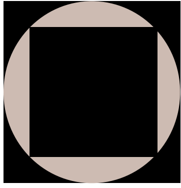
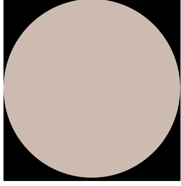
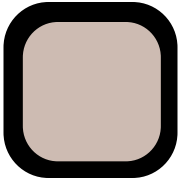

Association of State Correctional Administrators

Alternatives for Financing Prison Facilities

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Alternatives for Financing

Prison Facilities

Prepared by
Brown & Wood LLP

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EXECUTIVE SUMMARY

This paper considers the various alternatives currently available to finance, develop and operate new prison facilities.[1]

Due to the enormous growth in demands for limited state budget dollars, state officials and their advisors have needed to develop a number of alternative methods of financing and developing prison facilities in ways that will satisfy conflicting demands. This paper discusses the financing alternatives, assuming tax exempt financing where possible, and other methods of financing when necessary or preferable. As part of this analysis we consider the privatization alternatives now available from private companies.

The issuance of general obligation bonds has been the traditional methodology for financing prison facilities, but over time there has been increasing use of revenue bonds and certificates of participation, known as COPs. In the latter two, the debt is not secured by the general obligation of the state or municipality issuing the debt, but by a pledge of the streams of revenues that are generated by use of the facility. In a corrections context the revenue streams are payments made for housing inmates in the facility (per diem or fixed payment amounts), or for the exclusive use of the facility. A revenue bond or COP transaction might be structured to also include certain tax revenues or user fees as pledged revenues. Revenue Bonds and COPs will generally not be included within the state or local government's overall debt limit.

A revenue bond for a prison facility might be issued through a state authority, which is responsible for the financing of capital projects. The authority then leases the project to an operating arm of the state (i.e., the department of corrections) and has debt service on the bonds paid from a stream of appropriated payments coming from the state for the housing of inmates. One drawback to this kind of financing is that the state's obligation to make payments to house its inmates would be subject to an annual appropriation, so it is not equivalent to a full faith and credit obligation to pay debt service on outstanding debt of the state. As a result, interest rates on revenue bonds tend to be slightly higher than those on general obligation bonds. The annual appropriation from the state to pay the operating and debt service costs of such facilities can be supported by a variety of other revenue sources, such as a prison construction trust fund, fees collected by the state for automobile inspections or other purposes, or even revenue derived from inmate labor in industrial or agricultural programs.

[1] Martin E. Gold was assisted in the writing of this paper by Henry S. Klaiman, Mark O. Norell and Albert M. Rodriguez. Martin E. Gold is a partner with the law firm of Brown & Wood LLP and specializes in the areas of project finance, real estate and public-private partnerships including the privatization of prisons. He is also an adjunct associate professor at Columbia University. Henry S. Klaiman is a partner with the law firm of Brown & Wood LLP and specializes in tax law with an emphasis on tax exempt financings. Mark O. Norell is an associate with the law firm of Brown & Wood LLP and specializes in tax law with an emphasis on tax exempt financings. Albert M. Rodriguez was with Brown & Wood LLP and now is a Vice President with Merrill Lynch Pierce Fenner & Smith Incorporated specializing in tax exempt financings.

Certificates of participation are an alternative to revenue bond financing, but with the same purposes and a similar structure. With a COP, the state typically leases property that it owns to a third party called a "financing agent". The financing agent is usually a governmental corporation or authority or not-for-profit corporation, created specifically to develop projects for the state. The financing agent then subleases the property back to the state under a sublease, and the state makes lease rental payments. The financing agent assigns its interest in the sublease to an entity that acts as trustee for the purchasers of the COPs. Each purchaser of an interest in these certificates of debt gets a proportionate interest in the assigned revenues from the sublease, which is why they are called "Certificates of Participation."

In recent years, a number of states have facilitated the development of prison facilities through arrangements with counties or other local government entities. For example, a not-for-profit corporation, organized by the local county, can issue tax-exempt bonds to finance the construction of a new prison. The state, in turn, would agree with the county or the not-for-profit issuing the bonds to provide a certain number of inmates to the facility and make per diem payments on their behalf. The revenues received on behalf of these inmates would be pledged to the payment of debt service for the bondholders. Where a private prison developer is involved, the credit risk can be improved for the potential bond purchasers by having a private operating company guarantee payments in the event there are not enough inmates provided to adequately cover debt service or if revenues are not otherwise adequate to cover expenses. The stronger the state's obligation to place inmates in the facility to be financed and to pay for them, the less the need for credit enhancement. The local county can also assist, for example, by pledging a supply of inmates to the financing as a supplement or back-up to the state's supply.

In order to take advantage of tax-exempt financing, which has a lower cost than other means of financing, it is necessary to understand and comply with the numerous regulations issued under the Internal Revenue Code. If done properly, one can combine the off balance sheet formats of project revenue bonds or COPs together with tax exempt financing. This will allow tax exempt financing to be utilized with a private company acting as the developer/operator or just as operator. The federal tax rules are described briefly in Section III of this paper and are discussed more fully in Appendix A.

Section IV of the paper describes, in a spectrum format, the different degrees to which a project can be fully public (at one end of the spectrum) or almost entirely private (at the other end of the spectrum). The first model, also the traditional model, has public ownership, construction and operation is the first example. The second model moves slightly into the private realm by retaining public ownership but private design and construction. In the first model, construction by a private construction company is common, but private design would not be. A combination of private design and construction most likely would be undertaken by one of the many prison private companies now in existence. Each model constitutes a separate option for public officials to consider. The third model is public ownership and construction, and private operation. The fourth model has public ownership still, combined with private construction and operation.

An alternative to traditional state prison financing on the opposite end of the spectrum is private financing, private construction and private operation. Initiated less than twenty years ago as a highly experimental and controversial alternative to public prison operation, private prisons for both adults and juveniles, are now firmly established in many states. The Corrections Corporation of America and Wackenhut Corrections Corporation are the two biggest adult private prison operators. Private involvement in prison construction and operation covers a broad range. Many prisons are designed and built by private contractors, with funding through traditional general obligation bonds. Prisons may be built and owned by the state, but operated privately. Or they may be designed, constructed and operated privately, using private, taxable bond financing, usually after a state or county has made a commitment to supply a certain number of prisoners and pay the cost of their incarceration on a per diem basis.

In recent years prison privatization has undergone a major transformation. Today the major private prison operators are public companies. Some operate with or have folded themselves into Real Estate Investment Trusts, or REITS, which are special real estate corporations that are exempt from corporate income taxes as long as they comply with strict rules. Because these private financial structures sometimes offer short- and long-term financial advantages over traditional public ownership and operation of state prison facilities, some states have sold prison facilities to private companies and then leased them back, or sold the facilities and have the private prison companies also operate them.

The advantages and disadvantages of public vs. private construction and ownership can be complicated. The pros and cons of allowing all or part of a corrections operations system to become private are more easily understood. With privatization, the corrections system gains the flexibility and efficiency of an organization not beholden to a state bureaucracy and its extensive and sometimes counterproductive civil service rules. Private operators eager to show good faith and retain their contracts may react with greater responsiveness to directives for change and improvement from a department of corrections than their public counterparts who fear no consequences from their inaction. On the other hand, profit-making organizations are often be tempted to cut costs in order to maximize earnings—in construction, furnishing and providing security for a new facility, in hiring competent staff, and in providing care, protection and services to the prison population. More broadly, private prison staff may have a diminished sense of responsibility to protect the public interest in its broader sense.

The success of the private prison industry and its desire to expand and increase profits has yielded a new type of institution: the speculative prison. Since prison facilities are an attractive source of jobs, especially in communities that have a poor job base, some counties and cities have facilitated the development of prison facilities for economic reasons through revenue bonds issued locally, or through the private prison companies and their REITS. In the typical case, a not-for-profit corporation, organized by the county, issues tax exempt bonds to finance the construction of a new prison. In the best case scenario, the state agrees with the county or the not-for-profit organization issuing the bonds to provide a certain number of inmates to the facility and makes per diem payments for the cost of their incarceration. The revenues received on behalf of these inmates are pledged to the payment of debt service for the bondholders. Where a private prison developer or operator is involved, the credit risk can be improved for the

potential bond purchasers by having a private operating company use some of its guaranteeing capacity to assure that payments will be made by the company in the event there are not enough inmates provided each year by the state to adequately cover debt service. The stronger the state's obligation to place and pay for inmates in the facility to be financed, the less the need for credit enhancement—and the less speculative the enterprise.

The risk of failure, and thereby the financing cost, increases substantially for institutions that are built without adequate guarantees that they can fill their beds, or, with a design on staffing that does not meet state standards. In such cases the sponsors of the speculative prisons may seek prisoners from other states. If there are no contracts with any commitments to supply inmates, and inadequate guarantees from, or capacity on the part of the private operating company to obtain inmates from other jurisdictions or cover the risk, the project may not be financeable, or if financed, be a candidate for economic disaster.

I. GENERAL INTRODUCTION

The evolution of financing and operating prison facilities in many ways is representative of the evolution of public facilities in general. Both the original and the present base model use tax exempt general obligation bonds and public sector operation. To solve the problem of the expanding need for a larger variety of facilities and infrastructure and for competing use of public funds and stiff legal and political and economic constraints on state budgets, creative energies have been applied to the crafting of various new structures, as alternatives to tax exempt general obligation debt.

