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Letter of Comment No: 35 File Reference: 1082-194R Date Received: 5/25/99

Attention: Director of Research and Technical Activities

Re: File Reference No. 194-B

#### Ladies and Gentlemen:

We thank the Financial Accounting Standards Board for permitting us the opportunity to comment upon the Exposure Draft (Revised) Proposed Statement of Financial Accounting Standards Consolidated Financial Statements: Purpose and Policy Revision of Exposure Draft issued October 16, 1995, issued on February 23, 1999 (the "Exposure Draft"). The comment expressed in this letter reflects the views of 30 of our Firm's attorneys who are active in representing parties in leasing transactions.

We are concerned that under the functional control standard proposed by the Exposure Draft a lessee who has entered into a leveraged or single investor lease with a special purpose entity ("SPE") may be forced to include the SPE in its consolidated financial statements even though the lessee neither bears the substantial risks nor has the substantial potential rewards of ownership of the leased asset.

The potential scope of the Exposure Draft as applied to leveraged or single investor leases is unclear. The Exposure Draft does not explain which combination of lease attributes provide the lessee with the ability to increase the benefits and limit the losses relating to leased property held by an SPE. Based on Examples 7 and 8, the Exposure Draft can be interpreted as applying only to synthetic leases. However, without further guidance, practicing accountants may interpret the Exposure Draft as potentially applicable to all leases since they may view that such leases allow the lessee to direct the use of the leased asset during the lease term in essentially the same way as an owned asset. If this more expansive interpretation applies, then lessee consolidation would occur in all instances where the lessor is a special purpose entity, i.e. the purpose of the SPE is restricted in its organizational documents to the consummation of the

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lease transaction only. Consequently, most leasing transactions involving a SPE lessor, regardless of the lessor economic risk position (which would be significant in the case of a leveraged or single investor lease), would be consolidated with the lessee.

We are not only concerned on the effect of the Exposure Draft with regard to new transactions, but are concerned, based upon the fact patterns of many existing leveraged and single investor leases, that the lessor trusts in these transactions (which customarily are SPEs) will be consolidated with the lessee to which they lease assets. This result may change the method of accounting employed by the owner participant in these transactions, especially if the other parties to the lease transaction refuse to amend the documents during the transition period. In fact, as discussed below, there are strong commercial reasons why neither the lenders nor the lessee in a new or existing lease would be willing to relax the single purpose restrictions customary in the trust instrument.

#### Attributes of a Lease Transaction

Our concern is that many leveraged, and some single investor, leases have the following fact pattern, with variations thereon that are not material to an analysis:

- (A) A single owner participant provides the equity portion of the financing. There is no more than one owner participant because the federal income tax treatment of a partnership established to enter into a transaction may adversely affect the lease pricing.
- (B) If the transaction is a leveraged lease, there may be one or more institutional lenders. Most often, these lenders join in the transaction through a debt private placement or public or Rule 144A offering.
- (C) For the reasons set forth below, the equity investor funds its investment through a grantor trust or a "business" or "statutory" trust. The form of grantor trust was originated under common law; and the form of business or statutory trust was originated by statute. Notwithstanding the form of trust that is chosen, the key characteristic is that the trustee is not the active decision making party. The owner participant directs the actions (or refraining from action) which the trustee will take, subject to the transferring of certain of such rights to the institutional lenders or their agent in connection with the granting of security for the loan in a leveraged lease transaction.
- (D) For the reasons set forth below, the trust established by the owner participant does not engage in other business transactions during the term of the lease or the leveraged lease debt.
- (E) The owner participant and lessee (and lenders in a leveraged lease) structure the transaction with the expectation that the owner participant is the owner of

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> the leased asset for federal income tax purposes and the trustee acting on behalf of the trust for the benefit of the owner participant is the owner for commercial and bankruptcy law purposes. In each such case, in order to achieve the desired income tax and commercial results, the owner participant has the reasonably foreseeable benefits of the increase in value of the leased asset, and bears the risk of loss with respect to the diminution of value of the leased asset, at lease expiration. These premises are crucial to the transaction notwithstanding that many leases include fixed price purchase options and early buyout options (which options are intended to be for more than nominal consideration and not intended to cause the lease to be characterized as a "security interest" within the meaning of Section 1-201(37) of the Uniform Commercial Code<sup>1</sup> and/or some level of residual value insurance obtained by the lessee for the lessor's benefit or residual value guaranty from manufacturers or the lessee. Additionally, leases may have renewal options. Depending upon the economics of the transaction, these renewals may be at the option of the lessee or the lessor acting upon the direction of the owner participant; however, in all cases, except where the remaining options are for then fair market value rentals, the owner participant and its related trust are to retain the leased asset free of the rights (except for any aforesaid purchase option) of the lessee for a residual period, which residual period is within the expected economic useful life of the leased asset as determined at the inception of the lease transaction. That is, the owner participant expects to bear the risk, and to potentially enjoy the benefits, of the residual value of the leased asset after all lease renewals (other than then fair market rental renewals) have expired.

