



Synthetic Lease Financing Revisited

By Timothy J. Oxley

Recent market conditions have resulted in the near collapse of traditional real estate financing vehicles. For those companies with investment grade credit looking to finance the acquisition and construction of new real estate projects, it may be worth while to revisit the synthetic lease financing structure. Synthetic lease treatment is not available for existing real estate where title to the real estate is already held by a company. Any sale to a lessor and subsequent lease back will be subject to the Financial Accounting Standards Board (FASB) Statement of Revised Accounting Standards No. 98 Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate and be treated as a capital lease. Where title to real estate has not yet been acquired by a company and the company has not been involved in substantial construction related activities prior to the acquisition of title by a lessor, the synthetic lease can provide an attractive financing vehicle. Care must be given, however, to make certain that the company does not take on substantial construction period risk. In such case, under FASB Statement 98, the company will be treated as the owner of the real estate and, effectively, a sale and leaseback of the real estate occurs when the construction is complete and the lease term begins. Even if a transaction is treated as a capital lease, the possibility of 100 percent bank financing may prove valuable in today's tight credit market.

A synthetic lease is a secured financing structure treated as an operating lease for accounting purposes and as a secured loan (or conditional sale) for federal income tax purposes. The advantages to a lessee under a synthetic lease are:

- the lessee gets operating lease treatment for the financing so that neither the leased property nor the corresponding liability need to be accounted for on the balance sheet of the lessee;
- the lessee gets secured loan treatment for tax purposes so the lessee gets deductions for depreciation and interest (which typically exceed rent payments) associated with the ownership of the leased property;
- the lessee keeps the property's potential for appreciation in value;
- transactions that are documented as leases often do not contain the kinds of restrictions that are found in loan covenants; and
- because of the security arrangements, the pricing may be more favorable than in traditional debt financing.

SFAS 13 Standards

To achieve off-balance sheet treatment, a "synthetic lease" financing must satisfy the standards set forth in Statement of Financial Accounting Standards No. 13 (SFAS 13). SFAS 13, as modified by various amendments, interpretations and technical bulletins issued by FASB, applies fairly objective tests to distinguish between operating leases (*i.e.*, the desired result in a synthetic lease transaction) and capital leases. The goal of the lessee in a synthetic lease is operating lease treatment for financial accounting purposes, so that neither the asset nor the liability from the transaction is reflected on its balance sheet.

To reach the desired financial accounting goal, the synthetic lease:

- must not automatically transfer ownership of the leased property to the lessee by the end of the lease term;
- must not contain a bargain purchase option (i.e., a purchase price less than the reasonable estimate of fair market value at the end of the lease term);
- must have a term of less than 75 percent of the estimated economic life of the property; and
- must be priced such that the present value (typically discounted at the debt rate) of the rentals and other minimum lease payments is less than 90 percent of the fair market value of the leased property (the “90 percent Test”).

In a typical synthetic lease financing transaction, the borrower/lessee sells the asset to be subject to the financing to a lender/lessor for the amount of the intended financing (typically in an amount equal to 100 percent of its then current fair market value, which is generally equal to its all in cost). The lender/lessor immediately leases the financed asset back to the borrower/lessee. The amortization (i.e., the amount of “rent” earmarked for the principal component of debt service), back-end balloon (i.e., the unamortized amount of the loan) and tenor of the lease must satisfy the guidelines set forth in items 1 through 4 above.

On the maturity of the lease, the lessee will have the option either (a) to purchase the asset for the amount of the unamortized portion of the loan (the Balloon), (b) to renew the lease or (c) to market and sell the property as agent for the lessor provided that the lessee is required to pay to the lessor the maximum residual guarantee amount equal to the greatest number which still satisfies the 90 percent Test (the Residual Guarantee Amount). If the gross proceeds of any sale of the property exceed the Balloon, then the lessee is entitled to such excess net of the costs of selling the property. The at-risk portion for the lessor/lender (i.e., the difference between the Balloon and the Residual Guarantee Amount — the “At-Risk Amount”), is a risk the lessor/lender is willing to take because it would make economic sense for the lessor/borrower to walk away from its asset by paying the Residual Guarantee Amount only if the value of the financed asset is less than the At-Risk Amount. In fact, at the outset of a synthetic lease financing, the projected value of the financed asset typically is many multiples in excess of the At-Risk Amount.

Disfavored Leases

Due to the advantages noted above, synthetic lease financing was a very popular financing vehicle in the mid to late 1990s. Synthetic lease financing structures were used to finance computer equipment, transportation equipment, manufacturing equipment, plants, warehouses and office buildings to name a few. However, beginning in the early 2000s synthetic lease financing fell into disfavor for a number of reasons:

First, and perhaps most significantly, the collapse and bankruptcy of Enron. In addition, to various allegations of fraud, deceit and greed, Enron was a participant in various off-balance sheet financing transactions. Enron engaged in various activities (e.g. issuing impermissible guarantees) not permitted by the accounting rules and procedures which established off-balance sheet treatment of synthetic leases. So, while synthetic lease financing transactions that observed all of the accounting rules were not subject to challenge per se, the ensuing Enron scandal was of such a magnitude as to taint any and all off-balance sheet structures. As a result, Boards, management and accountants were all reluctant to recommend or authorize any further off-balance sheet transactions.

Second, Emerging Issues Task Force Issue No. 97-10 and related statements from FASB and subsequent interpretations of the same, began to severely restrict the risk that could be assumed by lessees during construction periods. As a result, lessors and lenders financing such lessors were required to take on more risk and found it more challenging to structure transactions within the boundaries established by FASB. These developments had a further chilling effect on the market for synthetic lease financing transactions involving real estate under construction.