These new financing formats seek to preserve the benefits of tax exempt financing wherever possible, while drawing upon alternative revenue sources for the payment of debt service. For many other public and quasi-public facilities, the source of revenues is from the project itself, i.e. those who pay to use the facility (e.g., buy tickets or space, pay tolls, advertise, etc.). For prison facilities, however, governments, not inmates are the source of revenue. Nonetheless, financings are being done outside of constitutional and statutory constraints through the use of authorities and not-for-profit corporations that are arms of the state or work in close conjunction with state and local agencies. Upon the termination of the vast majority of these financings, the government will become the owner of the facility.

In addition, the private sector is also offering alternatives to the public sector for nearly everything, including design, construction, financing, and operation. And public officials can choose which of the various forms of partnerships with the private sector it prefers, from none to full privatization. Most of these private sector partnerships can be combined with general obligation financing, or with revenue bond or certificate of participation financing, in structures that seek to satisfy the state's various purposes, and include tax exempt financing.

II. PUBLIC FINANCE VEHICLES FOR PRISON CONSTRUCTION

This section includes a general description of some of the methods used by states and municipalities (sometimes referred to as "governmental entities") to provide tax exempt long-term financing of capital projects, with brief discussions as to how some state and local governments have used different formats to finance construction or renovation of prison facilities. It should be noted that the information provided in this section is not generated by federal law, but by state law, so applicability will depend on the particular state in question. The legal framework of each state would require a more specific review than we can provide in this general paper. The power of a state to issue debt, or to make a conditional promise to pay an on-going obligation, must be authorized and is governed by the state's constitution and statutes. Some of the financing methods described in this section may not be authorized, or may be prohibited, in some states by state law or courts decisions, or may not be clearly authorized, or may require the enactment of authorizing legislation.

A. General Obligation Bonds

1. General Description

Historically, the most common method used by governments to provide long-term financing of capital projects has been through the issuance of general obligation bonds ("G.O. bonds"). In calendar 1997, approximately one-third of all publicly issued debt was general obligation debt. General obligation bonds are normally backed by a pledge of the "full faith and credit" of the issuer. This pledge generally represents an obligation of the issuer to levy and collect taxes on all taxable property, without limitation on the rate or amount of such taxes, for the payment of principal and interest on the bonds. The constitutional or statutory provisions authorizing general obligation debt may provide for the use of specific taxes or other receipts to pay the debt. Generally, such provisions do not limit the sources of payment and all other resources of the state or municipality must be utilized for such payment if the identified taxes or receipts are insufficient. Accordingly, the pledge of the full faith and credit of a state or municipality is considered in the debt markets to be among the most secure investments and thus results in low interest costs for the projects financed.

The ability of some states to rely on general obligation bonds, however, may be restrained by constitutional or statutory provisions which limit the purposes for which general obligation debt may be issued, and the aggregate amount of general obligation debt that may be incurred. In addition, many state constitutions require voter approval pursuant to a referendum prior to the issuance of general obligation debt. Because of such restrictions many governmental entities rely very heavily upon the issuance of revenue bonds or certificates of participation, ("COPs") which are not included in the calculation of a government's debt limit, to finance their capital programs.

2. Prison Financing with General Obligation Bonds

Approximately one-third of the states fund their prison construction programs exclusively with general obligation debt. Approximately one-sixth of the states use a mixture of general obligation debt and revenue bonds or COPs. Some states have authorized the use of both revenue bonds and COPs.

B. Revenue Bonds

1. General Description

Most, if not all, states authorize, directly or through lease arrangements, the issuance of revenue bonds for capital purposes. In calendar year 1997, revenue bonds accounted for at least 50% of all publicly issued debt. State governments do not usually issue revenue debt on their own account but through a state corporation, authority or other entity which is authorized by statute and established for that purpose. Revenue bonds are most commonly characterized as "limited obligations" or "special obligations" of the issuer because the payment of the bonds is secured solely by a pledge of a particular stream of revenues and not by a general taxing power of the state. Consequently, such debt does not count towards a state's debt limit. In general,

revenue bonds are considered a more risky investment than general obligation bonds and result in higher interest costs than G.O. bonds.

Revenue bonds are issued under a variety of structures with a variety of sources of payment. Typically, the pledged revenue source is (a) the operating income of the financed project, (b) lease payments from the lease of the financed project, (c) loan repayments from the loan of the bond proceeds or (d) a special state tax or revenue, or the general funds of the state.

In most cases, a revenue bond transaction will approximate one of the following:

(a) a state authority, such as a housing authority, issues bonds, loans the bond proceeds to a project developer pursuant to the terms of a loan agreement and a mortgage, and pays the debt service on the bonds from payments received from the project developer (sometimes referred to as a "conduit financing");

(b) a state authority, such as a bridge or port authority, issues bonds, constructs and operates a project and pays the debt service on the bonds from its operating revenues and/or a specific tax or other revenue appropriated by the state;

(c) a state authority responsible for the financing of state capital projects, such as a building authority, issues bonds to finance a project, leases (or subleases) the project to the operating arm of the state (e.g., the department of corrections) and pays the debt service on the bonds from the rentals paid by the state;

(d) a state authority issues bonds to finance a state capital project and the state agrees to appropriate money from its general funds or other specified revenues to the authority in amounts sufficient to pay the debt service on the bonds; or

(e) a state directly issues revenue bonds backed by some special state tax or revenue.

Under the law of most states, bonds issued as described in cases (a) through (d) are not considered a state debt for purposes of the state's debt limitations. The trade-off for avoiding a state's debt limitations is that the risk of non-appropriation by the state results in higher interest costs for revenue bonds. In case (e) the state's obligation is usually limited to the extent the special taxes or revenues are collected and the bonds are usually authorized by, but not considered a general debt, under the state's constitution.[1] In example (a) and where the bonds are backed solely by the operating revenues of the project, the state is under no contractual obligation to provide funds to pay debt service on the bonds. In cases (b), (c) and (d) the state's

[1] For example, the State of New Mexico funds its prison facilities (and some of its other capital projects) with a special severance tax levied on the energy and transportation industries in the state. These severance tax bonds are authorized by the state constitution. The bonds are payable only from the taxes actually collected although the state has pledged in related trust indentures to make a good faith effort to get the legislature to raise the rate of the tax, and therefore the collectibles, sufficient to pay debt service on the bonds in the event the debt service coverage ratio of the taxes to the debt service falls below 1.0.

payment obligation is almost always made subject to the legislature appropriating the required tax revenues or payments and the actual availability of such revenues or payments once appropriated.[2] And, where the bonds are supported by specific tax revenues or other special revenues, the state legislature may be under no obligation to continue directing such revenues to the authority or to even continue the tax at all.

It should also be remembered that state authorities do not have an unlimited capacity to issue debt. The authorizing statute of many state authorities limit the total amount of bonds the authority may issue. In addition, the trust indenture securing an authority's bonds will normally include a debt service coverage covenant which prohibits the issuance of additional debt unless the authority can maintain a certain debt service coverage ratio, i.e., produce revenues which exceed the operating and debt service expenses of the authority by a certain factor on an ongoing basis.

It should also be noted that new revenue bond programs are often the subject of litigation regarding whether the bonds result in a state debt under the state's constitution. In some states, almost every new program results in litigation brought by an outside party claiming the program violates the state's constitutional debt and referendum limitations in one way or another.

2. Prison Financing with Revenue Bonds

At least one quarter of all states currently use lease revenue bond financing for prison construction. Revenue bonds issued for a prison facility are usually issued by a state building authority or similar authority which uses the bond proceeds to reimburse the state for the costs of constructing or rehabilitating a project. As part of the transaction, the state[3] generally leases or conveys title to a project, in need of construction, rehabilitation or expansion, to the authority. The authority then leases (or subleases) the property back to the state for a term equal to the life of the bonds and the state promises to pay the lease rentals (which are assigned by the authority to the trustee) from its general fund or other specified revenues in amounts sufficient to pay the debt service on the bonds (plus any other incidental expenses such as trustee fees or letter of credit fees), subject to the appropriation and availability of such funds.[4] If the authority holds title to the property, the authority may give a mortgage to the trustee as further security for the bonds. Title (or possession in the case of a lease-sublease structure) to the project usually reverts back to the state at the point all lease rentals are paid (and, consequently, all the bonds) either at

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[2] It is a common perception in the debt markets that most states would not allow a state authority responsible for a key governmental function to default on its debt.

[3] The reference to the "state" here means the executive branch of the state, in most cases, acting through its department of corrections.

[4] The statute authorizing the State Public Works Board of California (which is the primary issuer of prison facility bonds in California) provides for an automatic appropriation for the lease payments (payable to the Board) if the legislature has failed to do so, and if the state director of finance certifies to the state controller that sufficient funds are available in the state treasury for such purposes.

the end of the lease term or upon the exercise of a lease prepayment option. A prepayment of all rentals would also lead to a reversion, if the amount is adequate to defease the bonds.[5]

Under the State of New York's revenue bond program, for example, the State generally sells the existing prison facility (or the facility to be built) to the Empire State Development Corporation ("ESDC") (formally called the New York State Urban Development Corporation ("UDC")), in exchange for the proceeds of the bonds and then uses the bond proceeds to renovate the existing facility, construct additions to it, or to build a new facility. New York has recently decided, however, to discontinue the practice of selling its prisons outright and instead will use a lease-sublease structure, and back ESDC prison bonds with a promise to pay debt service on the bonds pursuant to a service contract (sometimes referred to as a financing agreement).

