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Municipal Lease-Purchase Agreements: A Virginia Perspective

R. Webb Moore
University of Richmond

COMMENTS

MUNICIPAL LEASE-PURCHASE AGREEMENTS: A VIRGINIA PERSPECTIVE

America's state and local governments are in a fiscal vise.[1] Federal intergovernmental aid reached a high water mark in fiscal 1979,[2] but subsequent cutbacks by President Reagan and Congress brought the era of rapid growth in federal domestic spending to a screeching halt in 1981 with reductions of over fifty-three billion dollars in budgetary authority and thirty-five billion dollars in budgetary outlays.[3] Local governments have responded by taking one of three fiscal paths: (1) forced austerity, resulting in school and library closings, deteriorating infrastructure, elimination of mass-transit systems and benefit and personnel cuts;[4] (2) an increased dependence on local tax sources for financing of assets necessary to provide public services;[5] or (3) some combination of the two previous alternatives. As a result, states and localities no longer spend enough on the repair and replacement of existing public facilities.[6]

With this decline of revenues and increase of cutbacks in federal aid to states and localities, turmoil was concurrently experienced in the municipal bond market, the traditional vehicle of local government finance.[7]

1. "A diminishing flow of federal aid to cities, a diminishing flow of state dollars to cities, and a growing aversion to property taxes all put incredible pressure on municipal government." Lamm, *The Fiscal Squeeze on Local Government*, 13 CURRENT MUN. PROBS. 17, 17 (1986).

2. Van Horn & Raimondo, *Living with Less: New Jersey Copes with Federal Aid Cutbacks*, PUB. BUDGETING & FIN., Spring 1983, at 41.

3. *Id.*

4. Bisk, *State and Municipal Lease-Purchase Agreements: A Reassessment*, 7 HARV. J.L. & PUB. POL'Y 521, 521 (1984); *see also* Evans, *What Will Cities and Counties Do When There Is Less Money from the Federal Government?*, 12 CURRENT MUN. PROBS. 199 (1985).

5. *See* Van Horn & Raimondo, *supra* note 2, at 43. Apparently, the federal aid cutbacks have been "across the board," with the localities which are the "worse off" receiving no leniency with respect to reductions in federal assistance. *See id.* at 56 n.10.

6. Petersen, *Creative Capital Financing in the State and Local Sector*, PUB. BUDGETING & FIN., Winter 1982, at 73, ("State and local capital spending, which grew during the decades of the '50s and '60s, declined in real terms throughout the '70s and has been particularly depressed in the early '80s.").

7. *See* Flynn, *The "Creative" Revolution in Municipal Finance*, 11 CURRENT MUN. PROBS. 460, 460 (1985) ("As inflation skyrocketed, the traditional 'general obligation' debt was overtaken . . . ."); Lamm, *supra* note 1, at 18 ("[U]nder the [Reagan] administration's plan, estimates indicate that 62 percent of all municipal bonds would lose their tax-exempt status."); Molchan, *Reform of the Municipal Bond Market: Alternatives to Tax-Exempt Fi-*

Thus, local officials began and continue to seek new techniques to finance needed public goods and services.[8] This search is frustrated, however, by the legal restrictions imposed on the power of localities to incur indebtedness[9] by state constitutional debt limitations.[10] Such debt limitations, typically added by amendment to a state's constitution, place restraints on municipal borrowing power in order to protect local taxpayers from legislative fiscal recklessness.[11] Thus, local governmental entities must struggle to meet the needs of their citizens while complying with legal restrictions on debt.

Increasingly, local officials have turned to the lease-purchase agreement[12] as a means of resolving their fiscal/constitutional dilemma.[13] Lease-purchase agreements are rental contracts that pass title to the lessee at the end of the lease either automatically or through the exercise by the lessee of a purchase option.[14] Proponents of lease-purchasing argue

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nancing, 15 COLUM. J.L. & SOC. PROBS. 233, 234 (1980) ("[T]he combination of inflation, recession, tight credit, and urban unrest began to take its toll [on the municipal bond market].").

8. *See* Bisk, *supra* note 4, at 521; *see also* Flynn, *supra* note 7, at 462-63; Petersen, *supra* note 6, at 73-74.

9. *See* Magnusson, *Lease-Financing By Municipal Corporations As a Way Around Debt Limitations*, 25 GEO. WASH. L. REV. 377 (1957).

