

MEMORANDUM

To: Marc P. Hansen
Montgomery County, Maryland
County Attorney

From: Paul D. Shelton *PDS*
David LaRose *DL*

Date: February 18, 2019

Re: Tenant Improvement Financing Options

You have indicated that the County enters into negotiations with landlords of County-leased properties for the landlord, at its own expense, to renovate and improve the rented premises for the County's use ("Tenant Improvements"). Often the expense of constructing these Tenant Improvements is considerable. Understandably, landlords want to ensure that the cost of the Tenant Improvements will be recovered over the life of the lease, which landlords propose to recover on an annual pro-rata basis over the term of the lease.

As a general matter, the County's ability to enter into any contract which would obligate the County to expend County funds is limited by Section 311 of the County Charter ("Section 311"). Section 311 prohibits the County from making or authorizing an expenditure of funds in excess of the available and unencumbered appropriation for such expenditure. Although at the time the County enters into multi-year leases with landlords sufficient funds are not appropriated for the payment of rent for the entire term, such leases are negotiated and drafted to comport with Section 311 by making the County's obligation to pay rent due in each year explicitly conditioned on there being sufficient funds appropriated and available for such purpose.

We understand that while landlords are often willing to accept the risk that future rent may not be paid because funds for the rent have not been appropriated, they have generally not been willing to accept the risk that funds may not be appropriated for the County's repayment of the costs of Tenant Improvements. The County is interested in exploring whether it can provide landlords that have made Tenant Improvements with a note or bond, which would not be subject to appropriation, pursuant to the County's authority to incur debt under Section 312 of the County Charter ("Section 312").

Subject to the procedural requirements and limitations described herein, we are of the opinion that the County may provide landlords with either a general obligation note or a limited obligation revenue note to provide for the repayment of the costs of Tenant Improvements.

This memorandum focuses only on the County's financing and contracting options going forward and is not meant to provide an opinion on lease and financing structures already in existence.

Authority to Issue a General Obligation Note

The County regularly issues its general obligation bonds, which are secured by the irrevocable pledge of the County's full faith and credit and unlimited taxing powers, to finance a limited universe of projects which qualify as "public facilities" (as defined by County Code Section 20-14) pursuant to the combined authority of Section 10-203 of the Local Government Article of the Annotated Code of Maryland and Article IV of the County Code. However, Section 20-16 of Article IV requires, among other things, that such bonds or notes be offered only by solicitation of bids at a public sale. Thus, the County would not be able to issue a general obligation note directly to a landlord (a private sale), if the County's authority to incur debt were limited to these provisions of the County Code.

Section 19-208 of the Local Government Article of the Annotated Code of Maryland ("Section 19-208") provides additional authority to governmental entities, including counties, to issue and sell bonds in "small denominations" notwithstanding any other law, if doing so is determined to be in the public interest. Bonds issued under this provision may be sold in any manner that the issuer considers appropriate. The County previously issued a series of general obligation bonds under Section 19-208 in December of 2017 so that such bonds could be issued as variable rate demand bonds and sold by private negotiation, notwithstanding the restriction of County Code Section 20-16.

Bonds issued under Section 19-208 must be in denominations of \$1,000 or less, but may be sold in integral multiples. In addition, a government entity may not have bonds outstanding under Section 19-208 at any one time in total principal amount exceeding the greater of: (1) \$1,000,000 or (2) 10% of the total outstanding bonded indebtedness of the government entity at the time the bonds are issued. Further, to issue bonds or notes under Section 19-208, the County would have to approve and provide the buyer of the bonds with a disclosure document that includes: (1) a description of the security for the bonds, (2) a statement of the purpose for which the proceeds of the bonds will be used, (3) a description of the financial condition of the County, (4) a statement of the price and interest rate payable on the bonds and (5) a statement of the times and places of payment of principal and interest on the bonds. Finally, although Section 19-208 does not explicitly require the County to authorize the issuance of bonds or notes issued thereunder by resolution, we are of the opinion that a legislative act of the County Council should authorize the maximum principal amount of the note or series of notes to be issued, the use of the proceeds thereof, and the full faith and credit pledge of the County to meet its payment obligations

thereunder. Thereafter, the County Executive would, by order, determine the specific details of the note, the manner of sale, and other matters incidental thereto.

Authority to Issue a Revenue Note

Section 10-203(b) of the Annotated Code of Maryland and Sections 20-47 through 20-54 of the County Code authorize the County to issue revenue bonds or other obligations payable as to principal and interest only from funds or revenues received from or in connection with a project (defined in the County Code as a “system, structure, facility or undertaking”) all or part of which is financed with the proceeds of the bonds.

The County has historically interpreted this language to confer broad enough authority for the County to use the proceeds of its revenue bonds to finance facilities and structures that produce no revenue so long as part of the overall project consists of a revenue-generating facility, system or undertaking and those revenues secure the bonds.

Importantly, County revenue bonds can be sold by either public or private sale. Thus, if a Tenant Improvement benefits property that is used in connection with a revenue-producing system or undertaking of the County, the revenues of that system or undertaking could be identified as the source to secure a limited obligation revenue note given to the landlord.

Along with the factual predicate that the Tenant Improvements have some nexus to available County revenues, there are certain procedural and mechanical requirements for the County to issue its revenue notes and pledge revenues as security therefor. The County Code requires that: (1) the County Council authorize the issuance of revenue bonds by a resolution which specifies the project and the maximum principal amount of bonds that may be issued and (2) the County Executive determine and approve various matters and forms relating to the issue, including the rates of interest payable, maturity date, form of bond and manner of sale. Further, there would need to be a financing or other similar agreement between the County and the noteholder landlord, whereby the County, among other things, identifies and pledges the revenues as security for the note.