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Off-Balance-Sheet Sale-Leasebacks and Synthetic Leases After Enron

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I. INTRODUCTION

Prompted by the Enron accounting scandal,[1] the Securities and Exchange Commission has promised increased scrutiny of off-balance-sheet transactions[2] and has demanded immediate promulgation of new financial accounting standards for special purpose entities.[3] In response to such demands, on November 13, 2002, the Financial Accounting Standards Board, approved in concept, and expects to finalize and issue in December 2002, a new accounting regulation (the "Proposed Interpretation")[4] that dramatically changes the standards for consolidation of special purpose entities. Under the Proposed Interpretation, beginning in June 2003, a substantial portion of the over $100 billion[5] in existing synthetic leases will be added to tenants' balance sheets as debt. At the same time, several prominent public companies have cancelled plans to engage in synthetic lease transactions (an off-balance-sheet financing vehicle treated as a lease for accounting purposes but as financing for tax and other purposes). After Enron, these companies are electing conventional (on-balance-sheet) financing instead.[6] In light of these developments, some public companies may have concerns about another popular[7] and long-standing off-balance-sheet real estate financing vehicle – the sale-leaseback.

In a sale-leaseback transaction, a company owning real property sells that property and simultaneously leases it back from the buyer. Certain sale-leasebacks—particularly those financed with a credit tenant loan ("CTL")—have some of the same characteristics as synthetic leases. Specifically, in both the CTL-financed sale-leaseback and the synthetic lease, the lender is relying primarily on the credit of the tenant rather than the value of the mortgaged property. As a result, the landlord, generally a thinly capitalized special purpose entity, is able to finance over 95% of the value of the property. However, as discussed in this article, a properly structured off-balance-sheet sale-leaseback differs from a synthetic lease in one critical way: the off-balance-sheet sale-leaseback must, under current accounting rules, result in a lease with economic substance while a synthetic lease has no such requirement. As a result, although it may be subject to somewhat greater scrutiny, the off-balance-sheet sale-leaseback should continue to serve as a useful tool for both real estate investors and corporate real estate owners and users even in the post-Enron environment.

Section II of this article describes the characteristic benefits and costs of the sale-leaseback transaction and summarizes the financial accounting standards applicable to a seller-tenant seeking off-balance-sheet treatment of a real estate sale-leaseback. Section II then describes synthetic leases and compares a typical CTL financed sale-leaseback with a synthetic lease. It also discusses the effect the Proposed Interpretation will have on synthetic leases and sale-leasebacks. Finally, Section III of this article discusses two basic structures used in a sale-leaseback financed with a CTL to accommodate the often conflicting requirements of the landlord's lender and the tenant's auditor.

II. DESCRIPTION OF OFF-BALANCE SHEET LEASES AND SUMMARY OF CURRENT GAAP REQUIREMENTS

A. The Sale-Leaseback: Benefits and Costs to the Seller-Tenant

Companies that own their factories, retail outlets, or other real estate facilities often find that the capital tied up in these assets would yield a higher return if reinvested in their core businesses. Accordingly, many companies monetize their real estate assets through various forms of asset-based financing. The real estate sale-leaseback offers several advantages over conventional financing. First, the sale-leaseback should provide the company with cash equal to 100% of the fair market value of the property, while conventional mortgage financing generally yields cash proceeds equal to 75% or less of the value of the property. Second, when long-term interest rates are low, a sale-leaseback may enable the company to lock in a low cost of funds for a longer term than is available to the company through conventional financing.[8] Third, a company's ability to obtain a mortgage loan may be limited or precluded by state or federal regulations[9] or by financial covenants under its existing credit facilities. In such cases, a sale-leaseback may be the company's only practical means of raising capital without violating such restrictions. Finally, a properly structured sale-leaseback provides the seller-tenant with favorable financial accounting treatment: the seller-tenant removes the real estate and related liabilities from its balance-sheet and adds any profit from the sale to its income statement.[10] By contrast, with conventional financing, the borrower does not sell the property so there is no gain to recognize. Although conventional financing generally offers a favorable means of generating tax-free cash, the borrower must show the financing as a liability on its balance-sheet and must record annual depreciation charges for the property's improvements as an expense on its income statement. As a result, an off-balance-sheet sale-leaseback will improve the company's reported earnings, return on assets, and equity and debt-to-equity ratio as compared to conventional financing.

Sale-leasebacks also have drawbacks for the seller-tenant. First, the seller-tenant gives up the right to share in future appreciation of the property. Second, the seller-tenant is locking itself in to a lease term that may extend beyond the period for which the seller-tenant can profitably use the property. Third, the seller-tenant may have to pay capital gains tax on its profit from the sale. Fourth, a sale-leaseback triggers transfer taxes and reassessment for purposes of real property taxation.

B. Summary of Current GAAP Requirements

Although the Securities and Exchange Commission ("SEC") has the statutory authority to establish financial accounting and reporting standards for publicly held companies,[11] since 1938 it has relied on the private sector to formulate what is now termed "generally accepted accounting principles" or "GAAP".[12] Since 1973, the primary authority for GAAP has been the Financial Accounting Standards Board ("FASB"),[13] a private, independent organization composed of seven board members and additional support staff.[14]

Under GAAP, a sale-leaseback transaction will be "off-balance-sheet" from the tenant's perspective, if and only if all of the following are true: the transaction qualifies for sale-leaseback accounting under FAS 98[15] (see Section II.B.1 below), the lease qualifies as an operating lease under FAS 13[16] (see Section II.B.2 below), and the tenant is not required to "consolidate" the landlord under applicable accounting regulations (see Section II.B.3 below regarding consolidation rules).

1. FAS 98—The Question of "Continuing Involvement"

In 1988, FASB issued FAS 98, which imposes restrictive tests for off-balance-sheet treatment of real estate sale-leasebacks. FAS 98 defines "sale-leaseback accounting" as "a method of accounting for a sale-leaseback transaction in which the seller-lessee records the sale, removes all property and related liabilities from its balance-sheet, recognizes gain or loss from the sale … and classifies the leaseback in accordance with Statement 13."[17] If the lease is classified as an operating lease under FAS 13 (as discussed in Section II.B.2 below), the seller-tenant may be required to defer all or a portion of the gain, depending upon the terms of the lease. If the seller-tenant leases back only a minor part of the property, it immediately recognizes all gain from the sale.[18] If the leaseback is not minor, then the seller-tenant immediately recognizes gain to the extent it exceeds the present value of the minimum lease payments.[19] The balance of the gain is deferred and recognized straight-line over the term of the lease.[20]

Under FAS 98, sale-leaseback accounting should be used by the seller-tenant only if the transaction includes all of the following:

a. A "normal" leaseback - defined as one in which the tenant occupies the real estate as opposed to subleasing it,[21]
b. Payment terms and provisions that adequately demonstrate the buyer-landlord's initial and continuing investment in the property,[22] and,
c. Payment terms and provisions that transfer all of the other risks and rewards of ownership to the buyer-landlord, as demonstrated by the absence of any other continuing involvement by the seller-tenant.

It is the third condition—the absence of "continuing involvement" by the seller-tenant—that raises the largest number of issues for off-balance-sheet treatment. The word "other" in the phrases "other risks and rewards of ownership" and "other continuing involvement" means other than those that would ordinarily be present in a "normal leaseback"—i.e., one in which the seller-tenant intends to occupy the property.[23] Thus, the continuing involvement prohibition may be restated as follows: A transaction structured as a sale-leaseback will be respected for accounting purposes only if (i) the buyer-landlord receives all of the risks and rewards of ownership other than the right of possession during the lease term, and (ii) the seller-tenant retains no continuing involvement in the property other than the right of possession during the lease term.

FAS 98 provides the following examples of prohibited continuing involvement by the seller-tenant: (i) the seller-tenant has an obligation or an option to repurchase the property,[24] (ii) the seller-tenant guarantees the buyer-landlord's investment or a return on that investment,[25] (iii) the seller-tenant provides nonrecourse financing to the buyer,[26] (iv) the seller-tenant provides collateral on behalf of the buyer other than the property or guarantees the buyer-landlord's debt,[27] (v) the "seller-tenant enters into a sale-leaseback transaction involving property improvements or integral equipment without leasing the underlying land to the buyer-landlord,"[28] (vi) any other provision that allows the seller-tenant to participate in the appreciation of the leased property,[29] (vii) the sales contract or an accompanying agreement requires the seller to develop the property in the future or to construct facilities on the land.[30]

It is instructive to compare the continuing involvement prohibition of FAS 98 with the federal income tax rule governing ownership of leased property. In contrast to GAAP, which lacks any precedent setting case law and is subject to very few in depth articles, federal tax law in general, and the issue of tax ownership of leased property in particular, are the subject of a wealth of cases[31] and thoughtful articles.[32] According to the United States Supreme Court in *Frank Lyon Co. v. United States*, the landlord will be deemed the owner of the leased property for tax purposes so long as the landlord "retains significant and genuine attributes of the traditional [landlord] status…"[33] Or as stated by one commentator: "[s]o long as the nominal owner has retained either the upside or the downside potential," the nominal owner will also be the owner for tax purposes.[34]

In other words, for federal income tax purposes, the buyer-landlord in a sale-leaseback may be deemed to be the owner of the property even though it receives less than all of the benefits and burdens of ownership and even though the seller-tenant has some continuing involvement in the property (in addition to the right of possession). Thus, a sale-leaseback that includes a tenant purchase option may be respected for tax purposes,[35] but never for accounting purposes[36] because it provides the seller-tenant with a potential share in the residual value of the property. Similarly, non-recourse financing by the seller-tenant will not necessarily preclude a sale-leaseback from being respected for tax purposes, but it will always preclude sale-leaseback treatment for accounting purposes[37] because it exposes the tenant to loss exposure for the buyer-landlord's investment in the property. In short, the accounting standards for sale-leaseback treatment are generally stricter than those under federal income tax law.

