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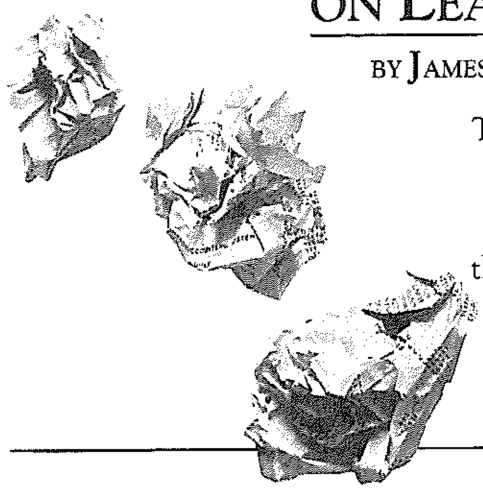

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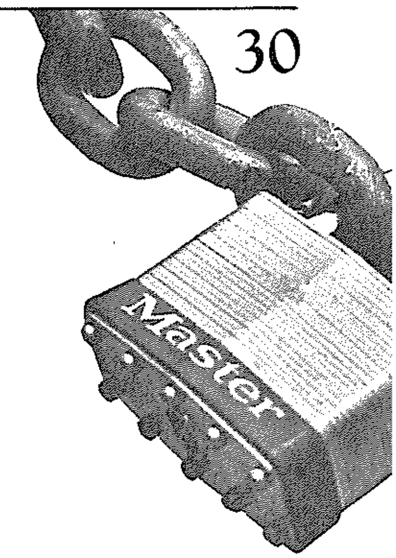

