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Sale-Leaseback Transactions in Today's Private Equity Environment

By

Brian E. Davis,
Robert Middleton
and
Gregory E. Spitzer

Brian E. Davis is a partner in Kirkland & Ellis LLP's Commercial Real Estate Practice Group. He represents and counsels clients in a broad range of real estate joint ventures, acquisitions, dispositions, leasing, development, and structured finance. Mr. Davis has extensive experience in structuring and restructuring sale-leaseback, leverage lease, and synthetic lease transactions, including in the context of leverage buy-outs and corporate restructuring. He received his J.D. from the University of Pittsburgh School of Law, a B.U.P.D. in Urban Planning and Development and a B.S. in Economics and Environmental Design from Ball State University. Mr. Davis can be reached at bdavis@kirkland.com.

Robert Middleton is an associate in Kirkland & Ellis LLP's Commercial Real Estate Practice Group. He represents management and hospitality clients within the real estate industry and advises private equity clients on the real estate components of their transactions. Mr. Middleton received his J.D. from the University of Virginia School of Law and an A.B. in Economics from Dartmouth College. He can be reached at rmiddleton@kirkland.com.

Gregory E. Spitzer is a former partner in Kirkland & Ellis LLP's Commercial Real Estate Practice Group. His experience includes representation of public and private companies and private equity firms in connection with acquisition, disposition and financing transactions, including all aspects of commercial real estate acquisitions and dispositions, development, leasing, financing and restructuring matters. Mr. Spitzer received his J.D. from Northwestern University School of Law and a B.S. from the University of Illinois - Urbana-Champaign.

As one looks at the vast array of private equity transactions taking place today, a recurring trend is clearly developing, as more and more transactions are being financed with or utilize some form of sale-leaseback financing. Why this sudden urge to tap into the real estate markets? The answer is simple. In the economics of today's transactions, sale-leaseback facilities make sense. We have all seen the tremendous run up in real estate values over the last few years. However, traditional financing for M&A transactions often fails to fully value the real estate assets of a target company. Thus, those astute investors trying to unlock the hidden value of a company, or present the best offer in today's overly competitive auction process, have turned to those old stodgy real estate assets to improve their returns and gain a competitive advantage. This article will attempt explain the basic elements of a sale-leaseback transaction in today's private equity environment and why all private equity investors need to consider this among the tools available to them in their pursuit to win deals and maximize returns for their investors.

Sale-Leaseback Basics

The mechanics of a sale-leaseback transaction are quite simple. The owner of a property sells its land and buildings to a buyer. Concurrent with this transaction, the seller leases the property back from the buyer

(typically for a period of anywhere from 10 to 20 years). Often times, the seller-lessee may also have the option to extend the lease beyond its initial term. The lease between the buyer-lessor and the seller-lessee are almost always "triple-net," which require the seller-lessee to pay for all taxes assessed upon the property and expenses associated with the occupancy of the property (i.e., insurance, utilities, maintenance). The practical significance of the structure of such a lease, in conjunction with the fact that the seller-lessee is usually the only tenant occupying the property, is that the buyer-lessor typically is not required to spend much time or energy actively managing the property. Every month, the buyer-lessor simply collects a check from the seller-lessee and writes a check to the mortgagee who financed the acquisition of the property.

Sale-Leaseback Advantages

Sale-leaseback transactions have become a common way for private equity firms and other companies to raise funds for acquisitions, to return capital to investors, to pay down debt, and to finance other operations. By entering into a sale-leaseback transaction, the seller-lessee is able to obtain cash now, all the while retaining exclusive use of the properties necessary for the operation of its business.

A sale-leaseback transaction offers several advantages to traditional mortgage financing of owned real estate. First of all, unlike mortgage indebtedness, if structured properly the seller-lessee will not record its obligation under the terms of the lease as debt on its balance sheet. Sale-leaseback transactions also have the potential to offer the seller-lessee a tax advantage vis-à-vis traditional mortgage financing. While only the depreciation and interest portion of a mortgage payment is deductible (the principal portion of a mortgage payment is not deductible), the seller-lessee's entire rental payment is deductible for the purpose of calculating taxable income. Additionally, the buyer-lessor typically imposes fewer restrictions on the seller-lessee and requires the seller-lessee to make fewer financial covenants than a lender who provides mortgage (or mezzanine) financing is likely to demand. Often times, the seller-lessee may only be obligated to provide periodic financial statements to the buyer-lessor, or less frequently, the seller-lessee may have to satisfy a fixed charge coverage ratio test in order to demonstrate that the financial condition of its business is not deteriorating. Finally, in a sale-leaseback transaction, the seller-lessee can convert equity in an owned property into cash in an amount equal to 100% of the in-use value of that property. In the case of a traditional mortgage, however, given lenders' loan to value limitations, a mortgagor can typically obtain cash in an amount equal to only 60%–80% of the market value of the mortgaged property. Further, in the typical M&A transaction, query whether the private equity investor can obtain any independent financing of its properties.