The ultimate source of payment of prison revenue bonds issued by a state authority is normally the general funds of the state, but some states tap a dedicated source of revenues. The State of Arkansas, for example, has a prison construction trust fund managed by the state treasurer for the payment of certain prison bonds issued by the Arkansas Development Finance Authority. In one of the Authority's bond programs, the primary source of the state's lease payments is income from the agricultural operations of the state's department of corrections, which is deposited by the state into a special subaccount of the prison construction trust fund.[6] Arkansas has pledged the net receipts of automobile safety inspection fees for deposit into the prison trust fund to secure prison bonds.[7]

C. Certificates of Participation

1. General Description

The most recent development in long-term financing of state capital projects is the use of certificates of participation ("COPs"). While the national market for COPs is less developed than the markets for general obligation and revenue bonds, in states such as California, where the restrictions on general obligation debt are quite severe, a strong market has developed for such

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[5] Some agreements may provide for purchase options, as opposed to lease payment or prepayment options, at or before the end of the lease term. These purchase option provisions are, in financial terms, usually very nearly identical to lease payment and prepayment provisions. In either case the transaction ends with title to the prison facility going to the state.

[6] For a description of this bond program, see the Official Statement of the Arkansas Development Finance Authority, dated December 12, 1996, regarding its $38,895,000 Correction Facilities Revenue Bonds, Series 1996.

[7] For a description of this bond program, see the Official Statement of the Arkansas Development Finance Authority, dated February 20, 1997, regarding its $20,710,000 Correction Facilities Refunding Bonds, Series 1997.

obligations. However, the sale of COPs backed by a pledge of appropriations generally requires higher interest coupons than general obligation bonds or even revenue bonds.

As with revenue bonds, COPs are issued under a variety of structures which are very similar to revenue bond structures. A financing utilizing certificates of participation will normally involve a lease-sublease, lease-purchase, installment purchase or loan structure as described below. As with revenue bonds, the governmental entity's obligation to make the payments under the applicable sublease, lease-purchase, installment purchase or loan agreement will almost always be subject to the appropriation and availability of funds and thus avoids applicable debt obligation limitations.

Lease-Sublease Financing

A lease-sublease COPs financing is generally composed of the following simultaneous events:

(a) the state leases property it owns (where it needs to build or renovate a new facility) to a third party (referred to as the "financing agent") for a nominal fee. Generally, the financing agent is a government corporation or authority or a not-for-profit corporation created specifically for the purpose of developing projects for the state and in many cases functions as a shell corporation or a trustee bank;

(b) the financing agent subleases the property back to the state pursuant to a sublease agreement which requires the state to make certain rental payments;

(c) the financing agent assigns its interest in the sublease agreement, including all rights to the sublease payments required under the sublease agreement, to the trustee for the COPs (the "certificates trustee");

(d) the certificates trustee, pursuant to a trust indenture, sells to investors "certificates of participation" which provides a proportionate interest in the sublease agreement including the lease rentals;

(e) the certificates trustee holds, and at the times provided for under the trust indenture, disburses the proceeds of the COPs to the state, as sublessee, for the costs of the construction, renovation or expansion of the project; and

(f) under the sublease, the state is required to pay lease rentals in amounts sufficient for the certificates trustee to make the required payments to the investors. Upon payment of all the lease rentals, the financing agent's leasehold interest ends and the state retakes possession of the property from the financing agent.

Lease-Purchase Financing

The structure of a lease-purchase financing (usually involving the construction of a new project) is substantially similar to a COPs lease-sublease transaction except for the following:

(i) the financing agent, which will always be a governmental entity, takes title to the financed project; and

(ii) pursuant to lease-purchase agreement, the financing agent leases the project back to the state which has the option to purchase the project prior to the end of the lease term by paying the amount required to pay off all outstanding certificates. Generally, if the state pays all lease rentals to the end of the lease term, title to the property transfers back to the state.

Installment Purchase Financing

The structure of a COPs installment purchase transaction is substantially similar to a lease-purchase transaction except for the following:

(i) The financing agent, which is always a governmental entity, sells the project to the state pursuant to an installment purchase agreement. Title to the financed project resides with the state; and

(ii) the financing agent will get a mortgage, deed of trust or other security interest with respect to the financed property until the last payment is made by the state under a purchase agreement, whether by prepayment or at the end of the agreement. The financing agent assigns the mortgage, along with the installment payments, to the certificates trustee.

Loan Financing Model

A COPs loan financing (sometimes referred to as an "installment financing") simply involves a loan of the proceeds of the sale of the certificates of participation to the state for the cost of constructing or rehabilitating the financed project and is substantially identical to an installment purchase financing except that the financing agent may be a commercial financial institution or a governmental entity.

2. Prison Financing with Certificates of Participation

At least seven states currently use COPs financing for prison construction. These states have financed prison facilities with lease-sublease, lease-purchase and loan structures as described above.[8] COPs generally have more appropriation risk, while revenue bonds depend

[8] For an example of a lease-sublease transaction, see the Official Statement of the State of Rhode Island and Providence Plantations, dated January 24, 1997, regarding its $24,000,000 Lease Participation Certificates (Howard Center Improvements - 1997 Series). For an example of a lease-purchase transaction, see the Preliminary Official Statement of the State of Illinois, dated April 26, 1996, regarding its Certificates of

more on project revenues or specified taxes without the need for appropriations. Research conducted by the Criminal Justice Institute indicates that more states are seriously considering or plan to increase the role of COPs financing in their prison construction programs because they have similar advantages to revenue bond structures and afford significant flexibility.

3. County and Municipal Financing of Prison Facilities

While a state authority normally issues revenue bonds for state prison construction, in recent years, several states have secured the use of prison facilities through leasing or other arrangements with county or other local authorities. These transactions are generally more complicated but serve several purposes. First, if the debt capacity of the state or of the state authority is a problem, such limited capacity is preserved. Second, depending on how the financing is structured, the state may have little or no financial risk. Recent prison financings in Virginia and Tennessee, one with a town backed by state payments and one with a county backed by a private company, provide examples of these types of transactions.

In the financing for the town of Big Stone Gap, the Commonwealth of Virginia (the "Commonwealth") and the Commonwealth's Department of Corrections ("VDOC") entered into certain agreements with Big Stone Gap and the Big Stone, Virginia Redevelopment and Housing Authority (the "Authority") to provide for the development and lease to VDOC of a 1,200-bed maximum security facility. The Authority was authorized by the Commonwealth's local housing authorities act but is controlled by the Town.

The Authority and VDOC entered into a development agreement in which the Authority agreed to cause the facility to be constructed to VDOC's specifications. The financing agreement requires the Authority to issue bonds to provide funds for the cost of constructing and equipping the facility, and the cost of completing the project is the Authority's responsibility.[9] The project is being constructed by Wallens Ridge Development Corporation ("WRDC"). WRDC is a Virginia non-profit corporation organized by the Authority to assist it in its activities. The financing agreement also required the Authority to issue bonds to provide funds for the cost of constructing and equipping the facility.[10] Pursuant to a license from the Authority,

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...(continued)

Participation (Bureau of the Budget), Series 1996A. For an example of a loan transaction, see the Official Statement of the State of Oregon Department of Administrative Services, dated April 17, 1997, regarding its Certificates of Participation, 1997 Series A.

9 Although the Authority is technically responsible for any cost overruns, the Commonwealth would probably provide or arrange financing for the completion cost since the related lease agreement requires lease payments by the Commonwealth whether or not the facility is completed.

10 For a description of the bonds and the Big Stone Gap transaction, see the Official Statement of the Big Stone Gap, Virginia Redevelopment and Housing Authority, dated October 24, 1995, regarding its $77,500,000 Commonwealth of Virginia Correctional Facility Lease Revenue Bonds (Wallens Ridge Development Project), Series 1995.

WRDC has been granted the rights to occupy and, as agent for the Authority, lease the facility to VDOC.

Under the lease agreements between VDOC and WRDC and the Commonwealth and WRDC, respectively, VDOC will occupy and operate the facility and the Commonwealth is obligated to make rental payments equivalent to debt service on the bonds, whether or not the facility is completed. The Commonwealth's payment obligation is, however, subject to the appropriation of funds by the Virginia General Assembly. This puts the state's backing behind the bonds (indirectly and subject to appropriation) while responsibility for the "debt" belongs to the "local" Authority. The interest on the bonds is tax exempt. Pursuant to the terms of the trust indenture, the income stream of the facility was assigned, and a mortgage on the facility was granted, to the trustee. In the event the Commonwealth defaults on its payment obligations, the trustee's remedies are limited to foreclosure on the facility. Upon payment of the bonds, title to the facility will vest with the Commonwealth.