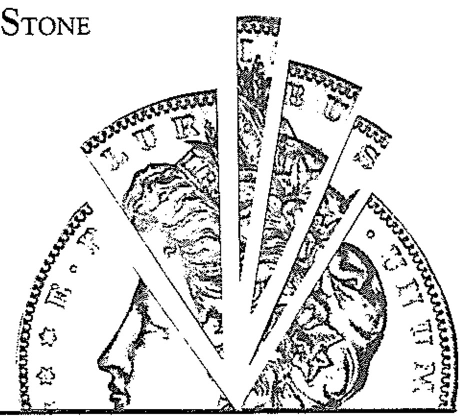

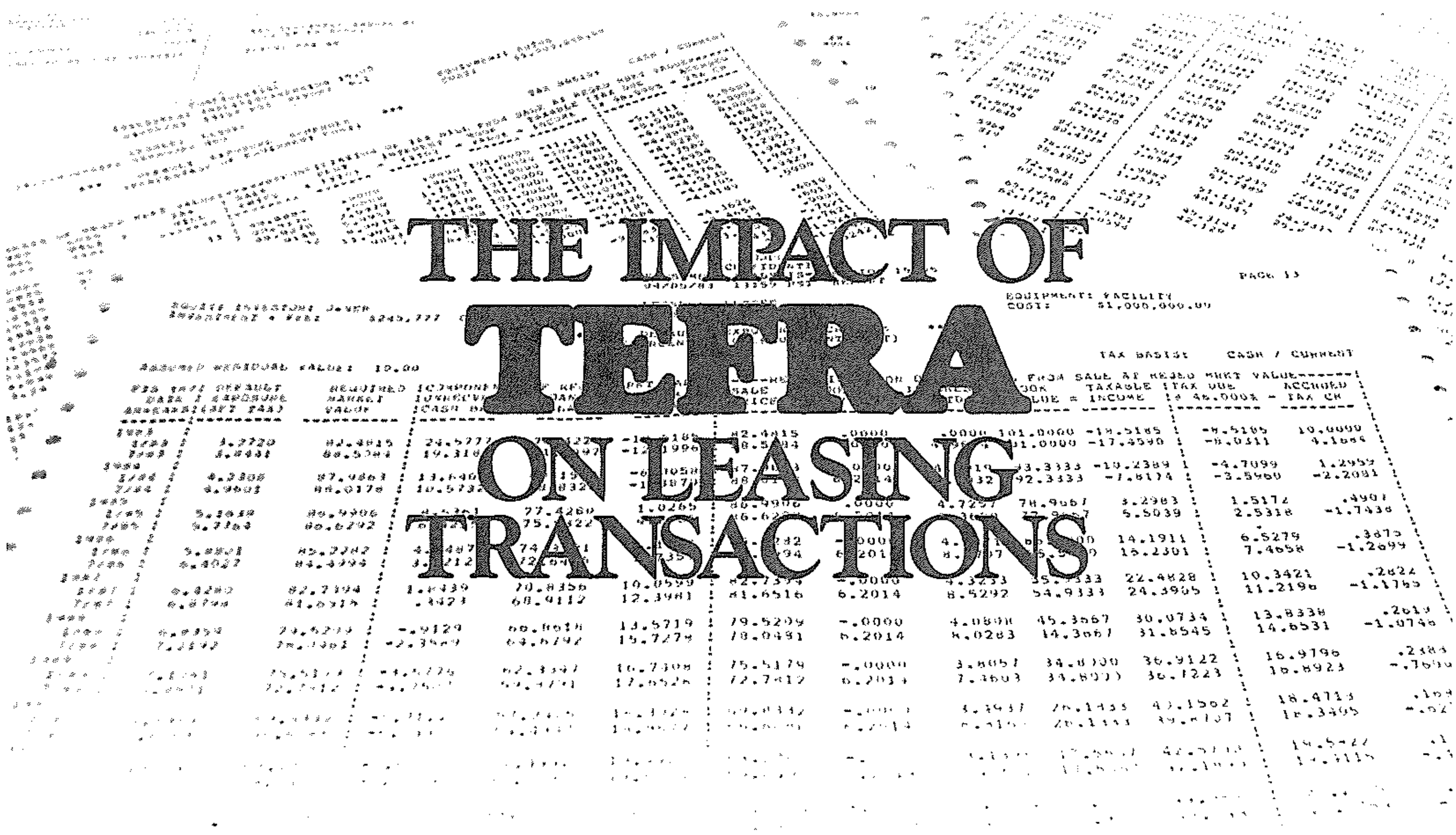

THE IMPACT OF TEFRA ON LEASING TRANSACTIONS

photo by Art Stein

by James M. Johnson, Ph.D.

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Introduction

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) reduced the tax benefits available to equipment owners relative to those which existed under the Economic Recovery Tax Act of 1981 (ERTA). As a consequence, it would be expected that leasing transactions governed by TEFRA would result in lower lessor yields, higher lessee rents, or both, than experienced under ERTA. The purpose of this article is to estimate the *magnitude* of TEFRA's adverse impact on leasing transactions. To accomplish this, the investment tax credit (ITC)/ depreciation elections TEFRA permits is discussed and compared to the provisions which existed under ERTA. Since TEFRA permits two options, rules for optimum elections under TEFRA are constructed. This then permits estimates to be developed concerning the relative impact of TEFRA on lessee rents (with the assumption that lessors pass on this unilateral cost increase rather than suffer a reduction in yield). To develop these "TEFRA disadvantage estimates," numerous illustrative lease transactions are analyzed. By evaluating rent increases necessary for lessors to earn the same yield before and after TEFRA for transactions with differing terms, tax rates, in-service dates, residual values, and yield requirements, an understanding of the overall magnitude of TEFRA's impact upon the equipment leasing industry is shown. The final section of the paper presents a summary and conclusions.

ITC/Depreciation Elections under ERTA and TEFRA

ERTA introduced a new and highly simplified method of depreciation dubbed the Accelerated Cost Recovery System (ACRS). Under ACRS, assets subject to depreciation are classified as three, five, ten or 15-year property and depreciated over that respective number of years for tax purposes. As part of the simplification process, 100% of an asset's cost may be depreciated; the requirement to depreciate down to a "reasonable" salvage value was eliminated. Depreciation deductions for each year are also easily determined by multiplying the asset's cost by percentages set forth in the Act.

The rules governing ITC were also simplified under ERTA. Property qualifying for ITC earns a credit equal to 6% of asset cost in the case of three-year property, and a 10% credit for all other qualifying property. In addition, ERTA eliminated a taxpayer's ability to elect a longer depreciable life to earn more ITC (and conversely).[1] Under the new systems (ERTA and TEFRA), ITC is determined solely by the classification life of an asset—regardless of the tax depreciation life chosen.

Faced with an awesome deficit, Congress approved TEFRA and therein reduced the ACRS/ITC benefit package available to asset owners. Owners placing assets into service may continue to earn the same amounts of ITC available under ERTA, or may continue to depreciate 100% of an asset's cost, *but not both.* TEFRA forces asset owners to give up some ITC or some depreciation, whichever is preferred.

The options available under TEFRA are twofold, and vary for assets of different life classifications. Three-year property may continue to earn 6% ITC, but this requires the asset's depreciable basis to be reduced from 100% to 97% (define this as the 6/97 option). Alternatively, three-year property may earn 4% ITC and be 100% depreciated (the 4/100 option). Five-year or greater property may earn 10% ITC by reducing the depreciable basis to 95% (10/95 option), or earn 8% ITC and depreciate 100% (8/100 option).[2]

Clearly, TEFRA offers an inferior mix of ITC/ACRS depreciation to that available under ERTA. However, since TEFRA offers two options, the optimal election must be determined prior to making a legitimate TEFRA/ERTA comparison.

Optimal ITC/ACRS Elections under TEFRA

Three-Year Property

In the case of three-year property, determining the better election—6/97 or 4/100, is a simple matter. The top half of Table 1 indicates the ITC and ACRS tax benefits earned under each option for a $100,000 asset, assuming an owner in 46%, 50% and 54% tax brackets (50% and 54% represent illustrative composite rates for businesses subject to significant state and local taxes). For the 6/97 and 4/100 options, ITC would be $6,000 and $4,000, respectively. The tax cash value of all ACRS deductions under the 6/97 option is determined by multiplying the asset's cost by 97% times the tax rate. For example, a 46% taxpayer's ACRS value is $100,000 × .97 × .46 = $44,620; this is the tax bill reduction which the owner will realize over the depreciable life of the asset. All other ACRS values in Table 1 are computed in the same fashion.

