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LJN's

# Equipment Leasing

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## Lessors and the Proposed New Accounting Rules

By Shawn Halladay

The race to overhaul U.S. lease accounting standards is entering the last lap and, although the final results are yet to be determined, the field is becoming clearer. This article examines the proposed lease accounting rules to date and their anticipated impact on lessors and the way they do business. This examination begins with a discussion of the proposed changes and their impact on lessee behavior, then progresses to how those behaviors impact lessors, and finishes with an examination of how lessors potentially will have to adjust to these market and rule changes.

### THE PROPOSALS

Getting to where we are with the current proposals has been a long and arduous process, one which began with regulators' concerns about off-balance-sheet assets and liabilities under today's lease accounting rules. This process gained momentum with the push to converge U.S. accounting standards with international standards and resulted, in March of 2009, in the joint issuance of a Discussion Paper on lease accounting by the International Accounting Standards Board ("IASB") and the Financial Accounting Standards Board ("FASB"), referred to collectively, as the Boards. See Discussion Paper, *Leases: Preliminary Views*,  
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## Environmental Liability

### *Equipment Lessor Is Responsible Under CERCLA for Cleanup Costs As the Owner of a 'Facility'*

By Charles F. Becker

Equipment lessors need to learn a new acronym: CERCLA. It stands for the Comprehensive Environmental Response, Compensation and Liability Act, and it has the potential to expose lessors to millions of dollars in environmental liability. This according to the recent Illinois federal district court case of *United States v. Saporito*, 210 WL 489703 (N.D.Ill. Feb. 9, 2010). Before discussing the case, some background is in order.

Cleanup of environmentally contaminated real estate is frequently a very expensive proposition. CERCLA (a/k/a Superfund) is the federal law that deals with the nation's most polluted sites. The cost of cleanup at an average CERCLA site is in excess of \$30 million. To establish who must pay these costs, the federal law identifies four groups: 1) The current owner and/or operator of a facility; 2) the owner and operator of the facility at the time of the release; 3) anyone who arranges for the disposal of hazardous waste; and 4) a transporter of hazardous waste.

As with many federal laws, the devil is in the details — in this case, the definitions. When CERCLA refers to the owner of a "facility," it is not referring to just a building or even the real estate. Rather, a facility is defined under CERCLA regulations to be:

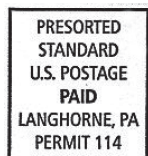
1. Any building, structure, installation, equipment, pipe or pipeline (including any pipe into a sewer or publicly owned treatment works), well, pit, pond, lagoon, impoundment, ditch, landfill, storage container, motor vehicle, rolling stock, or aircraft, or;
2. Any site or area where a hazardous substance has been deposited, stored, disposed of, or placed, or otherwise come to be located; but does not include any consumer product in consumer use or any vessel.

In other words, when you think "facility" under CERCLA, think a very broad universe. With these thoughts in mind, let's review the facts of *United States v. Saporito*.

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## Accounting Rules

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published by the Financial Accounting Standards Board, March 19, 2009.

It is this Discussion Paper that formed the basis for the evolving changes we see being considered today. The final version of the proposals will be published in an Exposure Draft, the contents of which will be open to public comment before they are finalized. The Exposure Draft, at press time, is expected to be issued in late July or early August. [Note: Although lease accounting is a joint project between the FASB and the IASB, the FASB will issue a separate lease accounting standard that will apply to companies in the United States.]

Although the proposed rules establish new requirements that, supposedly, will standardize the lease accounting process, they also will add more complexity to both lessor and lessee accounting. As a starting point, the proposals require that all leases be capitalized in the lessees' books as a right of use asset and a corresponding obligation to pay rent. Other changes include the requirement that lessees record the lease liability based on the present value of the payments over the most likely lease term.

Contingent rents also must be assessed and capitalized under the new rules. Furthermore, these assumptions must be reassessed each reporting period by both the lessee and the lessor. This reassessment is based on any new facts or circumstances that may arise. Any changes will require an adjustment of the

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lease debt in the lessee's books. Changes to the lease obligation arising from updated expectations about contingent rents or residual value guarantees, however, would flow through profit or loss.

