PACIFICA
LAW GROUP

T 206.245.1700
1191 2nd Avenue, Suite 2100
Seattle, WA 98101-2945
pacificalawgroup.com

Fifty Years of 63-20 Financing:

Revisiting an Alternative Development Tool
for Washington State Agencies and Municipalities

Introduction. Nonprofit corporations may issue tax-exempt bonds "on behalf" of state and municipal entities by following the requirements outlined in Revenue Procedure 82-26 of the U.S. Treasury (the "Revenue Procedure"). These bonds are commonly called "63-20 bonds," a reference to Revenue Ruling 63-20, which is an early ruling updated by the Revenue Procedure.

63-20 bonds have financed public buildings on behalf of Washington state agencies, counties, and cities. Projects have included administrative, student housing, research and other facilities. These entities have used 63-20 bonds to achieve capital project objectives, while preserving the benefits of tax-exempt financing and maintaining governmental control of the facility. Specifically, governmental entities have employed 63-20 bonds to shift construction and other risks to a private development team and to have more flexibility (than may be available under traditional public bidding requirements) to select a private development team well positioned to assume these risks.

Really an Alternative Development Tool. 63-20 bonds traditionally have been viewed as a tax-exempt financing tool. That conventional analysis misses the point. 63-20 bonds do not offer advantages from a narrow tax-exempt financing perspective.[1] The entities on whose behalf these bonds are issued generally can access tax-exempt financing directly.[2] So the question really is not whether 63-20 bonds can provide the benefit of tax-exempt financing, but whether the structure can deliver other benefits by transferring the financing, development, and

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[1] Some of the early benefits of 63-20 financings are no longer applicable. Specifically, governmental entities may not be able to use 63-20 financing to complete "off balance sheet" financings from an accounting and ratings agency perspective.

[2] There may be additional benefits to a state agency in entering into a financing lease rather than issuing state debt to finance the facility. An obligation to pay rent, subject to appropriation, is not a debt of the state agency for the purposes of constitutional and statutory limitations on state debt. In *Department of Ecology v. State Finance Committee*, 116 Wn.2d 246, 804 P.2d 1241 (1991), the Washington Supreme Court held that a state financing lease subject to appropriation did not constitute debt under Article VIII, Section 1 of the state constitution.

potentially operation of the facility to a private development team managed by the nonprofit issuer. In other words, 63-20 bonds should be considered an alternative development tool rather than an alternative financing tool.

Overview of a Typical 63-20 Financing. In a typical 63-20 financing, a nonprofit corporation issues bonds to finance the development of a facility "on behalf" of a state or municipal entity. The bond proceeds are applied to pay for the acquisition, construction and equipping of the facility. Under the Revenue Procedure, 63-20 bond proceeds must be used for the acquisition or construction of real or personal property, to fund a reasonably required reserve fund, and to pay costs of issuance. Notably, proceeds may not be used for working capital.

The bonds are repaid from net revenues of the facility and, if the governmental entity is the lessee of the facility, from lease payments sized to cover debt service on the bonds. Under the Revenue Procedure, the governmental entity must have a beneficial interest in the nonprofit corporation during the term of the bonds. There are a number of ways to meet this requirement, including by providing the governmental entity with the right to obtain unencumbered fee title to the project by defeasing the bonds and by providing the governmental entity with the exclusive option to purchase the project in the event the nonprofit defaults on its bond obligations. Under the Revenue Procedure, title to the property must transfer to the governmental entity when the bonds are retired without consideration.[3] Additional requirements apply to 63-20 bonds issued for refunding purposes including a limitation on the circumstances under which 63-20 bonds can be advance refunded or the maturity of the bonds extended.

Evaluating Potential Benefits. 63-20 bonds may make sense when a private approach to developing a governmental facility is likely to provide significant benefits compared to a traditional public approach. These benefits may be most apparent for facilities that:

- Are time-sensitive, requiring for example an expedited schedule compared to a traditional public work;
- Are cost-sensitive or require price certainty for annual budgeting or other purposes (that is, requiring a shift of all or a portion of the risk of project cost overruns from the governmental entity to the nonprofit issuer and its private development team); or
- Otherwise require specialized development skills, knowledge or approaches.