10. *See, e.g.*, VA. CONST. art. VII, § 10 (prohibiting counties from contracting debt which is payable from revenues not collectible in the current year *except* in accordance with certain specified means).

11. Bisk, *supra* note 4, at 521; *see also* Magnusson, *supra* note 9, at 381 (discussion of the origin of debt limitations). *See generally* Nichols, *Debt Limitations and the Bona Fide Long-Term Lease with an Option to Purchase: Another Look at Lord Coke*, 9 URB. LAW. 403 (1977) (discussion of historical background and evolution of municipal debt limitations); Note, *Power of Municipality to Exceed Debt Limit*, 14 COLUM. L. REV. 70 (1914) (discussion of split in judicial authority on the definition of "municipal debt"); Note, *Constitutional Law—Recent Interpretation of Ohio's Limitation on Indebtedness*, 6 OHIO ST. U.L.J. 297 (1940) (discussion of Ohio's constitutional debt limits); Comment, *Municipal Corporations—Constitutional Debt Limitations—What Constitutes a Debt*, 34 MINN. L. REV. 360 (1950) (analysis of case holding that bond issue did not create an indebtedness within meaning of constitutional debt limitations).

12. *See infra* notes 22-34 and accompanying text. *See generally* Comment, *Municipal Corporations—Circumventing Municipal Debt Limitations*, 48 MICH. L. REV. 1016 (1950) (comparison of views held by Indiana and Michigan with respect to lease-purchase agreements); Annotation, *Lease of Property By Municipality or Other Political Subdivision, With Option to Purchase Same, As Evasion of Constitutional or Statutory Limitation of Indebtedness*, 145 A.L.R. 1362 (1943) (supplementing annotation of same title at 71 A.L.R. 1318 (1931)).

13. *See* Petersen, *supra* note 6, at 85 ("It has been estimated that approximately $1 billion in tax-exempt leases were executed in 1981 as compared to $250 million in 1977."). Apparently, the popularity of lease-purchasing has been increasing since before the start of the current local fiscal crisis. *See* Rogers, *Municipal Debt Restrictions and Lease-Purchase Financing*, 49 A.B.A.J. 49, 49 (1963) ("An increasingly popular tool of municipal finance is the lease-purchase contract.").

14. Bisk, *supra* note 4, at 522.

that such contracts fall outside the ambit of constitutional debt limitations because of their contingent nature.[15] Additionally, lease-purchasing allows localities to avoid the high fixed costs and risks of a general bond issue.[16]

Critics of lease-purchasing argue that such contracts are merely facades masking unconstitutional general obligation debt.[17] They point to the paradox of classifying the rental payments under such arrangements as municipal debt for federal tax purposes[18] while, at the same time, treating such payments as current operating expenses, instead of general obligation debt, in order to comply with state constitutional debt limitations.[19]

This comment initially examines the structure, economic utility, and constitutionality of municipal lease-purchase agreements and then seeks to fill a void of information on the propriety of implementing such agreements in Virginia.[20] The comment concludes that lease-purchasing represents a solution to the current fiscal crisis experienced by local governments, and that lease-purchasing is constitutional with respect to Virginia localities, if enacted pursuant to two recent opinions of the Attorney General.[21]

I. An Overview of Lease-Purchasing

A. *The Mechanics of Lease-Purchasing: The Actors and Their Roles*

1. The Structure of the Lease-Purchase Agreement

Technically speaking, a lease-purchase agreement is not a lease.[22] In a simple true lease in which a governmental unit is the lessee, there are usually only two actors: the lessee and the lessor.[23] The lessor, normally a manufacturer, provides use of an asset to the lessee for a stipulated pe-

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15. Most lease-purchase agreements provide that the obligation of a governmental unit to make payments is contingent upon sufficient appropriation of funds to make such payments. *See* A Guide to Municipal Leasing 67 (A. Vogt & L. Cole ed. 1983) [hereinafter Guide]; *see also infra* notes 82-89 and accompanying text.

16. Bond issues generally require voter approval in a municipal referendum. Thus, localities may bear the cost of an election only to see the issue defeated. *See* Schickendantz, *Financing Through Municipal Leasing*, 5 Current Mun. Probs. 329, 329 (1979).

17. Bisk, *supra* note 4, at 522.

18. The interest that lessors earn under lease-purchase contracts is not subject to federal income taxation. I.R.C. § 103 (1986); *see also infra* notes 54-72 and accompanying text.