The primary, and very valid, concern for lessors is that requiring lessees to capitalize all leases will negatively affect volumes. Even today, we see reluctance by some lessees to even use operating leases, for fear of the impact of capitalization in the future. The compliance burden associated with reassessing the lease term also will have an adverse effect on lessees' decisions to utilize lease financing. These changes may result in an increase in capital, particularly for banks, as more debt is added to the balance sheet, and more judgment calls related to renewal options and contingent rents. Lessors also can expect lessee behavior to change in regard to renewal and purchase options.

On the flip side, lease volumes may increase in certain customer segments. Lessees with EBITDA concerns, for instance, will now find leasing more attractive, along with those lessees concerned with transparency. [Note, a 2006 study of 25 companies by the Georgia Tech Financial Analysis Lab found that the EBITDA for these companies would rise an average of 17.2%. Alan Rappeport, *Lease Accounting: Falling Rents Will Boost EBITDA*, CFO.com, Nov. 27, 2007.] Lessees still can achieve partial off-balance-sheet financing on those leases in which the lessor retains residual risk, so it can be expected that lessees will seek shorter-term leases. They also may request more leases with subjective options and contingencies inherent in the structure. In this respect, some lessees may choose to take on the greater risk of adopting shorter-term leases as a trade for taking a portion of the lease obligation off the balance sheet.

This move to shorter-term, more option-oriented leases will shift more residual value risk toward lessors. Lessors should be able to

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## Equipment Leasing

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# The Need for Independent Analysis On Portfolio Risks

By Rick Daubenspeck

With the current economic condition being the way it is, and the risk assumed by banks and lessors being scrutinized more and more, the once shunned idea of turning to an outside valuation provider for an assessment of potential exposure is now becoming more prevalent. Equipment and portfolio managers within the leasing community are being looked at by their institutions as being the last line of defense against the potential loss or shortfall from a leasing transaction as a result of the down economy or defaulting lessees.

Historically, the leasing community would primarily keep its portfolio reviews in-house to avoid the expense that turning to an outside opinion provider would incur. But as a result of recent economic events, and a growing pressure from management to assure that any shortfalls or potential losses are recognized and resolved prior to any surprises, the once "taboo" thought of allowing a non-employee access to information is becoming more of a necessity. Having the review for potential exposure or losses being performed by the same individuals who are initially setting the residuals is like having students grading their own exams. This is by no means a shot at the equipment personnel within banks and leasing

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companies; the ones that I deal with are some of the smartest equipment people whom I know. But the main concern is whether the people setting the original residuals are willing to say, "I think I missed this one, we need to take some action," or are they going to avoid bringing this to the forefront in hopes that the deal will right itself by the time it reaches the end of the lease term. Oftentimes, a potential loss from a lease transaction is a result of an occurrence that could not have been predicted as of the inception of the lease; but even knowing this, the opinion from a party with no "skin in the game" is something that can provide valuable insight and potentially eliminate a potential loss or risk exposure. Because an independent valuation provider has no involvement in the deal other than providing a value, there's less of a chance of the opinion of the valuation provider being swayed by the internal environment of the lessor. Whether there is a potential loss or not, the independent opinion provider will get paid regardless of the outcome of the particular transactions being reviewed.

## THE POTENTIAL FOR COMPLACENCY

Another concern within the leasing industry is the potential for complacency regarding its equipment knowledge and current research. It's something that we have all done in the past in some form or fashion; if you do something enough times you can easily fall into the trap of following procedure without looking outside of usual sources for a new perspective. The downside is that we sometimes miss out on new sources of knowledge and alternative perspectives to what might impact the value. From a lessor's perspective, a new set of eyes looking at transactions or an alternative viewpoint can sometimes provide critical information that can assist in the avoidance of a potential loss and the realization of a gain from a lease engagement.

From the occasions where an outside valuation provider has been en-

gaged to review leases that are either in trouble or are nearing the end of their lease term, some interesting situations have been uncovered:

1. When performing a review of a lease portfolio that included a mix of leases at risk and leases where payments were current, the biggest surprise was from a lease that had been current throughout its term. The lessee was a textile business in New England that made its lease payments for office furniture as scheduled every month. From basic due-diligence, it was learned that the lessee was being sued for age discrimination and had moved from its original location just months into a five-year lease term. The assets were still located at its corporate headquarters as if it were business as usual, and the lessee had arranged for an individual to show up and clean the furniture once a month. After three years of timely payments, the lessor was notified of the situation and was able to initiate action to avoid any losses under the existing lease agreement. In this case, the lessor had no idea of the current situation since the client was never delinquent and there was no need to consider this transaction to be of any concern. It was by random luck that the situation was uncovered because the lessor included this engagement with those it wanted reviewed. The lessor was able to put an action plan into motion that allowed it to recover the assets in accordance with the documented lease language and be proactive in heading off any potential loss or situation where the outcome could have been less than positive.
2. In some instances, a lessor may contract with a service provider who will provide the management of its portfolio.