Table 1

TOTAL TAX BENEFITS RELATING TO THREE AND FIVE-YEAR PROPERTY

Property Class	TEFRA Election	Tax Benefit	Tax Bracket 46%	50%	54%
3-year	6/97	ITC	$ 6,000	$ 6,000	$ 6,000
		ACRS	44,620	48,500	52,380
		total	$50,620	$54,500	$58,380
3-year	4/100	ITC	$ 4,000	$ 4,000	$ 4,000
		ACRS	46,000	50,000	54,000
		total	$50,000	$54,000	$58,000
5-year	10/95	ITC	$10,000	$10,000	$10,000
		ACRS	43,700	47,500	51,300
		total	$53,700	$57,500	$61,300
5-year	8/100	ITC	$ 8,000	$ 8,000	$ 8,000
		ACRS	46,000	50,000	54,000
		total	$54,000	$58,000	$62,000

When the total (ITC and ACRS) tax benefits of the two options for three-year property are compared, it is seen that the 6/97 option "wins" in the case of all three tax brackets shown (produces a larger total quantity of cash benefits, regardless of the owner's tax bracket). If an asset owner is a "current taxpayer," meaning tax benefits are used to reduce its tax bill as rapidly as they are earned, the ITC will be used during the first year the asset is in service. This means a current taxpayer will be cash ahead in year one by electing the 6/97 option (more ITC). But since total benefits are also greater under 6/97, the owner will be cash ahead[3] during the entire three-year tax benefit earning period: 6/97 provides more benefits up front and more benefits in total. Not surprisingly, the 6/97 option remains superior even if the owner is not a current taxpayer. Suppose, for example, that the business owner placing an asset into service is carrying tax operating losses forward, and estimates it will not exhaust these losses for three years. In such a case, all benefits under either option would be forecast to be utilized totally in year three. If this is the case, 6/97 still wins, since it will provide more total benefits at the time they can be used. In short, regardless of an asset owner's tax bracket or tax status (current or deferred), the 6/97 election will *always* be the better choice.

Five-Year Property

The optimal election relative to five-year property is not as clear. Inspection of the bottom half of Table 1 reveals

Table 2

TAX BENEFITS FOR FIVE-YEAR PROPERTY BY YEAR

Year	10/95 ELECTION ITC	10/95 ELECTION ACRS	10/95 ELECTION Total	8/100 ELECTION ITC	8/100 ELECTION ACRS	8/100 ELECTION Total	10/95 minus 8/100 Net
tax rate = 46%							
1	$10,000	$ 6,555	$16,555	$8,000	$ 6,900	$14,900	$1,655
2	0	9,614	9,614	0	10,120	10,120	(506)
3	0	9,177	9,177	0	9,660	9,660	(483)
4	0	9,177	9,177	0	9,660	9,660	(483)
5	0	9,177	9,177	0	9,660	9,660	(483)
tax rate = 50%							
1	$10,000	$ 7,125	$17,125	$8,000	$ 7,500	$15,550	$1,625
2	0	10,450	10,450	0	11,000	11,000	(550)
3	0	9,975	9,975	0	10,500	10,500	(525)
4	0	9,975	9,975	0	10,500	10,500	(525)
5	0	9,975	9,975	0	10,500	10,500	(525)
tax rate = 54%							
1	$10,000	$ 7,695	$17,695	$8,000	$ 8,100	$16,100	$1,595
2	0	11,286	11,286	0	11,880	11,880	(594)
3	0	10,773	10,773	0	11,340	11,340	(567)
4	0	10,773	10,773	0	11,340	11,340	(567)
5	0	10,773	10,773	0	11,340	11,340	(567)

that the 8/100 election will produce greater total benefits for each tax bracket shown. However, the 10/95 option will provide more cash early (in year one) due to greater ITC—provided the owner is a current taxpayer. Determination of the better option for five-year property will thus require a more refined analysis.

Conceptually, the better option would simply be that which produces the higher present value of benefits. The problem is that the present values will be influenced by the owner's tax rate, whether it is a current or deferred user of tax benefits, which quarter of the year the asset is placed in service, and the discount rate used. This last factor—the discount rate—should reflect the owner's required rate of return on investment or its opportunity cost of capital (the terms here will be used interchangeably), and may differ from owner to owner. To make the analysis manageable, then, indifference discount rates (IDR) will be developed. IDRs will indicate the required return a business must have which would cause it to be economically indifferent between the two options. A business may then maximize the present value of tax benefits by basing the election on whether its required return is greater or less than the IDR.

The following assumptions will be made in determining optimal elections for five-year property: (1) the asset will cost $100,000; (2) the asset owner makes quarterly tax payments; (3) the asset owner is a current-year tax estimator (makes quarterly tax payments based upon its projected tax bill for the current year; and (4) the asset will remain in service for at least five years.

The data in Table 2 defines the tax benefits derived from the $100,000 property by year, benefit type, tax bracket, and election option. The values in the top third of the table, for example, define the tax benefits for a 46% taxpayer. The year one ACRS value of $6,555 represents the cash value of first-year depreciation computed: $100,000 × .15 × .95 × .46. I.e., the asset's cost is multiplied by the first-year ACRS percentage of 15%, and then multiplied by 95% to reflect the required TEFRA adjustment for the 10/95 election. The product of these first three terms yields a year one depreciation tax deduction of $14,250; the deduction times the taxpayer's rate of 46% yields tax savings of $6,555. Other values in Table 2 are computed in similar fashion. The last column in the table shows the tax cash flow difference between the two options, with 8/100 benefits being deducted from 10/95 benefits.

