*State of Louisiana*

# OFFICE OF

# STATE INSPECTOR GENERAL

# ORLEANS LEVEE BOARD
# ASSET AMORTIZATION PROGRAM


Report by

Inspector General Bill Lynch


Prepared for

Governor M.J. "Mike" Foster, Jr.

October 27, 1998


File No. 1-98-0101

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# Asset Amortization Program

The Orleans Levee Board has obligated itself to more than $1.5 million in legal and consulting costs in an effort to obtain an $8 million windfall from a paper shuffling transaction by private investors seeking huge tax deductions through a federal tax loophole.

Of the $1.5 million, $1.1 million were unnecessary obligations for consulting engineering fees, legal fees of the private investors and appraisal fees, made before the Levee Board had any certainty the questionable transaction was viable under Louisiana law or that it even owned all of the property involved in the transaction. One potential investor already has withdrawn from the negotiations because of the unresolved legal issues.

The transaction, also known as the asset amortization program (AAP), is structured to capitalize on provisions of Section 467 of the Internal Revenue Code regarding tax treatment of lease agreements. It involves the leasing of Levee Board property, two marinas and three bridges, to private parties who in turn lease the facilities back to the Levee Board with the Levee Board retaining ownership, operational control and responsibilities.

The private investors would realize a deduction on taxes owed the federal government based on the amount of the leased property. The Levee Board is proposing to include $180 million of its assets in the AAP. This would give the investors a long term deferral on taxes and control over use of the deferred taxes for more than two decades.

The AAP, as proposed, subjects the Levee Board to various risks including a depository failure in which the Levee Board could wind up having to pay the $180 million. In the worst case default scenario, private interests could take control of bridges and marinas used by the public.

While the AAP may seem a windfall to the Levee Board, it is an enormous boon to the private investors and the middlemen promoting the deal, all at the expense of public tax revenues. We were unable to determine even a ball park figure on how much tax benefits the private investors would realize from this transaction. One private investor we contacted declined to provide that information.

The Internal Revenue Service (IRS) has pending regulations to close or restrict the tax benefits derived by the private investors associated with this type transaction.

# Background

The Legislature established the Orleans Levee District and the Board of Commissioners by Act 93 of 1890. The Levee Board consists of eight commissioners, six appointed by the Governor and two ex-officio commissioners who represent the city of New Orleans.

The Levee Board is responsible for the operations and maintenance of levees, embankments, seawalls, jetties, breakwaters, water basins, and other flood protection improvements for the parish of Orleans. Additionally, the Levee Board is responsible for roads and recreational areas along the south shore of Lake Ponchartrain.

Act 292 of 1928 authorized the Levee Board to dedicate, construct, operate and maintain public parks, beaches, marinas, aviation fields, and other similar facilities. The Levee Board owns and operates two marinas and the New Orleans Lakefront Airport. In addition, the Levee Board leases a riverboat berthing site to Bally's Casino Lakeshore Resort.

# Entities

The complex proposal involves several groups:

1. Orleans Levee Board - The state entity which owns the property to be leased.

2. The Group - An alliance consisting of United Properties Corporation, First National Bank of Commerce (FNBC), and Fuji Bank, serving as middlemen in promoting the AAP.

   FNBC has served as a trustee for Levee Board bond issues.

Fuji Bank, a banking corporation organized under the laws of Japan, also chartered in the U.S., has closed several letter of credit transactions with the Levee Board since 1986. Fuji Bank was involved in a similar transaction with the New Orleans Transit Authority, which involved movable equipment rather than real property.

3. Stroock & Stroock & Lavan, L.L.P. - A New York law firm contracted by the Levee Board to represent its interests in consulting on the AAP.

4. Equity Investor - A bank, financial company, or large, profitable domestic company which borrows some money and invests some of its own equity to lease the assets and then sublease them back to receive tax deductions amounting to at least the assets lease value.

5. Trustee - A U.S. trust company that acts as the owner for the Equity Investor to facilitate and protect the interests of the parties in the AAP.

6. Lending Institution - A highly rated international commercial bank or insurance company that lends money to the Trustee on behalf of the Equity Investor participating in the AAP.

7. Depository Institution - Typically an affiliate of the Lending Institution, which serves as custodian of a portion of advanced lease payments made to the Levee Board. This portion originates from monies borrowed by the Equity Investor through the Trustee from the Lending Institution.

8. Investment Institution - A financial institution that serves as custodian of a portion of advanced lease payments made to the Levee Board originating from the Equity Investor's own monies invested in the AAP.

9. Insuror - A financial institution that insures the Equity Investor is made whole in the event of default by the Levee District.

10. Design Engineering, Inc. - A consulting engineering firm contracted by the Levee Board to provide a detailed asset analysis to insure optimum valuation by the appraisers.

11. Rodney, Bordenave, Boykin, Bennette & Boyle - A law firm contracted by the Levee Board as its local counsel in the early stages of the AAP. For the remainder of this report the firm will be referred to as the Rodney firm.

12. Phelps Dunbar, L.L.P. - A law firm contracted by the Levee Board as its local counsel later in the AAP process to render legal opinions on the program.

13. The Godfrey Firm - Another law firm contracted by the Levee Board as its local counsel later in the AAP process to render legal opinions. This firm has served as bond counsel to the Levee Board for many years.

14. McKenzie, McGhee & Auzenne - Another law firm contracted by the Levee Board as its local counsel later in the AAP process.

15. American Appraisal - A company obtained by the Group to prepare a formal appraisal of the assets in the AAP.

# Players

James Huey

As president of the Levee Board, Mr. Huey is the agency spokesman.

Larry Sisung, Jr.

Mr. Sisung is president of United Properties Corp., a subsidiary of Sisung Securities Corp. Sisung Securities had been serving in the capacity of investment advisor for Levee Board funds and had also been an underwriter for previous Levee Board bond issues.

Ray Rabalais

Mr. Rabalais is vice president of FNBC. Prior to his affiliation with FNBC, Mr. Rabalais worked for Legg Mason, a company that had served in a bond financing capacity with the Levee Board.

Neither Mr. Rabalais nor Mr. Sisung had any prior experience with asset amortization programs.

Stephen Chin

Mr. Chin is a vice president with Fuji Bank and serves as head of the Public Finance Group in New York.

Victor Mora

Mr. Mora is a vice president with Fuji Bank and serves as head of marketing for the Leasing Group.

Richard Kronthal

Mr. Kronthal is an attorney with the Stroock firm. He was introduced to the Levee Board by Mr. Rabalais. Mr. Kronthal has experience in similar transactions.

Walter Baudier

Mr. Baudier is the president of Design Engineering.

Gary Benoit

Mr. Benoit is the Levee Board senior counsel.

Emile Schneider

Mr. Schneider was a former Levee Board associate general counsel.

Max Hearn

Mr. Hearn is the Levee Board executive director.

Roy Rodney

Mr. Rodney is an attorney with the Rodney firm involved with the AAP.

Trudy Bennette

Ms. Bennette is an attorney with the Rodney firm involved with the AAP

Harvey Wagar

Mr. Wagar is an attorney with Phelps Dunbar involved with the AAP.

Daniel Davillier

Mr. Davillier is an attorney with Phelps Dunbar involved with the AAP.

Gerald Godfrey

Mr. Godfrey is an attorney with the Godfrey firm involved with the AAP.

Frank Milanese

Mr. Milanese is a contract attorney to the Levee Board assigned as a liaison between the Levee Board and the Governor's office on matters including the AAP.

Gerard Metzger

Mr. Metzger is a contract attorney to the Levee Board with similar duties as Mr. Milanese.

Meredith Hathorn

Ms. Hathorn is an attorney with the law firm of Foley & Judell contracted by the Attorney General's office to assist with rendering an opinion on the legality of AAP transactions in Louisiana.

Mark Drennen

Mr. Drennen is the commissioner of administration for the State of Louisiana involved with evaluating the desirability and legality of AAP transactions in Louisiana including participation in meetings about the proposed AAP for the Levee Board.

Whit Kling

Mr. Kling is the deputy undersecretary for the Division of Administration assisting Mr. Drennen with evaluating AAP transactions in Louisiana.

Terry Ryder

Mr. Ryder is deputy chief of staff with the Governor's office involved in meetings and discussions regarding the proposed AAP for the Levee Board.

## The Assets

A Group presentation package dated Feb. 18, 1998, shows the following assets as being considered for use in the AAP:

| Asset | Year Built | Estimated Value | Remaining Useful Life |
|---|---|---|---|
| Sen. Ted Hickey Bridge | 1950's | $ 73 million | 45 years |
| West Approach Bridge | 1996-97 | 10 million | 45 years |
| East Approach Bridge | 1996-97 | 10 million | 45 years |
| Orleans Marina | 1960's | 20 million | 45 years |
| South Shore Harbor Marina | 1988 | 67 million | 45 years |
| Total | | $180 million | |

# Levee Board Costs

As of July 23, 1998, the Levee Board was contractually obligated for the following costs totaling over $1.5 million:

1. $640,000 - Consulting fees for Design Engineering.

2. $241,000 - Attorney fees for the Levee Board's local counsels on AAP.

3. $425,000 - Reimbursement of legal costs incurred by the Equity Investor and Lending Institution.

4. $135,000 - Consulting fees for the Stroock firm.

5. $ 50,000 - Appraisal fees for American Appraisal.

6. $ 25,000 - Reimbursement of "enumerated services" associated with AAP.

If the deal goes through, the Levee Board is to be reimbursed for its legal and consulting costs and would not have to pay the legal costs to the Equity Investor and Lending Institution. This is covered by the Group's contract with the Levee Board which provides that all transaction expenses would be paid from a pool of money amounting to 2.1% of the value of the leased assets or $3.78 million.

The Group contract also provides that the Levee Board is obligated up to a cap of $425,000 for legal fees incurred by the Equity Investor and the Lending Institution if the transaction does not close. Although representatives of the Group have assured that no claim will be made on this provision, this has not been set forth in writing.

The Group contract also provides that the Levee Board is obligated up to a cap of $50,000 for appraisal services and a cap of $25,000, for enumerated services. Mr. Rabalais was unable to provide detailed explanation of what these enumerated services are and who they are payable to.

Records indicate that the Stroock firm provided consulting services to the Levee Board as early as April 23, 1997, but the Levee Board did not enter a formal contract until an engagement letter dated Feb. 12, 1998, was signed.

