STAFF REPORT

SOUND TRANSIT
MOTION NO. M2001-22

Lease-to-Service Transaction for Commuter Rail Cars & Locomotives

Meeting:	Date:	Type of Action:	Staff Contact:	Phone:
Finance Committee	3/15/01	Discussion/Possible Action to Recommend Board Approval	Brian McCartan Finance & Administration	(206) 398-5100
Board	3/22/01	Action	Desmond Brown Legal Department	(206) 398-5017

PROPOSED ACTION

The proposed action would authorize the Executive Director to execute a lease-to-service contract for up to 26 Bombardier bi-level commuter rail passenger cars and six EMD F59PHI locomotives. Under the contract the Executive Director would lease up to $77 million in Sounder Commuter Rail cars and locomotives to a First Hawaiian Bank and AIG Insurance in exchange for an up-front cash benefit to Sound Transit.

KEY FEATURES

Highlights:

- The lease that is proposed by staff will allow investors to gain an interest in Sound Transit passenger and locomotives so that they will be able to depreciate the Sounder cars as assets. Under a lease-to-service contract transaction, Sound Transit would lease up to 26 Bombardier bi-level commuter rail passenger cars and six EMD F59PHI locomotives to a Delaware based trust. First Hawaiian Leasing Corporation, acting through the Trust investor would enjoy the depreciation tax benefits on the rolling stock. The Trust would lease the cars back to Sound Transit. Sound Transit would receive an up-front dollar benefit of approximately $3.5-$4.5 million for undertaking the transaction.
- The interest leased to the investors still allows for flexible use of the Sounder cars by Sound Transit. Sound Transit would retain the title and control over the vehicles. Under the contract, Sound Transit would be required to maintain insurance on the cars and keep them in good working order, and would be under some limitations regarding other sale and leasing of the cars.
- Staff updated the Finance Committee on the status of the transaction in July 1999 and February 2001.

Transaction Schedule/Status

Sound Transit has been pursuing a tax-benefit lease transaction for its rolling stock assets for several years. Under the transaction, Sound Transit would lease its commuter rail vehicles and locomotives through a trust to First Hawaiian Leasing (a subsidiary of First Hawaiian Bank). First Hawaiian Bank would enjoy the depreciation tax benefits on the equipment. First Hawaiian Bank, through the Trust, would lease the assets back to Sound Transit. Sound Transit would receive an upfront dollar benefit for undertaking the transaction. A detailed description of the transaction is included in the attachments.

Sound Transit has competitively selected participants and counterparties for the transaction. Sound Transit staff and its financial and legal advisors are now near completion of negotiations to execute the lease transaction. The transaction would currently yield an upfront benefit to Sound Transit of approximately $3.5-4.5 million. Staff is now seeking final authorization to execute the lease transaction. The Finance Committee has been briefed on the transaction at its July 20 and February 1, 2001 meetings.

How Does Transaction Work?

In a lease-to-service transaction, Sound Transit would lease its current fleet of Sounder Commuter Rail cars and locomotives to First Hawaiian (through a trust). First Hawaiian would in turn lease the asset back to Sound Transit. The institutional investor would be able to enjoy the tax benefits of depreciation on the asset. Sound Transit would receive a payment (about 6% of the asset value) as an up-front payment. These types of transactions have been executed by a number of transit agencies nationally, and by King County Metro and the Washington State Ferry system locally.

AIG, a major U.S. insurance corporation, would act as financial intermediary under the transaction, making payments on behalf of Sound Transit. AIG is a AAA rated entity, which insures many municipal and state bonds in the State of Washington.

Staff is proceeding with an initial transaction that involves the current fleet of Sounder vehicles rather than waiting until the total fleet is procured. As tax law regularly changes for these transactions, staff believes it is more prudent to undertake a partial transaction now, rather than wait until all Sounder cars are delivered in 2001. Undertaking a partial transaction now reduces the risk of change in tax law that would eliminate Sound Transit's ability to execute the transaction in the future. If the transactions are still viable after 2001, Sound Transit can complete a second transaction for the remaining cars.

Additional transactions for light rail cars and other assets will be evaluated after Sound Transit procures those assets.

