by guaranteeing repayment of or purchasing insurance on local bonds. Portions of the fund also can be invested and the interest earned applied to reduce the effective interest rate on local bonds. Finally, portions of the fund can be used to repurchase or refinance existing debt obligations.

State and local governments could easily adapt this concept to help finance other environmentally related facilities. It is particularly attractive in an era of so-called "unfunded mandates" because it can help leverage limited capital resources, enabling public sponsors to support more projects over a longer period of time than could be accomplished through grants or individual loans.

The current Clean Water Act and implementing regulations limit use of that act's revolving funds. For example, funds may still be used only for facilities wholly owned by public bodies, although EPA is considering regulatory changes that would include partly or wholly private facilities serving a public function.¹⁸ Funds are not available to purchase land, which is often a significant part of sewer or other projects. Use of these funds generally requires the concurrent issuance of local debt. While reduced interest rates may make these loans more affordable, revolving loan funds may provide little relief where local debt limitations would be exceeded or limited borrowing capacity is required for other purposes.

7. Special Authorities and 63-20 Corporations

Government entities will often be uncomfortable with a project structure that places ownership or control of essential public assets in private hands. At least two financing alternatives are available which leave control of the facility in the public sector: creating an "authority" or a creating 63-20 corporation to hold and manage the assets.

a. Authorities. Authorities are independent public benefit corporations, generally created by the state legislature. They have governing boards that are independent of, but usually appointed by, the sponsoring public body. Hence, they are controlled to a certain extent by their sponsors. They have a separate budget, are supported generally by the fees and charges they impose for the services they provide (for example, sewer charges, water charges or tipping fees), and may often issue their own debt, which may be tax-exempt.

Under this structure, the public body transfers its responsibilities for providing the public service—sewage treatment, waste disposal/management, recycling, water treatment and pumping, etc.—and sells existing assets used to perform the service to this new authority. The authority then either provides the services through its own employees or contracts out for the required services. The authority's purchase of the existing and new assets required to perform the services can be financed through issuance of the authority's own bonds, without impacting the sponsor's credit or borrowing capacity. An authority's credit rating may differ from that of its sponsoring municipality because the authority's credit is based on its revenues, user fees, and special assessments, while the municipality's credit is also based on its taxing powers. However, an authority that has established proper reserve funds and possesses adequate powers to ensure its revenue flow may have a higher credit rating—hence a lower cost of borrowing—than its sponsor.

While authorities can be useful financing tools, they are frequently criticized as imposing additional, unnecessary layers of government on the public. They may also become more independent of the sponsoring body than was anticipated or intended. Thus, creation of a "63-20" corporation may be preferable.

b. 63-20 Corporations. A 63-20 corporation is a non-profit corporation that meets the requirements of IRS Revenue Ruling 63-20.¹⁹ To meet these requirements:

- ▶ The corporation must be formed under a state's general not-for-profit corporation law;

- ▶ It must engage in activities that are essentially public in nature;

- ▶ Corporate income may not inure to the benefit of any private person;

- ▶ The state or a political subdivision must have a beneficial interest in the corporation while any of its indebtedness remains outstanding;

- ▶ The corporation and the specific debt obligations in question must have been approved by the state or sponsoring municipality; and

- ▶ The state or sponsoring municipality must obtain full legal title to the property of the corporation with respect to which any debt is incurred upon retirement of that debt.²⁰

Qualification as a 63-20 corporation generally permits interest on bonds issued by that corporation to be tax-exempt. Involving a 63-20 corporation in the acquisition and development of public facilities, therefore, can enable the municipality to finance development of a public facility using tax-exempt debt, without having that debt treated as the sponsoring municipality's debt for purposes of, for example, any debt limitations, referenda requirements, or credit ratings.

One potential project using a 63-20 corporation might be structured as follows. The municipality sells the site and existing facility, if any, to the 63-20 corporation ("NFP"). The transfer must meet the requirements of state and local laws regarding sales or transfers of public assets to non-public entities—for example, payment of a fair market value, bidding, referenda, and judicial and/or state agency approvals. The NFP leases the land and the new or modified facility back to the municipality. The lease provides that the NFP is responsible for constructing the facility to the municipality's specifications. During the term of the lease, legal title to the facility remains in the NFP and does not pass to the municipality until the NFP's debt incurred for the project is discharged.

The lease between the municipality and the NFP initially is for a fixed term but may provide for renewal. The lease also provides that it may be terminated by the municipality at the end of any fiscal year during the term if the municipality fails to appropriate money sufficient to pay the lease payments due during the next fiscal year, unless state law permits the municipal corporation to enter into long-term contracts without non-appropriation language and without treating the lease as municipal debt. In the event of termination by reason of non-appropriation, the municipality agrees for a specified period of time not to obtain other property to perform the same functions as the leased property or to perform the same functions as the lease facility with other municipal facilities. Finally, the lease provides that, except for the municipality's right to cease to make lease payments by reason of non-appropriation, the municipality's obligations to make lease payments are absolute and unconditional. Upon termination of the lease and discharge of the NFP's debt, title to the site and renovated facility pass to the municipality. The NFP will generally issue its own bonds to finance the construction or renovation of the facility.

There are several advantages to this structure: the debt incurred for the acquisition and renovation of the facility is not treated as debt of the municipality and is not subject to the requirements for issuance of municipal debt; the NFP may not be subject to all the procurement and civil service

rules applicable to municipal procurements and employees; and the debt incurred to construct or renovate the facilities is usually limited recourse debt, secured only by the facility itself and the revenues from the lease agreement.

