The Reality v. Legality of Conduit Financing by the State—Public Authorities, the Chosen Financiers

By George H. Weissman

Introduction

Conduit financing, or otherwise referred to at times as conduit borrowing, is the mechanism for obtaining tax exempt financing for certain private and also public entities in New York State. For example, in order to fund and replace the "House That Ruth Built," the New York City Industrial Development Agency has issued in excess of $1.2 billion of tax-exempt bonds to help finance the design and construction of the new Yankee Stadium, also sometimes called the "House That George Built." [1] Not to be outdone, the New York Mets have begun the 2009 baseball season in a new stadium known as "CitiField" that in all likelihood would not have been built without approximately $630 million of tax exempt financing, again issued by the New York City Industrial Development Agency.[2]

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By definition, the Yankees and Mets stadium projects are traditional forms of conduit financing, which is defined as:

> A form of financing in which a government or government agency lends its name to a bond issue, although it is acting only as a conduit between a specific project and bondholders. The bondholders can look only to revenues from the project being financed for repayment, and not by the government or agency whose name appears on the bond.[3]

A multitude of not-for-profit entities in New York including colleges, universities, hospitals, and museums, as well as for-profit entities, are beneficiaries of conduit financing.[4]

While the use of tax-exempt financing for stadiums and other items such as golf courses has raised the ire of commentators and the Internal Revenue Service, it is the explosion of conduit financing by governmental entities, especially the State of New York, for both governmental and arguably non-governmental purposes, that has caused State Comptrollers for the last forty years to rail against the issuance of state-supported debt by the State's public benefit corporations. Also known as public authorities, these legislatively created public corporations[5] are now responsible for well over ninety percent of state-supported debt issued on behalf of New York State.[6] It is this practice, commonly referred to as "backdoor borrowing,"[7] that has caught the attention of commentators and reformers alike.

The purpose for the creation of public authorities is simple: since 1846, the New York State Constitution has prohibited the State from contracting debt without a referendum approved by the voters, other than for short-term debt, refunding of existing debt, maintaining the peace, or fighting forest fires.[8] This constitutional requirement, also known as the people's resolution, has made financing New York's needs and desires for public improvements exceedingly complicated. While the State has continually attempted to finesse this constitutional restriction through varying means, public authorities have provided the most effective and legally defensible mechanism available for obtaining borrowed funds through the long term capital market in order to undertake necessary (and in some instances questionable) spending and improvements.

This article will examine types of financing by public authorities, the evolution of conduit financing on behalf of the State, legal issues that have affected conduit financing, and the form of conduit financing and its usage today. It is not meant to be exhaustive, but rather to provide the reader with an insight of how the State has managed to meet its financing needs.

Borrowings by Public Authorities

Exactly when the public authorities began conduit financing on behalf of the State is open to debate. In finding the answer to this question it is first important to understand the nature of borrowing by public authorities. From the State's perspective, there are essentially three types of debt offerings by public benefit corporations: debt for the corporate purposes of, and paid directly by, a public authority from revenues generated by tolls, fares, or other sources under its control; conduit borrowings by a public authority on behalf of and paid for by non-governmental or governmental entities, and debt paid for by State appropriations through a service contract, statute, or similar arrangement—State-supported debt. Certain debt offerings may involve more than one of these debt payment features.

The first group of debt issuers would include entities such as the Port Authority of New York and New Jersey, the Metropolitan Transportation Authority (including the Triborough Bridge and Tunnel Authority), or the New York State Thruway Authority. Each of these public authorities issues debt backed by revenues derived from operations that may consist of tolls, fares, rents, concessions, or other sources. Each of these public authorities issues debt for the purpose of executing capital improvements to its operating infrastructure. In the case of the Port Authority, this includes the Hudson River transportation crossings south of the Tappan Zee Bridge, the three major airports in the New York metropolitan region, certain port operations in both New York and New Jersey, and the PATH railroad system. The Metropolitan Transportation Authority runs the largest mass transportation system in the United States, which includes subways, buses, commuter railroads, bridges, and tunnels. The Thruway Authority is responsible for the longest tolled highway system in the United States.

Despite what some may think, this type of public authority as originally envisioned does not fall into the category of conduit borrower on behalf of the State. Although both the Port Authority and the Thruway Authority initially received state appropriations to start their missions, both have sufficient operational revenues to maintain their self sufficiency without additional revenues provided from state-enacted sources. Over the years the mission of both the Port Authority and the Thruway Authority have been expanded to undertake programs or perform operations that may have formerly been under the jurisdiction of a state. However, both these public authorities have been able to integrate these new functions without reliance of state-generated revenues. As will be discussed *infra*, the Thruway Authority has become a conduit borrower for the State of New York, while the states of New York and New Jersey have expanded the mission of the Port Authority. And, although the Metropolitan Transportation Authority is highly dependent on State of New York-imposed taxes and fees for maintaining its operations on a self-sustaining basis, the issuance of certain debt by the Metropolitan Transportation Authority is for its own corporate purposes and not dependent on the State for support.

The second category of debt is issued by public authorities such as the Dormitory Authority, Housing Finance Authority, and Environmental Facilities Corporation. Each of these entities issues debt backed by agreements by a party other than the State. The Dormitory Authority issues debt for independent colleges and universities, not-for-profit corporations providing medical and residential health care services,[9] educational, or other public services. The Housing Finance Agency, *inter alia*, offers financing to for-profit and not-for-profit developers for the purpose of encouraging the construction and preservation of affordable housing in communities throughout New York State.[10] Again, these types of debt offerings are generally not for State purposes and are not dependent on state appropriations for the payment of debt service.

It is the last category of borrowing—by public authorities and backed by State appropriations—that has caused many to believe that the constitutional prohibition against borrowing found in article VII, § 11 of the New York State Constitution has been rendered meaningless. Public authorities that issue debt but do not construct, operate, maintain, and use the improvements to liquidate the debt financed are generally viewed as conduit financers. Even the public authorities that liquidate their own indebtedness may employ conduit financing for their own purposes or those of the State. The State has employed public authorities to borrow on a conduit basis to eliminate short-term borrowing or resolve short-term operating deficits.