- (F) The initial term of the lease is for up to approximately 80% of the estimated remaining economic useful life of the leased asset. Generally, these initial terms are in excess of 5-7 years, and depending upon the nature of the leased asset (e.g., aircraft, rail rolling stock, real estate) may be for very extended initial terms.
- (G) The leases are net, "hell-or-high water" obligations where the lessee is obligated to maintain and insure the leased asset and must ensure on-going compliance of the leased asset with law. The lessee has exclusive possession and control of the asset during the lease term. The lessee also provides the other parties to the transaction a full general indemnity and often a tax indemnity against certain of the federal, foreign and state tax risks arising out of the transaction. The rental payments in the aggregate are likely to exceed the purchase price of the leased asset, although the present value of the payments usually is priced so that the lessee obtains operating lease treatment under FAS 13.

Section 1-201(37) of the Uniform Commercial Code Official Text of the American Law Institute and the National Conference of Commissioners on Uniform State Laws is set out in Appendix A.

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Without clarification in the Exposure Draft, lessee consolidation may be required for leases where the owner participant through the trust has substantially all of the risks and benefits of ownership of the leased asset from the viewpoint of commercial and income tax laws. Moreover, the Exposure Draft's focus on the legal vehicle used to consummate a particular transaction could result in inconsistent accounting treatment of otherwise identical leases. For example, assume that a commercial airline company leases two planes. One plane is leased to it by an SPE lessor created by a major leasing company with a large lease portfolio, and the other by the leasing company directly. Under the Exposure Draft, assuming the lease provides the lessee with the ability to increase benefits and limit losses from a FASB standpoint, the commercial airline company would consolidate its SPE lessor (essentially capitalize the lease) but not the mirror transaction directly with the leasing company.

#### Reasons for an SPE Lesson

The above-described transactions could be entered into by an owner participant without making use of a grantor or business trust. In fact, some transactions are so structured. Trusts, however, are a commonly used mechanism to satisfy owner participant, lessee and lender concerns. The participants in a lease transaction may each be motivated to insist on using a grantor or business trust rather than permitting the lessor to make a direct investment in the leased asset. From the owner participant's viewpoint, a trust permits ease of transferability of its economic interest in the leased asset and, in many circumstances, may insulate the owner participant from personal liability for the obligations of the trust. The lessee and lenders usually insist on a trust to insulate the leased asset from owner participant credit and bankruptcy risk. Thus, each party has significant economic and legal reasons for using an SPE lessor in a leveraged lease transaction. Discussed below are the principal reasons for use of a trust.

- 1. **Transferability**. The use of a trust permits the owner participant to easily transfer its interest without having to redocument the transaction. The "beneficial interest" in the trust is transferred. Therefore, the parties need not re-execute lease documents, including the notes issued in a leveraged lease, or refile financing statements, mortgages or other collateral documents. This often saves significant legal expenses, as well as filing, recordation and transfer fees and taxes.<sup>2</sup>/
- 2. **Limited Liability**. An owner participant of a Trust will generally be entitled to the same limitation of personal liability as enjoyed by stockholders of corporation. Depending upon the nature of the leased asset, the trust (and particularly a business or statutory trust) may provide the owner participant with protection against its assets unrelated to the lease becoming subject to a claim concerning breach of

The cost of filing in some state jurisdictions makes the refiling alternative impractical.

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environmental law or tort risks arising in the lease transaction.<sup>3/</sup> It should be noted that leases and related general indemnities almost invariably place the environmental and tort risks upon the lessee. The benefit of a trust is that its separate existence may limit the potential damages if the lessee does not, or is not able to, perform its obligations.

