

# **UNWINDING SYNTHETIC LEASES: WHAT ARE THE ALTERNATIVES?**

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## **Introduction**

Synthetic lease transactions, as a classic form of off-balance-sheet financing, have been absorbing a public relations beating recently in the wake of the Enron Corp. scandal. The fact is that tens of billions of dollars in synthetic leasing transactions have been consummated in the past ten years, and as many as one-half of all U.S. corporations use some form of off-balance-sheet financing (including synthetic leases). Unlike the Enron off-balance-sheet shenanigans, however, synthetic lease financing has not been characterized by violations or abuses of either the letter or the spirit of the accounting and tax rules and regulations that govern such transactions. Furthermore, credit-rating agencies such as Standard & Poor's, Moody's, and Fitch already take synthetic lease obligations into account when assessing a corporation's creditworthiness. Nonetheless, synthetic leases are being painted with the "Enronitis" brush, and it is likely that the new accounting rules proposed by the Financial Accounting Standards Board ("FASB") with respect to special purpose entities ("SPEs") and off-balance-sheet financing (which are likely to be implemented in the third or fourth quarter of 2002 in response to the Enron fiasco), as well as the negative public perception of any form of off-balance-sheet financing, are likely to severely curtail the use of synthetic leases as a viable corporate-financing device. The recent decline of the stock market and commercial real estate values also will have a negative impact on synthetic leases. This article will examine

these recent developments and the corporate strategies that likely will be employed to “unwind” synthetic leases and utilize alternative forms of financing.

### **What is a Synthetic Lease and Who Uses It?**

Since the early 1990s, many United States and foreign banks, as well as other capital sources, have become increasingly active in offering “off-balance-sheet” financing for corporate real estate acquisition, construction, and expansion. This method of structured financing is attractive to a corporate user of real estate because, if properly structured as a true “synthetic” leasing transaction, it offers significant economic and tax benefits to the lessee-corporate user. (It is estimated that financing through a synthetic lease can reduce financing costs by as much as 60 percent). Synthetic real-estate financing is a method used to provide off-balance-sheet financing to a corporate entity for the acquisition and development of a commercial facility or site, with a substantial credit support for debt issued by or through an investor or capital source, usually a bank. Off-balance-sheet financing has been used for many years as a source of capital financing for acquiring heavy equipment, especially airplanes, as well as for assets with a shorter economic life, such as automobiles and inventory for retail operations. One of the first synthetic lease transactions involving real estate occurred in 1986, when this structure was utilized to finance the sale of the Penn Mutual Towers in Philadelphia. Since the early 1990s, synthetic lease real estate financing has proliferated in connection with corporate acquisitions and with construction and development of commercial real estate facilities.

Off-balance-sheet real estate financing is most attractive to large, publicly traded, creditworthy corporations and businesses, such as the following: manufacturers; supermarket and drug store chains; food-service businesses; computer, transportation, and energy companies; high-tech and bio-tech companies; financial institutions; health-maintenance operations; and retailers. Major users of commercial real estate seeking medium-term, revolving-credit financing, that have substantial and highly specialized build-out costs and that seek an opportunity to maximize the value of their companies' stock, are likely to benefit from off-balance-sheet financing. This method of structured financing may also be employed in connection with a number of planned corporate acquisitions by developing a master lease facility for the inclusion of numerous properties, to be brought into the facility as they are identified and acquired or made ready for the construction of improvements. However, off-balance-sheet financing is less appropriate for smaller companies and smaller transactions because of additional credit-enhancement requirements and the significant structuring, documentation, and compliance expenses.

A synthetic lease agreement is commonly structured as a "triple net" or "bondable" lease, with the lessee-corporate user responsible for payment of all taxes, insurance, repairs, maintenance, etc., as well as management and operation of the property. The Internal Revenue Service ("IRS") and bankruptcy courts will closely examine the substance of the transaction, not the form, in determining the status of the transaction as

an operating lease or a financing transaction and whether the lessee is actually the beneficial owner of the property.

The lease is the most important document in characterizing the financing transaction as a synthetic leasing transaction. This document will commonly include a statement that the transaction is between unrelated parties and that the parties intend that the lease be treated as an operating lease for financial accounting purposes, but as a financing arrangement, or mortgage loan, for income tax, bankruptcy, real estate, and commercial purposes. Certain covenants typical of a corporate financing transaction also commonly will be contained in the lease, as well as covenants customarily contained in mortgage loan documents such as enforcement provisions and remedies, including an assignment-of-rents provision and the right to foreclose the property under applicable state law (by judicial sale, or, where permitted, power of sale). Synthetic lease documents are heavily negotiated and are transaction specific, with significant input from counsel for the parties to the transaction. In addition to the lease (or master lease), the operative documents may include some or all of the following: participation agreement, loan agreement, mortgage from the owner-lessor, trust agreement, guaranty(ies), and construction agency agreement.