The documents to be signed include the following:

Head Lease: The long term lease Sound Transit enters into with investors

Head Lease Supplement: Sets forth the terms and payments under the lease

Lease Agreement: The long term sub-lease between Sound Transit and investors

Lease Supplement: Sets forth terms and payments under the sub-lease

Tax Indemnification Agreement: Conditions needed to comply with tax code

Equity Payment Agreement: Sets forth payment terms of the equity investor

Debt Payment Agreement: Sets forth payment terms of debt investor

Equity Payment Undertaker Agreement: Guaranty for equity investor payments

Debt Payment Undertaker Agreement: Guaranty for debt payments

Strip Letter of Credit: Financial product to guaranty payments

Please see attachment for listing of key commitments of Sound Transit under these documents.

What Are the Benefits of the Transaction?

Recent transactions with other transit properties have yielded them a benefit of 4-10% of the asset value. Sound Transit has received a bid from First Hawaiian and Wells Fargo that would yield a benefit of approximately $3.5-$4.5 million (6% of asset costs) in the current interest rate environment.

What Are the Risks to the Transaction?

The transactions do entail risks for Sound Transit. While Sound Transit would endeavor to minimize and mitigate transaction risks, some risks to the agency will remain. The main elements of risk are:

- Risk of changes in tax law, prior to closing;
- Equipment risks if cars and locomotives are damaged or lost;
- Credit risks for all parties to transaction; and
- Economic risk of early termination of lease.

The transaction risks are detailed in an attachment to this document.

Would Sound Transit Lose Control Over the Assets?

The transaction would be structured so that Sound Transit would retain title and continue to have uninterrupted use of the Sounder cars and locomotives over the term of the lease. Sound Transit would maintain control and use of the asset. However, Sound Transit would be required to maintain insurance for the vehicles and keep them in good working order. In addition, if Sound Transit were to default on the lease, Sound Transit would be required to make a termination payment or risk losing ownership of equipment. The attached summary further details these risks.

BUDGET

If Sound Transit were to successfully execute a transaction, all costs would be covered by transaction proceeds (benefits). However, if Sound Transit were to undertake a transaction and be unable to successfully close a deal, there may be as much as $250,000 in transaction related costs as well as the opportunity costs of lost staff time.

There are no funds set aside for such a “broken transaction” in the agency’s 2001 budget. In the event of a “broken transaction,” fees would be incurred and staff may have to seek a budget amendment if the total agency operating budget is greater that what was approved by the Board.

ALTERNATIVES

The Board could choose not to implement a lease-to-service transaction at this time.

CONSEQUENCES OF DELAY

Successful execution of these types of transactions is dependent on a wide variety of factors, including tax law and interest rate levels. A lease-to-service transaction is currently viable for Sounder vehicles, but if initiation of a lease program is delayed then changes in tax law and market conditions could eliminate these transactions from possible execution.

REGIONAL PARTNERSHIP AND COOPERATION

The proposed transactions would involve only Sound Transit assets. However, the Federal Transit Administration (FTA) does encourage these transactions and sees them as evidence that a grantee is maximizing its resources. The FTA has been informed of the status of the transaction, and final FTA approval must be received prior to closing. In addition, Amtrak, which has a separate agreement with Sound Transit regarding the operation and maintenance of the vehicles, has pledged cooperation with Sound Transit to complete the transaction.

PUBLIC INVOLVEMENT

In the course of its work on the 2000 legislative program, Sound Transit discussed these transactions extensively with the State Treasurer's office and the State Legislature.

ATTACHMENTS

- Defeased Lease/Leaseback Transaction Summary
- Transaction Diagram Sound Transit Defeased Lease/Leaseback Transaction Summary
- Sound Transit Defeased Lease/Leaseback Transaction Risk
- Lease/Leaseback Contracts Summary

LEGAL REVIEW

EM 3/7/01

SOUND TRANSIT

MOTION NO. M2001-22

A motion of the Board of the Central Puget Sound Regional Transit Authority authorizing the Executive Director to execute a lease-to-service contract for up to $77 million in Sounder Commuter Rail cars and locomotives.

Background:

Sound Transit has been pursuing a tax-benefit lease transaction for its rolling stock assets for several years. Under the transaction, Sound Transit would lease its commuter rail vehicles and locomotives to First Hawaiian Bank and AIG Insurance. The investors would enjoy the depreciation tax benefits on the equipment. First Hawaiian Bank and AIG Insurance would lease the assets back to Sound Transit. Sound Transit would receive an up-front dollar benefit for undertaking the transaction. A detailed description of the transaction is included in the attachments.

