

Understanding Lease Purchase Financing for New Jersey School Districts Part II (*and what to watch out for*)

Forward by the authors, Hope R. Blackburn, Esq., Counsel, Scarinci Hollenbeck, LLC and Dennis Balodis, Director of Development, Hunterdon County Educational Services Commission

When we wrote the first “Understanding Equipment Lease Purchase Financing for New Jersey School Districts” in 2011, the article was intended to provide a brief overview of the legal, financial and practical requirements and considerations when buying equipment under tax-exempt lease purchase financing arrangements. As the former Director of the Division of Purchase and Property and current School Board attorney and the Director of Development/Financial Services Manager Lease Purchase Bidding Services, respectively, we assist our clients navigate the often murky waters of lease purchase financing on a constant basis. Our current goal is to make School Business Administrators as District purchasing agents aware that even the innocuous copier lease is probably a technical lease purchase and to make them aware that that 8-10% interest rate probably isn’t such a great deal. It’s been seven years since the first article was written and the collaboration hasn’t stopped. As a new January rolls around, and Business Administrators begin to craft the budget for next school year, there is a constant dialog with SBAs, the banking community, attorneys and Superintendents.

We have seen an increase in State and local purchasing cooperatives giving School Districts additional procurement avenues without the need to engage in the often time consuming public bidding process. In addition, the legislature has permitted public entities to use national cooperatives to buy goods and services. On the flip side, there has also been the entry of various contractor sales gimmicks include financing with terms that may or may not be consistent with New Jersey law and the federal tax laws.

Overview:

In this age of volatile school funding, major purchases and how they are paid for are not things that an administration and a board can take lightly. From the communities’ vantage point major purchases are highly visible and can be lightning rods for praise or criticism. These acquisitions will invariably be reviewed by your auditors and may also be reviewed by the New Jersey State Comptroller, the Department of Education’s Office of Fiscal Accountability and Compliance or a federal program auditor. Your understanding the process and what is compliant under New Jersey Public School Contracts Law, the Departments of Community Affairs and Education regulations, and the Internal Revenue Service regulations are key components that will permit you to get essential goods and services into the classroom. Being able to identify lease purchase arrangements and the processes of acquisition and payment from many vantage points can also help you to determine a good deal from one that is too good to be true and save Boards time and money in the long run.

Lease Purchase Financing

Over the years in presentations at local NJASBO meetings or in a training session, we often start off and pose the following question to the group: “Who has done lease purchase financing for their district?” “...a show of hands?” A few hands go up. Okay, we then ask “How many of you have copiers in your district?” Amazing, everyone raises their hands. Surprise! The majority of the copiers that are leased to school districts are utilizing a tax-exempt lease purchase.

First, a recap of the basics. In the public arena, a lease purchase is a statutory construct that gives public entities the option to finance acquisitions without seeking direct voter approval and incurring long term debt. Under the New Jersey Education Laws, a lease purchase is “any agreement which gives the board of education as lessee the option of purchasing the leased equipment or improvements...to existing school buildings during or upon termination of the lease, with credit toward the purchase price of all or part of rental payments which have been made” under the lease.¹ The arrangement has the extra added benefit of being able to finance the purchase at tax exempt interest rates, so long as certain Internal Revenue Service conditions are met. The remarks that follow are focused on equipment lease purchases rather than facility lease purchases, which are treated a little differently.

As with most public entity contracts, there are a series of statutory and regulatory requirements that must be met in order to seal the deal. It is important to remember that there are public bidding requirements for BOTH the equipment AND the funds. You are buying equipment and you are buying money with the promise to pay it back.

Cooperative Purchasing:

Over the past decade, public entities have realized the benefits of shared and cooperative services. There has been a growth in the use of cooperative purchasing organizations to save time and energy and to relieve Districts from many compliance headaches. Even though these vehicles have become more available, it does not relieve a public entity from all responsibility. A bank will still want to be paid, and will rely upon the public entity, as the purchaser, to get an all-important (to the bank) “Opinion of Counsel” from your board attorney that says that you did everything right before they will actually issue the funds.

