White and Williams LLP

Business and Corporate Law News Alert, June 2010 www.whiteandwilliams.com

RECENT CHANGES IN ACCOUNTING RULES PRESENT NEW CHALLENGES FOR ISSUERS OF LEASE-BACKED SECURITIZATIONS

By: Howard F. Mulligan, Esq.

Although relatively dormant throughout the duration of the financial crisis, the volume of securitization of equipment leases is expected to increase steadily in the second half of 2010 and into 2011 due to its flexibility and usefulness as a corporate financing tool. Leases, once considered a new asset class, have been accepted in the mainstream of asset classes and have now been securitized in many forms. For the past decade, a wide variety of equipment leases have been securitized, including leases of office equipment, computers (both personal and mainframe computers), medical equipment, telecom equipment, dental equipment, beauty parlor equipment, railcars, exercise equipment, video equipment and data processing equipment. Outside of the equipment lease sector, automobile leases, truck leases, motorcycle leases, recreational vehicle leases, cell tower leases and heavy machinery leases have been readily securitized.

In addition to the various challenges confronting issuers of lease-backed securities in these extraordinary times, sponsors of such securitizations are now grappling with recent amendments that could significantly impact customarily used lease-backed structures.

The purpose of this article is to discuss the typical structure deployed in equipment lease securitizations as well as the variations in this structure depending on whether sale treatment is the objective and how this structure has been impacted by recent statements issued by the Financial Accounting Standards Board (FASB), which alter existing applicable accounting rules.

BENEFITS OF LEASE SECURITIZATION

For the originator, perhaps the primary motivation for securitization is to reduce the cost of funds by strategically capitalizing on the higher credit rating of a segregated pool of leases rather than the originator's own credit rating. With proper management, securitization can serve as a useful liquidity tool, providing lease originators with an alternative source of financing to loans from banks and finance companies. As such, securitization can be an especially attractive means for raising capital for highly leveraged companies that originate leases. Securitization also may enable the originator, in certain circumstances described later in this article, to "borrow off balance sheet," in the sense that, if the transaction is structured as a sale, the assets are removed from the seller's balance sheet and the securities evidencing interests in the asset pool do not appear as liabilities on the seller's balance sheet.

FINANCIAL ASSETS

Any company contemplating the public issuance of lease-backed securities must be aware of the vexing issue of the application of the term "financial assets," which is defined for securities law purposes as assets that "convert into cash within a finite time period." This has an impact on how the securities are to be registered for a public offering and how an exemption may be obtained from registration under the Investment Company Act of 1940. But it also has wider implications. If the financial asset requires some future performance by an originator or by a third party, payment on the financial asset is subject to that third party's performance and bankruptcy risk. Thus, a lease dependent on performance by the lessor raises significant questions. Other assets that have been securitized, such as lease residual interests, may not turn to cash automatically, but may be packaged and used to raise capital (or provide credit support), even though they will have to be liquidated. Historical information on the amount of cash realized on equivalent assets is important in this context. Because the term ripples throughout the applicable accounting rules, understanding the application of the term "financial

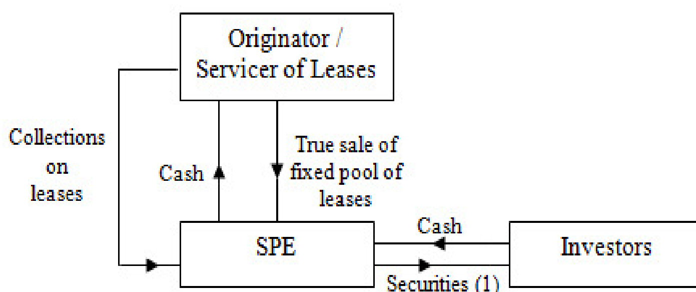
assets" is essential to comprehending the impact of the new rules on lease-backed securitizations.