Another difference between the test for tax ownership and the test for book ownership is the manner in which each test is applied. As explained above, the tax ownership test applies a substance over form approach in which the courts analyze the various transactional terms to determine their combined effect on the landlord's upside potential and downside exposure. By contrast, FAS 98 simply prohibits certain transactional terms regardless of their overall effect on the landlord's risks and rewards. For example, as mentioned above, FAS 98 categorically precludes a tenant purchase option in a sale-leaseback—even one that is based on fair market value at the time of exercise—because it constitutes "continuing involvement" on the part of the seller-tenant. For tax purposes, courts evaluate the effect of a tenant purchase option on the landlord's upside potential. Thus, in *Frank Lyon Co.*, the United States Supreme Court upheld a sale-leaseback with a tenant purchase option that, if exercised, would generate for the buyer-landlord a 6% compound annual interest on its equity investment.[38] Another example of the formal approach required by FAS 98 is the way in which the landlord's down payment is evaluated. FAS 98 incorporates FAS 66, which in turn imposes rigid mechanical rules for testing the adequacy of the landlord's down payment. Thus, under GAAP, the buyer-landlord may engage in a sale-leaseback with nothing down and 100% non-recourse financing, so long as such financing is provided by a party unrelated to the seller-tenant.[39] By contrast, while the courts may respect for tax purposes a sale-leaseback in which the buyer-landlord makes no down payment,[40] when combined with limited upside potential, the absence of an equity investment will likely result in a finding that the buyer-landlord is not the tax owner.[41]

2. FAS 13—The Four Questions

Like FAS 98, FAS 13: Accounting for Leases, is based on the principle that "a lease transaction that transfers substantially all of the benefits and risks of ownership of the property should be accounted for as the acquisition of an asset and incurrence of an obligation by the tenant."[42] Under FAS 13, such a lease is characterized by the tenant as a "capital lease." This treatment requires that the asset and the obligation associated with it be carried on the tenant's balance sheet.[43] In other cases, the tenant should account for the lease as an "Operating Lease," or a true rental arrangement.

In order to be classified as an operating lease under Paragraph 7 of FAS 13, none of the following four criteria can exist at lease inception (i.e., the tenant must "fail" all four tests):

> "a. The lease transfers ownership of the property to the tenant by the end of the lease term….
> b. The lease contains a bargain purchase option….
> c. The lease term …is equal to 75 percent or more of the estimated economic life of the leased property…. However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for the purposes of classifying the lease.
> d. The present value at the beginning of the lease term of the minimum lease payments…, excluding that portion of the payments representing executory costs such as insurance, maintenance and taxes to be paid by the lessor, including any profit thereon, equals or exceeds 90 percent of the excess of the fair value of the leased property… to the lessor at the inception of the lease over any related investment tax credit retained by the lessor and expected to be realized by [the lessor]."[44]

In a real estate sale-leaseback, subparagraphs 7a and b of FAS 13 do not impose any additional restrictions beyond those already imposed by FAS 98. In the case of subparagraph 7a, a lease that transfers ownership to the tenant would clearly constitute prohibited continuing involvement precluding off-balance-sheet treatment. Similarly, in the case of subparagraph 7b, a purchase option of any sort granted to the tenant is a prohibited form of continuing involvement under FAS 98. In theory, subparagraph 7c—prohibiting a lease term of 75% or more of the property's economic life—does impose an additional restriction for off-balance-sheet sale-leasebacks beyond those contained in FAS 98. However, given the relatively long economic life of most buildings, a limit of 75% of economic life for the lease term rarely poses a practical problem for landlords or tenants. As a result, it is subparagraph 7d of FAS 13 - the 90% test - that imposes the only practical limitation on off-balance-sheet real estate sale-leasebacks over and above those contained in FAS 98.

(a) The 90% Test

To apply the 90% test, the tenant must calculate the present value of the minimum lease payments and then compare that present value to the purchase price of the property.[45] If the present value of the lease payments equals or exceeds 90% of the purchase price of the property, then the tenant must treat the lease as a capital lease—an on-balance-sheet transaction. If the present value of the lease payments is less than 90% of the purchase price of the property, and the tenant fails the other three tests of FAS 13 paragraph 7, then the lease is considered an operating lease—an off-balance-sheet transaction.

In computing the present value of the minimum lease payments, the tenant is generally required to use a discount rate equal to its "incremental borrowing rate."[46] FAS 13 defines the tenant's incremental borrowing rate as "the rate that, at the inception of the lease, the tenant would have incurred to borrow over a similar term the funds necessary to purchase the leased asset."[47] In a credit tenant lease financing, since the landlord's loan is based on the tenant's credit, the tenant's auditor may question an incremental borrowing rate that differs materially from the interest rate on the landlord's real estate financing.

3. Consolidation Rules—The Question of Control

When the accounting standards require that one company "consolidate" another company, it means that the first company must report the results of operations and the financial position of both itself and the company it must consolidate essentially as if the two were a single company with one or more divisions.[48] A company must consolidate all other companies in which it directly or indirectly has a controlling financial interest.[49] "Control" means the non-shared decision making power over matters normally expected to be addressed in "carrying out the entity's current business activities."[50] According to APB Opinion 18,

> "The usual condition for control is ownership of a majority (over 50%) of the outstanding voting stock. <u>The power to control may also exist</u> with a lesser percentage of ownership, for example, <u>by … lease</u>, agreement with other stockholders, or by court decree." (Emphasis added.)

(a) Constructive Control

Control of a special purpose entity ("SPE") is often accomplished through the SPE's governance documents, contracts, or leases rather than through stock ownership. In such cases, it may be difficult to determine which party to the arrangement has the decision-making power that is normally held by shareholders, partners, or investors. Under certain circumstances, control is conclusively presumed to exist and consolidation is therefore required. Section II.B.3(b) below summarizes the current rules for determining constructive control over an SPE landlord in a real estate lease. Section II.C.4 below summarizes the Proposed Interpretation, which would create new rules for determining constructive control for SPEs in all transactions, including real estate leases.

(b) EITF 90-15

In 1990, the Emerging Issues Task Force ("EITF") of the Financial Accounting Standards Board issued EITF 90-15,[51] which describes the conditions under which a tenant must consolidate a special purpose landlord, despite the tenant's lack of any ownership interest in the landlord. In the event of consolidation, the landlord's debt is "on-balance-sheet" debt for the tenant. EITF 90-15 provides in relevant part as follows:

> "[A] lessee is required to consolidate a special-purpose entity lessor when all of the following conditions exist: (1) substantially all of the activities of the SPE involve assets that are to be leased to a single lessee, (2) the expected substantive residual risks and substantially all the residual rewards of the leased asset and the obligation imposed by the underlying debt of the SPE reside directly or indirectly with the lessee, (3) the owner of record of the SPE has not made an initial substantive residual equity capital investment that is at risk during the entire term of the lease."

A careful reading of this rule and FAS 98 reveals that a sale-leaseback qualifying for off-balance-sheet treatment under FAS 98 should never be subject to consolidation under EITF 90-15. Specifically, a sale-leaseback qualifying for off-balance-sheet treatment under FAS 98 will transfer all of the risks and rewards of ownership (other than possession) to the buyer-landlord and will therefore fail condition 2 of EITF 90-15, which is met if substantially all of the risks and rewards reside with the tenant. If a lease fails condition 2 of EITF 90-15, consolidation will not be required under EITF 90-15 because this standard requires consolidation only when all three conditions are met. As a result, if a sale-leaseback qualifies for off-balance-sheet treatment under FAS 98, it will not be subject to consolidation under EITF 90-15.

C. Synthetic Leases, CTL Financed Sale-Leasebacks, and the Proposed Interpretation

1. Synthetic Lease

In simplest terms, a synthetic lease is a financing vehicle that is treated as an operating lease under GAAP but as a financing mechanism under federal income tax law. The synthetic lease gained popularity in the 1990s and is the subject of many articles.[52] In its typical structure, the lease is an absolutely net lease that allocates all real estate responsibilities and risks to an investment grade rated tenant, while the landlord finances 97% of its purchase price of the property with a non-recourse, non-amortizing loan[53] and makes only a 3% equity investment. In most cases, the landlord is an SPE owned by the institution(s) making the 3% equity investment. The defining feature of the synthetic lease is the fact that the tenant has certain obligations at the end of the lease term that support repayment of the "funded amount"—that is, landlord's financing and equity investment after taking into account any amortization. Depending upon the structure of the particular transaction, at lease expiration, the tenant generally must either: (1) renew the lease if it can refinance the debt and equity investments, (2) purchase the property for a price sufficient to repay the funded amount, or (3) arrange for a sale of the property to a third party. If the property sells for more than the funded amount, the sale proceeds are used to repay the equity and debt holders and the tenant keeps the excess. As a result, the tenant realizes any appreciation in the value of the property. If the property sells for less than the funded amount, the tenant must pay the difference—not to exceed 85% of the funded amount.[54] Thus, the tenant absorbs all losses from depreciation of the property's value until the value of the property has declined to 15% of its original value, at which time the equity holder[55] (and at 12%, the debt holder) begin to suffer losses. This tenant obligation is known as a "residual value guarantee."