An analysis of the potential benefits of 63-20 bonds, therefore, should focus on challenges and opportunities presented by the procurement, development and operation of a particular facility

[3] The Revenue Procedure further requires that the governmental entity adopt a resolution stating that it will accept title to the property, and approving the nonprofit issuer and the bonds.

and the ability of the nonprofit issuer, together with its development team, to address these challenges and achieve these objectives.

Flexible Procurement. To this end, the nonprofit issuer may have more flexibility to assemble the development team than is available under traditional public works procurement approaches.

- In AGO 2008 No. 10, the Washington Attorney General opined that a facility financed through a properly structured 63-20 approach does not constitute a "public work" subject to the competitive bidding requirements of chapter 39.04 RCW. The Attorney General opinion noted that, "for purposes of determining whether a project is a 'public work,' there are two factors to consider: (1) whether the project is executed at the cost of the public entity; or (2) whether the project is subject to lien." The operative factor in determining whether a 63-20 project is a public work is whether the project is executed at the cost of the governmental entity.[4] In a 63-20 financing, the facility may be executed at the cost of the nonprofit issuer, rather than the governmental entity. The nonprofit issuer funds the project with its own bond proceeds and, depending on the terms of any lease between the nonprofit issuer and the governmental entity, may bear all of the construction and completion risk.
- Cities and certain counties have statutory authority to enter into lease financings under chapter 35.42 RCW that, combined with 63-20 financing, can also result in a more flexible procurement methodology. Under RCW 35.42.080, lease-financed projects may be procured "upon terms most advantageous" to the city or county. Under this authority the city or county can request proposals from nonprofit issuers and development teams to finance a facility for lease to the city or county.

Summary. 63-20 financing may offer an opportunity to combine tax-exempt financing with a private development approach to a public project. Marrying the public financing option with the private development approach requires careful attention to the "deal" between the governmental entity and the private development team. The deal will be reflected in the terms of the lease or use agreement between the nonprofit issuer and the governmental entity, and the terms of the development agreement between the nonprofit issuer and the developer. These documents allocate the upsides and risks of procuring, financing, owning, designing, constructing, operating, maintaining and equipping the facility, both in the ordinary course and in extraordinary circumstances such as a *force majeure* event.

[4] Even if the project is not a "public work" subject to bidding requirements under chapter 39.04 RCW, prevailing wage requirements will apply if 50% or more of the project will be acquired or leased by the governmental entity. See RCW 39.04.260.

An optimal allocation of these responsibilities would assign each responsibility to the party best able to manage the risk for the overall benefit of the project, would tie functions together where synergies can be achieved (say, through a tightly integrated approach to design, construction, operation and maintenance) and would create an alignment of incentives between the governmental entity and private development team. Among the questions to consider:

- How will construction risk be allocated?
- How will risk mitigation tools – including subordinated developer fees, builder's risk insurance, a guaranteed maximum price construction contract, liquidated damages and developer guarantees – be used?
- How will savings be rewarded and shared?

The process of negotiating the deal between the governmental entity and the private development team can be instrumental in identifying potential upsides and risks on the front-end and in making a deliberate decision to accept or shift these upsides and risks.

In summary, 63-20 financings offer Washington state and municipal entities an alternative development approach, and may be an option for projects that can benefit from a negotiated transfer of financing, development and/or operational responsibility to the nonprofit issuer.

Questions and More Information. Please call any of our public finance or public-private transaction attorneys if you have questions about 63-20 financings or the specific requirements to be addressed. Contact information is provided below.

Edward A. "Mac" McCullough	Edward.Mccullough@pacificalawgroup.com	206.245.1727
Deanna Gregory	Deanna.Gregory@pacificalawgroup.com	206.245.1716
B. Gerald Johnson	Gerry.Johnson@pacificalawgroup.com	206.245.1700
Faith Li Pettis	Faith.Pettis@pacificalawgroup.com	206.245.1715
Stacey Lewis	Stacey.Lewis@pacificalawgroup.com	206.245.1714
Jay Reich	Jay.Reich@pacificalawgroup.com	206.245.1723
Jon Jurich	Jon.Jurich@pacificalawgroup.com	206.245.1717

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