The contract includes a provision that the Stroock firm is entitled to a busted deal fee with a cap of $100,000 if the AAP does not close for any reason. If there is a successful closing, the firm would receive a fee based on a percentage of the cash benefit received by the Levee Board. Assuming a $180 million transaction and the Levee Board receiving a cash benefit of approximately $8 million, the firm would receive a fee of 4.75% or approximately $380,000.

Having a vested interest in consummation of the deal raises a question of independence on the part of the Stroock firm.

Particulars of the Design Engineering contract are explained later in this report.

# Lease Steps

In order to understand the project, IG auditors reviewed materials the Group used in a presentation to the Levee Board, and interviewed some of its members, as well as members of the Stroock firm to gain an understanding of the basic lease steps and money flows.

All numbers used are approximations and estimates. Group and Stroock members stated that the numbers derived from documents are subject to change until the closing date.

They also stated that most of the terms are driven by the Equity Investor and major interest rate changes. Significant terms and amounts, such as periodic rent payments, were undeterminable because persons interviewed said they did not know at this time. The following was created to give the reader only a basic understanding of one possible method of structuring these type of transactions. The actual transaction is much more complex and the risks more numerous than can be concisely written here. The final transaction may be structured differently.

**Initial Cash Flows**

1. The Levee Board decides to lease out assets consisting of two marinas and three bridges worth approximately $180 million in lease value. They then plan to lease them back, in order to obtain an immediate cash infusion. The Board hires a group of financial specialists, the Group, to help develop and implement the plan.

2. An Equity Investor that will provide and retain an equity interest and a Lending Institution are located by the Group. The Equity Investor creates a Trustee for the sole purpose of executing the leases and elects to structure them under IRS Code Section 467.

3. The Lending Institution loans approximately 80% of the lease value, $144 million, to the Trustee at an estimated 8.5% annually. The Equity Investor puts up the other 20%, $36 million, of the lease value.

4. The Trustee leases the assets and prepays a portion of or the entire $180 million cost of the lease to the Levee Board. The lease may run 40 years in length.

5. The Levee Board immediately signs a sublease agreement in which it leases back the assets for a term that may run 32 years in length. The sublease will include a fixed purchase option (FPO) that occurs at an earlier date of 22 years. Exercising the FPO will terminate the sublease. Sublease payments will occur on an annual basis.

6. The Levee Board then deposits in the Depository Institution an amount of money equal to the amount borrowed by the Trustee from the Lending Institution, $144 million. Typically, the Trustee requires the Depository Institution to be an affiliate of the Lending Institution. The Trustee requires the deposit rate to equal the lending rate of 8.5% annually. The investment vehicles are unknown at this time. The deposits are pledged as collateral to guarantee this portion of the sublease payments to the Trustee. They serve as an economic defeasance payment for this portion in the event of a default.

7. Of the remaining $36 million in advance lease payments that the Equity Investor has put up, the Trustee requires the Levee Board to pay all transaction expenses first. The transaction expenses are negotiated by the Group and limited to 2.1% of the lease value, or $3.78 million. The transaction expenses paid by the Levee Board include all legal expenses of the Trustee, the engineering services by Design Engineering, the appraisal cost by American Appraisers, legal cost of the Levee Board up to $150,000, insurance, and up to a maximum of $25,000 for enumerated services.

   The insurance requirement calls for two policies. One policy would insure the assets leased against casualty loss for replacement value and for tort liability within a range of $25 million to $50 million. A second policy would insure payment to the Trustee for a portion of the termination value attributable to the Equity Investor's share.

8. The Levee Board then pays the Group, who have assembled all parties to the contracts and negotiated some points for the Levee Board. Their payment is to be 1.75% of the lease value, approximately $3.15 million.

9. The Levee Board then retains for itself a guaranteed minimum 4.25% of the lease value, or $7.65 million dollars.

10. The remaining 11.9% of the lease value, $21.42 million dollars, is required by the Trustee to be held with an Investment Institution and generate a rate of return of 6.1% annually. The investment vehicles proposed are U.S. Treasury Notes, FNMA/FHLMC government guaranteed mortgages, or other securities acceptable to the Equity Investor. However, the termination value insurance company may require guaranteed investment contracts. The securities are pledged as collateral to guarantee this portion of the sublease payments to the Trustee. They serve as partial economic defeasance in the event of a default.

11. The Levee Board now pays other transaction costs not identified previously in any other contracts. These can include Levee Board legal counsel expenses beyond the $150,000 approved as a transaction expense and any necessary legal judgments. It may also include any other costs that may be associated with protracted negotiations. These costs would reduce the net cash benefit that the Levee Board receives.

**Periodic Cash Flows**

12. Per contractual arrangement, the Depository Institution now makes periodic annual rent payments on behalf of the Levee Board to the Trustee. The time and amount of the payments are to coincide with payments the Trustee must make to the Lending Institution. The payments may be in equal installments or increasing payments as allowed by Section 467. However, it is clear that the Levee Board is responsible at all times to cover for the inability of the Depository Institution to make the required payments.

13. The documents presented to the Levee Board indicate the Investment Institution may make payments on the lease, but no specifics were set forth.

14. During the years prior to the Fixed Purchase Option the Equity Investor amortizes the $180 million prepaid lease expense at a higher rate than the income from the sublease. This deficit accounting creates a significant tax deduction each year.

## Fixed Purchase Option

15. The FPO date arrives about year 22. By this time, depending on the Lending Institution's terms, all funds in the Depository Institution may or may not have been depleted in paying out periodic sublease rents. Any residual funds are released to the Levee Board.

16. Likewise, the Investment Institution releases the funds it has built up to the Levee Board. The net investment of $21.42 million would have grown over 3 1/2 fold to $78.73 million.

17. The Levee Board then pays the Trustee the costs of the FPO which is to equal the $78.73 million and any residual funds received from the Depository Institution. The sublease and the lease are complete at this point and there are no more cash flows. Shortly before the FPO date, the Equity Investor is no longer able to show a deficit and now must record a profit.

## Termination of Sublease

18. Although it is anticipated by all parties involved that the FPO will be exercised it cannot be contractually mandated. If the Levee Board does not exercise the FPO then the lease carries to the full term of the sublease of 32 years. It has been explained that under this scenario the account balances in the Depository Institution and the Investment Institution are to equal the outstanding obligations of the sublease for the remainder of the term. However, documents show that the Levee Board could be liable for increased costs of the Trustee's refinancing of any loans necessary for it to continue in the sublease. This constitutes a somewhat undefined area of the sublease. It appears that it may be an economic incentive to compel the Levee Board to exercise the FPO at the earlier date.

## Termination of Lease

19. The Trustee gains control over the Levee Board assets for the remainder of the eight years on the lease if the FPO has not been exercised. Documents reviewed indicate that there is a deferred rent payment due the Levee Board from 1 to 5 years after the termination of the lease. The reason and amount

of this unusual late payment is obscure at this time. It was stated by Stroock that it is for a tax advantage for the Equity Investor. It appears that this may be an economic incentive to compel the Levee Board to exercise the FPO at the earlier date.

# Benefits

The AAP provides monetary benefits to the Equity Investor, the Levee Board and the Group, explained as follows:

## A. Levee Board

The Group's contract with the Levee Board provides that if the transaction closes, the Levee Board would receive a net cash benefit, after transaction expenses, of 4.25% of the value of the assets leased. This equates to $7.65 million based on $180 million.

However, subsequent to the contract, the Levee Board passed a resolution authorizing Mr. Huey to close a transaction provided the net cash benefit was no less than $8 million. Based on this stipulation, a transaction providing a net return of at least 4.5% of the assets would have to be negotiated.

## B. The Group

The Group's contract with the Levee Board provides that if the AAP is consummated, the Group receives a fee of 1.75% of the value of the assets leased. Based on $180 million of assets, the fee to the Group would be $3.2 million.

If the transaction does not close for whatever reason, the Levee Board has no obligation to pay any fees to the Group. However, if the Levee Board consummates a similar lease transaction with another middleman before Jan. 7, 2000, the Group would receive a fee of 1% of the total assets leased.

C. Equity Investor

Review of Group presentation materials and interviews with members of the Group and the Stroock firm provided the following explanation of tax benefits realized by the Equity Investor:

> The Equity Investor earns a long term high rate of return by embarking on two paths to earn its money. First the Equity Investor is able to invest the $36 million in a lease that is supported by a sublease guaranteed by the account at the Investment Institution and insurance which is in turn guaranteed by the full faith and credit of the Levee Board and its assets. The end result in this scenario, the Equity Investor gets a 6.1% annual return on a net investment of $21.42 million returning it $78.73 million after 22 years. These funds flow through the Levee Board account.
>
> Second, by holding the equity interest the Equity Investor will receive the tax deduction of the full $180 million as a lease expense plus the 8.5% interest on the loan. These deductions will be offset somewhat in finality by the income received from the sublease. However, a substantial benefit is gained by accruing a higher lease expense versus low income accounting for the sublease. This substantial tax savings/deferral is then available to be invested to offset the future "deferred tax" obligation. The ability to defer the tax obligations will end shortly before the FPO date of 22 years.
>
> By this time a positive income flow will arise as the income from the sublease becomes larger than the amortization of the lease expense. The gain is twofold. The Equity Investor earns the actual interest on the deferred tax savings. Because the tax pay off is deferred, there is an imputed interest gain equal to the inflation rate.

# Tax Loophole

The Levee Board has exhibited questionable judgment by becoming involved in a highly complicated and specialized lease transaction that relies on a questionable federal tax law loophole.

## A. Origin of the Program

The AAP was brought to the attention of the Levee Board by Mr. Rabalais, who, as a consultant to the Levee Board since the late 1970s, was aware that the Levee Board is in serious financial straits. The Legislative Auditor reported that the Levee Board's general fund had declined from a surplus of $25,867,588 at June 30, 1991, to a deficit of $6,870,561 at June 30, 1996.

Mr. Rabalais stated that the proposal was first presented to the Levee Board April 25, 1996, by him and Mr. Sisung, whose firm was assisting the Levee Board with its investments, while William Nungesser was president. They discussed the proposal two months later with Mr. Huey when he became president. At Mr. Huey's request, they advised other members of the Levee Board about the proposal in informal meetings.

On Jan. 7, 1997, the Levee Board entered into an agreement with the Group, who, at that time, consisted of United Properities Corporation and First National Bank of Commerce, granting it exclusive rights to pursue the asset amortization program with the Levee Board. The contract was amended Feb. 18, 1998, to add Fuji Bank as a member. The term of the engagement expires Jan. 7, 1999.