Another characteristic of the synthetic lease is that the rent is usually sufficient to pay the interest on the debt plus a cash-on-cash return on the 3% equity investment.[56] The lease term is fairly short—generally five to seven years—so that the present value of the rent, including the payment pursuant to the residual value guarantee[57] that the tenant may be obligated to make on lease termination, is less than 90% of the fair market value of the property as required for operating lease treatment under FAS 13.

The requirement of a 3% equity investment is a result of EITF 90-15.[58] As discussed above, EITF 90-15 requires a tenant to consolidate a special purpose entity landlord when three conditions are met. A typical synthetic lease will always meet the first two conditions: (1) the special purpose entity landlord has no other business other than ownership of the property, and (2) the tenant has substantially all of the risks and rewards of ownership of the property. As a result, a synthetic lease is structured to avoid consolidation under EITF 90-15 by failing the third condition—the owner of the SPE has not made an initial substantive residual equity capital investment that is at risk during the entire term of the lease. The SEC has stated that 3% is the minimum acceptable investment that will satisfy the requirement of "an initial substantive residual equity capital investment" under condition #3.[59] Thus, synthetic leases require a 3% (or greater) equity investment in order to fail condition #3 and avoid consolidation under EITF 90-15.

2. Elements of a Typical Credit Tenant Lease Financing

A credit tenant loan (CTL) refers to a loan to the landlord that is supported primarily by the lease obligations of an investment grade[60] rated tenant.[61] That is, the loan is based primarily on the tenant's credit rather than the value of the property.[62] Most CTLs are made by life insurance companies, who must account for their investments in accordance with the risk-based capital rules established by the National Association of Insurance Commissioners (NAIC).[63] Under the NAIC rules, a life insurance company making a qualifying CTL is accorded advantageous regulatory accounting treatment for such loans in that the loan results in a lower charge against the life insurance company's balance sheet than would a conventional mortgage.[64] Specifically, a qualifying CTL is classified as a bond (a Schedule D investment) rather than a mortgage loan (a Schedule B investment).[65] Because the reserve requirements for investment grade bonds are significantly lower than those for mortgage loans,[66] qualifying CTLs (i.e., those qualifying for Schedule D treatment) have significantly lower reserve requirements than do conventional mortgage loans.

In a properly structured CTL, all risks of a loan default other than a lease default by the tenant are minimized. The lease is a triple net lease in which the tenant pays all costs associated with the property including utilities, maintenances, taxes, and insurance. Often, the lease will be a bond style lease in which the tenant's obligation to pay rent is not excused or reduced for any reason including complete destruction of the premises. If the lease is not a bond style lease, any real estate risks or obligations imposed on the landlord must be mitigated through insurance or other means.[67] In addition, many CTL lenders require a "lockbox" arrangement in which the tenant pays its rent directly to landlord's lender to cover the debt service of the loan.[68] Finally, the borrower-landlord is generally required to be a special purpose entity whose sole asset is the property, whose only business is owning and leasing the property and whose sole liability is the CTL.[69] This requirement minimizes the risk of the borrower filing bankruptcy for reasons other than the tenant's breach of the lease.

The holder of a properly arranged CTL owns a debt instrument similar in risk profile to a corporate bond issued by the tenant.[70] As a result, CTL lenders generally will allow the borrower-landlord to finance 100% of the cost of acquiring the property. Moreover, CTL lenders generally allow a debt coverage ratio of 1.0 – that is, they will make a loan in which the debt service payments are exactly equal to the rent under the lease. By contrast, other commercial real estate lenders generally require that the property have a value substantially higher than the loan amount and that the rental payments be substantially higher than the debt service payments in order to provide the lender with a margin of security.

Because equity capital commands a higher return than does debt capital, an investor who uses 100% CTL financing to acquire real estate will generally have a lower cost of capital than one who uses a combination of conventional financing and an equity investment for the "down payment."

3. *Comparison of Synthetic Lease and CTL-Financed Sale-Leaseback*

A synthetic lease and a CTL-financed sale-leaseback share several characteristics: (1) they both involve net leases in which all or substantially all of the real estate obligations are the responsibility of an investment grade rated tenant, (2) they are both financed with non-recourse loans from institutional lenders relying primarily on the credit of the tenant rather than the value of the property, and (3) in both cases, the landlord is typically a thinly capitalized special purpose entity.

However, a synthetic lease and a CTL-financed sale-leaseback have three critical differences. First, in a synthetic lease, the tenant did not previously own the property and is therefore not engaging in a sale-leaseback. As a result, the transaction is not subject to FAS 98, and the tenant may have "continuing involvement" with the property while keeping the lease off-balance-sheet. By contrast, a sale-leaseback is always subject to FAS 98 so that the tenant's "continuing involvement" will preclude off-balance-sheet treatment.

Second, in a synthetic lease, the tenant has substantially all of the risks and rewards of the property because (a) the tenant's option to buy the property for the amount of the landlord's original investment provides the tenant with all the upside potential and (b) by virtue of the residual value guarantee, the tenant has substantially all of the downside risk of the property. As discussed above, federal income tax law applies a substance over form approach in determining tax ownership of property—that is, where the tenant has both the risks and rewards of the property, it will be treated as the owner for tax purposes. Thus, by design, the tenant in a synthetic lease is treated as the owner of the property for tax purposes and is therefore entitled to the applicable depreciation deductions relating to the property and interest deductions on the financing.[71] However, after the fall of Enron, the form over substance structure characteristic of synthetic leases has proved troubling for some companies that are sensitive to transactions that appear to use "creative accounting" to hide debt. By contrast, in a sale-leaseback, the landlord must have all of the risks and rewards of ownership in order for the transaction to qualify for off-balance-sheet treatment under FAS 98. As discussed above, the accounting standards for sale-leaseback treatment are stricter than those under federal income tax law. Thus, the landlord in an off-balance-sheet sale-leaseback should always be treated as the owner of the property for federal income tax purposes. Moreover, since a sale-leaseback contemplates a "true sale" and a "true lease," it should not raise concerns that the tenant is using a form over substance structure to hide debt.

4. *Proposed Interpretation: Consolidation Based on Variable Interests*

The Proposed Interpretation will supersede EITF 90-15 and will impose stricter requirements for consolidating special purpose entities based on constructive control.[72] The final interpretation will be effective upon issuance for SPEs created after the issuance date and will be effective for SPEs created before the issuance date for fiscal periods beginning after June 15, 2003.

In its current form, the Proposed Interpretation is founded on the premise that when an SPE has "no voting equity interests or the voting equity interests do not provide sufficient financial support for the SPE to conduct its activities,"[73] the SPE will receive financial support (called "variable interests") in a form other than voting equity interests. Such financial support may take the form of loans, guarantees, or subordinate interests. The Proposed Interpretation states: "[e]conomically, the holders of variable interests would not be willing to provide an SPE with the type of support normally provided by equity investors without an expected return commensurate with the risk of an equity investment. The variable interest holders also will protect their interests…either by establishing predetermined limits on the SPE's activities or by wielding decision-making authority in some form other than a voting interest." Accordingly, FASB concluded that in this case, the holder of the majority of variable interests (called the "primary beneficiary") will have risks and rewards that are of the same character as an equity investment and should consolidate the SPE even though it does not hold a majority of the voting interests in the SPE.[74]

The Proposed Interpretation establishes five conditions for constructive (i.e., non-voting) control. If the SPE meets all five conditions, it is not subject to the Proposed Interpretation—that is, the SPE should be consolidated by another entity only if such entity has voting control of the SPE.[75] Conversely, if the SPE fails any of the five conditions, it must be consolidated by its primary beneficiary without regard to voting control.[76] The five conditions are as follows:

> a. The equity owners have voting rights that permit them to make decisions about the SPE's activities.[77]
> b. The equity invested in the SPE is sufficient to allow the SPE to finance its activities.[78] An equity investment of less than ten percent of the SPE's total assets is presumed to be insufficient.[79]
> c. The equity investment is subordinate to all other interests in the SPE, so that "it is the first interest subject to loss…and its return is not limited or guaranteed…"[80]
> d. The assets that the equity owners provided in exchange for their equity interest are not subordinated beneficial interests in another SPE.[81]
> e. The equity investment was not provided directly or indirectly to the equity owners by another party with an interest in the SPE.[82]

Finally, FASB reached a consensus at its meeting of October 16, 2002 not to define an SPE. Indeed, the final version of the Proposed Interpretation may not use the term "SPE." Instead, the Proposed Interpretation will apply to all entities other than those that are divisions of a "substantive operating enterprise."[83] A "substantive operating enterprise" is one that conducts business operations, "has employees, and has sufficient equity to finance its operations without support from any other enterprise or entity except its owners."[84] (When used in this article, the term "SPE" refers to an entity that is not a substantive operating entity.) Although the Proposed Interpretation will not apply to divisions of a substantive operating entity, it will apply to the subsidiary of a substantive operating entity unless that subsidiary is itself a substantive operating entity. Thus, the parties to a lease can avoid application of the Proposed Interpretation by structuring the transaction so that the property is directly owned by a substantive operating entity.

