

DORSEY & WHITNEY

A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

350 PARK AVENUE
NEW YORK, NEW YORK 10022
(212) 415-9200

3 GRACECHURCH STREET
LONDON EC3V 0AT, ENGLAND
01-929-3334

36, RUE TRONCHET
75009 PARIS, FRANCE
01-42-66-39-49

340 FIRST NATIONAL BANK BUILDING
P. O. BOX 848
ROCHESTER, MINNESOTA 55903
(507) 288-3156

510 NORTH CENTRAL LIFE TOWER
445 MINNESOTA STREET
ST. PAUL, MINNESOTA 55101
(612) 227-8017

2200 FIRST BANK PLACE EAST
MINNEAPOLIS, MINNESOTA 55402
(612) 340-2600

TELEX 29-0605
TELECOPIER (612) 340-2868

THOMAS S. HAY
(612) 343-7963

1200 FIRST INTERSTATE CENTER
401 NORTH 31ST STREET
P. O. BOX 7188
BILLINGS, MONTANA 59103
(406) 252-3800

201 DAVIDSON BUILDING
8 THIRD STREET NORTH
GREAT FALLS, MONTANA 59401
(406) 727-3632

127 EAST FRONT STREET
MISSOULA, MONTANA 59802
(406) 721-6025

315 FIRST NATIONAL BANK BUILDING
WAYZATA, MINNESOTA 55391
(612) 475-0373

April 24, 1989

Mr. Peter Sausen
Assistant Commissioner for Cash & Debt Management
Department of Finance
400 Centennial Building
658 Cedar Street
St. Paul, Minnesota - 55155

Re: Capital Improvement Bill

Dear Mr. Sausen:

At your request, I have reviewed a copy of H.F. 46 as passed by the Minnesota House which authorizes the issuance of state general obligation bonds to finance various projects. We will be unable to issue an unqualified legal opinion with respect to some of these bonds because the authorizations, either in substance or in form, do not conform to the requirements for the issuance of public debt set forth in Article XI of the Minnesota Constitution. The four constitutional requirements which seem to present the greatest problems are discussed briefly below:

1. The project for which bonds are to be issued must be publicly owned. Article XI, Section 5, of the Constitution provides, in part, that bonds may only be issued "to acquire and to better public land and buildings and other public improvements of a capital nature and to provide money to be appropriated or loaned to any agency or political subdivision of the state for such purposes if the law authorizing the debt is adopted by the vote of at least three-fifths of the members of each house of the legislature". (Emphasis added.) "Public" is not defined but may well refer to ownership of the project financed, rather than its use for a public

DORSEY & WHITNEY

Mr. Peter Sausen
April 24th, 1989
page two

purpose. Without a Minnesota Supreme Court ruling on the meaning of the word "public", state bonds cannot be issued to fund a project to be owned by a person or entity other than the State, either directly or through its agencies and instrumentalities or a political subdivision of the State.

2. The project funded must be a capital expenditure. Article XI, Section 5, also provides that state bonds may only be issued "to acquire and better public land and buildings and other public improvements of a capital nature". (Emphasis added.) Costs financed must clearly be of a capital nature; operating expenditures cannot be financed with state bonds. We are working on the development of a clear standard to determine what expenditures are "of a capital nature".

3. The expenditure must be for a public purpose. This requirement is implicit in several provisions of the Minnesota Constitution, including Article X, Section 1; Article XI, Section 2; and Article XII, Section 1. Public purpose, which is different than public ownership, may be determined partly by ownership, but also the purpose for which, and the persons or entity by which, a project will be used. The concept of what constitutes a public purpose has been expanded in recent years, and great deference is given to a legislative determination of public purpose. However, a line item in a capital improvement bond law may contain no legislative determination of the public purpose to be served, and an explanation of the public purpose to be served or a cross reference to the specific statutory provisions authorizing a program which contains such a reference is often needed.