19. *See* Petersen, *supra* note 6, at 84-85.

20. "Attorneys, leasing companies and local governments have all experienced frustration from lack of information and sources for information in the area of governmental leasing." Mardikes, Cone & Horn, *Governmental Leasing: A Fifty State Survey of Legislation and Case Law*, 18 Urb. Law. 1, 3 (1986).

21. *See infra* notes 96-115 and accompanying text.

22. Guide, *supra* note 15, at 29.

23. *Id.* at 6.

riod of time in return for specified rental payments made at regular intervals.[24]

In a municipal lease-purchase agreement, more actors are typically involved than in the simple true lease and the structure of the arrangement is also more complex.[25] The lessee acquires ownership as well as use of the leased asset from the inception of the "lease" term, and the contract typically specifies a date on which title to the property passes from lessor to lessee.[26] Thus, the lease-purchase agreement is more akin to an installment purchase or a conditional sale than it is to a true lease.[27] In addition, if the lease-purchase agreement involves realty, it may actually contain two leases: (1) a "ground lease" of municipal realty from the local government to a leasing agent; and (2) the lease-purchase contract itself, under which the municipality leases space as lessee in an improvement, such as a school or firehouse, to be constructed upon the municipal land.[28] Lease-purchase agreements have also been used by municipalities to acquire personalty such as telephone systems and water meters.[29] Finally, the periodic payments established in the agreement must be divided into principal and interest portions for the interest to qualify as tax-exempt for federal income tax purposes.[30]

Bulman v. McCrane[31] involved a typical lease-purchase agreement. In

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24. *Id.*
25. *Id.*
26. *Id.* at 3.
27. The Commissioner of Revenue has established criteria for identifying conditional sales contracts and distinguishing them from true leases: (1) portions of the periodic payments are made specifically applicable to an ownership interest to be acquired by the lessee; (2) the lessee acquires title upon payment of a stipulated amount of "rentals" which, under the contract, he is required to make; (3) the total amount paid by the lessee constitutes an inordinately large proportion of the total sum required to secure transfer of title; (4) the agreed "rental" payments substantially exceed the current fair rental value, thus indicating that such payments include an element other than compensation for use of the asset; (5) the asset may be acquired under a purchase option at a price which is nominal in relation to the value of the total payments to be made; and (6) some portion of the periodic payments is specifically designated as interest. Rev. Rul. 55-540, 1955-2 C.B. 39, 41-42. Each of these factors may be true with respect to a lease-purchase agreement. Indeed, one of the criteria which must be met in order to qualify the interest portion of the periodic payments for federal income tax exemption is that the agreement be structured as a conditional sale or an installment purchase rather than as a true lease. *See infra* notes 67-68 and accompanying text.
28. *See, e.g.*, City of Los Angeles v. Offner, 19 Cal. 2d 483, 122 P.2d 14 (1942) (proposed agreements constituted a "lease" and "option to purchase" and did not violate constitutional debt limit provision); County Bd. v. Brown, 229 Va. 341, 329 S.E.2d 468 (1985) (statute granting the county the discretion to lease any "unused lands" did not include land being used as a parking lot, despite arguments that it was "underutilized" and the county could profit by leasing it for development).
29. *See* Flynn, *supra* note 7, at 463.
30. *See infra* note 66 and accompanying text.
31. 64 N.J. 105, 312 A.2d 857 (1973).

Bulman, an arrangement was proposed whereby the State of New Jersey would take a twenty-five year lease on a building that was to be erected by a developer on state-owned land and was to be used by the state as a records storage center and printing facility.[32] The state was to have the option of purchasing the facility at a predetermined, progressively declining price during the tenth, fifteenth and twentieth years of the lease.[33] Even if the state failed to exercise its option to purchase, title to the building would pass to the state at the end of the lease term.[34] Thus, the state would acquire use of the facility during the term of the lease and ultimately would acquire title to the building through either the purchase option or the automatic reversion clause.