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## **Independent Analysis**

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Under these agreements, the responsibility of managing the portfolio is not within the lessor's direct control, and it is relying upon the contracted third party to review and stay on top of its portfolio. We had a chance to review a portfolio under these circumstances, and what we determined was that the portfolio manager was not fulfilling its responsibilities as indicated in the contractual agreement between the lessor and the portfolio manager. Delinquent accounts were not being followed-up in the manner they were supposed to be, and the retaining of specific lease documentation was not as it was supposed to be according to the contractual agreement. By reviewing the management of the portfolio, we were able to help the lessor tighten up the control of the portfolio and provide it with indications in advance as to whether there might be potential exposure for some of the leases within the portfolio.

### **RECENT UPSWING**

Adding to the increasing reliance on outside opinion providers is the recent upswing in new commercial equipment leasing that showed an increase of 15% in April 2010 as compared with the same period in 2009. This is the first year-to-year increase since July 2008, and is looked at as a positive sign that businesses are starting to invest in capital assets

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## **CERCLA**

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### **THE FACTS**

Crescent Plating Works was operational from the 1970s to 2003. As its name implies, it was a metal plating facility that used toxic substances in the process of dipping metal parts in a series of chemical baths. In 2003, the facility was found to be highly contaminated, and the EPA spent

again. With this flurry of new business, the review of existing transactions sometimes gets pushed to the back burner, which allows any potential exposure to continue to grow until it's too late to do anything about it. Now with that being said, we are not suggesting that the increase in new business is a bad thing. We are trying to remind the leasing community that the need to remain diligent for potential losses from existing deals has not gone away. While equipment personnel are busy researching and structuring new business, using an outside opinion provider to review the existing transactions allows for the pursuit of new business to remain a key focus.

### **THE COST**

Another area of concern to lessors is the cost to hire an independent opinion provider as opposed to just keeping the review in-house and performed by personnel already within the group. True, the use of an outside independent opinion provider will create an additional cost. But how would that cost be measured against the avoidance or recovery of a potential loss from lease transactions that lose money? The actual cost for bringing in an outside provider can be negotiated, and from our experience the costs are a fraction of the potential loss from bad transactions as well as repercussions from managers and shareholders who are wondering why the exposure was not determined and resolved before its impact was felt on the bottom line.

### **REDEFINING HOW LESSORS ACCOUNT FOR THEIR LEASES**

In addition, the Financial Accounting Standards Board ("FASB") and

the International Accounting Standards Board ("IASB") are attempting to redefine how lessors will be accounting for their leases. The new standard will replace FAS 13 in the United States and IAS 17 in those countries using international financial reporting standards. The new ruling is expected to do away with the "90% Rule," thereby eliminating the distinction between operating leases and capital leases, and returning the lease to the lessor's balance sheet. One of the areas of this new ruling that is expected to be a stumbling block is transactions with renewal options. Oftentimes, a renewal option is included in the structure of a lease transaction because the lessee is not sure what it will do at the point in time when a renewal is a possibility. Under the new ruling, the lessor would have to recognize the potential renewal as part of the overall lease term. In other words, a seven-year deal with a three-year renewal option would need to be reflected as a 10-year transaction.

The new draft of this rule change was scheduled to be released this June, and the final outcome cannot be predicted at this point in time. As of now, the FASB and IASB are indicating that this ruling could very well apply to existing leases, potentially requiring lessors to capitalize more than \$1 trillion in operating leases. It's a certainty that the leasing industry will be heard on this issue and that the outcome will have far-reaching effects not only for lessors, but also for independent opinion providers.



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\$1.5 million cleaning the property. As is its habit, the EPA wanted its money back and began searching for individuals or corporations that fell within one of the four groups.