The objective in a synthetic leasing transaction, for financial accounting purposes, is to have the lease treated as an operating lease, not a capital lease. If the lease is characterized as a capital lease, the lessee must record it as an asset on its balance sheet at the inception of the lease and show a corresponding liability equal to the minimum lease

payments during the lease term, provided that the aggregate amount does not exceed the fair market value of the property. If the lease is classified as an operating lease, the lessee may treat the payment of rent as an expense item during the term of the lease and omit the lease asset and corresponding rental obligation from its balance sheet. (However, certain information with respect to the lease must be disclosed in the lessee's financial statements). Notwithstanding this treatment for accounting purposes, a synthetic lease qualifies as a loan for federal and state income tax, bankruptcy, real estate, and commercial purposes. The lessee-corporate user is treated as the owner of the leased property, which enables it to realize appreciation in the value of the property, take depreciation on the property for tax purposes, characterize rental payments as payments of interest and principal, and avoid having the property appear as a “non-performing asset” on the company’s balance sheet.

Use of a synthetic leasing transaction substantially enhances the financial ratios of the lessee-corporate user because neither the real estate asset, nor any financing liability or equity ownership interest in the property appears on the lessee-corporate user’s balance sheet. This improves the company’s return on assets and equity, its reported earnings, its debt-to-equity ratio, and its stock value relative to conventional on-balance-sheet debt financing. Another benefit of a synthetic lease to the lessee-corporate user is that it may not trigger financial covenants in bank loan documents that otherwise limit the incurrence of indebtedness by the lessee-corporate user. As noted earlier, the lease between the parties commonly will state that they intend that the lease be treated as an operating lease

for financial accounting purposes but as a financing arrangement, or loan, for federal and state income tax, bankruptcy, real estate, and commercial purposes.

The Internal Revenue Code and the regulations issued thereunder do not provide specific guidelines for the treatment of a synthetic leasing transaction as a lease or financing transaction. The IRS treats the transaction as a conditional sale, qualifying the transaction for the favorable tax benefits associated with depreciation. There is no prescribed form for a conditional sale contract. However, the courts and the Internal Revenue Service have applied a fact-based analysis to determine whether the substance of the transaction is in accord with its form and the express intent of the parties. Although the issue of whether a transaction is characterized as a conditional sale or as a lease depends to a great extent on the intent of the parties, the economic substance of the transaction, not its label, will ultimately determine whether it is a true lease or a financing transaction. *See* James D. Bridgeman, *Tax Issues in Synthetic Leases*, Synthetic Lease Financing: Keeping Debt Off the Balance Sheet, ABA Section of Real Property, Probate and Trust Law (2002), Chapter 3; John C. Murray, *Off-Balance-Sheet Financing: Synthetic Leases*, 32 Real Prop. Prob. & Tr. J. 194, 196-98 (1997).

### **Current Problems With Synthetic Leases**

The new accounting rules regarding disclosure and consolidation proposed by FASB (in the form of an “Interpretation” of existing rules) likely will have a profound effect on

the use of SPEs in off-balance-sheet financing transactions, particularly with respect to synthetic leases. In many synthetic lease-financing transactions, an SPE (usually a pass-through entity such as a business trust, special-purpose corporation, limited partnership, or limited liability company) is formed. The SPE then takes title to the property, either directly or by assignment of the purchase contract, constructs the building, and leases the property to the lessee-corporate user or its subsidiary. A synthetic lease of real estate using an SPE commonly requires rental payments from the lessee equal to the sum of the interest on the SPE's debt plus a return on the SPE's equity investment, with no amortization of the debt's principal or return of its equity during the term of the lease. The SPE, acting as lessor, obtains financing for the transaction with a small equity investment in the project, usually three percent, and debt financing for the balance. The debt financing is generally in the form of commercial paper or commercial bank debt, often in combination with mortgage financing.

On June 28, 2002, the FASB issued an Exposure Draft of its Proposed Interpretation of existing accounting rules with respect to the consolidation of certain SPEs ("SPE Interpretation"). The FASB expects to issue the final SPE Interpretation (after reviewing comments) in the fourth quarter of 2002. The SPE Interpretation would be applied immediately to SPEs created after the issuance date of the final SPE Interpretation. For SPEs created before that date, the provisions would be applied to those SPEs existing as of the beginning of the first fiscal year or interim period beginning after March 15, 2003. The SPE Interpretation represents a significant change in current accounting practice and will have a profound effect on the use of SPEs in off-balance-sheet financing

transactions, particularly with respect to synthetic leases. The SPE Interpretation applies to businesses of all types and sizes, both public and private, and virtually every type of financing transaction that utilizes an SPE will need to be reviewed for compliance with the SPE Interpretation.

The SPE Interpretation makes clear that the new rules are not intended to restrict the use of SPEs -- which the SPE Interpretation acknowledges serve valid business purposes by isolating assets or activities to protect creditors against bankruptcy risk and/or allocate risks among participants and by facilitating various financing transactions and other arrangements, such as securitization, leasing, hedging, research and development, and reinsurance -- but to improve financial reporting by enterprises involved with SPEs and provide more complete and accurate information about the consolidated enterprise. The SPE Interpretation is concerned about accounting for transactions involving SPEs where the SPE is controlled by a business through means other than actual ownership of voting interests, e.g., by use of a loan arrangement, lease, management contract, guarantee, or other credit enhancement. The SPE Interpretation also would require disclosure of information regarding the assets, liabilities, and activities consolidated by enterprises that act as administrators of those SPEs.