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In addition, the State does not only employ this financing mechanism primarily for its capital needs. The State has created public authorities to rectify the finances of municipalities when access to the capital markets has been curtailed due to poor financial management and has also permitted municipalities to use the proceeds of debt issued by public authorities to circumvent the constitutional tax and debt limitations found in article VIII of the New York State Constitution. The Municipal Assistance Corporation created for New York City in 1975,[11] and for the City of Troy in 1995,[12] as well as the Nassau County Interim Finance Authority created in 2000,[13] are just three such examples of public authorities that were employed to provide market access for municipalities to remedy both operating deficits and the need to obtain capital for infrastructure improvements through the issuance of debt. The New York City Transitional Finance Authority was created in 1997[14] for the purpose of permitting the City to obtain capital for infrastructure as it bumped up against the constitutional tax and debt limits. Additionally, the Dormitory Authority, as well as the Environmental Facilities Corporation, issue debt on behalf of municipalities for statutorily enumerated purposes.[15]

Conduit Financing for the State

Today, conduit financing by public authorities is virtually the exclusive source of borrowed funds for State infrastructure needs. The reason for this is quite simple. Since 1990, New York has undertaken referenda for six different bond acts totaling approximately $14.6 billion. Of these six proposals that were put before the voters, only two passed, totaling $5.65 billion.[16] In fact, annual expenditures for state-related capital purposes over the next five years are estimated at $46.6 billion. Of this amount, approximately twenty percent will be federal funds. Slightly more than twenty-six percent will be spent on a pay-as-you-go basis from State resources, and this assumes a better than twenty percent increase from current pay-as-you-go spending in State Fiscal Year 2009-10. Therefore, more than half of the State's total capital spending will be funded with debt. If past practice holds true, ninety percent or more of the remaining spending will be from debt that is issued by public authorities on a conduit financing basis.[17]

Putting aside the various proposals developed by the Office of the State Comptroller and others over the past three decades, only one of which has been put to the voters in 1995 and rejected, the need in New York State for voter approval of full faith and credit general obligation debt remains a vestige of the 1846 constitutional convention. At that time the ill sought to be cured was near bankruptcy of New York and other states that had become enamored with public improvements such as canals and railroads and were responsible for the debt issued to construct these improvements.[18] Once the Erie Canal was built and successful, every legislator wanted a canal in his district. Has anything changed over the last one hundred-sixty years?

The questions for the reader are at least threefold: first, what is State-supported debt and how is it issued by public authorities; second, when did the State start using public authorities for the conduit financing of State-supported debt, and third, what capital (and other) needs are funded by conduit borrowing through the use of State-supported debt issued by the State's public authorities? State-supported debt is currently defined as

> bonds or notes, including bonds or notes issued to fund reserve funds and costs of issuance, issued by the state or a state public corporation for which the state is constitutionally obligated to pay debt service or is contractually obligated to pay debt service subject to appropriation, except where the state has a contingent contractual obligation.[19]

Bonds and notes for which the State is constitutionally required to pay debt service are general obligation, full faith and credit debt. The debt issued by a public authority that is paid for by the State, subject to appropriation by the Legislature, is State-supported debt.

There are two primary means that public authorities use to issue State-supported debt. Formerly, the most common method involved a lease through a lease-purchase or lease-lease-back arrangement between a State agency and public authority. Under this method, a public authority either obtains title to, or a leasehold interest in, the capital improvement being financed. Concurrently, the public authority issues debt for the improvement and the improvement is leased back to the state agency. The lease back to the state agency requires that agency, subject to appropriation by the Legislature, to pay the public authority an amount annually equal to the debt service (principal and interest) due on the bonds and generally any other costs incurred by the public authority in connection with the administration of the outstanding bonds, which may include fees due any credit or liquidity facility or trustee fees. Sometimes the underlying improvement serves as security to bondholders in the event debt service is not paid; other times, the underlying improvement in a lease financing arrangement is not available to bondholders in the event debt service is not paid.

The second method used to issue State-supported debt involves some form of a contract, sometimes called a service contract or financing agreement. Under this arrangement there is no transfer or leasing of the improvement being financed and the improvement is not available as security for the bondholder. Rather, the state agency and the public authority execute an agreement whereby the State agency agrees to make payments to the public authority, subject to appropriation by the Legislature, to cover annual debt service and the other previously mentioned costs associated with the debt. The public authority makes the bond proceeds available for the improvement being undertaken.

There may be a third method of issuing what would appear to be State-supported debt by a public authority that requires no underlying agreement. Instead, the public authority that issues the debt is statutorily directed to provide a certification to the State Comptroller for the amount required to pay debt service and other associated costs.[20] This amount is paid subject again to appropriation by the Legislature. The New York State Comptroller considers this debt to be contractual.[21] The explanation for this categorization may be that the payment mechanism is being viewed as a statutory contract or that some form of payment agreement that is not statutorily required has been executed between a state official and the public authority.

Pinpointing when the first issuance of state-supported debt occurred is difficult. For example, a series of enactments in the 1950s authorized the State to enter into agreements with the then New York State Employees' Retirement System to lease or purchase (i) a building for the needs of the Retirement System, (ii) buildings in Albany and Syracuse, and (iii) a complex of State buildings in Albany on what is now known as the Harriman State Campus.[22] At that time a limited use of the State Employees' Retirement System assets to provide financing for State buildings with a guaranteed rate of return from the State through lease payments garnered little notice, possibly due in part to the fact that the State Comptroller is also the sole trustee of the State Employees' Retirement System.

As noted in the Staff Report on Public Authorities prepared by the Temporary State Commission on the Coordination of State Activities in 1956 (also known as the Hults Commission after its Chairman, Senator William Hults), all public authorities required some form of initial governmental support in order to begin undertaking and advancing the public improvement for which they were created.[23] While repayment of these advances was somewhat haphazard, in the event the public authority issued bonds and started operating the improvement, the State was not called upon for debt service support. This is true even of the Thruway Authority, which was authorized by the voters in 1951 to issue up to $500 million of debt that was guaranteed by the State.

