

Equipment Leasing And Ethics

By Stephen R. Harwood and Nicholas Falzone

The Enron debacle has caused all of us in business in the United States to take a fresh look at our activities through a new ethical prism. The senior management at Enron has been accused of creatively producing distorted and misleading financials, driven by a compensation scheme, which was tied to the company's stock price, which in turn was driven by financial accounting results. Enabling them were various parties, including their auditors, bankers, lawyers and investment bankers.

During recent years we have also seen other major corporations restating earnings, where senior management took overly aggressive approaches to financial accounting. Included in the list are Adelphia, AIG, WorldCom, HealthSouth and Tyco. Some of these have resulted in criminal indictments or convictions.

Against this background, this article reviews some of the principal big-ticket equipment leasing structures used over last 30 years and considers them from an ethical perspective.

Ethical Perspectives

The equipment leasing industry has always been known for its creativity, and nowhere has it been manifested more than the structures that have been developed in response to financial accounting and tax incentives.

The creativity that led to the modern big-ticket equipment leasing industry after World War II took off with the dawn of the leveraged lease in the 1970s and reached its high point (or low point depending on your perspective) during the last decade with the LIFO. Creativity by definition works at the margin, and in the leasing industry the margins have been in the accounting and tax worlds.

Ethical questions occur in the boundary zone that lies between that which is illegal, and thus by definition unethical, and that which is generally accepted. As the various structures are described below, a number of ethical questions are considered. Is it ethical to devise structures that take advantage of the letter of the rules, but reach a result that would be prohibited by the spirit of the rules? Is there a larger obligation to the corporation than the maximization of the yield in a given transaction? Is the creation of tax benefits where there were

none before an ethical issue or an example of creativity? Does taking advantage of inconsistencies between different political jurisdictions or different disciplines in the same transaction demonstrate a moral failing or innovation? Can a transaction be so burdened with the multiplicity of otherwise acceptable features that it falls below the ethical line? Finally, does the volume of acceptance measured by the number and aggregate size of transactions answer these questions?

Big-Ticket Drivers

Most large U.S. corporations have actively used lease financing for equipment acquisition. Unlike smaller firms, that might turn to leasing out of convenience, or because they had few other financing alternatives, major public corporations typically have used leasing for well thought through, specific reasons, especially in the case of larger transactions.

The drivers fall into three main categories: economic, tax, and financial accounting. An example of an economic incentive is the desire to shift the risk of obsolescence or equipment disposal to the lessor. But equally strong drivers over the last 30 years have been tax and financial accounting advantages.

These tax and accounting advantages have been in response to the incentives and subject to the constraints set forth by Congress, the SEC, the Financial Accounting Standards Board, the IRS, the courts, the rating agencies and Wall Street.

Some of the major structures that have been developed over the last 30 years are outlined below, together with the specific forces that brought them into being and the desired outcome for the participants. The structures reviewed are leveraged leases, wrap leases, securitizations, LIFOs, synthetic leases and SILOs.

Leveraged Lease

The leveraged lease became popular in the early 1970s as the result of three events. In order to stimulate business, Congress provided for accelerated depreciation and investment tax credit. The FASB, through Statement 13, set forth clear treatment of leases by lessees and lessors, and the IRS, through Revenue Procedures 75-21 and 75-28, established safe harbor rules for true leases.

With a leveraged lease the lessor enters into a lease with the lessee, and borrows on a non-recourse basis from a lender. A full range of professionals may be involved in completing the transaction, including arrangers, lawyers, accountants, lease advisors, appraisers and tax experts.

FASB 13 allows the lessee to treat the lease as an off-balance sheet obligation, disclosed only in footnotes, as long as certain tests are met. This has been very appealing to many lessees. In addition, lessees that couldn't use the tax benefits of accelerated depreciation or ITC efficiently have been able to effectively monetize them through the lessor in exchange for lower rental payments.

From the lessor's viewpoint, the accounting has also been appealing. Leased assets are shown net of debt, and the non-recourse debt is not shown on the lessor's balance sheet. In addition, earnings are allocated proportionally to unrecovered investment, resulting in an attractive, front-loaded earnings profile. Lessors also had the option to take ITC immediately into earnings, resulting in even greater front-end booking.

Intermediaries arranging transactions often negotiated a share of the residual proceeds as part of their compensation. These intermediaries also fared well from an accounting viewpoint, as they were generally permitted by their accountants to book the present value of an estimate of their future residual share.