Over the last 10 years, widespread recognition of the advantages which sale-leaseback transactions can offer as compared with traditional mortgage financing has increased the number of seller-lessees who are considering these transactions. Consequently the number and aggregate value of properties available for sale-leasebacks transactions have increased dramatically. However, demand for these investments still greatly outpaces supply, therefore, there are more buyer-lessors with flexible and inexpensive lending terms than there are sellers of property available. These buyers are willing to invest in speculative properties that they were not willing to invest in five years ago.

Drawbacks to Sale-Leaseback Transactions

Sale-leaseback transactions, however, are not without drawbacks. The most obvious sacrifice that a seller-lessee who enters into a sale-leaseback transaction must make is the forfeiture of any future appreciation of the properties that were sold.[1] Additionally, the sale of a property that has appreciated since it was purchased or the sale of a property, the improvements on which have been significantly depreciated, will result in the recognition of a capital gain which is subject to

[1] Conversely, however, a seller-lessee is protected from any future decline in the value of the properties which it sold in connection with the sale-leaseback transaction. This risk is borne by the buyer-lessor.

taxation.[2] Potential seller-lessees may instead prefer to defer the taxation of this capital gain by continuing to own the property in fee. Another drawback is that the sale of the real property will reduce the seller-lessee's asset base. This could cause lenders to look for other collateral including receivables, equipment or a leasehold mortgage. Finally, by entering into what is likely to be a long-term lease, the seller-lessee will be subject to the obligations and conditions of this lease for an extended period of time without the ability to obtain a release of those obligations absent the lessor's agreement. Obviously, potential seller-lessees need to balance the advantages and drawbacks presented by sale-leaseback transactions before deciding to pursue such a transaction.

Dramatic Growth in the Sale-Leaseback Market and Its Consequences

Widespread recognition of the advantages presented by sale-leaseback transactions has increased the number of prospective seller-lessees and eligible properties. On the other side of the equation, the increased popularity of 1031 exchanges and "TIC" transactions (each discussed below) has increased the number of potential buyer-lessors and the amount of capital which is available for investment in the sale-leaseback market. The confluence of these two developments has led to dramatic growth in the sale-leaseback market over the last 10 years. In essence, an entirely new sale-leaseback industry has been created. This dramatic growth in the sale-leaseback market has had three practical consequences.

First of all, the advantages of sale-leaseback transactions are now available to a larger universe of potential seller-lessees. It used to be the case that most buyer-lessors were inclined to make conservative investments and purchase a property in a developed location where the seller-lessee of the subject property had an investment-grade credit rating. In fact, 10 years ago, for non-credit seller-lessees, the sale-leaseback was considered a lending source of last resort. Buyer-lessors could demand high cap rates (often in excess of 12%) and extract equity via strict covenants or warrants. However, as more and more capital has flowed into REITs, private equity funds, and other entities poised to make real estate investments (and specifically sale-leaseback investments), the sale-leaseback market became available to more highly leveraged sellers, sellers with lower credit ratings, and sellers whose properties are located in less developed and thus "riskier" locations.

The second practical consequence of the growth in the sale-leaseback market is that the size of sale-leaseback transactions has increased. Seller-lessees are now in a position to be able to sell (and leaseback) all of their owned real estate as part of a one large transaction. Dozens, if not hundreds, of properties can now be part of a single transaction. For seller-lessees, being able to liquidate all (or a large portion of all) of their real estate assets as part of one transaction can achieve efficiencies by economizing on accounting, legal, and other professional service fees as compared with negotiating and documenting a separate sale-leaseback transaction with multiple buyer-lessors for each of the seller-lessee's owned real estate assets. This growth in the size of transactions also allows the sale-leaseback transaction to be used as a viable alternative to more costly mezzanine loans, high yield note offerings, and subordinated financings that the typical private equity investor would otherwise likely employ.

Finally, the increase in the number of buyer-lessors interested in pursuing sale-leaseback transactions bodes well for prospective seller-lessees. In order to outbid the competition, a successful buyer-lessor must offer a larger purchase price for the sale-leaseback properties and must accept a lease whose terms are more favorable to the seller-lessee, including flexible assignment rights, and in some cases substitution rights and expansion and contraction rights. This increased competition among buyer-lessors often means that seller-lessees may be able to raise more funds upon the sale of their properties and may be able to lease back the properties at lower rental rates.

[2] Such a capital gain, however, may be offset against Net Operating Loss carry forwards if available.

1031 Exchanges

As noted above, the number of buyer-lessors and their demand for real estate investments has increased, in part, as a result of two developments in particular—the growth in popularity of 1031[3] exchanges and "TIC" transactions.

The 1031 exchange market has grown considerably over the last 10 years.[4] By increasing the number of potential buyer-lessors, the growth in the 1031 exchange market has fueled growth in the sale-leaseback market. In a 1031 exchange, a seller of real estate can defer the recognition of capital gain on this sale, and thus the taxation of this capital gain, by reinvesting the sale proceeds in a similar replacement property. In order to qualify for this tax deferral, the seller must identify a suitable replacement investment property within 45 days of the sale and must complete the purchase of this replacement property within 180 days of the sale. The desire of many real estate investors to take advantage of this deferral has resulted in the creation of a market for suitable replacement properties. The sale-leaseback market has provided a very large supply of suitable replacement properties.

