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Sale-Leaseback Transactions – in the "Corporate Scandal" Era

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Background

On March 25,2004, a federal judge sentenced Jamie Olis, a 38 year old former mid-level executive at Dynegy, Inc., to more than 24 years in prison for his role in a 2001 finance scheme "designed to mask the company's financial difficulties"[2] The judge felt he had no choice but to impose the sentence, and that the punishment "reflects Congress' intent" that white-collar corporate fraud defendants receive harsh sentences.[3]

Even in an age of increased sensitivity to white-collar crime, Mr. Olis' sentence seems excessive, especially for an employee whose highest combined annual salary and bonus was, $272,000.[4] Unfortunately for Mr. Olis, though, for frauds causing losses in excess of $100 million, the federal sentencing guidelines are quite severe. In hindsight, it is obvious that in the era following Enron, Worldcom, Tyco, IMClone and Martha Stewart, when fraudulent actions or even alleged fraudulent actions can cause significant stock market losses, those operating "on the edge", if found guilty of "going over the edge", may face a sentence that could be incarcerative as well as economically punitive.

Since the "corporate scandal" trials almost always involve financial re-engineering, it is no surprise that these trials and the concomitant publicity would have an impact on sale-leaseback transactions ("SLT's") and those planning such transactions. It thus should be expected that in the "post-Enron era", all financial and accounting transactions will be examined with a heightened degree of scrutiny, particularly those with an "aroma of fancy accounting" - for corporate executives and outside advisors now know that it is much harder to obtain a "free pass" for "bad" accounting. With the stakes for aggressively advising on SLT's having been significantly raised, it follows that SLT's are now becoming increasingly more difficult and complicated to complete.

SLT's have been a favored "financing" technique because a property owner can obtain more capital from the "sale portion" of an SLT than by retaining ownership and arranging a conventional mortgage. SLT's allow the property owner to realize up to 100% of the fair market value of the property – significantly above what traditional loan-to-value lending would provide -- while retaining full possession and use of the property. Of even greater importance, if the lease-back portion of the SLT is treated for financial accounting purposes as a true "operating lease", as opposed to a "capital lease", the seller will be able to strengthen its financial statements since the full amount of the proceeds

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[2] New York Times, March 26, 2004.
[3] Wall Street Journal, March 26, 2004.
[4] New York Times, March 24,2004.

from the sale of the property will be treated on the balance sheet as an increase in assets, and the Seller will retain possession and use of the property without an offsetting liability on the balance sheet (although a footnote to the balance sheet will be required).

An SLT, however, is almost always more complicated to close than a conventional mortgage. Such is the case because (i) restrictions imposed by the SLT lessor on use of the underlying property by the SLT-seller/lessee are often more onerous than with conventional financing; (ii) there are always more "parties at the table"; and (iii) the accounting requirements are significantly more restrictive, often flying in the face of real estate as well as economic realities thereby giving the business parties much pause to ponder. As a result, most SLT's are entered into by sellers who are primarily motivated by a desire to enhance their balance sheet; hence, their willingness to endure more lease restrictions and "work through" a more complicated transaction.[5]

Business Concerns

Each SLT is driven by the business realities impacting the particular deal. For instance, the prospective purchaser (SLT-lessor) (i) will likely want significant restrictions on the ability of the SLT - seller/lessee to further transfer the property during the lease period, unless a credit guarantee remains in place; (ii) may want approval rights regarding transfers; (iii) might insist on higher standards of maintenance and/or an enhanced capital replacement program (thereby creating negative impact on the deal economics); (iv) may want input or perhaps even veto rights with respect to any significant management issues relating to the property; and (v) could have conflicting views on the development of adjacent property if owned or becomes owned by the SLT seller/lessee. Although the overall economics of the SLT (*i.e.*, the sale price in relation to the lease carry costs) may make all of the foregoing of minor concern to the SLT seller/lessee, nonetheless, these issues must be worked through and reconciled. While having a "rated" guarantor of the SLT-seller/lessee or a "rated" SLT-seller/lessee lessens the concerns of the purchaser/lessor on the foregoing issues, since the purchaser/lessor could then look primarily to the creditworthiness of the guarantor or SLT-seller lessee as opposed to the real property collateral, significant negotiation on these issues is still likely.