The leveraged lease has endured and continues to be a mainstay of big-ticket leasing. Some changes have occurred. Over time, the leveraged lease has evolved to include early buy-out options, low fixed renewal options, and fixed price purchase options, which have reduced the lessor's upside potential.

Wrap Lease

Another structure that came into being in the 1970s was the wrap lease. This structure was actively used in the computer leasing industry. It came about as the result of a number of factors. During this period individual investors could offset ordinary income with investment losses. Also, corporations could freely shelter taxable income with net operating losses carry forwards, or NOLs. Finally, computer leases tended to be much shorter than the useful life of the equipment. Clever tax specialists were able to combine these elements into a tax optimal structure.

In this structure, a leasing company would enter into a short term lease with a user, discount the lease with a bank, and then sell the equipment subject to the user lease to a wrap lessor, retaining functional control and responsibility for remarketing the equipment, for which it received a share of the proceeds through a long term lease which wrapped around the user lease.

The result of the transaction for the leasing company was significant current taxable income in the early years followed by tax losses in the later years. The leasing companies frequently had NOLs, so that the taxable income could be absorbed, thereby creating economic value with the NOL. When the leasing company did not have NOLs, a more elaborate structure was used, designed to incorporate other entities that had could absorb the taxable income.

The result for the equipment owners, who were typically individuals, was the mirror image of the NOL party's tax profile, resulting in initial tax losses which could be used to offset ordinary taxable income.

The structure also had accounting appeal for the leasing companies involved. They were given the option of treating the equipment as owned, while booking the cash sale proceeds fully into earnings as the "sale of tax benefits."

The wrap structure for individual investors died with the passage of the 1986 tax act, which defined passive losses, and said they could be used only to offset passive income.

Subsequently the IRS challenged some wrap transactions, with mixed results for the investors. Ultimately, the back end cash flow of leasing companies that used aggressive wrap accounting rarely equaled front-end booked income, and write-offs were often taken.

Securitization

The 1990s saw the dramatic growth of the use of securitization for many financial assets including equipment leases. Originally available for very large issuers of at least \$500 million, securitization became accessible by smaller companies in transactions as small as \$10 million.

The structure involved pooling groups of financial assets in a special purpose entity and creating a rated debt security that was secured by the pool. Usually the leasing company or a third party provided a first loss guaranty.

Securitization was hailed as a leveling of the playing field, giving smaller firms access to a lower cost of capital. However, equally powerful as a driving force were accounting results for the leasing company, which was given the opportunity to use of gain-on-sale accounting, which front-ended the transactions' earnings. In addition, the securitization was kept off the leasing company's balance sheet.

A number of IPOs in the 1990s involved leasing companies whose earnings showed spectacular growth. In fact, their growth was often exaggerated due to the use of gain-on-sale accounting, and could not be sustained. Not surprisingly, the stock prices of these companies tumbled sharply in the late 1990s.

For market reasons, as the decade came to an end, the ability of smaller firms to use securitization also became much more difficult. The accounting appeal was also lost, as gain-on-sale accounting became unacceptable to Wall Street after mortgage and car financing companies that had been using it were forced to take write-offs in late 1990s.

LILOs

In 1984, Congress passed the Pickle-Dole Bill, which eliminated accelerated depreciation for assets held by non-taxpayers such as those leased to overseas lessees. During the mid-1990s a series of creative structures were developed which had the effect of generating significant tax benefits for U.S. lessors, when "financing" foreign-based assets. The activity grew to be very large, with major banks and finance companies financing as much as \$50 billion annually.

The LILo, for "lease-in, lease-out," was a type of cross border structure used during this period. A United States institution would enter into a sale/leaseback, employing leases to and from the lessor of a European

municipal facility such as a mass transit system or airport. These transactions were leveraged leases taken to their most extreme.

These transactions were creative in that a form of accelerated depreciation was devised where none had existed before. Since the obligations of the parties were defeased, there were economic returns with little or no economic risk. The earnings were booked following traditional leasing practice, which resulted in most of the earnings being booked in the first three years.

Following a 60 Minutes television expose and a series of *Wall Street Journal* articles that drew attention to the structure, the Treasury attacked the structure aggressively through a series of pronouncements. Treasury Secretary Rubin went so far as to publicly denounce the structure. Recently lessors have negotiated settlements with the IRS with respect to these transactions, and are making major cash payments.