2. Certificate of Participation Leases

Traditionally, lease-purchase agreements have been used by state and local governments to acquire personal property such as equipment; the amount financed usually is modest and the term for payment short, e.g., five years or less.[35] Financing for major improvements, expensive equipment acquisitions, or real property acquisitions that require longer repayment terms has not been widely available.[36] The advent of the certificate of participation (COP) lease, however, has facilitated the acquisition of such items through lease-purchase financing.[37]

A COP lease is a specific type of tax-exempt[38] lease-purchase agreement in which fractional interests, or shares, in the agreement are created and marketed either privately or publicly.[39] The shares may be few in number, with each one representing a substantial fraction of the total financing, or they may be smaller in amount, e.g., $5,000 each, in which case the COP's would probably be marketed to the public.[40] Each share gives the investor a fractional interest in the periodic payments made by the lessee during the lease-purchase term.[41] In a COP lease, the lessee and lessor enter into an agreement which is similar to the traditional lease-purchase agreement, but which contains certain provisions unique to the COP lease, such as a clause in which the lessee authorizes the creation of the fractional interests.[42]

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32. *Id.* at 107, 312 A.2d at 858.
33. *Id.*
34. *Id.*
35. GUIDE, *supra* note 15, at 31.
36. *Id.*
37. *Id.* COP leasing has provided financing on projects valued up to $50 million. *Id.*
38. *See infra* notes 54-72 and accompanying text.
39. GUIDE, *supra* note 15, at 31.
40. *Id.*
41. *Id.*
42. *Id.* at 32.

B. *The Economics of Lease-Purchasing*

Attractive financial benefits for both the government lessee and the investor/lessor are the primary reason for the emergence of lease-purchasing as a practical public finance device.[43] Through a lease-purchase agreement, a local government can acquire immediately needed equipment or office space with an affordable initial investment.[44] Thereafter, each "rental" payment increases the governmental unit's equity interest in the asset until title ultimately passes to the lessee through the automatic reversion provision or through the exercise of the nominal purchase option.[45] The interest earned by the lessor is tax-exempt;[46] in a competitive market, lessors, who are often equipment manufacturers or developers, will compete for a municipality's business which will force these tax savings back to the government in the form of lower periodic payments.[47]

Occasionally, governments must acquire midterm assets which cost too much to fund from a single year's budget but which have an economic life too short to finance with traditional municipal bonds.[48] Lease-purchase financing is an ideal method by which to spread the cost of such acquisitions over several years.[49] Moreover, if bond issues are secured by general municipal revenues, they must be approved in many jurisdictions by a majority of qualified voters in a municipal referendum.[50] The expense and risk of submitting the question to the voters may not be justified by the amount of financing needed;[51] indeed, the locality may require the asset to be financed before the procedures for a referendum could be enacted.[52] Other advantages for the government lessee include: (1) conservation of current operating reserves; (2) contract terms within the framework of existing state laws; (3) repayment schedules designed to match municipal budgets; and (4) passage of all normal warranties and guarantees provided by the manufacturer to the locality.[53]

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43. *See id.* at 35; *see also* Bisk, *supra* note 4, at 523-24; Schickendantz, *supra* note 16, at 329-30.

44. Schickendantz, *supra* note 16, at 330.

45. *See supra* notes 25-34 and accompanying text.

46. *See infra* notes 54-72 and accompanying text.

47. "Lessors will be forced to bid among themselves to win the government lessee's business. To some extent therefore, market competition will insure that the lessor's federal tax savings will be passed on to the state or municipality." Bisk, *supra* note 4, at 523 n.15.

48. Municipal bonds are usually issued to finance large capital improvement projects and have maturity or retirement schedules that span 15 years or more; very few fully mature in less than 10 years. As a result, bond issues are often not suitable for financing equipment and other capital assets with useful lives of 10 years or less.

GUIDE, *supra* note 15, at 37.

49. *Id.*

50. *See, e.g.*, VA. CODE ANN. § 15.1-180 (Repl. Vol. 1981).

51. *See* GUIDE, *supra* note 15, at 37.

52. *Id.*

53. *See* Schickendantz, *supra* note 16, at 330.

