

Protect Your Investment, Improve Your Portfolio

Consider these 15 business points when structuring your next lease.

by Jeffrey A. Kocim

Recently at the ELA Large Ticket Conference in Naples, Florida, I had the privilege to listen to several knowledgeable business and tax professionals discuss various IRS and legislative issues that may affect our industry and business investment. Our industry has allocated substantial intellectual capital to the development of sophisticated tax leasing structures over the past 20 years. Such vehicles include the 467 loan structure, O-Fisc, C-Fisk, Lilo, prepaid-deferred rent, tax advantaged partnership, pickle lease, QTE, extraterritorial income exclusion, synthetic lease, and Japanese, German and Swiss lease structures, to name a few.

These tax deferral structures have financed billions of dollars of large ticket assets, including aircraft, satellites, railroad rolling stock, commercial real estate, marine vessels and utility power plants. These legitimate investment vehicles are intended to increase the return and lessen the risk to lessors, while minimizing the present value of the lessee's cash outflow within the confines of the appropriate tax regime. Congratulations to all who have successfully implemented these structures!

Shortchanging Yourself

But not so fast. We know these structures are geared to provide significant up-front tax benefits to investors who pass along a portion of the tax arbitrage by lowering the present value of lease payments to the lessee. New creative tax structures are extremely important to the continued viability of the leasing industry relative to other forms of asset finance (EETC's, cash purchase, Rule 144A's, etc).

Too often, however, the structuring agents are so focused on the tax and legal aspects of a deal that they fail to adequately address equally important business terms and conditions con-

nected with most long term leases. Those terms can have a dramatic impact on the value and marketability of the investment. This shortcoming has become a serious issue to manage because today, much more so than 20 years ago, most investors will sell a portion of their lease investment portfolio prior to lease maturity. Accordingly, the transaction documents should contain specific business provisions that allow, not restrict, lessors to capture any upside potential in the securitized investment, protect a lessor's downside risk, and ensure the documents do not detract from an otherwise marketable investment during the term.

From a business management perspective a lessor may have no intention of ever selling/trading any or all of its lease portfolio, and there are other considerations such as leveraged lease accounting that may limit a lessor's desire to sell a lease investment in its embryonic stage. Notwithstanding this, I believe every investor must strive to create a portfolio of lease investments with marketable business provisions that can capture maximum value because business strategies can and do change, as evidenced by the sudden exit of Westinghouse Capital, Concord Commercial, US Leasing, AT&T Capital,

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Metlife Financial and Merrill Lynch Leasing, among others.

The Wish List

Structuring the business terms of a lease is a tactical game of negotiations that must balance the lessee's, lender's and lessor's interests, and is influenced by the competitive nature of the market along with the negotiation skills of the executives at the bargaining table. This article is directed mainly at large ticket lease investments, although the principles apply to all types of leases.

What follows is a non-exhaustive "wish list" of business related points every investor should attempt to incorporate into its transaction documents on a new lease. These items do not require advanced rulings from the IRS nor a professional with a degree in thermo nuclear applied statistics. However, a leasing company negotiator with direct lease sales, portfolio lease investment management, credit, equity and debt syndication, and secondary market lease investment experience will benefit the investor in negotiating one or more of these terms into the

documents. By addressing these points you are better able to see the trees and the forest. These items can heighten your return, improve your negotiating position during the lease term, protect your investments and make them more marketable.

1. In the sale of a beneficial interest in an existing lease, the documents usually require the new owner to satisfy minimum net worth requirements of \$50 million to \$100 million. This can limit the liquidity, marketability and profitability of the investment. The documents should optimally provide that after a period of time (50 percent to 75 percent into a 20 year or longer lease term) the net worth transfer provision falls away.
2. Lessees are much more sophisticated today than 20 years ago. It is common for lessees to require end-of-lease purchase options giving them the right to purchase the asset at the end of the lease for i) the lower of fair market value or ii) a modest capped value (50 percent of original cost). The lessor should attempt to provide a floor to minimize the downside risk in the event that unfavorable conditions apply at the expiration of the lease.
3. The casualty value in the last 25 to 33 percent of the lease term should be the higher of the casualty value schedule or the then fair market value of the asset. This allows the investor to avoid an opportunity loss and provides flexibility when syndicating the position one to seven years prior to lease expiration given an original lease term of 20 years.
4. Provide for a lessor's right of termination in the last 20 percent of the lease term if the lessee's credit falls below a certain credit rating. This allows the lessor more time to find

an alternative lessee, especially if the asset has maintained a considerable portion of its original value. Ideally, a lessor would like this right anytime during the lease but it more saleable to the lessee if the lessor only has this right during the final portion of the lease.

