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Synthetic Leases After FIN 46: As FASB Issues New Accounting Rules, the Future Remains Unclear

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Earlier this year, after lengthy debate both internally within the Financial Accounting Standards Board (FASB) and industry groups,[1] the FASB finally issued FASB Interpretation No. 46, entitled "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51."

More than a year of anticipation and post-Enron fallout preceded this pronouncement, so the rippling shock waves barely jolted the Richter scales of banks and corporate users of synthetic leases. As seemingly daily press releases of new indictments and settlements continue to report unimagined levels of corporate greed and financial manipulations, it is becoming more apparent that the real evils are not off-balance sheet leases—synthetic or other. Rather, the sudden drops into bankruptcy or similar liquidity crises of numerous blue-chip "wannabes" such as Enron, Global Crossing, Tyco, Worldcom, and Qualcomm since Fall 2001, and major earnings restatements of prior years' results, were triggered by sham fabrications of financings disguised as sales to generate revenue and earnings.

Because bogus deals, such as the "round-tripping" or global cable and telecom swaps, and the sale of energy through aptly named Mahonia entities[2] or Liberian barges,[3] utilized bank-formed special-purpose entities, the immediate reaction was to shut down special purpose entities (SPEs), by requiring the consolidation of the SPE, virtually without regard to the economic substance of the transaction.

To its credit, the FASB recognized the legitimacy of single-purpose ownership entities for real estate and equipment, and securitization of receivables and other financial assets, and partially modified the ban on SPEs. First, it exempted[4] qualifying SPEs meeting the criteria of FAS 140 used in securitizations of financial assets. The FASB then created a new category called "variable-interest entities" or VIEs, in which different entities—owners, investors, managers, lenders, and operators—may have divergent interests in the outcome of transactions.

WHAT'S A VIE?

VIEs (not to be confused with "voting interest entities") may be trusts, limited liability partnerships, or limited liability companies, or they may take any other legal form, but their common thread is that decisionmaking and control are not strictly determined by ownership interests or attributes—as contrasted with voting interest entities. The latter can either issue separate financial statements, or may be consolidated with a parent. However, a VIE must be carefully scrutinized to determine which, among its competing and often supportive interests, is the primary beneficiary of the VIE. This is generally stated as first, the party that would absorb a majority of the entity's expected losses and sec-

ond, the party slated to receive the majority of the residual return or gain, or both.

The test for determining whether an ownership entity is a VIE is basically whether it possesses *any* of these attributes:

1. Equity investors are unable to make decisions through exercise of their voting rights.
2. The total equity at risk is insufficient to finance the entity's operations without additional financial support from other entities, such as lenders, subordinated debt providers, the lessee, or related parties, or is less than or equal to expected losses.
3. Voting rights and returns and risk and reward analysis are not commensurate.
4. Equity investors do not have the right to receive expected residual returns because, for example, their return is capped.
5. Equity investors are shielded from expected losses through guaranteed returns or similar arrangements.

It should be noted, however, that the infusion of true equity capital at risk in amounts sufficient to withstand reasonably expected losses generally would be sufficient for an entity to fail all of these tests.

SAFE HARBOR

The originally proposed equity "safe harbor" of 10 percent[5] has been modified into a rebuttable presumption of insufficiency. Thus, if a trust or LLC were to develop or purchase real estate for lease, and were to have equity capital at risk throughout the life of the lease and any subsequent ownership period, 10 percent equity might well suffice, but if the nature of the property warranted great equity to absorb expected losses, more might be required. If, however, the property owner entered into a long-term lease with a strong credit tenant, 10 percent equity, or in some cases, even less, might well suffice. This threshold in FIN 46 may be drawn from Para. 54 of FAS 66,[6] in which 10 percent is listed as an acceptable minimum for properties leased to credit tenants (CTL financings).

However, many CTL transactions can be done with 5 percent[7] or less equity, depending on the strength of the property's residual value, the property type, and the long-term credit profile of the tenant.[8] The rule leaves the adequacy of the equity in an entity seeking to finance leased property to a case-by-case determination, which can certainly vary with the term of the lease, the credit of the tenants, the nature of the financing, and, in some cases, the property type as it affects expected residual value. For example, a non-recourse mortgage for a fairly short term of perhaps five-to-seven years on a healthcare facility, hotel, or movie theater leased to a non-credit tenant (i.e. an experienced, but not financially strong, unrated or subinvestment-grade operator) would probably require minimum equity of 30 percent to 40 percent, if only to cover the cost of vacancy and renovation or conversion if the tenant should default or fail to renew the lease. By contrast, a well-located office headquarters building leased for 20 years to an investment-grade tenant at or below a market rent could probably be financed with minimal equity of 5 percent if the financing were structured to be substantially self-amortizing and the rent stream was sufficient to amortize the debt.[9] The same property could also be financed with an 85 percent to 90 percent loan-to-value mortgage in the conventional 10-year market with 10 percent to 15 percent equity.