The information in the last column of Table 2 provides the basis for computing IDRs between the two TEFRA options. Consider first a current 46% taxpayer which places the $100,000 asset in service at the beginning of the first quarter of a tax year (prior to its first quarterly tax filing for that year). In this instance, the net cash flow advantage or disadvantage of 10/95 relative to 8/100 for each quarter over the five-year tax life will be one-fourth of the annual values shown. Thus, 10/95 has a net tax cash flow advantage of $413.75 for quarters one through four ($1,655/4); a disadvantage of $126.50 for quarters five through eight ($506/4); and a disadvantage of $120.75 for quarters nine through twenty. If these tax cash flow differences are now discounted at a rate which causes them to collectively equal zero, their IDR will have been determined which will permit any business to then determine which option would be more profitable. The IDR for this example is 6.9%. This means that under the circumstances described, a taxpayer with a required after-tax return on investment in excess of 6.9% will derive a higher present value of benefits by electing the 10/95 option. Alternatively, if the owner's required return is less than 6.9% (unlikely) it will be more profitable to elect the 8/100 option.

Table 3 gives the IDRs for taxpayers in various tax brackets, for current taxpayers by the quarter in which the asset is placed in service, and for deferred taxpayers which expect to become current taxpayers in one or two years. In all cases, the IDRs shown are nominal annual rates, meaning that the quarterly indifference rate was calculated and then multiplied by four. Effective annual rates may be computed by adding one to the decimal equivalent of the quarterly rate, raising the sum to the fourth power, and subtracting one from the result (the 6.9% nominal rate translates into an effective rate of 7.1%, for example).[4]

IDRs for the case of a current taxpayer placing the asset in service during the second, third, or fourth quarters were computed by dividing first-year cash flow values from Table 2 by three, two and one, respectively; cash flow differences for all subsequent periods were identical to the first quarter in-service case. (The assumption here is that if the asset is placed in service during quarters one, two, three or four, the first-year cash flow difference will be uniformly recognized in four, three, two and one quarterly tax payments respectively). The two sets of deferred taxpayer analyses indicate that tax benefits commence in quarter five or nine. The quarter five commencement means the taxpayer is presently carrying losses forward and does not expect to use tax benefits created by the new investment until next year. IDRs for this case were determined by adding together benefits for years one and two, and recognizing one-fourth of them during each of the four quarters in year two. IDRs for the ninth-quarter deferral were determined by adding cash flows for years one through three together and recognizing one-fourth of them during each of the quarters in year three.

The IDRs in Table 3 indicate that the 8/100 option becomes relatively more attractive (or less unattractive) as a business becomes less able to use tax benefits efficiently; e.g., a 46% taxpayer would generally find the 10/95 option more attractive if benefits are used as earned, but would find the 8/100 option more profitable if it was estimated that new benefits could not be used for two years. It may also be noted from Table 3 that the 8/100 option becomes relatively more attractive as the taxpayer's effective tax bracket increases. Suppose an owner has a required return of 15%. If the business is a 46% taxpayer, it should elect the 10/95 option if benefits are used as earned, or if it expects to be a current taxpayer within the next year. If the business faces a 50% composite rate, it should elect the 10/95 option only if it is a current taxpayer. If the effective tax rate is 54%, then the 8/100 option will be more profitable in all cases.

In sum, a singular rule for making optimum five-year property elections under TEFRA does not exist; the preferable choice will depend upon the taxpayer's required return on investment, the taxpayer's effective tax bracket, when the asset is placed in service during the year, and whether the business is a current or deferred user of newly created tax benefits.

Table 3

INDIFFERENCE DISCOUNT RATES (IDRs) FOR FIVE-YEAR PROPERTY*

Taxpayer Status	Tax Benefits Commence in Quarter	46%	50%	54%
current	1	6.9%	11.3%	15.5%
	2	7.3	11.9	16.5
	3	7.7	12.7	17.5
	4	8.2	13.5	18.8
deferred	5	12.0	20.2	28.8
	9	26.1	47.4	73.9

*Elect 10/95 if after-tax return on investment is above the appropriate IDR; otherwise elect 8/100

TEFRA's Impact upon Rent Requirements

It is difficult to make a categorical statement relative to the impact TEFRA should exhibit upon rents paid by lessees due to the tremendous diversity of leasing transactions; it would be impossible to present one definitive "plain vanilla" financing and make general inferences based upon that one finding. Accordingly, thirty-two simulated lease financings are presented in this section which should permit a feel for the range of impacts to be discerned. Examples will be provided for three and five-year property, two terms for each, first and fourth quarter commencements, 46% and 54% tax rates, residual values from 10% to 30% of equipment cost, and nominal annual pricing yields of 12% and 16%.

In all cases, the following will be assumed: (1) the owner/lessor is a current taxpayer; (2) the owner is a current-year tax estimator making quarterly tax payments; (3) the asset is placed in service either at the beginning of the first or fourth quarter of the year; (4) the residual value is realized at termination and taxes thereon paid immediately; (5) the lessor is either a 46% or 54% composite taxpayer; (6) all rents are received and taxes paid on a quarterly basis; and (7) the lessor prices to earn an internal rate of return of either 3% or 4% per quarter (12% or 16% nominal annual yield, respectively) on total capital invested.