James Saporito was allegedly involved with the plant in several ways, but the court focused on one particular relationship — it was undisputed that Saporito owned, and leased to the facility, some of the equipment that was used in the plating process.

The equipment included 14 rectifiers, a two-ton filter press, boilers, computers, and a semi-truck and trailer. None of the equipment was directly involved in the release of any chemicals, though all of the equipment was necessary to the plating process. Like most other equipment lessors, Saporito was not alleged to have manufactured, installed, operated, maintained, or directed the

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## CERCLA

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use of the equipment. Nevertheless, Judge Rebecca Pallmeyer held Saporito liable for all of the cleanup costs, \$1.5 million, as an “owner” of the “facility.”

### MERE OWNERSHIP

The basis for the ruling involved the CERCLA definitions. As noted earlier, a “facility” includes the buildings, structures, installation, equipment, pipe or pipeline, well, pit, pond, lagoon, impoundment, ditch, landfill, storage container, motor vehicle rolling stock, aircraft or contaminated site or area. Since “equipment” is part of the “facility” the owner of the equipment can be liable. That’s all it takes — mere ownership. The landlord who owns the land and the building owner can likewise be liable for contamination found on their land or in their building, though they did nothing other than rent the property or the building to someone who allowed the release of a hazardous substance. It is the ultimate example of guilt by association. It is, also, the law. Is it fair to find the innocent landowner, the innocent building owner, or the innocent equipment lessor liable for the tenant’s environmental sins? Of course not, but it is expedient. It is much easier to prove liability if one doesn’t have to prove that the property owner, building owner, or equipment owner caused (or even knew about) the contamination. In many cases, the person causing the release can be identified, and it is not necessary to look to the guilty-by-association defendants. In this case, Judge Pallmeyer had to reach further because that’s where the solvent defendant could be found. However, Saporito did not go down without a fight.

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### NOT WITHOUT A FIGHT

During the course of the hearing, Saporito tried to argue that it was not fair to hold him responsible since all he was doing was leasing equipment to an independent party that then used the equipment to cause pollution. The court found that the plating line was “no less a facility than the land on which it operated.” Therefore, “an owner of equipment necessary to the operation of the plating line is no less an ‘owner’ than a part-owner of land.” In fact, according to the court, the equipment owner is “arguably more culpable” than a land owner because “a land owner might not inquire into how her land is being used, but an equipment owner is likely to know exactly what her equipment can do.”

Saporito next argued that there was no evidence offered that connected any of his leased equipment to any release or threatened release or to any cleanup costs. The court found that CERCLA requires no such connection to be shown. It was enough that the equipment was a necessary part of a plating process that caused a release of a hazardous substance. The equipment need not be the actual cause of the release.

In what was a fairly creative defense, Saporito argued that he was entitled to the CERCLA exception that owners who are simply protecting a security interest are not liable. This is the exception that protects banks from liability, and Saporito felt he was like a bank in that he owned the equipment simply to secure his interest in a loan that he supposedly made to the company. The problem here was that he was unable to show that he made a loan to the company, which would be necessary to support his theory. According to the court, without that showing, a mere lease of equipment could not support the exception.

Finally, Saporito argued that even if he is liable, he did not own all of the equipment in the process, and some of the equipment was clearly shown not to ever have touched any hazardous substances. Therefore, he argued, the liability should be apportioned, and he should get only a very small (or no) percentage of the

total liability. The court was unsympathetic and found:

Defendant’s ownership of some of the equipment necessary to the plating process makes him comparable to a joint venturer. And apportionment is not appropriate for joint venturers.

### SIGNIFICANT REPERCUSSIONS

If it is confirmed that the mere owner of leased equipment, the operation of which is part of a line that results in a hazardous waste release, is responsible for the environmental cleanup caused by a sloppy lessee, the repercussions would seem to be significant. Certainly under the court’s analysis, all equipment that is associated with the production line where a hazardous waste release is identified would fall within the terms of the ruling. That could include acid baths, printing presses, paint lines, white goods production and any line with a degreaser, among many others. Even if you limit liability to equipment that, in some manner, touches a hazardous substance or is in a production line that uses a hazardous substance, you have already placed at risk a large number of very profitable leasing companies in the United States as well as the many equipment sale/leaseback arrangements that occur on a daily basis.