Based upon the definition that now exists in the State Finance Law related to state-supported debt, it can be argued that the Dormitory Authority of the State of New York provided the first conduit financing by a public authority. Originally created in 1944[24] to assist the State's eleven Teacher Colleges (now part of the State University of New York) by financing, constructing, and operating dormitories and attendant facilities, the Dormitory Authority sold its first bonds in July 1949.[25] In December 1954, the Dormitory Authority and the State University signed a lease removing the Authority from the direct operation and maintenance of the dormitories. The lease required the Dormitory Authority to finance and build the dormitories and then turn them over to the State University, which in turn provided sufficient funds for annual debt service payments and other costs.[26] Although the argument remained that the room rentals and fees liquidated the debt, the underlying lease required payment by the State University, an agency of the State.[27]

The model of using lease payments to public authorities to support the issuance of conduit debt was soon followed elsewhere. In 1962, the State decided to undertake the expansion of the educational facilities of the State University of New York. Rather than seeking approval of the voters, Governor Rockefeller proposed, and the Legislature passed, amendments to the New York State Housing Financing Agency Act authorizing a new financing program.[28] These amendments, *inter alia*, authorized the Housing Finance Agency to enter into leases with the newly created State University Construction Fund, a public benefit corporation.[29] Tuition and fees from students were paid into the State University Income Fund and these moneys were available to be paid under the lease between the Construction Fund and the Housing Finance Agency for debt service payments on outstanding bonds.

Quickly using the model designed for expanding the State University, in 1963 the Legislature passed and Governor Rockefeller signed legislation for the improvement and expansion of State facilities for the mentally disabled.[30] In order to obtain financing for this program, the Mental Hygiene Facilities Improvement Fund, a public benefit corporation, was created with the power to enter into leases with the Housing Finance Agency. The Mental Hygiene Facilities Improvement Fund received all payments for the care, maintenance, and treatment of patients, and these moneys were deposited in the Mental Hygiene Services Fund. The Housing Finance Agency issued bonds based upon lease payments to it by the Mental Hygiene Facilities Improvement Fund from the Mental Hygiene Services Fund.

In both these programs a public benefit corporation was placed between the State and the public authority issuing debt, insulating the State from the transaction. However, State funds, whether tuition or patient revenues, were the actual source of payments. And although legal support exists for the theory that funds of a public benefit corporation or public authority are not funds of the State,[31] there is little doubt that this represents conduit financing on behalf of the State. Finally, it would be dilatory not to note that the Housing Finance Agency bonds originally issued for both the State University and Mental Hygiene programs contained the moral obligation pledge to replenish reserve funds should they be drawn upon for debt service. While not all moral obligation debt was necessarily State-supported debt issued through conduit financing, the issues related to moral obligation debt have been well documented and will not be discussed.

The lease model between a statutorily created public benefit corporation using moneys for debt service directly from the State, or from the State to an intermediary public authority, became the vehicle for the State to create and use public authorities for the purpose of financing needed public improvements. A fair number of statutes were enacted by the Legislature for numerous purposes.[32] During the 1960s, State Comptroller Arthur Levitt started to detail the number and types of non voter-approved debt that, although not technically State debt, had the same fiscal impact.[33] Concurrently, Comptroller Levitt also noted that the State was not only using the lease method with public authorities for the issuance of State-supported debt; the State had also entered into similar arrangements with local governments for the construction of State office buildings and complexes, such as the Empire State Plaza in Albany.[34]

Another method available to the State to obtain financing is through the use of a service contract or other financing agreement. One of the first service contracts, however, was not directly for a State program. By 1981, the Metropolitan Transportation Authority's mass transit system had fallen into a state of disrepair. Years of underfunding the capital needs of the largest mass transit system in the country, along with the systematic deferred maintenance of the rolling stock and infrastructure in order to promote the suspect policy of maintaining a low fare, created a system that had failed. The Metropolitan Transportation Authority's Chairman at that time, Richard Ravitch, proposed a number of new funding initiatives in order to begin the process of bringing the system back to a state of good repair.

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For a number of years, the State had appropriated approximately $40 million annually for the capital purposes of the Metropolitan Transportation Authority's subways and commuter railroads. Chairman Ravitch proposed two changes to that annual appropriation: first, the State should increase the annual appropriation to $80 million; second, and more importantly, he sought legislative authorization for the Metropolitan Transportation Authority and the State, through the Division of the Budget, to execute one or more service contracts not to exceed thirty-five years, thereby permitting the Authority to issue service contract bonds.[35] The statute was clear that payment by the State under the service contract was subject to annual appropriation by the Legislature and the debt issued by the Metropolitan Transportation Authority was not debt of the State.

Subsequently, the use of service contracts or other financing agreements eventually became the preferred method for conduit borrowing on behalf of the State, unless the Legislature determined that the availability of the asset being financed provided additional security for the bonds or other political considerations existed for using a lease structure. From a legal perspective a service contract is a much simpler financing structure than leases between parties that also may include a transfer of title to real property.

Legal Issues

The legal questions relating to public authorities and the issuance of debt have generally stemmed from several constitutional provisions that exist, in addition to the standard prohibition against the State incurring full faith and credit indebtedness without approval of the voters. In response *Williamsburgh Savings Bank v. State*,[36] where the Court of Appeals permitted a claim to be brought against the State based upon a moral obligation theory, the 1938 Constitutional Convention proposed, and the voters approved, several amendments to the State Constitution that affect the issuance of debt. A portion of article X, § 5 prohibits the State or political subdivisions from assuming the liability from the obligations of public corporations and precludes the Legislature from doing so, unless the State or the public subdivision takes over the properties of the public corporation. Article VII, § 8 and article VIII, § 1 prohibit the State or a municipal corporation, respectively, from giving or loaning any money or property to an individual or private entity or from giving or loaning its credit to any individual, private, or public corporation.