A variation on the above approach can be found in the 1997 Hardeman County financing in Tennessee. Hardeman County Correctional Facilities Corporation ("HCCFC"), a not-for-profit corporation organized by Hardeman County, Tennessee, issued two series of tax exempt bonds to finance the construction of a 1700-bed facility for the purpose of housing Tennessee, out-of-state, and federal inmates. Pursuant to a construction and management agreement between HCCFC and the Corrections Corporation of America ("CCA"), CCA constructed and operates the facility. HCCFC leased the facility to Hardeman County. Hardeman County agreed, pursuant to an incarceration agreement with the State of Tennessee, to make available housing for Tennessee inmates at the facility for per diem payments. The incarceration agreement also provides the State the option to purchase the facility at a price less than the outstanding principal and interest on the bonds. Neither the incarceration agreement nor the lease with Hardeman County required the State of Tennessee or Hardeman County to house inmates at the facility. Nor were there any contracts to house federal or out-of-state inmates. While the gross revenues of the facility are pledged to payment of the bonds, the main security for the transaction resides in a credit support agreement (the Debt Service Deficits Agreement) between HCCFC and CCA. Pursuant to that agreement, CCA has agreed to pay HCCFC any deficit to the extent moneys on hand are insufficient to pay debt service on the bonds when due and payable, and to pay any difference between the purchase price paid by the State of Tennessee upon exercise of its option to purchase the facility and the outstanding principal and interest on the bonds. Neither the State of Tennessee nor Hardeman County are under any obligation to pay the debt service on the bonds.[11] A financing very similar to the Hardeman County financing involving CCA was

[11] For a description of the Hardeman County transaction, see the Official Statement of the Hardeman County Correctional Facilities Corporation, dated April 21, 1997, regarding its $15,675,000 Correctional Facility Revenue Bonds, Series 1997. For additional discussion of this financing see infra Section IV G "Economic Development and Speculative Bonds."

conducted by the Cushing Municipal Authority ("CMA"), a local authority of the City of Cushing, Oklahoma.[12]

Counties in the State of New Mexico have planned similar transactions involving the Wackenhut Corrections Corporation. In the New Mexico transactions, however, the state has made a firm commitment to provide inmates for the facilities and it is expected that counties will also use the facilities. These transactions have been postponed by litigation challenging, among other things, the constitutionality of the State's commitment to provide and pay for prisoners housed at the facilities.[13] A proposed financing in Huerfano, Colorado failed to attract the necessary tax exempt bond purchasers because the State's commitment to sending inmates was extremely limited and the privatization was open to potential legal challenge as well.[14] CCA ultimately financed the facility from its own resources.

III. FEDERAL TAX CONSIDERATIONS

Federal tax statutes and regulations (the "Regulations") issued by the Internal Revenue Service (the "IRS") impose a variety of constraints on the use and investment of proceeds of tax exempt bonds and on the facilities financed with such bonds. A larger discussion of applicable rules is set forth in Appendix A attached hereto.

One of the key issues for prison financings with tax exempt bonds is that of "private business use." With certain limited exceptions, private business use is not permitted. Generally, a private business use is the use of a facility by a privately owned entity. The policy reason for limiting private business use is that tax exempt financing is viewed as a subsidy and that while the subsidy is appropriate for governmental entities, there should be limits placed on providing subsidies to private entities.

However, recognizing that certain services inevitably need to be provided by the private sector, the IRS has set forth rules that provide certain safe-harbors with respect to management and service contracts, which if satisfied, will not result in private business use. The operating agreement's payment formula is key. To qualify for a safe-harbor, compensation must be reasonable, and no part of the compensation can be based on a share of "net profits" obtained from the operation of the prison. The more the compensation is based overall on "Periodic Fixed Fees", the longer the term of the agreement to operate the facility may be. A "Periodic Fix Fee" is a stated dollar amount for services rendered for a specified time period.[15] In contrast a "Per

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[12] For a description of this transaction, see the Official Statement of the Cushing Municipal Authority, dated October 23, 1996, regarding its $36,070,000 Correctional Facility Revenue Bonds, Series 1996.

[13] For a description of these proposed transactions, see the Preliminary Official Statement of Lea County, New Mexico, dated August 29, 1997, regarding its $59,980,000 Jail Project Revenue Bonds, Series A, and the Preliminary Official Statement of Guadelupe County, New Mexico, dated August 29, 1997, regarding its $31,500,000 Jail Project Revenue Bonds, Series A.

[14] See, infra Section IV G for further discussion of the financing of the Huerfano County facility.

[15] Such term is more fully discussed in Appendix A.

Unit Fee" is a fixed dollar amount per unit of service.[16] A per diem fee (dollars per inmate per day) is a Per Unit Fee and does not generally qualify as a Periodic Fixed Fee (see Appendix A for more details). If more than 95% of total compensation will be paid in the form of a Periodic Fixed Fee, then it may be possible for the term for a prison facility agreement to be as long as 15 years. If the Periodic Fixed Fee constitutes between 80% and 95% of total compensation, then it may be possible for the term to be 10 years. If it is only 50% of the total compensation, then the maximum term can be 5 years as long as the governmental entity has the right to cancel at the end of the third year. If the Periodic Fixed Fee is below 50% and is combined with a per diem payment for the remaining portion of compensation, then the maximum term for the operating agreement can be only three years, provided a right on the part of the government to cancel exists at the end of the second year. This last formula would apply also if all compensation is based on per diem fees. The following table summarizes these safe-harbor provisions derived from the Code and regulations.

Compensation	Maximum Term	Cancellation Requirement
95% Periodic Fixed Fee	Lesser of 80% of Useful Life or 15 years	N/A
80% Periodic Fixed Fee	Lesser of 80% of Useful Life or 10 years	N/A
50% Periodic Fixed Fee	5 Years	3 Years
Per Unit Fee or Combo With Periodic Fixed Fee	3 Years	2 Years
Percentage of Revenue/Expense or Combo With Per Unit Fee	2 Years	1 Year

Of course there are a number of caveats and wrinkles to these tax rules. Many of these are discussed in Appendix A.

IV. PUBLIC/PRIVATE COMBINATIONS

A. Public Ownership, Construction, and Operation

The traditional method of financing facilities has been the issuance of general obligation bonds for the total cost. The public sector owns the facility, the facility is constructed pursuant to public works construction requirements (which may be by bidding to a private company) and the department of corrections operates the facility.

The total cost, (i.e., true cost) of operating prison facilities by the public sector is not generally tracked because the costs are often allocated to the budgets of several agencies besides the department of corrections. For example, litigation would be handled by the law department or attorney general's office; building maintenance and restorations would be handled by a

[16] Such term is more fully discussed in Appendix A.

department of general services; medical costs might be the responsibility of the health department or a separate program; and transportation might be the responsibility of yet another agency. This of course is also true for other public facilities such as schools and police facilities.

B. Public Ownership, Private Design-Build

In order to get the benefits of private sector expertise in designing modern correction facilities the government can hire a private prison design team, which can provide state-of-the-art designs for each particular security level. The right design can improve the ability to provide both appropriate security and services, require fewer correctional officers, and reduce operating costs.

Studies indicate that no matter how it is financed, construction by private companies generally is faster and cheaper than public works construction. The typical public works construction period averages around two and a half years and the average for private company construction appears to take only one and a half years to two years.[17] Private companies will sometimes guaranty the construction period and price, and pay damages if they are late. CCA agreed to pay $5,000/day if it was late in its Puerto Rican prison development agreements. (The credit rating of the guarantor can be important to realizing the full benefit of such guaranties.) The net result, according to reports, can produce significant savings in construction costs. Bonuses for early completion may provide further incentive for quick completion.

Also, when a single team is hired to both design and build (or renovate) a facility, there can be more than a combining of efficiencies. A design-build team can be hired on a competitive basis. The proposals will often produce valuable ideas and feedback to officials and should also yield a superior price. Design-build construction should create a single seamless entity that is responsible for the project from design commencement through the various stages of construction, the completion of the work, and the warranty period. If there is a problem, or a flaw, the government will not be caught between parties claiming the other is primarily responsible. (This can be an even greater problem in renovation projects than it is in new construction.) The likelihood of completing the work on time and on budget should also increase.

Design-build requires the company to complete drawings after being selected. In the traditional format the government must complete all drawings before it bids the work to private contractors. Private prison companies can suggest designs that will be innovative, and reflect

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[17] Charles H. Logan, Private Prisons: Pros & Cons 215-18 (Douglas C. McDonald, ed. 1990). The quicker speed is one of the sources of savings. Unrestricted procurement procedures and minimal approvals is another. *See* Samuel J. Brakel, *Privatization and Corrections*, POLICY INSIGHT, (Reason Foundation), Jan. 1989, at 7; Eric J. Savitz, *Pros and Cons*: *The Jury Is Still Out on Private Prisons*, BARRONS, Nov. 6, 1993, at 13. Costs per cell or bed are higher as the security level increases. CCA estimates that its average savings are about 30%. *See* T.C. Bradford & Co., Corrections Corporation of America—Company Report (July 15, 1989). Charles Thomas estimates that the capital cost of private facilities is generally 15 to 25% lower.

their multijurisdictional experience. These designs should also facilitate more efficient operations (at lower cost) if the same private company is going to operate the facility.[18]

Design-build, however, may not provide as many checks and balances as is the case when the architect is independent of the contractor and has its own contract with the government. The government, therefore, should always have some design expertise to review the plans and the construction work in design-build projects. It is also possible that state authorization for design-build public procurement does not exist.[19]

Private prison companies, using the design-build approach, can, according to a number of estimates, reduce construction costs by 15 to 30 percent.[20] In addition, the financing can be done with tax exempt G.O. Bonds.

C. Public Ownership and Construction, Private Operation

To get both the advantage of public sector tax exempt financing and the lowest available interest rate, officials may combine G.O. bond financing and public construction programs with private operation. Or a completed prison, even with outstanding tax exempt financing, may be turned over to a private company for operation. Provided that the service agreement is a "qualified management contract" the interest on the bonds will remain tax exempt. (See Appendix A.)

There is a substantial amount of literature comparing public and private sector operation of corrections facilities. Today, virtually every type of facility can be managed by some private provider of services. This includes maximum security facilities and specialized youth offender facilities.

Private operation has been reported in a number of studies as providing savings, especially when total costs are compared. Without going into detail, efficiencies can be derived, at least in theory, from private operation through the following:

1. Maximum use of state-of-the-art design and technological systems which can permit operation with fewer or less expensive personnel.