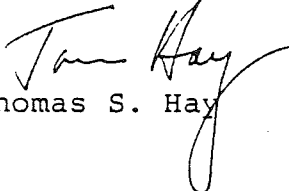
4. The purpose for which bonds are to be issued must be clearly set forth in the law. Article XI, Section 7, of the Constitution provides that "each law authorizing the issuance of bonds shall distinctly specify the purposes thereof and the maximum amount of the proceeds authorized to be expended for each purpose. (Emphasis added.) Thus, in the law authorizing the bonds, either the specific project to be financed must be identified or there must be a specific reference to a statute establishing a specific governmental program which authorizes public projects of a capital nature to be financed.

DORSEY & WHITNEY

Mr. Peter Sausen
April 24th, 1989
page three

As you are aware, there are other requirements related to the issuance of public debt set forth in the Minnesota Constitution. However, it is the four requirements that are outlined above which have resulted in the most misunderstanding. I hope this brief outline will be helpful to those drafting legislation authorizing the issuance of state bonds. If we can be of further assistance, please let me know.

Very truly yours,


Thomas S. Hay

TSH:DAV

CCS: Ms. Christie B. Eller
515 Transp. Bldg.
John Ireland Blvd.
St. Paul - 55155

Mr. John R. Tunheim
102 Capitol Bldg.
St. Paul - 55155

EXPENDITURES ELIGIBLE FOR
STATE GENERAL OBLIGATION BOND
FINANCING

1. Purpose of Memorandum.

The purpose of this Memorandum is to provide guidance to State legislators, legislative staff and others as to what type of expenditures are eligible for State general obligation bond financing. However, it does not discuss all legal requirements for the issuance of bonds, but only those which most often present problems for legislators and legislative staff in preparing state bonding legislation. The guidelines were developed by a task force made up of staff from the Department of Finance, offices of the Legislative Auditor and Attorney General and Bond Counsel for the State, the Dorsey & Whitney law firm.

2. Minnesota Constitution, Article XI.

The Minnesota Constitution, Article XI, governs the issuance of general obligation bonds by the State. Article XI, Section 5, provides in part that State bonds may be issued:

"to acquire and to better public land and buildings and other public improvements of a capital nature and to provide money to be appropriated or loaned to any agency or political subdivision of the state for such purposes if the law authorizing the debt is adopted by the vote of at least three-fifths of the members of each house of the legislature".

Article XI, Section 7, provides in part that:

"each law authorizing the issuance of bonds shall distinctly specify the purposes thereof and the maximum amount of the proceeds authorized to be expended for each purpose."

These provisions (and others) establish, either explicitly or by implication, the following constitutional requirements which must be met by legislation authorizing State bonds:

- (a) The expenditure funded must be for a public purpose.
- (b) The project for which the bonds are issued must be publicly owned.
- (c) The expenditure funded must be of a capital nature.
- (d) The purpose for which the bonds are issued must be clearly set forth in the law.

3. Public Purpose.

All expenditures of State moneys, including bond proceeds, must be for a public purpose. Public purpose is present when the expenditure can reasonably be expected to achieve a legitimate public goal or benefit, even though some benefit may result to non-public interests. A determination of public purpose depends upon the nature of the expenditure and extent to which the public goal or benefit is accomplished, and the extent to which it is the dominant or overriding benefit to be derived from the expenditure. Private benefit may result, but it should not be the dominant or overriding benefit resulting from the expenditure. The nature of the expenditure as public is affected by whether, by both historical and contemporary standards, the expenditure is to be made with respect to a subject matter which is proper for government action; or instead is made with respect to a subject reserved (or which has been or should be reserved) for the private sector.

Public purpose is determined in the first instance by the Legislature, but in the final analysis it is determined by the Minnesota Supreme Court which gives a legislative determination of public purpose great weight in making its decision. This is why it is so important for a law authorizing the expenditure of State funds, including bond proceeds, to clearly determine the public purpose character of the expenditure when the expenditure involves loans or grants to private individuals or entities, or will otherwise result in substantial benefit to a private group of persons or entities.

