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Synthetic and Other Structured Leases After Enron: A Halftime Update on Proposed Accounting Reforms

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The August issue of Real Estate Finance reported on the accounting industry's reaction to the public crisis in confidence in financial reporting and the prospective impact on certain key segments of the real estate leasing markets.[1] Recently, the Financial Accounting Standards Board (FASB) took a new approach to the consolidation of special purpose entities (SPEs) in an Exposure Draft appropriately captioned, "Proposed Interpretation-Consolidation of Certain Special Purpose Entities: An Interpretation of ARB No. 51."

Instead of continuing its focus on voting control of SPEs, including so-called "orphaned" SPEs that service the multibillion-dollar synthetic lease industry, the FASB took a giant step forward by moving toward an analysis of risks and rewards. The resulting release emphasized primary and variable interests in a transaction involving SPEs and would force consolidation of an SPE's assets and liabilities on the lessee, if it provided a residual value guarantee (RVG) or if the SPE did not have sufficient capital to absorb all conceivable risks, with 10 percent true at-risk equity set as a minimum but not as a safe harbor. The lender or parent/organizer of the SPE would have to consolidate the SPE in most other cases, with duplication of assets and liabilities imposed on lenders that must carry both the leased real estate asset and the loan. Preferred status was indirectly granted to lessors qualifying as substantive operating enterprises or SOEs—generally larger public or private real estate enterprises or multiasset leasing companies to which neither the minimum risk equity nor the RVG constraints would apply.

This response to the universally condemned abuses of SPEs designed to conceal economic debt and risk appears to be an overreaction that elevates form over substance; in this case, the evil SPE that was seized on by Enron, Global Crossing, WorldCom, and other purveyors of "Generally Manipulated Accounting Principles," or GMAP. This "blunderbuss"[2] approach could threaten the existence and effective continuation of the multibillion-dollar credit-tenant-lease (CTL) industry, as well as the synthetic lease structure itself. By focusing exclusively on SPEs as owners of real estate,[3] instead of analyzing the economic merits of each transaction, the proposed rules require more and different kinds of upfront equity in I.R.C. § 1031 exchanges of real property, as well as in sale-leasebacks, than previously required and discourages credit lenders in hybrid CTL-type transactions from financing or investing in either traditional CTL bond-type transactions or financing 1031 purchases. Even non-traditional commercial mortgage lenders, such as mortgage REITs and CMBS conduit lenders, could be enveloped in these

new rules and required to consolidate both the properties and the loans.

THE PROBLEM WITH OFF-BALANCE-SHEET LEASING

The problems of understating liabilities and expenses, while overstating assets and earnings, are not unique to leasing or real estate. More often than not, the abusive fabrications and roundtrip exchanges of assets involved SPEs effectively controlled by the borrower or a friendly lender but did not involve a real estate lease. The off-balance-sheet aspect of the transaction and the convenient use of an SPE to shield lenders from unwanted risks frequently were used to disguise a loan and, even more abhorrent, to fabricate income-producing transactions to meet Wall Street projections. However, these creative practitioners of GMAP were operating in a world far from synthetic and CTL leases and 1031 exchanges, which also happen to use SPEs in their legitimate operating leased transactions.

Consider a few off-balance-sheet leases in which the real property is owned by an SPE to see if they meet the new reporting integrity and transparency standards.