The SPE Interpretation requires each such enterprise to determine whether it provides financial support to the SPE through a “variable interest.” Variable interests are defined in the SPE Interpretation as “the means through which financial support is provided to an SPE and through which the providers gain or lose from activities and events that change

the values of the SPE's assets and liabilities." Variable interests could arise from financial instruments, service contracts, nonvoting ownership interests, or other arrangements, and include loans to the SPE, leases, management contracts, referral agreements, options to acquire assets, purchase contracts, credit enhancements, guarantees of debt or asset values, and derivative instruments.

If it is determined that an SPE is subject to the SPE Interpretation, each party involved with the SPE must determine whether it provides substantial support to the SPE, e.g., by holding a subordinate debt instrument or by providing a guarantee of the value of the SPE's assets or liabilities. If an enterprise holds (1) a majority of the variable interests in the SPE, or (2) a significant variable interest that is significantly more than any other party's variable interest, that enterprise would be the "primary beneficiary" of the SPE. The primary beneficiary would be deemed to be the "parent" of the SPE and would be required to include the assets, liabilities, and results of the SPE in its consolidated financial statements. An SPE can have only one primary beneficiary, which itself must be a substantive operating entity that is not an SPE.

The SPE Interpretation provides that the primary beneficiary is "an enterprise that has a controlling financial interest in an SPE that is established by means other than holdings of voting interests. The primary beneficiary provides significant financial support to an SPE and benefits from its activities by holding a majority of the variable interests in the SPE or a significant portion of the total variable interests that is significantly more than the variable interest held by any other entity." An enterprise involved with an SPE must

determine at each reporting date whether it is a primary beneficiary by ascertaining whether it provides significant financial support to the SPE through a variable interest. If it does not, the enterprise is not the primary beneficiary. However, if the enterprise does provide such support, it must then determine whether any other party or parties also provide support to the SPE through variable interests. If other entities also provide financial support, the enterprise is the primary beneficiary if it provides a majority of the financial support or a significant portion of the total financial support that is significantly more than any other party, as noted above. An enterprise that has a variable interest in an SPE also must treat other variable interests in that SPE held by its related parties as its own interests for the purpose of determining whether it is the primary beneficiary. If it is not apparent which party's activities are most closely associated with the SPE's activities, the party with the largest variable interest is the primary beneficiary. For purposes of determining which party is the primary beneficiary if two or more parties hold variable interests in the SPE, if two or more parties with variable interests have an agency relationship the principal is the primary beneficiary, and if the relationship is not that of a principal and an agent, the party with activities that are most closely associated with the SPE is the primary beneficiary.

With respect to arrangements whereby contractual or other legal provisions or agreements substantially restrict an enterprise's rights and obligations to specifically identified assets of an SPE ("silos") and the interests of the creditors of the SPE apply equally to all of the SPE's assets, the SPE Interpretation provides that the enterprise must

treat those assets and the portions of the SPE's liabilities attributable to those assets as a separate SPE.

The SPE Interpretation would require primary beneficiaries to consolidate SPEs if the SPEs do not effectively "disperse" risks among the parties involved with the SPEs. SPEs that effectively disperse risks would not be required to be consolidated unless a single party holds an interest (or combination of interests) that effectively recombines risks that were previously dispersed. The Summary of the SPE Interpretation, which prefaces the new rules, states that, "SPEs used for leasing may not be as effective at dispersing risk as qualifying SPEs." Currently, a lender to an SPE lessor is not required to consolidate the SPE unless it holds a majority voting interest in the SPE. However, the SPE Interpretation "would require consolidation of an SPE that leases to a single lessee by either the lessee or the lender unless the equity investor has decision-making authority and the investment meets specified conditions for sufficiency, which may require an investment significantly greater than 3 percent [as required under current practice] of assets. If an enterprise that leases from an SPE that is subject to this proposed Interpretation provides a guarantee of the value of the property at the end of the lease [such as a residual value guarantee in a synthetic lease] or otherwise accepts risk of loss from changes in value of the property, the lessee would probably consolidate the SPE lessor. If the lessee does not provide such a guarantee, the lender to the SPE would probably consolidate the SPE." This may cause lenders to SPEs (such as insurance companies) involved in credit tenant lease transactions where there is no residual value guarantee by the tenant, to be deemed to be primary beneficiaries of SPEs and subject to

the SPE Interpretation (even if the lease contains a purchase option at fair market value). Appendix A (Examples) to the SPE Interpretation states that an example of an arrangement that would cause an SPE to be subject to the Interpretation would be where “[a] variable interest holder other than the nominal owner guarantees residual values of the SPE’s assets or agrees to future purchases of the SPE’s assets at predetermined prices that protect the interests of other variable interest holders or lenders or has made arrangements for another party to do so.”