State Comptrollers, past, present, and future, will always raise questions when public authorities issue debt that is not backed solely from operations and contains some form of financial support from the State. Although Comptroller Levitt had been questioning the wisdom of the ever-increasing amount of conduit debt that was being issued and financed with State revenues during the 1960s, in 1972 he authored a blistering review of a newly enacted State-supported debt program to be undertaken by the Thruway Authority.

By way of background, in 1971 the voters in New York rejected a proposed transportation bond issue in the amount of $2.5 billion. The rejection of this bond issue exacerbated a budget problem for the State that was resolved, in part, through increased taxes on fuel that were enacted at an extraordinary session of the Legislature in December 1971.

In 1972, the Legislature enacted a financing proposal that authorized the Thruway Authority to issue bonds that would be used to reimburse the State for expenditures arising from the reconditioning and preservation projects for State highways and other major arterials.[37] Those state expenditures were actually incurred by the Department of Transportation. The bonds were to be paid from a portion of the newly enacted fuel taxes that were set aside in a special fund. Included in the agreements between the Department of Transportation and the Thruway Authority for the payment of debt service by the Department were either deeds or leases to the Authority to the portions of the highways where the projects were undertaken. The Thruway Authority then issued use permits to the Department of Transportation coterminous with either the deeds or leases. Upon redemption of the Thruway Authority's bonds, the highways reverted back to the Department of Transportation. These bonds, which could not have a maturity longer than the period of probable usefulness of the work performed, became known as "pothole bonds," as the work performed by the Department of Transportation was basic reconditioning and minor structural work, which included a fair amount of filling potholes.

Comptroller Levitt's letter to Governor Rockefeller's Counsel recommending disapproval of the bills contained the following arguments that best focus the legal issues that have forever encircled the use of conduit financing by public authorities:

> This bill as pointed out quite clearly in the statement of legislative findings, is designed to accomplish, through the use of the financing powers of the Thruway Authority, that which the State cannot accomplish itself through the normal appropriation process because of budgetary limitations. In summary, the bill provides that the State will, in effect, advance its own funds to pay for highway reconditioning and preservation projects undertaken by the Commissioner of Transportation; will be repaid by the proceeds of bonds and notes issued by the New York State Thruway Authority; and, will earmark certain tax revenues, and pledge those revenues, to the Thruway Authority as the fund out of which the debt service requirements of the Thruway Authority on *its* bonds will be met.
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> In the past, numerous schemes have been devised to avoid the constitutional restrictions on the creation of state indebtedness. Laws creating public authorities have provided that the State would appropriate funds sufficient to meet the debt service reserve requirements of the authorities involved. In other instances, appropriations have been made which serve as a guaranty to the holders of the obligations of public authorities in the event a loan made by an authority is not repaid. This bill goes much further. Certain tax revenues are earmarked, and may be pledged and assigned to a public authority. This pledge of revenues will become part of the contract between the Thruway Authority and its bondholders. Thus, the State is irrevocably committed to the division of tax revenues for the payment of the bonds of the Thruway Authority issued for the purposes of this program.
>
> In our opinion, this financing scheme is a thinly veiled indebtedness of the State, raising a question as to whether it violates the restrictions of Article VII, Section 11 of the New York State Constitution. If, on the other hand, the *form* of the scheme prevails and the indebtedness is treated as that of the Thruway Authority, it is quite clear that State tax revenues will be the source of payment of the obligations issued by the Thruway Authority, raising a question of constitutionality in view of the last paragraph of Section 5 of Article X of the New York State Constitution.[38]

Nevertheless, when the agreements to implement this program between the Department of Transportation and the Thruway Authority arrived on Comptroller Levitt's desk for his approval or rejection, he felt constrained to approve the agreements because the Attorney General, as the State's chief legal officer, had previously approved the agreements. This did not, however, stop Comptroller Levitt from questioning the fiscal wisdom on another State-supported borrowing program.[39]

The courts in New York have always given the Legislature considerable latitude in applying the State Constitution to both borrowing constructs and the use of public authorities. At this juncture the case law is well settled in New York that conduit financing by a public authority for either State or local purposes is legal. Nevertheless, it is still important to understand the Court of Appeals' interpretation of the underlying principles permitting the issuance of this form of debt.

While there are a significant number of cases that have been litigated over the years, several cases provide the actual framework for conduit financing by public authorities. As public authorities were originally created to issue revenue-supported debt, most of the initial cases always raised the question whether the debt of a public authority was also the debt of the state or municipal corporation that obtained use of the public improvement. The drafters of these statutes were always very careful to insure that the Legislature, when enacting a statute for the creation of a public authority, clearly stated that the debt incurred by a public authority is not debt of the municipality or State. While the statutory construct reviewed in *Robertson v. Zimmermann*[40] by the Court of Appeals was subsequently limited by changes in 1938 to the State Constitution, a fundamental premise was established in *Robertson* that the debt of a public authority is not the debt of the State or municipality.[41]

Without intentionally giving short shrift to many of the earlier decisions that review the framework for the issuance of debt, the following two cases, coming after the 1938 constitutional amendments, examine the application of article VIII, § 1 of the State Constitution and the actual limitations of that section as they apply to a municipality in giving or loaning any money, property, or credit to any individual, or private or public corporation. Article VII, § 8 of the Constitution is the companion provision that applies to the State.