The greatest concern to the investor/lessor involved in a lease-purchase agreement is the tax-exempt status of the interest portion of the periodic lease-purchase payments.[54] Along with the rules, regulations, and procedures promulgated by the Internal Revenue Service, the Internal Revenue Code has established three criteria with which the lease-purchase agreement must comply to receive tax-exempt treatment:[55] (1) the government lessee must be a state or political subdivision thereof;[56] (2) the agreement must be an obligation that is issued pursuant to the lessee's "borrowing power" and must specifically identify the interest portion of the periodic payments;[57] and (3) the lease must be structured as a conditional sale or an installment purchase rather than as a true lease.[58]

First, under section 103 of the Internal Revenue Code, interest on any "State or local bond" is not includable in gross income and, therefore, is not subject to federal income tax.[59] The term "State or local bond" is further defined as "an obligation of a state or political subdivision thereof."[60] "Political subdivision," in turn, is defined as "any division of any State or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit."[61] Three sovereign powers have been identified: (1) the power to tax; (2) the power of eminent domain; and (3) the police power.[62] If an entity does not qualify for the tax-exemption as a political subdivision under this definition, it may still qualify if the entity acts "on behalf of" a state government or one of its political subdivisions.[63]

Second, the lease-purchase agreement must be executed pursuant to the government lessee's "borrowing power" in order to qualify as an "obligation" under section 103 of the Internal Revenue Code.[64] Thus, the investor/lessor must enter into the lease-purchase agreement on a voluntary basis, rather than be compelled to take government compensation for an exchanged asset, as would occur, for example, when the power of eminent domain is exercised.[65] Also, the lease-purchase contract must specifically state that the periodic payments will include a portion designated as in-

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54. *See* GUIDE, *supra* note 15, at 54.
55. *Id.*
56. *See infra* notes 60-63 and accompanying text.
57. *See infra* notes 64-66 and accompanying text.
58. *See infra* notes 67-72 and accompanying text.
59. I.R.C. § 103(a) (1986). For the exceptions to this subsection, see *infra* note 71.
60. I.R.C. § 103(c)(1) (1986).
61. Treas. Reg. § 1.103-1(b) (amended 1972).
62. Rev. Rul. 77-164, 1977-1 C.B. 20, 21.
63. Treas. Reg. § 1.103-1(b) (amended 1972).
64. Kurtz Bros. v. Commissioner, 42 B.T.A. 561, 565 (1940).
65. "It disregards the whole purpose of the exemption to apply it to interest upon obligations of a state which it can *compel* a citizen to take in exchange for the fair value of his property." Drew v. United States, 551 F.2d 85, 88 (5th Cir. 1977) (quoting United States Trust Co. v. Anderson, 65 F.2d 575, 578 (2d Cir.), *cert. denied*, 290 U.S. 683 (1933)).

terest that is distinguishable from principal.[66]

Third, in order for interest paid under a lease-purchase agreement to be tax-exempt, the agreement must be structured as a conditional sales contract rather than as a true lease.[67] The Internal Revenue Service has established criteria for identifying a leasing arrangement as a conditional sale rather than as a true lease.[68]

On August 27, 1986, Congress passed the Tax Reform Act of 1986 (the "Act"),[69] an extensive overhaul of the Internal Revenue Code. The Act reorganized, amended, and partially repealed the rules governing tax exemption for the interest on government obligations.[70] The basic framework for government bonds was retained, as was the traditional exclusion from gross income of interest earned on government obligations whose proceeds are used exclusively for governmental purposes.[71] Thus, municipal lease-purchase lessors will continue to enjoy tax-exempt interest income. Indeed, the popularity of lease-purchasing may increase as other forms of tax "sheltering" are eroded.[72]

C. *Constitutional Debt Limitations and the Nonappropriation Mechanism*

State constitutional debt limitations restrict the amount of "debt" that state and local governments may incur.[73] Such restrictions on state borrowing began in 1842 in response to various government financial debacles which occurred during the 1830's and 1840's;[74] the economic crisis of 1873-74 precipitated limits on municipal borrowing.[75] Debt ceilings take three principal forms:[76] (1) a percentage of a region's assessed property value;[77] (2) a specified absolute sum;[78] or (3) no debt whatsoever.[79] Be-

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66. Newlin Machinery Corp. v. Commissioner, 28 T.C. 837, 842 (1957).

67. Priv. Ltr. Rul. 8,042,143 (1980) (following Rev. Rul. 72-399, 1972-2 C.B. 73).

68. Rev. Rul. 55-540, 1955-2 C.B. 39, 41-42. For a discussion of this authority, see *supra* note 27.

69. Pub. L. No. 99-514.

70. [1987] 2 Stand. Fed. Tax. Rep. (CCH) ¶ 1200.

71. *Id.* Bond interest will no longer be tax-exempt when it is derived from: (1) private activity bonds that are not exempt as qualified bonds; (2) arbitrage bonds; or (3) state or local bonds not issued in registered form. I.R.C. § 103(b)(1)-(3) (1986).

