



## MEMORANDUM

Date: 11-14-03

To: Members of the City Council, Rapid City  
The Honorable James Shaw, Mayor  
James Preston, City Finance Officer  
Coleen Schmidt, Assistant City Finance Officer  
Jason Green, City Attorney

From: Allco Finance Corporation

Re: *Long-Term Lease/Leaseback Transaction*

We have been informed by KBC Bank, the equity investor to the long-term lease/leaseback transaction under consideration by the City, that they have withdrawn their bid to Rapid City. They indicated that it was an imprudent use of bank expense and resources to continue work on a transaction that, based upon their serious concern with the negative press it has received, especially quotations from City Council members drawing incorrect conclusions and interpretations, appears to have a high likelihood of not closing.

On October 6<sup>th</sup>, 2003 the Council voted to continue dialogue on the transaction, but we now understand that on Wednesday, November 12<sup>th</sup>, the Public Works Committee of the City Council voted to discontinue discussions of the possibility of a leasing transaction for the city's wastewater treatment system. It is our understanding that the issue will again be before the full Council on Monday November 17<sup>th</sup>, 2003.

As the arranger of the transaction, it has been Allco's goal to bring an investor to the City with terms, conditions and economics that are acceptable to the City. Likewise, it is critical that the City Counsel members are fully apprised of the correct facts, and fully understand the terms, conditions and economics.

Prior to the recent decision by KBC Bank, the transaction process in behalf of the City included legal review of the transaction and negotiation of terms and conditions by a group of lawyers representing the City and State of South Dakota. The steps prior to the City finally executing a transaction called for:

1. A complete review of the transaction and closing documents with the Council by the lawyers representing the City and State,
2. Approval by the State Board of Water and natural Resources,

3. Approval by the SD Municipal Facilities Authority,
4. Approval by the US Environmental Protection Agency (EPA).

If the decision on Monday the 17<sup>th</sup> by the Council is to continue its efforts towards a transaction, Allco is prepared to reinitiate the bidding process in the effort to secure another investor for the City. However, it appears the investor community as a whole is well aware of the current situation regarding the Rapid City transaction. Under the current environment, it is fairly unlikely that KBC Bank could be convinced to reconsider, or that other investors would make offers to Rapid City. That being the case, it is Allco's opinion that for that effort to be successful, the Council would have to give a clear message to the investor community that it understands the transaction, and is prepared to close a transaction, of course assuming it can negotiate acceptable terms, conditions and economics.

If the Council believes that the City should pursue a transaction, Allco suggests that at a future meeting the Council pass a resolution indicating its desire to consider a transaction, and approve a full summary of the minimum terms and conditions of the transaction under which the City would participate.

In anticipation of discussion, and decision to be made at the Council meeting on the 17<sup>th</sup>, we have attached to this memorandum a list of issues and topics for the Council's review. It is intended to clarify the misperceptions that we believe some of the Council members may have regarding the transaction. Furthermore, Allco, as well as the City's co-bond counsel Lynn Endorf (of the Dorsey & Whitney law firm) would be willing to attend the meeting if asked by the Council.

If the City elects to not continue its efforts towards a transaction, then Allco will cease its activities in behalf of the City.

We remain willing to work with city if there is genuine support for the transaction, but we all must recognize that the events that have transpired have made the task considerably more difficult, particularly when an increasing number of cities (and county and state governments) around the country are stepping forward eagerly in pursuit of transactions.

As always, we are available to discuss the topic and answer any questions. Jim Wavle is on 212/885-9517 or [jwavle@allcony.com](mailto:jwavle@allcony.com). Scott Scofield is at 605/256-0717 or [sscofield@svtv.com](mailto:sscofield@svtv.com).

Cc: Dorsey & Whitney  
Chapman and Cutler  
SD Municipal Facilities Authority  
SD Board of Water and Natural Resources  
Editor, Rapid City Journal

# **FACT SHEET**

Before addressing specific points, there are some general observations that should be noted.

The type of leasing transaction that is being considered by Rapid City is nothing new. In fact, the transaction is well established and has been in use around the country for many years, predominantly for subway cars, maintenance facilities and power plants. Market acceptance of such a transaction on domestic wastewater assets is fairly new, but no longer novel – at the end of September, a transaction of this type was closed for a large wastewater operator in New Jersey, the North Hudson Sewerage Authority. The same type of transaction for water and wastewater assets is now in process in at least two dozen cities or counties in at least seven states besides South Dakota, and under serious consideration in many more.

Virtually all, if not all, of the parties who have entered into this type of transaction in the past have been so pleased with the results that they have done follow-on transactions – repeatedly. The state’s financial advisor (Dougherty and Co) contacted many of the transit agencies around the country to confirm; they concluded all cities and authorities were very pleased with the results of the transaction (including those whose transactions were arranged by Allco). None had lost control of their assets, none had suffered any loss and all reported that the transaction worked as understood.