A proposal made by a Dutch holding bank, ABN AMRO, to put together the deal without any cost to the Levee Board, was dismissed as inadequate. Mr. Huey stated the bank made an oral presentation with no written documentation.

B. Specialized Transaction

The special Board meeting of April 23, 1997, included the first formal presentation by the Group and the Stroock firm of the proposed AAP.

The minutes showed that Mr. Kronthal had consulted on AAP transactions involving local transit authorities regulated by the Federal Transit Administration (FTA). Mr. Kronthal stated he did not know of any other levee boards or similar organizations which had entered into such transactions, but that it had become of great interest in non-transit agencies as well.

Mr. Rabalais said that Fuji Bank had done one with the Regional Transit Authority in New Orleans. Mr. Kronthal said that the RTA transaction was similar to the proposed Levee Board transaction except the RTA involved foreign tax laws. He added that while the basic concepts are similar, the Levee Board transaction would be much more complex and was really a new product.

In a letter dated Dec. 8, 1997, to Mr. Drennen, Mr. Chin advised that the type of highly structured tax driven transaction proposed for the Levee Board had only been actively applied to the domestic U.S. market over the past two years. Attached to the letter was a list of similar transactions known to have closed or under consideration. Review of the list revealed 23 transactions with only one involving bridges. This transaction was classified as being under review and not closed.

C. Depiction as Tax Loophole

Several documents reviewed depicted AAP transactions as tax loopholes.

For example, in a Bond Buyer magazine article dated May 16, 1996, the comptroller of the Chicago Transit Agency commented that her agency was working on a lease/leaseback arrangement but she could not disclose details citing concerns that the federal government would seek to close the tax loophole. She goes on to say that there is a proliferation of such deals but nobody wants to put a lot of attention on them because the federal government could close it up.

A Bond Buyer magazine article dated June 15, 1998, described the transaction as a deal which benefits a private investment group because the law allows it to gain a tax shelter by taking tax deductions on the assets of the public agency.

In a memorandum dated May 29, 1998, to Mr. Drennen, Mr. Kling described the Levee Board's proposed AAP as a transaction allowed under Section 467 of the Internal Revenue Code. However, he stated that from a financial perspective the transaction is nothing more than a variation of a traditional leveraged lease transaction which takes advantage of the tax code treatment of rental revenue streams and amortization thereof. He further stated that it is extremely complex and expensive and involves manipulation of the tax code with the result being significant long term tax saving to the Equity Investor.

The April 23, 1997, Board minutes showed that Mr. Mora explained to the Levee Board that the Equity Investors on the transaction are typically companies that generate large tax bills every year and are seeking to shelter some of those tax gains over time using the leasing transaction. In this same meeting, Mr. Kronthal stated that the transaction should not work but it does for the moment. He added it is the latest in the evolutionary structure of these type of deals, and whether it is abusive from an equity perspective, only the IRS can say.

D. Proposed IRS Regulations

During the April 23, 1997, Board meeting, Mr. Rabalais advised the Levee Board that the transaction was currently authorized under federal tax laws and regulations, but there was a set of proposed federal regulations, which, if they went into effect, would prevent the Levee Board from closing the transaction being proposed. He added that it would not mean a transaction would not be possible but the economic advantages of the transaction would be significantly reduced.

Mr. Rabalais also stated that the window available for the transaction probably would not be available beyond the calendar year, if that long, therefore, the Levee Board needed to make a decision whether to move forward. He urged the Levee Board to make its decision within two weeks. The need for speed was a constant refrain during the deliberations.

Mr. Kronthal also reiterated that the proposed regulations if adopted would diminish the benefits available in the deal and encouraged a decision within two weeks regarding whether the Levee Board wanted to proceed with the program.

During the April 23, 1997, meeting, Mr. Rabalais provided Board members with presentation materials showing that if the Levee Board did proceed to closing but the tax law changed just prior, that the Levee Board would be obligated to as much as $525,000 of legal costs incurred by the Equity Investor, Lending Institutions, and the Stroock firm. Presentation materials also showed a target date of June 30, 1997, to close the transaction.

While the participants expressed concern over possible closure of the loophole by the IRS and the need for speed in closing the transaction, the negotiations went through a series of deadlines during 1997. Board records indicate that the transaction did not close as planned, because various legal issues were still being researched. The records also showed that the Group was not given authorization to proceed with the transaction until the special Board meeting of Feb. 18, 1998.

To date, the transaction has not closed due to legal problems.

During this special meeting Mr. Huey commented that one of the primary concerns of risk was that the IRS would come into the process and discontinue the program before closing, leaving the Levee Board with various costs. He advised that in the first of the year the IRS normally does not make these decisions and this is when the Equity Investor have their money to invest.

He further stated that for these reasons he felt the risk factor was very minimal and urged the Levee Board to move forward with the transaction as expeditiously as possible. He also pointed out that an IRS policy change on this issue does not require a legislative change and could be done very rapidly.

To date, the IRS has not adopted the proposed regulations.

When questioned by IG auditors regarding the constant pressure to move rapidly on the deal, Mr. Huey stated there was a sense of urgency due to the Levee Board's financial condition. He also emphasized the Levee Board's concern with the IRS closing the loophole.

When asked why the Levee Board would pursue this type of deal at all, Mr. Huey responded that the program is a tax incentive for investment in governmental agencies and it was apparently designed for government entities that need money.

# Legality

The critical point at which the Levee Board committed itself to the unnecessary expenditure of $640,000 in consulting engineering fees, $425,000 in legal fees of the Equity Investor and Lending Institutions, and $50,000 in appraisal fees occurred at a special meeting Feb. 18, 1998, when it authorized Mr. Huey to proceed with various contracts, including one with Design Engineering Inc. to provide a professional detailed estimate of the value of its facilities.

The Levee Board did not know at that time whether it could legally proceed under Louisiana law with the lease project.

The Levee Board had employed outside local counsel, the Rodney firm, to represent its interests during the early stages of pursuing the matter. While the firm, had provided preliminary opinions on various issues that had to be addressed, the firm had specifically advised that it had not rendered a final opinion on the overall proposal.

In fact, the Rodney firm was instructed not to attend the critical Feb. 18 meeting.

During the meeting, the Levee Board adopted a resolution authorizing Mr. Huey to execute a contract admendment with the Group, and contracts with Design Engineering, the Stroock law firm, and any other additional law firms.

Mr. Huey explained later that the Rodney firm had fulfilled its role of providing an initial opinion and it was decided that a nationally known firm would be hired to proceed to the next stage which would involve dealing with Equity Investors. The firm of Phelps Dunbar, L.L.P., was selected.

As it turned out, the Levee Board not only did not know its legal authority, but found out much to its dismay from Phelps Dunbar that it might not have clear title to the Senator Hickey Bridge, a matter which later became a major point of concern. This ownership issue is discussed later in the report.

One of the key issues unresolved was the legal recourse in case of default by the Levee Board. The question of whether tolls could be placed on the bridge as a means of recoupment in event of default became significant. This is discussed in more detail later.

Another key issue unresolved at the time was the effect of state law requiring that any state funds deposited in a bank must be collateralized 100 per cent by the bank. This would pose a signficant problem in the structure of how the lease funds would be handled and still comply with state law. This is discussed in more detail later.

After the Feb. 18 meeting when it appeared the Levee Board was eager to proceed as rapidly as possible to a conclusion, the Governor became involved and essentially brought the program to a halt by requiring the Levee Board to get a go ahead opinion from the state Attorney General. Mr. Huey agreed that nothing would be finalized until such an opinion was obtained. The Attorney General assigned the matter to the firm of Foley and Judell to research and opine. No opinion has yet been made.

Detailed explanation of the events surrounding the legality issue is as follows:

A. Preliminary Legal Analyses

The minutes of the April 23, 1997, special Board meeting show that after the Group and Mr. Kronthal discussed the AAP and its various risks, Mr. Huey stated that there were many questions that would need to be researched and addressed. Minutes of the May 6, 1997, finance committee meeting show that Mr. Huey said he was encouraged that the program was a viable opportunity, but it would be appropriate at this point to get a legal opinion on the issues.

With a letter dated May 6, 1997, from Mr. Benoit to Mr. Rodney, the Levee Board engaged the Rodney firm as local counsel in connection with the AAP. The letter stated the scope of the engagement included researching all matters assigned to the firm by the Board president, any Board members, and other outside counsel who are engaged by the president or the Levee Board.

In a letter dated July 11, 1997, to Mr. Huey, Ms. Bennette advised that the Rodney firm would move ahead to analyze certain Louisiana and local law issues, outlined in a memorandum prepared by Mr. Kronthal, that are likely to arise in connection with the proposed transaction. Mr. Kronthal's memorandum included 19 legal issues, some with sub-parts, regarding limitations and restrictions, if any, on the Levee Board's authority to do certain things.

By way of a letter dated Oct. 17, 1997, from Ms. Bennette to Mr. Kronthal and copied to Mr. Huey, the Rodney firm issued what it referenced as a consolidated opinion. However, the letter clearly stated it was the understanding of the firm that the progam is in a preliminary "take a look see" stage and that the letter is a preliminary response to the various questions previously posed in Mr. Kronthal's memorandum.

The letter stated that terms and conditions of a transaction of this type are deal specific, and that the transaction negotiated for the Levee Board may differ significantly from the transaction reflected in the presentation materials of the Group. The letter further stated that once more concrete information regarding this transaction was provided, the firm would want an opportunity to further address the questions/issues.

In a letter dated Feb. 16, 1998, to Mr. Rabalais and copied to Mr. Huey, Ms. Bennette advised that her firm's previous analyses were preliminary and only covered or addressed particular Louisiana law issues, and that the firm had not rendered a legal opinion on the entire transaction.

According to Mr. Benoit, Mr. Huey directed him to advise Ms. Bennette it was unnecessary for representatives of the Rodney firm to attend the special Board meeting scheduled for Feb. 18, 1998.

Minutes of this special Board meeting revealed that the Rodney firm did not attend. Also, they showed no evidence of any discussion regarding the firm having not rendered a legal opinion on the entire transaction. Mr. Huey did advise the Board members that a lot of preliminary legal questions had been answered so that the Levee Board could proceed with the transaction as expeditiously as possible.

Despite not having a legal opinion on the transaction and only a limited preliminary analyses, the Levee Board in its special meeting, adopted resolution No. S1-021898 to proceed with implementation of the AAP.