72. "The drastic curtailment of other forms of shelter will prevent use of most tax shelter losses to offset wage, dividend and interest income . . . . This will leave tax exempt income the only income excludable from tax computation." 2 PAINEWEBBER TAX REFORM REP. 2 (Sept. 3, 1986).

73. Bisk, *supra* note 4, at 525.

74. *See* Bowmar, *The Anachronism Called Debt Limitation*, 52 IOWA L. REV. 863, 863 (1967); *see, e.g.*, R.I. CONST. art. IV, § 13 (1842, repealed 1951).

75. *See* Williams & Nehemkis, *Municipal Improvements as Affected by Constitutional Debt Limitations*, 37 COLUM. L. REV. 177, 177-78 (1937).

76. Bisk, *supra* note 4, at 525.

77. *See, e.g.*, ARIZ. CONST. art. IX, § 8.

78. *See, e.g.*, R.I. CONST. art. XXXI, § 1.

79. *See, e.g.*, IDAHO CONST. art. VIII, § 3.

cause state constitutions rarely define "debt,"[80] that task has fallen to the courts when municipal financing has faced judicial scrutiny. As a result, an issue arises as to whether municipal lease-purchase agreements constitute municipal "debt" so as to fall within the ambit of state constitutional debt limitations. A majority of courts addressing this question have based their decision on the presence or absence of a nonappropriation clause in the lease-purchase contract.[81]

The nonappropriation clause, which is one of the more important identifying characteristics of the lease-purchase agreement, is a contractual provision that allows the government lessee to terminate the agreement by choosing not to appropriate funds for the periodic payments in a given appropriation period.[82] Because of this provision, the obligation created by the lease-purchase agreement can be said to be payable out of current operating expenses and, as such, not restricted by constitutional debt limitations.[83] This basic premise is illustrated by *State ex rel. Thomson v. Giessel*,[84] where the Supreme Court of Wisconsin considered three separate municipal lease-purchase agreements, each containing a nonappropriation clause.[85] The court, relying on the nonappropriation clauses, upheld all three leases, stating that "no state debt is created where payments are to be made solely at the state's option."[86]

A minority of states, which are represented by New Mexico in *McKinley v. Alamogordo Municipal School District Authority*,[87] hold unconstitutional lease-purchase agreements in which the debt exceeds constitutional limits, despite the presence of a nonappropriation clause. In *McKinley*, the Supreme Court of New Mexico struck down a lease between a municipal school district as lessee and a municipal school district building authority even though the district could terminate the lease at the end of any given year, stating that "[t]he effort to circumvent the constitutional restraints in the manner attempted cannot be upheld."[88]

The nonappropriation mechanism ensures that the policy of constitu-

80. *See, e.g.*, VA. CONST. art. VII, § 10.

81. *Compare* Scroggs v. Kansas City, 499 S.W.2d 500 (Mo. 1973) (invalidating lease-purchase agreement without nonappropriation clause) *with* St. Charles City-County Library Dist. v. St. Charles Library Bldg. Corp., 627 S.W.2d 64, 67 (Mo. Ct. App. 1981) (validating lease-purchase agreement with nonappropriation clause).

82. *See* GUIDE, *supra* note 15, at 30.

83. *See, e.g.*, Teperich v. North Judson-San Pierre High School Bldg. Corp., 257 Ind. 516, 521, 275 N.E.2d 814, 817 (1971), *cert. denied*, 407 U.S. 921 (1972).

84. 271 Wis. 15, 72 N.W.2d 577 (1955).

85. *Id.* at 41, 72 N.W.2d at 590.

86. *Id.* at 40, 72 N.W.2d at 590.

87. 81 N.M. 196, 465 P.2d 79 (1969).

88. *Id.* at 201, 465 P.2d at 84.

tional debt limitations, i.e., maintaining governmental fiscal responsibility, is furthered with respect to municipal lease-purchase agreements. By allowing governing bodies to terminate the periodic payments without penalty, the nonappropriation clause protects future taxpayers from current fiscal recklessness,[89] and at the same time, allows current municipal leaders to address the local government fiscal crisis. Jurisdictions which adhere to the reasoning found in *McKinley* can only be said to be unreasonably unsympathetic to the struggle of local officials to develop alternative means of needed financing.