A 1031 exchange involving reinvestment of proceeds in a property which is the subject of a sale-leaseback transaction furthers the goals of both a buyer-lessor and a seller-lessee. In a 1031 exchange coupled with a sale-leaseback transaction, a buyer-lessor uses the proceeds obtained from an unrelated real estate transaction and reinvests these proceeds by buying a replacement property which is then leased back to the seller-lessee. Provided that the 1031 requirements are satisfied, the buyer-lessor is able to defer taxation on the capital gain from the unrelated real estate transaction. At the same time, the seller-lessee is able to raise funds from the sale while retaining use of the subject property. Because of the tax efficiencies of the transaction and the need to deploy capital quickly, there is often much competition to purchase pools of potential replacement properties. Many real estate firms have been created over the last few years with the sole or at least a major purpose of acquiring and facilitating or even stockpiling desirable replacement properties (in many cases properties which are the subject of sale-leaseback transactions) which may then be sold off to 1031 purchasers.

Valuable industrial buildings, distribution centers, warehouses, and in particular retail properties, have become prime candidates for hybrid 1031 exchange/sale-leaseback transactions. Such properties are generally located in established and developed areas and have usually been well-maintained. As the seller-lessee in these 1031 exchange/sale-leaseback transactions will typically continue to be the sole tenant occupying and operating the subject property under the terms of a long-term triple-net lease, the 1031 buyer-lessor is not usually required to devote much attention to the management of the subject property.

Moreover, 1031 exchanges are not confined to single property for single property exchanges. A single property may be exchanged by a 1031 buyer-lessor for a group of properties, which may be diversified across asset classes and locations. That is, the 1031 buyer-lessor may sell an unrelated single property and reinvest the sale proceeds by purchasing a group of replacement properties from the seller-lessee (all of which are then leased back to the seller-lessee). In addition to receiving the benefit of a tax deferral, a 1031 buyer-lessor also achieves greater diversification in risk by exchanging an ownership interest in one property for an ownership interest in a number of properties. Again, provided that (i) the seller-lessee is the only tenant occupying the properties which are the subject of the sale-leaseback transaction and (ii) the seller-lessee has entered into long-term triple-net leases on the subject properties, the 1031 buyer-lessor is spared the expense associated with active management of the sale-leaseback properties.

The advantages of combining 1031 exchanges with sale-leaseback transactions have led an increasing number of tax-sensitive real estate investors to look

[3] Section 1031, or simply 1031, refers to Section 1031 of the Internal Revenue Code codified at 26 U.S.C. § 1031.

[4] In 1999, there were 171,600 1031 exchanges. By 2003, the number of 1031 exchanges had increased by 28% to 220,000. *Bulging Sale-Leaseback Pipeline* by Beth Mattson-Teig in the National Real Estate Investor (June 1, 2006).

to the sale-leaseback market for suitable replacement properties. For the private equity investor/seller-lessee capable of supplying this product to 1031 buyer-lessors, this increased market demand translates into higher prices and more favorable rental terms.

"TIC" Transactions

The field of potential buyer-lessors has also been expanded by the availability and increased popularity of tenant-in-common transactions, also known as "TIC" transactions. As a result of a 2002 IRS ruling, buyer-lessors can now acquire a tenant-in-common interest in a property, which is the subject of a sale-leaseback transaction, as opposed to acquiring the entire fee interest in this property.[5] Because "TIC" transactions allow different real estate investors to pool their wealth, these investors can achieve greater diversification. For example, a prospective buyer-lessor with $20 million to invest could use all of its capital to buy a fee interest in a seller's manufacturing facility for $20 million and then lease this manufacturing facility back to the seller-lessee. Alternatively, the same buyer-lessor could pool its capital with the capital of three other investors with each contributing $5 million towards the purchase the seller-lessee's manufacturing facility. After this transaction, the buyer-lessor and the three other investors would each own a 1/4 interest in the manufacturing facility as tenants-in-common. The buyer-lessor in our example would still have $15 million in capital to invest. The buyer-lessor could invest another $5 million as a tenant-in-common in a warehouse facility in another geographic location, another $5 million as a tenant-in-common in a large retail site in yet another geographic location, and another $5 million as a tenant-in-common in a distribution facility in still yet another geographic location. At the end of the day, this buyer-lessor who entered into the four "TIC" transactions would have an interest in four different types of property (i.e., real estate asset classes), in four geographic locations, and with four different seller-lessees providing a different rental stream.

[5] Rev. Proc. 2002-22.

In contrast, the buyer-lessor who invested its entire $20 million to acquire a fee interest in the manufacturing facility would only have an interest in one type of property, in one location, and with the credit risk of a single tenant with a single rental stream. As a result, this buyer-lessor has not diversified its risk among different geographic locations, real estate asset classes, or levels of tenant creditworthiness. Combining a "TIC" transaction with a sale-leaseback transaction allows for greater diversification of a buyer-lessor's investment dollar than an ordinary sale-leaseback transaction would allow.