The resolution authorized Mr. Huey to execute a contract amendment with the Group, to execute a contract with Design Engineering, Inc., to execute a contract with the Stroock firm as well as additional law firms as needed for the AAP. The resolution also authorized the Group to enter into negotiations with providers of necessary services in connection with the AAP and to obtain a definitive proposal from Equity Investors for consideration in closing the deal.

When questioned regarding the Levee Board proceeding without a legal opinion on the transaction, Mr. Rabalais acknowledged that the Rodney firm's analyses was not a legal opinion. However, he explained that due to the nature of the transaction, attorneys do not render a definitive opinion on legality and enforceability until they have reviewed the closing documents. He said that the terms of the transaction are negotiated to the very end.

Mr. Huey said the Levee Board felt the legal analyses presented by the Rodney firm verified it could move forward with the transaction.

## B. Premature Contractual Obligations

With authority to proceed, Mr. Huey executed an amended contract with the Group dated Feb. 18, 1998. The contract included a fee cap provision which provided that the Levee Board could be obligated to a maximum of $425,000 for the legal expenses of the Equity Investor and Lending Institution if after proceeding with the transaction, the deal did not close. The contract also included a maximum obligation of $50,000 for appraisal services and $25,000 for enumerated services.

Mr. Huey also executed a consulting contract with Design Engineering, Inc. Design Engineering's primary responsibilities included preparing an inventory of District assets, determining the remaining useful life of the assets, assisting the appraiser in determining the present values of the assets, preparing boundary surveys of the assets, performing environmental site assessments, analyzing potential catastrophic event loss and cost estimates for repairs, and other duties.

If the transaction closes, the Design Engineering contract provides a lump sum fee of $734,228 plus an additional fee of .05% of the transaction value, or $90,000 based on $180 million, for services rendered from December, 1996, through February 18, 1998, prior to the execution of the contract. This equates to a total fee of $824,228. If the transaction fails to close after April 18, 1998, the Levee Board's obligation is at least $640,000. The $640,000 includes the $90,000 retroactive fee.

Regarding the retroactive fee, a Board resolution was adopted in December, 1996, designating Design Engineering as a consultant to the Levee Board with respect to AAP. Board records also indicate that Design Engineering had been providing consulting services since this time. However, in violation of prudent business practices, the Levee Board did not have a written contract defining the terms and conditions of the business arrangement.

C. Subsequent Events

Board records showed the transaction did proceed and the Group contacted 20 Equity Investors and 6 Lending Institutions regarding the transaction. The Group received a written bid proposal from one Equity Investor, Dana Commerical Credit Corp. The Group also received a written bid proposal from one Lending Institution, AIG Financial Products, Inc.

Also, the Group received a written bid proposal from the Insuror, MBIA Insurance Corporation. The Insuror insures the District's payment to the Equity Investor for the equity portion of the transaction in the event of default. The Group explained that insurance may not be necessary, depending on the Lending Institution and Equity Investor ultimately selected.

Minutes from the Board meeting of March 18, 1998, showed that the Levee Board authorized Mr. Huey to accept the proposals submitted by the three companies and to proceed to the closing of the transaction including the authority to sign closing documents, provided the net cash benefit to the Levee Board was no less than $8 million.

With a letter dated March 20, 1998, the Levee Board engaged three additional law firms to give certain legal opinions with respect to the AAP. The firms were Phelps Dunbar, L.L.P.; the Godfrey firm; and McKenzie, McGhee, & Auzenne. Engagement of these firms to render legal opinions was further evidence that the Levee Board had not fully addressed legal issues associated with the transaction before obligating itself to significant engineering and third party expenses.

Board records showed that these firms were asked to analyze and opine on generally the same basic issues upon which the Rodney firm had prepared its preliminary analyses along with a few additional issues. These basic issues included the following:

- What restrictions, if any, are there on the Levee Board's ability to lease the property of the state or Levee Board and to enter the sublease?
- Are there restrictions on the ability of the Levee Board to select the professionals that will act as the arrangers (the Group) on the transaction?
- Does the execution of the sublease constitute debt and subject the transaction to State Bond Commission approval?
- Do the payment obligations of the Levee Board under the sublease and other documents have to be subject to appropriation?
- Are there restrictions on the Levee Board's use of the rent prepayment from the Trustee including whether it has to be deposited in the state's Bond Security and Redemption Fund and then appropriated?
- Are the deposits, defeasance payments, and investments associated with he transaction subject to state depository law and restrictions on investment of public funds?
- Are there restrictions on the Levee Board's ability to grant a security interest in the monies deposited with the Depository Institution and Investment Institution or a mortgage on the property?
- Can the Levee Board grant general indemnifications covering tort and environmental liabilities?
- Can the Levee Board grant tax indemnities triggered as a result of the Levee Board defaulting in its contractual obligations under the transaction?
- What taxes would be applicable to this transaction?
- If the Levee Board created a public benefit corporation, what limitations would exist regarding the transaction?
- What restrictions, if any, after termination of the sublease due to default or failure to exercise the FPO, are there that limit the lessee from placing tolls or other fees on a bridge or other publicly owned property that is included in the transaction?
- What are the limitations on the Levee Board's ability to agree to New York or other state choice-of-law provision and/or a non-exclusive submission to an out-of-state jurisdiction provision in the transaction documents?
- Would the proposed transaction have any affect on the tax free status of currently outstanding Levee Board bonds?
- What are the risks to the Levee Board of the bankruptcy of the Equity Investor and/or the Investment Institution?
- What are the limitations on the Levee Board's ability to impose tolls on the bridges that it owns and operates?

- Assuming the sublease terminates due to default or the FPO not being exercised and the Equity Investor obtains possession of the bridges, what limitations would there be on the Equity Investor's ability to impose tolls on said bridges?
- Are there restrictions under Louisiana law which would limit the Trustee from subleasing the property to another lessee?

Board records showed that the Governor's office became aware of the Levee Board's AAP no later than September, 1997.

On Sept. 25, 1997, representatives of the Levee Board and the Group met with Mr. Ryder, Mr. Drennen, and other members of the Governor's staff and provided them with proprietary information and legal analyses that had been prepared on AAP. Records also showed that on Dec. 4, 1997, representatives of Fuji Bank gave a presentation to Mr. Drennen regarding the AAP contemplated for the Levee Board.

Mr. Ryder recalled that at the end of the Sept. 25 meeting he told the Levee Board representatives that this program sounds like something the Levee Board and other government entities should look at. However, he said he made it clear to them that he was not sure how such a transaction may actually be consistent with state law. He said he also expressed his concerns that this was a substantial governmental policy decision and that his office had not reached a conclusion at the state level, let alone for a political subdivision.

By way of a memorandum dated March 6, 1998, the Levee Board provided Mr. Ryder a complete presentation booklet regarding its AAP. The memorandum also advised Mr. Ryder that the Levee Board had adopted a resolution in the Feb. 18, 1998, special meeting to proceed and the issue was in the national market being negotiated with prospective Equity Investor and Lending Institutions. Mr. Drennen was also provided a copy of the booklet.

The first written evidence that the Governor's office and the Division of Administration had strong reservations regarding the program came after the March 18, 1998, meeting when the Levee Board voted to proceed to closing and accept proposals from certain providers.

With two letters dated March 19, 1998, to Mr. Huey, Governor Foster expressed his serious concerns with AAP transactions and the need for a definitive Attorney General's opinion regarding legality before any transactions of this type take place in Louisiana. The letters also included his concern that there had been a communication breakdown between his office and the Levee Board.

This same date, Mr. Drennen issued a strongly worded letter to Mr. Huey stating the previous presentation led him to believe the AAP was in the very tentative and formative stages of discussion and that his office would be apprised of any actions and time frames. He further stated that the Levee Board proceeded with AAP despite his office previously advising the Levee Board it was not in a position of comfort and was in the process of determining legality through the Attorney General's office.

He further admonished the Levee Board's action as ill advised on the part of a public body, particularly one which is entrusted with assets upon which a vast majority of the state's taxpayers rely.

According to Mr. Huey, he had several conversations with Mr. Ryder and Mr. Drennen and told them the Levee Board was moving forward with the AAP. He said they never told him they approved of the transaction but they never said they opposed it until after the March 18, 1998, meeting. Several Board members stated the Governor's office never told them not to proceed.

Mr. Ryder confirmed there were several conversations, but he stated his consistent message to Mr. Huey was the same concerns he expressed in the Sept. 25, 1997, meeting regarding his doubts about legality of the transaction and the governmental policy issue. Mr. Ryder said the policy issue related to whether the Levee Board was getting enough revenue from the transaction to offset the amount of risks it seemed to be facing. Mr. Ryder acknowledged his concerns were expressed verbally and not in writing.

Mr. Ryder also stated the Levee Board may have vaguely told him it was moving forward with the transaction but he was not told the Board was at the point of signing contracts and binding the Levee Board.

Mr. Drennen, by way of a letter dated April 24, 1998, to Attorney General Richard Ieyoub, requested an opinion regarding the overall legality of the State of Louisiana and its political subdivisions entering these transactions. The request included many of the legal questions previously listed. According to Mr. Kling, the Attorney General's office has retained the firm of Foley & Judell to assist with rendering an opinion. He said Ms. Hathorn has been assigned by the firm as the attorney to write the opinion. To date, an opinion has not been rendered.

Mr. Huey stated that the Governor recently advised him that the Levee Board could proceed without an Attorney General's opinion pending obtaining legal opinions on the issues and obtaining any additional insurance needed to back the opinions.

When asked why the Levee Board did not solicit an Attorney General's opinion, particularly in the early stages of transaction, Mr. Huey stated that it never entered his mind. He said in a transaction of this nature, he knew the Attorney General's office did not have the expertise internally. He said he knew the Levee Board had the expertise of the Stroock firm which had been involved in several of these transactions.

However, it was made clear in presentations to the Levee Board that the Stroock firm was hired for the purpose of explaining tax and transaction risks issues, and that state law issues were to be addressed by local counsel.

D. Toll Issue

Minutes of the June 2, 1998, finance committee showed detailed discussion of a toll issue plaguing the transaction. The viablity of imposing tolls is considered a necessary ingredient for moving forward with the transaction.

During this meeting, Mr. Rabalais explained that there is a difference in opinion between Phelps Dunbar and the Godfrey firm regarding the authority of the Levee Board to impose tolls on the bridges in the event that the Levee Board defaulted or not exercise the FPO under the transaction. He stated the Godfrey firm has indicated a willingness to issue an unqualified opinion that the Levee Board may impose tolls; whereas, Phelps Dunbar is willing to issue a qualified opinion. He stated the difference is a matter of degree of certainty.