In a prior draft of the SPE Interpretation, the FASB proposed a “bright line test” that would allow a company to exclude an SPE from its consolidated financial statements if there was an independent equity investment of at least 10 percent in the SPE. The SPE Interpretation contains some exceptions as well as more flexibility, but also creates some ambiguity. The SPE Interpretation provides that an equity investment of less than 10 percent of the SPE’s total assets will create a presumption that the SPE is incapable of financing its business activities without relying on financial support from other variable interest holders. This presumption can be successfully rebutted only if there is “persuasive evidence” that a lesser equity investment is comparable to the equity in similar businesses that are not SPEs and that engage in similar risks. However, even an equity interest of 10 percent is not considered sufficient unless it allows the SPE to finance its own activities without reliance on investments that are deemed to be variable interests.

The SPE Interpretation provides that a subsidiary, division, department, branch, or other portion of a “substantive operating enterprise” (i.e., an enterprise that is not an SPE and that “conducts business operations other than those performed for it by an SPE, has employees, and has sufficient equity to finance its operations without support from any other enterprise or entity except its owners”) that is the lessor for a leveraged lease, direct financing lease, or sales-type lease will not be consolidated with any enterprise other than its parent, even if it is otherwise similar to an SPE that would be subject to the requirements of the SPE Interpretation. Furthermore, the SPE Interpretation would not require consolidation of an SPE by a transferor of assets of the SPE or its affiliates, or require consolidation of a qualifying employee benefit plan by an employer subject to the provisions of certain other FASB Statements. Appendix B (Background Information and Basis for Conclusions) to the SPE Interpretation states that the FASB “considered whether an entity that is consolidated by a substantive operating enterprise (or a group of assets and related liabilities held by a substantive operating enterprise) could be an SPE covered by this Interpretation. An example is a subsidiary in which a parent has a very small equity investment that leases property financed by nonrecourse debt to a single lessee. If the lessee provides a residual value guarantee or if other provisions in the lease expose the lessee to essentially all of the risks related to the price of the leased property, the lessee could be considered the primary beneficiary of those assets and liabilities. However, the Board decided that an SPE-like subsidiary or group of assets and liabilities included in consolidated financial statements of a substantive operating entity should not be subject to the provisions of this Interpretation.”

The determination of whether an SPE should be consolidated will depend to a great extent on the method the SPE uses to get its financial support. The FASB has identified four conditions, as set forth in the SPE Interpretation, that indicate whether the equity investment of the nominal owners of the SPE is sufficient to permit the SPE to independently finance its operations. Failure to meet any one of these conditions would result in a determination that support is provided by another party and would require consolidation. The four conditions are: (1) the nominal owners' equity investment is sufficient to permit the SPE to conduct its activities without additional financial support; (2) the nominal owners' equity investment (and the return thereon) is the most subordinate interest; i.e., it is not guaranteed and the return is not limited; (3) the invested assets provided by the nominal owners in exchange for their equity interests are not subordinated beneficial interests in another SPE (or SPEs); and (4) the nominal owners' equity investment was not provided, either directly or indirectly, by the SPE or other parties involved with the SPE.

Although the SPE Interpretation is not intended to limit the use of SPEs, the elimination of off-balance-sheet treatment will occur in many situations. The implementation of the SPE Interpretation will force thousands of U.S. companies to add synthetic-lease liabilities to their balance sheets by the end of the first quarter of 2003. Many companies (including lessees in synthetic-leasing transactions) that have used SPEs will be required to bring assets and liabilities on the balance sheet with negative effects on their debt-to-equity ratios, return on assets, operating and profitability margins, and cost of financing. This could lead to downgraded credit ratings, regulatory concerns, and

debt-covenant violations of loan agreements. It likely will be very difficult for many existing SPEs to be restructured in order to meet the new FASB criteria, and these transactions certainly will become more expensive for the participants.

Upon issuance of the SPE Interpretation, many corporations will be forced to revise structures used for many years as efficient sources of financing, and capital costs may increase as the result of having to seek less attractive and more costly alternative sources of financing. Investors will be looking for indications of these increased costs in the months to come. However, after implementation of the SPE Interpretation, SPEs will continue to be utilized in structured financing transactions, to the extent they represent cost-efficient financing vehicles and sources of capital. “Substantive lessors,” such as bank leasing subsidiaries or specialty leasing companies that are substantive operating companies with significant “true” equity at risk in the transaction -- as opposed to thinly capitalized, bankruptcy-remote, and transaction-specific SPEs -- likely will be the preferred lessor entities after final issuance of the SPE Interpretation. It also may be possible for substantive lessor entities to enter into joint-venture relationships with other parties, so long as the substantive lessor entity is the “significant” equity partner and consolidates its activities with its parent. The alternatives to synthetic leasing, such as sale-leasebacks, credit tenant leases, conventional leases, outright ownership with mortgage financing, and “synthetic debt,” have both advantages and disadvantages compared to synthetic leases, and some or even all of these alternatives may not be attractive to corporations even after issuance of the Interpretation.