To illustrate exactly how the values in Tables 4 and 5 were developed, consider the first lease shown in Table 4. Suppose the asset underlying this lease is three-year property; has a cost of $100,000; lease term is three years (twelve quarters); the lessor is a 46% taxpayer; the asset is placed in service at the beginning of the first quarter of the year; a residual value of $30,000 (30% of equipment cost) is expected to be realized at the end of quarter twelve; rents and

Table 4

TEFRA RENT INCREASES REQUIRED FOR THREE-YEAR PROPERTY

Yield	Tax Rate	Lease Term	In Service	Residual	TEFRA % Rent Increase under: 6/97	4/100
12%	46%	3	Q1	30%	2.5%	4.1%
			Q4		2.9	4.6
12	54	3	Q1	30	3.3	4.6
			Q4		3.9	5.3
16	46	3	Q1	30	2.2	3.7
			Q4		2.6	4.3
16	54	3	Q1	30	2.8	4.1
			Q4		3.2	4.6
12	46	5	Q1	20	2.2	3.7
			Q4		2.6	4.1
12	54	5	Q1	20	2.9	4.1
			Q4		3.4	4.7
16	46	5	Q1	20	1.9	3.3
			Q4		2.3	3.8
16	54	5	Q1	20	2.5	3.7
			Q4		2.9	4.2
Average increase of optimum method					**2.8%**	
Average increase of inferior method						**4.2%**

taxes will be paid quarterly; and the lessor prices the lease to earn a quarterly return of 3% (12% nominal annual yield) on total capital invested.

Under ERTA, the quarterly rent which must be charged in this example would be determined as follows: (1) Compute the present value of depreciation tax savings. Depreciation would be 25%, 38% and 37% of equipment cost in years one through three respectively, and thus $6,250, $9,500, and $9,250 on a quarterly basis during years one through three. Tax savings would be 46% of these amounts; thus, the cash value of depreciation deductions would be $2,875 in quarters one through four, $4,370 in quarters five through eight and $4,255 in quarters nine through 12. The present value of all depreciation tax savings, discounting at the quarterly rate of 3% would be $37,604.49. (2) Compute the present value of ITC. ITC will be used to reduce the lessor's tax bill during the first year. Since the asset is in service during the first part of quarter one, savings of $1,500 will be realized in quarters one through four (for a total of $6,000, or the allowable 6% of equipment cost). The present value of ITC, discounted at 3% per quarter is $5,575.65. (3) Compute the present value of the residual. It is assumed that a residual of $30,000 will be realized at the end of quarter 12; since the asset will be fully depreciated, the after-tax value of the residual at that time will be $16,200 ($30,000 × (1−.46)). The present value of the residual will be $11,362.35. (4) Determine the amount to be recovered through lease payments. The lessor invests $100,000 at the outset, but derives the benefits of ownership specified in parts (1)-(3) above. Thus, the present value of the rent stream must enable the lessor to recover his investment of $100,000 less the present value of benefits computed above. The present value of depreciation tax savings, ITC and residual represent total benefits of $54,542.49; accordingly, the rent stream required will have an after-tax present value of $45,457.51 ($100,000− $54,542.49). (5) Determine the quarterly rent required. Rent will be received at the end of quarters one through 12, and will be reduced by tax payments thereon. The cash value of each rent payment is thus RENT × .54. Since rent payments will be level over the term, an annuity factor may be applied; the after-tax present value of the rent stream will be RENT × .54 × 9.954. Setting the value of rents equal the net costs to be recovered permits the quarterly rent to be computed: RENT = $45,457.51/.54 × 9.954; RENT = $8,456.96 per quarter.

Since the 6/97 election has been shown to be preferable for three-year property, the rent requirement with an optimal TEFRA election may now be determined. Under 6/97, ITC will be the same as under ERTA; however, the value of depreciation is reduced by 3%. The present value of depreciation tax savings determined under ERTA above was $37,604.49. Thus 3% of this total depreciation benefit is $1,128.13 and becomes an additional cost to recover, since it is lost under TEFRA. Adding this incremental cost to the net cost to recover value of $45,457.51 computed in (4) above yields a net cost to be recovered under TEFRA of $46,585.64. Rent under TEFRA for the same financing may now be determined: RENT = $46,585.64/.54 × 9.954; RENT = $8,666.84 per quarter, or 2.5% more than required under ERTA to achieve the same yield. All other values in Tables 4 and 5 are determined in the same manner.

Table 4 presents the rent increases required under each TEFRA election for 16 simulated lease financings for three-year property. Yield in Table 4 means nominal annual yield; all simulated financings were solved using either 3% or 4% quarterly values, which translate into 12% or 16% nominal annual yields. The tax rate column refers to the tax bracket of the lessor, and the lease term defines the number of years the lease will run (although all values are determined on a quarterly basis). The in-service column indicates whether the asset was placed in service at the beginning of the first (Q1) or fourth quarter (Q4). The residual column indicates the expected liquidation value of the asset at the end of the lease term, expressed as a percentage of the equipment's cost. The last two columns indicate the percentage rent increase necessary under each of the two TEFRA options for the lessor to maintain yield, and thus reflect the magnitude of TEFRA's adverse impact upon lessee rents. Table 5 presents the same type of information for 16 simulated lease financings involving five-year property.

The data in Tables 4 and 5 indicate that lessors making optimum ITC/ACRS elections under TEFRA will be required to raise their rents by an average of 2.8% and 3.6% for three and five-year property, respectively.