While lessor characterization as a VIE is not necessarily fatal, it generally would preclude off-balance-sheet lease treatment for corporate lessees in synthetic leases and other structured lease financings in which either the lessee provided a residual value guarantee or residual value guarantee (RVG)[10] and/or had a typical synthetic lease purchase option.[11] This combination of residual risk and benefit on the part of the lessee would make the lessee the primary beneficiary, and require it to consolidate the assets (*i.e.*, the property) and liabilities (*i.e.*, the loan) of the VIE lessor. Obviously, this treatment would defeat the purposes of the synthetic lease, and make a more conventional secured or unsecured loan financing a more attractive option.[12]

BUSINESS AS USUAL?

If and when corporate lessees become more comfortable with the new rules, and the taint disappears from so-called synthetic structures, it should be relatively straightforward to avoid classification as a VIE, and conduct synthetic leasing business as usual with 10 percent equity, plus or minus a few points,[13] and a few other bells and whistles. The requirement of 10 percent equity will alter somewhat the economic profile of the synthetic lease, as some amortization may be required to make lender/lessors comfortable with the risks inherent in the FIN 46 "equity" requirement, as defined in practice.[14] It remains unclear whether synthetic lessee auditors will continue to treat the usual RVG as a first-loss cushion, or the triggering level will be deferred until after the equity has been lost. The common

lessee guarantee of a portion of the lender/lessor's debt may also be problematic, as inconsistent with the true risk equity required to avoid VIE classification.

For example, if bank equity sponsors of synthetic leases can no longer retrieve their 10 percent equity on a "first-out" basis, or the RVG cannot be invoked by the sponsor/equity investor until after the debt is fully satisfied and the equity has been exhausted, the equity is likely to require a level of return commensurate with true real estate risk, as well as some amortization. Another approach may be to modify the automatic purchase option structure in the typical synthetic to provide some residual upside for the equity investor. All of this moves the structure closer to the more traditional world of real estate financing, presenting other issues.[15]

Some corporate properties will find more traditional non-bank financing for properties with strong residual values as attractive alternatives to the synthetic, without the complexity and accounting scrutiny.

It is, however, also possible that the auditors of public companies may analyze particular synthetic-type leases and find that the presence of an RVG is not fatal. Such cases might include, for example, well-located generic properties such as a newly constructed, efficiently built corporate headquarters whose projected residual value at the end of the synthetic lease term is greater than the unamortized lease investment balance. This could occur either because the lease amortized a portion of the debt, or because the estimated future residual value was determined by expert opinion to be particularly strong. In such cases, the auditors could determine that the RVG was highly unlikely to be invoked—essentially an "out of the money" guarantee that was requested by a conservative lender. This conclusion also would minimize or avoid a charge against earnings for the amortized cost of the lessee's guarantee.

THE FUTURE

During the past 18 months, relatively few new synthetic leases were initiated, and several large programs were collapsed in an effort to improve corporate transparency. The limited clarity now being provided by FIN 46, along with some creative use of established real estate valuation techniques, could produce more comfortable renewals and some restructured synthetic lease programs. Some corporate properties will find more traditional non-bank financing for properties with strong residual values as attractive alternatives to the synthetic, without the complexity and accounting scrutiny. Special purpose properties, as well as older or less well-located properties, will probably find credit-oriented synthetic variations to be most advantageous to their income statement, utilizing some form of RVG as a substitute for amortization. The option of a long-term full amortization CTL financing remains if tax-exempt or sheltered lessors can absorb potential phantom income.

It is also likely that the longer-term CTL financing structures, or newer hybrid credit lease programs will combine sufficient equity (*i.e*, 10 percent or more) to avoid VIE treatment with low-cost renewable or long-term debt available in the credit markets. These could emerge to supplement and replace the synthetic lease. Unlike the short-term synthetic lease, a longer credit-lease term permits some amortization, which could reconcile "balloon" risk with conservatively estimated future residual values. This type of structure would serve to reduce the residual risk to the equity provider, as well as to the lender.[16]

BANKRUPTCY CONCERNS

Another uncertainty, not yet considered in depth, is the effect of FIN 46's greater equity requirement and risk/reward analysis on the characterization of these credit leases in bankruptcy. All synthetics and many CTL leases contain acknowledgments that the lease are not intended to be "true" leases for bankruptcy purposes, and may not be rejected or disaffirmed. The desired result is acceptance of the lessor/lender's right of acceleration of rents, and succession to the role of secured creditor. While bankruptcy courts have often viewed these provisions favorably, as lessor equity risk increases along with residual returns, bank and financial institutions serving as accommodation lessors begin to look less like lenders and more like landlords.[17] The counterpoint is that the rent structure in a credit lease more closely resembles the repayment stream on a credit facility than the normally higher market rent schedule, and

that the lessor/lender was induced to offer a below-market rent because of the acceleration and other credit terms. Ultimately, the bankruptcy courts will have to unravel to many facets of this threshold issue, and in the interim, banks and other lessors/lenders will choose their credit tenant borrowers more carefully than ever, especially if a renewal or refinancing of shorter-term credit facilities is required.[18]