Legitimate Synthetic Leasing Option

Company A, an A+-rated Fortune 1000 public company, wants to build or acquire a piece of real estate for use as a regional office at a total estimated cost of $100 million. It has identified the property and negotiated the price. In addition, company A can work with D, a preferred builder/developer that knows A's specifications and requirements and is willing to build the office either for resale to company A or for lease to company A for a long or short term. All parties agree the location is excellent, and the expectation is that the property will retain its value or appreciate over the next five to seven years. Company A wants the lowest possible rent, and because it is uncertain of its regional business needs beyond the next five to seven years, it prefers to lease rather than to own. Company A can choose a five-year synthetic lease, with the rent reduced from a standard real estate rent to slightly more than the interest on a five-year loan from a credit lender (perhaps LIBOR plus 100 bps (currently about 3 percent) for an A-range credit), or it can ask D to finance the project and issue a five-year lease. If D has to provide substantial real estate equity, usually 10 percent to 20 percent commanding a higher 6 percent to 8 percent return, and finance the project in the longer-term mortgage markets[4]—perhaps at a fixed rate of the 10-year Treasury note yield plus 250 bps (currently about 6.25 percent)—it will have to charge a much higher rent to cover these financing costs and set aside a reserve for the possible re-leasing risk after the initial lease term.[5] If, however, company A provides an RVG[6] and obtains financing from one of its relationship banks through a synthetic lease, D can either remain as lessor—with or without significant equity—or confine its role to builder/developer financing. Company A's annual rent might be $3.25 million, as compared to as much as twice that if D is required to turn to the real estate markets.

In this context, it is less important that company A receives a tax deduction for depreciation as putative tax owner or, for that matter, that company A avoids the GAAP charge for depreciation[7] than that it obtains a lower economic rent as an operating expense charged to earnings. Consistent with its economic objectives, company A also preserves flexibility in its access to and use of the property and retains all or nearly all of the residual appreciation from the property through the purchase option. Of course, this is commensurate with company A's willingness to put its credit on the line through both financial covenants in the lease and the RVG.

For financial reporting purposes, company A discloses in its footnotes that it has a contingent liability for the RVG should the property decline in value, and so long as there is no reason to expect that a decline will occur and the RVG will be invoked, that should suffice. The disclosure also includes full reference to the financial covenants and acceleration-of-rents clause, and absent property-specific or age factors requiring depreciation or reserves, company A's rent without GAAP depreciation should not result in a material understatement of expense.[8] The rent is included in noncancellable lease obligations under "Comments and Contingencies." A's bank lenders, rating agencies, and analysts all compute balance-sheet and operating ratios with and without synthetic leases and add to the standard EBITDA leverage and cash flow measures an EBITDAR,[9] including leases on both sides. It is hard to see how this transaction is, in and of itself, deceptive or abusive.

Potentially Abusive Synthetic Lease

If, however, A had used the same structure for billions of real and personal property and included customized and poorly located special-purpose properties, which by their

nature have little residual value at the end of lease terms, the synthetic structure could produce a material understatement of both risk and expense. If the synthetic lender were in fact relying primarily on the RVG and the residual value was unlikely to be sufficient to support a non-amortizing facility or lease, the lessee should properly disclose the true nature of its risk, and include either depreciation as an economic owner or a reserve against the probable lease renewal, purchase, or call on its RVG. In such cases, it may be more appropriate for A to carry the properties synthetically leased on its books to reflect both risk and reward factors.

Credit Sale-Leaseback

Another example involves property held by company A for 10-15 years, which is also well-located but has increased some 35 percent in value to $135 million since its original construction for $100 million, while its book value has depreciated by 35 percent to $65 million. Company A would like to capitalize on this appreciation but would like to continue to occupy it for the next 20 years. Company A invites I, a major real estate investor, to provide a sale-leaseback for 20 years. Investor I may provide 3 percent, 5 percent, or as much as 100 percent equity,[10] but if the rent is sufficient and the property is expected to continue to retain value or appreciate, Investor I is comfortable with both cash flow and residual risk. The lease contains neither an RVG nor a purchase option, because they are not permitted under SFAS 98.[11] In fact, an RVG is not required to reduce Investor I's residual risk because the rent over the longer lease term is sufficient to amortize all or most of any mortgage financing obtained or provided by Investor I and to return Investor I's equity investment, based on a conservative assumption as to residual value of the property. Company A has no purchase option but does have a renewal option at either actual market rent at the time or at a fixed amount estimated to at least equal market rent. Investor I would receive a base return from company A's annual rent and an enhanced return based on a sale or refinancing at assumed renewal rents and/or residual value estimates.