II. The Virginia Perspective

A. *Background*

Virginia follows Dillon's Rule,[90] which states that the authority of local governments is fixed by statute and is limited to those powers conferred expressly or by necessary implication.[91] Thus, Virginia local governments must identify express statutory authority granting power to enter into lease-purchase agreements as a lessee and, if the agreement involves a "ground lease" of realty,[92] as a lessor. In addition, the Constitution of Virginia provides for limitations on local debt[93] which are similar to those found in other states.[94] Finally, if a ground lease is involved, the Code of Virginia requires public hearings,[95] which should be considered by the parties to a prospective lease-purchase agreement. Because the Code of Virginia grants authority to act separately to counties on one hand, and to cities and towns on the other, the remainder of this comment is organized in a similar fashion.

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89. "[A]lthough there is an expectation of continued appropriations by the legislature, there is no prohibited state debt or pledge of credit if the legislature is not *obligated* to act." State *ex rel.* W. Va. Resource Recovery—Solid Waste Disposal Auth. v. Gill, 323 S.E.2d 590, 595 (W. Va. 1984) (overruling State *ex rel.* Hall v. Taylor, 154 W. Va. 659, 178 S.E.2d 48 (1970) (invalidating a lease-purchase agreement despite presence of nonappropriation clause)).

90. J. Dillon, Commentaries on the Law of Municipal Corporations § 237 (5th ed. 1911).

91. *See* County Bd. v. Brown, 229 Va. 341, 344, 329 S.E.2d 468, 470 (1985).

92. *See supra* text accompanying note 28.

93. *See* Va. Const. art. VII, § 10(a). This subsection prohibits Virginia cities and towns from contracting debt in excess of 10% of the assessed value of the taxable real estate in the locality. Virginia counties are prohibited from contracting any debt at all except through special authority conferred by the general assembly. *Id.* § 10(b).

94. *See supra* notes 73-79 and accompanying text.

95. *See* Va. Code Ann. § 15.1-262 (Cum. Supp. 1986).

B. *Authority of Virginia Counties to Enter Into Lease-Purchase Agreements*

In *County Board v. Brown*,[96] a Virginia county petitioned for a writ of mandamus directing the county manager to carry out the provisions of a lease-purchase agreement which required the county, as lessor, to lease public land under a seventy-five year ground lease to a private developer. The developer, in turn, was to construct improvements upon the leased realty and lease office space in the improvements to the county.[97] The Supreme Court of Virginia held that there was no statutory authority for such an arrangement because, contrary to the county's assertion, the Code of Virginia did not authorize a county to act as a lessor of its real property.[98]

In reaction to *Brown*, the Virginia General Assembly amended section 15.1-262 to provide express statutory authority for a county to act as lessor of improved or unimproved publicly owned realty.[99] In addition, the Attorney General of Virginia has stated that this section now authorizes a Virginia county to enter into a ground lease such as the one at issue in *Brown* as a lessor, after conducting the requisite public hearing on the matter.[100] Section 15.1-262 also authorizes a county to *acquire* real property by lease for any public purpose.[101]

The Constitution of Virginia prohibits counties from incurring debt to be paid from revenues not collectible in the current year except by certain specified means not relevant to lease-purchase agreements.[102] However, the Attorney General of Virginia has stated that lease-purchase agreements which are subject to an annual appropriation of the funds necessary for the annual payments are constitutionally permissible.[103] The Supreme Court of Virginia has not ruled on the propriety of this opinion.[104]

There is no express power for a Virginia county to acquire personalty by lease comparable to the power with respect to realty found in section 15.1-262. In the Virginia Attorney General's view, however, section 15.1-

96. 229 Va. 341, 329 S.E.2d 468 (1985).

97. *Id.* at 343-44, 329 S.E.2d at 469-70.

98. *Id.* at 346, 329 S.E.2d at 471. The code section at issue in *Brown* was at that time codified at VA. CODE ANN. § 15.1-262 (Cum. Supp. 1984).

99. VA. CODE ANN. § 15.1-262 (Cum. Supp. 1986).

100. 1985-1986 Op. Va. Att'y Gen. 70, 71.

101. VA. CODE ANN. § 15.1-262 (Cum. Supp. 1986).

102. VA. CONST. art. VII, § 10(b).

103. 1985-1986 Op. Va. Att'y Gen. 70, 71. This condition is the so-called "nonappropriation" clause. *See supra* notes 73-89 and accompanying text.

