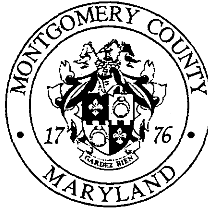


OFFICE OF THE COUNTY ATTORNEY

Douglas M. Duncan
*County Executive*

Charles W. Thompson, Jr.
*County Attorney*

**MEMORANDUM**

TO: Richard J. Duthoy
Chief, Division of Administration
Department of Liquor Control

VIA: Marc P. Hansen *Marc Hansen*
Chief, General Counsel Division

FROM: John J. Fisher
Associate County Attorney

DATE: November 25, 2002

RE: Capital Lease-Leaseback of Dispensary Facility

You have asked our office's advice as to whether the County may lease County owned property currently utilized by the Department of Liquor Control (DLC) to a third-party developer who will then construct a built-to-suit facility on the property for use of the DLC. The new facility construction will be financed by a sublease of the property back to the DLC. The sublease will be for a term of less than five years with the annual lease payments equal to the amount of the construction cost for the new facility plus a reasonable profit to the third-party developer. This method of lease-leaseback financing you have indicated has been used successfully by other liquor control boards.[1] You have further asked whether this type of financing will require Council involvement.

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[1]The proposed financing of this particular transaction differs somewhat from the traditional lease-leaseback arrangement in that the party leasing the property is not the same party leasing back the property. Under the proposed method of financing, it would be the County (in whose name the property is currently titled) that would enter into the lease with the third-party developer and the Department of Liquor Control that would sublease back the property from the third-party developer to create the financing conduit to fund the construction of the new facility. This differentiating characteristic of the transaction, however, has no impact on the present analysis.

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For the reasons which follow, this type of lease-leaseback financing of a new dispensary facility is permissible under State and County law, but may, depending on the form of the financing used, require Council involvement.

## I. Authority of DLC to Lease-Purchase New Dispensary Facilities

The Department of Liquor Control is "a department of the county government under the general supervision of the chief administrative officer [and granted all] powers of a liquor control board." Art. 2B, § 15-201(a). Pursuant to Art. 2B, §§ 15-205(e) and (g), liquor control boards are authorized to enter into "all contracts . . . which they may deem necessary or desirable to carry out the powers conferred upon them by this article." *Id.*, § 15-205(e). To this end, liquor control boards are authorized to "lease, or purchase premises necessary for the conduct of [alcohol beverage] dispensaries." *Id.*, § 15-205(g).

In addition to the powers granted all liquor control boards, "the Department of Liquor Control [has the] power to acquire, with the approval of the County Executive, by lease, purchase or otherwise, such real . . . property as may be deemed necessary by the director to operate dispensaries, stores or warehouses." Art. 2B, § 15-205(k). Thus, the Department of Liquor Control, subject only to approval of the County Executive, has the clear authority under State law to acquire by lease or purchase new dispensary facilities, provided it has sufficient funds available for such acquisition.

## II. DLC Funding Sources and Limitations

Except for an appropriation in the County budget or a County bond issuance, which we understand are not contemplated by this transaction, the DLC's only source of funds are from monies derived from the sale of alcoholic beverages. The use of these funds is proscribed by Art. 2B, § 15-207(e), which requires that the funds from the sale of alcoholic beverages "be applied in the first instance towards the payment of current interest and retirement charges on such notes, certificates of indebtedness and/or bonds as may be issued by the County Council for the purpose of raising funds for the establishment and operation of the dispensary system. Secondly, the net proceeds [are to] be applied to the maintenance of adequate working capital. [and] Thirdly, the balance of the net proceeds [are to] be deposited as general funds of Montgomery County." This State law also provides that the amount retained by the DLC as "working capital shall be adequate to provide for the continued operation of the dispensary system." Further, what constitutes "an adequate balance of working capital" for the continued operation of the dispensary system is to be determined by "the director of the Department of Liquor Control and the director of Finance, . . . subject to the approval of the County Executive."

Accordingly, the DLC, without involvement of the County Council,[2] has the right to establish the amount of the revenues from alcoholic beverage sales that will be retained for working capital, which may then be used for any purpose related to "the continued operation of

[2] *See* for a detailed discussion of the County Council's lack of budgetary and appropriation authority over the DLC this office's Memorandum of May 8, 1998.

the dispensary system" – coupled with the authority granted to the DLC to acquire by lease or purchase real property necessary "to operate dispensaries, stores or warehouses," under Art. 2B, § 15-205(k), subject only to the County Executive's approval, State law clearly authorizes the DLC, without Council involvement, to use its working capital for the lease or purchase of new dispensary facilities. Thus, the DLC, with the County Executive's approval, could retain as working capital in any one year an amount equal to the purchase price of a new dispensary facility. Alternatively, the DLC, again subject only to the County Executive's approval, could retain as working capital in any one year amounts necessary to pay annual lease payments for a new facility.