5. Synthetic Leases Under the Proposed Interpretation

Although the landlord in a synthetic lease is usually an SPE, that is not always the case. Thus, where a single financial institution is willing to provide 100% of the equity financing for a synthetic lease, it may simply arrange for one of its subsidiaries (which is a substantive operating entity) to serve as landlord. In that case, the Proposed Interpretation would not apply and off-balance-sheet treatment could be obtained in accordance with FAS 13. Assuming that the landlord in a synthetic lease is an SPE, the next step is to determine whether the SPE fails any of the five conditions of constructive control noted in the preceding section. The third condition on constructive control requires that the equity investment be in first loss position and that its potential return be unlimited. In other words, the SPE's owners must have the risks and rewards typically associated with equity ownership. The landlord in a synthetic lease has neither. As a result of the tenant's 85% residual value guarantee, the tenant takes first loss position—the landlord is not exposed to loss unless the property's value drops to less than 15% of its cost. Furthermore, in a synthetic lease, the tenant rather than the landlord has all of the upside potential of the property by virtue of the tenant's fixed price purchase option. As a result, an SPE landlord in a synthetic lease has a limited potential return. Thus, the SPE fails this condition. It must therefore be consolidated by its primary beneficiary.

According to the Proposed Interpretation, "if the lessee provides a residual value guarantee …, the lessee to the SPE is the probable primary beneficiary."[85] As a result, under the Proposed Interpretation, the tenant in a synthetic lease will probably be required to consolidate an SPE landlord. Since the purpose of the synthetic lease is obtaining off-balance-sheet treatment for a financing transaction, synthetic leases will no longer be arranged with an SPE landlord.

Synthetic leases face another potential obstacle apart from the Proposed Interpretation. In November 2002, FASB issued an accounting regulation that changes the manner of accounting for guarantees.[86] Under this regulation, a tenant under a synthetic lease is required to record on its balance sheet at the inception of the lease, a liability for the residual value guarantee contained in the lease.[87] The liability is required to be reported at fair value.[88] However, under this regulation the tenant records an offsetting debit on the asset side of its balance sheet in the form of prepaid rent.

6. Sale-Leasebacks Under the Proposed Interpretation

Assuming that the landlord in a sale-leaseback is an SPE, the SPE will be subject to the Proposed Interpretation's constructive control test. Consider first whether an SPE would pass the third condition in the constructive control test (i.e., that the equity investment be subordinate to all other interests in the SPE). In a sale-leaseback, the tenant does not make a residual value guarantee because such a guarantee would constitute prohibited continuing involvement under FAS 98.[89] As a result, the landlord's equity investment is in "first loss" position. Similarly, FAS 98 precludes the tenant in a sale-leaseback from having an option to purchase the property. Thus, the landlord's upside potential (due to appreciation in the residual value of the property) is unlimited. Consequently, in contrast to an SPE landlord in a synthetic lease, an SPE landlord in a sale-leaseback will pass the third condition in the Proposed Interpretation's test for constructive control.

If the equity owners of the SPE are willing to invest sufficient equity capital (referred to herein as a "substantive equity investment"), the SPE landlord in a sale-leaseback may be structured to comply with the remaining four conditions for avoiding consolidation with the primary beneficiary under the Proposed Interpretation. On the other hand, if the equity owners are unwilling to make a substantive equity investment, the SPE will fail the second condition and its primary beneficiary will be required to consolidate the SPE. According to the Proposed Interpretation, "if the lessee does not provide a residual value guarantee or make other arrangements that ensure that the value of the SPE's assets will be sufficient to meet its obligation at the end of the lease term, the *lender* to the SPE is the probable primary beneficiary."[90]

However, at the October 16, 2002 FASB meeting, most of the board members expressed the opinion that if a lender's only variable interest in the debtor is investment grade debt (or debt with terms similar to that of investment grade debt), the lender should rarely if ever be the primary beneficiary of the debtor. As stated by one board member, "the issue is variability; on its own, investment grade debt doesn't have much variability."

Because a CTL has terms similar to that of investment grade debt, a CTL lender should rarely, if ever, be the primary beneficiary of the borrower-landlord under the Proposed Interpretation. Consider the case of a CTL-financed lease with an investment grade tenant where the landlord is an SPE in which the equity owners have made a nonsubstantive equity investment. As discussed in Section III.B.2(a) below, if the CTL has a balloon payment, it will be secured by a residual value insurance policy. As the guarantor of asset value, a residual value insurer will be considered a variable interest holder under the Proposed Interpretation.[91] Given that the equity holders in this example are assumed not to have made a substantive equity investment, under the Proposed Interpretation each equity holder is also considered to be the holder of a variable interest.[92] Although there are arguments to the contrary, the landlord's lender will apparently also be considered the holder of a variable interest, as the lender is at risk of losing its investment if the tenant defaults and the property is of insufficient value to repay the loan.[93] By contrast, it appears that the tenant in this example is not a variable interest holder because it is not subject "to a risk of losing an investment in the SPE or incurring a loss as a result of a contingent obligation to transfer assets or issue securities to the SPE."[94]

Now that the variable interest holders have been identified, it is possible to identify the primary beneficiary. At the October 16, 2002 meeting, FASB reached a consensus that the primary beneficiary is the entity holding the majority of the variable interests and that such determination will be both quantitative (i.e., based in part on the interest holder's expected future losses and expected future gains) and qualitative (i.e., based in part on the extent to which the variable interest is subordinate to other interests). Thus, if two or more variable interest holders have similar expected future losses and gains, the primary beneficiary will be the one in first loss position.[95] The lender in this example has its loan payments backed by the lease payments from an investment grade tenant and its balloon payment guaranteed by a residual value insurance policy; and it is in third loss position —behind the equity holders and the residual value insurer— with respect to the risk of decrease in the residual value of the property. Thus, its expected losses are nominal and its right to repayment is not subordinate to that of any other interest holder. Furthermore, it has no claim against the future appreciation of the property. Accordingly, the lender will not be the primary beneficiary. As a result, in this example, the primary beneficiary — and therefore the entity required to consolidate the SPE landlord — will be the residual value insurer or one of the equity holders, rather than the lender or the tenant.

FASB's recent shift away from consolidation by a CTL lender is supported by GAAP's conceptual framework. According to FASB Concepts Statement 6, Elements of Financial Statements, "all classes [of equity] depend at least to some extent on enterprise profitability for distributions of enterprise assets, and no class of equity carries an unconditional right to receive future transfers of assets from the enterprise except in liquidation, and then only after liabilities have been satisfied."[96] Because a CTL lender has an absolute right to repayment collateralized by a senior lien on the borrower-landlord's sole asset, it would be inconsistent with GAAP's conceptual framework for the CTL lender to classify its interest in the borrower-landlord as an equity interest. The lender's consolidation of the borrower-landlord would result in the lender treating the borrower-landlord's assets as those of the lender; therefore, consolidation by the lender is inconsistent with GAAP's conceptual framework.

Finally, it is important to emphasize that the Proposed Interpretation will only affect lenders' GAAP accounting. Thus, insurance company regulatory accounting (which is based on statutory accounting principles[97]) will not be affected by the Proposed Interpretation.[98] Consequently, the Proposed Interpretation will not affect insurance companies' asset valuation reserves under the risk-based capital rules established by the NAIC.[99] Of course, publicly traded insurance companies, like other public companies, must also file financial statements prepared in accordance with GAAP with the SEC. Such GAAP-based financial statements will be subject to the Proposed Interpretation.

III. BASIC STRUCTURING ISSUES FOR CTL FINANCED OFF-BALANCE-SHEET SALE-LEASEBACKS

A. Overview

There is an intrinsic tension in structuring a CTL-financed sale-leaseback: by definition, the lender expects that loan repayment will be fully supported by the tenant's credit, while FAS 98 precludes any "continuing involvement" by the tenant and specifically forbids the tenant from guaranteeing, or providing collateral for, the landlord's debt.[100] On the other hand, FAS 98 recognizes and accepts "the form of guarantee that is inherent in a normal leaseback."[101] In other words, the landlord may rely on the tenant's rental obligations to support the landlord's financing, so long as the tenant is not directly guaranteeing, or providing additional collateral for, such financing. Therefore, as discussed below, the challenge in structuring a CTL-financed off-balance-sheet sale-leaseback is in creating credit support for the balloon payment, or in some cases the lease payments themselves, without the tenant providing additional collateral or a debt guarantee.

B. Failing the 90% Test of FAS 13

As discussed above, to obtain off-balance-sheet treatment, the CTL-financed lease must qualify as an operating lease under FAS 13. To do so, the lease must, among other things, "fail" the 90% test. That is, the present value of the lease payments must be less than 90% of the purchase price of the property.

1. *The Need for a Balloon Payment*

Consider the case of a fully amortizing CTL. Using a discount rate equal to the interest rate on this loan, the present value of the debt service payments on the loan is equal to the original loan amount. Now also assume that the original loan amount is equal to the purchase price of the property — i.e., the CTL has a 100% loan-to-value ratio. Again, using a discount rate equal to the interest rate on this loan, the present value of the debt service payments must also be equal to the purchase price of the property. Finally, assume that, as is typically the case, the lease payments are equal to the debt service payments on such loan. Then using a discount rate equal to the interest rate on the loan, the present value of the lease payments is equal to the present value of the debt service payments, which is equal to 100% of the purchase price of the property. As a result, the lease in this example would not "fail" the 90% test (i.e., the present value of the lease payments would not be less than 90% of the purchase price of the property) as required for operating lease (off-balance-sheet) treatment under FAS 13.