2. Freedom from civil service hiring requirements yields significant flexibility. This flexibility includes salary levels crafted to specific needs, tighter fringe benefits (such as pensions, medical insurance packages, or annual leave) and use of economic incentives to obtain

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18 *See* Martin E. Gold, *The Privatization of Prisons,* 28 THE URBAN LAWYER 359, at 382 (1996).

19 Also, in some states the architect must be a locally licensed. So a private company that uses an out-of-state architect may also have to hire a local one.

20 Industry annual reports; Alex Singal and Raymond Reed, "An Overview of the Private Corrections Industry," Legg Mason Equity Research, 1997, p.16. Charles W. Thomas, "Private Adult Correctional Facility Census, 1994," University of Florida, Gainesville, 1994, p.2.

maximum performance. There is greater flexibility to move officers and specialists within the facility for different shifts, during emergencies and for efficiency generally.

3. Part-time workers are more easily employed and expensive overtime is avoided.

4. There are fewer administrative personnel so there is less overhead.

5. Supplies, such as medicine, food and linens, can be purchased in bulk at a better price.

6. There is a single entity responsibility for all liability risk and costs; this leads to greater overall cost efficiency and cost-saving preventative programs. For example, to avoid incidents that will incur litigation expenses and liability, and possibly affect insurance costs and the company's reputation, most private operators will spend substantial amounts on training, grievance procedures, and internal operations, such as lawyers who can warn the operator of potential problems early on and protect against law suits.

Does private operation actually produce cost savings? There have been numerous studies of companies' operating costs. An analysis of these is beyond the scope of this paper. In one review of 14 studies, 12 showed a savings from private operation of from 5 to 28 percent. The other two showed no difference.[21] On the other hand, the General Accounting Office (GAO) examined five studies by others and summarized its findings by saying:

> "We could not conclude from these studies that privatization of correctional facilities will not save money. However, these studies do not offer substantial evidence that savings have occurred."[22]

The GAO Report and its conclusion, however, has been criticized on an number of grounds.[23] At this time, there is less of a consensus that there would be savings from private operations, than from private design and construction.

For full operating agreements, longer term agreements can now be negotiated using tax exempt financing. The higher the proportion of the compensation that is on a fixed basis, the longer the allowable term. The alternatives are summarized in Appendix A.

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[21] Adrian T. Moore, *Private Prisons: Quality Corrections at a Lower Cost,* REASON PUBLIC POLICY INSTITUTE, April 1998, at 10-12.

[22] U.S. General Accounting Office (GAO), "Private and Public Prisons: Studies Comparing Operational Costs and/or Quality of Service," at 3, Washington, D.C., August 1996, at www.gao.gov/AindexFY96/abstracts/gg96158.htm.

[23] *See* Adrian T. Moore, *Private Prisons: Quality Corrections at a Lower Cost,* REASON PUBLIC POLICY INSTITUTE, April 1987, at 10-12.

A longer term allows the operator to recoup more return on its expenditures but many private operators with public financing are content with short or moderate term contracts because they may wish not to continue, or to renegotiate. If the relationship is working well, the built-in mutual option to renew can suffice.[24] When the facility is paid for by the public sector, the limited investment made by the private operator will not require a very long term for recoupment or amortization.

D. Public Ownership, Private Construction and Operation

Some states, counties and municipalities have chosen to turn construction and operation of their facilities over to private companies while maintaining public ownership. This allows privatization as well as government financing through tax exempt bonds. Allowing the private sector to have a major role in design and construction allows the design aspects to be fully integrated with the company's operating philosophy and staffing plan. In theory at least, it should yield some benefit in lower operating costs for the public sector.

The operating company will use its own construction forces, or hire a company to handle construction under its direction. State statutory authority to enter into such a combination of roles with a single company, as in other scenarios considered here, would have to be assessed. Usually this is achieved through a request for proposals for the combination of roles. That way construction costs and operating costs can both be assessed, and analyzed together for their total (present value or life-cycle) cost.

The build-operate combination should also help in the transition from the construction phase to the full operating phase. The company can create its start-up team and commence the hiring and training of staff as timing and the level of the facility's completion dictate. The operator may need a period during which staff act as if the facility is populated with inmates before actual intake begins. All equipment can be tested by the people who installed it and the people who must now operate it. A single company responsible for ramp-up and transition should mean a single point of responsibility and less conflict or finger pointing. This should be true whether the single entity is the public sector or the private sector.

E. Private Financing and Construction: The Use of REITS

Entities such as a real estate investment trust (REIT) will do design/build/finance projects. A REIT is a corporation that holds and manages real property in compliance with federal tax rules that allow it to distribute income to its shareholders without paying corporate level income taxes. Seventy five percent of gross income must come from real property or mortgages, and ninety-five percent of gross income must come from the same two categories or securities, and 95% of all income must be distributed to stockholders each year. REITS generally can not actively operate properties, but performing certain limited management duties

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[24] See Appendix A for a discussion of renewal options.

is acceptable (such as taking on landlord type responsibilities as the owner of leased property). They therefore typically act through leases and independent contracting.

The capital markets—the world of public trading in debt instruments and stocks that Wall Street is known for—generally evaluate REITS within the real estate category along with other real estate holding companies.[25] REITS in turn have broad corporate access to the capital markets. REITS can issue shares to investors reflecting the value of their real estate assets (and income therefrom) and make the equity they raise available to finance a public sector project. Their shares of stock can be purchased by any entities worldwide, such as mutual funds, and they can raise more capital equity by issuing more shares. REITS also can borrow from capital market institutions. Their financings do not have the advantage of tax exempt financings, but they can obtain competitive capital market interest rates. The interest rate is generally lower than what can be obtained by a corrections company (whose ability to borrow is limited, because they are evaluated as prison operating companies), although it will be some basis points higher than tax exempt interest rates. A REIT is judged by investors by the rental income it gets, the certainty of continuing receipts, and the residual value of the underlying property.

The two largest for-profit prison companies each recently created REITS. CCA created CCA Prison Realty Trust (PRT) as its REIT in 1997, and Wackenhut created Correctional Properties Trust (CPT) with an initial public offering (a first offering of stock to the public) in April 1998. The equity and debt raised by these REITS can be combined by the REITS into a single blended taxable rate that can be made attractive to the local government. While REIT financing is not facility specific ("one off" is the expression used in the capital markets), the debt payment obligations of the public sector can still be crafted to fit the government's preferences. The government can select the maturity date and repurchase options. Generally fixed rates will be offered. Responsibility for maintenance and property taxes are negotiable.[26]

Following its initial public offering in 1997, CCA's Prison Realty Trust purchased 13 correctional facilities from CCA, having 11,500 beds and an aggregate value of over $500 million. It reported in November 1999 that it owned, or was in the process of developing, 51 facilities, 40 of which are in operations.[27] Prison Realty Trust had a credit facility (available loan capacity) of $1 billion in mid-1999.[28]

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[25] That may not have been the case, however, with CCA's Prison Realty Trust. Purchasers of that REIT's stock were mostly growth oriented investment funds (rather than real estate oriented investors) and there has been a 60 percent overlap of owners between CCA and its REIT. The New York Times, April 21, 1998, at D5.

[26] Memorandum from Prison Realty Trust, received March 5, 1998, and a telephone discussion with J. Michael Quinlan, CEO of PRT, on March 5, 1998.

[27] Prison Realty Trust, News Release, November 10, 1999.

[28] It also had to borrow $100 million at a high 12% rate after its stock price dropped substantially. Prison Realty Trust, News Release August 11, 1999 and S.G. Cowen, Perspectives: Prison Realty Corp., June 28, 1999.

Wackenhut's CPT purchased and owned 8 facilities as of May 1998, all of which were leased back to Wackenhut Corrections. By November 1999, CPT owned two more facilities for a total of 10.[29] CPT has a $100 million credit facility. CPT plans to enter into leases with governmental agencies and other operating companies in the future.[30] (Wackenhut Corrections has its own credit facility of $250 million.)[31]

A REIT might be particularly useful where renovations are sought using private resources and the government wishes to continue to operate the facility. This can be done through a sale and lease back. The sale of publicly financed properties, such as schools, hospitals or prisons, is permissible, but the rules applicable to sales to private entities normally require the tax exempt debt to be retired before the transfer. The sale price would generally be based on the current market value. A lease back to the government would then allow the government to operate the facility. In the lease the government would pay principal and interest, on money borrowed by the REIT, as rental. At the end of the term, or upon a prepayment of outstanding principal or the exercise of a purchase option, title to the facility would revert back to the public sector. New facilities can be financed using this mechanism or old ones sold for cash, renovated and leased back for government operation.

Notwithstanding CCA's expectations for its REIT, however, general market hostility to REITS in 1999 and CCA's operating and intercorporate problems caused company stock to plummet. At the end of 1999, CCA decided to convert its corporate structure back to that of a single tax-paying company and announced that it would sell over $300 million in equity interests as part of the restructuring[32]. Sale and lease backs presumably, can still be done with re-combined entity.

F. Private Financing, Construction and Operation (a/k/a Build-Own-Operate)

Some of the private operating companies have undertaken to build, own and operate facilities using equity and taxable debt raised by the operating company. CCA has owned at least 18 facilities financed this way. Some of these have been purchases of an existing property, which are renovated by the company and leased back to the government for debt service payments. In the District of Columbia, CCA paid over $50,000,000 for the Correctional Treatment Facility and will be repaid (and earn a profit) under its lease back to the District.