Mr. Rabalais further explained that the difference of opinions has created a problem for Dana Commerical Credit Corp., the proposed Equity Investor. The proposed Equity Investor has stated it will not proceed with the transaction without a unified opinion. He advised that the two firms are standing by their original positions.

He explained that this is a crucial issue because for IRS purposes the bridges have to be able to generate income through tolls for the Equity Investor to qualify for the tax benefit. He stated this is a theoretical problem, because there is no intention to impose tolls.

During this meeting one Board member questioned how the Levee Board has spent a lot of money to get legal advice and legal opinions in this overall process and now all of a sudden legal problems are arising. Another Board member expressed concerns that the Levee Board is far down the line and is not sure it can even do the transaction.

We noted that Board records showed no evidence that this toll issue was ever examined, much less analyzed, by legal counsel prior to the Feb. 18, 1998 meeting, when the Levee Board obligated itself to significant costs and proceeded with the transaction.

When asked when the toll issue arose, Mr. Rabalais said he recalls it became an issue when the appraisers came down after the March 18, 1998, Board meeting. He said the appraisers were using an income approach to valuation, meaning they did not only want to know what it would cost to replace the bridges, but what kind of revenues could the bridges generate. He said the appraisers asked to see the legal authority for the Levee Board to impose tolls, thus, the toll issue became known.

## E. Collateralization Issue

Another key legal issue unresolved at the time of the critical Feb. 18, 1998, meeting was that of collateralization.

Presentation materials showed that Levee Board monies held by the Depository Institution may be in the form of certificates of deposit. It also showed that Levee Board monies held by the Investment Institution may be in the form of U.S. government securities.

During the April 23, 1997, special Board meeting, Mr. Kronthal advised that foreign Lending Institutions could be involved in the transaction and that there was a bankruptcy risk associated with institutions holding Levee Board deposits.

During the Feb. 18, 1998, meeting, Board members were provided an analysis prepared by Mr. Hearn, executive director, which pointed out a collaterization issue with the AAP.

He advised that the certificates of deposit associated with the transaction must be issued by state banks organized under the laws of Louisiana, or national banks having their principal offices in Louisiana as defined by R.S. 6:703(16) and (17). He also advised that monies held by the Depository Institution must be in U. S. government obligations allowed by R.S. 33:2955.

He further advised that funds invested shall not exceed at any time the amount insured by the Federal Deposit Insurance Corporation in any one banking institution unless the uninsured portion is collateralized by the pledge of securities in the manner provided in R.S. 39:1221.

The Levee Board proceeded with the transaction on Feb. 18, 1998, without fully addressing these issues.

In a letter dated March 31, 1998, to Mr. Godfrey and Ms. Auzenne, Mr. Wagar stated there is a significant problem given the limited scope of permitted investments by the State. He further stated that the deposits themselves or characterization of the deposits as belonging to the the Levee Board may need to be restructured or recharacterized in order to avoid state law problems.

F. Title Issue

The Levee Board exhibited questionable judgment by obligating itself to significant costs before it had reasonable assurance that it had clear title and full ownership of the property involved in the AAP.

During the April 23, 1997, special Board meeting, a Levee Board member asked whether the District had clear title to the properties proposed to be used in the transaction. Mr. Schneider advised that the Levee Board owns the property and has clear title.

In a letter from Ms. Bennette to Mr. Kronthal dated July 11, 1997, she advised that the Rodney firm would analyze certain legal issues including the status of the title of each asset selected for the transaction to ensure that no encumbrances exist that are inconsistent with the transaction. However, in a letter dated Aug. 14, 1997, Mr. Benette advised that the title status of the assets would be addressed later, after completion of the preliminary legal research.

In the June 2, 1998, finance committee meeting, several months after the Levee Board obligated itself to significant costs, Mr. Rabalias advised the Levee Board of a title issue involving the Senator Ted Hickey bridge that must be resolved before the transaction could go forward.

He explained that originally, the Port of New Orleans, the City of New Orleans, and the Levee Board each had one third ownership in the bridge. He stated there is clear documentation that the Port ceded its one third interest to the Levee Board with the understanding that the Levee Board would operate and maintain the bridge. He added that there is correspondence that indicates the City of New Orleans took similar action, but a clear city resolution or ordinance substantiating this has not been found.

When a Levee Board member stated he could not understand this ownership issue being unknown until now, Mr. Rabalais responded he was not sure there is a ownership issue, he would catergorize it as a gap in documentation.

When asked by IG auditors if Mr. Schneider had been given responsiblity to conduct title searches on the assets for this program, Mr. Huey responded that Mr. Schneider had a tremendous historical background with the Levee Board having been the Board president at one time. He indicated that frequently the Levee Board would ask him title questions and Mr. Schneider could respond from memory without research. Mr. Rabalais responded that Phelps Dunbar actually did the title seaches and found the problem.

In a letter dated May 13, 1998, to Mr. Godfrey, Mr. Davillier explains that the three entities jointly constructed and financed the bridge. The letter says documentation showing the Port ceded its portion were found, but the firm has not been able to locate any evidence of a similar transfer by the City of New Orleans.

## G. Costs to Date

The Levee Board's finance department provided the IG with a letter detailing Levee Board costs for the transaction, paid or unpaid but contractually due, as of July 23, 1998. The total spent or committed is $1,066,532 with the breakdown by contractor explained as follows:

Design Engineering has been paid $360,000 with an additional minimum due of $280,171. The letter shows that appraisers are owed $50,000.

The Levee Board has paid $102,519 of legal fees to local counsel with $138,842 unpaid but earned and due. The Levee Board has paid the Stroock firm $35,000 with an additional minimum due of $100,000.

The letter also pointed out that legal fees for local counsel will be higher because on July 27, 1998, the Attorney General's office approved a higher fee schedule for the previous invoices submitted by the Godfrey firm and Meckenzie, McGhee & Auzenne. The letter also referenced two additional contract attorneys, Mr. Metzger and Mr. Milanese, rendering services related to the program.

We noted that the Levee Board's letter does not include any costs associated with the $425,000 maximum fee cap provision discussed earlier for legal expenses of the Equity Investor and Lending Institution.

According to Mr. Rabalais, it is his understanding that Dana Commercial Credit Corp. and its legal counsel have not turned on the meter to begin charging the Levee Board although they have expended considerable time on the project. He said Dana Commercial Credit Corp. had the attitude that the meter would not start until the toll issue is resolved and the Levee Board is ready to proceed.

He said the same holds true for the attorneys of the Lending Institution and the Levee Board should not expect invoices from any of these parties.

Although Mr. Rabalais claimed there are no billable amounts for the Equity Investor and Lending Institution legal counsels, we noted that this has not been set forth in writing.

Including the potential $425,000 obligation, the total costs to the Levee Board may be at least $1.5 million if the transaction does not close.

## The Risks

Minutes for the April 23, 1997, Board meeting showed that the Group provided the Levee Board with presentation materials detailing various risks associated with the transaction.

Also, Mr. Kronthal addressed the Levee Board during this meeting regarding risks. These risks are explained as follows:

A. Default Risk

This risk involves the Levee Board defaulting on the lease due to one of the following events:

- Failure to make rental payments
- Failure to maintain insurance
- Failure to observe material terms, conditions or covenants
- Incorrect representation or warranties
- Insolvency

If an event of default can not be cured in a timely manner, causing the sublease and head lease to terminate, the Levee Board would be required to pay the Equity Investor a stipulated loss value. The stipulated loss value is an amount equal to the sum of the Equity Investor's outstanding investment balance, anticipated yield and the outstanding debt balance through the date of termination.

Mr. Kronthal explained that if something occurs in the first six months of a deal, it could cost the Levee Board approximately 117% of its cash benefit. Based on $8 million, this would be approximately $9.7 million. He said that it goes down on a sliding scale on an accelerated basis so that by the third or fourth year the loss would be 100% of the benefit, and by the eighth year, there is a crossover where you basically would keep all of your benefit.

Mr. Kronthal stated this risk is 100% controllable. He said that the defeasance, a fundamental part of the deal, would protect against this happening. He explained that economic defeasance means to put aside an amount which will increase, with a fixed interest rate, to be equal to what the obligation is, at a point in time.

It should be noted that since the obligation for the stipulated loss value does not expire until the eighth year, the Levee Board cannot feasibly use the $8 million benefit for its current dire cash needs.

According to the Levee Board's finance committee minutes of March 4, 1997, Mr. Schneider advised Board members of a worst case scenario in which the Equity Investor takes control of the assets if the Levee Board defaults. This scenario would be triggered if the Levee Board could not meet the stipulated loss value obligation.

In a memorandum to Mr. Drennen dated May 29, 1998, Mr. Kling points out that if the Levee Board does not exercise the option to purchase the Equity Investor's leasehold interest at the end of the initial term of the sublease, the Levee Board may be required to return leased assets to the Equity Investor for operations or re-leasing. Mr. Kling stated another possibility is the Equity Investor may require the Levee Board to renegotiate the lease which would likely include extremely unfavorable terms to the Levee Board.

When questioned if the Equity Investor has the right to deny public access to the bridges in the event of foreclosure, Mr. Rabalais responded that issues such as this have not been negotiated at this point and would have to be addressed in the closing documents.

When questioned if the bridges in the deal are dedicated to public use, Mr. Rabalais commented it is his understanding they are not dedicated to public use. Mr. Huey acknowledged that the bridges, particularly the east approach bridge, are tremendous enhancements for emergency evacuation and have allowed a better flow of transportation. He stated that a large part of the justification for building the approaches was to benefit evacuation as part of flood protection.

When asked why the Levee Board would collateralize bridges that are necessary for the public, Mr. Huey said that if you can take a non-revenue producing asset and turn it into revenue he would try to collateralize everything.

B. Asset Casualty

This risk involves a fire, flood, hurricane, or any event that would render an asset in the deal not suitable for its intended use due to loss, condemnation, or destruction. If the asset was not repaired, replaced, or a substitute asset provided, then the stipulated loss value would be due to the Equity Investor.

Presentation records state this risk can be mitigated through negotiating broad repair, replacement and substitution provisions. The Levee Board would likely be required to procure additional insurance or amend existing insurance policies to compensate for any additional exposure associated with this risk.

Mr. Kronthal advised the Levee Board that he felt this is the greatest potential risk.