To meet company A's requirement of low rents, Investor I seeks to finance 95 percent to 100 percent of the purchase price in the CTL bond market at a small spread of perhaps 25-50 bps over company A's prevailing interest rate in the credit markets,[12] resulting in an annual rent constant of about 9.25 percent or $12.5 million.[13] This is reduced by the amortized annual gain on sale of about $3.5 million, reducing the net annual rent expense. Compared to the cost of borrowing $135 million at, say, 6.25 percent, or $8.775 million, and continuing to take $5 million of annual book depreciation totaling $13.775 million, it would seem that company A's income statement and balance sheet are both enhanced by the sale-leaseback. Currently, there is no minimum equity requirement[14] applicable to sale-leasebacks as such, even though the purchaser, Investor I, may choose to use an SPE to acquire and hold the property for risk management purposes.

From a reporting integrity standpoint, company A truly has realized a $70 million gain—$3.5 million a year over the 20-year lease term—based on having sold an asset at a higher market price than its depreciated book value and has removed an asset, and any corresponding financial liability, from its balance sheet. It should properly disclose that it has entered into a bondable lease containing, in appropriate cases, financial covenants that permit rent acceleration under certain events and include the rents in its summary of noncancellable lease obligations. Notably, the fact that property ownership is vested in an SPE organized by a real estate or financial institution, with or without a minimum amount of equity, does not support the type of presumption of misrepresentation of the company's financial condition that the new consolidation rules are designed to address.

Abusive Sale-Leaseback

Of course, the credit sale-leaseback structure also can be abused if company A's CFO or his or her greedy minions on Wall Street turn to GMAP.

Here's how. Suppose the properties include older power plants with barely 15 years of useful life left or high-technology properties such that the properties cost $500 million and have about $200 million left in mortgage bonds or trust certificates outstanding but that, due to technological obsolescence or environmental regulation, they are now really worth more than the appreciated value of the land put to another use, perhaps $100 million. At most, their fair value might be the sum of the discounted cash flows from a fair market rent for comparable properties, if any, for their remaining lives. If a friendly appraiser can be induced to provide estimates of a longer useful life and higher rent projections,[15] and perhaps a higher residual value, company A has the opportunity to play the kind of games the accounting rules should and do preclude. If the properties' book value after depreciation were $200 million, company A should have taken a $100 million write-down and charge to earnings,[16], but somehow it escaped with the aid of our

helpful appraiser. This same appraiser now provides an appraisal that supports a 27-year remaining life and a fair market value based on higher rent comps and residual value estimates of say $400 million, A can enter into a credit sale-leaseback at that price, reflect a $200 million gain spread over the life of the leaseback, and schedule a rent based on a new 20-year amortization schedule at a favorable rate in the bond market, which is much lower than book depreciation would have been if A had retained the properties.

The results are significant: At a 6.5 percent current conservatively estimated interest rate for an A+ credit, the rent on a $400 million CTL bond issue would be about $36.3 million. After offsetting the $10 million annual credit from amortizing the $200 million gain on sale, the effective rent charged to A's operating earnings is reduced to $26.3 million. Had A kept the property and continued to pay off its remaining$200 million of debt, it would have continuing interest charges averaging perhaps $15 million annually and would have either taken an impairment charge or depreciated the $200 million over the next 10 years, producing total annual charges of $35 million. If it needed to borrow another $200 million at say 6.5 percent, it would have another $13 million in annual interest expense. So, in contrast to total charges to earnings of $48 million, the sale-leaseback costs only $26.3 million, all with a reduction in company A's total debt of the $200 million of old bonds retired with the sale proceeds.[17]

THE INDUSTRY POSITION

The timetable for finalizing the Exposure Draft on consolidations is late 2002, and some modification is anticipated in response to the CTL industry's strong comments. In sum, the major participants in the CTL market have observed that the proposed rules improperly favor banks and other real estate enterprises that use substantial operating enterprises (SOEs) as lessors. SOEs are not subject to any minimum equity investment requirement and similarly are free from any constraints regarding lessee RVGs. This group is primarily concerned with perceived disruption and illiquidity[18] in the 1031 exchange market, which relies on SPEs as lessors in smaller transactions in which minimum investments and retention of 10 percent or greater equity are less common, and with the reluctance of CTL bond investors and 1031 lenders to make loans to SPE borrowers. They make the further point that consolidation of properties leased should be dictated by the merits of each transaction, not by whether the lessor is an SOE or an SPE, and whether that status changes over the life of the lease. They observe that a CTL or synthetic lease with an SOE lessor could be reclassified, with the property placed onto the lessee's books, if the property were sold to an SPE.

