UAD-11

U.S. Department of Transportation

Urban Mass Transportation Administration

CIRCULAR

UMTA C 7020.1

Subject: CROSS-BORDER LEASING GUIDELINES

April 26, 1990

1. PURPOSE. This circular sets forth the Urban Mass Transportation Administration's (UMTA) Cross-border Leasing Guidelines to provide grantees with current guidance on UMTA's treatment of these transactions. Since cross-border leases involve substantial expense and delicate timing, it is also the purpose of this circular to provide clear guidance as to how UMTA will make its case-by-case decisions whether to approve a particular lease.

2. REFERENCES.

   a. Urban Mass Transportation Act of 1964, as amended, 49 U.S.C. sec. 1601 *et seq.*

   b. 49 CFR Part 18, Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments.

   c. UMTA Circular 4220.1B, "Third Party Contracting Guidelines," dated 5-5-88.

   d. UMTA Circular 5010.1A, "Urban Mass Transportation Administration Project Management Guidelines," dated 9-18-87.

   e. "Moving America: New Directions, New Opportunities," A Statement of National Transportation Policy, dated 3-8-90.

3. POLICY. One of the goals of "Moving America: New Directions, New Opportunities" is to reduce dependence on scarce Federal transit resources. To attain this goal, it is UMTA's policy to encourage and facilitate its grantees' use of innovative financing and funding options. One of these options is for grantees to enter into certain leasing arrangements with foreign entities referred to as cross-border leases.

DISTRIBUTION: UMTA Headquarters Offices (U-W-2)
UMTA Regional Offices (U-X-2)

OPI: Office of Policy

4. APPLICABILITY. This circular applies to grantees' cross-border leases of transit equipment acquired with UMTA assistance under Sections 3, 5, 9, or 18 of the UMT Act, 23 U.S.C. Section 103(e)(4), and Stark-Harris. This circular does not apply to any other types of leases that grantees enter into, especially those leases governed by 49 CFR Part 639, Capital Leases.

5. DEFINITIONS. All definitions in the UMT Act are applicable to this circular except as is otherwise provided in this paragraph.

   a. "Cross-border lease" means the lease by an UMTA grantee of UMTA-funded transit equipment from a foreign entity.

   b. "Defeasance" means a condition whose performance defeats or renders a deed or other instrument void.

   c. "Operative documents" means all the documents including, but not limited to, the sales agreement, lease agreement, loan agreement, security agreement, schedules, and exhibits, which define and explain the terms of a cross-border lease.

   d. "Term sheet" means the basic summary of the agreement, including, but not limited to, identifying the parties to the agreement, the equipment involved, expected closing dates, benefits to the grantee, unwind events, terms of the lease, repurchase option, steps in the transaction, and such other information and conditions that are pertinent to considering the merits of the lease.

   e. "Unwind events" means those events including, but not limited to, loss of the leased equipment through casualty or removal from mass transportation service, bankruptcy of a party to the cross-border lease transaction, or other event identified in the operative documents, which could cause the premature termination of the lease.

6. BACKGROUND. Sections 3(a)(2)(A)(ii) and 9(e)(3)(B) of the UMT Act require the grantees which receive UMTA assistance under these grant programs to retain "satisfactory continuing control, through operation or lease or otherwise, over the use of the facilities and equipment..." UMTA imposes this same requirement on Section 18 grantees pursuant to the authority in Section 18(f) which authorizes the Secretary of Transportation to subject these grants "to such terms and conditions...as the Secretary may prescribe." The primary purpose of this requirement is to ensure that UMTA-funded

projects will become, and will remain, operational. Philadelphia Council of Neighborhood Organizations v. Coleman, 437 F. Supp. 1341 (E.D. Pa. 1977), aff'd without opinion, 578 F.2d 1375 (3rd Cir. 1978).