Table 5

TEFRA RENT INCREASES REQUIRED FOR FIVE-YEAR PROPERTY

Yield	Tax Rate	Lease Term	In Service	Residual	TEFRA % Rent Increase under: 10/95	8/100
12%	46%	5	Q1 Q4	20%	3.3% 3.8	3.6% 4.1
12	54	5	Q1 Q4	20	4.3 5.1	4.0 4.6
16	46	5	Q1 Q4	20	2.8 3.3	3.3 3.7
16	54	5	Q1 Q4	20	3.6 4.3	3.6 4.2
12	46	8	Q1 Q4	10	3.1 3.5	3.4 3.8
12	54	8	Q1 Q4	10	4.0 4.7	3.8 4.0
16	46	8	Q1 Q4	10	2.6 3.1	3.1 3.5
16	54	8	Q1 Q4	10	3.4 4.1	3.4 3.9

Average increase of optimum method 3.6%
Average increase of inferior method 3.9%

Summary and Conclusions

The purpose of this article has been to develop estimates of the adverse impact TEFRA should be expected to have on lessee rents. Care was exercised to make the analysis as realistic as possible, recognizing that it is extremely difficult to characterize a "typical" lease. In order to make the analysis as precise as possible, rules for making optimum elections under TEFRA were developed prior to making a comparison between ERTA and TEFRA.

It was shown that virtually any business will always be better served by electing the 6/97 option for three-year property. For five-year property, the important parameters were identified which should enable lessors to make optimum elections there as well.

Table 3 displays indifference discount rates for five-year property applicable to lessors which are current or deferred taxpayers, and are in the 46%, 50% or 54% composite tax bracket. To use the table, a lessor may identify his tax status and tax rate, and would more profitably elect the 10/95 option if his after-tax return on investment is greater than the IDR shown. If the lessor's return on capital is less than the applicable IDR, it will be more profitable to elect the 8/100 option.

The last section attempted to estimate the magnitude of TEFRA's injury to the leasing community. A review of the 32 simulated leasing transactions shown in Tables 4 and 5 suggests that TEFRA will cause lessees to suffer rent increases on equipment placed in service ranging from about 2.8% on three-year property to 3.6% on five-year property.

FOOTNOTES

1. For an analysis of how optimum tax life elections were made pre-ERTA, see references 2 and 3.

2. Technically, TEFRA states that election to retain maximum ITC requires the asset's depreciable basis to be reduced by 50 percent of the credit taken. Alternatively, an election to retain maximum (100 percent) depreciable basis allows ITC of 4% on three-year property and 8% on other qualifying property (expressed as a percent of asset cost) to be earned.

3. Cash ahead in the sense that the *cumulative* cash flow advantage of 6/97 over 4/100 persists for all periods.

4. Nominal rates do not reflect the reinvestment of funds within a given year. Effective rates, on the other hand, reflect an ability to reinvest cash as it is received.

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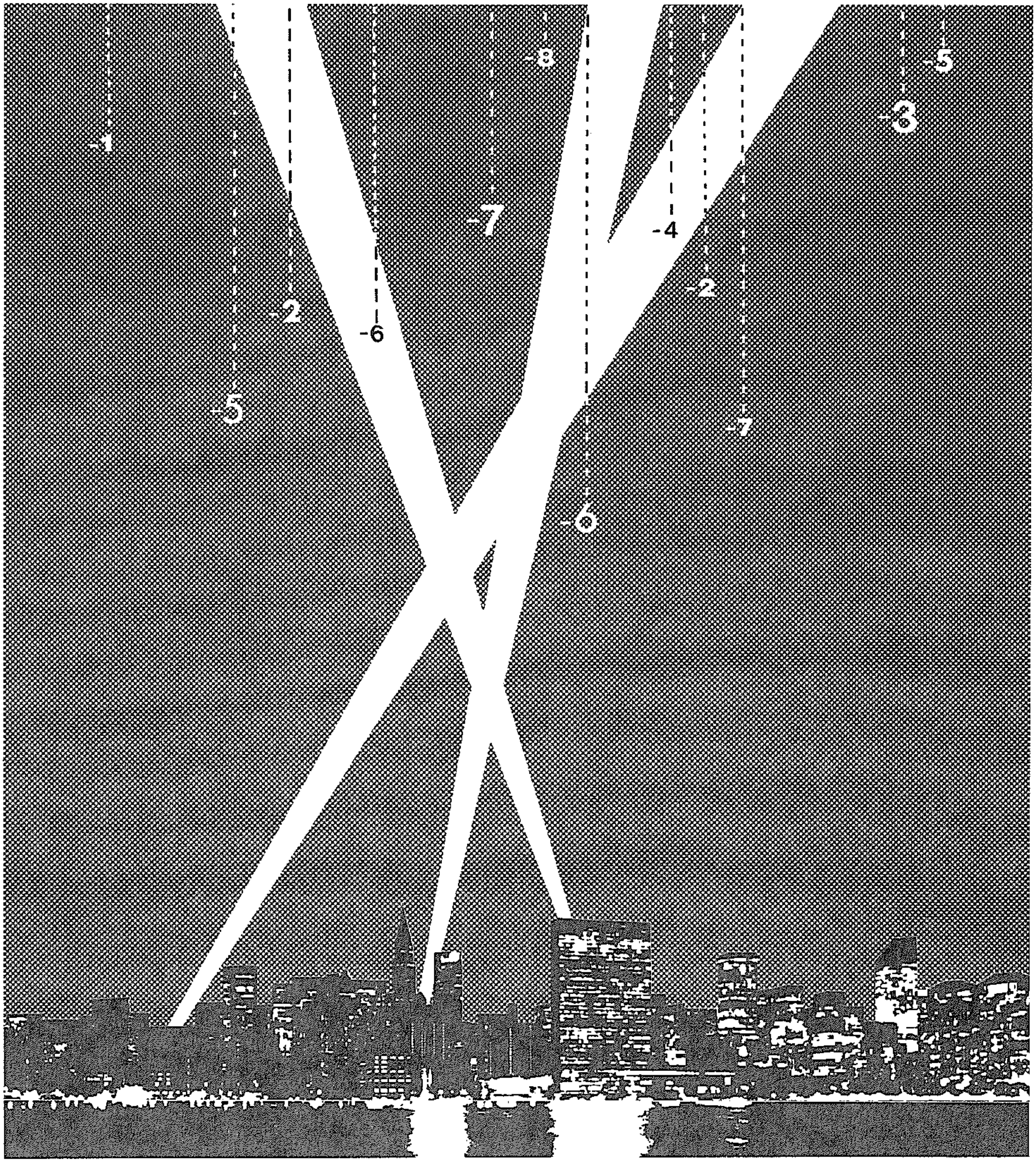
IN SEARCH OF TAX LIABILITY