The "TIC" transaction market has grown exponentially over the last few years. The aggregate value of property involved in "TIC" transactions has increased from $167 million in 2001 to more than $4 billion in 2005.[6] Much of the growth in this market has resulted from the combination of 1031 exchanges, "TIC" transactions, and sale-leaseback transactions. There are a wide range of intermediaries standing ready to help investors deploy their capital and complete these transactions in a very short time frame. Transaction sponsors for 1031 exchanges and "TIC" transactions often purchase single assets or portfolios of properties from sale-leaseback seller-lessees. These properties will then be sold individually or in groups to 1031 exchange and "TIC" buyers or other investors.

Incorporating a Sale-Leaseback Transaction into Your Private Equity Deal

Private equity investors may find it advantageous to incorporate a sale-leaseback transaction into the landscape of their deals. A private equity investor may acquire a target who owns real estate which is used in connection with the target's business. Contemporaneous with the acquisition of the target, or subsequently thereafter, the private equity investor may sell and leaseback the property used in the acquired business. The funds raised through such a transaction may be used to finance the acquisition of the target, to pay down debt, or to expand the business

[6] *IRC Section 1031 Tax-Deferred Exchanges: Using Tenancy-in-Common Interests as Replacement Property*, by Larry Maples, Charles W. Caldwell, and Bob G. Wood, Jr. in The CPA Journal Online (January 2007).

of the acquired target. Depending on the nature of the target's business and the investment objectives of the private equity investor, such a sale-leaseback transaction could involve one, several, or potentially hundreds of properties. The dramatic growth in the sale-leaseback market means that there now is likely to be a potential buyer-lessor for the highly leveraged deals of a typical private equity investor. Ultimately, a sale-leaseback transaction could increase the return on the private equity investor's investment in the target and may provide a superior form of financing relative to a mezzanine loan or high yield financing.

The means for comparing lease transactions is based upon "Cap Rates", which in essence is the rate that results from the annualized rent divided by the purchase price for the property. For example, if a $100 million portfolio of properties will result in net rental income of $9 million over the first year, the initial Cap Rate would be 9 percent. That Cap Rate, however, may be high in today's marketplace. If the purchaser of that portfolio can take that same $9 million rental stream and turn around and sell it to an investor who is willing to invest their funds at a Cap Rate of 8 percent, the resulting purchase price would be $112,500,000 (i.e., $9 million divided by 0.08). Thus, the portfolio that was acquired for $100 million has a value in the market place of $112,500,000.

The purchaser who buys in bulk may be able to acquire the assets at a collective discount. The private equity investor/seller-lessee, for example, who needs to sell all the target's properties at one time to raise capital to complete the acquisition of the target may need to pay a higher rental price (i.e., offer a higher Cap Rate) in order to find a willing purchaser, than if the assets were sold one at a time or in smaller portfolios. From the seller-lessee's perspective, the 9 percent Cap Rate may still be attractive relative to other financing alternatives such as mezzanine financing or high yield debt. The proceeds received from the sale-leaseback transaction could be viewed as a long-term financing arrangement. Thus, the Cap Rate has been locked into place subject to negotiated rental adjustments over the life of the lease. That base rate may stay in place for the next 20 years.[7] Accordingly, the private equity investor/seller-lessee needs to assess the transaction with a long-term view in mind and consider how it will affect the valuation of the acquired target's business.

When it is time for the private equity investor to sell its interest in the target, be it 5 to 10 years down the road, the sale-leaseback transaction will still be in place. A transaction that started at a 9 Cap with a 2 percent annual increase in rent will be at 9.94 percent at the end of year 5 and 10.97 percent at the end of year 10 (relative to the initial purchase price). Adjusted for inflation and property appreciation, however, this may still be an attractive rate. Of course, when it is time to sell the acquired target, the sale price will be affected by the EBITDA multiple times the rent under the lease. But given that the sale price is paid up front for the property and that the private equity investor/seller-lessee has the ability to use those proceeds (i) to reduce its equity contribution up front (thus reducing its risk) or (ii) as a substitute for more expensive mezzanine financing or high yield debt, the benefit from the sale-leaseback transaction can be quite substantial. For example, on a $50 million sale-leaseback transaction at a 9 Cap Rate (and 2 percent annual rental increases), the annual rent would be $4.5 million in the first year and almost $5 million/year by the end of the 5th year. With an EBITDA multiple of 6, that would result in a $30 million reduction in sale proceeds. If mezzanine financing had been used instead of the sale-leaseback, the interest rate during the term would have been higher and the entire $50 million initially borrowed would need to be repaid to the lender.

With the sale-leaseback transaction in place, the private equity investor is $20 million better off, because the sale price is only reduced by $30 million while $50 million is received upfront. Further, in the typical sale of a company, it is unlikely the seller will receive full value for real estate assets when the company is sold if the price is based on EBITDA. Thus, by using a sale-leaseback transaction, the private equity investor has

[7] Note, it is common in today's marketplace for rents to increase 1.5 percent to 2.5 percent per year. Whereas other acquisition debt may be shorter-term and subject to market fluctuations, the implicit financing rate for the sale-leaseback transaction will be more efficient and stable.

uncovered hidden value in the target's real estate assets on the front end and reduced interest carry throughout the term by virtue of the sale-leaseback transaction.