Consequently, a properly structured off-balance-sheet CTL with a 100% loan-to-value ratio will not fully amortize – that is, it will have a balloon payment that is not matched by any rental payment. Using a discount rate equal to the interest rate on the loan, the present value of this balloon payment must exceed 10% of the loan amount in order for the present value of the rental payments to be less than 90% of the purchase price of the property.

Even if the buyer-landlord is not using 100% loan to value financing, it still may wish to arrange financing that has a balloon payment. Non-fully amortizing financing provides higher tax deductions[102] and a postponement or elimination of so-called "phantom income,"[103] as compared to fully amortizing loans.

2. *Providing Credit Support for the Balloon Payment*

(a) Residual Value Insurance Policy

The NAIC rules preclude Schedule D treatment for loans with unsupported balloon payments of over 5%.[104] Furthermore, even lenders that are not subject to the NAIC rules may require that the balloon payment be supported by something other than the property. The most effective way to secure the balloon payment is through a residual value insurance policy.[105] The policy is issued for the benefit of the lender, as an additional named insured, in the amount of the balloon payment. Generally, such policies exclude coverage if the lender makes any changes to the loan documents without the insurer's consent. In addition, the policy generally requires that the mortgage and other loan documents be assigned to the insurer upon payment of the policy amount. If the residual value of the property exceeds the balloon amount, it is unlikely that a claim will be made under the policy, as the buyer-landlord will probably be able to repay the balance of the loan out of the proceeds of a sale or refinancing of the property.

An important financial accounting feature of these policies is the treatment of the premiums under FAS 13. The premium of such a policy is generally paid by the tenant. However, under FAS 13 the premium is considered an "executory cost" and, as such, is excluded from "minimum lease payments" for the purposes of the 90% test.[106] Accordingly, by using non-fully amortizing financing supported by residual value insurance, the buyer-landlord is able to lower debt service payments, and therefore the tenant's rent, without any offsetting increase in minimum lease payments for purposes of the 90% test under FAS 13. By contrast, if the tenant were to directly guarantee all or a portion of the balloon payment—as is the case in a synthetic lease, the guarantee would be considered a minimum lease payment for purposes of the 90% test.

(b) Tenant Lease Obligations

There are numerous other possible structures that provide credit support for the balloon payment through lease obligations imposed on the tenant. These structures should be scrutinized to make sure they do not constitute a form of continuing involvement, thereby precluding off-balance-sheet treatment.[107] For example, when the balloon comes due, the tenant could be required to make an offer to purchase the property at a price equal to the balloon payment unless the landlord is able to arrange new financing. The balloon would be paid either from the proceeds of the landlord's new financing or from the proceeds of the tenant's purchase of the property. This structure appears to be covered by Paragraph 11 of FAS 98, which provides in part as follows: "[an example] of continuing involvement…frequently found in sale-leaseback transactions are provisions or conditions in which…the seller-lessee has an obligation or an option to repurchase the property or the buyer-landlord can compel the seller-lesser to repurchase the property." Under the above structure, the landlord's failure to obtain new financing to pay off the balloon is a "condition" under which the tenant "has an obligation to repurchase the property." As a result, it would appear that this structure is a form of "continuing involvement" prohibited under FAS 98.

C. Enhancing the Tenant's Credit

The landlord may find that it can significantly improve the terms of its financing by providing its lender with an irrevocable standby letter of credit securing all or a portion of the lease payments.

A standby letter of credit is an obligation of the issuing bank to pay the beneficiary upon certification of nonperformance of an agreement.[108] The certification may take the form of a written statement signed by the beneficiary certifying simply that the applicant has not performed.[109] Upon payment of the letter of credit, the issuing bank may recover the amount of the payment from the applicant, who is generally a customer of the bank.

In a CTL-financed lease, the tenant should act as the applicant so that the issuing bank relies on the credit of the tenant. The landlord, being a special purpose entity, would have insufficient credit to obtain a letter of credit. Furthermore, even if one of the landlord's principals were capable of obtaining a letter of credit, such a structure would tie up significant equity and capital of the landlord, thereby increasing the landlord's cost of funds and consequently, the tenant's rental rate.

Lenders generally prefer a standby letter of credit over a surety bond as a form of credit enhancement. The beneficiary of a letter of credit is entitled to payment promptly upon the presentation of a certificate of nonperformance. By contrast, the beneficiary under a surety bond must prove the existence of a default. Meeting this burden to the satisfaction of the surety generally results in some delay in payment and may lead to litigation.[110]

From the viewpoint of the landlord and its lender, a letter of credit obtained by the tenant and issued by a creditworthy bank is more advantageous than a tenant security deposit because it provides much stronger protection against a tenant bankruptcy than does a cash security deposit. Because a letter of credit creates an independent contract between the issuing bank and the beneficiary, in the event of a tenant bankruptcy, the proceeds of a letter of credit are not property of the tenant's bankruptcy estate.[111] As a result, absent fraud in the underlying contract, neither the tenant nor the bankruptcy trustee may prevent the issuing bank from distributing the proceeds of the letter of credit by invocation of the automatic stay or otherwise.[112] Finally, although the law is still unsettled on this point, a landlord's draw under a tenant provided letter of credit may not be subject to the bankruptcy limitation on the landlord's lease termination damages under Section 502(b)(6) of the Bankruptcy Code,[113] which is the greater of one year or 15% (so long as that amount does not exceed three years' worth of rent) of the rent for the remaining lease term.[114] By contrast, in the event of a tenant bankruptcy, a security deposit becomes an asset of the bankruptcy estate, and if the tenant rejects the lease, the landlord's claim against the security deposit is subject to the damages cap under Section 502(b)(6).[115]

The EITF has approved the use of an uncollateralized, irrevocable letter of credit to secure the tenant's lease payments in an off-balance-sheet real estate sale-leaseback. Specifically, under EITF 90-20, a tenant providing such a letter of credit from its bank is not engaging in "continuing involvement" that precludes sale-leaseback accounting under FAS 98.[116] Note that EITF 90-20 allows the tenant to provide a letter of credit securing the lease payments, not the loan payments; thus, the landlord, rather than the lender, will be the beneficiary under the letter of credit.[117]

1. Acceleration of Rent

Letters of credit generally are short-term instruments of no more than one to three years duration whereas the financing of a long-term leaseback may have a term of 20 years or more. As a result, the landlord's lender will require assurance that it will be protected in the event the letter of credit is not renewed by the tenant's bank. One technique for covering non-renewal risk is to require that the loan (and lease payments) accelerate upon non-renewal of the letter of credit and that such accelerated lease payments be secured by the letter of credit. So long as the tenant has paid the accelerated rent and otherwise complies with the lease terms, the tenant should retain possession of the property. In addition, the accelerated amounts should be discounted to present value. Thus, the letter of credit would be in the amount of the present value of the lease payments.

If an acceleration clause is being considered, counsel must first determine its enforceability. The American Law Institute has recognized rent acceleration clauses as an enforceable remedy:

> "The parties may provide in the lease that if the tenant defaults in the payment of rent or fails in some other way to perform his obligations under the lease, the total amount of rent payable during the term of the lease shall immediately become due and payable."[118]

In California, certain of a landlord's remedies for tenant's breach of a real estate lease are limited by statute. For example, Sections 1951.2 and 1951.4 of the Civil Code state the landlord's measure of damages when the tenant breaches the lease and abandons the premises or when the tenant's right of possession is terminated by the landlord because of a breach of the lease. However, the proposed acceleration clause merely changes the timing of rental payments; it does not terminate the lease or the tenant's right to possession. As a result, Sections 1951.2 and 1951.4 are not applicable. Indeed, according to a report by the Assembly Committee on Judiciary:

> "Section 1951.2 is not a comprehensive statement of the lessor's remedies…Where the lessee is still in possession but has breached the lease, the lessor may regard the lease as continuing in force and seek damages for the detriment caused by the breach…See also Section 1951.5 (liquidated damages)."[119]

Section 1951.5 of the Civil Code provides that "Section 1671, relating to liquidated damages, applies to a lease of real property." And the courts have held that the validity of an acceleration clause in a lease is determined by the liquidated damages statute.[120] Under Section 1671(b) of the Civil Code, a liquidated damages clause in a commercial lease is "valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made." In the words of the California Supreme Court, a liquidated damages clause is unreasonable, and therefore unenforceable, "if it bears no reasonable relationship to the range of actual damages that the parties could have anticipated would flow from a breach."[121]

To compensate the landlord for non-renewal of the letter of credit, the proposed acceleration clause requires the tenant to immediately pay the present value of the rent and allows the tenant to stay in possession for the remainder of the lease term. Landlord's lender is making its loan to landlord in reliance on the letter of credit; therefore, non-renewal will probably result in acceleration of the landlord's financing. Consequently, acceleration of the rents (discounted to present value) clearly bears a reasonable relationship to landlord's damages. Accordingly, although there are no cases directly on point, the proposed acceleration clause should be enforceable under California law.