Sound Transit has competitively selected participants and counterparties for the transaction. Sound Transit staff and its financial and legal advisors have now near completion of negotiations to execute the lease transaction. The transaction would currently yield an up-front benefit to Sound Transit of approximately $3.5-4.5 million. Staff is now seeking final authorization to execute the lease transaction. The Finance Committee has been briefed on the transaction at its July 20, 2000 and February 1, 2001 meetings.

Motion:

It is hereby moved by the Board of the Central Puget Sound Regional Transit Authority that the Executive Director is authorized to execute a lease-to-service contract for up to 26 Bombardier bi-level commuter rail passenger cars and six EMD F59PHI locomotives. The Executive Director is authorized to execute all necessary contracts to complete the lease-to-service contract, including a head lease, sub-lease, trust agreements, head lease supplement, lease agreement lease supplement, tax indemnification agreement, equity payment agreement, debt payment agreement, equity payment undertaker agreement, debt payment undertaker agreement, strip letter of credit or similar surety product, incur transaction fees, with First Hawaiian Bank and AIG Insurance, and subsidiaries and designees, and make all necessary and appropriate warranties and indemnifications.

APPROVED by the Board of the Central Puget Sound Regional Transit Authority at a regular meeting thereof held on the 22nd day of March, 2001.

David O Earling

David Earling
Board Chair

ATTEST:

Marcia Walker

Marcia Walker
Board Administrator

DEFEASED LEASE/LEASEBACK TRANSACTION SUMMARY

PARTICIPANTS AND KEY DETAILS

Sublessee:	Central Puget Sound Regional Transit Authority (Sound Transit)	
	First Tranche	**Second Tranche**
Equity Investor:	First Hawaiian Leasing	Wells Fargo Equipment Finance, Inc.
Equipment:	26 Bombardier Bi-Level Passenger Cars	32 Bombardier Bi-Level Passenger Cars
	6 EMD F59PHI Locomotives	5 EMD F59PHI Locomotives
Estimated FMV:	$61,000,000	$73,000,000

Head Lessee/Subessor/Trustee: A Delaware business trust created by the Equity Investor. A trust is used in part to help insulate other Transaction Parties from risks associated with a bankruptcy of the Equity Investor.

Lender: AIG-FP Funding (Cayman) Limited. The Lender will lend to the Trustee a substantial portion of the amount of the Trustee's prepayment of the Head Lease rentals.

Debt Payment Undertaker: AIG-FP Special Finance (Cayman) Limited. The obligations of the Debt Payment Undertaker will be guaranteed by American International Group, Inc., a AAA/Aaa rated company.

Equity Payment Undertaker: AIG Financial Products (Jersey) Limited. The obligations of the Equity Payment Undertaker will be guaranteed by American International Group, Inc. a AAA/Aaa rated company, and collateralized with U.S. government agency securities (Fannie Mae's and/or Freddie Mac's).

Strip Coverage: To the extent required, strip coverage will be provided by AIG Financial Products Corp., a AAA/Aaa rated insurer, in an amount equal to the difference between the equity portion of termination value and the scheduled accreted value of the Equity Payment Agreement.

Head Lease Prepaid Rent: Approximately US $134,000,000

Appraiser: PricewaterhouseCoopers

Rail Expert:	Harral, Winner, Thompson, Sharp, Lawrence
Lease Term:	Approximately 28 years
Service Contract Term:	Approximately 15 years
Equity Counsel:	Watson, Farley & Williams
Sublessee Counsel:	Davis Wright Tremaine, LLP
Lender Counsel:	O'Melveny & Meyers
Local Equity and Lender Counsel:	O'Melveny & Meyers

SOUND TRANSIT LEASE-T0-SERVICE
TRANSACTION SUMMARY

General Description

The lease-to-service transaction would be structured as a lease/leaseback between Sound Transit and one or more corporate Equity Investors, in this case, First Hawaiian for the First Tranche and Wells Fargo for the Second Tranche (First Hawaiian/Wells Fargo). Under this structure, Sound Transit would lease the cars to First Hawaiian/Wells Fargo under a long-term lease contract. Simultaneously, Sound Transit would enter into a leaseback of the cars from First Hawaiian/Wells Fargo. The leaseback to Sound Transit will include a purchase option (at approximately year 28) that will allow Sound Transit to buy out First Hawaiian/Wells Fargo's remaining rights under the lease - thereby terminating the entire transaction.