The Use of National Cooperatives and Compliance

Over the past decade, the statutes governing State cooperative purchasing have been amended to give the New Jersey Director of the Division of Purchase and Property (“Division”) greater discretion in authorizing the use of national cooperative contracts and in making them available for local government use. Those contracts are vetted for compliance by the Division. Later, in 2011, the Legislature adopted, and the Governor signed Chapter 139² that permits local contracting entities to “purchase goods, or to contract for services” using cooperative contracts that have been

¹ N.J.S.A. 18A:20-4.2(f).

² N.J.S.A. 52:34-6.2.

entered into “by another contracting unit...within any other state” if the purchasing agent determines that it will result in cost savings. After its adoption the Division of Local Government Services, in conjunction with the Division of Law and Public Safety, the Division of Purchase and Property and the Office of the State Comptroller, issued Local Finance Notice 2012-10 to guide local entities in the use of the many national cooperatives.

With the proliferation of cooperative contracting opportunities, some vendors that do not hold local awards are relying on the awards of national cooperatives to sell their products. We are seeing two different aspects of the use. Some vendors are asserting national cooperative availability because their manufacturers are telling them that their products are on national contracts whether that is in fact the case or not. Others are taking advantage of the fact that they have a national contract and hoping that statement will be taken at face value to close a sale.

Vetting a national contract is complicated. While not including all of the requirements for the purposes of this article, there are several important caveats to keep in mind if you are going to finance a purchase made through a national cooperative. Some of the important factors are:

- the national cooperative must be an actual governmental purchasing entity, rather than a for or not for profit entity that coordinates or aggregates different state and local contracts;
- the purchase must be for goods and or services;
- the purchase may not be for public works or construction;
- The contract must have been initially awarded as a cooperative contract;
- the contract must have been awarded through a competitive bidding process; and
- the contract must require the vendor to comply with all applicable contract requirements, i.e., the New Jersey Business Registration, Statement of Corporate Ownership, Public Equal Employment Opportunity requirements.

Once that has been determined Boards are required to do a cost savings determination that the procurement is financially prudent including a consideration of all “charges for service, material, and delivery.” *N.J.S.A. 52:34-6.2(b)(3)*

The Division has greatly expanded its vetting many national contracts so most of the work has been done for you. The Educational Services Commission of New Jersey has also taken much of the burden from public entities by vetting the Association of Educational Purchasing Agencies (“AEPA”) cooperative contracts as they are introduced or renewed. But the mere fact that some organization has stated that their contracts are recognized on a national basis doesn’t mean that they can always be used by governments in New Jersey.

Why Does it Matter?

Why does it matter whether the national cooperative contract complies with the current New Jersey legal requirements? If you want to finance the purchase, the financial bidders are going to ask you for an Opinion of Counsel from your board attorney. That Opinion has several parts. The financial institutions ask your attorney to certify that you have the authority to enter into the underlying equipment purchase and that you have complied with all applicable federal, state and local laws and regulations when entering into and authorizing the purchase. As discussed later, they will also ask if you have complied with the federal tax standards so that the financier can treat the transaction as a tax-exempt undertaking.

You can't just rely on the vendor's salespeople to tell you whether you can use the contract or not. That is not their job. Their job is to sell you goods and equipment. While cooperative contracts often place responsibility on the vendors to only make sales in accordance with the applicable contract, reliance on verbal representations will not be sufficient to establish that you have done due diligence. It is not that vendors may be trying to mislead you, even in conversations with their local counsel, many think that that they are eligible to sell in New Jersey. At first blush, *N.J.S.A. 52:34-6.2(b)(3)* looks very broad, especially to non-New Jersey lawyers and to salespeople trying to make a sale.

Co-op's: Is what you are purchasing really on an award?

When selecting items from a contracting vehicle it is time to once again proceed with caution. Because a vendor or manufacturer holds an award either national or state wide does not automatically give that vendor or manufacturer carte blanche to sell everything they present. The specific items must be on the award or on the catalog that was awarded. It is incumbent upon you to make sure that their products are on the specific award. When using a New Jersey State or local cooperative or national contract your vendor should clearly state the name of an award number of the equipment that you are purchasing on their proposal and invoice.

Ask for the actual award documentation and the contract. The best way to determine whether the contract is used is to actually check for yourself. Some cooperative contracts make a primary and a secondary. If you review the rules of the cooperative you can determine whether the vendor in second place may be used. It usually means that you have to solicit proposals from the first vendor on the contract. If, and only if, that vendor is not available can you use the second vendor. Cooperatives also may make awards by geography: south, central and northern New Jersey. In that instance, you can only use the vendor in your District's region.