C. Defeasance Risk

This risk involves the bankruptcy or insolvency by the financial institutions holding the Levee Board's funds from the Equity Investor's advanced $180 million lease payment.

As described earlier, approximately 80% of the advanced lease payment is held by the Depository Institution in an interest bearing account referred to as the debt defeasance. The remaining 20%, less the Levee Board's cash benefit and transaction expenses, is held with the Investment Institution in the form of U.S. government securites and is called the equity defeasance.

The earnings and principal in the Depository Institution account functions as the source of payment for the rents due under the sublease. The Levee Board is also required to pledge this account as security to the Lending Institution which loaned the Equity Investor a substantial portion of the advanced rental payment. The Depository Institution is normally an affiliate of the Lending Institution willing to ensure that the deposit rate and the lending rate are the same.

If the Depository Institution were to become insolvent, the Lending Institution's security and the Levee Board's source of rental payments may be in serious jeopardy since the deposit could be lost in whole or part. If the deposit were impaired, the Levee Board would not be able to make its rental payments which would result in a default under the sublease since the Levee Board is technically responsible for the obligation.

Funds invested in the investment account for meeting future repayment obligations to the Equity Investor face a similar risk to the Levee Board if the Investment Institution became insolvent. The Levee Board is required to pledge security interest in this account to the Equity Investor.

Presentation materials show that the risk can be mitigated by implementing the following protections:

- Use of highly rated (AA or better) lending and depository institutions.

- Negotiating a right to refinance the loan and deposit in the event of a rating downgrade below the Levee Board's investment criteria.

- Collateralization of the deposit in the event of a rating downgrade below the Levee Board's investment criteria.

However, the materials noted that these protections are not a cure in and of themselves and they may result in additional costs to the Levee Board.

Mr. Kronthal advised the Levee Board that protective measures could be taken for just about everything but the possibility of an overnight failure by the Depository and the Investment Institution.

Although not included in the presentation materials or discussed by Mr. Kronthal, another risk to the Levee Board involves bankruptcy by the Equity Investor. In his May 29, 1998, memorandum to Mr. Drennen, Mr. Kling pointed out that if the Equity Investor declares bankruptcy that the security interest the Equity Investor has in the investment account could be viewed by the courts as assets of the Equity Investor available to satisfy debts of the entity. He further stated this would leave the Levee Board still liable under the sublease for debt payments with no remaining assets to cover the obligation.

D. Lending Institution Illegality Risk

There is risk that involvement by the Lending Institution, if a foreign entity, may become illegal by a change in the laws of that entity's country.

Mr. Kronthal advised the Levee Board that this risk is highly unlikely. He explained that the transaction is considered domestic; however, the Lending Institution could potentially be a foreign entity. He provided no further explanation of the causes of illegality nor did the Board members request it.

When questioned by IG auditors, Mr. Rabalais explained that a foreign government could pass a law saying the transaction could not be continued by a Lending Institution in its jurisdiction. When asked why the Levee Board would have to accept a risk involving the loan between the Lending Institution and the Equity Investor, he advised that equity investors are unwilling to accept this risk and it must be borne by the government entity.

E. Tax Law Event

As discussed earlier, in the event of a tax law change prior to closing, such as finalization of the proposed IRS regulations, the Levee Board is obligated for various costs including those of other parties in the transaction. Since the Levee Board proceeded with the transaction on Feb. 18, 1998, and the transaction has still not closed, this risk looms heavy at this time.

According to Mr. Huey, once the deal closes the Equity Investor accepts the risk if the tax law changes.

Mr. Kronthal advised the Levee Board that in the event of a tax law change after the closing it is highly unlikely that the Levee Board could become liable for federal taxes before it could exercise the fixed purchase option. He said there has never been the imposition of a retroactive tax in such a transaction.

He also advised that the Levee Board does not bear any risk on the tax structure of the transaction as it relates to the Equity Investor, if the Equity Investor's conclusion on what it is permitted to do is incorrect.

However, Mr. Kling's memorandum dated May 29, 1998, to Mr. Drennen points out that the Levee Board's federal tax risk exposure is governed by the representations, warranties and disclosure of factual matters within its control. If any of these prove to be defective then a change in the tax code which has a detrimental effect on the Equity Investor shifts to the Levee Board.

Because the tax treatment of this transaction, to a great extent, is dependent upon the Levee Board's representations, warranties and disclosure of factual matters, the Board is at great risk in becoming embroiled in any disputes or litigation that arises if the IRS disallows this transaction.

F. Tax Indemnity

The Levee Board is responsible for indemnifying the Equity Investor for all current and future taxes, except federal income taxes that may become payable in relation to the lease. This would include franchise, property, sales or any tax payments caused by the Levee Board's acts or omissions.

## G. Net Lease Provision

The transaction is structured as a net lease of the assets to the Equity Investor. As such, the Levee Board continues to be responsible for all amounts with respect to use, ownership, condition, design, and operation of the assets, including tort liability. Consistent with its role, the Levee Board is required to indemnify the Equity Investor and Lending Institution for such payments.

For example, if the Equity Investor is required to pay a legal judgment to someone injured on the bridge, the Levee Board would be required to indemnify the Equity Investor from existing resources.

## H. Lender's Increased Costs

If costs are imposed on the Lending Institution that were not anticipated at the commencement of the transaction, these costs would flow through and be imposed upon the Levee Board.

This risk can be mitigated by negotiating a best efforts obligation on the part of the Lending Institution to move the loan to a jurisdiction not affected by increased costs. If the loan could not be moved, the lease would provide the Levee Board with an opportunity to refinance the loan with another institution.

## I. Flexibility and Control

The assets pledged under the lease would limit the Levee Board's future flexibility to dispose of the assets.

During the Feb. 18, 1998, special Board meeting, Mr. Hearn advised the Board members that there had been previous consideration to give the Senator Ted Hickey bridge to the Louisiana Department of Transportation and Development so it would be responsible for the maintenance costs. He pointed out that once the bridge is leased the Levee Board would have to forego this option and continue maintaining the bridge.

Mr. Kling's memoradum to Mr. Drennen points out that operational flexibility is constrained in regards to the Levee Board's ability to terminate the lease early since this would diminish or completely remove the tax benefits to the Equity Investor.

The presentation materials made a brief reference to insurance that may be required to cover the liability the Levee Board would incur for the Equity Investor's deferred tax obligations in the event of early termination.

J. Breakage Costs

The Levee Board is responsible for paying certain costs in the event the transaction does not close. These costs are known as breakage costs. Presentation materials show different types of breakage categorized as no fault, tax event, and fault.

Fault breakage includes the Levee Board or the Equity Investor arbitrarily terminating the transaction before closing. If the Equity Investor terminates due to reasons under its control, it would be expected to pay its own legal costs but the Levee Board would normally be required to pay all other transaction expenses. If the Levee Board terminates the transaction for any reasons under its control, it is responsible for legal costs of the third parties in addition to its own costs.

In a no fault breakage whereby non-completion of the transaction is outside the control of all parties, the Levee Board is normally required to pay all transaction expenses.

The third type of breakage, a tax event such as the adoption of the proposed IRS regulations, was discussed previously.

During the April 23, 1997, special Board meeting, Mr. Sisung advised the Levee Board that he had participated in $6 billion of underwriting since 1985, but had never participated in a transaction where the agency was at risk if the transaction did not occur. He emphasized that this transaction is unique and creative and would provide significant benefits to the Levee Board. However, he urged each Board member to weigh the risks and understand the rewards.

## *Conclusions:*

1. The Orleans Levee Board prematurely committed itself to the expenditure of more than $1 million for consulting and legal services on a high risk and complicated financing scheme. The Levee Board committed itself unnecessarily before knowing whether the project would be viable under Louisiana law.

2. In our opinion the numerous risks associated with this project are far too great under these circumstances to justify the Levee Board's participation.

## *Recommendation:*

1. We recommend that the scheme not be pursued.

## *Responses:*

Responses from the Levee Board, the Group, and Mr. Kling are attached.

## *IG Comment:*

We have addressed the concerns raised by the Levee Board and the Group in their responses to the draft report and have made changes in our report as warranted. The propensity of the Orleans Levee Board to shift the blame to all others for the potential or probable failure of its ill starred venture is noted.

Further, it is also noted that in its response, the Levee Board failed to address the principal concern of why it pushed forward without having adequate legal advice that it could do so under Louisiana law. The Board's response makes no effort to address the premature consulting engineering contract which may cost it $640,000 with no return.

File No. 1-98-0101
BL/gl/vc/fs

State of Louisiana
DIVISION OF ADMINISTRATION

OFFICE OF THE COMMISSIONER

M. J. "MIKE" FOSTER, JR.
GOVERNOR

MARK C. DRENNEN
COMMISSIONER OF ADMINISTRATION

September 15, 1998

Mr. Bill Lynch
State Inspector General
P. O. Box 94096
Baton Rouge, Louisiana 70804

Dear Mr. Lynch:

Re: File No 1-98-0101 (Orleans Levee District Asset Amortization Program)

I have reviewed the above referenced draft report prepared by your office. The report is in my opinion correct in regards to the stated facts and representations. I appreciate the opportunity to have reviewed and commented.

Sincerely,

Whitman J. Kling, Jr.
Deputy Undersecretary

SEP 16 1998

The Board of Commissioners

OF THE

Orleans Levee District

SUITE 202 - ADMINISTRATION BUILDING
6001 STARS AND STRIPES BLVD.
New Orleans, La.
70126-8006

TEL. 504-243-4000

PROTECTING YOU
AND YOUR FAMILY

October 12, 1998

Hon. Bill Lynch
State Inspector General
Post Office Box 94095
State Capitol Annex
Baton Rouge, LA 70804-9095

RE: Orleans Levee District
Asset Amortization Program
Your File No. 1-98-0101

Dear Mr. Lynch:

I have received and reviewed the draft report provided in connection with your office's investigation of the Orleans Levee Board's Asset Amortization Program. Since your letter of September 10, 1998 indicates that the report provided is only a draft and subject to revision, I respectfully suggest that the matters discussed infra will provide a basis for further refinement of the report.

As President of the Board of Commissioners of the Orleans Levee District, (sometimes hereafter referred to as "OLD"), I take exception to the report in it's present form, for the reasons set forth hereinbelow.

## O V E R V I E W

The report lacks of objectivity in its presentation and analysis. This is especially evident in the use of inflammatory terms such as loophole, paper shuffling, and scheme. These terms, in the manner used, carry pejorative connotations which are offensive to the dignity of the Board and its Members. If in fact what is intended is an analysis of the AAP, the report would have more creditability as such, absent the extensive subjective commentary.

