Counties Beat Deadline; Get Hospital Finance

By Lori Raineri

In 1984, the California Health Facilities and Services Plan (CHFSP) identified a need for a convalescent hospital in Tehachapi, Kern County. In 1986, the state determined that the Concord area of Contra Costa County had a similar need.

When the CHFSP recognizes demand for health care facilities, it authorizes a specific health care provider to construct and operate them. In the case of Contra Costa and Kern Counties, the same health care company had received authorization. The company, Medical Holdings, is a national health care provider which, due to its excellent reputation and the growing need for convalescent hospitals, was in demand by communities all over the United States.

Tax-Exempt Bond Sought

Both counties, at the request of the health care company and with the assistance of a professional finance team consisting of bond counsel and investment banker, researched the possibilities of tax-exempt bond financing for the proposed convalescent hospitals.

There was none available.

So counties, company, and finance team developed a special solution. The answer was a certificate of participation financing structure. A certificate is a negotiable security sold in the municipal market similar to a municipal bond. Each certificate represents a proportionate share in lease payments (interest and principal) from a municipal entity. The interest is tax-exempt because it is paid by a municipal entity. Certificates of participation became widely used in California after the passage of Proposition 13.

Certificates of participation were not used only as efficient lease-purchases of equipment, but as a method of capital project financing. Essentially, certificates of participation allow municipal entities to access the capital markets for funding without the restraints imposed on bond financing and the curtailed ability to raise revenues imposed by Proposition 13.

Traditionally, certificates of participation were simply an alternative structure to finance public projects, projects which a municipality would own and operate. However, both Kern and Contra Costa were interested in the private development of convalescent hospitals. They were turning to certificates of participation as an alternative to industrial development bonds. The bond counsel found Contra Costa and Kern counties had the authority to enter leases, notwithstanding the fact that the project to be leased was a private for-profit business.

Lease-Leaseback Used

Both counties entered into a lease with the company for the convalescent hospital. The company subleased the hospital back from the county. The county's lease payments are only due and payable to the extent sublease payments are made by the company. Therefore, the county's obligation under the lease and sublease agreements is simply to pass on sublease payments received as its own lease payments.

Investors Get Payments Via County Leases

Cranston Securities, the underwriter/investment banker, sold certificates of participation to investors which entitled them to receive the lease payments of the county (which are, in fact, the sublease payments of the company). The proceeds from the sale of certificates funds the convalescent hospital construction.

Lease-leaseback certificates of participation structure allows the counties of Contra Costa and Kern to act as conduit financing vehicles to the tax-exempt market and provide low-cost financing to the company, without assuming any project risk. Their only obligation is to pass on funds received as sublease payments in the form of lease payments to investors.

Race To Beat Deadline

Despite the fact the certificates of participation structure was adopted because California industrial development bonds were not legally available for this type of project, the certificates did fit the definition of industrial development bonds in the Tax Reform Act of 1986. The Act prohibits the use of industrial development bonds to finance non-manufacturing facilities after Dec. 31, 1986. Since convalescent hospitals are non-manufacturing facilities, the transactions had to be completed by Dec. 31. Both counties and the company decided to proceed with the financing less than one month prior to this sunset date. So, both counties had a financing structure that accomplished the goal of inducing the development of the desired convalescent hospital. The problem remained of how to complete the issue of certificates on time.

First Hurdle Overcome

One of the first hurdles to overcome was the practical inability of the company to obtain and allow the certificates to receive a satisfactory debt rating ("AA" or "AAA") in such a short time frame. The answer was to escrow the certificates proceeds in "AAA" U.S. Treasury securities pending the delivery of a letter of credit by the company to each county. The finance team went to work to produce the necessary documents, the company met state allocation requirements as required by the Tax Reform Act, and both counties went the extra mile to complete the necessary public hearings and approvals on time. Cranston Securities provided a "firm underwriting" for both counties, taking the certificates into inventory without yet having an investor in line, due to the lack of time for a traditional marketing effort. O'Melveny and Myers, the bond counsel, worked past midnight on Dec. 30 to ensure that all documents were accurate and properly executed. Both counties, supervisors and staff took the necessary steps to complete the transactions on time. The Kern County Board of Supervisors interrupted its holiday recess to meet Dec. 30 to hold the required TEFRA hearing, a forum for public comment on the transaction, and give final approval. In Contra Costa County, Jim Kennedy, Chief of Development Finance Programs for the Community Development Department held the TEFRA hearing early Dec. 30 in Martinez and arrived in Los Angeles that afternoon to provide the necessary signatures to the documents and also to conduct some last-minute negotiations with the company to ensure that the convalescent hospital would meet the County's public purpose requirements. ■

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