2. Tax Consequences of Acceleration

Counsel should also consider the tax consequences of accelerated rent. A lease providing for prepaid rent may be considered a "Section 467 rental agreement" and, therefore, subject to Section 467 of the Internal Revenue Code requiring the landlord and tenant to use the accrual method of accounting and time value of money principles for income tax purposes.[122] As long as their principal purpose is not tax avoidance, the landlord and tenant may allocate rents (including accelerated rents) in the lease as they see fit.[123] Accordingly, the landlord will want the lease to allocate the prepaid rent over the entire lease term rather than the year in which it is actually paid. If the accelerated rent were allocated to the year in which it was paid, the landlord would have taxable income in that year for the full amount of the accelerated rent[124] but no cash flow with which to pay the tax since the lender would probably require that the entire amount of the accelerated rent be applied to repayment of its loan to the landlord. If the accelerated rent is allocated over the entire lease term, then the landlord may offset a substantial portion of the rental income by deductions for imputed interest expense[125] and annual depreciation.

3. Effect of Acceleration on Tenant's Accounting

Finally, the tenant will need to determine whether the acceleration clause precludes it from obtaining off-balance-sheet treatment under GAAP. EITF 97-1[126] (Question 2) addresses lease remedies for defaults that are not based on tenant's failure to perform obligations customarily related to possession of the property. The EITF concluded that "non-performance related default covenants do not affect lease classification under FAS 13 when all of the following conditions exist: (1) the default covenant provision is customary in financing arrangements, (2) the occurrence of the event of default is objectively determinable …, (3) predefined criteria, related solely to the lessee and its operations, have been established for the determination of the event of default, and (4) it is reasonable to assume based on the facts and circumstances that exist at the inception of the lease, that the event of default will not occur."

A clause accelerating rent upon the tenant's failure to obtain renewal (or replacement)[127] of a letter of credit appears to satisfy all of the above conditions with one possible exception: an argument can be made that non-renewal of the letter of credit is not "related solely to the lessee and its operations" because non-renewal could result from a collapse of the capital markets rather than from a reduction in the tenant's financial strength. However, the continued functioning of capital markets (at least at some minimum level) as well as the existence of certain basic governmental institutions are necessary to any U.S. company's existence and, therefore, must be "related to its operations." Moreover, a complete collapse of the capital markets might also affect the tenant's ability to comply with other customary lease provisions such as its obligation to maintain insurance for the property. Default penalties for the tenant's failure to insure the property are accepted as customary provisions that do not affect lease classification under FAS 13 despite the fact that default could result from a collapse of the capital markets. As a result, it appears that an acceleration clause for non-renewal of a letter of credit should not affect lease classification under FAS 13.

The task force also considered whether a non-performance related default covenant would violate the continuing involvement criteria in FAS 98 and wrote:

> "Regardless of whether the above conditions exist, if the lease is part of a sale-leaseback transaction that is subject to the provisions of [FAS] 98, a default remedy that allows the buyer-lessor to put the lease property to the seller-lessee would violate the continuing involvement criteria in [FAS]98 and, therefore, the transaction would be [on-balance-sheet]."[128]

Although not explicitly addressed by the task force, it is reasonable to conclude that a default remedy should not preclude sale-leaseback accounting under FAS 98 so long as it does not allow the buyer-landlord to put the lease property to the seller-tenant. Because a typical acceleration clause will not allow the landlord to put the property to the tenant, it should not preclude off-balance-sheet treatment under FAS 98.

Furthermore, EITF 90-20 (permitting an uncollateralized letter of credit in an off-balance-sheet sale-leaseback) would be rendered practically meaningless if rent acceleration for non-renewal of the letter of credit were considered "continuing involvement" under FAS 98. Absent an acceleration clause, either the landlord has no right to draw down on the letter of credit upon non-renewal or the landlord is allowed to draw but must set aside the proceeds as a cash security deposit (as there is no accelerated rental obligation to which the rent might be applied). If there is no penalty for non-renewal, a letter of credit, which is typically of much shorter duration than a commercial lease, would provide little benefit to the landlord or to its lender. If the letter of credit proceeds become a security deposit on non-renewal, it would appear that the landlord is receiving additional collateral, which is "continuing involvement" precluding off-balance-sheet treatment under FAS 98. Therefore, the use of an acceleration clause for non-renewal appears to be the only viable structure for an off-balance-sheet real estate sale-leaseback supported by a letter of credit.

IV. CONCLUSION

Promoters of synthetic leases now face several new obstacles. First, the Enron scandal has deterred many corporations from using certain off-balance-sheet financing vehicles, particularly those that rely on form over substance accounting structures. Second, under the Proposed Interpretation, synthetic lease transactions must be structured without an SPE landlord—in other words, the financial institution funding the transaction (or one of its operating subsidiaries) must be the landlord under the synthetic lease. Finally, under the new regulation on accounting for guarantees, the tenant under a synthetic lease will have to record a liability on its balance sheet for the fair value of the residual value guarantee although it will also record an offsetting asset.

By contrast, promoters of sale-leasebacks may benefit from these changes. First, to be respected for accounting purposes under current accounting regulations, sale-leasebacks must involve a true leasing arrangement and should withstand the scrutiny to which off-balance-sheet transactions are currently being subjected. Second, the Proposed Interpretation does not preclude the use of SPE landlords in properly structured off-balance-sheet sale-leasebacks. Third, because the seller-tenant under a sale-leaseback does not make a residual value guarantee (because of the rule against continuing involvement), sale-leasebacks should not be adversely affected by the adoption of the regulation on accounting for guarantees.

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ENDNOTES

1. On December 2, 2001, Enron Corp. filed a Chapter 11 bankruptcy petition listing over $24 billion in assets and over $13 billion in liabilities not including off-balance-sheet transactions — the largest corporate bankruptcy in American history at that time. Originally a gas company, Enron became an international trading and investment company, ranking fifth on the Fortune 500 list for 2001 with revenues of $139 billion for the first nine months of the year. However, Enron disguised its losses by hedging its investments through off-balance-sheet partnerships created by Enron with Enron stock. In other words, "Enron was essentially hedging with itself." *See* testimony of William C. Powers before the House Committee on Financial Services, February 4, 2002. On June 15, 2002, a federal court jury found Enron's auditor, Arthur Andersen LLP, guilty of obstructing justice in connection with an SEC inquiry into Enron. *U.S. v. Arthur Andersen, LLP,* USDC South District of Texas.

2. On March 21, 2002, Harvey Pitt, Chairman of the Securities and Exchange Commission, submitted the following written testimony before the Senate Committee on Banking, Housing and Urban Affairs [hereinafter, *Pitt Testimony of March, 21, 2002*]: "Enron is the poster child for something that has been evident for a long time – our financial disclosure and reporting system has not kept pace with changes in our markets …. Enron also must be a catalyst for lasting reform."
3. *Id.*
4. Financial Accounting Standards Board, Exposure Draft, Proposed Interpretation, "Consolidation of Special-Purpose Entities, an interpretation of ARB No. 51" as modified by certain decisions by FASB as set forth at www.fasb.org/project/decisions_spe.shtml. [hereinafter, *Proposed Interpretation*].
5. Bloomberg News, "Board Considers Delaying Tougher Accounting Rules" (April 4, 2002).
6. *See, e.g.,* Forbes.com, "Krispy Kreme Reverses Accounting Plans" (Feb.12, 2002).
7. The sale-leaseback has been used as a financing technique in England since as early as the late 19th century. *Yorkshire Railway Wagon Co. v. Maclure,* 21 Ch. D. 309 (1882). It first became popular in the United States during the 1940s when the Safeway supermarket chain used sale-leasebacks to finance its expansion. *See* Real Estate Forum, "Off-Balance-Sheet Financing," September, 2000 at p. 42.
8. *See* Real Estate Forum, *Off-Balance-Sheet Financing,* September, 2000 at pp. 44-45.
9. *See Frank Lyon Co. v. U.S.*, 435 U.S. 561 (1978).
10. Such profit is generally amortized over the term of the lease. *See infra* Section II.B.1.
11. *See, e.g.,* 15 U.S.C. §775(a) *(Section 19(a) of Securities Act of 1933).*
12. *See* Accounting Services Release No. 4, 1938, codified in Financial Reporting Release No. 1; see also *Pitt Testimony of March 21, 2002, supra* note 2 (in which the Commissioner supported the continuance of private sector standard setting but stated that the SEC "plans to take a more active role" in overseeing the standard setting process).
13. *See* Accounting Services Release No. 150, codified in Financial Reporting Release No. 1. According to the American Institute of Certified Public Accountants (AICPA) Statement on Auditing Standards 69, the hierarchy of authority for determining GAAP is as follows: first, FASB Statements and Interpretations, Accounting Principles Board (APB) Opinions and AICPA Accounting Research Bulletins; second, FASB Technical Bulletins, AICPA Industry Audit and Accounting Guides and AICPA Statements of Position; third, consensus positions of the FASB Emerging Issues Task Force and AICPA Practice Bulletins; fourth, AICPA accounting interpretations, "Qs and As" published by the FASB staff, as well as industry practices widely recognized and prevalent; and fifth, other accounting literature, including accounting textbooks, and articles.
14. *See* www.fasb.org/facts.
15. Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales Type Leases of Real Estate, Definition of the Lease Term, Initial Direct Costs of Direct Financing Leases, Statement of Financial Accounting Standards No. 98 (Financial Accounting Standards Board 1988) [hereinafter FAS 98].
16. *See* Accounting for Leases, Statement of Financial Accounting Standards No. 13 (Financial Accounting Standards Board 1976) [hereinafter FAS 13].
17. FAS 98, *supra* note 15, at app. C.
18. FAS 13, *supra* note 16, ¶ 33 (as amended by FAS 28).
19. *Id.*
20. According to paragraph 33 of FAS 13 (as amended by FAS 28), if the lease is an operating lease, any "profit shall be deferred and amortized… in proportion to the related gross rental charged to expense over the lease term." *Id.* FAS 13 further provides that rental expense "shall be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which [the leased property is physically employed]." *Id.* ¶ 15; *See slso* FASB Technical Bulletin No. 85-3. As a result, profit on the sale should also be recognized on a straight-line basis. *See* FAS 28 *supra* note 18, ¶ 26.
21. A "normal" leaseback may include subleasing that is minor. "If the present value of a reasonable amount of rental for [the subleased premises] is not more than 10 percent of the fair value of the asset sold, the … sublease is considered minor." FAS 98, *supra* note 15, ¶ 8. Some accountants have interpreted the requirement of a "normal" leaseback according to the conventional meaning of the word "normal" rather than the technical definition contained in FAS 98, ¶ 8. These accountants have therefore taken the position that a lease containing atypical terms is not a "normal" leaseback and would disqualify the transaction from sale-leaseback accounting under FAS 98. This position is inconsistent with the plain meaning of FAS 98. Indeed, FAS 98 clearly contemplates that leases with atypical terms may qualify so long as such terms do not constitute a form of continuing involvement. *See* FAS 98 *supra* note 15, ¶ 9.
22. GAAP contains various rules for determining whether the buyer has made a sufficient initial and continuing investment in the property to justify the seller's recognition of profit on the sale. See Accounting for Sales of Real Estate, Statement of Financial Accounting Standards No. 66 (Financial Accounting Standards Board 1982) [hereinafter FAS 66], at ¶3. That is, profit shall be recognized in full (the "full accrual method") when real estate is sold, provided the "collectibility of the sales price is reasonable assured." *Id.*
23. *See* FAS 98 *supra* note 15, ¶¶ 48 and 52.
24. *Id.* ¶ 11.
25. *Id.*
26. *Id.* ¶ 12.
27. *Id.*
28. *Id.* ¶ 13.
29. *Id.*
30. FAS 66, *supra* note 22, ¶ 41, incorporated by reference in FAS 98 *supra* note 15.
31. *See e.g., Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *see also infra* n.32 and cases cited therein.
32. *E.g.,* "Determining Tax Ownership of Leased Property," 38 Tax Lawyer 1 (1984); "Sham in Substance, The Tax Court's Emerging Standard for Testing Sale-Leasebacks," 14 J. of Real Estate Tax'n 3 (1986).