4. Public Ownership.

As indicated above, Article XI, Section 5, uses the word "public" to characterize the land, buildings and other improvements which may be financed with State bonds. "Public" is not defined but may well refer to ownership of the project financed, rather than its use for a public purpose. Without a Minnesota Supreme Court ruling on the meaning of the word "public", State bonds cannot be issued to fund a project to be owned by a person or entity other than the State, either directly or through its agencies and instrumentalities or a political subdivision of the State. Projects of the Minnesota Historical Society have been determined to be public and have been financed with State bonds. However, projects of the following entities or for the following purposes are not so clearly publicly owned that State bonds could be issued to finance them under present law: (a) Indian tribes, (b) Minnesota public radio, (c) Minnesota public

television, (d) grants to private property owners to build or improve on-site sewage disposal systems, and (e) grants to private corporations to build or improve sewage treatment works which will serve the public. These projects probably involve a public purpose but must be financed with appropriations or local government unit bonds as part of a local government program of some sort.

5. Capital Expenditure.

Article XI, Section 5, limits the expenditure of State bond proceeds to expenditures for land, buildings and other public improvements of a "capital nature". Operating costs cannot be financed with State bonds.

The best, although perhaps not the exclusive, method of determining what constitutes an expenditure of a "capital nature" is to determine what constitutes an expenditure which must be or may be "capitalized" under generally accepted accounting principles applicable to governmental entities. The Legislative Auditor has furnished the following relevant definition:

Capital Expenditures. Expenditures resulting in the acquisition of or addition to the government's fixed assets which are long-lived tangible assets obtained or controlled as a result of past transactions, events or circumstances. Fixed assets include buildings, equipment, improvements other than buildings, and land.

The definition, while not precise, indicates that (a) expenditures must be made with respect to identifiable land, buildings and other improvements, including capital equipment, and (b) the useful life of the property with respect to which the expenditure is made must be substantial and at a minimum more than a single budget period. Fixed assets purchased by internal service or enterprise funds are not included for this definition of capital expenditures.

Based upon the above and various other considerations, the Department of Finance has prepared and distributed to State departments and agencies as part of the Capital Budget instructions a memorandum of advice on the capital expenditure versus operating expenditure classifications, a copy of which is attached hereto as Exhibit A. However, the explanation will be further expanded in order to address issues that continue to arise (i.e., personnel costs).

In reviewing recent legislative proposals, it is apparent that they contain some bond authorizations to finance what cannot clearly be classified as an expenditure of a capital nature. Expenditures best classified as operating expenditures that are proposed to be financed by the issuance of State bonds include: (a) expenditures for staff or consultants to prepare general preliminary studies to determine whether some type or group of capital projects may be needed in the future; (b) expenditures for Staff or consultants to prepare general studies to determine whether a type of modification or improvement to State buildings are needed or desirable, and (c) expenditures for minor repairs and replacements to buildings and related equipment, such as lamp replacement, minor roof repairs, etc.

Another problem is that proposed legislation is often so brief or so vague as to be difficult to understand what actual expenditures State bonds are being authorized for. A related problem is discussed below.

6. Specific Legislative Authorization.

As indicated above, Article XI, Section 7, requires that a law authorizing State bonds must "distinctly specify" the purposes for which the bonds are issued. Thus, in the law authorizing the bonds, either the specific project to be financed must be identified or there must be a specific reference to a statute establishing a specific governmental program which authorizes public projects of a capital nature to be financed. State bonding laws some times do not meet this requirement because: (a) the description of the purpose for which the bonds are to be issued is so brief or vague as to be unintelligible, and (b) the description authorizes expenditures for projects not identified or even presently identifiable, and does not "distinctly specify" the purpose by reference to a well-established State program which is set forth in the general statutes. Examples of these shortcomings are: (a) "planning" or "statewide", and (b) pollution control expenditures not related to programs established by Minnesota Statutes, Chapter 116.