Zero Percent Tax-Exempt Financing is it an Oxymoron?

Zero percent financing: If only it were true! First there was Lee Iacocca in the 80's selling Chrysler, Plymouth and Dodge cars with "Zero Percent "financing. Then Xerox started selling copiers with the same gimmick. Today we see car dealers hawking new cars with zero percent financing with the additional statement, "or \$ ___ cash back." Okay, we can pay the promotional price over time with no interest or pay up front and get a discount? Sounds fair enough, banks are not in the business to give money away so the promotional zero percent financing the dealer offered was

being subsidized by the auto manufacturer. Makes sense in a commercial transaction. In fact advertising a sale of a car at a promotional low subsidized rate is common place. And it is caveated in small print "to qualified tier one customers". Can a commercial sales practice that is in place to control the sale and limit the ability of potential customers to seek other source of funding that may lose the potential sale once that customer walks out the door work in the public sector?

Let's look at this from the large manufacturer's mind set. The zero percent or low interest promotions work in the commercial market. The greatest portion of these companies' sales are commercial to businesses or individuals. So, the corporate edict is handed down that these types of proven programs should be offered across the board to all of their customers. Well the public sector sales represent only a small percentage of these companies' sales. Corporate logic is if this program works in one market segment it should work in all. With the corporate edict from on high the sales forces take their marching orders and make things happen. Unfortunately, in the public sector we have to deal with public bidding laws and IRS regulations and so do our vendors.

The fact of the matter is that the "Zero Percent Finance" offering to a public entity is a subsidized sale. The vendor is actually selling the equipment with two different prices. The price they quote to you and the second is the lower price that they offer to the financial institution which will make the lease purchase to you under the zero percent financing scheme.

The subsidy is in the form of a lower sales price to the financial institution that the vendor has selected to offer the lease purchase to their governmental customer. This price to the selected financial institution is lower and is on a sliding scale to make up the difference between the interest rate that the institution would offer a government taking into consideration the credit worthiness of the entity. The greater the credit risk perceived by the financial institution the greater the discount the vendor gives to institution. All this is to maintain the zero percent financing program that the corporation is marketing.

This price is less than what was stated on a bid or contracting vehicle award and is not made available to you, the government purchaser. So why should it concern you as a business administrator and your district when we're getting the equipment at the price that was stated on the contracting vehicle award and we're getting the financing at zero percent? The problem is, the bank will make you certify to both the zero percent financing AND the actual rate that is being financed by the vendor with the actual interest rate.

Are you and your board willing to pass a resolution stating that you are purchasing a few hundred thousand or millions of dollars of equipment at a stated price at zero percent financing to only find out that the transaction documents, upon closer review, state something different?

Are you prepared to execute documents show a payment schedule at zero percent, with a simple reduction of principal over the term with no interest component that has a simple small type statement that there is really an interest component of the transaction which is higher than you may have found on another cooperative contract or in the competitive market? Further that you acknowledge that the price to the financial institution is actually lower or may be lower to satisfy the credit requirements of the institution? And to add insult to injury you are also asked to acknowledge that you will certify to the IRS on their form 8038-G that the transaction is for an

amount less than your board has approved and the interest rate that the financial institution has given will be certified by you as a tax exempt issue by your district?

Are you prepared to do this to accommodate the whims of a corporate marketing program? If so maybe you should consider actually asking your Board to make two sets of representations. The first is that the purchase is being made at zero percent interest. The second is certifying that the purchase is actually NOT at zero percent interest because the vendor has chosen to lower its sales price for purposes of selling the debt to a financial entity.

Bidding the Lease Purchase and the Principle of Aggregation

The criteria that we use in determining whether or not a lease purchase transaction is conducted as a request for quote or a request for bid is the amount of interest paid over the term of the lease contract not the amount borrowed. It seems strange to say that you are bidding for an authorized financial institution to lend you money that you will pay back over time. Further, regardless of what equipment the lease purchase pays for, you are paying the bank its fee for the utility of lending you an amount of money.