STRUCTURAL CONCERNS IN EQUIPMENT LEASE SECURITIZATION TRANSACTIONS

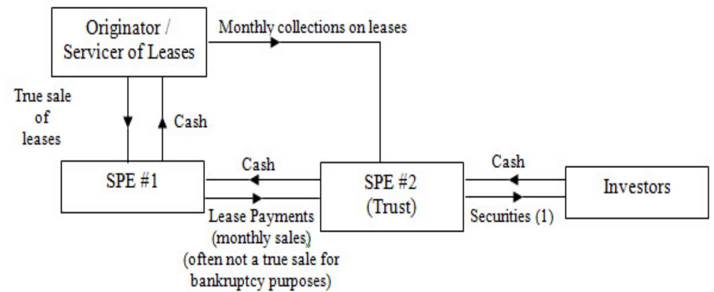
The essence of lease securitization is the isolation of cash flows on the leases from the bankruptcy risk of the originator. Thus, the purchasers of the securities look to the performance of the leases and not, at least theoretically, to the solvency of the originating company. Confidence in securitization structures has allowed many below-investment grade companies to raise capital through the packaging of lease receivables. Since repayment can be calculated actuarially if comprehensive data on the credit performance of the asset is available, capital costs can be reduced. Lease-backed securities are typically rated "AAA" and very few leasing companies can raise capital at such a credit rating.

Although the market continues to refine securitization structures, lease-backed securitization transactions follow a general pattern that has been validated by consistent deployment. The originator of the leases transfers them to a special purpose entity (SPE), which, in turn, issues securities backed by those leases and lease payments. The SPE may be a corporation, a trust, a limited liability company (LLC), or a partnership—the choice of organizational entity often being influenced by tax or accounting considerations. Essentially, the isolation from bankruptcy risk of the originator is the axis on which the success of the securitization turns. Typically, although not always, the originator acts as servicer of the leases and remits payments on a periodic basis, usually monthly (although some recent issuances have included a limited amount of quarterly or bi-annually paying leases). It is precisely this bankruptcy isolation of the SPE that allows securities of pools of leases to be rated "AAA." Along with the "AAA" rating comes a lower cost of funds for the lease originator. Without bankruptcy isolation, lessee payments are subject to the automatic stay under Section 362 of the Bankruptcy Code in a bankruptcy case of the originator and the rating of the transaction generally will be capped at the originator's rating level.

TYPICAL LEASE-BACKED SECURITIZATION STRUCTURE



REVOLVING LEASE-BACKED SECURITIZATION STRUCTURE



OFF-BALANCE-SHEET ACCOUNTING

Throughout the mid to late 1990s, off-balance sheet accounting treatment commonly was the goal. Smaller entities took advantage of the "gain on sale accounting" and significantly boosted earnings as a result. Needless to say, this procedure generated appreciable rewards in the marketplace. However in the period preceding the 2008 ructions on Wall Street, such accounting treatment began to be viewed with a jaundiced eye by investors, regulators and rating agencies. As a result, a much greater frequency of "on-balance sheet" securitizations were then being implemented. Structurally, these two types of accounting transactions are similar to those described above. The difference is in the way in which the SPE is structured. Prior to recently enacted accounting rules that went into effect this year, Financial Accounting Standard No. 140 (FAS 140) (supplemented by FASB Interpretation No. 46 (R) (46(R)) governed the analysis and required that, for off-balance sheet treatment, the SPE must be a qualified special purpose entity (QSPE), essentially passive in outlook. Failing to meet the detailed characteristics set forth in FAS 140 had caused the QSPE to be consolidated on the books of its originator parent, thus bringing the securitization on-balance sheet, thereby precluding sale treatment. The QSPE designation of FAS 140 engendered a great deal of confusion. In fact, the requirements consistently defied precise application, such that an entire generation of structured finance professionals in the post-Enron era will nostalgically recall countless hours spent on conference calls in which "brain-dead" was frequently the metaphor of the moment.