Many companies (especially high-tech and bio-tech companies in Silicon Valley) entered into synthetic leases during the period from late 1999 through the early part of 2001, when well-located commercial real estate sites were selling at a premium. During this time, for example, square footage costs in Silicon Valley increased from \$150 per square foot to \$400 per square foot. The problem for these companies -- apart from the proposed accounting rules that would require consolidation of the assets and liabilities on the lessee-corporate user's balance sheet -- is that as these synthetic leases (the terms of which are commonly three to seven years) expire, the properties must be brought back onto their balance sheets at substantially reduced values. Of course, the lessee-corporate user could simply "buy out" the remaining lease obligation. However, this alternative requires that the lessee corporation pay to the lessor the "residual value guarantee," which is an amount not greater than 89.9% of the fair market value of the property established at the inception of the lease. To comply with existing accounting rules regarding synthetic leases, the lessee corporation must either buy the property or arrange for a sale of the property to a third party in an amount sufficient to cover the lessee-corporate user's lease liability. However, if the lender is unwilling to "roll over" the synthetic lease because of a downturn in the lessee corporation's business (caused, in most cases, by a general economic decline) and a decline in the lessee's credit rating, chances are that this also would be the time that the lessee corporation would have the most difficulty selling the property for the amount required to repay the lender. The lessee corporation thus is faced with a "double whammy" -- the need to sell the property at the same time that it is least able to do so because the property's value is falling.

The lender's decision whether to roll over the synthetic lease for an additional period of time necessarily would be based on the then credit strength of the lessee corporation. Also, the interest-rate environment on the lease-termination date may not be advantageous from the lessee-corporation's perspective. The interest charged is typically based on the London Inter-bank Offered Rate ("LIBOR"), and the rent is subject to monthly or other periodic adjustments based on fluctuations in this rate.

In addition to the problems mentioned above, the negative publicity surrounding all forms of off-balance-sheet financing in the wake of Enron Corp.'s collapse has caused corporations to be understandably wary of entering into synthetic lease transactions, even when it might otherwise make economic sense to do so. Recently, Krispy Kreme (the highly successful doughnut maker) saw its stock plunge 10 percent after it first announced its plans to utilize a synthetic lease, in connection with the construction of a \$35 million manufacturing and distribution facility in Illinois. This proposed transaction was described in one financial-magazine article as an "off-balance-sheet trick." The stock price recovered only when the company's management announced that it was abandoning the synthetic lease structure and would instead use conventional mortgage financing. Also, due to investor concerns about accounting procedures and a stated determination to increase transparency and decrease shareholder concern, Cisco Systems (the world's largest maker of computer-networking equipment) announced in May 2002 that it would pay approximately \$1.9 billion to terminate existing synthetic leases by buying back the properties, thereby discontinuing all but one of its synthetic lease transactions.

Companies seeking synthetic lease financing that are not rated “investment grade” by rating agencies such as Moody’s, Standard & Poor’s, or Fitch, are commonly required to post collateral (which can be in an amount equal to 75-100 percent of the project cost) with the financing source in the form of an escrow or defeasance account, letter of credit, surety bond, first deficiency guarantee, or some other form of credit enhancement. This obligation often will be described on the company’s balance sheet as “restricted cash,” “long-term asset,” or included within the category of “total cash, and cash equivalents, restricted cash and short-term investments.” However, this segregated cash is not in fact available to fund the company’s business operations, and may be used only to fund the company's obligations under the synthetic lease. Investors and analysts are increasingly suspicious of these types of “disclosures.” As a direct result of the Enron debacle, the Securities and Exchange Commission issued, on January 22, 2002, a statement (Release Nos. 33-8056; 34-45321; FR-61; (“SEC Statement”) clarifying its views and providing immediate guidance with respect to “material off-balance-sheet activities.” This statement applies to financial disclosures by public companies for the calendar year 2001, and provides interpretive guidance for companies with respect to liquidity and capital resources (including off-balance-sheet transactions). The SEC Statement is designed to provide more “transparent” disclosures in the wake of the Enron failure, and encourages companies to provide more specific and understandable information. The SEC believes that this information should go beyond the minimum technical legal requirements (or “boilerplate”), and should be tailored to the company’s individual circumstances. The SEC Statement stresses the need for a narrative explanation of financial statements as opposed to numerical presentation and brief accompanying footnotes. The SEC

Statement also emphasizes that the information provided should be “useful and understandable,” and available in a single location rather than in a fragmented manner throughout the company’s financial statements.

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act, as a direct result of the intense political pressure to respond to the many corporate and accounting abuses and scandals affecting publicly traded companies. The stated purpose of this legislation is “to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws.” The Act expressly addresses off-balance-sheet financing by requiring the SEC to issue, not later than February 1, 2003, final rules mandating that each annual and quarterly financial report filed with the SEC disclose all material off-balance-sheet arrangements and obligations (including contingent obligations) that may have a material effect on, among other things, financial condition, results of operations, liquidity, capital resources, or significant components of revenues or expenses. Within one year after the new SEC rules’ effective date, the SEC is required to complete a study of filings by companies to determine the extent of off-balance-sheet transactions and SPEs.