To be sure, there are risks associated with the transaction, however minimal. On August 26, Dougherty and Co, along with the City’s co-bond counsel and Allco, delivered a detailed review of the transaction, and endeavored to answer all questions about the nature of the transaction and the risks. Unfortunately, not all of the Council members attended that briefing, which may have been what led to their confusion. Allco has also addressed all questions about the transaction that have been addressed to us by city officials, City Council members and the South Dakota legal team since that time.

None of which is to say that the City has to take those risks or do this deal, but in a time of tight budgets and cuts it would be especially unfortunate to hastily throw away millions of dollars that could be of benefit to your citizens based upon misconceptions or simply a lack of full understanding.

***Particular issues that we are aware of that have been misinterpreted, and need to be addressed are:***

- **Preliminary Documents** – To set the record straight, the Council requested in its August 26 meeting, transaction documents be sent to the

City for review. Those documents, the very first draft (July version), were delivered shortly thereafter per that request. The documents were transmitted to the city by its own lawyers (Dorsey & Whitney) with a covering email that noted that the documents were “preliminary”. It was never the intention that these documents be considered as final or taken to the Council for final approval on September 15.

Throughout August the South Dakota legal team, along with Jack Arnold of Dougherty & Co as financial advisor to the State, reviewed and prepared comments on the first (July) draft of documents. They submitted their collective comments to King and Spalding, lawyers for KBC Bank, in late August. Those changes were received by King and Spalding, and a new set of documents were delivered electronically as a “revised-draft” on September 15<sup>th</sup>.

Unfortunately, there was confusion, and the City acted on September 15<sup>th</sup> on the old (July) draft in the mistaken belief they were final documents.

In fact, the lawyers are continuing to negotiate the transaction on behalf of all of the cities and the State, and we expect there could be as many as 3 to 5 drafts before the lawyers get done. We are convinced that all issues will be addressed to the satisfaction of all of the cities, and the State.

Having said all of that, most of the perceived defects in the documents were not there in the first place.

- **Structural Tax Risk** – There continues to be a misunderstanding regarding the tax benefits anticipated by the equity investor. *The investor assumes all of the risk that they may not get any or all of the tax deductions they expect, whether because the law changes or they just got it wrong under current law; it is not the city’s risk.* This is the market standard across all U.S. leasing in the large-dollar asset market, it is the case in all of the domestic transactions referred to above, and it was also the case in the preliminary drafts the city received. There are indemnity and other risks that should be discussed and understood, however they are standard risks in the marketplace that have been considered many times, by many lessees and many lawyers, and have been found to be remote risks – and they do not include the structural tax risk. All obligations and indemnities that are the responsibility of the City will be fully explained and reviewed by its co-bond counsel before it would enter into the transaction. We feel that with a full understanding, the City would also find the risks that do exist to be remote and acceptable risks.
- **Governing Law** – The preliminary (July version) documents did indeed call for New York law to govern the transaction. However, the South Dakota lawyers working on the transaction had already communicated to the investor’s counsel that only South Dakota law could govern documents

signed by a South Dakota municipality, and the investor and their counsel agreed. This occurred, prior to the City Council vote on September 15, and was reflected in the draft documents electronically delivered to the City on the 15<sup>th</sup> of September.

- **Waiver of Jury Trial** – The preliminary transaction documents reflect that all parties – not just Rapid City – waive a right to jury trial. In the past our experience has been that the lawyers, not just in leases but in any complicated financial transactions, think this is preferable for all parties. If this is considered to be a serious issue, it could certainly be discussed with the other parties.
- **Control of the System** – It is a standard feature of this kind of transaction that the lessee – in this case the city – remains in full control of the assets. The city continues to own the system, would retain all rights and responsibilities with respect to running, maintaining and improving the system. The City would continue making employment decisions, setting the rates, delivering the services, and retaining the revenues. It is not the case that the city would have to go to the investor for approval to make improvements to the system.
- **Allco** – Allco’s involvement in the transaction dates back almost nearly two years. Allco identified the potential opportunity and benefit to the cities of South Dakota. It approached the South Dakota Municipal League to gauge whether the transaction had appeal for the SD municipalities, and subsequently spoke to the financial staffs in the First Class cities. Hearing a level of sincere interest on the part of the cities, Allco approached the Governor and then the legislature with the concept, and ultimately helped the legislature draft and pass legislation to create the South Dakota Municipal Facilities Authority and provide the cities the powers to execute the transaction.

Allco then approached the entire community of investors engaged in these transactions to solicit interest in the South Dakota transaction (the bid from KBC in fact was the result of a true marketing process, not simply Allco showing up with a bid).

- **Financial Risk** – This is, in Allco’s view, the principal risk in the transaction and the one that garnered most of the discussion in the August 26th meeting.