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[29] Interview with Charles Jones, CEO of CPT, November 23, 1999.

[30] Correctional Properties Trust, News Release, May 12, 1998. CPT also plans to acquire facilities from other private prison operators and from governmental entities, but so far has not. Interview with Charles Jones, CEO of CPT, November 23, 1999. Prospectus for Correctional Properties Trust, dated April 22, 1998, regarding the issuance of 6,200,000 common shares.

[31] Interview with Patrick Cannan, Director, Corporate Relations, Wachenhut Corrections. November 23, 1999.

[32] The New York Times, December 28, 1999, at C6, and The Wall Street Journal, December 27, 1999, at A4. CCA and PRT also came under criticism for the fees PRT paid to CCA and the various interrelationships between the two companies. Both Doctor R. Crants, chairman and CEO of PRT, and his son Robert Crants III, president of PRT, will step down.

Generally, renovations are handled the same way as new facilities, but construction costs are more difficult to fix in renovations, and renovated old facilities with poorer layouts are more difficult to use and more expensive to operate.

A REIT has the capacity to finance and do design and construction work but not to operate a facility. Construction or renovation work might be done by its own employees or the company might turn to a local construction company. If private operation of the facility is part of the plan, an operating company will have to be brought in. Prison Realty Trust has had an exclusive option to do all the projects that CCA would otherwise own or finance, and brought CCA into the picture when an operating company was required on a PRT project. There are a good number of projects where CCA's PRT purchased the facility from CCA and then leased it back for operations.[33] Correctional Properties Trust uses Wackenhut, and other private operators, or the government, as an operator.[34]

During 1999, CCA utilized three companies for operations: one for management of government owned adult prison facilities, one for other facilities owned by governments, and one for facilities owned by CCA or PRT.[35] This corporate structure was intended to improve CCA's ability to develop or purchase facilities which would be operated by the public sector but allow governments to privatize the asset (freeing money for other uses) and avoid political or labor opposition to private management.[36] How CCA will satisfy these goals after it restructures yet again in 2000, is yet to be seen.

G. The Birth of Speculative Prisons

Since the construction of a prison can produce several hundred construction jobs, and operation of a corrections facility can produce 200 to 500 permanent jobs, communities that are eager for job growth and a flow of public dollars sometimes push for the development of prison facilities in their own community. The economic effect of such a facility, through the payment of salaries, and the growth of ancillary businesses cannot be predicted exactly, but it is likely to have a positive effect on the housing market and retail establishments in the area. In addition, rent payments under a site lease or payments in lieu of taxes may be used by the local government for other economic development or infrastructure improvement purposes.

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[33] Telephone discussion with J. Michael Quinlan, CEO of PRT, on March 5, 1998. As of November 1999 CCA had contracts for 83 facilities of which 70 facilities with a design capacity of 55,000 beds were in operation.

[34] Telephone discussion with Patrick Hogan, CFO of CPT, July 17, 1998.

[35] Prison Realty Trust, News Release May 5, 1999. One of the three, called "OPCO" is primarily owned by management, key employees and wardens, with 32% ownership by outside investors. It manages 30 prisons leased from the REIT plus 10 others. The other two, Prison Management Services and Adult and Juvenile and Jail Facilities Services have contracts for 30 facilities none of which are owned by Prison Realty Trust. S.G. Cowen, Perspectives: Prison Realty Corp., June 28, 1999.

[36] The New York Times, April 21, 1998, at D5, and Legg Mason Wood Walker, Inc., CCA Prison Realty Trust/Corrections Corp. of America Merger Analysis, May 26, 1998; and telephone call with J. Michael Quinlan, CEO of PRT, on July 14, 1998.

The impetus for such a facility may come from local officials, a developer, construction companies and trade groups, private prison operating companies or their shareholders, or from any combination of these. The financing is likely to be done through a local economic or industrial development agency which will issue project revenue bonds or act as a financing agent for COPs.

The issuance can be tax exempt if ownership is public and the tax requirements discussed previously are satisfied. The issuer may, in the alternative, be a not-for-profit corporation that is an instrumentality of the local county. Its sole asset may be the revenue generated by the project. There would be no full faith and credit pledges from the state or the county or municipality. Even the issuer may have no obligation. The payment of debt service will be dependant on the revenues generated from the per diem payments made for the incarceration of inmates. The ability to issue the bonds may therefore depend upon the level of the state commitment to send inmates to the facility. This commitment may vary from substantial and long term, to minimal, or subject to periodic full review, on down to no commitment at all. A large portion of commitments are also subject to annual appropriations. Lenders are accustomed to annual appropriation risk and know how to evaluate it. Subjecting a facility to a periodic "policy" evaluation is a more serious credit risk for lenders.

If the project is subject to annual policy review, the local department of corrections (the host state may be the intended major supplier but not the sole supplier) will be in a position to re-evaluate the use of this facility in comparison with other available correction facilities that then exist or are being built. If the bonds for a proposed project are being considered by institutional lenders or the capital markets, the potential lenders will study the projections, looking most carefully at gross revenues, costs, and the risks that are involved. The analysis will be based on the agreements, the parties, and projected cash flows, and other things.

The risks include the quality of the design of the facility, and the variety/type of inmates the facility is designed and staffed to accommodate. There needs to be a match between projected demand and the capacity of the facility to satisfy it. The larger the variety of possible inmates the prison can take in terms of age, gender and custody level, the greater the flexibility to find inmates if the need arises. The geographic location of the facility (which can affect recruiting, salaries, other costs and political support) and the selected operator are also important. If the operator is a reputable company and the operating agreement is reasonable, and for a substantial period of years, this will help market the bonds. The level of the operator's financial commitment (which may include an equity investment or other financing help) and the ability of the sponsor or operator to secure additional inmates from other states, will also affect the marketability of the bonds. Since the commitment from the main provider of inmates (usually the host state) will be crucial, these will be evaluated closely. The facility will be evaluated by private lenders as being in potential competition with other facilities during the term of the financing.

The weaker the cash flow projections, and the greater the risks, the more the facility will be perceived as truly speculative in nature, and the more there will be a need for some form of credit enhancement such as guarantees, bond insurance or letters of credit backing the bonds.

Credit enhancement is most apt to come from a key sponsor of the project like the operating company and/or the developer.

In the Hardeman Tennessee Correctional Facilities Corporation financing, for example, neither the State of Tennessee (which signed an agreement allowing it to send prisoners) nor the County was obligated to provide a minimum number of inmates to the facility. If the trustee were forced to foreclose, the bondholders would have a facility that was not likely to be useful for anything besides a prison. But CCA signed a Debt Service Deficits Agreement obligating CCA to cover shortfalls in amounts required to pay principal and interest on the bonds. If there is a mandatory redemption of the bonds, CCA is only obligated to pay principal and interest on the originally scheduled payment dates and is not obligated to advance funds to cover any premium that may be due (in e.g., a determination that interest paid on the bonds is taxable). The State of Tennessee was also granted an option to purchase the prison at prices that would be less than outstanding debt. If the option is exercised, the Debt Service Deficits Agreement calls upon CCA to pay the difference between the State's purchase price and the bonds outstanding (all of which must be redeemed upon exercise of the option by the State). If there is a foreclosure, CCA is not liable for any deficiency that may remain unless the acceleration is the result of a default by CCA under the Debt Service Deficits Agreement or a bond document. The interest on the bonds was tax exempt. In some projects (e.g., Huerfano, Colorado) the proposed institutional lenders, which were generally mutual funds, found the project to be too risky even for their high yield tax exempt portfolios. So in some, such as Huerfano, the company, in this case CCA, went ahead using its own taxable debt and equity to finance and develop the project.

Some facilities which have been financed (either on a taxable or tax exempt basis) were even more speculative than Hardeman County or its cousins. The N-Group for example built nine prisons in Texas, six of which failed. They were financed without *any* contracts in place to supply prisoners. These were totally speculative prisons. Some of the N-Group prisons in Texas did not even meet state standards, so they could not be supplied with Texas inmates even if Texas had wanted to use these facilities. Ultimately, the N-Group company failed, the bonds defaulted and investors sued.[37] In speculative financings that fail (as was the case with the N-Group) the developers are apt to be sued by the bond purchasers . Fortunately such financings have been a small minority among correctional facility project financings, and there appear to be fewer today, now that the market has become more knowledgeable and mature.

If the risk is too high today, the facility will not be financed on a project finance (non-recourse basis) at all. The sponsor or operating company may have to finance it itself, using company credit, or bring in a REIT. Most host states today will not provide long-term commitments to send inmates to a speculative prison. But the political pressure to provide inmates to a struggling local community will be noticeable and perhaps compelling. One town in Oklahoma, in poor economic shape, built a speculative prison in 1996 with CCA's help. The state which was in need of additional cell space, proceeded to send inmates. Over the next two

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[37] *See* Martin E. Gold, *The Privatization of Prisons,* 28 THE URBAN LAWYER 359, footnote 50, at 374 (1996)

years, five more spec prisons were built in various Oklahoma communities, causing the state to pull its prisoners out of facilities in other states in order to fill these facilities.[38] The private sector, acting without state commitments or encouragement, moved the state from one that only two plus years earlier had a substantial shortage of cells, to one with excess capacity.

With so many prisoners moving to rented cells across state borders or to speculative prisons in their home state, inmates are starting to look more and more like commodities. And to the private sector, building an economic development or speculative facility, that to an important extent is what they are: commodities having a stream of revenue attached.