Once the aggregate interest of the transactions entered into over the past 12 months from a single lender is added to the potential interest of the new issue, that dollar amount is compared to the specific bid threshold your board has authorized. If that threshold is exceeded, then a formal request for bid is conducted. If the amount is less than our bid, then competitive quotes can be received.

While aggregation for state law purposes requires the use of your professional judgment, aggregation for the purpose of tax exempt debt that you have issued does not. For purposes of tax exempt borrowing, we look to what lease purchases you have issued during a calendar year, be it for copiers, school buses, technology or marching band uniforms. That is because in order for you to get a lower interest rate, the bank wants to be able to treat the interest they receive from you as fully tax exempt. The IRS regulations require that in order for the transaction to be deemed “bank qualified” to give financial institutions the full benefit of tax exempt debt, you must not have issued more than \$10 Million in tax exempt debt (be it through bonds or other lease purchase financings) during the calendar year in which the obligations are issued.

If you entered into that errant copier lease, and have issued bonds for a new roof, you may not be able to treat the purchase of school computers as bank qualified to attract the interest of a bank or other financial institution, even if you weren’t aware that the copier contract was really a tax-exempt lease purchase. You must be cognizant of the total debt, bonds, anticipation notes, and lease purchases issued in the calendar year, which is from January 1 to December 31, not your government entity’s fiscal year. If that exceeds more than ten million dollars, the full tax-exemption cannot be taken by banks. This has to be mentioned as the question will be asked by special counsel or an interested lessor to see if your entity tax exempt interest is qualified to be taken by banking institutions.

Planned and Incidental Acquisition Financing

The annual ritual of budget preparation for the next fiscal year is daunting. The competing needs to support the educational program -- buses, computers, tech infrastructure, maintenance equipment -- all of have to be considered by business administrators and boards of education in preparation of the annual budget. Many BA's across the state take advantage of the free budgetary run service provided by the Hunterdon County Educational Services Commission that gives them some idea of how much to budget for the aggregate amount that will have to be paid for by lease purchase financing in the new fiscal year. But sometimes unexpected things come up. A new bus, a pick-up with plow, some additional technology or copiers; standalone items that came up outside of the budget process; or maybe your district doesn't need a lease purchase for an amount that exceeds \$200,000. What can be done and still be compliant with public bidding laws and IRS Regulations?

Historically these incidental acquisitions have relied on "vendor financing" to bridge the gap. But given the rates associated and requirement that once an amount has surpassed the quote threshold the lease purchase must have bids for the amount financed, vendor financing may actually be in violation of the public bidding laws. Over the years we have found out that the small transactions are the hardest to fund through quotes. Why? Size does matter when it comes to documenting these transactions. For a traditional lender the normal costs associated with quote response and documentation exceed any profit there is in these transactions. What can be done to obtain the financing needed and still be in compliance with public bidding laws?

Tax Exempt Lease Purchasing Small Ticker Cooperative Contract a Compliant Financing Program for Transactions from \$2,500 to \$200,000

Okay, you want to play it safe and insure that you are compliant?

The Hunterdon County Educational Services Commission's New Jersey State Approved Cooperative (# 34HUNCCP) has awarded its Small Ticket Tax Exempt Lease Purchase ("TELP") Program³. This award covers the financing of essential use equipment with funding ranging from \$2,500 to \$200,000. The Award complies with New Jersey public bidding laws. It was developed to answer the need to finance at competitive rates without having to conduct a request for quote and hope there is a response, or worse, utilize a vendor financing program. [Not sure what you mean with the last sentence so took it out }

As always, this article is not intended to provide legal advice. Be sure to contact your board or special counsel before entering into any lease purchase financing.

We thank Andrea Kahn, Esq. of McManimon, Scotland & Baumann. LLC, for reviewing this article regarding federal tax implications. Andrea is working on proposed changes in legislation which will attempt to correct certain of the workarounds which we have had to deal with in New Jersey. We greatly appreciate Andrea's experience and expertise in her contribution to this article.

³ <http://www.hunterdonesc.org/hcesc/Lease%20Purchase/>

Hope Blackburn, Esq.
Counsel
Scarinci Hollenbeck
hblackburn@sh-law.com
201 896 7013

Dennis Balodis
Dir. Development/Lease Advisory
Hunterdon County ESC
dbalodis@hunterdonesc.org
908 572 7715