by Vincent Cannaliato, Jr.



A major challenge confronting the leasing industry today, aside from the ever present possibility of changes in governing law, is the diminishing tax base of lessors. The passage of the Economic Recovery Tax Act of 1981 (ERTA) and the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) have caused significant, if in some cases temporary, changes in the leasing business. However, a constant problem has been the overall insufficiency of corporate tax liability to absorb the tax benefits potentially available. The lack of usable tax base simply forces some lessors out of the business.

Adverse economic conditions have affected every segment of the economy, but the traditional lessor groups seem to have been more profoundly impacted. The original lessor group was comprised largely of banks or bank subsidiaries. Over the last few years bank revenues have shrunk overall thus providing little current tax appetite. Additionally, in earlier and better times, a number of banks made commitments for future funding which further diminish available tax base. Moreover, recent foreign loan losses and potential losses shelter large portions of income which would otherwise be available.

In recent years, industrial credit and finance companies have become a major force in leasing. They, like many others, have had earnings reduced because of the adverse economy. In many cases, poor earnings have changed the corporate mentality from one of sheltering income to one of improving operations and operating efficiency. The high costs of doing business, particularly interest rates, have absorbed a larger part of cash flow from operations, and simultaneously, generated tax deductions which have further reduced taxable income.

It is difficult to postulate the entire extent to which the reduction in tax base will affect lease financing. However, certain results are likely. Overall, fewer transactions will occur, despite a constant lessee demand for lease financing. Not only will fewer tax dollars lead to a significant curtailing of leasing business, but also as more institutions realize that tax base must be treated as a limited resource, tax liability will be more and more carefully allocated.

As lessors become progressively more selective, the more complicated, riskier transactions will become more difficult to accomplish and, probably more expensive to the lessee. Notwithstanding the higher profits possible in the more esoteric financings, few leasing companies are likely to take substantial risks with a scarce commodity. Additionally, rules of supply and demand indicate that leases completed in the future will be at higher effective rates than currently charged. While this will somewhat improve the tax base problem, high rents and a preference for more straightforward and less aggressive deals will make leasing a somewhat-less-attractive financing alternative for companies placing new equipment into service.

Most organizations in the leasing industry are well aware of the need for greater profits or greater tax liability (or both) and a number of proposed solutions have been put forth. Some leasing organizations, particularly lease brokers, have been investigating the profits available from offering lease consulting and analysis services as well as software packages. Traditional lease buyers are now considering brokering deals. Obviously, raising lease yields will also increase profits and, subsequently, expand tax base (create more taxable income). However, raising yields is a two-edged sword; as the profits of lessors improve, the economic benefits of leasing to lessees diminish. Hence, raising rents may, in the long run, create more problems than it solves.

These actions collectively will not solve the problem of lack of tax base. If everyone is consulting or selling software, who is buying the transactions? What is the good of higher profits if there are too few deals? It seems clear that short-term schemes for generating revenue will not solve the problem of diminished tax liability.

Some leasing operations have dealt with their own lack of tax base by entering into arrangements with more profitable organizations. By contracting exclusively with a particular industrial concern to provide accounting, legal and analytical services, a leasing company can continue to process transactions using this new tax base. Similarly, one can expect to see a number of independent leasing operations with little or no tax base merge into or be acquired by either industrial corporations or financial institutions and, as a subsidiary, act as an arranger of lease transactions for the new tax base.

While these actions solve the tax base problem for individual leasing operations, joining forces with a captive tax base is of limited applicability. What is needed, instead, are structural innovations in leases and off-balance sheet financing. Such more fundamental changes in the structuring and approach to lease transactions will go farther in correcting the economic problems of the leasing industry. Some of these structures have already been implemented in a number of unusual transactions and more innovations are sure to be introduced which will remedy the lack of tax liability.

An obvious solution to reduced tax appetite is to make any particular transaction less tax intensive. TEFRA, by requiring a basis reduction equal to 50% of investment tax credit claimed, automatically lessens the tax impact of a lease transaction. Of course, transactions have been structured where either investment or energy tax credit is passed through to the lessee and, thereby, less of the lessor's tax base is required to accomplish the transaction. By having the lessee and lessor enter into a special type of joint venture and subsequently lease

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the equipment in question, it is possible to achieve attractive economics to both parties, use less tax base and still keep the transaction off balance sheet.