33. *Frank Lyon Co. v. United States,* 435 U.S. 561, 584 (1978) (emphasis added).
34. "Determining Tax Ownership of Leased Property" 38 Tax Lawyer 1, 31 (1984).
35. *See Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).
36. FAS 98 *supra* note 15, ¶ 11.
37. *Id.* ¶ 12.
38. *Frank Lyon Co. v. United States,* 435 U.S. 561, 567 (1978).
39. The landlord's use of 100% non-recourse financing will not by itself preclude off-balance-sheet treatment. As discussed above, one of the FAS 98 requirements for off-balance-sheet treatment is that the buyer make an initial and continuing investment in the property in accordance with FAS 66. However, as articulated by the Emerging Issues Task Force ("EITF"), "when the seller has unconditionally received all amounts it is entitled to from the sale and is not at risk related to the financing, the buyer's commitment to pay for the property is not a factor in the seller's recognition of profit." Effect of Various Forms of Financing Under FASB Statement No. 66, EITF Abstracts Issue No. 88-24 (Financial Accounting Standards Board, Emerging Issues Task Force 1989), ¶ 1. Thus, the buyer's use of 100% non-recourse financing to purchase the property justifies use of the full accrual method under FAS 66 and, therefore, "adequately demonstrates the buyer's initial and continuing investment in the property" as required by FAS 98.
40. *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976) (dicta); *see also Hudspeth v. Commissioner*, 509 F.2d 1224 (9th Cir. 1975) (sale-leaseback upheld even though purchaser financed 100% of the acquisition of the real estate with nonrecourse purchase money debt and no down payment).
41. In *Hilton v. Commissioner*, 74 T. C. 305 (1980), the rent during the primary term was exhausted by debt service payments, 100% of the down payment went to the promoter and the lease provided for bargain renewals. The court held that the lease was in reality a financing because "the opportunity to earn $23,000 annually commencing 30 years from the inception of the transaction would not in and of itself appear to justify the $334,000 original investment by the taxpayers."
42. FAS 13, *supra* note 16, ¶ 60.
43. *Id.* ¶ 10. Specifically, the tenant is required to record a capital lease as an asset and an obligation at an amount equal to the present value of minimum lease payments. *Id.*
44. *Id.* ¶ 7.
45. Under FAS 13, subparagraph 7d, the tenant is required to compare minimum lease payments to the "fair value of the leased property to the lessor at the inception of the lease." Under subparagraph 5(c)(i), "when the lessor is a manufacturer or dealer, the fair value of the property will ordinarily be its normal selling price…" Under subparagraph 5(c)(ii), "when the lessor is not a manufacturer or dealer, the fair value of the property at the inception of the lease will ordinarily be its cost." In the latter case, the tenant should ordinarily use the property's purchase price plus the landlord's closing costs.
46. Subparagraph 7d of FAS 13 requires the tenant to use "his incremental borrowing rate…unless (i) it is practicable for him to learn the implicit rate computed by the lessor and (ii) the implicit rate computed by the lessor is less than the lessee's incremental borrowing rate." The implicit rate computed by the lessor is defined as "the discount rate that, when applied to (i) the minimum lease payments… and (ii) the unguaranteed residual value accruing to the benefit of the lessor causes the aggregate present value at the beginning of the lease term to be equal to the fair value of the leased property to the lessor at the inception of the lease." FAS 13 *supra* note 16, ¶ 5k. Typically, the tenant will not know what value the landlord places on the residual value. As a result, the tenant will usually be unable to calculate the implicit rate to the landlord. Therefore, the tenant will generally be required to use its own incremental borrowing rate.
47. FAS 13, *supra* note 16, ¶ 5l. The tenant is not required or prohibited from using a secured borrowing rate. The tenant should use the rate consistent with the type of financing (either secured or unsecured) it would have used had it purchased the leased asset. FASB Technical Bulletin No. 79-12, *Interest Rate Used in Calculating the Present Value of Minimum Lease Payments.*
48. Accounting Research Bulletin No. 51, Consolidated Financial Statements, ¶ 1 [AICPA 1959].
49. Consolidation of all Majority-Owned Subsidiaries, Statement of Financial Accounting Standards No. 94 (Financial Accounting Standards Board 1987) [hereinafter FAS 94], ¶ 13. An investor in a real estate venture is required to apply the rules relating to consolidation that are generally applicable to corporate subsidiaries. AICPA, Statement of Position 78-9.
50. EITF Abstracts Issue 96-16 (Financial Accounting Standards Board, Emerging Issues Task Force 1996).
51. Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions, EITF Abstracts Issue No. 90-15 (Financial Accounting Standards Board, Emerging Issues Task Force 1990) [hereinafter EITF 90-15].
52. *See e.g.,* Synthetic Leases: Structured Finance, Financial Accounting and Tax Ownership, 25 J. of Corp. L. 445 (2000) [hereinafter *Weidner*]; The Synthetic Lease: Off-Balance-sheet Financing of the Acquisition of Real Property, 16 Cal. Real Prop. J. 16 (1998) [hereinafter *Hodge*]; Off-Balance-Sheet Financing: Synthetic Leases, 32 Real Prop., Prob. and Tr. J. 193 (1997) [hereinafter *Murray*].
53. The interest rate is usually a variable based on three-month LIBOR plus a credit spread determined by the tenant's credit rating. *Murray*, *supra* note 52, at p. 199, n.6.
54. *See* Hodge, *supra* note 52, at p. 19.
55. Recall that the landlord typically makes a three percent equity investment. Thus, typically the tenant is exposed to the first 85% of loss, the landlord to the next three percent and the lender to the final 12%.
56. *Murray*, *supra* note 52, at p.199, n.6.
57. *See* FAS 13 *supra* note 16, ¶ 5(j)(i)(b).
58. As discussed above, the Proposed Interpretation will supersede EITF 90-15. Under the Proposed Interpretation, the landlord in a synthetic lease will have to be a substantive operating enterprise to avoid consolidation with the tenant. With a substantive operating enterprise as the landlord, there is no minimum equity investment requirement for off balance sheet treatment. Of course, the transaction still must be structured to "fail" the 90% test of FAS 13.