TSH:DAV

OPERATING BUDGET vs. CAPITAL BUDGET

There is a certain amount of unavoidable subjectivity in assigning requests to the capital budget or the operating budget, which generally results in projects being financed through bonding or direct appropriations, respectively. The basic test will be the extent to which a proposed expenditure relating to physical facilities is linked to a new program, changes the scope of existing programs, or significantly extends the life or increases the value of existing facilities. Further tests will be whether the proposed expenditure is of a recurring nature or not and the dollar amount of the request.

All repair and replacement requests should be made through the biennial **Operating Budget**. Repair and replacement requests have the following characteristics:

- They do not involve program improvements or expansion or new construction.
- They do not significantly extend the life or enhance the value of existing facilities.
- They are for predictable, recurring expenditures involved in the maintenance of facilities.
- Priority of expenditure is determined by agency management, ideally through some type of formula related to past experience in maintaining the agency's facilities.
- Examples include expenditures for minor roof repair, tuckpointing, caulking, window replacement, painting, resurfacing parking lots and roads, recarpeting, etc.

There are always exceptions that prove the rule. Some requests that are not related to program changes or scope could involve multi-million-dollar projects. Others could combine some of the above features with changes in program or scope, such as a major remodeling project. Such requests are handled in the **Capital Budget**. Capital Budget requests are distinguished by the following characteristics:

- They involve program improvements or program expansion.
- They extend the life of or enhance the value of a facility.
- They are nonrecurring in nature.
- They normally are financed through the sale of bonds.
- They are project-specific.
- Examples include new construction projects, building remodeling projects, demolition of facilities, purchase of land, major roof replacement or major window replacement projects.

DORSEY & WHITNEY

A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

350 PARK AVENUE
NEW YORK, NEW YORK 10022
(212) 415-9200

1330 CONNECTICUT AVENUE, N. W.
WASHINGTON, D. C. 20036
(202) 837-0700

3 GRACECHURCH STREET
LONDON EC3V 0AT, ENGLAND
01-929-3334

36, RUE TRONCHET
75009 PARIS, FRANCE
01-42-66-59-49

FAR EAST FINANCE CENTER
HONG KONG
852-5-8612555

2200 FIRST BANK PLACE EAST
MINNEAPOLIS, MINNESOTA 55402
(612) 340-2600

TELEX 29-0605
FAX (612) 340-2868

THOMAS S. HAY
(612) 343-7965

340 FIRST NATIONAL BANK BUILDING
ROCHESTER, MINNESOTA 55903
(507) 288-3156

315 FIRST NATIONAL BANK BUILDING
WAYZATA, MINNESOTA 55391
(612) 475-0373

1200 FIRST INTERSTATE CENTER
BILLINGS, MONTANA 59103
(406) 252-3800

201 DAVIDSON BUILDING
GREAT FALLS, MONTANA 59401
(406) 727-3632

127 EAST FRONT STREET
MISSOULA, MONTANA 59802
(406) 721-6025

March 15, 1990

Mr. Peter Sausen
Minnesota Department of Finance
400 Centennial Office Building
658 Cedar Street
St. Paul, Minnesota - 55155

Re: Capital Expenditures --
State General Obligation Bonds

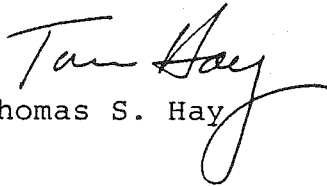
Dear Peter:

As promised at our March 12th meeting with you and members of your staff, the Attorney General's staff, the Minnesota Senate Counsel's office, and the Minnesota House Counsel's office, enclosed herewith is a Memorandum discussing what expenditures qualify as capital expenditures financeable from state general obligation bond proceeds.

The Memorandum expands upon Section 5 of the Memorandum entitled "Expenditures Eligible for State General Obligation Bond Financing", a copy of which is attached to it. It attempts to provide a clearer and more concise statement of the principles to be applied in determining the eligibility of expenditures, and to apply those principles to the types of expenditures (planning, repair or replacement, and equipment) which give rise to the most difficult questions.

Assuming the Memorandum is satisfactory, I suggest that it be distributed among the same group of people as the earlier Memorandum identified above.