And what about the court’s comment that the “equipment owner is likely to know exactly what her equipment can do”? Does this really have anything to do with environmental liability? If it does, the possible universe of potentially responsible parties has grown significantly. Certainly a lessor of a backhoe knows that the backhoe could be used to break through a gas pipeline or scoop up coal tar tailings. Certainly a lessor of plastic totes knows that a company might use them to store solvents that might be spilled or otherwise released. Certainly a company that leases computers is aware that they could be used to monitor

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## CERCLA

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levels of hazardous substances in a production line. If the lessors of such equipment can be responsible for the contamination, there is not much left that can be safely leased.

The *Saporito* case is very disturbing in how far it goes to find a responsible party. Ownership liability under CERCLA has always been a broad concept, but this case seems to stand the concept on its head. If followed elsewhere, it is hard to believe that equipment leases are not going to be severely impacted. However, since CERCLA was enacted, cases that have liberally construed the provisions of Superfund have resulted in changes that provide limitations of environmental liability for large groups including lenders, trustees, and prospective land purchasers. Protection for equipment lessors should be part of this group. It would certainly help to get us back to the principle that the "polluter pays."

### A FEW SUGGESTIONS

Until an exemption can be created, what can a lessor do? Though one should always consult legal counsel to obtain state-specific and lease-specific advice, here are a few suggestions if the equipment is to be leased to a company that may use hazardous materials in its process:

- Include a broad indemnification provision. Since the indemnification is only as deep as the pocket giving it, the provision should address how it will be paid if it becomes necessary.

- Include a provision that the use of the equipment is warranted to be in compliance with all federal, state, and local laws and regulations. The court stated that such a provision would not prevent liability to the lessor, but it will encourage the lessee to carefully watch its operations.
- Consider requiring the lessee to obtain environmental liability insurance with the lessor as a named insured.
- Include a provision that states that the lessee will not use any hazardous substances in its process and be sure to discuss this with the lessee prior to execution of the lease. If the lessee cannot make this representation, then you know that a problem could come up, and more investigation is needed prior to completing the lease:
  1. Obtain representations as to how long production has been occurring at the site using hazardous substances;
  2. Consider visiting the site to determine whether lessee runs a clean operation;
  3. Consider requiring that a Phase II Environmental Site Assessment be conducted to determine if the site is already contaminated.
- Include a provision that allows lessor to visit the site at any time to view all operations so that it can determine if releases may be occurring.
- Include a provision that hazardous releases from the les-

see's production process will constitute an event of default under the lease.

- Obtain information about the lessee's financial stability. Personal guarantees or the guaranty of a parent corporation may be appropriate.
- Include a provision allowing lessor to immediately terminate the lease and to transfer ownership of the equipment to lessee at the discretion of the lessor with remaining payments to be treated as a loan repayment. Though this would not necessarily eliminate liability for the lessor during the lease period, it might limit future or ongoing liability.
- Include a provision that lessee releases and waives any and all environmental claims against lessor. This will not prevent a regulatory agency from pursuing the lessor, but it will help to prevent the lessee from attempting to include lessor as a third party in an action brought only against lessee.

### CONCLUSION

The court's decision in *Saporito* should send a clarion call to all lessors. If appealed, there could be a change in the outcome, but Judge Pallmeyer's decision is not obviously wrong. As a result, lessors would be well advised to take care in making equipment leases to companies that use any hazardous substances in their process.



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## Accounting Rules

*continued from page 2*

charge a premium for this greater risk and flexibility, however. This trend will create opportunities for those lessors willing to take residual risk and either fine-tune, or adjust, their business model. Consequently, there will be opportunities to provide accounting-based products for those lessors who are willing to take residual risk. And, in spite of dire predictions to the contrary, lessees also will continue to utilize leasing

for its many other benefits such as cash flow savings, tax motivations, and flexibility.

### LESSOR COMPLIANCE

The initial thought process of the Boards, which was reflected in the Discussion Paper, was to defer consideration of lessor accounting until after the lessee guidance is in place. This is no longer the case, as the Boards' recent struggles with some rather thorny lessor issues have shown. Although aspects of the lessor accounting model are still under heavy debate by the Boards, the di-

rection of the new requirements is beginning to come into better focus. The concern over leveraged leasing, for example, is now a thing of the past, as this form of lease has been eliminated under the new model.