59. *See* EITF 90-15, *supra* note 51, Response to Question 3.
60. "Investment grade" generally refers to a company whose senior unsecured debt is rated (i) BBB- or better by Standard & Poor's and Fitch, and (ii) Baa3 or better by Moody's Investors Service.
61. *See generally,* NAIC, "Purposes and Procedures Manual of the NAIC Securities Valuation Office" (December 2001), at Part Seven, Section 4(a).
62. *Id*. at Part 7, Section 4(a)(iii)(A).
63. *See, e.g.,* Cal. Ins. Code §739.2. *See generally,* Kevin Driscoll, *Credit Tenant Loans*, Real Estate Finance (Winter 2002) [hereinafter "Credit Tenant Loans"].
64. Life and accident and health insurance companies must establish a reserve (Asset Valuation Reserve) "to offset potential credit-related investment losses on all invested asset categories" subject to limited exclusions. NAIC, Statement of Statutory Accounting Principles # 7, "Asset Valuation Reserve and Interest Maintenance Reserve" (2001), ¶ 1.
65. *See* NAIC, SVO Purposes and Procedures Manual (2001), Part Seven, Section 4(a). Bonds are reported on Schedule D of a life insurance company's annual report to the Insurance Commissioner, while mortgage loans are reported on Schedule B. *See generally* "Credit Tenant Loans," *supra* note 63, at p. 66.
66. *See* NAIC, "Annual Statement Instructions for Life and Accident and Health Insurance Companies."
67. *See* NAIC, SVO Purposes and Procedures Manual, Part Seven, Section 4(a)(iii)(A). For example, if the tenant is permitted to terminate the lease in the event of casualty or condemnation, the CTL lender will often require (although the NAIC rules do not require) a special "Loss of Rents" insurance policy that pays off the lender upon lease termination for casualty or condemnation. After paying off the lender, the insurer is assigned all of the lender's rights under the loan documents. Alternatively, the risk of casualty or condemnation is covered by the tenant's obligation to make a purchase offer for the property in an amount not less than the projected loan balance.
68. *See* NAIC, SVO Purposes and Procedures Manual (2001), Part Seven, Section 4(a)(iii)(C)(6).
69. Although CTL lenders generally impose this requirement, it is not mandated by the NAIC rules. *See* NAIC, SVO Purposes and Procedures Manual (2001), Pt.7, § 4(a)(E)(6).
70. However, a CTL differs from a corporate bond in one important way: in the event of a tenant bankruptcy the holder of the bond will have a claim in the tenant's bankruptcy for the full amount of the bond while the holder of a CTL will (after foreclosing on the property) have a claim in the tenant's bankruptcy that is subject to the damage limitations of Section 502(b)(6) of the Bankruptcy Code. Under Section 502(b)(6), if the tenant elects to terminate the lease, termination damages are limited to the "rent reserved" in the lease, without acceleration, for the greater of either one year or 15 percent (not to exceed three years) of the remaining term of the lease. 11 U.S.C. §502(b)(6).
71. Weidner, *supra* note 52, at 465-485.
72. FASB has not yet adopted the Proposed Interpretation. A final vote is expected in December 2002. Even if it adopts the Proposed Interpretation, FASB has indicated that it will make significant changes to the current Exposure Draft. Details on the status of the Proposed Interpretation, including the full text of the final version, if adopted, may be ordered through FASB's website at www.fasb.org.
73. *Proposed Interpretation, supra* note 4, at ¶ B12.
74. *Id*. ¶¶ B10, B14, B15, and 7c.
75. *Id*. ¶ 9.
76. *Id*. ¶ 13.
77. *Id*. ¶ 9a.
78. *Id*. ¶ 9b.
79. *Id*. ¶ 12.
80. *Id*. ¶ 9c.
81. *Id*. ¶ 9d.
82. *Id*. ¶ 9e.
83. *Id*. ¶ 8c.
84. *Id*. ¶ 7a.
85. *Id*. ¶ A3.
86. FASB, Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirement for Guarantees, Including Indirect Guarantees of Indebtedness of Others."
87. *Id*. ¶¶ 9 and A8(a).
88. *Id*. ¶ 9.
89. FAS 98 *supra* note 15, ¶ 12d.
90. *Proposed Interpretation supra* note 4, ¶ A3 (emphasis added).
91. *Id*. ¶ 18.
92. *Id*. ¶ 10.
93. *Id*. ¶ 18.
94. *Id*.
95. *Id*. ¶ 20.
96. FASB, Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements* (1985), ¶ 63.
97. NAIC, Guide to Statutory Accounting Principles, Preamble, ¶¶ 22 and 28.
98. NAIC, Statutory Issue Paper No. 1, "Consolidation of Majority-owned Subsidiaries" (1998).
99. *See* NAIC, Statement of Statutory Accounting Principles No. 7, "Asset Valuation Reserve and Interest Maintenance Reserve" (2001).
100. FAS 98, *supra* note 15, ¶ 12d.
101. *Id*. ¶ 47.
102. Non-fully amortizing debt has a higher average loan balance and therefore higher interest payments than does fully amortizing debt.
103. "Phantom income" occurs when there is insufficient cashflow to cover income taxes. Because the landlord in a CTL financed transaction generally receives no cash flow, any taxable income is "phantom income."
104. NAIC, SVO Purposes and Procedures Manual (2001), Pt. 7, § 4(a)(v)(A)(2). There are two ways in which balloon payments are typically "supported": residual value insurance or a residual value guarantee from the tenant.
105. *See generally* Robert M. Schwartz, *Residual Value Insurance: A Time Bomb for Credit Tenant Loans*, Real Estate Review (Spring 2000).
106. FAS 13, *supra* note 16, ¶ 7(d); FASB Interpretation No. 19, ¶5.
107. As set forth in Paragraph 9 of FAS 98, "Terms of the sale-leaseback transaction that are substantially different from terms that an independent third-party lessor or lessee would accept represent an exchange of some stated or unstated rights or privileges. Those rights or privileges shall be con-

sidered in evaluating the continuing involvement provisions….of this Statement."

108. *See generally* Dolan, *The Law of Letters of Credit* (revised edition 2002), ¶ 1.04. The nature of the payment trigger differentiates a standby letter of credit from a commercial letter of credit. The beneficiary of a commercial letter of credit must demonstrate that it has performed its contract. By contrast, the beneficiary of a standby letter of credit must certify that its obligor has not performed the contract. *Id*.

109. As stated by one commentator, "The purpose of the certificate is not to determine whether the recited facts indeed have occurred but to give the bank and the applicant the beneficiary's warranty that they have occurred and therefore give the bank and the applicant a cause of action against the beneficiary if they have not occurred." *Id.* § 1.04, n. 70.

110. *See generally id*. ¶ 1.05.

111. *Kellogg v. Blue Quail Energy, Inc.,* 831 F.2d 586, 589 (5th Cir. 1987); *Postal v. Smith*, 522 F.2d 791 (9th Cir. 1975) (Court implied that if the credits had been secured, it may have decided differently). Because a tenant bankruptcy would bar the landlord from sending a notice of default, either the letter of credit should permit the landlord to draw on the letter upon landlord's certification of default without notice to tenant or the letter of credit should not require notice of default if sending notice is barred by law.

112. *See* Dolan, *supra* note 108, ¶ 7.03 [3].

113. *See Structuring Deals with High-Tech Tenants – "The Good, the Bad and the Ugly,"* 18 Cal. Real Prop. J. 4, 7-8 (2000) [hereinafter *Structuring Deals with High-Tech Tenants*].

114. *In re Clements,* 185 B.R. 895 (M.D. Fla. 1995).

115. *See Structuring Deals with High-Tech Tenants, supra* note 113, at p. 7.

116. Impact of an Uncollateralized Irrevocable Letter of Credit on a Real Estate Sale-Leaseback Transaction, EITF Abstracts Issue No. 90-20 [hereinafter EITF 90-20].

117. For a discussion of the issues relating to a lender's perfection of its interest in a letter of credit provided to the landlord, see *Letters of Credit Posted by Dot-Com Tenants – How Lenders Can Avoid Becoming a Victim of Tulipmania,* 18 Cal. Real Prop. J. 3 (2000).

118. Restatement (Second) of Property, Landlord & Tenant, Section 12.1, comt. k (1977); *Fifty States Mgmt. Corp. v. Pioneer Auto Parks Inc*,. 389 N.E. 2d 113, 46 N.Y.S 2d 800 (1979) (New York's highest court upholds acceleration of 19 years of rent without requiring any discounting to present value); *Aurora Business Park Assos. v. Albert*, 548 N.W. 2d 153 (Iowa 1996).

119. Cal. Civ. Code §1951.2, legislative committee comments.

120. *See Ricker v. Rimbough*, 120 Cal. App.2d Supp. 912, 261 P. 2d 328 (1953) (invalidating acceleration clause under former statute); *Atel Financial Corp. v. Quaker Coal Co.*, 132 F. Supp. 2d 1233 (N.D. Cal. 2001).

121. *Ridgley v. Topa Thrift & Loan Ass'n*, 17 Cal. 4th 970, 977 (1998).

122. *See* IRS Reg. 1.467-1 (a) and 1.467-1 (c).

123. I.R.C. § 467(b). However, for federal income tax purposes, prepaid rent generally represents a loan from the tenant to the landlord for which the tenant must recognize imputed interest income and the landlord must deduct imputed interest expense. *See* IRS Reg. 1.467-4.

124. IRS Reg. 1.467-1(c)(2)(ii)(A)(1).

125. *See* IRS Reg 1.467-4.

126. Implementation Issues in Accounting for Lease Transactions, Including Those Involving Special-Purpose Entities, EITF Abstracts Issue No. 97-1 (Financial Accounting Standards Board, Emerging Issues Task Force (1997) [hereinafter EITF 97-1].

127. In the event of non-renewal of the letter of credit by the tenant's bank, the tenant should be permitted to obtain a replacement letter of credit issued by another bank with a sufficiently strong credit rating.

128. EITF 97-1, *supra* note 126.