Synthetic Leases

After starting in the mid-1980s, during the 1990s synthetic leases became widespread, both in equipment leasing and in real estate. In fact, during this period the structure accounted for a significant share of the leasing activity for some lessors.

The structure involved a lease that was a conditional sale for Federal income tax purposes, but an operating lease for financial reporting purposes. Off-balance sheet treatment for lessees was achieved by using special purpose entities with as little as 3% third party at risk equity.

This structure effectively died post-Enron because of pressure from the investment community, which looked negatively on any form of off-balance sheet financing and steps by the accounting industry overseers to force consolidation of special purpose entities.

SILOs

Somewhat as an outgrowth of the cross-border leasing activity was the development of structures designed to allow lessors to effectively take accelerated depreciation on assets leased to municipalities. Just as in the case of foreign-based assets, normally assets leased to municipalities would not qualify for accelerated depreciation. But once again, creative minds devised innovative structures within the tax rules, which generated tax benefits for the lessor.

One of the structures developed was the SILO, for "sale-in, lease-out." A widely known example of a SILO was the sale and leaseback of the Chicago 911 emergency call system, where the payment to the City of Chicago by two major institutional lessors for the asset was \$140 million. Despite forceful lobbying by municipalities and others, Congress prohibited future SILO transactions as part of the American Jobs Creation Act of 2004.

Secondary Market Sales

The big-ticket leasing environment today is quite different from what it was during the 1990s. The volume of big-ticket transactions has been radically reduced, as cross-border transactions, tax-aggressive municipal transactions, and synthetic leases have been virtually eliminated.

In addition, most lessors have shied away from aircraft leasing, which historically has been a major sector. To make matters worse,

many financial institutions have or are taking write-offs associated with their aircraft portfolios or LILLO settlements.

The consequence for the leasing industry has been reduced earnings, leading to a retrenching or consolidation for many lessors, and pressure to identify other avenues to generate current earnings. The search for earnings has stimulated secondary market sales.

Secondary market sales are another example of a category of transaction motivated by accounting considerations. When a lease is booked by a lessor, it makes a residual assumption. Usually that has been conservative, and the actual equipment value can be substantially above the booked amount. When that becomes apparent, accounting standards do not permit the lessor to revise the book value upward, like securities, where mark-to-market valuations are permitted. Instead, the leasing company is faced with the prospect of waiting to the end of the lease, selling the equipment, and then recording a gain over book value. An alternative for the lessor is to sell the transaction in the secondary market at a price above the book value, and, in effect, accelerate the recognition of earnings.

Conclusions

Looking back over the last 30 years of big-ticket leasing we see structures embraced because they allowed for the accelerated recognition of earnings and tax benefits, or because they allowed off-balance sheet treatment of assets and liabilities. We see structures embraced that made use of third-party NOL, generated tax benefits that were otherwise unavailable or avoided the intent of the Pickle-Dole Bill. Was any of all of this improper or unethical?

In particular, we need to consider the responsibilities of the professionals involved in these highly structured transactions and their unique roles in creating them. What is the proper role of the professional? To whom do they owe a duty? What is the overarching regulatory scheme, and who is writing the rules of professional conduct? What are society's reasonable expectations as to their proper role and conduct, and do these expectations coincide with or exceed the existing rules?

There has been a sea change in many corporate boardrooms following the debacles mentioned in the introduction to this article. Directors are showing an increased reluctance to approve any transaction that appears to be "excessively creative" or is described as "off-balance sheet." They are less deferential to management and outside advisors. The legal responsibility of management and boards has been heightened by legislation and the role of the independent director and the thoughtful advisor has been enhanced.

How long this attitude will prevail is unknown. Just as it is possible for the effects of Enron to be enervated over time, it is also possible that another corporate scandal or scandals will lead to even tighter strictures. One has only to think of the abuses of the last century that led to regulatory accounting in some industries.

Against this background of heightened concern with financial accounting and ethics, participants in the equipment leasing industry will continue to optimize given goals to which compensation or advancement is tied. This is a good thing, as it reflects the drive that makes American business creative and strong. At the same time, constraints

and transparency are needed. To be able to understand a company's true economic condition, investors and other interested parties need to understand the nature of a business' underlying transactions. Public confidence in financial reporting is critical to the liquidity of the capital markets, the lifeblood of business.

Going forward, the leasing industry, if it is to flourish in this new atmosphere, must be prepared to come to grips with the ethical demands of this new regime. **m**

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