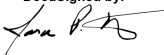




COP Financing Policy for IT Acquisitions	
Policy Number DMT – 403	Effective June 17, 2022
Responsibility Deputy Treasurer, Debt Management	Last Revised N/A
Approved By <div style="border: 1px solid black; padding: 2px; display: inline-block;"> <small>DocuSigned by:</small>  <small>4C1AFB974557498</small> </div>	Approved June 17, 2022

Purpose:

The Office of the State Treasurer (OST) manages the issuance by the State of Certificates of Participation (COPs) to finance the acquisition of personal property by entering into financing contracts for the State and participating state and local agencies (Agency). The property being financed typically comes in the form of a tangible asset. However, many Information Technology (IT) acquisitions require intangible items in order to operate, such as software, software licenses, warranty/support agreements, and subscriptions. As an example, OST may receive a request for a tangible asset such as a firewall. However, the firewall itself does not function without the software and license. Additionally, the acquisition may also include a subscription agreement that provides 24/7 support if something goes wrong or a warranty claim needs to be placed to replace the hardware, or provide updates to the software.

The purpose of this policy is to establish the eligibility requirements and limitations for IT systems that an Agency may finance through a COP financing, especially in terms of intangible assets, security interests, and transferability of the IT system.

The detailed legal background section at the end of this policy provides the legal framework and limitations of the COP Program for Agencies looking to finance certain IT acquisitions. This legal background section includes a description of the legal history of financing contracts in the State, the authority of OST to act on behalf of the State Finance Committee with regard to the execution of financing contracts, as well as the terms of the financing contract and the requirement for the granting of a security interest in any financed property.

Policy Definitions:

Agency – The state agency or local agency that has requested to finance an IT acquisition through the issuance of COPs, referred to collectively as Agencies.

Corporation – The nominal seller in an IT acquisition financing. The Corporation serves an important function as a third party in the transaction which facilitates COPs to not count against the state debt limit.

Financing Contract – The financing contract executed between OST and the Agency in tandem with the issuance of COPs based on the form State Agency Financing Contract or Local Agency Financing Contract approved by the State Financing Committee.

Information Technology (IT) – Property such as computers, servers, firewalls, routers, security appliances, etc.

IT System Property – All elements of an IT financing request, both tangible and intangible (defined below).

Intangible Assets – Items related to an IT acquisition that do not consist of tangible personal property. Intangible assets could include software, software licenses, warranty/support agreements, and subscription agreements.

Tangible Assets – The hardware and other tangible personal property being financed in an IT acquisition.

Trustee – The financial institution, that enters into, and serves as Trustee under, a Trust Agreement with the State and the Corporation securing payment by the State of COPs issued by the State.

Other capitalized terms not defined here have the meaning as defined in the Financing Contract.

Policy:

In order for all components of an IT acquisition to be financed:

A. The Agency’s financing request must include the acquisition of a Tangible Asset(s). Because of the COP Program’s restrictions and limitations, it is unable to finance projects that only consist of Intangible Assets.

B. The Agency must be permitted to grant a security interest in all components of the IT system property being financed.

1) Agencies are required to receive from their vendor(s) explicit permission to grant a security interest in all components of the IT system property in accordance with Section 2.4 of the Financing Contract. System purchase or license documents must include explicit provisions that (a) permit the Agency to grant to the Corporation the required security interest in the financed IT system property, and (b) permit the assignment by the Corporation to the Trustee, without recourse, of (i) all of its rights to receive payments under the Financing Contract, and (ii) all of its remaining right, title and interest in, to and under the Financing Contract and the financed IT system property (including any security interest therein), including but not limited to its right to take all actions and exercise all remedies under and pursuant to the State’s master financing contract and the Agency’s Financing Contract to another third party user, notwithstanding any other provisions in the vendor sale or license documents to the contrary.

a) If a security interest has previously been granted, the Agency should monitor any changes to the vendor terms of service to ensure compliance.

C. Limited Transferability

1) Consistent with the requirement that the Agency must grant a security interest in the IT system property to secure the Agency’s payment and other obligations under its Financing Contract, each component of the IT system property must be transferable to another user in the event the Trustee is required to pursue any remedies available under the Financing Contract and Trust Agreement. If an Agency Event of Default, or, in the case

of a state agency, a Permitted Termination Event, were to occur, the Trustee (as successor by assignment from the Corporation) must have rights to the financed IT system property sufficient to enable the Trustee to pursue on behalf of the owners of the COPs the remedies provided by the Financing Contract.

Further, in the case of an Agency whose governmental functions involve the acquisition of IT system property for use by other Agencies, the use of that IT system property may be so transferred to another Agency for that purpose if otherwise permitted by the terms of both the vendor's sale documents and the COP financing documents relating to the acquisition and financing of that IT system property.

D. Capitalization

- 1) Payments for the costs of all components of the IT system property being financed must have been determined by the Office of Financial Management (OFM) and the Agency to be capital expenditures that will be properly chargeable to the capital account of the financed IT system property. The cost of software, software licenses and hardware, as well as the cost of implementing imbedded software templates and modeling and design of such software may be capitalized.
 - a) Agencies should consult the State Administrative and Accounting Manual (SAAM) for further guidance on the State's capitalization policy.
 - b) COP financing will not be allowed for the payment of costs relating to IT systems that are properly treated as ordinary operating expenses rather than capital expenditures.
 - c) COP financing will not be allowed for the payment of future and/or ongoing subscription payments required under a Subscription-Based Information Technology Arrangement as defined in Statement No. 96 of the Government Accounting Standards Board.

