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Sale-Leasebacks: A Tool for the Times

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In this article, the authors explain that although there are legal and accounting implications of sale-leaseback transactions, the ability to unlock the value of newly acquired (and sometimes long-held) tangible assets, while continuing to operate or utilize them, can be extremely valuable for businesses, particularly those that are struggling to find attractive debt financing or find themselves in volatile or high interest rate environments.

A sale-leaseback is an arrangement in which a company sells an asset, such as real estate, vehicles or manufacturing equipment, and then immediately leases it back from the purchaser. The seller, which becomes the lessee, receives a lump sum payment but retains the rights to use the asset during the term of the lease in return for regular rental or lease payments to the buyer, which becomes the lessor. The economic terms of the lease are structured to be economically similar to those of a secured loan, with a portion of each rental payment including an implied financing cost, and the lessee typically has the right to acquire the leased asset. This implied financing cost is generally lower than the rate at which the seller/lessee could otherwise borrow, thus making these types of arrangements attractive to companies that already own or are acquiring tangible assets.

ADVANTAGES

A sale-leaseback transaction offers a company the ability to obtain cash proceeds to meet other business needs, such as building liquidity, paying down debt or making investments. In addition to the ability to raise capital at a relatively attractive cost (and often more capital in the aggregate than in a traditional financing secured by the same asset), sale-leaseback documentation may allow for greater operating flexibility than debt agreements that are based on the cash flow of the company, as they may not include change of control provisions or include covenants that regulate the operations of the lessee generally (just the specific assets that are subject to the lease arrangements). While the lease obligations are often treated as on-balance sheet, they can sometimes be structured as off-balance sheet operating leases for purposes of a lessee's debt agreements.

In addition, even if they are on-balance sheet and treated as financial debt for purposes of a lessee's debt agreements, such debt agreements may have specific exceptions

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that permit the capital lease obligations and may exclude them in calculating financial ratios.[1]

LEGAL CONSIDERATIONS IN DOCUMENTATION

There are a number of key legal considerations that companies need to consider before embarking on a sale-leaseback to the extent they have outstanding other debt agreements with restrictive covenants.

The lessee should consider the following in its debt agreements:

- Whether the agreements include a specific restriction on sale-leaseback transactions or similar restrictions through a restriction on asset sales;
- Whether the sale of assets in connection with the sale-leaseback would trigger a mandatory prepayment obligation or requirement to reinvestment the proceeds of the sale in a particular manner; and
- How the lease obligations will be treated for purposes of financial definitions under such debt agreements (e.g., interest expense), particularly those used in financial maintenance covenants (e.g., leverage ratios), and debt and liens covenants.

Negative covenants limiting asset dispositions (and mandatory prepayment triggers relating thereto) and the incurrence of debt and liens are typically relevant, and some debt agreements have negative covenants that specifically limit sale-leaseback transactions (often limiting them to transactions involving assets acquired within 270 days or limiting the amount of debt that can be incurred thereby) or counting them against otherwise available lien capacity.

Whether the debt and lien covenants are implicated (even if not specifically addressed by a company's financing arrangements) and how the lease obligation is treated in the financial maintenance covenants often depends on the accounting treatment of the lease obligations. Off-balance sheet lease obligations (or operating leases under older US GAAP) are often not treated as debt, while on-balance sheet lease obligations (or capital leases under older US GAAP) are likely to be treated as debt secured by an implied lien. Many debt agreements "hard-wire" the older US GAAP definitions as to the status of lease obligations, and thus it can be very important to consult accounting experts as to the characterization of the lease under the relevant accounting principles.

Sale-leaseback documentation often includes language whereby the lessee grants a security interest (i.e., a lien) in the leased assets to the lessor, as a precaution in the event the sale-leaseback arrangement is subsequently recharacterized as a secured loan by the courts in a bankruptcy or restructuring proceeding.

In the event of such recharacterization, the lessee would be deemed to have retained its ownership of the assets and the lessor is treated as a secured lender. It is important that any such lien provision not be overly broad such that it would encompass assets that are not, in fact, subject to the sale-leaseback and that any such precautionary lien is released upon the termination or expiration of the lease.

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SUMMARY

While there are legal and accounting implications of sale-leaseback transactions, the ability to unlock the value of newly acquired (and sometimes long-held) tangible assets, while continuing to operate or utilize them, can be extremely valuable for businesses, particularly those that are struggling to find attractive debt financing or find themselves in volatile or high interest rate environments.

NOTES:

[1]The actual tax and accounting treatment of a sale-leaseback requires a complex analysis made by accounting and tax professionals, and is in any event outside of the scope of this article.

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