Accounting and Legal Expertise

While the basic mechanics of a sale-leaseback transaction can be rather simple, there are many complex accounting rules and legal negotiation points which must be considered. In order for the private equity investor/seller-lessee to obtain the benefits of a sale-leaseback transaction, the transaction must be properly structured in light of applicable accounting standards and the contractual obligations to which the private equity investor/seller-lessee is subject. The seller-lessee should contact its accountants so that it may be properly guided through the process of structuring the sale-leaseback transaction to achieve the desired accounting treatment.

Experienced attorneys familiar with sale-leaseback transactions are also needed to coordinate with the accountants and to draft and negotiate the underlying lease to reflect these accounting requirements. Certain provisions of these leases must be carefully negotiated so that the seller-lessee's investment objectives are realized. The standards and customs for sale-leaseback documentation vary in some significant regards from traditional leases. Thus it is critical to have an experienced sale-leaseback team in place.

Drafting the Lease

There are numerous provisions that the attorneys drafting and negotiating the underlying lease should consider and tailor to reflect the specific details of the sale-leaseback transaction. The economic terms of the leases and the mechanics relating to the operation of the underlying properties will likely be important to the private equity investor/seller-lessee. The attorneys should also pay careful attention to the terms of the leases which relate to the private equity investor/seller-lessee's (i) ability to pledge collateral as security and (ii) exit strategy.

Lease Provisions Relating to Collateral

The lender that provides the private equity investor with financing to acquire the target often may require that the target's personal property be pledged as collateral to secure the loan. This requirement of most lenders may be at odds with statutes in certain jurisdictions which expressly grant the landlord a lien in the tenant's personal property located at or on the leased premises to secure the tenant's performance of its obligations in whole or in part under the lease. In other cases, a landlord may attempt to negotiate a provision into the lease by which the tenant grants to the landlord a security interest in the tenant's personal property located at or on the leased premises. However, any additional collateral which is provided to the buyer-lessor is a form of continuing involvement, which precludes sale-leaseback accounting under the applicable accounting rules. The landlord's desire for such a provision is particularly common where the personal property would assist the landlord in re-letting the property, such as a restaurant or movie theater. To accommodate the lender who provides financing to the private equity investor/seller-lessee, the lawyers should insert a provision into the leases which allows the lessee thereunder the flexibility to pledge its personal property as collateral. Such a provision should also (i) contain an express waiver by the landlord of any statutory lien it may have in the tenant's personal property and (ii) grant the lender the right to enter the premises to seize its collateral. It is advisable to build this provision into the lease up front so that the private equity investor/seller-lessee does not have to approach the landlord after the fact to obtain a lien waiver.

Similarly, it is also often desirable to incorporate flexibility into the leases to allow the private equity investor/seller-lessee to grant leasehold mortgages to the lender who provides financing for the acquisition of the target. By incorporating a sale-leaseback transaction into a private equity deal, the private equity investor/seller-lessee has obtained valuable leasehold interests which may be pledged as collateral. In order for the private equity investor/seller-lessee to pledge its interest as lessee under the leases as collateral to the

lender, the private equity investor/seller-lessee must ensure that these leases do not contain any restrictions or limitations which prohibit such collateralization. Even if the lender who provides financing for the initial acquisition of the target does not require leasehold mortgages, it is important to build flexibility into the underlying leases to allow the lessee thereunder to grant leasehold mortgages in the future. For example, down the road when the private equity investor/seller-lessee decides to sell the target company and assign its interest as lessee under the leases to a new purchaser, the lender providing financing to this new purchaser may require that it be granted leasehold mortgages at that time. Accordingly, the leases which are part of a sale-leaseback transaction should be negotiated with these considerations in mind.

Exit Strategy

It is also essential that private equity investors/seller-lessees think about their exit strategy from the outset, even though this exit may not be for another five or ten years. To ensure that the private equity investor/seller-lessee can sell its investment in the target at the time and in the manner that it pleases, the private equity investor/seller-lessee should devote considerable attention to negotiating the assignment provision.

The vast majority of commercial leases contain a provision which prevents the lessee from assigning its interest in the lease without first obtaining the lessor's consent. Often times, these provisions also prohibit a change in control of the tenant (either directly or indirectly), without the lessor's prior consent. If the lease does not contain any exclusions or carveouts, the private equity investor, as lessee under such a lease, may be severely limited in its ability to sell its interest in the target. Many assignment provisions do contain the qualification that the lessor shall not unreasonably withhold its consent to an assignment, while other assignment provisions may provide that the lessor will not unreasonably withhold its consent to an assignment provided that the assignee has a certain credit rating or net worth. These "reasonable" and "creditworthy" standards are too vague and subject private equity investors/seller-lessees to an unacceptable level of uncertainty.[8] The practical significance of these provisions is that the sale of the private equity investor/seller-lessee's investment in the target is subject to the whims and discretion of the lessor. In effect, the private equity investor/seller-lessee becomes locked in, thereby turning its acquisition of the target into an illiquid investment. A landlord should not be given this kind of control and discretion as they may demand unwanted or unnecessary extensions, rent increases or even warrants.