E. Regarding specific intangibles

- 1) Warranties, software, and software licenses are permitted to be included in a financing request assuming that a security interest in that IT system property is granted by the Agency to the Corporation.
- 2) If any intangibles are term limited, the term of their use must exceed the requested financing term.
- 3) Subscriptions are not allowed to be included in a financing request, unless:
 - a) The subscription provides a license for use of the hardware,
 - b) The subscription is transferrable if an event of a default or if a Permitted Termination Event were to occur (see Limited Transferability), and
 - c) The subscription is for a term greater than the financing term.
- 4) Support is not allowed to be included in a financing request, unless such support is bundled with a warranty.

Legal Background:

Chapter 39.94 of the Revised Code of Washington (RCW) authorizes the State to enter into financing contracts for the acquisition of real and personal property for itself and on behalf of local government agencies. In enacting Chapter 39.94 RCW, the legislature declared that state financing contracts, and COPs evidencing the State's payment obligations under such financing contracts, would not constitute "state debt" within the meaning of Article VIII, Section 1, of the State Constitution.

In *Department of Ecology v. State Finance Committee*, 116 Wn.2d 246 (1991) ("*Ecology*"), the Washington Supreme Court, in a closely divided opinion, held that financing contracts entered into by the State, and the issuance of COPs therein, consistent with Chapter 39.94 RCW would not result in the creation of "state debt" under Article VIII, Section 1, of the State Constitution.

One of the fundamental bases for the Court's opinion in *Ecology* was stated as follows:

Under the terms of the master lease [for the financing of the DOE headquarters building], DOE can terminate its payment obligations at any time if the Legislature fails to appropriate funding for the lease payments, or if an Executive Order imposes budget cutbacks on DOE. If DOE terminates its lease, then it must vacate the headquarters building. The trustee then may take possession of the building and relet it for the benefit of the COP holders. Any payments received by the trustee on reletting of the building will be used to pay the COP holders. This is the COP holders' only remedy against the State. (116 Wn.2d at p. 250.)

Thus, the Court in *Ecology* relied upon the COP program's provision to COP holders of alternate security in respect of the financed property rather than a pledge of the State's full faith, credit and taxing power as a key factor in its decision that the State's payment obligations under the financing contract did not create "state debt" under Article VIII, Section 1, of the Constitution.

In this regard, RCW 39.94.030(3) states in part:

The state or an other [local] agency may grant a security interest in real or personal property acquired under financing contracts. The security interest may be perfected as provided by the uniform commercial code - secured transactions, or otherwise as provided by law for perfecting liens on real estate. Other terms and conditions may be included as agreed upon by the parties.

RCW 39.94.040 delegates to the State Finance Committee (SFC) the authority to approve the forms of all financing contracts (or standard formats thereof). SFC Resolution No. 1190 (October 31, 2016) approved the current forms of financing contracts used by OST to facilitate COP issuances.

Consistent with Chapter 39.94 RCW and the judicial and constitutional underpinnings of the COP program set forth in *Ecology*, Section 2.4 Security Interest of the form of State Agency Financing Contract states in part:

(b) *State Agency Security Interest*. In order to secure the payment and performance by the State Agency of its obligations under this State Agency Financing Contract, the State Agency grants to the Corporation a lien on and security interest in all right, title and interest of the State Agency, whether now owned or hereafter acquired, in and to the Property. Accordingly, this State Agency Financing Contract constitutes a security agreement. The State Agency agrees that each provision of this State Agency Financing Contract is also a provision of the security agreement. If required by the Corporation, the State Agency will execute and deliver to the Corporation in form

satisfactory to the Corporation such security agreements, financing statements and/or other instruments covering the Property and all accessions thereto.

Section 2.4 of the form of Local Agency Financing Contract is to the same effect.

Consistent with the Court's opinion in *Ecology*, Section 5.1 Permitted Termination Event of the form of State Agency Financing Contract permits a state agency to terminate its financing contract in the event the legislature elects not to appropriate sufficient funds for its payment or the Governor issues an Executive Order resulting in the unavailability of sufficient funds for its payment (each, a "Permitted Termination Event"). However, also consistent with the Court's opinion in *Ecology*, Section 5.2 Remedies of the Corporation Upon a Permitted Termination Event of the form of State Agency Financing Contract provides that if a Permitted Termination Event were to occur, the state agency would be required to return the financed property to the Trustee (as successor by assignment from the Corporation) to be sold, relet or otherwise disposed of by the Trustee to third parties for the benefit of owners of the COPs.

Similarly, Section 7.1 Agency Event of Default and Section 7.2 Rights of Corporation Following Agency Event of Default of the form of State Agency Financing Contract provide that if an Agency Event of Default occurs because of a failure by the state agency to pay its financing contract or to perform any covenant, agreement, term or condition as required by its financing contract, the state agency may be required to promptly return possession and use of the Property to the Trustee (as successor by assignment from the Corporation). The Trustee then may, among other things, take whatever action may appear necessary or desirable to collect amounts due from the state agency or exercise any other rights or remedies it may have under applicable law. These remedies would include realizing upon its security interest in the financed property by a sale, reletting or other disposition of the financed property to third parties for the benefit of owners of the COPs.

Sections 6.1 and 6.2 of the form of Local Agency Financing Contract are to the same effect.

Authorizing Sources:

- Chapter 39.94 Revised Code of Washington
- State Finance Committee Resolution No. 1190
- State Agency Financing Contract
- Local Agency Financing Contract