RECENTLY ENACTED AMENDMENTS TO ACCOUNTING RULES

The amendments, published in June 2009 and effective January 1, 2010, to FAS 140 entitled *Accounting for Transfers of Financial Assets* are set forth in Accounting Statement No. 166 (Statement 166) and the amendments to 46(R) entitled *Amendment to FASB Interpretation No. 46(R)* are set forth in Financial Accounting Statement No. 167 (Statement 167).

In a nutshell, the amendments to FAS 140 set forth in Statement 166 change the accounting standards that determine whether a

transfer of a receivable in a securitization should be treated as a sale or a financing, and the amendments to 46(R) set forth in Statement 167 change the standards used to determine whether reporting entities should consolidate SPEs on their balance sheets.

Following publication of the Statements, Robert Herz, the chairman of the FASB, described the changes as necessary to "improve existing standards and to address concerns about companies who were stretching the use of off-balance sheet entities to the detriment of investors" and expressed his belief that the new standards would "provide better transparency for investors about a company's activities and risks." In subsequent testimony before the House Financial Services Committee, Hertz testified that the FASB adopted Statements 166 and 167 as a result of the financial crisis and emphasized that the FASB's "independent standard setting process is the best means of ensuring high quality accounting standards." Yet, many other professionals, both within and outside the structured finance sector, have voiced concerns that these accounting changes will engender uncertainty in the marketplace and serve as an impediment to private lending and investment as the markets attempt to anticipate what impact these developments may have on capital and liquidity.

CHANGES TO ACCOUNTING FOR TRANSFERS (STATEMENT 166)

Statement 166, which generally expunges references to QSPEs, essentially preserves the three-part test for sale treatment contained in paragraph 9 of FAS 140, but revises each of its three parts.

Paragraph 9(a) of FAS 140, which requires legal isolation of transferred assets, has been revised to incorporate some already existing and applicable guidance about the need for isolation from both a transferor and its consolidated affiliates. Most significantly, the paragraph permits transferors to achieve legal isolation using the two-step transfer (*described in the charts above*) of the type common in revolving lease-backed securitizations, so long as both transfers cover entire financial assets as per the application of Paragraph 8 of FAS 140 (*described below*).

Paragraph 9(b) of FAS 140 has been mainly modified to conform to new definitions and still requires that a transferee have the right to pledge or exchange the transferred assets. Consequently, the paragraph continues to generally permit transferability of "beneficial interests" (including debt instruments) to substitute for transferability of the transferred financial assets when the transferee is a securitization SPE.

Paragraph 9(c) of FAS 140, which denies sale treatment if the transferor retains "effective control" over the transferred financial assets, has been revised to clarify that this effective control test applies to beneficial interests in financial assets, as well as the financial assets themselves. The revisions provide that "put rights" granted to transferees are now deemed to give the transferor effective control if the put price to the transferee is either "in the money" or reasonably expected to be "in the money" in a short period of time after the sale (such that the right is likely to be exercised).

In addition to the changes to Paragraph 9, Paragraph 8 of FAS 140 has been amended so that only an entire financial asset, or a portion of a financial asset that meets the definition of a participating interest, will be eligible for sale treatment. This change will primarily impact accounting treatment for loan or lease receivable participations, and will limit sale treatment generally to pro rata participations. However, it will also impact the two-step structural model in revolving lease-backed securitizations where the second step transfer is in the form of a senior undivided interest in a pool of receivables, to the extent that sale treatment is the objective. Those professionals involved in structuring lease-backed issuances should be aware that an undivided interest of this type would fail the new "unit account rule," since it is neither an entire financial asset nor an eligible participating interest.