Therefore, with respect to the assignment provision, it is very important that the private equity investor/seller-lessee not compromise on the negotiation of the underlying lease with the lessor in an attempt to quickly complete the sale-leaseback transaction. The private equity investor/seller-lessee should insist that under the terms of the lease, the following occurrences do not require the landlord's consent:

- an initial public offering of the lessee's (or parent's/guarantor's) stock;
- transfers of the lessee's stock while traded on a public exchange or over-the-counter market;
- transfer of the lessee (or the lessee's interest in the lease) to an affiliate;
- a merger of the lessee with another entity which results in an assignment of the lease by operation of law;
- a change in control or ownership (at any level) of the lessee; and
- a sale of all or substantially all of the assets or equity ownership of the lessee (or its parent/guarantor).

Clearly, if the private equity investor/seller-lessee is unable to execute the most advantageous exit strategy (or any exit strategy at all), the return on its investment will be severely adversely affected.

[8] Additionally, standards which require the assignee of the lease to be a "creditworthy" entity prevent the sale of the target (and the assignment of the underlying leases) to other private equity investors who are likely to use a high leverage strategy as well.

Other Lease Considerations

The above discussion by no means provides an exhaustive list of all of the components of the lease that warrant the attorneys' attention. Other provisions which are likely to require careful negotiation include, among others, (i) the level of and amount by which rental payments escalate over time; (ii) renewal options; (iii) insurance requirements; (iv) consequences of casualty and condemnation; (v) surrender of the premises upon expiration of the leases; (vi) security deposits; and (vii) guarantees. For all of these reasons, it is necessary to have an experienced legal team in place to negotiate the underlying lease agreements.

A private equity investor/seller-lessee should also consider using a sale-leaseback advisor. Such advisors have resources regarding asset valuation, market lease terms, buyer-lessor creditworthiness (and certainty of completion) and other critical business points that will not otherwise be available to the private equity investor who does not regularly participate in sale-leaseback transactions. Further, these advisors can assist with diligence and analysis and can help to facilitate coordination between the accountants, target, purchaser, and purchaser's lender. Given the length of the lease term, small changes in the Cap Rate of the lease alone and the renewal rates can have a significant effect on the value of the deal to the private equity investor/seller-lessee. There are literally hundreds of buyers with various specialties, costs of capital and tax motivations. An advisor will drive a competitive process to maximize the transaction structure and pricing for the seller-lessee. An advisor may also do much of the initial feasibility study or valuation work upfront for the seller-lessee to help them decide in advance what type of transaction should be pursued.

Accounting Considerations[9]

Ensuring that the resulting lease in a sale-leaseback transaction is appropriately classified for financial accounting purposes is critical to the realization of the private equity investor/seller-lessee's objectives. In most circumstances, the private equity investor/seller-lessee desires that the lease be treated as an operating lease for accounting purposes. In order to classify the lease as such, the underlying sale-leaseback transaction will need to comply with several accounting standards. Principally, the lease must first qualify for sale treatment and accounting derecognition under the accounting rules before classification as an operating lease is considered. One misstep may result in adverse accounting treatment which could completely undermine the private equity investor/seller-lessee's motivations for entering into the sale-leaseback transaction in the first place.

Consequences of Adverse Accounting Treatment

Adverse accounting treatment could mean that the arrangement does not allow for accounting derecognition of the property and that the lease is treated as a capital lease, thus requiring the private equity investor/seller-lessee to record additional indebtedness on its balance sheet. Such adverse accounting treatment may mean that a covenant made by the private equity investor/seller-lessee in its loan documents to not enter into a capital lease or to not incur additional indebtedness has been breached. Also, the recording of additional indebtedness on the private equity investor/seller-lessee's balance sheet may result in the violation of financial tests and ratios to which the private equity investor/seller-lessee is subject. Even a sale-leaseback transaction which qualifies for operating lease accounting treatment may be prohibited by the private equity investor/seller-lessee's contractual

9 The accounting treatment of any sale-leaseback transaction is highly complex and requires the assistance of skilled accountants experienced in the lease accounting area. This article contains only a general discussion of accounting considerations which may arise and should not serve as a substitute for consultation with accountants who are experienced with sale-leasebacks transactions. Any and all accounting decisions should be made only upon and with the advice of accountants familiar with the underlying transaction.

obligations under the credit documents. For these reasons, it is always critical to structure the sale-leaseback transaction in light of the credit agreements which were put into place in connection with the acquisition of the target (or other obligations which may exist). Conversely, it is equally as critical to build flexibility into the credit documents to allow the target acquired by the private equity investor/seller-lessee to subsequently enter into a sale-leaseback transaction should the economics of such a transaction appeal to the private equity investor/seller-lessee.