As noted above, even if a company remains intent on pursuing a synthetic lease, the cost could be significantly higher as the result of “Enronitis” and investor suspicion of any form of off-balance-sheet financing. Many companies still in the market now have to pay more to issue commercial paper, as investors cut their risk of exposure to companies

with “questionable” accounting practices, and borrowing costs for the most active investment-grade corporate borrowers have increased significantly.

### **Options Available to Lessees to “Unwind” Synthetic Leases**

If a company’s intention is to “unwind” a synthetic lease (or simply to seek another form of financing) as the result of the recent negative publicity regarding off-balance-sheet financing and the proposed changes in the accounting rules regarding SPEs and consolidation, several other alternatives are available. These include the following: outright ownership of the property with traditional mortgage financing; a sale-leaseback of owned property; a conventional lease; a credit tenant (or “bondable”) lease; and “synthetic debt.” It is often said that synthetic leases result in a “financing mismatch,” i.e., using short-term financing to support a long-term obligation. While this generally is true, each of the alternatives mentioned above also has certain drawbacks.

#### **A. Sale-Leaseback**

A qualifying sale-leaseback will result in off-balance-sheet treatment of the transaction for the lessee corporation, provide cash from the sale to invest in its core business, enable it to maintain control of the property at a fixed rent for a substantial period of time, and provide (in effect) 100% financing. Over the term of a long-term lease (that is at least 75 percent of the estimated useful economic life of the property) the annual rent deductions will (except in the early years of the lease) almost always exceed

the annual interest and depreciation on debt (which would be available with a synthetic lease). Furthermore, a long-term lease more closely matches long-term liabilities with long-term financing, because the maturity of the lease obligation more closely approximates the economic life of the asset.

However, a sale-leaseback may not enable the seller-lessee to obtain other financing or tax benefits available with a synthetic lease (at least based on existing accounting rules). For example, the seller-lessee will be unable to deduct depreciation on the building for tax purposes, as the risks and rewards of ownership remain with the buyer-lessor. Recently, interest payments on a synthetic lease, even for a non-investment-grade borrower, have been as little as 150 basis points over LIBOR. In the current market, this works out to an effective interest rate of approximately 4%, versus approximately 15% for a sale-leaseback transaction. If the seller-lessee has an investment-grade rating, or the transaction is supported by a credit enhancement such as a guarantee from a creditworthy entity, a synthetic lease arrangement can be even less expensive.

Sale-leasebacks generally are more expensive than synthetic leases. This is because the term is much longer (usually 15-25 years, with options that may extend the lease term to 40 years or more), and the rental payments due over the term of the lease must be sufficient to cover the buyer-lessor's mortgage-financing costs (which may include rating-agency compliance costs if the mortgage is syndicated) as well as provide a return on its investment and cover its management fee. Furthermore, the aggregate rental payments due over the term of the lease may exceed the value of the property, especially

if the seller-lessee is required to pay percentage rent (based on gross or net sales or profits) in addition to base rent. The seller-lessee may, in fact, be no better off economically or financially than if it had obtained conventional mortgage financing. Also, at the end of the lease term, the buyer-lessor will own the property free of the lease, forcing the seller-lessee to seek alternative space (and pay all costs associated therewith) and remove or relinquish some or all of its tenant improvements (unless the seller-lessee has a repurchase option, or is able to negotiate an extension -- which will be at the then prevailing rental rate), and the buyer-lessor will realize all of the property's appreciation and any increase in demand for renting the space. If the lease grants the seller-lessee an option to purchase, the purchase price will be 100% of fair market value at the time the option is exercised, which will probably be well in excess of the original cost paid by the buyer-lessor.

The FASB has adopted specific accounting rules for sale-leaseback transactions (including real estate with equipment that is attached to and part of the real estate), which provide that such transactions do not qualify for sales recognition or "off-balance-sheet" treatment if the seller-lessee has not transferred all of the risks and rewards of ownership (other than the "active use" of the property by the seller-lessee) to the buyer-lessor, e.g., the seller-lessee cannot retain an option to purchase, provide guarantees or credit enhancements, share in the appreciation of the value of the property with the buyer-lessor, make substantial expenditures of generally more than ten percent of the total cost of construction of improvements on the property, or take any other actions that constitute "continuing involvement" with the property. If any such prohibited activities occur, the

seller-lessee must recognize the “construction in progress” asset on its balance sheet and will be subject to sale-leaseback treatment of the transaction under the FASB’s Statement of Financial Accounting Standards No. 98. If SFAS 98 applies, the sale-leaseback cannot include an option to purchase the property at the end of the lease term (although the lessee may be granted a right of first refusal or right of first offer).