Finally, FASB Interpretation 46 on Consolidation of Variable Interest Entities (promulgated in January 2003 and revised in December of 2003) (FIN 46) each further contributed to the decline in synthetic lease financing transactions. Until FIN 46, most synthetic lease financing transactions utilized special purpose entities (SPEs) as the lessors. These SPEs were intended to provide an extra level of risk mitigation and were designed to be bankruptcy proof. Critics of the use of SPEs contended that some companies, including Enron, were taking advantage of the accounting literature's vagueness with respect to SPEs to use these structures for other purposes, such as to avoid reporting assets and liabilities, defer reporting losses or report illusory gains. Based on such concerns, FASB enacted FIN46 which utilizes a new "risk and rewards" model for determining when a company has a "controlling financial interest" of another entity.

FASB coined a new term "variable interest entity" (VIE) for entities subject to the risk and rewards model. For determining whether a VIE exists, you must determine whether the equity at risk has any of the following characteristics:

1. Is the equity investment at risk sufficient to finance the activities of the entity?
2. Do the holders of the equity investment at risk lack decision making rights?
3. Was the entity established with non-substantive voting rights?
4. Do parties other than the holders of the equity investment at risk have the obligation to absorb expected losses?
5. Do parties other than the holders of the equity investment at risk have the right to receive the residual returns?

If the answers to all of the above questions is "no" the entity is not a VIE. If the answer to any of the questions is "yes" the entity is a VIE and the identity of the "primary beneficiary" must be determined. The party exposed to the majority of the risks and rewards associated with the VIE is named its primary beneficiary and must consolidate the entity.

Under FIN 46, where a "variable interest entity" is deemed to exist, in most synthetic lease financing transactions the lessee will be deemed to be the "primary beneficiary" and required to consolidate with the SPE lessor. This is due primarily to the existence of the residual value guaranty and the preservation of the upside value of the leased property for the benefit of the lessee.

When making an assessment as to whether a lessor entity is a "variable interest entity," factors 2 through 5 do not appear to present significant obstacles to avoiding such treatment. In order for an equity investor to have the ability to make decisions and exercise substantive voting rights as required by factors 2 and 3, such investor must hold voting rights similar to a common shareholder or a general partnership interest. Further, such voting rights must be proportional to such investor's obligation to absorb expected losses or receive residual returns and the entity's activities may not be conducted on behalf of an investor that has disproportionately less voting rights. In order to satisfy the requirements of factor 3, an equity investor cannot be protected or guaranteed a return (i.e., first risk of loss must be held by the equity). In typical synthetic lease financing transactions, the residual value guarantee runs in favor of the debt and the equity investor does in fact bear the first risk of loss. According to factor 4, the equity investor must have the right to receive expected residual returns. This right may not be limited by the governing documents or agreements with other variable interest holders or the entity (i.e., the lessor or lessee in a synthetic lease financing).

"At Risk" Equity

Given the relative ease of satisfying the requirements of factors 2 through 5, much of the focus to date has been on the first factor. The at risk equity must be greater than the expected losses of the entity. FASB Interpretation 46 states that an entity must have equity of at least 10 percent of total assets unless it can demonstrate that:

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1. the entity is financing activities without support;
 2. the entity has an amount of equity invested similar to other entities that hold similar assets of similar quality and operate with no additional support; or
 3. the amount of the equity is greater than a reasonably reliable estimate of the entity's expected losses.

The 10 percent standard is only intended as a guideline and not a hard and fast rule. In some cases where entities are engaged in high risk activities, equity in excess of 10 percent may be required, while in other cases, based on industry precedent, less than 10 percent may suffice.

While the foregoing factors have contributed to the significant decline in the use of synthetic lease financing, none of these factors are fatal. It should be possible to continue to structure synthetic lease financing transactions satisfying the requirements of, and providing the accounting and tax benefits desired by, lessees. For instance, if off-balance sheet treatment is an important consideration, synthetic lease financing transactions should be able to be structured without the lessee having to consolidate the lessor as a "variable interest entity" of which the lessee is the "primary beneficiary" as long as you have a substantive lessor (e.g. leasing company engaged in multiple leasing transactions, with independent employees and sufficient capital). However, even if the accounting benefits of off balance sheet operating lease treatment are not being sought, synthetic lease financing provides a way to finance with a bank 100 percent of the cost or value of real estate. This may be of significant value in today's tight credit market. Further, if accounting benefits are not being sought, already owned real estate should also be able to be financed with a synthetic lease.

Conclusion

Given current market conditions and the difficulty in financing real estate transactions, it may be time to revisit synthetic lease financing structure as a viable means of providing 100 percent debt financing for the acquisition and construction of real estate for those companies with investment grade credit capable of supporting a secured financing. Under a secured real estate loan, a down payment is traditionally required, which reduces the percentage of the acquisition price that can be financed. The ability to finance 100 percent of the costs associated with the asset under the synthetic lease may be attractive to those firms with alternative uses for their cash. Even when residual value guarantees are required by the terms of the lease, firms are able to purchase residual guarantee insurance or invest restricted cash amounts and generate interest income, both of which provide greater investment opportunities for the firm than a down payment on a traditional real estate loan. Further, bank leasing companies affiliated with the lessee's lead bank may be comfortable lending at low short-term rates (floating or swapped) for a short-term lease, and can look to the lessee's investment grade credit, rather than the residual mortgage value, lessee-leasing, refinancing and related costs, for repayment of what would otherwise be a non-recourse mortgage.

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