CHANGES TO CONSOLIDATION STANDARD (STATEMENT 167)

Statement 167 eliminates the long misunderstood QSPE designation, and instead, sets forth a two-prong qualitative test for consolidation. This new test examines whether a transferor has (i) the power to direct the activities of the subject variable interest entity that most significantly impacts the entity's economic performance and (ii) either the obligation to absorb losses of the entity, or the right to receive benefits from the entity (or both) – each being potentially significant to the variable interest entity.

Statement 167 includes guidance on some features that may impact the determination of whether a particular enterprise has the power to direct the activities of the subject variable interest entity that most significantly impact the entity's economic performance. This guidance includes statements to the effect that:

- the determination should not be impacted by participating or "kick-out" rights, unless a single entity has the unilateral ability to exercise them;
- the fact that other parties may have approval or veto rights does not preclude an enterprise from having controlling economic power;
- if power is shared among multiple unrelated parties such that no one party has controlling economic power, then no party should consolidate;
- the fact that an enterprise is involved with the design of an entity does not, by itself, establish that the enterprise has controlling economic power, but such involvement may be

CONTRIBUTOR

HOWARD MULLIGAN

Howard has recently joined the New York Office of White and Williams and is a member of the firm's Business Department. His practice focuses on the intersecting disciplines of capital markets transactions and business reorganizations. He has represented issuers, underwriters, originators (including first-time originators of new assets) and servicers on a wide range of issuances of structured and synthetic products (including interest rate, credit default and total return swaps) as well as the securitization of various traditional assets (commercial and home mortgages, auto loans and credit card receivables), in addition to other classes, including energy related products, utility receivables, trade receivables, telecom receivables, franchise loans, health care receivables, insurance and annuity related products, and intellectual property assets. In addition, Howard has direct of dozens of restructurings in the structured finance sector.

Howard's practice has a particular emphasis on equipment and operating lease transactions and, over the last decade, he has represented a wide range of issuers, underwriters, placement agents, monoline insurers, servicers, originators, conduits, vendors, asset based lenders, warehouse borrowers, purchasers and sellers of portfolios and purchasers of FDIC held assets in numerous equipment related transactions.

For more information, please contact Howard at 212.631.4419 or email him at mulliganh@whiteandwilliams.com.

indicative that the enterprise had the opportunity and incentive to establish arrangements that gave it controlling economic power; and

- in situations in which an enterprise's economic interest in a variable interest entity is disproportionately greater that its stated economic power, such an economic interest may be indicative of the amount of power the enterprise holds.

CONCLUSION

As lease finance companies and other originators explore their financing options in a recrudescent securitization market, the recent changes to FAS 140 and 46(R) must not be overlooked to the extent that sale treatment is the desired objective. Consequently, players in the equipment lease securitization arena must be cognizant that the concept of QSPE has been jettisoned and transactional structures must be modified accordingly. Moreover, in lease-backed issuances predicated on sale treatment, business people, bankers, lawyers and accountants must understand the two-part qualitative test on which the determination of SPE consolidation and ultimately "on-or-off balance sheet" treatment will now be decided.

White and Williams, founded in 1899, is a multi-practice law firm based in Philadelphia with a stellar reputation for client service. The firm's Business Department has a deep bench of highly talented partners, counsel and associates who have worked on equipment leasing and equipment related transactions, as well as a broad range of complicated transactions of all kinds, including private equity, hedge fund linked transactions, M&A, public equity and debt issuances, private placements of debt and equity, derivatives, asset based lending, corporate compliance and joint venture transactions. The recent growth trajectory of the White and Williams China practice has complemented the firm's already well-established International Practice Group. White and Williams also has highly regarded tax, litigation and bankruptcy practice groups.

OFFICE LOCATIONS

Berwyn, PA | Boston, MA | Center Valley, PA | Cherry Hill, NJ | Conshohocken, PA | New York, NY | Paramus, NJ | Philadelphia, PA Pittsburgh, PA | Wilmington, DE

©2010. White and Williams LLP
This alert should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only, and you are urged to consult a lawyer concerning your own situation with any specific legal question you may have.