Although this group seems disinterested in preserving synthetic leases, the banking industry is also expected to have reflected its displeasure in formal comments to the FASB. It is anomalous that the Exposure Draft would seem to scrap the minimum 3-percent equity requirement for synthetic leases with SOEs, while SPEs may need more than 10 percent in so-called "true" leases, in which the lessor retains upside benefit and downside risk. Moreover, the lessee in a synthetic or other lease can continue to provide an RVG to an SOE lessor, in a short-term synthetic or a longer-term true lease, but apparently cannot provide an RVG to any SPE, even if is substantially capitalized. This emphasis on the nature of the lessor misses the critical issue of whether the particular lease reflects a true transfer of risk and reward and whether the rent fairly reflects the cost of occupancy as an owner or lessee. Although much of the real estate industry would support the extinction of the synthetic lease based solely on the lessee's retention of substantial risk and reward, it seems clear that synthetic leases provide efficient interim leasing, as well as financing, for well-located properties. In these cases, the long-term value and use to the lessee must remain flexible, and there is no basis for assuming a future loss or charge or understated risk or occupancy cost. These situations should be evaluated on a case-by-case basis as a form of true lease financing and not discarded as if they were the source of the problem.

Similarly, certain features of the synthetic lease warrant separate analysis. The residual value guarantee, or supplemental or contingent rent payment, should not be singled out for prohibition since it is merely a substitute for a longer rent stream in a long-term credit lease. A 20-year or longer lease enables the lessor to recoup its equity, if any, and repay highly leveraged mortgage debt and conveys no more risk to the lessor than in a five-year synthetic lease with an RVG. Why should a lessee be unable to reduce its rent by offering to accept some later risk of non-renewal or market decline or for that matter to offer to make the lessor whole if its credit should decline? Similarly, a purchase option at or close to the lessor's unamortized lease investment balance should not be fatal in and of itself. A lessor is in a very real

sense a lender seeking a return on risk capital, whether that risk is a real estate residual value risk or a credit risk. A lessor, as well as a lender, offers rents and other lease terms, including purchase and renewal options, commensurate with the risk, and a lower lessor return is justified by a lower risk.

CONCLUSION

If reporting companies are motivated and permitted to manipulate accounting principles, it is not necessarily because those principles are wrong or inadequate. Moreover, it is certainly not because SPEs are preserved to serve as measures for insulating real estate and bond investors from unwanted bankruptcy and other risks of property ownership.

Accounting principles must be drafted with clear statements of intention and permit practitioners and principals to classify their transactions based on their economic merits and overriding intentions. Bright-line tests and safe harbor provisions are useful and should be included in published guidelines whenever possible, but the focus should be on the substance of each transaction. Hopefully, the wide circulation of this Exposure Draft and broader recognition that the evils of Enron are the inevitable result of corporate greed and fraud, with or without SPEs, and result in a final set of guidelines that preserve lease accounting and real estate lease financing.