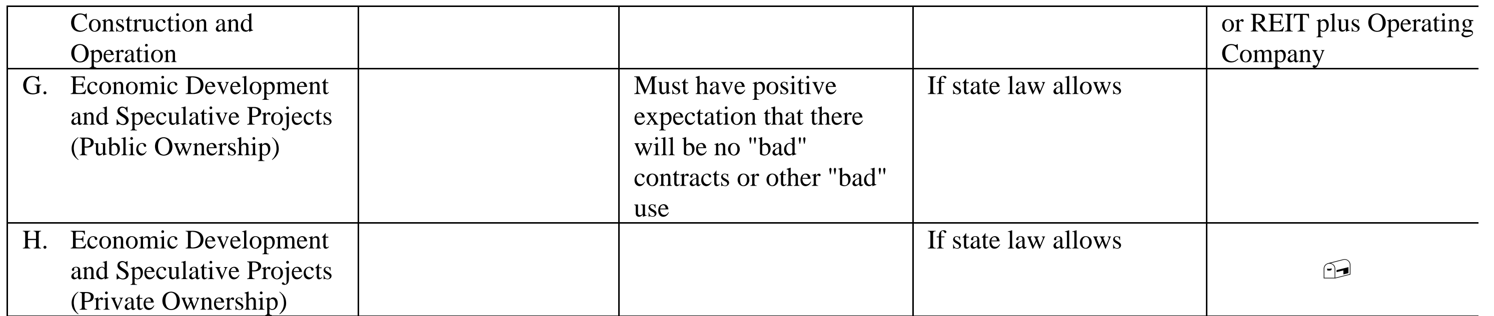
V. A MATRIX SUMMARY

The following matrix sets forth the financing and development methods availability for the various combinations of public/private ownership projects. Across the top of the matrix are the types of debt issuances, running from most public (G.O. bonds) to most private. The column down the left contains the spectrum of construction and operation models also running from the most public to the most private. A check mark indicates that the combination can be done. Where there is a note the combination can be done (or occur) as stated in the note.

Summary of
Financing and Development Methods Available

Type of Development/Operations and Debt	Tax Exempt G.O. Bonds	Tax Exempt Revenue Bonds or COPS	Government Issued Taxable Bonds	Private Company Taxable Debt
A. Public Ownership, Construction and Operation	✓	✓		
B. Public Ownership, Private Design-Build	✓	✓		
C. Public Ownership and Construction, Private Operation	✓	Must have positive expectation that there will be no "bad" contracts or other "bad" use	If fail to satisfy Tax Rules for Management Contracts	
D. Public Ownership, Private Construction and Operation	✓	Must have positive expectation that there will be no "bad" contracts or other "bad" use	If fail to satisfy Tax Rules for Management Contracts	
E. Private Financing and Construction			If state law allows	Either by Operating Company or REIT
F. Private Financing,			If state law allows	By Operating Company

38 *See* Christopher Swope, *The Inmate Bazaar*, GOVERNING, October 1998, at 18-21.



Construction and Operation				or REIT plus Operating Company
G. Economic Development and Speculative Projects (Public Ownership)		Must have positive expectation that there will be no "bad" contracts or other "bad" use	If state law allows	
H. Economic Development and Speculative Projects (Private Ownership)			If state law allows	

APPENDICES

Appendix A

FEDERAL TAX CONSIDERATIONS

A. Introduction

Federal tax statutes[1] and regulations (the "Regulations") issued thereunder by the Internal Revenue Service (the "IRS") of the United States Treasury Department (the "Treasury") impose a variety of constraints on the use and investment of proceeds of tax exempt bonds and on the facilities financed with such bonds.

This section provides the reader with a general understanding of certain of the fundamental concepts of the Code and Regulations concerning the tax exempt financing of prison facilities, but cannot comprehensively address all tax exempt financing issues.[2] Tax exempt financing can be used not only with general obligation bonds, but also with revenue bonds and COPs. It may therefore be used with private company operators, if structured properly.

The topic addressed in this Appendix is private business issues, which is further subdivided into use issues, payment issues, and security issues.[3]

B. Private Business Issues

Normally, governmentally owned and operated prison facilities can be financed with tax exempt bonds. However, tax exempt bonds cannot be used to finance prison facilities in two important circumstances. First, tax exempt bonds generally cannot be used to finance prison

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1 The subject federal statutes are contained in the Internal Revenue Code of 1986, as amended, and may be referred herein as the "Code."

2 One issue beyond the scope of this paper is the requirement that as of the issue date, the issuer have certain "expectations" regarding how the prison facilities are to be used during the stated term of the bonds.

Another such issue is that of a "federal guarantee." The Code provides that the payment of principal or interest on tax exempt bonds may not be guaranteed in whole or in part by the United States or any agency or instrumentality thereof. All arrangements for the use of prison facilities by the federal government must be carefully reviewed to determine whether, under federal income tax principals, such arrangements give rise to a legal or economic federal guarantee for the payment of principal or interest on tax exempt bonds. Similarly, arrangements regarding the use of prison facilities by state and local governments under circumstances where the payment of principal or interest on tax exempt bonds is derived from the federal government must be carefully reviewed for federal guarantee concerns.

3 An additional tax issue is that of "reimbursement." Under limited circumstances, the proceeds of tax exempt bonds can be used to reimburse a borrower for costs incurred prior to the issuance of such bonds Generally, reimbursement is permitted only if and to the extent "official intent" is declared (and documented) prior to the expenditure to be reimbursed. Consequently, issuers planning to reimburse themselves for the costs of prison facilities paid prior to the issuance of the bonds, are best served by adopting official intent declarations prior to the time of making such expenditures. A detailed discussion of reimbursement is beyond the scope of this paper.

facilities if (1) a person or organization other than a state or local governmental unit (hereinafter referred to as a "Private Entity") is using the facility in a trade or business (such use is referred to hereinafter as "Private Business Use")[4] and (2) the payment of debt service on the subject bonds is directly or indirectly derived from payments in respect of property used for a Private Business Use (such payments are referred to hereinafter as "Private Payments").

Second, tax exempt bonds cannot be used to finance prison facilities if (1) there is Private Business Use, and (2) the payment of debt service on the subject bonds is secured by either any property used for a Private Business Use or by payments in respect of property used for a Private Business Use (such security is referred to hereinafter as "Private Security").[5] If the financing fails to satisfy the requirements, then the bonds will be fully taxable.

This can be summarized as follows:

IF	(1) PRIVATE BUSINESS USE	**PLUS**	(2)(a) PRIVATE PAYMENTS **OR** (2)(b) PRIVATE SECURITY	**THEN**	TAX EXEMPT FINANCING UNAVAILABLE

Of course there are a number of caveats and wrinkles to these tax rules. It is recommended that qualified tax counsel be consulted as early as possible in the financing process.

1. Private Business Use

Private Business Use is the use of facilities financed with the proceeds of tax exempt bonds by a Private Entity for use in its trade or business. Determining whether a Private Business Use may exist is critical since the presence of a Private Business Use is a prerequisite to the existence of both Private Payments or Private Security and to the possible failure to use tax exempt financing.

Private Business Use may result from either actual or beneficial use by a Private Entity of the facility. Generally, Private Business Use arises only if a Private Entity has "special legal entitlements" to use the tax exempt financed property. Also, if a prison facility is used by the

[4] The federal government (including its agencies and instrumentalities) is treated as a Private Entity. Consequently, absent the satisfaction of a "90 day exception," use of tax exempt bond financed facilities by the federal government will result in Private Business Use.

[5] Under certain circumstances, the statutes and regulations allow for up to ten percent (10%) of Private Business Use and allow for up to ten percent (10%) of the debt service on an issue of tax exempt bonds to be paid with and secured by Private Payments and Private Security without jeopardizing the tax exempt status of the subject bonds. The 10 percent threshold drops to five percent (5%) in certain circumstances.

federal government and payments from the federal government secure the debt service on the subject bonds, use by the federal government is Private Business Use because the federal government is deemed to be a "Private Entity" and the application of such payments to “secure” debt service gives rise to Private Security. The result is taxable bonds.[6] These concepts will now be discussed in more detail.

a. Ownership and Leases

The ownership by a Private Entity of the bond financed property results in Private Business Use. The lease of bond financed property to a Private Entity also results in Private Business Use.[7]

b. Management/Service Contracts

The actual or beneficial use of a facility pursuant to a management or service contract under which a private company provides services for a facility will generally give rise to Private Business Use. But, the IRS has provided certain “safe-harbors” with respect to management or service contracts, which if satisfied, will not result in Private Business Use. Contracts for services that are solely incidental to the operation of prison facilities (such as janitorial and office equipment repair) will not give rise to Private Business Use. Additionally, use during construction by a developer is not Private Business Use if the issuer and developer proceed with all reasonable speed to develop the property and transfer it to the governmental entity after completion of construction.

For a contract to satisfy one of the safe-harbors, it must provide for reasonable compensation and no part of the compensation can be based on a share of net profits from the operation of the facility.[8] The following two forms of compensation are not considered to be a share of net profits: (1) a percentage of gross revenues (or adjusted gross revenues) or a percentage of the expenses of a facility[9] or (2) a per unit fee (hereinafter a “Per Unit Fee,"[10]).