One of the ways that UMTA ensures that grantees comply with this requirement is through Section 109, "Encumbrance of Project Property," in Part II, Terms and Conditions of the Grant Agreement. This provision provides in pertinent part,

> The Recipient may not execute any transfer of title, lease, lien, pledge, mortgage, encumbrance, contract, grant anticipation note, alienation, or other obligation that in any ways affects the Federal interest in any Project real property or equipment, nor may the Recipient obligate itself, in any other manner, tc any third party with respect to Project real property or equipment, unless such transfer of title, lease, lien, pledge, mortgage, encumbrance, contract, grant anticipation note, alienation, or other obligation is expressly authorized in writing by the Government (UMTA).

Recently, several UMTA grantees have entered into cross-border leases involving locally-funded transit equipment. As a result of these transactions, the grantees have netted approximately 5 percent of the purchase price of the equipment after deducting fees and other expenses incurred in negotiating with the lessor.

These transactions are similar in some respects to the safe harbor leases that were permitted under the 1981 Economic and Recovery Tax Act and implementing Department of Treasury regulations. Under this authority, a grantee was permitted to enter into a sale-lease back transaction of transit equipment with a U.S. entity. As a result of such a transaction, the lessor was able to take depreciation on the assets. As a matter of policy, the U.S. Department of Treasury regulations did not permit the Federal interest in such assets to be included under safe harbor leases. Accordingly, UMTA restricted safe harbor leasing to the local interest in any UMTA-funded equipment. By law, the safe harbor leasing of mass commuting vehicles expired at the end of 1987.

The typical cross-border lease which grantees and foreign entities have entered into for locally-funded assets have generally had the following characteristics. The foreign entity (lessor) and the grantee (lessee) enter into agreements which stipulate that the lessor will pay the

purchase price of the assets to the lessee. This amount covers the lessee's lease cost of the assets and includes an additional sum for the lessee. This additional amount, negotiated by the parties, represents a portion of the savings or other benefits obtained by the lessor as a result of the transaction.

The lessee pays the full amount of the lease payments to an intermediary bank, often referred to as a defeasance bank, which actually makes the periodic lease payments and also may have made a loan to the lessor for the initial purchase of the assets. Thus, as a result of the defeasance of the lease, the lessee is no longer held liable for any of the lease payments. The lessee, however, is liable for other risks such as casualty loss, bankruptcy of the parties, change in the tax laws, change in currency exchange rates, and premature termination of the lease. The agreements generally include provisions which give the lessee the option of purchasing the assets at the end of the lease period. The lessee usually has the option of securing clear title to the equipment upon payment of an amount stipulated in the agreements.

After a careful review of cross-border leasing transactions as described above, UMTA has concluded that the incremental risks assumed by the grantee, over the normal risks of owning the assets or entering into a conventional lease, appear to be small when compared to the benefits. As a result, UMTA has determined that it is able, consistent with Sections 3(a)(2)(A)(ii), 9(e)(3)(B) and 18(f) of the UMT Act, and Section 109 of Part II of the Grant Agreement, to approve cross-border leases that include the Federal interest in UMTA-funded transit equipment when such transactions provide a financial benefit to the grantee and all other terms and conditions of the grant agreement will be met.

7. <u>REQUIREMENTS.</u>

a. UMTA Circular 4220.1B, "Third Party Contracting Guidelines," which implements the requirements of 49 CFR Part 18, requires that the grantee obtain all services, including but not limited to legal services and financial services, related to the cross-border lease through a competitive process consistent with the terms of the circular. Consistent with these requirements, the grantee may not treat the availability of cross-border leasing as an evaluation factor in selecting a vendor under an UMTA-assisted contract for the procurement of capital assets.

b. UMTA Circular 5010.1A, "Urban Mass Transportation Administration Project Management Guidelines," which implements the requirements of 49 CFR Part 18, requires that the revenues derived from arrangements such as cross-border leases be treated as program income. UMTA permits a grantee to use program income for any transit capital or operating need and may reserve the right to direct its use to a particular capital or operating need. Pursuant to the UMT Act, grantees may use program income as local share for subsequent grants, but it may not be used to refund or reduce the local share of an existing grant without a proportionate refund or reduction of the UMTA share of the grant.