The original industry expectation for lessor accounting, based on lessee capitalization of all leases, was that lessors would treat leases in their financial statements as either direct financing or sales-type. The new lessor proposals being discussed do not follow this logic,

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## Survey of Equipment Finance Activity

### *New Business Volume Declines 30.3% in 2009*

Like many other sectors of the economy, the equipment leasing and finance industry is still in the process of evaluating the severity of the financial storm weathered over the past few years. As a result, the question was never really if business volume would be off, but more accurately, by how much. The answer, a lot.

The Equipment Leasing and Finance Association ("ELFA") recently released its 2010 Survey of Equipment Finance Activity ("SEFA"), which shows that new business volume among a sample of the ELFA member companies declined 30.3% in 2009, in contrast with a 2.2% decline in 2008. Pre-tax income and net income, in dollar terms, declined by 55.7% and 54.4%, respectively. Decreases in revenues and total headcount were only 13.8% and 5.8%, respectively.

For the first time in the past 10 years of the SEFA, weighted average return on equity ("ROE") was in the single digits at 5.2%, a decline from 11% in 2008. Return on assets ("ROA") declined by half, falling to 0.6% from 1.2% during the year-earlier period.

Independent equipment finance organizations had the largest decline in new business volume with a rate of 46.3%, while new business volume for banks and captives declined by 26.1% and 20.9%, respectively. From an asset perspective, new business volume by equipment type declined for all categories, with transportation and construction equipment hardest hit and computer equipment investment close behind. Similar trends were seen in equipment investment by end-user industry with construction, utilities, and services showing the sharpest declines.

### **OTHER KEY FINDINGS**

*Portfolio Performance.* Equipment finance organizations report average charge-offs of 1.6% of the average net lease receivables balance, up from 0.7% in 2008. Receivables over 90 days rose to 1.4% from 1.0% the prior year.

*Margins.* Average pre-tax yield decreased to 7.15% from 7.29% in 2008. Average cost of funds were lower at 3.30%, down from 4.21% in 2008. Pre-tax spreads increased to an average of 3.85% from 3.08% in 2008.

*Lease Applications Processed.* Total number of applications submitted (1.87 million) is down from 2008 (1.96 million), with the number of applications approved (66.9%) also declining when compared with the previous year (72.5%).

*Workforce.* Total number of full-time equivalent ("FTE") employees declined in all types of equipment finance organizations. Headcount of Independents fell 9.7%, while Bank and Captive FTEs declined 5.3% and 3.8% respectively.

### **BETTER TIMES AHEAD**

"Fortunately, it appears the worst is behind us," noted ELFA President Woody Sutton. "More recent data collected during the past two quarters suggests a gradually improving U.S. economy extends to the equipment leasing and finance sector." The remaining question, is: How long is this going to take? Only time will tell.

The SEFA is the broadest compendium of industry data, comprising a representative cross-section of equipment lease and loan origination by product, structure, and origination. It provides a baseline and benchmark for companies operating in the equipment finance space through a voluntary survey of ELFA member companies. In the 2010 SEFA project, results were compiled from surveys sent to 341 eligible ELFA members, of which 100 companies representing 106 entities submitted 2009 U.S. domestic lease and loan data.

PricewaterhouseCoopers LLP managed the SEFA for the ELFA. It is available for purchase at [www.elfaonline.org/](http://www.elfaonline.org/).



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## Accounting Rules

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however, and, in some cases, create a mix of operating and direct financing lease attributes.

Rather than staying with an existing model, the Boards tentatively have decided to use a hybrid lessor accounting model. Under this model, the lessor would use the performance obligation approach to lessor accounting for leases that expose the lessor to significant risks and benefits associated with the underlying asset. The derecognition approach would be applied to all other leases that are subject to the new rules.

Based on the most recent decisions (although nothing is certain

until the final standard is issued) it appears that lessors will be required to account for four different types of leases. These include:

- Substantive sales in the form of a lease;
- Performance obligation leases;
- Derecognition leases; and
- Short-term leases.

Leases that are, in substance, sales and financings are expected to be excluded from the requirements of the new leasing rules. In a reincarnation of the capital lease tests under FAS 13, substantive sales will be determined by application of four criteria indicating a transfer of ownership from the lessor to the lessee. These criteria are more subjective than the so-called "bright line" tests of FAS 13.