At closing, Sound Transit receives a lump sum prepayment of First Hawaiian/Wells Fargo's rental obligations. Sound Transit uses these proceeds to economically prepay its Leaseback rental obligations as well as provide for the potential payment of the purchase option.

The difference between a) what Sound Transit receives from First Hawaiian/Wells Fargo under the Lease prepayment and b) what Sound Transit pays under the Leaseback defeasance equals the Up-Front Benefit in the transaction. All transaction expenses will be paid by First Hawaiian/Wells Fargo. Sound Transit's Up-Front Benefit is anticipated to be about 6% of equipment cost depending on interest rates and other market conditions at the time of closing.

The transaction allows the First Hawaiian/Wells Fargo to depreciate the cars for federal income tax purposes by passing tax ownership from Sound Transit (who cannot absorb depreciation) to First Hawaiian/Wells Fargo. Because FTA grant money was used to purchase the Sounder cars, FTA consent will be required for this transaction.

Head Lease

Sound Transit will lease the Equipment to the Trustee under a long-term lease (the Head Lease). The Trustee will make a prepaid rental payment at closing for all amounts due under the Head Lease. The prepaid rent will be funded by loans made by the Lender to the Trustee in an amount approximately equal to [84%] of the fair market value of the Equipment and an equity investment made by First Hawaiian/Wells Fargo in an amount approximately equal to [16%] of the fair market value of the Equipment.

Loan

The loan provided to the Trustee by the Lender will be made under a Loan and Security Agreement and secured in part with a security interest in the Trustee's interest in the

Head Lease and the Sublease and in the payments to be made by the Debt Payment Undertaker to the Trustee under the Debt Payment Agreement.

Sublease

The Trustee will enter into a sublease of the Equipment with Sound Transit, the Sublessee, for a term of up to approximately 28 years. Under the terms of the Sublease, the Sound Transit will make annual payments of rent and will have a purchase option at the end of the Sublease term for a specified fixed price payable in installments over a period of one year. The Sublease will be a true lease for US tax purposes.

The rent payable under the Sublease by Sound Transit to the Sublessor will have two components: (1) the debt portion in amounts equal to the debt service payments owed by the Trustee to the Lender in connection with the Loan and (2) the equity portion. The debt portion of the rents will be defeased by Sound Transit's making a payment to the Debt Payment Undertaker under a Debt Payment Agreement and the Debt Payment Undertaker's agreement to pay to the Sublessor amounts equal to the debt service payments.

The equity portion of the rents will be defeased by Sound Transit's making a payment to the Equity Payment Undertaker under an Equity Payment Agreement and the Equity Payment Undertaker's agreement to pay to the Sublessor amounts equal to the equity portion of the rents. The Equity Payment Agreement will be pledged to the Sublessor for the benefit of the First Hawaiian/Wells Fargo and will be specifically excepted from the collateral under the Loan and Security Agreement.

Use of Prepayment Proceeds

Sound Transit will utilize the moneys received from the prepayment of the Head Lease rents to:

(i) make a payment under the Debt Payment Agreement, in consideration of which the Debt Payment Undertaker will agree to make scheduled payments to the Sublessor in amounts which match the debt service payments under the Loan and Security Agreement; and

(ii) make a payment under the Equity Payment Agreement, in consideration of which the Equity Payment Undertaker will agree to make scheduled payments to the Sublessor in amounts which match the equity portion of the rents and the equity portion of the purchase option price.

Up-front Benefit

Sound Transit's Up-Front benefit is equal to the excess of the Head Lease prepaid rent over the Debt and Equity Payment Agreement payments.

Equity Security

The Trustee will receive a pledge of the Equity Payment Agreement, which will be for the sole benefit of First Hawaiian/Wells Fargo. In addition, Sound Transit will provide the Trustee, for the benefit of First Hawaiian/Wells Fargo, with a financial guaranty insurance policy (Surety Bond) in an amount equal to the difference between the equity portion of termination value and the accreted value of the Equity Payment Agreement.

If the credit rating of the Surety Bond provider falls below Aa3 or AA-, then Sound Transit will replace the Surety Bond provider with a letter of credit or Surety Bond from an acceptable financial institution rated AA and Aa2 or better.