Neither of these options, however, is contemplated by the DLC, and neither would accomplish the results sought by the DLC in its proposed lease-leaseback arrangement. The first of these options – purchasing a new dispensary facility out of current working capital – would reduce below acceptable levels the balance of the revenues from sales of alcoholic beverages that would be available for deposit into the general fund. The latter, a customary lease at rental rates equal to the fair market rental value of the property, would not generate sufficient lease payments to interest a third-party developer to construct a new dispensary facility.[3] The proposed lease-leaseback arrangement will avoid these pitfalls, however, it raises the question whether the lease-leaseback arrangement proposed by DLC is in essence a form of borrowing.

## III. Lease-Leaseback May Constitute Borrowing

In the case of *Hall v. City of Baltimore*, 252 Md. 416, 250 A.2d 233 (1969), the Court of Appeals was confronted with the question of whether a lease-leaseback arrangement by the City of Baltimore created a debt of the City within the meaning of the Maryland constitutional provisions of Art. XI, § 7, which prohibited the City from creating any debt unless the debt, *inter alia*, had been authorized by an act of the General Assembly.

In *Hall*, "Baltimore City officials published a request for bids on a lease and leaseback arrangement under which the successful bidder would construct a one story warehouse on land owned and to be rented to [the successful bidder] by the City at a nominal rent, the completed structure to be subleased back to the City for the same term of the lease at a yearly rent to be submitted with the bid." *Id.*, at 418. The bid that was accepted "proposed to complete the warehouse within seven months and . . . to accept an annual rent of $96,000 for the original term of the fifteen years." *Id.*

The bid proposed lease further provided an option to the City to purchase the warehouse "at an appraised value of the premises and appurtenances mutually agreed upon by two licensed appraisers." *Id.*, at 419. Testimony before the trial Court, which was uncontravened, showed that the fair market rental value of the property during the 15-year term of the lease was the annual rent of $96,000. This, coupled with the fact that the property was to be acquired based on

[3] A long-term lease of sufficient duration (20-30 years) to allow amortization of the useful life of the new facility, with a buy-out right at the then fair market value of the facility, might solve this problem, and if properly structured, may avoid the borrowing limitations imposed on the DLC (*see* e.g. Section III of this memorandum and the cases cited therein), but would implicate the County's property disposition regulations (31-97).

its appraised value, led the trial Court to find, and the Court of Appeals to agree, that the lease did not constitute the creation of debt. The Court of Appeals distinguished this case from cases in which the lease-leaseback arrangements constituted debt on the basis that the Baltimore City lease was not above fair market rental value,[4] and the lease did not allow purchase of the property at a nominal sum, supporting the conclusion that the rental payments were only for the fair-market-rental-use value of the property and not hidden loan repayments. *See* to the same effect *Eberhart v. Mayor and City Council of Baltimore*, 291 Md. 92; 443 A.2d 1118 (1981); and *see* generally McQuillin, *Municipal Corporations* (3rd Ed.), § 41.16, at p. 398.

Both of these determining factors, rent limited to fair-market-rental-use value and no below-market-purchase option, are absent in the transaction contemplated by the DLC. It is, therefore likely that the contemplated transaction would be characterized by the courts as an incurrence of debt.

The unconditional nature of the obligation to make the lease payment appears to be the linchpin as to why the court required in both the *Hall* and *Eberhart* cases that the leases in question constitute bona fide lease arrangements rather than disguised debt obligations. Thus, the transactions described in *Hall* and *Eberhart* differ from the County's lease-based financings, in that the *Hall* and *Eberhart* transactions lack the "subject-to-appropriation" language which is included in all County-lease based financings. Since Section 15-207(e) requires the County Executive to approve the amount of revenues retained by the DLC for use as working capital, it may be possible to write the lease to make the lease payments subject to the approval of the County Executive of retention of sufficient working capital to pay the lease payments. This may be a sufficient "non-appropriation option" to render the lease payments no longer unconditional obligations and thus not debt.