104. The opinions of the Attorney General, while entitled to due consideration, are advisory in nature and are not binding on the Supreme Court of Virginia. *See Brown*, 229 Va. at 347, 329 S.E.2d at 472.

105, dealing with the powers of county purchasing agents, implies this power.[105]

Finally, it should be noted that Virginia counties qualify as tax-exempt "political subdivisions"[106] because of their tax,[107] eminent domain,[108] and police powers.[109]

C. *Authority of Virginia Cities and Towns to Enter Into Lease-Purchase Agreements*

Chapter 18 of Title 15.1 of the Code of Virginia provides an integrated set of powers that the council of a city or town may exercise when the general assembly specifically confers those powers by charter.[110] Among those is the authority provided in section 15.1-897 for a city or town, as lessee, to lease both real and personal property, but only if the general assembly has placed the language of this section, or its equivalent, in the city or town charter.[111] Likewise, section 15.1-847 grants to Virginia cities and towns the authority to act as lessor of their real property.[112] Moreover, a city or town, like a county, may enter into a long-term lease-purchase agreement as a lessee if the agreement contains a nonappropriation mechanism.[113]

The issue arises whether article VII, section nine of the Constitution of Virginia and section 15.1-307 of the Code of Virginia—companion provisions which limit the power of a city or town to franchise, lease, or sell its real property—limit the power granted in section 15.1-847 to act as lessor in the "ground lease"[114] portion of a lease-purchase agreement involving the acquisition of realty. In addressing this issue, the Attorney General of Virginia has opined that the limiting provisions of section 15.1-307, which require advertising and receiving of bids, apply only where the city or town grants a franchise.[115]

Finally, it should be noted that Virginia cities and towns, like counties, qualify as tax-exempt "political subdivisions"[116] because of their tax,[117]

105. *See* 1985-1986 Op. Va. Att'y Gen. 86, 89.
106. *See supra* notes 60-63 and accompanying text.
107. VA. CODE ANN. § 22.1-95 (Repl. Vol. 1985).
108. *Id.* § 25-232.01 (Cum. Supp. 1986).
109. *Id.* § 15.1-131.7 (Repl. Vol. 1981).
110. 1985-1986 Op. Va. Att'y Gen. 86, 88.
111. *See* VA. CODE ANN. § 15.1-897 (Repl. Vol. 1981); *see also* 1985-1986 Op. Va. Att'y Gen. 86, 88.
112. *See* VA. CODE ANN. § 15.1-847 (Repl. Vol. 1981).
113. 1985-1986 Op. Va. Att'y Gen. 86, 89; *see supra* notes 73-89 and accompanying text.
114. *See supra* note 28 and accompanying text.
115. *See* 1975 Op. Va. Att'y Gen. 533, 534.
116. *See supra* notes 60-63 and accompanying text.
117. VA. CODE ANN. § 15.1-841 (Repl. Vol 1981).

eminent domain,[118] and police powers.[119]

III. Conclusion

Municipal lease-purchasing provides a vehicle to ease the current fiscal crisis experienced by local governments nationwide, including those in Virginia. Lessors under lease-purchase agreements enjoy tax-exempt interest,[120] while government lessees benefit from increased financial flexibility and, at the same time, avoid the risk and expense of a bond issue.[121] In addition, the nonappropriation framework incorporated into most lease-purchase agreements maintains governmental fiscal responsibility and satisfies state constitutional debt limitations in a majority of jurisdictions.[122]

Virginia cities and towns are statutorily authorized to enter into lease-purchase agreements to acquire either realty or personalty, so long as the agreement is conditioned by the presence of a nonappropriation clause.[123] Thus, Virginia has joined a majority of states in allowing local governments to employ municipal lease-purchasing to ease their fiscal difficulties. Moreover, the nonappropriation mechanism, which allows localities to terminate the arrangement without penalty, preserves the integrity of Virginia's constitutional debt safeguard.

R. Webb Moore

118. *Id.* § 25.232.01 (Cum. Supp. 1986).
119. *Id.* § 15.1-131.7 (Repl. Vol. 1981).
120. *See supra* notes 54-72 and accompanying text.
121. *See supra* notes 43-53 and accompanying text.
122. *See supra* notes 82-88 and accompanying text.
123. *See supra* notes 96-119 and accompanying text.