Sale-Leaseback Accounting[10]

Statement of Financial Accounting Standards No. 98 "Accounting for Leases" ("FAS 98") establishes standards of financial accounting and reporting applicable to a seller-lessee involved in a real estate sale-leaseback transaction.[11] Sale-leaseback accounting is only appropriate where the transaction includes, among other things,[12] (i) a normal leaseback[13] and (ii) payment terms and provisions that transfer all of the other risks and rewards of ownership as demonstrated by the absence of any other continuing involvement by the seller-lessee.[14]

A normal leaseback is a lessor-lessee relationship that involves the active use of the property by the seller-lessee in consideration of the payment of rent (including contingent rentals that are based on the future operations of the seller-lessee) and excludes other continuing involvement as described in paragraphs 11-13 of FAS 98.[15]

Continuing involvement is, in essence, a situation that results when the seller-lessee does not transfer all the risks or rewards of ownership to the buyer-lessor. Examples of continuing involvement which may arise in the context of a sale-leaseback transaction include situations where:

- The seller-lessee has an obligation or an option to repurchase the property[16] or the buyer-lessor can compel the seller-lessee to repurchase the property;[17]
- The seller-lessee guarantees the return on the buyer-lessor's investment;[18]
- The seller-lessee is required to pay the buyer-lessor at the end of the lease term for a decline in the fair market value of the property below the estimated residual value on some basis other than excess wear and tear of the property levied on inspection of the property at the termination of the lease;[19]
- The seller-lessee provides nonrecourse financing to the buyer-lessor for any portion of the sale proceeds or provides recourse financing in which the only recourse is to the leased asset;[20]
- The seller-lessee is not relieved of the obligation under any existing debt related to the property;[21]
- The seller-lessee provides collateral on behalf of the buyer-lessor other than the property directly

10 Depending upon the private equity investor/seller-lessee's objectives, it may sometimes be desirable to structure a transaction so as to avoid qualification for sale-leaseback accounting. One way of structuring such a transaction requires the target in an asset sale transaction to first sell its owned real estate before the target's assets are acquired by the private equity investor. Upon the acquisition of the target's remaining assets, the private equity investor would then enter into a lease agreement on each of the properties previously sold by the target. In structuring the transaction in this manner, because the private equity investor was not the prior owner of the subject property, the private equity investor may be able to avoid the necessity of complying with FAS98 and the sale-leaseback accounting rules. The beneficial consequence of this structure is that it may allow the private equity investor to have an option to purchase the subject properties at the expiration of the lease term at the properties' then fair market value (although a bargain purchase option would still be prohibited under FAS13's rules governing operating leases). Additionally, as the lessee under the leases, the private equity investor would not be required to comply with the same limitations on security deposits and restrictions upon subleasing as would apply if the transaction were subject to FAS98's sale-leaseback accounting rules.

11 FAS98, paragraph 6.

12 Additionally, in order to qualify for sale-leaseback accounting, the payment terms must adequately demonstrate the buyer-lessor's initial and continuing investment in the property. *See* FAS98, paragraph 7(b) and FAS66, paragraphs 8-16 for further details.

13 FAS98, paragraph 7(a).

14 FAS98, paragraph 7(c).

15 FAS98, paragraph 8.

16 A right of first refusal based on a bona fide offer by a third party ordinarily is not an obligation or an option to repurchase. An agreement that allows the seller-lessee to repurchase the asset in the event no third-party offer is made is an option to repurchase. *See* FAS98, paragraph 11(a), footnote 7.

17 FAS98, paragraph 11(a).

18 FAS98, paragraph 11(b).

19 FAS98, paragraph 12(a).

20 FAS98, paragraph 12(b).

21 FAS98, paragraph 12(c).

involved in the sale-leaseback transaction, the seller-lessee or a related party to the seller-lessee guarantees the buyer-lessor's debt, or a related party to the seller-lessee guarantees a return of or on the buyer-lessor's investment;[22]

- The seller-lessee's rental payment is contingent on some predetermined or determinable level of future operations of the buyer-lessor;[23]
- The seller-lessee enters into a sale-leaseback transaction involving property improvements or integral equipment without leasing the underlying land to the buyer-lessor;[24]
- The buyer-lessor is obligated to share with the seller-lessee any portion of the appreciation of the property;[25] and
- Any other provision or circumstance that allows the seller-lessee to participate in any future profits of the buyer-lessor or the appreciation of the leased property.[26]

A sale-leaseback transaction that does not qualify for sale-leaseback accounting because of any form of continuing involvement by the seller-lessee other than a normal leaseback shall be accounted for by the deposit method or as a financing (effectively as a secured borrowing).[27] The requirements for sale-leaseback accounting are numerous and technical. Accordingly, the seller-lessee's accountants should be involved with both the structuring and documentation of the transaction.[28]

Classification as an Operating Lease

In addition to qualifying for sale-leaseback accounting treatment, the private equity investor/seller-lessee will want the resulting lease to qualify as an operating lease. If at its inception, a lease meets any of the following four criteria described in Statement of Financial Accounting Standards No. 13, "Accounting for Leases" ("FAS 13"), it should be classified as a capital lease by the private equity investor/seller-lessee.[29] If, however, the lease does not meet any of the four criteria below, it is classified as an operating lease.[30] The four criteria are as follows:

1. the lease transfers ownership of the property to the lessee by the end of the lease term;[31]
2. the lease contains a bargain purchase option;[32]
3. the lease term is equal to 75% or more of the estimated economic life of the leased property;[33] or
4. the present value at the beginning of the lease term of the minimum lease payments (excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the buyer-lessor, including any profit thereon) equals or exceeds 90% of the excess of the fair value of the leased property to the buyer-lessor at the inception of the lease over any related investment tax credit retained by the buyer-lessor and expected to be realized by the buyer-lessor.[34]

Accounting for Capital Leases

If classified as a capital lease, the private equity investor/seller-lessee shall record the lease as an asset and as an obligation in an amount equal to the present value[35] at the beginning of the lease term of minimum lease payments during the lease term, excluding that

22 FAS98, paragraph 12(d).

23 FAS98, paragraph 12(e).

24 FAS98, paragraph 13(a).

25 FAS98, paragraph 13(b).

26 FAS98, paragraph 13(c).

27 FAS98, paragraph 10.

28 *See* discussion in paragraphs 25-39 and 41-43 of FAS66.

29 FAS13, paragraph 7.

30 FAS13, paragraph 7.

31 FAS13, paragraph 7(a).

32 FAS13, paragraph 7(b).

33 FAS13, paragraph 7(c).

34 FAS13, paragraph 7(d). A buyer-lessor shall compute the present value of the minimum lease payments using the interest rate implicit in the lease. A private equity investor/seller-lessee shall compute the present value of the minimum lease payments using his incremental borrowing rate unless (i) it is practicable for him to learn the implicit rate computed by the buyer-lessor and (ii) the implicit rate computed by the lessor is less than the private equity investor/seller-lessee's incremental borrowing rate. *Id.*

35 The discount rate to be used in determining present value of the minimum lease payments shall be that prescribed in paragraph 7(d) of FAS13. FAS13, paragraph 10.

portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the buyer-lessor, together with any profit thereon.[36] However, if the amount so determined exceeds the fair value of the leased property at the inception of the lease, the amount recorded as the asset and obligation shall be the fair value.[37] If the portion of the minimum lease payments representing executory costs, including profit thereon, is not determinable from the provisions of the lease, an estimate of the amount shall be made.[38]

Accounting for Operating Lease Rent Payments

Normally, rental payments on an operating lease shall be charged as an expense over the lease term as it becomes payable.[39] If rental payments are not made on a straight-line basis, rental expense nevertheless shall be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property.[40]

Working with the accountants who are versed in the specific lease accounting rules is critical to ensuring that the desired accounting treatment is obtained. While the private equity investor/seller-lessee's general outside accountants and auditors may be reasonably familiar with the accounting rules and standards applicable to sale-leaseback transactions, this area is extremely complex and these transactions often require the specialized experience and interpretation of the accounting firm's leasing practice group.

Conclusion

Sale-leaseback transactions present many advantages to mezzanine financings, high yield public debt offerings, and even traditional mortgage financing of owned real property. Private equity investors may consider incorporating a sale-leaseback transaction into the landscape of their deals (i) to increase their return on investment or (ii) to be used as a superior substitute for mezzanine or other financing.

Sale-leaseback transactions are complex and require the expertise of experienced professional advisers. The consequences of failing to negotiate and structure the sale-leaseback transaction in a way which satisfies the requirements for the desired accounting treatment are often irreversible. The buyer-lessor, and the lender who financed the sale-leaseback on behalf of the buyer-lessor, are often not receptive to renegotiating the lease after the transaction has been completed. Additionally, some buyer-lessors may quickly sell off their properties and their interest in the leases to third-parties after a transaction is completed.[41] Accordingly, an improperly structured transaction or lease may leave the private equity investor/seller-lessee in the undesirable position of having to renegotiate with multiple landlords for multiple leased sites. Attempting to correct a problem that has resulted in adverse accounting treatment will certainly prove to be costly and might prove to be impossible. It should also be stressed that an acquired target will be burdened by poorly negotiated leases for many years. Moreover, such leases could severely hinder a private equity investor/seller-lessee's ability to execute the most advantageous exit strategy. A private equity investor/seller-lessee's inability to sell the target to whom and when it desires will surely reduce the private equity investor/seller-lessee's return on investment in the target. For all of these reasons, it is critical to structure and document the sale-leaseback transaction properly from the outset so that the maximum benefits are achieved. ◎

36 FAS13, paragraph 10.

37 FAS13, paragraph 10.

38 FAS13, paragraph 10.

39 FAS13, paragraph 15.

40 FASB Technical Bulletin 88-1 "Issues Relating to Accounting for Leases" ("FTB 88-1").

41 It has also become quite popular for the buyer-lessor to sell or flip the properties to another buyer-lessor even prior to their actual acquisition. If the contract is assigned, each of the buyer-lessors may be able to avoid transfer taxes in connection with the original acquisition and the need for additional title insurance, surveys, and other closing costs.

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