Another area of concern that often complicates an SLT is environmental. Even with the credit of a strong guarantee, a lender funding the SLT and particularly a residual value insurer[6] -- an oft-involved party in an SLT -- will require a comprehensive environmental review. The environmental review, depending on the lender's requirements and whether there may be a future securitization, can be more rigorous and may therefore necessitate enhanced environmental remediation or the implementation of additional environmental compliance and maintenance programs beyond that which might have been required in a conventional mortgage. Thus, notwithstanding scope and quality, creditworthiness by itself may not be enough to vitiate the higher environmental standards that may be required by a lender.

Accounting Treatment

As noted above, the structure of an SLT is often dictated by the accounting requirements necessary to obtain "operating lease" characterization. What may be agreed to in a term sheet between a motivated SLT seller/lessee and SLT purchaser/lessor may not survive the required accounting hurdles. Post-Enron, accounting firms are even more conservative in their approach to granting "operating lease" status to the leaseback portion of SLT's. The major accounting firms, in particular, will often hew to the "black and white" of the accounting industry guidelines and their manuals, and are unwilling to go into the "grey". SLT's are further complicated by the fact that the Financial Accounting Standards Board ("FASB") financial accounting criteria are not identical to published Internal Revenue Service ("IRS") guidance. FASB provides more "bright-line" tests which are therefore, "safer" to work with than the IRS' safe harbors which are not "bright-line" and even less consistently

[5] Sale-Leaseback Transactions after Enron and Worldcom-A Tougher Landscape, in New Jersey Business, October 2002; By Jeffrey H. Newman and Mark S. Levenson.

[6] Residual value insurance is a form of financial guarantee insurance that protects the insured party against unexpected declines in market value upon the termination or expiration of the lease agreement. Harper Risk Inc., Insurance and Risk Resources Library.

market-realistic[7]. Reconciling these potentially conflicting FASB and IRS guidelines requires creativity, patience and special effort to achieve the parties' respective goals and yet remain in respective compliance.

To accomplish this, as well as "operating lease" treatment, the accounting requirements applicable to the proposed transaction should be ascertained in light of the SLT-seller/lessee's specific objectives at the early stages of the transaction. In so doing, before unnecessary time and cost is expended, the parties can determine their ability to (i) meet the applicable accounting requirements; and (ii) adjust the proposed transaction in order to satisfy the accounting requirements in a manner that will not interfere with the attainment of the SLT-seller/lessee's financial goals from the proposed SLT.

While this article should not be construed as providing accounting or tax advice, it is appropriate to highlight some of the major accounting issues in a proposed SLT. Separate from the lease-back of the property by the SLT-seller--which must be tantamount to an independent, stand-alone transaction -- it is also necessary that "the payment terms and provisions" in an SLT "must clearly transfer all of the other risks and remedies of ownership as is demonstrated by the absence of any other continuing involvement by the seller/lessee"[8]. Accordingly, for instance, options to repurchase the property by the seller/lessee are generally prohibited as a form of "continuing involvement" under SFAS 98[9]. Even rights of first refusal must be based upon bona fide offers from unrelated third parties; otherwise, they too would be considered options to repurchase the property[10] which will taint the "operating lease" status of the SLT. In fact, SFAS 13 specifically defines a "capital lease" (which characterization would defeat the benefits accruing to the balance sheet of the SLT-seller/lessee were the lease-back treated as an "operating lease") as a lease where "(1) the lease transfers ownership of the property to the lessee by the end of the lease term; or (2) the lease contains a bargain option[11]."

Any lease not classified as a "capital lease" is classified as an "operating lease", the characterization virtually always the more favorable to SLT-seller/lessees. As stated above, when the lease-back portion of the SLT is treated as an "operating lease", an asset (cash and/or an account receivable which is derived from the sale portion of the SLT) is added to the balance sheet with no corresponding liability even though the SLT-seller/lessee retains possession and use of the property conveyed in fee, although a footnote disclosure respecting the lease-back portion of the SLT is often required[12]. This asset increase without an offsetting increase in liabilities, when coupled with the beneficial inconsistent treatment for financial versus tax statement presentation (see footnote 7), is the "holy grail" sought via the SLT.

The length of term of the lease-back in the proposed SLT is also an important element. Many existing long term leases that would be candidates for SLT's have terms of 49 or more years. The proposed basic lease term in a bondable SLT, however, is customarily for 15 or 20 years. Even with the generally allowable six renewal terms of up to five years each, this could leave the seller/lessee with a shorter possessory period than it currently has since an option to re-purchase the property is not allowed[13]. Although the "length" of term issue can be partially addressed by

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[7] On account of the sometimes non-identical treatment, some transactions are structured to take advantage of these differences to obtain the benefit of inconsistent book and tax treatment, *i.e.*, an "operating lease" for book purposes and "a financing" for tax purposes, to avoid a gain on any appreciation. Holthouse, 593 Tax Management (BNA), Real Estate Leases, Section VI, SLT's at A-49 through A-56(1) ("Holthouse").