- 3. Avoidance of Owner Participant Credit Risk. Lenders and the lessee do not want to take owner participant credit risk. The lessee and lenders are vitally interested in ensuring that there are no liens upon the financed leased asset which are extrinsic to the lease transaction and not indemnified against by the lessee. Each of the lessee and such lenders want its claim to the leased asset to be free of the risks attendant to such liens. Therefore they prohibit the trust from engaging in other transactions. Such a prohibition is clearly the most effective way to reduce the risk of an unrelated lien upon the leased asset. By definition such a prohibition is impossible if the lessor is not a special purpose entity. In leasing transactions rated by the rating agencies, any change in the single purpose restrictions imposed on the trust instrument would probably result in the downgrade of the notes issued by the trust or a refusal of the rating agencies to approve such proposed changes.
- 4. **Bankruptcy Protection**. Some lenders and lessees believe that a grantor or business trust will provide protection against the potential bankruptcy of the owner participant. A lessee is especially concerned that an owner participant which directly owns the leased asset could reject the lease in bankruptcy thereby thwarting lessee's right to acquire ownership of the leased asset by exercising a purchase option contained in the lease.

Paragraphs 137 and 138 of the Exposure Draft refer to the decision-making powers attendant to a purchase option, and the fact that the lessee may use the leased asset in essentially the same manner as its owned assets. In the transactions described in this letter, purchase and renewal options may be fixed at the inception of the lease, and there may be some form of residual value support. Through the contractual arrangements embodied in the transaction documents, the lessee may be viewed as having the ability to increase the benefits it can derive

Mere holding of title to certain assets may under state law make the title holder absolutely liable for certain torts. The most common example is the ownership of an automobile.

The Delaware Business Trust statute reflects this concern by expressly providing that no creditors of the owner participant shall have any right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the business trust. Section 3805(b) of the Del. Bus. Trust Act. Comparable language is found in the Connecticut Statutory Trust Act.

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and limit the losses it can suffer in respect of all of the assets of the lessor trust. And, as in all financial leases, the lessee has the right to direct use, care and improvement, subject to negotiated limitations, of the leased asset. Paragraph 150 refers to a trust's ability to invest in other transactions, which investment is normally prohibited in the above-described transactions. Thus, the broad language of such paragraphs could be interpreted to cover the described transactions. The mere use of a trustee under a grantor or business trust should not affect the substance of the parties' expectations that ownership of the above-described lease is to be presented on the owner participant's balance sheet. Such treatment is consistent with the underlying commercial relationships.

Thus, the question must be asked as to what underlying accounting rationale is served by requiring a lessee in a leveraged or singe investor lease to treat leased assets as assets that constitute part of the business enterprise of the lessee where the leased assets are treated for commercial law purposes, including bankruptcy, as the assets of the owner participant, the sole beneficial interest holder of the trust. Will such assets become deconsolidated if a lessee files a petition in bankruptcy and rejects the lease?

There are several practical and structural impediments that may make it almost impossible for lessors and lessees to amend existing lease transactions (assuming the final Exposure Draft does not clarify that the control standards are inapplicable to SPEs used in leases). First, existing lease documentation using a trust structure customarily does not require the parties to the documentation to adopt any amendment to preserve the lessee's current accounting. Second, in order to comply with the provisions of the Exposure Draft, lease documentation would have to be amended to adversely affect bargained for rights -- i.e., at a minimum, the single purpose nature of the trust would be expanded, thereby exposing the leased asset to liens unrelated to the transaction. Why would lenders and the lessee agree voluntarily to assume such risks in previously consummated transactions? Third, it is unfair that lessees who negotiated their lease transactions under current accounting standards would loose such treatment because of their inability to amend existing lease documentation. Finally, even if these technical and structural problems could be overcome, the time and expense of amending lease documents would be unduly burdensome and costly. At the very minimum, existing lease transactions using SPEs should be grandfathered from the rules of the Exposure Draft.

If the Exposure Draft is adopted as proposed, it is uncertain whether the financial markets will accept the risks resulting from the creation of a multi-purpose lessor without indemnification against these risks from a highly rated institution. If this becomes the case, leasing transactions will become more expensive to lessees, who will ultimately bear this cost, and the pool of available equity capital also may shrink.

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We believe that Examples 7 and 8 should be clarified so as to explicitly remove from their purview the long accepted treatment of true leases entered into using trusts or other forms of special purpose entities.

Very truly yours,

MAYER, BROWN & PLATT

Cary J. Malkin

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