5. Expand the number of cure rights the lessor has with non-recourse lenders pertaining to payments in default. Having more flexibility, as opposed to less, strengthens the lessor's portfolio.
6. Set a floor for a lessee purchase option at the end of a renewal period, avoid very short renewal periods and provide a floor rental rate to minimize the risk in a bear market. Consider: A lessee has the option at the end of a 20 year lease to purchase the asset at the lower of fair market value or 50 percent of original asset cost. Furthermore, the lessee has the right to renew the lease for up to a total term of two years on 3 month renewal periods. After any renewal period the lessee can purchase the asset for its then fair market value. A fair market value purchase option at then end of a renewal term is very common lease language, but in this case it constrains value and marketability and is a potential disaster for the original lessor or successor lessor. The lessee might renew the lease for a total of six months, and if the market falls into a black hole in that time (as occurred in the aviation market in 1992 and the rail market in 2000) the lessor can be forced to sell in a down market without having received sufficient renewal rentals to cover the ever greater residuals that lessors are required to book to win business.
7. If the lessee elects to exercise its early buyout option or end-of-lease

purchase option, make sure to incorporate language that allows the lessor to treat the sale as a like kind exchange under IRS Regulation 1031, which gives the

lessor the opportunity to defer taxes. There is no cost to the lessee, yet the lessor can defer taxes and increase yield. You could ask the lessee to give you this right

years after the original lease is executed but, tactically, lessors should avoid asking the lessee for favors after a deal is closed. The lessee might favorably respond and comply, but only if the lessor provides a quid pro quo that might be detrimental to the value of the investment.

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8. If a lessee has an early fixed price buyout or end-of-lease fixed price purchase option, incorporate provisions restricting the lessee from buying the asset from you and then entering into a sale leaseback with another investor within 24 months of the lessee's purchase. If the asset has value above the fixed price option price, a sophisticated lessee will buy your asset and sell it to somebody else and benefit on the appreciated value of your investment. Often, lessees do not have the capital in their approved budgets to purchase the assets outright at the end of a lease unless they are able to immediately enter into a sale leaseback with another lessor or sell the asset outright.
 9. If the lessor refinances the non-recourse debt at a lower rate during the lease, some transaction documents allow the lessee to receive 75 percent of the benefit in the form of lower rent. Lessors should never allow this provision, since it limits their flexibility and, if rates drop, significantly constrains the value of the fixed income portion of the investment. If the lessor refinances because rates drop, the lessor should realize all of this benefit and not allow any reduction in the rent. Leveraged lease investments with high rate non-recourse debt, relative to current market debt rates, limits the marketability of the investment and constrains the investment's value. This is because

many equity investors will not be able to raise the necessary acquisition financing since they cannot provide their new lower rate lender with a first lien against the asset that is often a requirement of many lenders. This is one reason why single investor leases are much more marketable. Lessors can negotiate provisions into the debt documents to effectively convert leveraged investments into single investor investments to improve the marketability of the portfolio.

10. Usually the lessor and lessee do not have the right to prepay fixed rate non-recourse debt unless there is a casualty or early termination. If one prepays there is usually a make-whole premium outside of a casualty occurrence. The lessor should negotiate language giving it the right to prepay the non-recourse debt in the final 25 percent-33 percent of a twenty year loan without a prepayment premium. Typically this provision is not problematic to lenders but is seldom sought after by lessors.
11. In the event of an early termination option by the lessee, the lessor should have the option to retain the asset and not be forced into a sale. It may be more beneficial for the lessor to lease it to another user, modify the asset (reconfigure the utility plant or convert the "all passenger" aircraft to freighter) and then lease/sell it, or possibly trade it to another operator or manufacturer in the creation of a lease of a new asset.
12. If the lessee has the right to terminate the lease based on "asset surplus or economic obsolescence" language then be sure to restrict the lessee from substituting newer equipment to replace your asset. If market rents decline dramatically below your lease rent then you minimize the risk of having an early termination if you incorporate the proposed provision.
13. Avoid the three-party appraisal method for determining the fair market value or rental of an asset. Instead, provide that if the lessor and lessee do not agree on the fair market value then the asset will be returned to the lessor at lessee's expense in compliance with the return conditions set forth in the lease.
14. Have strong asset return conditions and be sure you understand their intent. Too often such requirements are crafted by those unfamiliar with the asset. Attorneys are seldom the best choice to prepare asset specific return conditions. Get the advice of an outside technical consultant in crafting return conditions to protect your investment. In advising institutional aviation lessors on their existing aviation assets I often see boiler plate aircraft "1/2" time return conditions passed down from legal generation to legal generation that are basically worthless. Upon further review of certain typical "1/2" time return language in a commercial aircraft lease I ask, "Half time to what." Half time until the Super Bowl festivities? The lessee's response to my question will be "Yes," and then you have a big problem. Be specific.
15. A lessor typically syndicates its seasoned lease investments in the fourth quarter of any given year to generate accounting gains. This is the same time when other lessors syndicate certain of their lease investments. This creates significant demand on a lessee's time as it arranges asset inspections, legal review and execution of the infa-

mous Lessee Notice and Acknowledgment document that is really for benefit of the lessor, not the lessee. In the original lease document be sure to incorporate language requiring the lessee to give you preference regarding asset inspection and documentation execution. Moreover, lessors should attach a thorough and comprehensive form of Lessee Notice and Acknowledgement as an exhibit to the lease when the lease investment is initially closed. While the actual form required by a new equity investor in the secondary market may vary from the Lessee Notice and Acknowledgement attached as an exhibit, it will provide an excellent starting point, improve the lessor's negotiating position with respect to the lessee in the event of a lease syndication, and improve on your chances of closing a secondary market sale.

There are many other items that could be placed on the "wish list" of business terms. Not all of these items will be applicable to every situation, while others will be readily obtainable. To incorporate them you have to be aware of their existence, be diligent in your pursuit and push yourself as a negotiator within prudent and professional guidelines. By achieving one or more of these items the investor will create a more flexible portfolio that will yield a combination of increased return, lower risk and improved marketability. **ELIT**

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