NOTES

1. Gil Sandler, "Synthetic and Other Structured Leases After Enron: The Impact of Reforms and Capital Markets perceptions," *Real Estate Finance* 29 (August 2002).
2. This characterization appears in a comment letter from the credit-tenant-lease (CTL) industry to the FASB.
3. Bankruptcy-remote SPEs have been widely used to minimize bankruptcy and financial transaction risk, as well as real estate ownership risk, for decades and are essential to the securitization of real estate and related financial assets.
4. The most liquid commercial mortgage market ranges in term from 10 years, prevalent in CMBS mortgage conduit financing, to 15- to 20-year mortgage loans from life insurance companies and mortgage REITs.
5. Even though property may retain its residual value over both short and long terms, the leasing market and fit-up costs at any time may fluctuate. Thus, a mortgage lender may require more equity and reserves from the borrower in the case of a short-term lease.
6. The residual value guarantee (RVG) would provide that, if the property were not sold to a third party or refinanced in a manner producing a return of the unamortized lease investment balance of $50 million, the lessee would be required to pay "contingent rent" of up to 85 percent of $50 million, or $42.5 million, or the lesser amount generated by such a sale or refinancing.
7. It must be noted that these two attributes are, of course, benefits of the synthetic lease structure.
8. Understatement of expense is a major criticism of synthetic leases. Arguably, however, the solution is not to ban synthetics but to require a charge in appropriate cases that reflects a reserve for anticipated exercise of the RVG. Thus, if a special purpose property can be expected to have a market value at the end of a five-year term of only 85 percent of original cost, perhaps a 3 percent annual reserve should be required.
9. Earnings before interest, taxes, depreciation, and amortization (EBITDA) is a standard cash flow measure. EBITDAR is earnings before interest, taxes, depreciation, amortization, and rents. Rating agencies have devised different methodologies for projecting *pro forma* balance sheets and income statements reflecting simulated capitalization of finance-type leases, but there is often a remaining advantage to the lessee, both economic and analytic.
10. Equity REITs and certain pension funds invest in high-quality commercial and multifamily properties on an all-equity basis with the expectation of higher long-term internal rates of return reflecting both cash flow and residual value returns than alternative investments. Generally, however, CTL-leased and other single-tenant properties are not expected to provide as great an IRR for equity investors as multi-tenanted commercial or residential properties, primarily because top-credit tenants insist on locking in lower rents over longer lease terms. Thus, CTL transactions are often funded by leveraged investors seeking an enhanced equity return and/or a bond-equivalent yield greater than the tenant's then current bond yield.
11. To qualify for lease accounting under SFAS 66, and meet Company A's objective of reflecting a gain on resale, and removal of the asset and financial liability of the property, a sale-leaseback prohibits purchase options, residual or financial guarantees and other forms of "continuing involvement" by the seller-lessee.
12. These CTL bonds are often sold to "accredited investors" in the Rule 144A private placement market and are structured to be fully amortized by scheduled rents. Any shortfall is supported by the property and is financed either by equity or subordinated debt issued by Investor I or the SPE lessor.
13. A fully amortizing CTL bond issue of $135 million bearing a 6.75 percent interest rate (225 bps over the interpolated 14-year average-life Treasury bond) would require annual debt service of approximately $12.48 million.
14. Investor may elect to finance the sale-leaseback using 100 percent equity if it is an equity REIT or pension fund or to limit its leverage to 50 percent, an ERISA limit on leverage for private pension funds.
15. Even though there might be no market for properties of the same age and technology, the appraiser might extract from a broader database higher rents from newer or better located properties or project a long enough useful life to justify both a 20-year lease term within SFAS 13's 75 percent useful life lease limitation for operating lease classification.
16. SFAS 121 requires a charge to earnings for assets whose values have been impaired. Special-purpose properties, in particular, as well as older properties in remote locations, should be appraised periodically, unless depreciation schedules have been adjusted to reflect shorter lives or higher replacement costs. This process is often ignored by the reference to materiality thresholds or the use of friendly appraisers who support book values.
17. It should be noted that sale-leasebacks are a legitimate and well-established vehicle for creditworthy corporate owners of real estate to obtain favorable financing of appreciated assets. So long as the terms are at arms length and reflect fair market values, the accounting constraints in SFAS 66 and SFAS 98, along with SFAS 13's classification criteria, provide ample protections.
18. Liquidity and competitive pricing are also factors in the synthetic and CTL markets, as many providers who use SPE's would be eliminated, and even lenders and investors who have SOE's may be reluctant to consolidate their real estate assets that previously were off its books.