The Court of Appeals in *Union Free School District v. Town of Rye*, involving the payment by a town of uncollected school taxes to a school district, held that Article 8, Section 1, while prohibiting the gift or loan of money from a public corporation to an individual or private entity, permits a public corporation (a town) to provide another public corporation (a school district) with a gift of money, so long as it for a public purpose.[42] This provision of the Constitution does prohibit, however, the gift or loan of credit to an individual, or public or private corporation or association. This decision was the basis for the Court of Appeals in *Comereski v. City of Elmira*, dispensing with the constitutional challenge to a contract between the City of Elmira and the Elmira Parking Authority that provided for the City to make payment to the Authority of not more than $25,000 in any calendar year should the Authority experience a deficit.[43] The Court in *Comereski*, citing *Union Free School District* as "flat authority," held that the City may make a gift of public funds to a public authority for a proper public purpose.[44] Most telling in *Comereski* was Judge Desmond's admonition that

> [w]e should not strain ourselves to find illegality in such programs. The problems of a modern city can never be solved unless arrangements like these [used in other States, too] are upheld, unless they are patently illegal. Surely such devices, no longer novel, are not more suspect now than they were twenty years ago when, in *Robertson v. Zimmerman* we rejected a charge that this was a mere evasion of the constitutional debt limitations, etc. Our answer was this: "Since the city cannot itself meet the requirements of the situation, the only alternative is for the State, in the exercise of its police power, to provide a method of constructing the improvements and of financing their cost. The statute in question affords an equitable and proper method of accomplishing such a result."[45]

The next two cases impacting the use of conduit financing involved the near bankruptcy and bailout of the City of New York in the mid-1970s. In *Wein v. City of New York* (*Wein I*), the Court rejected a number of challenges to the Stabilization Reserve Corporation, created for the purposes of stabilizing the City's finances.[46] The Court upheld subsidies for debt service to the Corporation whether from the City or the State and stated that debt issued by the Corporation was not debt of the City or the State and that a gift of money to a public authority does not violate the constitutional restriction on contracting debt.

In *Wein v. State of New York* (*Wein II*), the Court rejected a challenge against the State providing cash to the City of New York and Municipal Assistance Corporation for the City of New York that was raised through the issuance by the State of revenue anticipation notes.[47] A significant portion of the decision in *Wein II* focused on the State's short-term borrowing practices. The Court was clear, however, that once the State obtains the cash from the borrowing, the payment to the Municipal Assistance Corporation after appropriation does not constitute a gift or loan of credit.

The case that brought forth all the salient issues relating to conduit financing on behalf of the State was *Schulz v. State of New York*.[48] In 1993, the State enacted a four-year, $20 billion program designed to aid all modes of transportation.[49] Both the Thruway Authority and the Metropolitan Transportation Authority were authorized to issue State-supported debt. The Thruway Authority's debt was to be issued to fund State highways, bridges, and other programs. The Metropolitan Transportation Authority's debt was authorized for mass transportation purposes. The enabling act was clear that the debt of the two authorities was not debt of the State; the debt was to be considered special obligations of each authority secured solely from appropriations, and agreements or payments by the State were executory only to the extent of moneys available to the State.

Mr. Schulz alleged that the legislation violated the provisions of the Constitution against the State: incurring indebtedness without voter approval in article VII, § 11; lending its credit to a public corporation in article VII, § 8; and the assuming the debt obligation of a public corporation in article X, § 5. This case provided the Court of Appeals with the opportunity to either sanction the continued use of conduit financing by public authorities or bring an end to the use of public authorities for this purpose.

At the outset, Chief Judge Kaye afforded deference to the Legislative enactment that addressed programs in need of public funding and that the burden of proof standard for declaring an act unconstitutional is beyond a reasonable doubt.[50] Her decision clearly stated that the debt of a public authority, an independent entity with a separate corporate existence from the State, is not the debt of the State. Further, future gifts of money to a public corporation do not invoke the prohibition against the gift of credit to a public corporation. As to Mr. Schulz's argument that debt issued under the enabling act would constitute moral obligation bonds, as the only hope of repayment was from the State appropriations, Chief Judge Kaye was emphatic—the enabling act means what it says—there is no requirement to appropriate, and annual appropriation does not create debt.[51] While Mr. Schulz did not meet his burden of proof for declaring this act invalid, this decision effectively answered all the questions that had been raised by many commentators and others over the years related to conduit financing by public authorities.

One last case worth noting is the *Local Government Assistance Corporation v. Sales Tax Asset Receivable Corporation*.[52] From a political standpoint, this litigation was started by two unlikely allies in the arena of conduit financing—the Governor and the Comptroller, as both are involved with the governance of the Local Government Assistance Corporation ("LGAC"). This is also a case that involved imprecise drafting of a statute. The case involved the refinancing of the last several years of Municipal Assistance Corporation ("MAC") debt incurred in the course of rectifying the City of New York's finances from the 1970s. In 2003, the City was again facing financial difficulty. Over the Governor's veto, a mechanism was created to refinance this outstanding MAC debt and use a portion of the State's sales and compensating use tax made available through appropriation to LGAC. Eliminating the MAC debt service would provide the City with approximately $500 million for immediate budget relief, while the State would take on additional State-funded debt service to the tune of $170 million for a thirty-year period. LGAC was to make this payment annually to the City.

While LGAC challenged the enabling act on several grounds, the act did create confusion, as LGAC argued, that the required payment of $170 million to the City—the amount equaling the new debt service—obligated the State to make the payment without an appropriation. The LGAC argument was not without merit; the literal words of the statute in question did purport to negate the requirement for an appropriation.[53] The Court found, however, when reading the enabling act and the LGAC statute together, that the language LGAC found objectionable related to the timing of the payment and not appropriation of the payment.[54] Nevertheless, drafters should take heed that imprecision can lead to challenges.