The initial intention under the KBC proposal was for the a portion of the transaction to be defeased with U.S. Government Agency securities and for the smaller (“loop”) portion to be defeased with a payment undertaking agreement (e.g. GIC) from AIG, one of the world’s largest insurance companies.

Based upon the city's perceived discomfort with the GIC agreement, an offer was also put forward to defease the entire transaction with U.S. Government Agency securities. If Rapid City had chosen this option, the cash benefit would have gone from roughly 3.62% to 3.0% .

If, instead, Rapid City wanted to stay with the 3.62% cash benefit, and use the AIGGIC (or potentially another provider of the same kind of agreement), KBC would have funded an escrow account that Rapid City could draw from if they needed to switch to a new GIC provider during the leaseback period.

There has been considerable confusion on this matter as related in the press. If further explanation is required, please advise. If a transaction for Rapid City is to go forward, the same kinds of choices will likely be faced.

- **Cayman Islands** – We understand there has been some concern with the fact that a Cayman Islands entity was part of the draft documents. If this is a critical matter for Rapid City, we can certainly find a solution which does not involve an entity organized in the Cayman Islands or anything of the like. AIG has traditionally done business using subsidiaries all over the world, including the Cayman Islands, and they have closed transactions on this basis for many public entities throughout the United States. Whatever subsidiary AIG uses, it's important to note that AIG, the parent in the U.S., fully guarantees the obligations of its subsidiaries. Other potential solutions include telling AIG to use other entities, using a provider other than AIG (for example, the municipal bond insurer, FSA) or possibly using U.S. Government Agency securities, as noted above.
- **Legality/Propriety** – As your counsel has advised, it is legal for the city to enter into this type of transaction and the investors in these transactions receive advice from highly experienced and reputable counsel that they are entitled to the tax deductions they are expecting.

On October 21<sup>st</sup>, the United States Senate Finance Committee held a hearing regarding a broad spectrum of corporate tax shelters. Leasing transactions were discussed, with particular emphasis on transactions involving foreign entities, however the majority of the hearing was concerned with questionable tax strategies which create permanent tax reductions, are often concluded without disclosure to the IRS, and have nothing to do with leasing.

The leasing transaction the City is currently considering and arranged by Allco Finance, in contrast:

1. Complies with federal law,

2. Is tax positive (i.e., the investor ultimately pays *more* tax in the transaction than is deferred in the transaction),
3. Is registered with the IRS, and
4. Is clearly identified on the equity investor's tax return

There are some important points which were left unclear or unsaid during the hearing. For instance, departments of the federal government, such as the Federal Transit Administration, support leasing transactions as an additional tool for local governmental entities to obtain much-needed funding and as a way for local government to reap some of the benefits associated with privatization. The leasing of publicly owned assets is a form of public/private relationship that has been used by cities and other political subdivisions for many years. In addition, several state governments have current plans to make use of leasing transactions and at least one arm of the Federal government – the Tennessee Valley Authority – currently uses these transactions itself in order to raise additional funds.

In the October 21 hearing, the United States Treasury Department even restated its own opposition to the core proposals that would affect leasing, stating “... a statutory rule will bring uncertainty for careful practitioners and taxpayers.”

It is appropriate for Congress to continue to exercise its prerogative to review and improve the federal tax code and to eliminate bogus and illegitimate tax scams, however leasing transactions such as those under consideration by the city are an appropriate use of tax policy to encourage private sector entities to help local government.

It is possible that Congress could change the law and that these transactions would no longer be permissible – there are some in Congress now who would like to do so and have been trying to do so for some time, without success. So long as the law remains as it is, however, it is quite clear that private investors and public entities around the country will continue to enter into these transactions as they are permitted to do and as they have done for a long time.

Law allows for a city to issue tax-exempt debt, and law allows individuals to deduct the interest on our mortgages if we own homes. That and a lot of other tax breaks all cost the taxpayers, but of course it is done. The law says that investors and communities can do leasebacks, and they do it. And further, the transactions are registered with the IRS and also included on the investor's tax return.

Leaseback transactions aren't something somebody just dreamed up – the big cities all across the country have been doing the same thing for years, except that the assets were subway cars, maintenance depots, power plants, even whole rail lines.

If Rapid City opts out on some “philosophical” basis, the market will not be affected; it is only the citizens of Rapid City who will suffer from the missed opportunity.

In conclusion, Allco has taken great effort to help the City put together a team of legal and financial experts working specifically in the City's behalf on these issues. Feel free to contact any of them in regards to the facts presented herein, or other questions you may have. Your co-bond counsels are Lynn Endorf (of Dorsey & Whitney 612/340-2651), and Dave Williams (of Chapman & Cutler on 312/845-3800); Bill Libit (of Chapman & Cutler on 312/845-2981) is also an excellent resource. The State's financial advisor is Jack Arnold (of Dougherty & Company 612/376-4125). These people have spent a great deal of time studying the transaction and have a tremendous amount of experience with complicated commercial transactions.