Coates' Canons Blog: Debt Financing Primer for Local Governments: Installment Finance Agreements

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Quick Quiz: Which of the following constitutes an installment finance agreement under North Carolina law?

1. The Village of BlueSky purchases a fire truck for $350,000. To pay for the truck, the town enters into a financing agreement with a local bank. The financing contract extends for a period of five years, at 4.2% interest. The town pays for and takes title to the truck, but grants the bank a security interest in the truck until the loan is repaid in full.

2. Hazy County enters into a contract to build a new sheriff department annex. The total cost is $9 million. To finance the construction, the county borrows money from a large lending institution. The terms of the loan are as follows: five years, at 3.9% interest. The bank retains title to the building until the loan is paid in full. At that point, title to the sheriff department annex reverts to the county.

3. Cloudy City enters into a lease agreement with a local vendor for five copier machines. The lease is for a term of 59 months and includes use of the equipment for that period of time, as well as all maintenance and up-keep of the copiers by the vendor. The lease requires a monthly payment of $600. It further provides that at the end of the five year period, the county has the option to purchase all of the copiers at fair market value.

4. Storm County borrows $1 million from a local bank to finance the purchase of parkland. The term of the loan is 59 months, at 2.9% interest. Because the local bank is looking to bolster its image in the community and because it wants to establish a long-term relationship with the village, it agrees to forgo any security for the loan.

The answer is only (1.) constitutes an installment finance agreement under North Carolina law.

As detailed in a previous **post**, there are five general mechanisms (some may argue that there are six, but that is a subject for another post) through which local governments in North Carolina may borrow money. Any time a local government borrows money it must do so according to one of the statutorily authorized mechanisms and it must comply with all of the prescribed requirements. Among the authorized debt financing mechanisms are installment finance agreements.

What is an Installment Finance Agreement?

Both counties and municipalities (along with several other local entities) are authorized to borrow money by entering into installment finance agreements. **G.S. 160A-20**. (Note that **G.S. 160A-20(h)** lists the local entities (including cities, counties, water and sewer authorities, sanitary districts, local airport authorities, area mental health authorities, and regional transportation authorities) that are authorized to enter into the installment finance contracts (collectively referred to as "unit of local government"). Additionally, **G.S. 115C-528** provides (more limited) authority for local school administrative units to enter into installment finance agreements for certain purposes.)

G.S. 160A-20 is very specific, however, as to what constitutes an installment finance contract. It allows a unit of local government to "purchase, or finance or refinance the purchase of, real or personal property by installment contracts that create in some or all of the property purchased a security interest to secure payment of the purchase price . . . ." It also allows an authorized entity to "finance or refinance the construction or repair of fixtures or improvements on real property by contracts that create in some or all of the fixtures or improvements, or in all of some portion of the property on which the fixtures or improvements are located, or in both, a security interest to secure repayment of moneys advanced or made available for the construction or repair."

There are a few key requirements in the above-quoted language that are worth highlighting. The first is that the installment finance transaction must involve an actual purchase. The unit of local government must take title to the asset once the asset or property is delivered or the construction project is completed. The vendor, bank, or other entity that provides the financing for the project may not keep or take title to the asset until the loan is repaid. For example, if a county or municipality purchases a vehicle and procures vendor financing over a five-year term, the unit of government must take title to the vehicle when it takes possession of the vehicle. If the vendor owns the car until the end of the five-year term (when the loan is repaid), the financing agreement is not an authorized installment financing under **G.S. 160A-20**. Similarly, an option to purchase at the end of a lease term is not sufficient to satisfy the requirements of **G.S. 160A-20**.

Second, the unit of local government must grant a security interest in (some or all of) the asset(s) that is being purchased or in the real property and/or fixtures and improvements to that real property that are being financed with the borrowed funds. A unit of local government must provide a security interest in at least a portion of the asset or assets being financed. It may not enter into an unsecured installment finance agreement. A unit of local government also may not grant a security interest in real or personal property that is not part of the financing transaction. To illustrate, take a routine construction project of a maintenance garage that will be located on property owned by a county or municipality. The government may borrow money to finance the cost of constructing the maintenance garage and may pledge as security the garage structure itself and/or the real property on which the garage is built. It may not pledge as security any other property that it owns, however, such as the city hall or county library.

What are the Forms of an Installment Finance Contract Transaction?

Installment finance contracts generally take one of three basic forms. The simplest form is commonly referred to as “vendor financing.” The parties enter into a contract under which the vendor conveys the equipment or property to the local government and the local government promises to pay for the equipment or property through a series of installment payments. The contract gives the vendor a lien in the equipment or a deed of trust on the property to secure the government’s payment obligations under the contract. If the government defaults under the contract, the vendor may repossess the equipment or foreclose on the property.