Current Conduit Financing

Public authorities are responsible for obtaining most of the borrowed capital funds now available for State or State-related purposes.[55] The Division of the Budget, recognizing the myriad state-supported conduit financing programs that had been enacted over the years to meet numerous demands, sought to reduce and streamline debt issuance by public authorities for these purposes. In 2001, the State enacted the Revenue Bond Financing Program as a means to efficiently finance multiple purposes in few consolidated transactions.[56] Under this program, the Dormitory Authority, the Thruway Authority, the Housing Finance Agency, the New York State Environmental Facilities Corporation, and the New York State Urban Development Corporation, also known as the Empire State Development Corporation, were authorized to issue Personal Income Tax Revenue Bonds ("PIT Bonds"). These five public authorities are currently the primary issuers of state-supported debt used for capital improvements. Upon enactment, the Revenue Bond Financing Program replaced virtually all individual State-supported debt programs with the exception of four specific revenue-based programs.[57]

Putting aside the actual mechanics, the PIT Bond program is a relatively straightforward financing program. On a monthly basis, twenty-five percent of the State's personal income tax receipts are deposited into the Revenue Bond Tax Fund. So long as an appropriation exists, these funds are available to make payments under the applicable financing agreements between the Division of the Budget and the five public authorities previously mentioned. Once the sufficient funds have been set aside for the monthly payments, the remaining tax receipts flow to the General Fund. In the event moneys are insufficient in the Revenue Bond Tax to meet financing agreement (debt service) payments under the financing agreements, the State's General Fund is required to fund the difference.

While there can be no liens on the amounts on deposit in the Revenue Bond Tax Fund, the State has agreed that in the event that the Legislature fails to make appropriations to fund all financing agreement payments, or after appropriations there is a failure to make a financing payment, the greater of twenty-five percent of the State's personal income tax receipts, or six billion dollars ($6,000,000,000) are locked in the Revenue Bond Tax Fund and not available to fund State operations. This is a strong incentive for the State to "do the right thing."

> *"While the Dormitory Authority was created for financing, constructing, and operating dormitories and attendant facilities, the mission of the Dormitory Authority has expanded exponentially."*

Based upon the amount of money that is currently generated by the State's personal income tax annually (approximately $37.2 billion), the amount available to make financing agreement (debt service) payments on a pro forma basis ($9.8 billion), and a coverage ratio approaching seven times outstanding finance agreement (debt service) payments,[58] along with the financial penalties for the failure to appropriate, PIT Bonds carry a Triple A (AAA) rating from Standard & Poor's, one of the three major rating agencies. Since an AAA rating is the highest rating available, the cost of debt service for PIT Bonds is less than the cost would be if these programs were still financed individually. Finally, and most telling, the AAA rating on the PIT Bonds is even higher than the State's rating for its full faith and credit general obligation debt, which only carries an AA rating. Conduit debt issued through PIT Bonds on behalf of the State is now considered more credit-worthy than State general obligation debt, as measured by Standard and Poor's.

It would appear that the largest issuer on conduit debt on behalf of the State is the Dormitory Authority. While the Dormitory Authority was created for financing, constructing, and operating dormitories and attendant facilities, the mission of the Dormitory Authority has expanded exponentially. The Dormitory Authority is now responsible for financing the following infrastructure programs on behalf of the State using PIT Bonds (in addition to dormitories for State University of New York and certain facilities for the Department of Health using the original revenue specific financing programs):

- Educational facilities for the State University of New York ("SUNY") and City University of New York;
- The State's fifty-percent share of educational facilities for SUNY community colleges throughout the State;
- Facilities for State and voluntary institutions for the Department of Mental Hygiene, which includes the Office of Mental Health, the Office of Mental Retardation and Developmental Disabilities, and the Office of Alcoholism and Substance Abuse Services;
- Facilities for the State Education Department, the Department of Health, the Office of Court Administration, the Office of General Services, and the Office of the State Comptroller; and
- Grants for the State's Expanding Our Children's Education and Learning Program (EXCEL), Healthcare Efficiency and Affordability Law for New Yorkers (HEAL-NY), and almost two dozen grant programs for local governments, not-for-profits and other entities.

This is only a partial list of programs that the Dormitory Authority finances for the State on a conduit basis using the PIT Bond program.

The Thruway Authority is responsible for financing at least two important highway programs for the State of New York. The Thruway Authority issues State-supported debt to fund the New York State Department of Transportation's capital program under the Dedicated Highway and Bridge Trust Fund.[59] This is the primary source of funds for matching federal highway grants and funding other State highway programs. The Thruway Authority also finances the State's payments to municipalities for certain local highway and bridge improvements under what is known as CHIPs—the Consolidated Highway Improvement Program[60]—and several other programs enacted by the State using PIT Bonds.

The Empire State Development Corporation finances state facilities and economic development grant programs on behalf of the State. State facilities financed by Empire State Development Corporation include correctional and youth facilities and other projects needed by State agencies. Similar to the Dormitory Authority, Empire State finances numerous grant programs for local governments, not-for profits and other entities. All these programs are financed using PIT Bonds.

The Housing Finance Agency finances over a dozen housing assistance programs established by the State providing families of low and moderate income with affordable housing using PIT Bonds. These programs offer grants and loans to municipalities, not-for-profit organizations and for-profit developers. The housing programs are in both urban and rural areas and include multi-family and single-family housing, rental as well as owner-occupied housing. Four separate public benefit corporations are responsible for the different programs: the Affordable Housing Corporation, the Homeless Housing and Assistance Corporation, the Housing Trust Fund Corporation, and the Housing Finance Agency.[61]

The Environmental Facilities Corporation finances a number of programs on behalf of the State using the PIT Bond program, including, but not limited to, environmental infrastructure projects, the remediation of hazardous waste sites, the Western New York Nuclear Service Center, the Pipeline for Jobs Fund, as well as matching funds to the Water Pollution Control Revolving Fund.[62]

Public authorities have also been used by the State on a conduit basis to fund certain cash needs. In 1990, LGAC was created for the purpose of eliminating the annual intra year short-term "Spring Borrowing" that had grown to over $4.0 billion to make payments to school districts and for other governmental assistance programs.[63] LGAC bonded out the annual short-term borrowing by the State for the purposes of making these aid payments. Debt service is paid through the set aside and appropriation of a percentage of the State's sales tax. Included in this legislation were strict limitations on future short-term borrowings. Although a form of backdoor borrowing, commentators and even the Comptroller hailed LGAC as an important step in fiscal reform for the State.