NOTES

1. FASB received and digested more than 140 comment letters, and held several public meetings.
2. The Mahonias were SPEs formed by or for J.P.Morgan Chase to facilitate an Enron financing reported as a series of energy sales. Delivery, and repayment of the loans, was to be guaranteed by surety bonds obtained from insurance companies. Unfortunately for Chase, the insurance companies refused to honor the surety bonds, claiming fraud and misrepresentation. The case was settled in early Spring 2003. This sale and repurchase of energy was designed to avoid the incurrence of debt, and generate income-producing revenue, when the repurchase occurred at a higher price including interest accrued to the "lenders."
3. The Liberian barges were the vehicles for another short-term loan from Merrill Lynch to Enron. Masked as a sale of the barges to a Merrill SPE, Enron's since-indicted CFO, Andrew Fastow, reportedly "guaranteed" to arrange a repurchase of the barges at a profit equal to the interest expense. This served dual purposes: It concealed the liability from Enron's balance sheet, but more importantly, it forged the appearance of a sale at a gain.
4. Other exemptions were carved out for employee benefit plans, non-profits, investment company subsidiaries, life insurance separate accounts, and virtual SPEs.
5. Under EITF 90-15, as further delineated in EITF 96-21, a minimum of 3 percent equity was a safe harbor for SPE lessors of synthetic leases.
6. Para. 54 includes the minimum down-payment/equity for certain types of non-recourse mortgage loans.
7. Unlike conventional real estate mortgage financings, which rely on a property's residual value, CTL bond issues purchased by insurance companies and pension funds (functioning as lenders) rely primarily on the rent stream from CTL leases to substantially amortize their debt, and will accept not more than 5 percent of unamortized residnal value risk. This maximum "balloon" risk is codified in regulations of the National Association of Insurance Commissioners.
8. While CTL bond investors will only accept high-investment-grade credits, regardless of property type, other lenders may rely on the superior location and generic residual values of leased office buildings and distribution facilities, while according less respect to the residual values of special-purpose facilities of hospitality and entertainment facilities, which are likely ro find fewer new users in rhe event of property vacancy.
9. This type of full-amortization financing is suitable for either tax-exempt investors (*i.e.*, certain public pension funds) or investors who have available tax shelter or plan to enter into Section 1031 exchanges of "like kind" properties. Long-term amortizing financings produce "phantom" income when taxable income exceeds cumulative deductions for depreciation and interest expense.
10. The lessee's RVG typically requires the lessee to arrange for a full takeout through a sale to a third party, exercise of the lessee's purchase option or refinancing for an amount sufficient to repay the lessor's non-amortizing financing at the end of the short lease term. The lessee's alternative is to pay a "contingent rent" of up to approximately 85 percent of the original cost. Thus, the lessee assumes a first loss position in the event of any decline in the property's residual value.
11. The synthetic lessee usually has a purchase option at the lessees' unamortized lease investment cost, which would include all debt and equity, plus cumulative interest on the debt and accrued return on equity. In such cases, the lessor has no positive residual interest and is essentially a lender.
12. In synthetic leases, the lessee gains the dual benefit of off-balance sheet accounting treatment and tax ownership. It can deduct interest expense (which remaius constant in a non-amortizing structure), plus tax depreciation from taxable income, while it avoids charges to income for book depreciation. Once the property and the financing are both on the books, the maximum tax deduction would result from a non-amortizing "bullet" note whenever the lessee's credit permits issuance at reasonable rates.
13. As previously noted, the rules permit rebuttal of the 10 percent presumption and investment of less equity based on a quantitative showing that it can finance its operations without additional subordinated financial support; that other lessors also operate with less than 10 percent equity; and that the equity invested is sufficient to absorb all reasonably expected losses. The mere inclusion of an RVG would, however, that the lenders believed there was a need for additional subordinated financing, and this would suggest the potential need for at least 10 percent equity.
14. FIN 46 leaves open several key issues for case-by-case concept definitions applied in practice and the FASB has declined to issue advisory opinions.
15. The tax analysis may be affected by these modifications, although the lessee's retention of tax ownership is not the primary benefit of the synthetic structure. *See also* "Bankruptcy Concerns" herein.
16. It also moves this form of finance lease closer to the limited-amortization lease funded through conventional 10-year commercial mortgages, although single-tenant properties are disfavored in the wholesale CMBS mortgage market.
17. Bank counsel have been less comfortable with certain types of "hybrid" credit-tenant leases in which the lease economics of the rent determination, and renewal and purchase options more closely resemble a conventional lease than a financing. Arguably, the key concept in all finance-type leases of formulating rents based on fixed or indexed financing costs and fixed or floating "equity" returns is sufficiently clear to snpport enforceability of the "true lease disclaimer" clanse.
18. Assuming a strong credit tenant, the use of short-term credit facilities involving little or no renewal or replacement risk should not affect either accounting or bankruptcy characterization.