Conclusions

Numerous creative financing techniques are available to public or private borrowers when developing facilities, equipment, or processes needed to assure compliance with increasingly stringent and costly environmental requirements. While economic and political factors will determine which are feasible for any particular project, the range of options is steadily expanding.

Perhaps most suggestive for private-party compliance is that combination of asset repositioning and off-balance-sheet project finance that allows utilities, chemical companies, refineries, and other major industrial installations to meet their pollution control or prevention obligations under the Clean Air Act, the Clean Water Act, and similar environmental statutes through a sale to a third party of pollution-control assets in exchange for a compliance guarantee financed in part by the primary service agreement and in part by revenue streams generated by sale of emission or effluent credits produced by overcompliance.

Slightly extended, this model suggests such approaches as conversion of the superfund into a leveraged lending mechanism authorized to bundle remediation loans, provide loan guarantees to mobilize private capital for cleanup, and issue its own debt for revolving-fund purposes. By making more cleanup dollars more readily available in ways that do not penalize potentially responsible party balance sheets, this approach could complement reforms aimed at better liability allocation and improved selection of remedies by reducing the incentive for drawn-out battles over which PRP has what share of a particular site and who will pay for the rest. But that is a subject for another article.

Endnotes

¹ This article was adapted from a paper presented to the 86th annual meeting of the Air and Waste Management Association in Denver in June 1993. For related articles on the potential liabilities created by environmental audits and innovative ways to limit those liabilities, see Hymes and Levin, "Liability Without End? Consultants, Contracts, and the Limits of Environmental Responsibility," 24 ER 863 (BNA) (Sept. 10, 1993); Levin, Hymes and Mullaney, "Discovery and Disclosure: How to Protect Your Environmental Audit Report," 24 ER 1606 (BNA) (Jan. 7, 1994).

² While not within the scope of this paper, we note that credit enhancers, such as banks issuing letters of credit and insurance companies insuring bond obligations, could also be included in the list of third parties.

³ Criteria used to determine which party is to be treated as the tax owner are discussed generally in Internal Revenue Service Revenue Ruling 55-540, 1955-2 C.B. 39.

⁴ For example, if tax-exempt, private activity bonds are used, the maturity of the bonds cannot exceed 120 percent of the average weighted economic useful life of the facility. Internal Revenue Code § 147(b) (1986).

⁵ This clause frequently reads, in substance: "This contract shall be deemed executory only to the extent of the monies appropriated and available for the purpose of the contract, and no liability on account thereof shall be incurred beyond the amount of such monies."

⁶ But see note 7 below.

⁷ COP financing structures have been particularly popular in California. Recently, however, investors' confidence in this financing technique has been severely strained by events in Brevard County, Fla. (\$23.9 million COPs issue sold in 1989). Brevard County threatened to cancel its lease, by exercising its rights under a "non-appropriation" clause, on its newly constructed government center, not because it could not pay the lease payments but because there was a political debate over whether the facility should have been constructed in the first place. In a referendum held in the spring of 1993 on the issue, voters narrowly decided to continue to fund the lease payments. Despite the favorable outcome, this referendum and the public debate surrounding it served to highlight the investors' risk in COPs transactions and may cool enthusiasm for this form of municipal financing. See *The Bond Buyer*, Jan. 21, 1993, at 5.

⁸ A revenue bond is typically rated one step below a general obligation bond of the same issuer. However, with credit enhancement, the rating could be the same or higher for the credit enhanced bonds.

⁹ After the federal Tax Reform Act of 1986, only a relatively limited class of specialized projects, principally those having to do with public infrastructure (e.g., solid waste facilities, sewage treatment plants, airports), may still be financed with tax-exempt IDBs. See, e.g., Internal Revenue Code § 142 (1986). Many private developers of environmental facilities, therefore, will finance such expansions, new construction and/or acquisitions through issuance of "taxable" bonds.

¹⁰ E.g., N.Y. Tax Law §§ 208.9(b)(2) (McKinney 1986) [business corporations], 1453(b)(1)(B) (McKinney 1987) [banking corporations].

¹¹ The volume cap limits the amount of private activity bonds which a state may issue for certain types of projects.

¹² Rev. Proc. 93-19, 1993-1 C.B. 526.

¹³ Treas. Reg. § 1.103-8(f)(2)(ii)(a).

¹⁴ See Hume, "Private Activity Rules, Arbitrage Rule Changes Top IRS, Treasury Agenda." *The Bond Buyer*, March 3, 1994, Markets at 2; Hume, "Outlook '94 Tax Legislation: Enforcement and Private-Activity Rules Are IRS Priorities For Year Ahead," *The Bond Buyer*, Dec. 27, 1993, at 1; Hume, "Lawyers Call On IRS To Allow Use Of Munis In Financing Private Facilities For Sewage," *The Bond Buyer*, May 21, 1993, at 1.

¹⁵ See also the discussion below regarding "asset repositioning"; most benefits and risks discussed there are applicable to public-private partnerships as well.

¹⁶ See, e.g., CAA §§ 401 et seq., 42 USC §§ 7651 et seq.

¹⁷ The federal revolving fund program was created under the Water Quality Act of 1987, which amended the Clean Water Act of 1972; see 33 USCA 1381 ff. New York State's revolving fund program was established by 1989 N.Y. Laws Chap. 565.

¹⁸ See 57 FR 28867-69 (June 29, 1992).

¹⁹ Rev. Rul. 63-20, 1963-1 C.B. 24.

²⁰ While these criteria appear relatively straightforward, there are different ways to satisfy them, each of which involves highly technical hidden pitfalls.