The performance obligation approach ("POA") being considered is a new way of looking at the lease from the lessor's perspective. Under the POA, the lessor retains the leased equipment as a long-term asset on its books and recognizes a financial asset measured at the present value of the minimum lease payments. This financial asset is supported by a non-debt liability (the performance obligation). This liability represents the lessor's obligation to provide continued use of the asset to the lessee. The performance obligation will be amortized to income over the life of the lease.

The derecognition model, on the other hand, removes the leased asset

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## Accounting Rules

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from the balance sheet and recognizes the receivable (a financial asset) and residual value (a non-financial asset). This model is essentially the same as direct financing lease accounting under FAS 13. The IASB, however, has considered a partial derecognition model in which the residual value would be separated from the receivable and reported as a long-term asset, so this model represents another potential result under the final rules.

Measuring results based on the potential POA represents a shift in the lessor's management reporting environment, as most lessors expect the economics of the transactions they price to be reflected accurately in the financial statements. Although the yield data are accurately captured in the financial statements under the direct financing lease model, this is not the case under the POA. Instead, an asymmetry is created between the economic yield and book yield reported under the POA. This difference is due to the amortization of the performance obligation.

A leased asset is not a pure long-term asset in the traditional accounting sense. The POA does not capture this nuance. For example, when an asset comes off lease under the current rules, it is put into available-for-lease inventory, where it can be monitored from both a market and risk perspective. The leased asset is a current asset at this point, not a long-term asset. A separate shadow accounting process will have to be set up to accomplish this important function under the POA.

### **Operations**

The operational burden faced by lessors will increase substantially under the proposed lease accounting rules as lessors establish new processes and data analytics to accommodate the new requirements. For example, there will be increased customer analysis and tracking nec-

essary to determine the most likely lease term, not only at inception, but also at each reporting period. These incremental processes and procedures will alter the internal control environment and potentially increase audit costs.

Other increases in the operational burden for lessors include:

- Changes in how sales taxes are remitted;
- Increases in deferred tax tracking associated with the performance obligation and inception date assets and liabilities;
- Renegotiation and modification of debt covenants;
- Modification to treasury management processes and models;
- Changes to regulatory requirements and reporting;
- Adaptation of processes to track inception date assets and liabilities, including fair value adjustments;
- Adjustments to regulatory capital; and
- Alterations to reporting and budgeting processes.

### **Information Systems**

Current lease management systems have the capability to track operating leases and finance leases. The POA, however, will require each of these modules to be linked and then integrated. New performance obligation capabilities will have to be created and then linked to the leased asset and receivables.

The POA also will require more asset tracking capabilities than some legacy lease management systems currently possess. Tracking subvention income, blended income, and other subsets of income and deferred charges now will become even more complicated and difficult to implement as the number of components associated with the lease transaction increases under the POA. Additionally, lease origination systems will need to be modified to track and accom-

modate the performance obligation and inception date assets and liabilities booked at inception.

### **Affected Constituents**

The effect of adopting the POA goes well beyond lessors, as other constituents of the equipment leasing industry also will be impacted. There will be disruption of the regulatory oversight function, for example, as regulatory capital, as measured in the financial statements, will be inadequate under the POA if netting is not allowed. This change will necessitate altering metrics, regulatory guidance collateral, and, potentially, audit approaches, documentation, and focus.

The rating agencies will be forced to adjust their metrics and analysis, not only in their scrutiny and investigation of leasing companies, but also in how they measure and assess lease securitizations. Investors and lenders in the equipment leasing industry also will have to adjust to viewing the industry in a whole new light.

### **CONCLUSION**

The good news is that, although sweeping in scope, the proposed accounting changes apply to only a portion of the customer population. A large segment of the leasing market, such as lessees with capital leases and those who choose to lease for non-accounting reasons, will not be affected. Changes to the way lessors must approach their customers and account for the subsequent leases are imminent, however, although their full extent is not known as of the date of this article.

So what must be done? As with any change, there will be opportunities. These include providing accounting-based products for those lessors willing to take residual risk, implement appropriate processes, and adjust their business models. In other words, the creativity and prudent risk-taking that represent the foundation of the equipment leasing industry still will have a role.



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