The report also lacks objectivity in that the underlying political/economic ideology inherent in such expressions as "taxpayer expense", and "pockets the interest" is suggestive of a biased philosophical perspective. The report reflects an overriding concern with the more distant and removed prospect of diminished federal corporate tax payments while failing to consider that any funds derived by the OLD will be used to accomplish a public purpose of state and local significance, thereby alleviating the burden of local taxpaying property owners.

In addition, the report purposely includes erroneous statements in an obvious attempt to create shock value. A prime example of this occurs on page 23 of the report (discussed infra) with the allegation that a consulting contract was signed the day before the Board authorized it. The use of such tactics and devices utterly undermines the creditability of the report, taints it's criticisms, and renders it's findings suspect and useless.

## SPECIFIC RESPONSES

What follows is an attempt to identify specific areas or issues within the report to which I take exception. Regarding technical inaccuracies in the report, I have requested that our financial advisors review it, and they have issued a letter dated October 8, 1998, outlining their findings. A photocopy of that letter is attached for your ready reference and is incorporated herein as part of this response to the draft report.

Page 1
The first two paragraphs are riddled with subjective political commentary which has no place in a formal technical report. The use of such inflammatory language is intended to bias the outcome of the report.

Paragraph Three, last line: the terms "possession" and "ownership" were omitted. Since it is a lease, ownership may be assumed, however to understand the concept fully, it is significant to note that the OLD and the public's use of the assets in question would be unimpaired.

Paragraph Four: I do not understand, nor does the report explain, the assertion that the investors would have control over the use of the money for more than two decades. Certainly the OLD will have exclusive control of its portion of the proceeds of the transaction from the date of closing.

"Depository failure" - Since the deposit would be required to be placed in a manner consistent with Louisiana law, the risk for this transaction is no different than for any other investment of funds of Louisiana public bodies.

"Public revenue" - refers to federal taxes. The report curiously omits the term "Federal". The report tries to lead (mislead) the reader to believe it is state or local revenues.

IRS regulations. Maybe pending, but neither adopted, nor retroactive. Furthermore, the report does not offer any information or evidence as to how such action would adversely impact a closed transaction.

Page 3
Regarding Fuji Bank being chartered "under the laws of Japan," the report fails to mention that it is also chartered to do business in the U.S.

Page 5
Relative to Mr. Rabalais and Mr. Sisung - The report fails to acknowledge their background in complex financial agreements leading one to believe their experience is limited. In addition to the reported background, Mr. Rabalais has over 25 years of financial arranging experience, is a professor at Loyola Law School, and holds degrees from Princeton University and Harvard Law School.

Page 8
This list of assets and values are inaccurate as well as the year constructed and remaining useful life. Since the Fuji presentation was prepared these figures have been revised.

Page 11
The sublease payments required will be made by the Trustee on behalf of the OLD from the proceeds being held by the Trustee.

Transaction expenses - these sums are paid at closing as is typical of all closings. The report is not clear that the transaction expenses also include reimbursement to the OLD of enumerated expenses paid in connection with AAP. In fact, the payment of transaction expenses are made concurrent with the OLD's receipt of the net proceeds.

Pays the Group - Again the transactions at closing occur contemporaneously with the Board's receipt of its reimbursements and proceeds. Furthermore, the report appears to purposely understate The Group's efforts in relation to the fee earned.

Page 12
Board "then" retains for itself. All transactions occur simultaneously.

"Any necessary legal judgments?" We are unclear as to what is meant here.

"Other Transaction Costs": The report mentions costs associated with protracted negotiations, however it fails to mention that responding to questions and issues raised by the Division of Administration, the Inspector General, and the Governor's Office, have significantly increased the OLD's legal costs and other expenses. Answering hypothetical questions, conducting additional research, participating in additional meetings and investigations, postponing or delaying transactions to accommodate additional inquiry and review have appreciably increased the OLD's "other transaction costs." This in unfortunate since none of the foregoing has identified anything "illegal" or any other valid reason why the OLD should not proceed with the AAP.

"OLB is responsible at all times to cover for the inability of the Depository Institution to make required payments." Since the issue is economically defeased and the interest rates are locked in for the investments and the Depository Institution is an AAA rated institution, the Board assumes no more risk than in a defeased bond issue.

Page 13
"Termination of Sublease - " The report offers a hypothetical condition in which the Board may not conclude the lease at the end of 22 years. The report however does not offer any reason(s) why the Board would choose not to exercise the FPO. It is not realistic to assume that the OLD would not exercise the option, and without other reasons why the hypothetical situation would come to fruition it is difficult to respond to this contention. Certainly we could hypothesize any number of unlikely situations that might occur. Given the nature and structure of the transaction, there is every incentive for the Board to exercise the FPO on time and not delay.

"Trustee gains control of assets if the FPO is not exercised." This is a continuation of the above referenced hypothetical. Clearly the Board, future and present, must and will exercise the FPO at the earlier date.

Page 16 TAX LOOPHOLE

"Questionable judgement ... Questionable Federal Tax Law Loophole": The report once again resorts to subjective, judgmental opinions without any authoritative basis. The OLD considered the AAP as a means of bolstering a budget that has been victimized by an unsympathetic legislature; the resulting loss of a major revenue source, the Bohemia Spillway properties; litigation expense in connection therewith; and, prior major capital expenditures. Confronted with these circumstances, it is laudable that the OLD sought to cure it's own financial ills.

Absent from the report is the fact that the AAP, as a funding mechanism, has worked for other political subdivisions and agencies in other states, and locally, for the Regional Transit Authority in New Orleans. Accordingly, the OLD was not unreasonable in pursuing this funding mechanism. The State should take note and the OLD should be commended for it's leadership in pursuing an alternate means of securing millions for public purposes, with little and very controlled risk to it's assets.

No evidence is presented that allows an objective conclusion to be derived that the Board's judgement was anything other than prudent application of economic principles by the OLD for the public's gain.

The only suggestion given that the OLD acted improvidently is that ABN AMRO proposed to put together the deal without cost to the OLD. The old adages that "if it's too good to be true" ... "you get what you pay for"... and that "there's no such thing as a free lunch" come to mind. The Board had the opportunity to listen to and evaluate the ABN AMRO proposal. It is certainly significant that the proposal was not in writing and clearly ABN AMRO was not familiar with the OLD and/or its assets.

The report attempts to second guess the Board, strictly on price, and without the benefit of having been there. This type of second guessing, Monday morning arm chair quarterbacking, should be reserved for football and not analytical governmental reports.

Page 17
Depiction as tax loophole: The word "loophole" is intended to inflame and create bias against the proposal. This is a federal tax incentive, not State. Despite the report's obvious suggestions to the contrary, the Federal government is aware of the Tax Code provisions permitting the advantages to be derived from this type of transaction. The fact that Congress has not seen fit to amend the Tax Code to prohibit such can only be construed as the Congressional intent to allow corporate and public entities to continue to avail themselves of these provisions, at least until such time as amendments are enacted. There is no reason to believe, nor does the report offer one, that the Tax Code will be amended prior to the OLD consummating an AAP transaction.

Page 20 "LEGALITY": The report fails to provide any authority to support the contention that the OLD does not have legal authority to proceed nor is any provided to suggest that the transaction is contrary to Louisiana law. Indeed, the RTA's experience indicates to the contrary. If a legal opinion exists outlining the positions adopted implicitly in the report, then why not share this information with the OLD?

Regarding the Senator Ted Hickey Bridge, the indication is that certain curative title work is required in order to perfect the OLD's ownership interest. Curative title work is quite common in commercial real estate transactions.

Page 21 The report mentions Governor Foster's involvement in the AAP and the requirement that a "go ahead" opinion be obtained from the Attorney General. The report, however, fails to update these matters.

At a meeting on July 22, 1998, with James P. Huey and Terry Ryder present, Governor Foster relieved the OLD of the requirement to obtain an Attorney General's opinion prior to proceeding, and revised the conditions to be met for closing. These conditions are set forth in correspondence from James P. Huey to Terry Ryder, dated July 29, 1998, and confirmed by Terry Ryder in his letter to James P. Huey dated July 30, 1998. For your ready reference, photocopies of these letters are attached hereto.

Accordingly, the report, as of the time written, is inaccurate regarding the requirements imposed by the Governor. Furthermore, it is interesting to note that the report states that the Foley and Judell firm was engaged by the Attorney General's Office and assigned to research the legality of the AAP in April of 1998. As early as September 25, 1997, Mr. Mark Drennen, Secretary of the Division of Administration suggested that he would engage counsel to research the legality of the AAP. To date, more than a year later and the OLD is unaware of any opinion having been issued. Nonetheless, the lack of a legal opinion has not deterred the report from repeated criticism of the Board concerning the AAP's legality. Absent some citation of legal authority or reasons supporting this contention, this criticism is unwarranted, unreasonable and irresponsible.

Page 23
Premature contractual obligation: February 17, 1998 - This is clearly a red herring issue, included solely to create controversy by recklessly accusing James P. Huey, individually, of wrongdoing. A full explanation of this matter has previously been given. In sum the discrepancy is a clerical one which occurred when inserting the date into the contract after it had been executed by the parties.

In fact, the contract was signed on 2/18/98, subsequent to the Board Meeting, and in the presence of the commissioners; Mr. Max Hearn, the executive director; Mr. Steven Spencer, the Chief Engineer; Mr. James Bollinger, the assistant comptroller; and Mr. Gary Benoit, the Board's staff attorney. Certainly there are sufficient witnesses available to the Inspector General's investigators that are able to verify the date the contract was executed, had the investigators desired to ascertain this information.

Page 24
Retroactive fee: The term retroactive is misleading. Design Engineering's services were provided without obligation, except in the event the Board decided to move forward with the AAP. Accordingly, DEI assumed the risk entirely for services performed from December, 1996 through February 18, 1998. If the Board did not elect to proceed with the Asset Amortization Program on February 18, 1998, no fee was due. Furthermore, the fees that would become due if the matter proceeded were known. The Board could have elected not to proceed and pay nothing for the work performed between 1996 and 1998. The report fails to mention these additional facts in it's criticism of the Board's actions.