## B. Outright Ownership

A corporation also may consider, as an alternative to synthetic leasing, outright ownership of the asset. The value of ownership depends on whether the company believes it is reasonably feasible to utilize a building for a lengthy period of time (usually ten years or more) and the company’s estimate of what the property will be worth on the maturity date of any mortgage financing placed on the property. The company must analyze whether it is cost-effective to make a substantial cash investment in real estate. The opportunity cost to the company (i.e., the cost of foregoing product development or capital improvements, and the ability to allocate capital to core operations and other use of funds) may be too high. Assuming that a company’s cost of borrowing funds (i.e., its corporate- credit rate) is less than its investment opportunity rate, it should not invest all of its available cash in real estate. (If the opposite is true, it should go into the real estate business full time!). If the company elects to own the real estate, such ownership must be disclosed on its balance sheet, and any debt incurred in connection with the acquisition or ownership of the property must shown as a liability. The corporate owner also will

assume the full risk of depreciation in value of property and loss of property to casualty, condemnation, or environmental contamination.

The occupancy and finance costs of ownership can be high. An equity contribution of at least 20-30% is usually required in order to obtain financing at a favorable rate. If the corporate owner obtains a construction loan, the lender will impose controls on disbursements, require strong financial covenants in the loan documents, and charge a relatively high interest rate (often at the lender's prime rate plus a spread, which may be subject to periodic adjustment by combining a shorter-term "call" with a longer-term loan amortization). It is virtually impossible to obtain 100% financing, because an institutional lender usually supplies only a 70-80% loan-to-value mortgage. In addition, principal amortization will be required when the company switches to permanent financing. The mortgage debt appears on the company's balance sheet, and depreciation is charged against earnings for accounting purposes. Since depreciation of an on-balance-sheet asset is charged against the owner's income for accounting and book purposes, earnings are diluted compared to alternative forms of financing the occupation and use of the property. The corporate owner's tax benefits are limited to depreciation of the building(s) and improvements, and any debt-service payments applied to principal are not deductible. Finally, non-standard or specialized use or operation of the property by the corporate owner may diminish the marketability of the property and the subsequent resale price.

### C. Conventional Lease

Under the “conventional lease” alternative, the company will lease the property rather than purchase it or utilize a synthetic lease or sale-leaseback. The lessor will be an independent third party, and the term of the lease usually will be the period of time that the company estimates will serve its business needs and not exceed the useful economic life of the property. The lessor may be responsible for many -- but rarely all or even most -- of the obligations of ownership, including maintenance and repair, real estate taxes, insurance, and utilities. The lease payments will be off-balance-sheet obligations for the lessee, and the company will be able to deduct the rent payments for federal income-tax purposes.

However, the occupancy costs of renting property can be high, as rent contains a return on investment for the developer. The cost of funds is that of the lessor, and is not based on the less expensive corporate-credit rate of an investment-grade lessee. The developer’s cost of funds includes its real- property-acquisition and loan-amortization expenses. In addition, the company does not receive the benefit of appreciation as the result of tenant improvements or property appreciation, and the lessee cannot depreciate the cost of amortized tenant improvements.

Furthermore, the lease may be subject to rent escalation reflecting appreciation in property value, and periodic escalation of rentals is common. The lessee will have limited design and tenant-improvement input because only “generic” improvements benefit the developer-owner. The lease usually will obligate the lessee to remove or relinquish the tenant improvements at the end of the lease term. Also, there is no ability to control a

future property sale by the developer-lessor or a future owner-lessor. The developer-lessor may default on its mortgage loan (or become insolvent) and the lender -- or an unexpected (and unwanted) third party -- could become the owner. The lessee can't manage or control the facility, or make major improvements without the lessor's consent (and at the lessee's cost). At the expiration of the lease term, the lessee must vacate the premises, or seek renewal at the lessor's discretion at the then market rent (unless the lease contains an automatic or optional right of renewal at pre-determined rate). Finally, the lessee may be responsible for many -- and perhaps virtually all (under a triple-net lease) -- of the expenses and real-estate risks of ownership, including maintenance, taxes, insurance, utilities and environmental contamination. The lessee commonly also will assume real-estate risks such as casualty and condemnation, and will not own the property at the end of the lease term even though the total rent payments presumably will have repaid the lessor's investment with interest.

#### D. Credit Tenant Lease

Another alternative to a synthetic lease is a credit tenant lease (sometimes referred to as a "bondable lease" or "leveraged lease"). This structure is often used when a company desires long-term use of an asset, but will not be able to utilize the tax benefits of ownership of the asset. If a company net-leases a property under a credit tenant lease it can deduct 100% of the lease payments against its taxable income, which can result (depending on the overall circumstances) in a lower after-tax cost for the company over

time. Also, companies with low effective tax rates may be able to shift some of the tax benefits to the lessor and achieve a lower basic lease rental.