c. Pursuant to Sections 3(a)(2)(A)(ii), 9(e)(3)(B), and 18(f) of the UMT Act, the grantee must demonstrate that it has continuing control and use of the UMTA-funded equipment in mass transit service. UMTA does not require a grantee to maintain title to the assets as an indication of its continuing control. UMTA does not specify any particular language or terms that the lease must contain in order to meet this requirement. The defeasance of obligations under the lease is generally one way to demonstrate continuing control.

d. Pursuant to Section 108, "Project Real Property, Equipment, and Supplies," Part II, Terms and Conditions, Grant Agreement, which implements 49 CFR Part 18, grantees must immediately notify UMTA and reimburse UMTA for its proportionate share in assets that are removed from mass transit service contrary to the terms and conditions of the underlying grant agreement. In cases where the UMTA-funded assets in a cross-border lease have not reached the end of their useful life at the end of the lease, this requires the grantee to acquire the assets without further UMTA assistance and continue to use them in mass transportation service or to reimburse UMTA for the fair market value of the asset's remaining useful life at the expiration of the lease.

8. EVALUATION FACTORS. When UMTA evaluates a grantee's proposed cross-border lease, UMTA will review the entire transaction to ensure that it complies with the requirements listed in Paragraph 7, *supra*, and that the following factors are adequately addressed.

a. Financial Benefit. A cross-border lease should provide a financial benefit to the grantee that outweighs any increased risks either to the grantee's continuing control of the UMTA-funded assets or to UMTA's interest in the assets.

b. Unwind Risks. A cross-border lease should contain documentation that clearly indicates all events which may result in the grantee's loss of control of the leased assets. In addition, where possible, the grantee's remedies should be specified. Although certain risks, such as currency risks and interest rate risks, cannot be determined in advance, they should be addressed. Regardless of the event, the grantee's obligations under the grant agreement still must be fully met.

c. Grantee's Financial Condition. UMTA will consider the grantee's financial condition and its ability to pay any unwind fees and arrangements made with respect to potential casualty losses. This consideration will be based on the grantee's latest audited financial statements and the operative documents. Since the greatest risks in a cross-border lease occur during the lease's first years, the grantee's short-term financial condition is of particular consideration. Any determination made on a grantee's financial condition for a cross-border lease, however, has no bearing on a grantee's capacity for other major capital investments.

d. Defeasance of Lease. As stated in Paragraph 7.c., supra, the defeasance of a grantee's obligations under a lease is one way in which a grantee can demonstrate that it maintains continuing control of the UMTA-funded assets. UMTA will, therefore, consider the extent to which the lease has been defeased.

9. PROCEDURES.

a. UMTA will review each proposed cross-border lease on a case-by-case basis.

b. Grantees planning to enter into a cross-border lease should contact UMTA as soon as a term sheet has been developed.

c. UMTA's formal review of a proposed cross-border lease begins when the grantee submits a letter requesting such review to UMTA. The letter should include at a minimum a term sheet, specific information on the unwind events including, but not limited to, tables of the costs per year of such events, and drafts of any of the operative documents that may exist. In addition, the letter should reflect what the grantee's responsibilities are to UMTA if any unwind events should occur and how those responsibilities will be met.

d. When UMTA completes its review, which will be coordinated by the UMTA Chief Counsel, of the material submitted by the grantee, UMTA will state in writing whether it will approve the proposed cross-border lease. Grantees may rely on this in executing the cross-border lease as long as there are no material changes either in the grantee's condition or in the terms of the transaction following the date of UMTA's finding. If any such changes occur, the grantee should immediately notify UMTA.

e. Grantees must submit an executed copy of the lease and any operative documents to UMTA.

f. Grantees' contacts with and submissions to UMTA under this paragraph should be made through the appropriate Regional Office. UMTA's finding will be made by UMTA Headquarters.

10. EFFECTIVE DATE. This circular is effective on the date of issuance.

Brian W. Clymer
Administrator

U.S. Department
of Transportation

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