Pages 26 - 27: The OLD would reiterate the information presented supra relative to the meeting with Governor Foster on July 22, 1998, and the correspondence issued and received in connection therewith. Further, while the report seems to place a substantial significance on the Board obtaining an Attorney General's opinion, it should be noted that such opinions are only advisory, and not legally binding. The OLD would not have any recourse against the Attorney General in the event his opinion proved to be contrary to law. On the other hand, the OLD would and does have legal recourse against it's outside counsel under these circumstances. Accordingly, the OLD's interests were better protected, i.e. it was more prudent, to rely on the opinion of outside, private counsel.

<u>Page 28 "The Toll Issue"</u> : The Toll issue has been resolved. The Godfrey firm has issued an "unqualified" opinion on the matter and the Phelps firm is no longer serving as AAP counsel.

<u>Pages 30-31 "The Title Issue"</u>: Please see response given at Page 6, supra, relative to this issue in connection with the "Legality" section (draft report page 20), regarding the Senator Ted Hickey Bridge.

## C O N C L U S I O N

For the foregoing reasons, the draft report is not accurate, and its findings erroneous. The report in its present form should not be submitted to or approved by the Governor, as its release would only serve to recklessly undermine and denigrate the credit and dignity of the State of Louisiana, its citizens, and the OLD. As a further unfortunate consequence, the report would certainly dissuade any potential equity investor from considering an asset amortization transaction in the State of Louisiana, and most assuredly guarantee that the efforts and resources invested by the Orleans Levee District will be lost.

The present Board of Commissioners of the Orleans Levee Board has maintained an open door policy and has strived to foster a spirit of cooperation with all levels and divisions of state and local government. If the purpose of the Inspector General's review of the Asset Amortization Program is to present a report which is factually accurate and precise in its analysis of the technical aspects of the transaction, I would welcome the opportunity to further assist the Inspector General's staff in this endeavor.

Sincerely,

James P. Huey

**JAMES P. HUEY,**
**PRESIDENT**

JPH/lac
Enclosures

cc: All Commissioners, w/enc.

October 8, 1998

Mr. James Huey
President
Board of Commissioners
Orleans Levee District
Suite 202 Administration Building
N.O. Lakefront Airport
New Orleans, Louisiana 70126

Re: **Office of State Inspector General ("IG") Draft Report on Asset Amortization Program ("AAP")(File No. 1-98-0101, "Draft Report").**

Dear President Huey:

First National Bank of Commerce, United Properties Corporation, The Fuji Bank, Limited and The Fuji Bank & Trust Company (collectively the "Arrangers"), are pleased for this opportunity to comment on the above referenced report. Our review was directed toward the technical/structural accuracy of this highly complex financial product as reported by the IG's office with some comments on interpretations applied by the IG's office to the AAP.

<u>General Comments</u>

We recognize the extensive efforts of the Office of State Inspector General to understand a highly complex financial product developed by specialized tax counsel dedicated to interpreting the relevant IRS code provisions and structured by leasing professionals with many years of experience in this field.

<u>While the Draft Report raises some important issues it also contains significant inaccuracies which may lead to inappropriate conclusions. We submit the following response for your review:</u>

1. <u>Investor Returns/Tax Benefits.</u> The Draft Report points out the difficulty "...to determine even a ball park figure on how much tax benefits the private investors would realize..." and yet refers to "huge tax deductions" available to investors. This contradiction is significant in that the Arrangers are able, to a reasonable level of accuracy, through use of sophisticated and specialized software and general market knowledge, to approximate the investor's return, which return is typical for transactions of this nature with other municipal entities. In any event, the determination of the investor's return is only one factor in the decision process of the Levee Board whether to close the transaction.

2. "...give the investors...control over use of the money..." (pg. 1, para. 4) We are uncertain of the meaning of this sentence. The upfront benefit delivered to the Levee Board is unrestricted as to use and the funds dedicated to the economic defeasance of the debt and equity components belong to the Levee Board.

3. Public Tax Revenues. The AAP is able to provide benefits to public sector entities as permitted under current IRS code provisions in a manner which is not conceptually different from all tax-exempt bond issuances in Louisiana.

Specific Comments
(Note: the Draft Report's use of incorrect percentage and dollar amounts is ignored if not material to structural risk issues)

1. Levee Board Costs. No contractual obligation currently exists for legal costs to the Equity Investor and Lending Institution of $425,000 as stated in the Draft Report (pg. 8).

2. Lease Steps/Initial Cash Flows.
Pg. 10, Para. 4. Trustee leases the assets and prepays a portion of, not the entire, $180mm cost of the leased assets in the illustration which is used.
Pg. 10, Para. 6. Trustee does not require the Depository Institution to be an Affiliate of the Lending Institution. The depository generally is an Affiliate of the Lending Institution to achieve matching deposit and lending rates, which benefit the Levee Board.

3. Lease Steps/Fixed Purchase Option.
Pg. 13, Para. 15. No residual funds should exist at the FPO (fixed purchase option) date since the Equity and Debt are economically defeased.
Pg. 13, Para. 17. There are no interest earnings for the Equity to "pocket" because all funds are accounted for under the leases.

4. Lease Steps/Termination of Lease.
Pg. 13/14, Para. 19. Deferring the second head lease payment by 5 years increases the present value benefit to the Levee Board.

5. Benefits/Equity Investor. This section appears to be the Draft Report's attempt to determine the return to the Equity even though it was deemed to be impossible in the beginning of the report to "...determine even a ball park figure...". The referenced 6.1% annual return is not a return to the Equity Investor, rather, this return is for the account of the Levee Board to meet its future rental obligations in the illustration which is discussed.

The Draft Report lacks balance, as no discussion of the Equity Investor's risks is discussed to justify its return. The following are risks undertaken by the Equity independent of any credit related issues of the Levee Board:

a. Possible IRS action to disallow deductions after the closing.
b. Possible Change in Federal tax rates, which may negatively impact Equity's return.

c. Possibility that Equity Investor's tax position becomes negative.

6. The Risks/Default Risk. Reference on Pg. 33 of the Draft Report to a 5/29/98 memorandum from Mr. Kling to Mr. Dremmen states the possibility of the Equity Investor requiring the Levee Board to renegotiate the lease, which may include unfavorable terms. This event is not possible as all rents are pre-negotiated and determined by an appraiser to be fair market value rents.

7. Bankruptcy Risk/Defeasance Risk. The issue of a bankruptcy of the Equity Investor leading to a disruption of the Levee Board's operations and the public mandate is highly complex. There is no certainty that in an event of an Equity bankruptcy the AAP will be disrupted.

Summary

The Draft Report represents an effort to analyze a highly specialized structure (the AAP) with a limited number of market participants. This has obviously hampered a full understanding of all the highly technical structural, legal and tax issues. Suggestions that the AAP is abusive with respect to the tax code or exploitative of the public trust are misleading at best. We believe a further in depth study by the IG will result in a better understanding of the benefits and risks of this program and will require greater accuracy.

The procedural path taken by the Commissioners of the Orleans Levee District Board, which included significant legal review prior to authorization to proceed, as confirmed by information in the Draft Report, indicates a conservative approach toward undertaking risk. The risks inherent in the AAP have received the benefit of extensive analysis by over 25 major public sector entities and their attendant boards, advisors and elected officials and have been found to be appropriate for the entities to undertake.

Sincerely,

The Fuji Bank & Trust Co.

First National Bank of Commerce

The Fuji Bank, Limited
New York Branch

United Properties Corporation

The Board of Commissioners

OF THE

Orleans Levee District

SUITE 202 - ADMINISTRATION BUILDING
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PROTECTING YOU
AND YOUR FAMILY

July 29, 1998

**VIA FACSIMILE: (504) 342-5598**
**and U.S. MAIL**

J. Terry Ryder, Esq.
Office of the Governor
Post Office Box 94004
Baton Rouge, Louisiana 70804-90004

RE: Asset Amortization

Dear Terry:

I am writing this in follow-up to our meetings on Wednesday, July 22, 1998, in connection with the above-referenced matter. As a result thereof, it is my understanding that Governor Foster has authorized the Orleans Levee District to proceed with the Asset Amortization Program, provided that the following requirements are satisfied:

1) An unqualified legal opinion as to the legality of the Asset Amortization Program and the Orleans Levee District's ability to fulfill it's obligations in connection therewith;

2) That the attorneys rendering the opinion should have sufficient errors and omissions coverage; and

3) The Orleans Levee District should substantiate the availability of insurance coverage, in the event that it would be required to indemnify the equity provider under the terms of the agreement.

Accordingly, it was my understanding that, in light of the foregoing, we would no longer be required to wait for issuance of the Attorney General's opinion previously requested, nor the formulation of a uniform state policy relative to this type of transaction in general.

I will be advising the Asset Amortization team as to the referenced prerequisites and will present evidence of the satisfaction of same to you.

Should any of the foregoing not comport with your recollection of our meeting, please advise me immediately.

I appreciate the opportunity to meet with you and Governor Foster, and the time and efforts spent assisting us in this matter.

Very truly yours,

James P. Huey

JAMES P. HUEY
President

cc: Hon. Governor M.J. "Mike" Foster
Mr. Max Hearn
Gary G. Benoit, Esq.
Frank A. Milanese, Esq.

State of Louisiana

OFFICE OF THE GOVERNOR

M. J. "MIKE" FOSTER, JR.
GOVERNOR

J. TERRY RYDER
SPECIAL COUNSEL
DEPUTY CHIEF OF STAFF

July 30, 1998

James P. Huey, President
Orleans Levee District
Suite 202 - Administration Building
6001 Stars and Stripes Blvd.
New Orleans, LA 70126-8006

Dear Jim:

After review of your letter of July 29, 1998, I concur with its description of the discussions which took place in our meetings of July 22, 1998, with the following caveats.

Consistent with our position in other Orleans Levee District decisions, or for that matter issues before other political subdivisions of the state, whether or not the Orleans Levee District Board proceeds with the Asset Amortization proposal before it is a matter for the board to decide based upon the board's priorities and all information available to it. It is the board and not the governor's office which is statutorily authorized and responsible for the board's decisions on matters which are properly before it. Thus, it would be inaccurate to characterize our position as "authorizing" such actions.

Should the Board vote to proceed, we would caution that the unqualified legal opinion, the professional liability coverage and the indemnification coverage referenced in your letter be very specific and air-tight to ensure that the interests of the district and thus the citizens protected thereby are thoroughly protected in the event of the failure of the transaction, however remote the risk may be.

Please provide this correspondence to other board members for their information.

Thank you for your communication and efforts in this regard.

Sincerely,

Terry

J. Terry Ryder

mtj