End of Term Options

If Sound Transit does not exercise its purchase option at the end of the Sublease, the Sublessor may elect to require Sound Transit do one of the following:

(i) return the Equipment; or

(ii) (a) procure a service contract with an acceptable service buyer who would pay for passenger capacity over approximately 15 year term and/or;

(b) procure an operator of the Equipment who will be responsible for the operation and maintenance of the Equipment. In addition, Sound Transit will be required to refinance the Loan in the event the purchase option is not exercised.

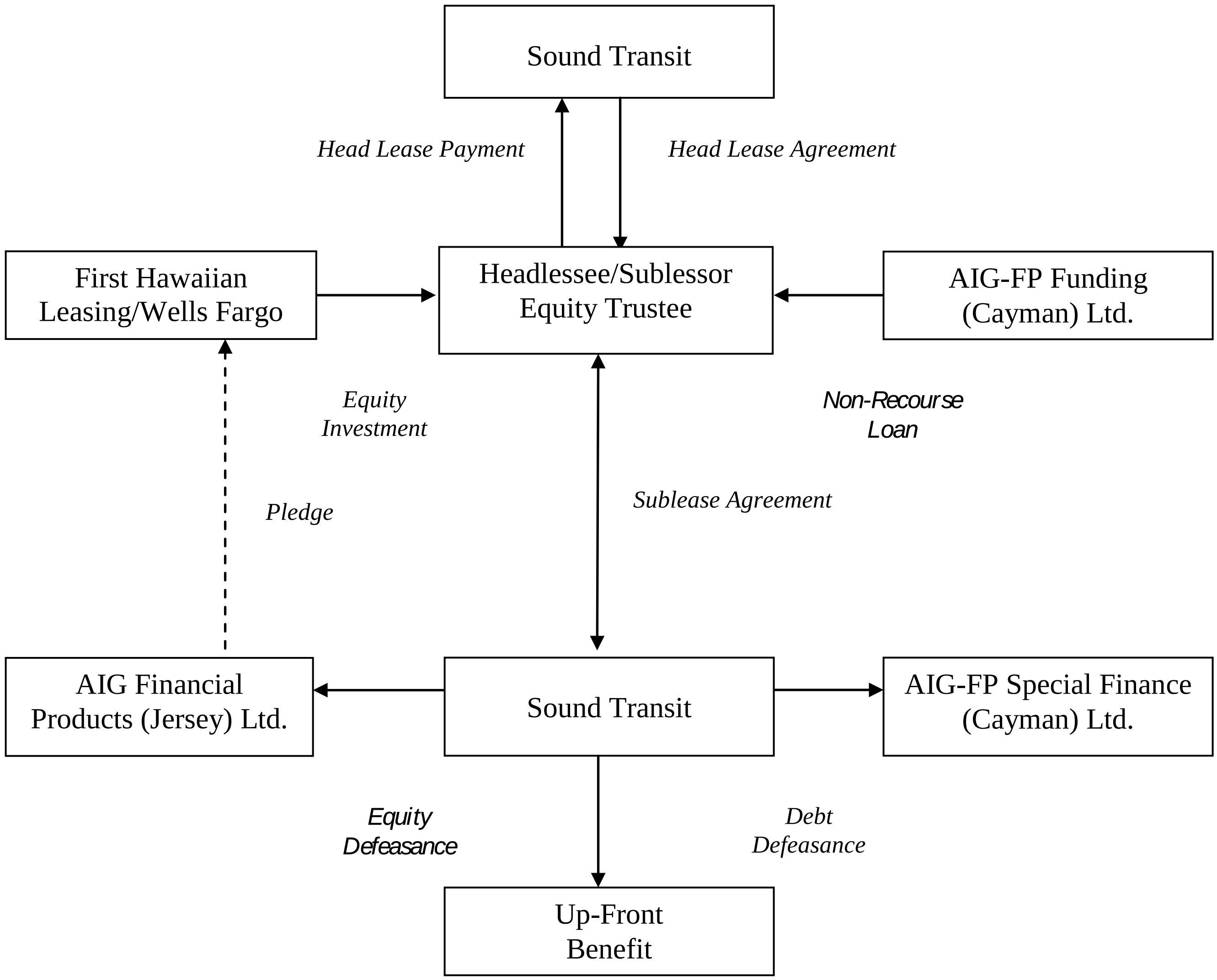
Appraisal

First Hawaiian/Wells Fargo will receive an appraisal of the Equipment from the Appraiser, which is in form and substance satisfactory to First Hawaiian/Wells Fargo.