Over the years there have been other instances when the State has used conduit financing by public authorities to undertake questionable borrowing practices. One of the most infamous transactions occurred almost twenty years ago during a severe economic downturn when the State "sold" Attica prison to the Urban Development Corporation for cash to provide budget relief. The State then leased it back in order to make debt service payments. Around the same time, the State attempted to obtain cash from the Thruway Authority by having the Authority issue $80 million of service contract bonds to replace the cash that was going to be used for pay-as-you-go capital projects, and the State would pay debt service on the bonds. This transaction never came to fruition as Comptroller Regan brought suit challenging the underlying statute,[64] and the State ultimately abandoned the financing.

In 2003, during another period of fiscal distress, the State created the Tobacco Settlement Financing Corporation for the purpose of securitizing future payments under the 1998 Master Settlement Agreement executed between most states and several of the largest tobacco companies.[65] The State sold its right to receive payments from the Master Settlement to the Tobacco Financing Settlement Corporation. This Corporation issued in excess of $4.5 billion in bonds and the available proceeds were used by the State for general funds purposes. Under the State Finance Law discussed previously, these bonds are not considered State-supported debt, as there is no ongoing amount to be appropriated by the State and only a contingent contractual obligation supports the bonds in the event payments from the Master Settlement Agreement that have been assigned are insufficient to meet debt service. However, the Comptroller has taken the position that this debt should be considered State-supported debt and his position is not without merit.[66] Another complaint expressed by the Comptroller and others is that State-supported debt under the debt reform statute enacted in 2000 is supposed to be for only capital works or purposes, and not used for operating purposes.[67] The Comptroller has made a similar argument of relating to the refinancing of the MAC debt discussed earlier in the Sales Tax Asset Receivable Corporation case.[68]

Conclusion

Conduit financing on behalf of the State clearly brings to the fore the reality-versus-legality argument of who is responsible for this type of debt. This distinction has caused State Comptrollers and government reformers alike to call for changes in how the State uses public authorities to finance State and State-related expenditures. However, the citizens of the State have chosen, for various reasons, to reject the most recent attempt to reform the State's borrowing practices. Further, the continued difficulty in obtaining voter approval for full faith and credit general obligation debt for needed improvements has sent the State in the only available direction. The courts have avoided the policy debates and followed their judicial role when interpreting the constitutional provisions relating the issuance of conduit debt.

Even during the recent meltdown in 2008 of the financial markets, the State's use of public authorities for conduit borrowing survived relatively unscathed. The bankruptcy of Lehman Brothers did cause disruption in the orderly disposition of certain variable rate debt, but this was more the result of a lack of liquidity in the market, as opposed to credit issues with State-supported debt. The Legislature and the Executive both appear to recognize the importance of public authorities, notwithstanding the occasional need by some to grandstand against certain authorities for real or perceived mistakes. Public authorities are no different than every other institution public or private—no entity is perfect. All state-supported conduit financings by public authorities, whether for capital or other purposes, are authorized by the Legislature and the Executive. Barring a depression, the failure of the Legislature to enact appropriations on a timely basis, or an event that causes a fundamental shift in the voters' understanding of New York's debt practices, conduit borrowing by public authorities has become an efficient and effective means of financing the State's capital needs.

"Conduit financing on behalf of the State clearly brings to the fore the reality-versus-legality argument of who is responsible for this type of debt."

Endnotes

1. Official Statement, New York City Industrial Development Agency, $258,999,944.60 Pilot Revenue Bonds Series 2009A (Yankee Stadium Project) (Jan. 28, 2009).
2. Official Statement, New York City Industrial Development Agency, $82,280,000 Pilot Revenue Bonds Series 2009 (Queens Baseball Stadium Project) (Jan. 28, 2009).
3. Gary L. Gastineau and Mark P. Kritzman, Dictionary of Financial Risk Management 71 (1999).
4. *See* N.Y. Pub. Auth. Law §§ 1675 *et seq.* (2009); N.Y. Unconsol. Law §§ 6251 *et seq.* (2009); Priv. Hous. Fin. Law §§ 40 *et seq.* (2009).
5. *See* N.Y. Gen. Constr. Law § 65 (2009).
6. *See* New York State Office of the State Comptroller, Frequently Asked Questions about State Debt, www.osc.state.ny.us/press/debtfaq.htm (last visited Sept. 10, 2009).
7. *See* Citizens Budget Comm'n, Public Authorities in New York State 14 (2006), *available at* http://www.cbcny.org/PubAuthorities.pdf.
8. *See* N.Y. Const. art. 7, §§ 10, 11 (2006).
9. Another type of debt that has been issued by public authorities creates a contingent contractual liability upon the State. Certain programs such as the distressed hospital program, N.Y. Unconsol. Law §§ 7411 *et seq.* (2009), have a state service contract providing a source of payment in the event the entity responsible for debt service is unable to meet its financial obligations. From a statutory perspective, this is not considered to be State-supported debt. *See* N.Y. State Fin. Law § 67-a(1) (2009).
10. New York State Housing Finance Agency, Mission, http://www.nyhomes.org/index.aspx?page=47 (last visited Sept. 13, 2009).
11. N.Y. Pub. Auth. Law §§ 3030 *et seq.* (2001).
12. *Id.* §§ 3050 *et seq.*
13. N.Y. Pub. Auth. Law §§ 3650 *et seq.* (2000).
14. N.Y. Pub. Auth. Law §§ 2799-aa *et seq.* (2001).
15. N.Y. Pub. Auth. Law § 1678 (2007); *id.* § 1678.
16. *See* Citizens Budget Comm'n, Pub. Auths. in N.Y. State 11 (2006), *available at* http://www.cbcny.org/PubAuthorities.pdf.
17. *See* N.Y. State Div. of the Budget, 2009–10 Executive Budget Five Year Capital Program and Fin. Plan 29 (2009), *available at* http://publications.budget.state.ny.us/eBudget0910/capitalPlan/CapPlan.pdf.