[8] Statement of Financial Accounting Standards ("SF AS") 98.

[9] Ernst & Young, Financial Reporting Developments, September 2003, L716 at Page 130 ("Ernst & Young").

[10] Ernst & Young, L715 at Page 130.

[11] The other two of the four criteria, either of which would cause a sale-leaseback lease to be treated as a "capital lease", are:
(3) The lease term is equal to 75% or more of the estimated economic life of the leased property. If, however, the beginning of the lease terms falls within the last 25% of the total estimated economic life of the property, including earlier years of use, this criterion is not used in classifying the lease; or
(4) The present value at the beginning of the lease term of the minimum lease payments, excluding that portion of the payments representing executory costs to be paid by the lessor, including any profit thereon, equals or exceeds 90% of the fair market value of the leased property to the lessor at the inception of the lease. If, however, the beginning of the lease terms falls within the last 25% of the total estimated economic life of the leased property, including earlier years of use, this criterion is not used in classifying the lease. SFAS 13.

[12] Paragraph 16 of SF AS 13. *See also* Holthouse.

[13] SFAS 13; Ernst & Young, L716 at Page 130.

providing for fair-market value lease extension rights, this will no doubt have some impact on the deal economics thereby creating yet another potential complication. Moreover, if the lease extension option is not determined to be at fair market, the lease would then be characterized as a "capital lease" with the concomitant loss of "financial presentation" benefits[14].

Another accounting hurdle that must be overcome to obtain favorable "operating lease" accounting treatment requires that the SLT's "payment terms and provisions … adequately demonstrate the (SLT) buyer-lessor's initial and continuing investment in the property"[15] and, of course, the corollary, that the SLT-seller/lessee has no "continuing involvement" in the property[16]. Hence, for example, while the condemnation or casualty loss provisions under the lease-back portion of the SLT might typically allow for a termination of the SLT-seller/lessee's obligation to continue paying rent upon a substantial condemnation or casualty loss since the SLT-seller/lessee will not have use of the property, the economic underpinning of the SLT nevertheless requires that the SLT-buyer/lessor be made whole. However, whatever termination fee is agreed upon to make an SLT-buyer/lessor "whole" for its purchase price or loan equivalent, that termination fee cannot be dependent upon, or determined by, the value of the property at the time of the loss, because it would violate the accounting requirements under the "continuing involvement" theory. In fact, under the accepted accounting treatment, only a damages provision or termination fee that does not take into account appreciation or depreciation of the property (lest the SLT-buyer/lessor be "compelled" to accept the SLT-seller/lessee's offer), might be acceptable[17]. In other words, terms worked out and satisfactory to the parties, which are nevertheless deemed too favorable to the SLT-buyer/lessor, might prevent obtaining "operating lease" accounting treatment. As expressed earlier, SLT's are too time consuming and expensive not to resolve these significant points at the outset.

As alluded to earlier, while FASB criteria, and in particular SF AS 13 and SFAS 98, provide clear-cut tests to be followed, the tax law in this area is less clear and the IRS "safe harbors" often seem to be under severe mist if not fog. Nevertheless, taxpayers challenging adverse IRS sale-leaseback characterization have had some successes in the courts. Perhaps, the leading sale-leaseback case is *Frank Lyon Co. v. U.S.* ("Lyon")[18] in which the U.S. Supreme Court summarized the relevant criteria in analyzing an SLT, even though the Court failed to provide explicit guidelines for differentiating true sale-leasebacks (*i.e.*, "operating leases") from financing arrangements (*i.e.*, "capital leases"). Subsequent Tax Court decisions and particularly the literature analyzing these cases, however, do suggest the elements or "thresholds" that should be included in an SLT in order to avoid an IRS challenge. Holthouse's Tax Management sets forth a useful checklist:

(1) The property should be sold at fair market value, the amount of which is supported by an independent appraisal.

(2) Rent should be fair market value and also supported by independent appraisal.

Level or increasing rental payments are desirable.

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[14] Another issue in this context that needs to be weighed in the economics in certain tax jurisdictions is whether a lease-back to the seller/lessee for more than 49 years would require payment of a second transfer tax, in addition to the first transfer tax that would be imposed at the time of the initial sale. For jurisdictions like New York, which treat leases of more than 49 years as a transfer of property, a long term extension might result in a second transfer tax at the rate of 3.025% of consideration. It would, in any event, likely be the case that the exercise of a subsequent purchase option by the seller/lessee would require payment of the transfer tax, although if operating lease treatment is desired, there can be no purchase option.