Documentation

The documentation will contain standard conditions precedent, representations and warranties and covenants and indemnities regarding the use and operation of the Equipment that are consistent with the defeased leases entered into earlier this year by Los Angeles Metropolitan Transit Authority, California Department of Transportation (Caltrans), and Dallas Area Rapid Transit.

TRANSACTION DIAGRAM



Listing of Key Commitments

TO: Eric Mendelsohn

FROM: Rick Schroeder

DATE: February 28, 2001

RE: Leveraged Lease Financing Transaction/
List of Items for Sound Transit Board

A. Documentation.

Sound Transit will be required to execute, among other documents, the following ("Operative Documents"):

Head Lease: The long term lease Sound Transit enters into with investors
Head Lease Supplement: Sets forth the terms and payments under the lease
Lease Agreement: The long term sub-lease between Sound Transit and investors
Lease Supplement: Sets forth terms and payments under the sub-lease
Tax Indemnification Agreement: Conditions needed to comply with tax code
Equity Payment Agreement: Sets forth payment terms of the equity investor
Debt Payment Agreement: Sets forth payment terms of debt investor
Equity Payment Undertaker Agreement: Guaranty for equity investor payments
Debt Payment Undertaker Agreement: Guaranty for debt payments
Strip Letter of Credit: Financial product to guaranty payments

B. Representations and Warranties.

Sound Transit will be required to make the following representations and warranties to the Participant:

1. Sound Transit has power, authority and right to enter into and perform the Operative Documents;

2. Sound Transit has taken all necessary action to authorize the transactions.

3. There are no threatened claims, actions or litigation that would affect the transactions.

4. Sound Transit waives any immunity from setoff or other legal proceedings for enforcement of the Operative Documents.

5. Sound Transit has obtained all certificates, franchises, licenses, permits and consents needed for the transaction.

6. Sound Transit has obtained the consent of Amtrak and BNSF to enter into the Operative Documents to the extent such consent is required;

7. All sales, use, stamp, or transfer taxes and governmental charges relating to the Rolling Stock have been paid.

8. Sound Transit is not in default under any mortgage, deed of trust, indenture, or other instrument or agreement to which it is a party.

9. Sound Transit is not specifically authorized to file for relief under Chapter 9 of the U.S. Bankruptcy Code.

10. Sound Transit will be responsible to pay or to promptly cause to be paid, all taxes applicable to the Lease, Head Lease, the Rolling Stock, and Operative Documents.

11. Sound Transit will provide its annual audited financial statements and annual operating budget to the Participants.

12. Sound Transit will not consolidate, merge, or assign or transfer or convey its interests in the Lease or the Rolling Stock without the consent of the Participants except to a U.S. person, acquiring substantially all of the assets of Sound Transit, and have long-term debt and senior debt ratings as specified.

13. Sound Transit shall keep the Rolling Stock and Operative Documents free of liens.

14. Sound Transit shall obtain FTA concurrence.

C. General Indemnification

Sound Transit is to indemnify the Participants for:

1. Liabilities, obligations, losses, damages, penalties, claims incurred in connection with amendments, supplements, modifications, consents or waivers of any of the Operative Documents or the Rolling Stock.

2. Any claims arising out of Sound Transit's failure to perform any covenant, condition or agreement in the Operative Documents.

D. General Tax Indemnities

Sound Transit will indemnify Participants for:

1. Taxes associated with any payment of rent or supplemental rent.

2. Any applicable withholding taxes.

3. Taxes resulting from a breach of the representations contained in the Operative Documents.

4. Taxes relating to the Head Lease interests and the Rolling Stock.

5. Failure of the transactions to be registered as a tax shelter under Section 6111 if the Internal Revenue Code.

6. Taxes imposed by the State of Washington or any political subdivision.

7. Federal income taxes imposed on the transactions.

8. Loss of federal tax depreciation benefits due to acts or omissions of Sound Transit or breach of its representations, covenants and warranties.

E. Replacement of Security

Sound Transit will:

1. Pay for the Payment Undertaking Agreements.

2. Replace the payment undertaker or collateralize the undertaking in the event of a credit rating drop by the payment undertaker.

3. Post strict collateral in the form of a standby letter of credit, and will have to replace the strip collateral in the event of a commercial rating deterioration by the issuer.