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[6] In addition to providing rules regarding Private Business Use, Private Payments, and Private Security, the Code and Regulations also contain provisions regarding the investment of proceeds of tax exempt bonds until such proceeds are spent, as well as other money that is used to pay debt service on or is security for the bonds. Generally, these provisions contain rules regarding the yield that may be earned on tax exempt bond proceeds before they are spent, specific investments that may be purchased with tax exempt bond proceeds, how quickly tax exempt bond proceeds must be spent, and those circumstances under which positive arbitrage earned must be remitted to the federal government.

[7] For this purpose, any arrangement that is properly characterized as a lease for federal income tax purposes is treated as a lease.

[8] Reimbursement of the service provider for expenses it pays to unrelated parties is generally not treated as compensation.

[9] However, the use of both percentage of gross revenue and a percentage of expenses at the same time will be considered a share of net profits.

[10] A Per Unit Fee is generally defined as a stated dollar amount based on a unit of service, such as a per diem fee.

In addition, to keep interest tax exempt under a safe-harbor, the compensation and term provisions must satisfy one of the following arrangements:[11]

(1) At least 95 percent of the compensation for each annual period is based on a "Periodic Fixed Fee" (defined as a stated dollar amount for services rendered for a specified period of time)[12], and the term of the contract, including all renewal options,[13] must not exceed the lesser of (1) 80 percent of the reasonably expected useful life of the financed property and (2) 15 years.

(2) At least 80 percent of the compensation for each annual period is based on a Periodic Fixed Fee, and the term of the contract, including all renewal options, must not exceed the lesser of (1) 80 percent of the reasonably expected useful life of the financed property and (2) 10 years.

(3) At least 50 percent of the compensation for each annual period is based on a Periodic Fixed Fee, the term of the contract, including all renewal options, does not exceed five (5) years, and the contract must be terminable by the governmental entity on reasonable notice, without penalty[14] or cause, at the end of the third year of the contract term.

(4) All compensation is based on a Per Unit Fee or a combination of a Per Unit Fee and a Periodic Fixed Fee, the term of the contract, including all renewal options, must not exceed three (3) years, and the contract must be terminable by the governmental entity on reasonable notice, without penalty or cause, at the end of the second year of the contract term.

(5) All compensation is based on a percentage of fees charged or a combination of a Per Unit Fee and a percentage of revenue or expenses, the term of the contract, including all renewal options, must not exceed two (2) years, and the contract must be terminable by the governmental entity on reasonable notice, without penalty or cause, at the end of the first year of the contract term.

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[11] An additional requirement is that the service provider must not have any role or relationship with the owner or governmental unit that, in effect, substantially limits the ability of the owner or governmental unit (based on all facts and circumstances) to exercise its rights, including cancellation rights, under the contract.

[12] A fee that is a "Periodic Fixed Fee" per year may automatically increase according to a specified objective external standard such as an index, or another acceptable formula under the rules.

[13] For purposes of all five safe-harbor exceptions, a renewal option is defined as a provision under which the service provider has a legally enforceable right to renew the contract. A provision under which a contract is automatically renewed for specified periods absent cancellation by either party is not a renewal option.

[14] For purposes of the safe-harbor exceptions, penalties for terminating a contract include a limitation on the owner's right to compete with the service provider; a requirement that the owner purchase more than minor amounts of equipment, goods, or services from the service provider; and a requirement that the owner pay a penalty for canceling the contract.

The table set forth in Appendix B summarizes these safe-harbors. If a safe-harbor is satisfied there is no reason to apply the other safe-harbors. The general concept of the safe-harbors is that the greater the Private Entity's compensation is based on fixed amounts, the longer the permissible term.

Per diem fees, by themselves, constitute "per unit" fees, not fixed fees or stated dollar amounts. Fixed fees or stated dollar amounts means the aggregate total must be fixed (subject to acceptable adjustments).[15] If there is a guaranty from the state, for example, that 80% of all cells will be paid for regardless of use, the contract can qualify for the 80% Periodic Fixed Fee and have a 10 year term. The fixed daily compensation would be calculated using the following formula: Fixed Fee = (number of inmates) x (per diem amount per inmate) x 80%. If the calculation period is a year, the preceding would then be multiplied by 365.

It should be noted that an arrangement that is referred to as a "management" or "service" or "operations" contract may nevertheless be treated as a "lease" because a proper characterization under tax rules depends upon a detailed analysis of facts and circumstances. A lease will give rise to Private Business Use.

Renewal options that require mutual agreement of the parties to continue are not included in a base period, i.e., are not part of the "term". Automatic extensions unless either party exercises its right to terminate do not become part of the contract term either. If the operator alone has the right to renew, however, the periods covered by those options are counted as part of the term. No right of the government to terminate is required in 10 and 15 year contracts that otherwise qualify. A right to terminate without cause a qualifying 5 year contract is required after the third year, and such termination must be without penalty.

Prison operating agreements are commonly funded on a per diem basis, with escalations and some pass-through payments for disbursements. Escalators based on an index or a combination of indices are acceptable for adjusting the periodic fixed fee or the per diem fee. They may also grow by fixed dollar amounts or fixed percentages. The portion of the compensation that is not a fixed fee, however, must still fall into another acceptable fee payment category. These include per-unit fees (per diems), and percentages of gross revenue categories. No portion of the compensation may ever be based on net profits. The latter might arise in prison operations, possibly, if the prison accepts prisoners from other entities or the operator is paid on a per diem, per prisoner basis, and adjusts payments required from the state to reflect reduced operating costs. Bonuses for efficiencies, or cost savings, may be acceptable. Each such arrangement would require review by counsel.

If the formula uses 100 percent per diem payments and pass-throughs, then even the five-year term (with a right of termination after three years) cannot be used, but a contract with a three-year term with a two-year cancellation provision (a "3/2" term) can be used, and would be the longest base term available. A "5/3" contract is only available if at least 50% of the fee is fixed. But these short terms should not necessarily be viewed as a serious barrier: if the business

[15] A per diem fee is not "capitation fee" as used here.

relationship works, the parties will probably renew the agreement. And mutual renewal terms can be added without limit.[16] If, however, there is a minimum payment commitment due the operator (e.g. on the assumption that the facility will be utilized to a minimum percentage level), and if that minimum fee is contractually required to equal 80% or 95% of the total annual compensation (pass-throughs being ignored), then it may be possible for the contract to be written for a term with 10 or 15 years and no early termination would be required.

c. Special Economic Benefits – The Catchall

Private Business Use may also arise solely on the basis of a "special economic benefit" to a Private Entity, even if such entity has no special legal entitlement to the physical use of the financed property. A priority right such as a right of first refusal for space (cells) (e.g., by the federal government) or to purchase a facility would be a Private Business Use. In determining if the circumstances give rise to a special economic benefit, all facts and circumstances are considered.

2.(a) Private Payments

As stated above, Private Payments are payments of debt service on tax exempt bonds which are directly or indirectly derived from any facilities which are used in a Private Business Use. The most common form of a Private Payment is payments of rent by a private corporation for the use of property financed with tax exempt bonds.

But the source of revenue that is typically used to satisfy the debt service requirements of bonds that finance prison facilities is, directly or indirectly, tax revenues of governmental entities, since such governmental entities will be obtaining the benefits of the financing by virtue of their prisoners being housed in the subject facilities.[17] Normally, the use of general tax revenues (or any particular taxes not related to the specific property) as the source of debt service payments on bonds will not give rise to Private Payments; however, tax revenues combined with the existence of a Private Business Use may result in Private Payments. For example, under the tax rules, Private Payments will arise if the payment "is with respect to property used in a Private Business Use." Consequently, if a prison facility is treated as "used" by a Private Entity (e.g., because a safe-harbor under the management contract rules was not used) payments with respect to such Private Business Use, such as payments to the operator for prisoners from other jurisdictions for more than 10 per cent of the facility's space, are apt to be Private Payments[18]. If such payments, however, are made to the host government and the operator only receives

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[16] They probably need to satisfy the same tax rules as the initial term, but that is not certain.

[17] It is noted that revenues from the federal government may also give rise to "federal guarantee issues" discussed more fully in a footnote above.

[18] Under §141(b) of the Internal Revenue Code, up to ten percent of total use may be for Private Business Use and ten percent of total revenues may be Private Payments without causing the bonds to be taxable. For this purpose a cumulative test may be available to help keep the issue from turning taxable. This may be helpful in facilities, for example, where federal prisoners are housed.

additional amounts therefor under its qualified management contract with the host government, the payments are unlikely to be Private Payments.[19]

2.(b) Private Security

"Security" exists if the property serves as security for debt service on the bonds (e.g., under a mortgage or deed of trust or other security instrument producing a lien or pledge). Security also exists if the revenues from the facility are pledged or otherwise available for payment of debt service. If there is also Private Business Use, this security will be "Private Security" and the bonds will be taxable. For example, if a mortgage secures debt service on bonds issued to finance a prison facility used by the federal government or operated by a Private Entity pursuant to an arrangement that does not satisfy one of the IRS safe-harbors, there will be Private Security. Hence, if you have a Private Business Use because a safe-harbor was not used, and you have a mortgage to secure payments, the bonds will not be exempt.

Since the vast majority of financings involve either a mortgage or a pledge of the revenue stream, tax exemption can generally only be obtained by avoiding Private Business Use in the first place. That is best achieved by direct government operation of the prison or employment of a private company using a qualified management contract.

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[19] It is not clear whether it would be acceptable to have several states enter into contracts relating to a single facility which all attempt to be qualified management contracts because an operator is supposed to be operating a facility on behalf of a single government which owns the facility. Bond counsel may be reluctant to give an opinion that more than one qualified management contract can exist at a time with respect to a single facility owned by one governmental entity.