A more common form of an installment finance contract transaction involves two different contracts—one between the unit of government and the vendor or contractor and one between the unit of local government and the lending institution. The government enters into a purchase contract with a vendor or contractor, who is paid in full upon delivery of the asset or completion of the construction project. The government enters into a separate installment purchase contract with a financial institution; under this contract the institution provides the moneys necessary to pay the vendor or the contractor and the local government agrees to repay those moneys in installments with interest. The financial institution takes a security interest in the asset being purchased or constructed (or the land on which it is constructed), to secure the government’s payment obligations under the installment purchase contract.

Most installment finance contracts are arranged with a single bank or financial institution. If the project is particularly large or if the local government has borrowed a significant amount of money during the current calendar year, however, a single institution usually is unwilling to make the loan and retain it within its loan portfolio. Instead, the borrowing government has to turn to the bond market. This is because there are certain federal tax advantages to a financial institution when it loans money to a government that borrows less than $10 million within a calendar year. Governments that fall below this borrowing threshold (and meet certain other criteria) are classified as bank qualified. If a local government is not bank qualified the installment financing typically is publicly sold. That is, rather than the government borrowing the money from a single bank or vendor, the loan is sold to individual investors through the issuance of limited obligation bonds (LOBs) (formerly certificates of participation (COPs)). The actual form of the installment financing transaction is very complicated and involves additional entities.

What are the Procedural Processes for an Installment Finance Transaction?

Unlike other types of debt financing mechanisms, there are not detailed procedural hurdles to enter into an installment finance agreement. For example, as discussed in a previous **post**, there is no voter approval requirement. There also are no specific limitations on what revenue may be used to make the installment payments. A local government is free to use any unrestricted funds to repay the debt.

There are a few constitutional and statutory requirements, though. And these requirements apply no matter what form the installment finance transaction takes.

An installment finance contract must include a **non-appropriation clause**. The clause makes all loan repayment obligations subject to yearly appropriation decisions by the unit's governing board. The non-appropriation clause is necessary to avoid an inadvertent pledge of the unit's taxing power. Such a pledge, even a limited pledge, likely would violate the North Carolina Constitution's prohibition against contracting debts secured by a pledge of its faith and credit without obtaining voter approval. *See Generally* Wayne County Citizens Ass'n v. Wayne County Bd. of Comm'rs, 328 N.C. 24, 399 S.E.2d 311 (1991). Note that **G.S. 160A-20** further provides that "no deficiency judgment may be rendered against any unit of local government in any action for breach of an [installment purchase] contractual obligation . . . ."

An installment finance contract may not include a **nonsubstitution clause**. Specifically, the contract may not "restrict the right of the local government to continue to provide a service or activity" or "replace or provide a substitute for any fixture, improvement, project or property financed, refinanced, or purchased pursuant to the contract." **G.S. 160A-20(d).**

A unit of government that enters into an installment finance contract that "involves real property" must hold a **public hearing** on the contract. **G.S. 160A-20(g).** No public hearing is required for acquiring personal property, though.

Finally, a unit of government that enters into certain installment finance contract must obtain **approval from the state's Local Government Commission** (LGC). *See* **G.S. 160A-20(e); G.S. 159-148**. To determine if a particular installment purchase contract must be approved by the LGC, the unit should ask (and answer) the following questions (in the order they are presented below):

1. Is the contract with a state or federal government agency?

    If yes, LGC Approval NOT REQUIRED

    If no, Go to Next Question

2. Does the contract involve the purchase of motor vehicles or voting machines?

    If yes, LGC Approval NOT REQUIRED

    If no, Go to Next Question

3. Does the contract involve a construction or repair of fixtures or improvements on real property?

    If yes, LGC Approval REQUIRED

    If no, Go to Next Question

4. Does the contract extend for 5 years of more from the date of the contract, including any terms that can be added through options?

    If yes, Go to Next Question

    If no, LGC Approval NOT REQUIRED

5. Does the contract obligate the unit to make payments of at least $500,000 or 0.1 percent of the unit's property tax base (whichever is less)?

    If yes, LGC Approval REQUIRED

    If no, LGC Approval NOT REQUIRED

What about the Other Hypothetical Transactions?

Turning back to the original hypothetical transactions, only (1.) constitutes an installment finance agreement under North Carolina law. The problem with (2.) is that the county does not take title to the sheriff department annex until the loan is repaid. The problem with (3.) is that it does not involve a purchase—it is a lease with an option to purchase. Local governments are authorized to enter into lease agreements, with or without options to purchase, but the agreements are not installment finance contracts. (Note that there is a potential argument that the statutes authorizing local governments to enter into lease agreements also authorize a sixth form of borrowing, commonly known as a capital lease or lease-purchase. I will sketch out the argument (and my skepticism of it) in a future post.) Finally, the problem with (4.) is that it is an unsecuritized loan.

Links

- canons.sog.unc.edu/?p=2720
- www.ncga.state.nc.us/EnactedLegislation/Statutes/HTML/BySection/Chapter_160A/GS_160A-20.html
- www.ncga.state.nc.us/EnactedLegislation/Statutes/HTML/BySection/Chapter_115C/GS_115C-528.html
- www.ncga.state.nc.us/EnactedLegislation/Statutes/HTML/BySection/Chapter_159/GS_159-148.html