4. Pay or cause to be paid all costs, fees and expenses of the owner-Participant, the lender, the trust, the trust company, the payment undertaker. the equity payment undertaker, the strip LC issuer.

F. Lease Agreement

In connection with the Lease, Sound Transit will:

1. Lease equipment for the lease term.

2. Remain liable for payment of rent throughout the lease term.

3. Be unconditionally obligated to make the lease payments, without setoff, counterclaim, recoupment, or reduction in rent in any way.

4. Waive any rights to cancel, quit or surrender the Lease except in accordance with its terms.

5. Assume all liability and responsibility for the condition, operation, performance, fitness, latent defects or other aspects of the Rolling Stock.

6. Not sublease the Rolling Stock except on certain specified terms.

7. Keep the Rolling Stock in the continental United States or Canada and require any transit system operating to do so.

8. Be responsible for maintenance of the Rolling Stock.

9. In the event of a loss, replace a car or pay it off within a specified time.

10. Insure the Rolling Stock against all risks.

11. Obtain third party liability insurance in amounts of at least $15 million per occurrence.

12. Keep the Rolling Stock free and clear of all liens.

13. In the event that the Lease is terminated without exercise of the purchase option, return all of the Rolling Stock to the Lessor and enter into a Service Contract for use of the Rolling Stock..

14. Be in default of the Lease if the Payment Undertaker fails to make lease payments when due.

15. Be in default if it fails to perform in any material respect all of its obligations under the Lease and Operative Documents.

16. Be in default if it files a petition for bankruptcy or other insolvency proceeding.

SOUND TRANSIT
LEASE-TO-SERVICE RISK

Under the lease-to-service transaction First Hawaiian seeks to achieve a tax benefit by acquiring tax interest in property which is then leased back to Sound Transit. In this transaction, the documents will be drafted by counsel to First Hawaiian. Davis Wright Tremaine and Capstar Partners will advised Sound Transit in evaluating the risks associated with this transaction. Set forth below is a summary of certain risk issues that are addressed in the documents.

Control of Equipment

The lease-to-service transaction will entitle Sound Transit to retain the right to possession and beneficial use of the Leased Equipment; however, the transaction documents will impose certain covenants upon Sound Transit related to maintenance, repair, replacement, restoration and insurance (possibly including self-insurance) of the Leased Equipment. The documents will not impose higher maintenance standards than Sound Transit is currently observing. Sound Transit, however, has restrictions on its right to sell or sublease the Leased Equipment. The subleasing rights recognize the existing Amtrak Lease.

State and Local Taxes

Sound Transit will be required to indemnify the Lessor against any state and local taxes imposed on it as a result of the transaction. To the extent the Lessor is liable for any state and local taxes incurred as a result of the defeased lease/leaseback transaction, Sound Transit will be required to reimburse the Lessor for any taxes imposed on the Lessor.

Sound Transit received a favorable ruling from the State of Washington DOR that exempts both the Lessor and Sound Transit from any sales tax related to this transaction. However, Sound Transit staff is still working with the State Department of Revenue regarding certain other state and local taxes which may be owed on the transaction.

Credit Risk Relating to Defeasance

Sound Transit's lease payments will be made over-time by a third party – AIG. Sound Transit is liable for payments under the lease if AIG goes bankrupt, a potential liability of $70 million at the beginning of the lease and steadily declining each year of the lease.American International

Group (AIG) is AAA rated entity, and insures many bond issuances in the State of Washington. Furthermore, the documents provide for a replacement of AIG in the event of a downgrade in its rating. While Sound Transit would likely be required to pay all costs associated with replacement, such a right would mitigate Sound Transit's exposure to the debt payment undertaker's credit failure.

Credit Difficulties by First Hawaiian

To an extent, Sound Transit is also taking the credit risk of First Hawaiian. Participation by First Hawaiian is through a special purpose trust that protects Sound Transit in the event of bankruptcy of First Hawaiian. The documents are drafted to ensure that the structure of the defeased lease/leaseback transaction provides maximum protection to Sound Transit in the event of bankruptcy by First Hawaiian.

Early Termination Risk

In the event that the lease-to-service transaction is terminated prior to the purchase option date, Sound Transit will owe a termination payment. In the early years of the transaction, the termination payment would wipe out Sound Transit's economic benefit from the transaction and cost Sound Transit additional money. Later in the transaction, the termination payment would reduce Sound Transit's up-front benefit. The most likely reasons for such an early termination are examined below.