If the DLC believes that the financial markets would accept a lease which was subject to the County Executive's approval as a condition to the obligation to make payments, this type of conditional lease arrangement may be worth considering. If the lease payments, however, are not so conditioned and thus constitute debt, the question then becomes whether the DLC is authorized to incur debt.

## IV. **No Borrowing Permitted by DLC**

Until 1951, State law permitted the County Commissioners of each county to borrow funds to provide a liquor control board with adequate working capital "for acquiring, establishing and operating a county dispensary," and also authorized liquor control boards to borrow money directly from time to time from any banking institution on their own credit, subject to certain aggregate borrowing limitations. Md. Ann. Code, art. 2B, § 140(b).

In 1951, however, when the General Assembly created the Montgomery County Department of Liquor Control, it withheld from the DLC the independent borrowing authority of

[4]Where the rent payments exceed the fair market rental value, the Court's have found lease -leaseback arrangements to be disguised debt amortization payments, and thus to be treated as debt.

county liquor control boards. In Montgomery County, only the County Council may issue debt for DLC purposes. *Laws of Maryland* (1951), Chapter 633, codified at Md. Ann. Code Art. 2B, § 151(d). This limitation on borrowing has continued unchanged to this date, and now appears as current Art. 2B, § 15-202(d).[5]

Thus, unlike liquor control boards in some other jurisdictions, which retain independent borrowing authority subject to certain borrowing limitations (*see* § 15-202(b)), the Montgomery County Department of Liquor Control specifically is not authorized to borrow funds, although borrowings evidenced by notes, certificates of indebtedness and/or bonds or obligations entered into by the Liquor Control Board of Montgomery County prior to the effective date of the 1951 legislation remained valid. § 15-202(d).

Accordingly, the Department of Liquor Control, although broadly authorized to establish and use its working capital it lacks authority to borrow, only the County Council may borrow funds for DLC purposes, and the revenues derived from the sale of alcoholic beverages are required, in the first instance, to be applied to the payment of any such indebtedness. Art. 2B, § 15-207(e).

## V. Conclusion

Since it is likely that the lease-leaseback transaction contemplated by the DLC would establish debt or a borrowing that is prohibited by Art. 2B, § 15-202(d), the DLC may not enter into the transaction on its own behalf unless payments under such a lease are conditioned upon the County Executive's approval of retention of sufficient working capital to pay the annual lease payments.[6] The County Council, however, is still authorized to borrow funds on behalf of the DLC and the DLC may not only, but in fact is required to, apply net revenues first to the payment of any certificates of indebtedness and/or bonds issued for such purpose. § 15-207(e). Thus, while the DLC could not enter into such a lease-leaseback arrangement, the County Council could do so.

There may be a disadvantage to this arrangement since this lease-leaseback type of arrangement normally results in additional cost to the leasee because the private developer, who would borrow funds against its leasehold interest, would likely get a less favorable interest rate than would the County through the issuance of tax exempt bonds.[7]

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[5] It may be argued that § 15-202(d) makes not only subsection (b) (liquor control boards' borrowing authority) inapplicable to the DLC, but the entire section, including subsection (a) (county commissioners' borrowing authority), also inapplicable in Montgomery County; and that the Council's authority to borrow on behalf of the DLC derives instead from § 15-207(e), rather than § 15-202(a). Either interpretation, however, results in the same conclusion, i.e., that the DLC has no authority to borrow directly, but the County Council retains the authority to borrow on behalf of the DLC.

[6] The County Executive's approval discretion would have to be unfettered. For example the County Executive could not as part of such a lease agree that he would be bound to grant such approval.

[7] In addition, the issue of whether the developer construction of a new facility under a lease-leaseback arrangement would implicate zoning, subdivision and site plan requirements has not been addressed by this memorandum, but would have to be considered if this type of a financing arrangement is utilized and if applicable would add cost to the project.

Consequently, the best vehicle for financing the proposed new construction of a dispensary facility may be the issuance of revenue bonds (as opposed to GO bonds), with the bond repayment obligation limited to revenues from the sale of alcoholic beverages by the DLC. Whether such a revenue backed bond issuance would be exempt from the debt limitations of County Code, § 20-31 has not been determined for purposes of this memorandum, however, as a general rule, revenue bonds do not implicate debt limitations.

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cc: Robert K. Kendal, Director, Office of Management and Budget
Timothy L. Firestine, Director, Department of Finance
Martha Lamborn, Office of Management and Budget

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