Compared with conventional mortgage financing, a credit tenant lease can provide greater leverage because it combines a small portion of third-party equity, usually 10-12%, with third-party debt financing in the range of 88-90%. Under a credit tenant lease, the lender provides financing based on the credit strength of the corporate lessee, which usually results in a below-market rent paid by the lessee corporation. This relatively lower rental rate may be fixed for the entire term of the lease (typically 15-25 years, depending on the credit strength of the lessee). In addition, the rent structure can be structured to be flexible to meet the lessee's needs, including provisions for periodic stepped-up rental payments, floating-rate rents, and a balloon payment of rental at the expiration of the lease term. An investor (or investor group) seeking tax-depreciation benefits will take title to the property, commonly through the creation of an SPE, and lease it to the corporate user. When properly structured, a credit tenant lease will be treated as an operating lease and not a capital lease for accounting purposes, thereby providing the lessee with the benefits of off-balance-sheet financing. Because the investor is interested primarily in the tax benefits and not on a return on investment from the rent payments, most of the rental obligation goes to service the debt.

This feature of a credit tenant lease, and the fact that the financing is based on the lessee corporation's credit and not the real estate, enables the lessee to obtain a lower all-in 100% financing rate that is comparable to the lessee corporation's internal corporate-

credit cost of funds. There is a large market for credit tenant loan-backed securities that has grown significantly in recent years, primarily as the result of published guidelines by the Securities Valuation Office of the National Association of Insurance Commissioners and several nationally recognized statistical rating organizations. The pricing advantage to the lessee of this structuring of credit tenant leases is further enhanced by the availability of residual value insurance, which covers the unamortized principal balance of the loan outstanding at the expiration of the initial lease term (in those credit tenant leases that contain a balloon payment due at the end of the lease term). The insurance commonly available covers 30-35% of the lender's residual risk (although the lessee usually pays a premium of 3-4% for this protection).

However, as noted above, a credit tenant lease does not provide the tax benefits (i.e., deduction of interest payments and depreciation) that currently are available to the lessee in a synthetic lease transaction. The lessee corporation will not own the property at the end of the lease term, and will not be able to capture any appreciation in the residual value of the property. Also, the longer term of a credit tenant lease limits the lessee corporation's flexibility, especially if it is restricted in the amount of tenant improvements it can make during its occupation of the property. Furthermore, the lease may provide for periodic increases in rental or a large balloon payment upon termination or expiration of the lease. The lessee corporation will assume virtually all the real estate risks and obligations of ownership, including casualty and condemnation losses and environmental contamination of the property.

## E. Synthetic Debt

The concept underlying the synthetic debt structure is that fully rented real estate constitutes a “bundle of rights” that may be separated into a term-of-years interest and a remainder interest, in order to meet the needs of different types of investors and create an all-equity capital structure. The term-of-years interest becomes the equivalent of a fixed-income obligation with default protection (summary proceedings for recovery of rent and dispossession instead of mortgage foreclosure) and the remainder interest becomes an unencumbered lien-free non-fixed-income form of equity that enjoys the benefits of property appreciation not directly related to lease valuation increases. Remainder interest investment positions are debt-free on-balance-sheet assets for corporate investors.

These transactions are in some respects the opposite of synthetic leases: they transform conventional off-balance-sheet leases into unconventional synthetic debt for investment purposes. The transactions are nonevents from the lessee’s perspective. The respective interests in the property are conveyed by separate deeds: a general warranty deed of the estate-for-years and improvements and a general warranty deed conveying the remainder interest. The synthetic debt structure utilizes a conventional use-related operating lease that minimizes exposure to the recent changes in FASB accounting standards and permits the lessee to participate as an investor in the remainder interest.

However, lessees cannot invest in the term-of-years interest because of financial and tax-accounting rules that recharacterize leases as debt if lessees obtain equity positions in their lessors. The use of the synthetic debt structure has not, to date, achieved widespread

market acceptance, most likely because of unfamiliarity with the concept and the unusual nature of the structure. The correct structuring of synthetic debt requires the advice and guidance of highly qualified tax and accounting consultants and the involvement of skilled legal counsel, which can add significantly to the cost of the transaction. The structure also will need to be carefully explained to title insurers, who may need to create specialized non-traditional forms of coverage and endorsements for the transaction. *See* Richard A. Graff, *Off-Balance-Sheet Corporate Finance With Synthetic Leases: Shortcomings and How to Avoid Them With Synthetic Debt*, 22 *Journal of Real Estate Research* 213 (2001).

### **Conclusion**

The fallout from the collapse of Enron Corp. has, unfortunately, raised the suspicion that off-balance-sheet transactions in general, and synthetic leasing structures in particular, are inherently suspect. However, there have been no allegations (to the knowledge of the author) that any participants in synthetic leasing transactions have abused the technique, deliberately misled investors or analysts, or failed to comply with existing legal or accounting requirements. It will be difficult for many SPEs in synthetic leasing transactions to effectively restructure in a manner sufficient to meet the anticipated changes in accounting requirements applicable to synthetic leases, and these transactions will certainly become more expensive for the participants. However, and synthetic leases still are likely to be used occasionally where these types of alternative financing structures provide cost-efficient sources of capital. The alternatives to

synthetic leasing, as described in this article, have both advantages and disadvantages compared to synthetic leases, and some or even all of these alternatives may not be attractive to corporations that have utilized synthetic-lease financing in the past.