> *Default* – As described above, Sound Transit's payment obligations will be "economically" defeased at closing. Consequently, with proper precautions (described above), a payment default may be considered unlikely. Sound Transit will have to make certain covenants with respect to the operation and maintenance of the Equipment. To the extent these covenants are broken and not remedied in a reasonable period, they will become events of default. The covenants Sound Transit will be required to make are consistent with the operating and maintenance requirements that are imposed on Amtrak and BNSF under their service agreements.
>
> *Obsolescence* – In the event any of the Leased Equipment becomes economically or technologically obsolete or surplus, Sound Transit

will be entitled to sell the Equipment and terminate the transaction as to that Equipment. Note that Sound Transit may be entitled to sublease an obsolete or surplus item of Equipment rather than sell it. The anticipated useful life of Leased Equipment is well in excess of the lease term.

Casualty – Destruction of the Leased Equipment or requisition of it by a third party will result in an early termination of the lease with respect to that unit or units of equipment. However, Sound Transit will be required to insure against such loss, and the transaction documents will allow for a substitution period where a new unit or units of equipment can be substituted without termination.

While there are other potential causes of an early termination (such as illegality, a non-payment default or a large indemnity payment that triggers a "burdensome layout" event), they are considered more remote than payment defaults or disposition of assets through obsolescence or casualty.

Federal Tax Indemnities

Federal Income Tax Savings to First Hawaiian-From First Hawaiian's standpoint, this transaction is designed to grant federal tax ownership to First Hawaiian so that it can recognize the benefits and risks of tax ownership. First Hawaiian, at the direction of their tax counsel, will structure the leaseback so that it meets the test for a "true" lease for federal tax purposes. First Hawaiian takes the structural risk that this transaction will pass that test.

Indemnities – Because the federal tax benefits from the transaction are what determine its return on the investment, First Hawaiian will be indemnified by Sound Transit for any misrepresentation about certain factual information on the equipment.

First Hawaiian Takes Most Risks Relating to Interpretations of, and Changes in, Federal Tax Laws – First Hawaiian will require Sound Transit to make certain representations of facts and covenants concerning its use of the Leased Equipment. It is on the basis of these factual representations and covenants that First Hawaiian makes the legal determination under the federal income tax laws that it will realize the tax benefits it is seeking in the transaction. So long as Sound Transit abides by its representations and covenants, it has no responsibility for First Hawaiian's failure to realize those tax benefits that might result from First Hawaiian's misinterpretation of the federal income tax laws, a change in those laws that occurs after the transaction is accomplished, or a change in First Hawaiian's federal income tax profile.

The representations and covenants are generally straightforward and of a type that should not interfere with Sound Transit's use of the Leased Equipment in its transportation activities. Two representations and covenants on which Sound Transit should focus at the outset relate to:

> <u>No compulsion to exercise options to "buy out" of the transaction</u>-The transaction will contain options, exercisable by Sound Transit from time to time, to pay First Hawaiian a predetermined amount to reacquire unencumbered ownership of the Leased Equipment. It is essential to the federal tax analysis that Sound Transit be able to represent accurately that there are no facts or circumstances that require it to exercise any of those options.
>
> <u>No significant non-severable improvements to the Leased Equipment</u>- First Hawaiian will require Sound Transit to represent that it will not make "non-severable improvements" to the Leased Equipment (i.e., improvements that cannot be removed from the Leased Equipment without causing material damage to the property) that would (1) cause the property to become "limited use" property, (2) substantially increase (by more than 25%) the productivity or capacity of the property, or (3) modify the property for a materially different use.

Indemnity against imposition of withholding taxes where foreign lenders are involved – The Trust will borrow part of the amount paid to Sound Transit for the Leased Equipment. In some instances, the lenders will be domiciled outside the United States, in which case they will insist on an indemnity that the United States will not impose a withholding tax on the interest paid to them. First Hawaiian will insist that this indemnity come from Sound Transit. Withholding tax indemnities are not an issue where the lenders are United States persons.

General Indemnification

The defeased lease/leaseback transaction will also impose other very broad indemnification obligations upon Sound Transit intended to fully protect First Hawaiian from all risks other than certain risks associated with the tax structure of the transaction. The indemnity mostly relates to any third party claims that arise as a result of the operation of the leased equipment. First Hawaiian will look to Sound Transit's commercial insurance carriers to backstop Sound Transit's indemnity.