18. *See* William J. Quirk and Leon E. Wein, *A Short Constitutional History of Entities Commonly Known as Authorities*, 56 Cornell L. Rev. 521 (1971). While this article is one of the more definitive works on the history of state and local debt in New York, it is worth noting that with the Panic of 1837, states called on the federal government to assume more than $200 million of outstanding debt. This event is eerily similar to state calls made in 2009, when many states requested the federal government to guarantee or provide liquidity for state debt.
19. N.Y. State Fin. Law § 67-a(1) (2009).
20. N.Y. Pub. Auth. Law § 3240 (2001).
21. *See* New York State Office of the State Comptroller, Frequently Asked Questions about State Debt, www.osc.state.ny.us/press/debtfaq.htm (last visited Sept. 10, 2009).
22. N.Y. Retire. & Soc. Sec. Law § 13(h) (1999).
23. *See* Temp. State Comm'n on Coordination of State Activities: Staff Report on Public Authorities Under New York State 261 (1956).
24. Dormitory Authority of the State of New York, DASNY History, www.dasny.org/history/index.php (last visited Sept. 10, 2009).
25. While it is likely that the State University collected room rentals from students at this time, there would have been no legal prohibition against the Dormitory Authority from collecting those moneys in a direct fashion similar to a transportation authority collecting tolls or fares.
26. *Id.*
27. It is unclear whether the lease payments were appropriated at that time as they are today.
28. *See* 1962 Laws of N.Y. ch. 251.
29. *Id.*
30. 1963 Laws of N.Y. ch. 932.
31. *See Smith v. Levitt*, 30 N.Y.2d 934 (1972).
32. *See, e.g.*, 1966 Laws of N.Y. ch. 782 (City University of New York financing program).
33. *See* Office of the State Comptroller, Annual Report of the Comptroller (1969); Office of the State Comptroller, Annual Report of the Comptroller (1968); Office of the State Comptroller, Annual Report of the Comptroller (1967).
34. *Id.*
35. *See* 1981 Laws of N.Y. ch. 314, § 16. A Report by the Office of the State Comptroller—*New York State's Debt Policy; A Need for Reform*—states that the first contractual obligation was executed by the State in connection with the financing and construction of the Jacob Javits Convention Center in New York City. *See infra* note 66. A review of 1979 Laws of N.Y. ch. 35, the authorizing statute for this project, finds that a series of leases and subleases was used to effectuate the State's rental/debt service payment (*see* 1979 Laws of N.Y. ch. 35, §§ 9, 13).
36. *Williamsburgh Sav. Bank v. State*, 243 N.Y. 231 (1926).
37. *See* 1972 Laws of N.Y. ch. 648–49.
38. *See* Report to the Governor on Legislation, Arthur Levitt to Michael Whiteman (May 25, 1972).
39. *See* Memorandum of Approval from Comptroller Arthur Levitt (July 26, 1972).
40. *Robertson v. Zimmermann*, 268 N.Y. 52 (1935).
41. *Id.* at 62–63.
42. *Union Free Sch. Dist. v. Rye*, 280 N.Y. 469, 480–81 (1939).
43. *Comereski v. Elmira*, 308 N.Y. 248, 251, 254 (1955).
44. *Id.* at 252.
45. *Id.* at 254 (citations omitted).
46. *Wein v. City of N.Y.* (*Wein I*), 36 N.Y.2d 610, 613, 621 (1975).
47. *Wein v. State* (*Wein II*), 39 N.Y.2d 136, 140 (1976).
48. *Schulz v. State*, 84 N.Y.2d 231(1994).
49. *See* 1993 Laws of N.Y. ch. 56.
50. *Schulz*, 84 N.Y.2d at 237, 241.
51. *Id.* at 248–51.
52. *Local Gov't Assistance Corp. v. Sales Tax Asset Receivable Corp.*, 2 N.Y.3d 524 (2004).
53. *Id.* at 536.
54. *Id.* at 537.
55. While payment of debt service comes from State funds, it is important to note that the actual bond proceeds are not state moneys, but rather funds of the public authority. *See Smith v. Levitt*, 30 N.Y.2d 934 (1972).
56. *See* 2001 Laws of N.Y. ch. 383, Part I; State Fin. Law § 68-b (2009).
57. *But see* 2009 Laws of N.Y. ch. 56 (authorizing the use of PIT Bonds during State Fiscal Year 2009-10 for mental hygiene facilities).
58. *See* Official Statement, Dormitory Authority of the State of New York, $798,010,000 State Personal Income Tax Revenue Bonds (June 25, 2009).
59. *See* N.Y. Pub. Auth. Law § 385 (2008).
60. *See* N.Y. Pub. Auth. Law § 380 (2008).
61. *See* Official Statement, New York State Housing Finance Agency, $230,000,000 State Personal Income Tax Revenue Bonds (June 6, 2008).
62. *See* Official Statement, New York State Environmental Facilities Corporation, $279,355,000 State Personal Income Tax Revenue Bonds (Mar. 11, 2009).
63. *See* 1990 N.Y. Laws ch. 220.
64. *Regan v. Cuomo*, 182 A.D.2d 1060 (3d Dep't 1992).
65. *See* 2003 Laws of N.Y. ch. 62, Part D-3.
66. *See* Office of the State Comptroller, N.Y. State's Debt Policy; A Need for Reform 28 (Feb. 2005), *available at* http://www.osc.state.ny.us/press/debtreport205.pdf.
67. *See* 2000 Laws of N.Y. ch. 59.
68. Debt Policy, *supra* note 66, at 8.

George H. Weissman is a Managing General Counsel to the Dormitory Authority. Mr. Weissman is responsible for the oversight of the Authority's financing programs for public entities, public construction programs and procurement. He is a member of the New York State Bar and the U.S. District Court, Northern District. Mr. Weissman previously served in various capacities with the Office of the State Comptroller and the NYS Senate. He holds a Bachelor of Arts Degree in Political Science from State University College at Cortland and a Juris Doctor degree from Albany Law School. Mr. Weissman has lectured on issues relating to public authorities, state debt and construction matters.