[15] SFAS 98. SLT's must also satisfy a third condition: a "normal-leaseback" involving the active use of property by the seller-lessee in consideration for the payment of rent and excluding certain continuing involvement provisions or conditions. *See also* Holthouse.

[16] SFAS 98.

[17] The issue of the amount of acceptable termination fee in the context of a casualty or condemnation loss is also a matter of some tension between the accountants and the parties, particularly the SLT-seller/lessee. In such a situation, the SLT-Seller/Lessee wants to pay as little a termination fee as possible, and the SLT-buyor/lessor may be willing to accede to such a position given the unlikelihood of occurrence, and the possibility of insuring against the risk or covering the risk by other approaches. The accountants, however, insist on a rather high pre-determined amount, fixed at the time of entering into the transaction, so as to avoid "economic compulsion" on the SLT-buyer/lessor. In fact, the "safe harbor" amount that is generally considered to be acceptable by the major accounting firms is the rather costly payment of an amount equal to the present value of all remaining lease payments at the time of the termination.

[18] 435 U.S. 561 (1978) revising 536 F2 746 (8th cir. 1976), revising and remanding 75 USTC, 9545 (E. D. Ark 1975).

(3) Multiple (more than two) parties are recommended: the seller-lessee, the buyer-lessor, and, preferably, an institutional lender.

(4) The lease term should not exceed the economic life of the property. Renewal options should provide for a fair market rental value at the time the option is exercisable.

(5) There should be no repurchase options. If one is necessary, ideally it should be based on the fair market value of the property at the exercise date.

(6) All condemnation and insurance payments in excess of liabilities on the property should inure to the buyer-lessor.

(7) There should be a business purpose for the transaction and the formalities of the agreement should be followed. The agreement should avoid loan language or structure.

(8) A substantial cash return on the leaseback should be included, to avoid having the transaction viewed as being created solely for tax purposes.

(9) The lease should not be structured as a pure net lease.

(10) The sale-leaseback should be designed to qualify as an operating lease under GAAP.[19]

(11) The leaseback should terminate in the event the property is destroyed.

(12) If possible, the term of the leaseback should be less than 30 years.

(13) Two entirely different sets of documents should be drafted, one for the sale of the real estate and one of the lease agreement.

(14) The buyer-lessor should make an equity investment in the property.

(15) The seller-lessee should not provide guarantees of the loans financing the purchase of the property (although a pledge of the lease would not be uncommon).

(16) The transaction should not be between related parties.

(17) The buyer-lessor should not have a put on the property.

(18) The seller-lessee should not possess the right to sell the property without the buyer-lessor's consent.

(19) The transaction should be structured so that the buyer-lessor can meet the so-called imprudent abandonment test. This means that the buyer-lessor must be able to demonstrate that he or she: (i) has made more than a negligible investment in the property, (ii) possesses more than a negligible right to receive rents, and (iii) reasonably anticipates more than a negligible return from the right to enjoy the residual value of the property.

Holthouse's ***Tax Management*** at pps. A-56 and A-56(1).

Conclusion

The foregoing has been intended to highlight some of the potential accounting "pitfalls" on the path to obtaining "operating lease" status for the lease-back portion of an SLT. SLT's are effective devices to enhance a balance sheet in the context of raising liquidity from the sale of realty while maintaining possession and use status quo. However, they have become somewhat less attractive in the "post-Enron era", perhaps due to an intuitive sense that the SLT device is somehow "counterintuitive" by virtue of the disproportionately positive impact to the balance sheet of the SLT-seller/lessee notwithstanding that which looks, on the surface, from an operational perspective, as maintaining the status quo ante. As a result, it is not surprising that accounting firms put SLT's under an even more magnified glass to assure themselves that the lease-back component of the SLT should be treated as an "operating lease". This heightened scrutiny by the accountants (and tax lawyers) should not be a reason to forego an SLT; rather, it should merely alert clients and their counsel to "bring on the terms" to all interested parties early in the process, thereby avoiding the excess costs that flow together with the agony of a deal which aborts late in the process. Moreover, involving the accountants and tax lawyers early on will probably enable the parties to more easily find practical solutions, when flexibility on both sides is generally the greatest.

[19] *See* SFAS 13 and SFAS 98.