Very truly yours,


Thomas S. Hay

TSH:DAV
Enclosures

WHAT EXPENDITURES QUALIFY
AS CAPITAL EXPENDITURES
FINANCEABLE FROM STATE BOND PROCEEDS

1. Purpose of Memorandum.

The purpose of this Memorandum is to provide guidance to State legislators, legislative staff and others as to what types of expenditures qualify as capital expenditures which can be financed from State general obligation bond proceeds. This Memorandum is supplemental to the earlier memorandum entitled "Expenditures Eligible for State General Obligation Bond Financing", a copy of which is attached, and attempts to clarify and expand upon Section 5 of the earlier memorandum. Accordingly, Section 5 of the earlier memorandum should be read before reading this Memorandum, and the other requirements for issuing State bonds discussed in the earlier memorandum should not be overlooked.

2. Statement of Principles.

Neither the Minnesota Constitution, State law, nor generally accepted accounting principles contain any precise definition of the term "capital nature" or "capital expenditure", terms treated here as equivalents. However, the following criteria, to be used in determining whether an expenditure is a "capital expenditure", can be extracted from accounting principles and rules.

In order to be a capital expenditure:

(a) an expenditure for acquisition or improvement of property must be made with respect to a "fixed asset", such as land, buildings, improvements to land other than buildings or equipment;

(b) a fixed asset being acquired must be "long-lived"; an interest in land of ten (10) years duration has been determined to qualify, and it is suggested that only other fixed assets with an actual useful life of at least ten (10) years should qualify;

(c) an expenditure to improve a fixed asset already owned must (i) comprise a substantial improvement or expansion of the fixed asset, (ii) extend the useful life or substantially increase the value of the fixed asset, and (iii) not be predictable or recurring; and

(d) an expenditure must be project specific.

3. Application of Principles.

These criteria, when applied to some of the most troublesome areas (planning, repair and replacement, equipment), indicate the following conclusions:

(a) Planning. Expenditures for studies or similar work, the purpose of which is to determine or evaluate need for a project or system needs; expenditures for educational, promotional, informational or lobbying expenditures with respect to a type of project or a "particular" project which has not been sited; and expenditures for computer modeling, financial modeling and preparing financial information with respect to a type of project or a "particular" project which has not been sited; are not sufficiently "project specific" and are not eligible capital expenditures.

(b) Acquisition of Land, Buildings and Related Equipment. Expenditures for initial acquisition of land, buildings and other "permanent" improvements to real property; equipment which is incorporated into land, buildings and other permanent improvements (such as heating and air conditioning systems, communication systems, food storage and preparation equipment, etc.); and other equipment which is purchased and installed upon initial acquisition and construction or renovation in order to provide a complete facility usable for the legislatively authorized purpose for the first time; are eligible capital expenditures.

(c) Equipment Acquired Independently. Expenditures for equipment acquired independently of any acquisition or construction project which has an actual useful life of less than ten (10) years are not eligible capital expenditures.

Some specific examples of expenditures which do or do not qualify as "capital expenditures" are as follows:

(a) Do Not Qualify: Expenditures for minor roof repairs, tuckpointing and caulking; occasional window or window glass replacement; repair or replacement of wornout portions of equipment originally incorporated in a building project, such as heating and cooling systems, communication systems, and food storage and preparation equipment, etc.; replacement of items which typically do not last as long as the structure in which they are located, such as light bulbs, carpeting, wallpaper or painting; interior building reorganization; moving expenses; and purchase or repair of minor moveable equipment or other equipment having an actual

useful life of less than ten (10) years; are not eligible capital expenditures.

(b) Do Qualify: Expenditures for major building renovation projects, major roof reconstruction and replacement projects, and major window replacement projects, which add to the value or life of a building and are not of a recurring nature; somewhat less extensive building renovation projects in connection with initial acquisition and preparation of an existing building for initial use by the State; major items of equipment incorporated in a building upon initial construction or renovation; major "free standing" items of equipment having an actual useful life of at least ten (10) years; are eligible capital expenditures.