A natural outgrowth of the billions of dollars of tax benefit transfers (TBTs) accomplished in 1982, is the introduction of TBT purchasers to the traditional leasing market. However, the main attractions of purchasing TBTs (simple documentation, high yield, quick payback, little credit or tax risk and the view of TBTs as a source rather than use of funds) are not as evident in traditional leasing. In order to circumvent this problem, there has developed a new structure for leasing which more closely resembles the economics of TBTs while staying with the Internal Revenue Service leasing mandates. This type of creative structure could become very important in bringing new sources of tax base into the leasing equity marketplace.

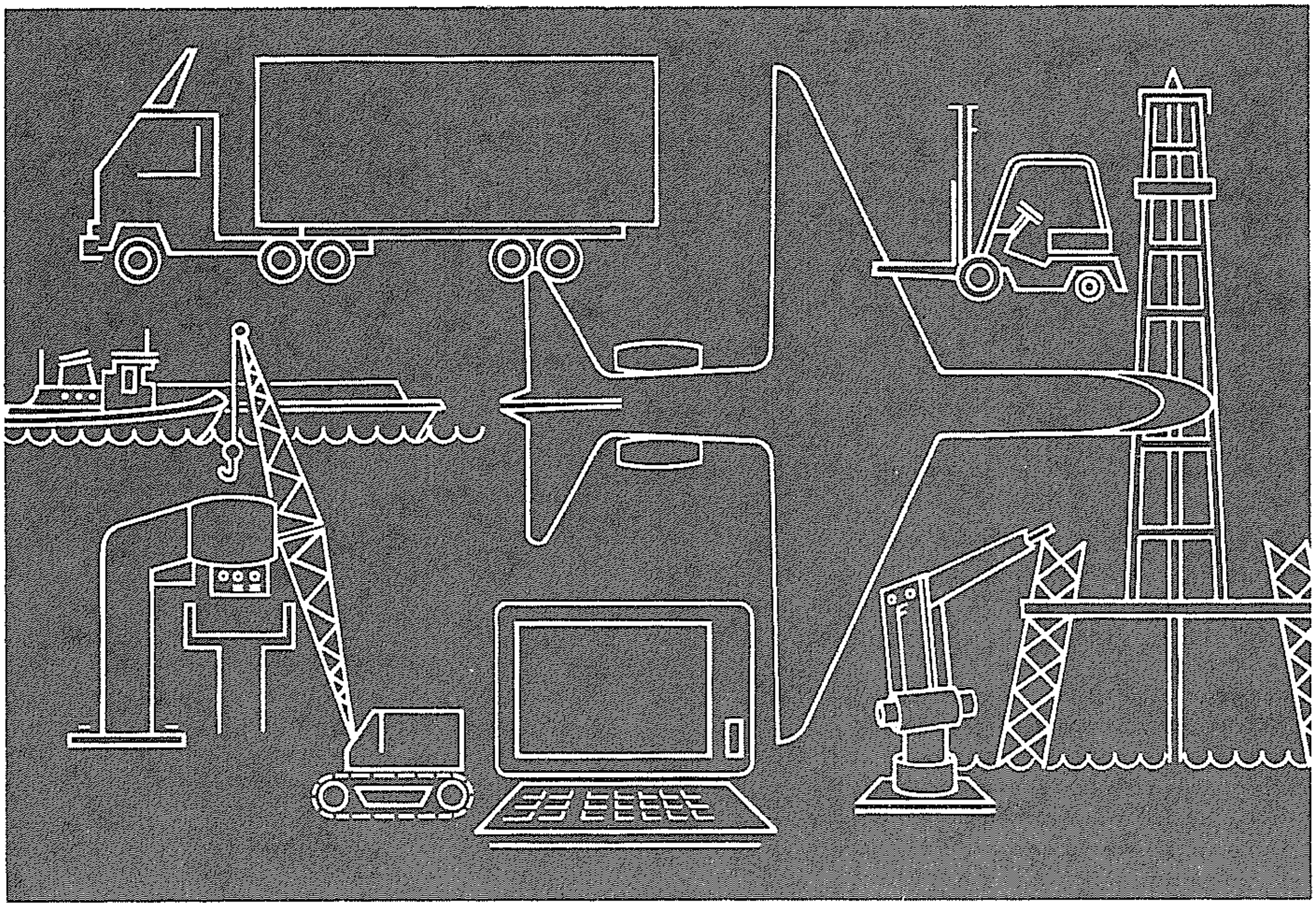
Similarly, general industrial clients provide excellent potential equity sources. Developing innovative financing techniques such as vendor financing through a variety of partnership structures requires excellent client relationships and the willingness to devote substantial amounts of time but can yield a multitude of equity investors.

Because of the increasing competition for equity dollars, it is becoming more difficult to arrange a financing through a single equity source. Thus, new forms of equity partnership structures allowing for the combining of a number of tax bases while avoiding the problem of lessened tax deductions due to the short partnership tax year will become more common. While this will make for more efficient use of corporate tax base, additional equity is still needed.

One obvious source for more equity is individual investor equipment leases. However, it must be kept in mind that the new variety of lease transactions for individuals must be better than the old variety. These new transactions must be for better assets used by stronger companies and the leases must present more attractive economics and be less dependent on residual asset values. Individual purchasers appear more sophisticated than initially anticipated, and therefore are willing to take the time to understand and analyze leases as an alternative investment vehicle. Of course, any such transaction requires especially careful structuring and the ability to broadly market the equity interest.

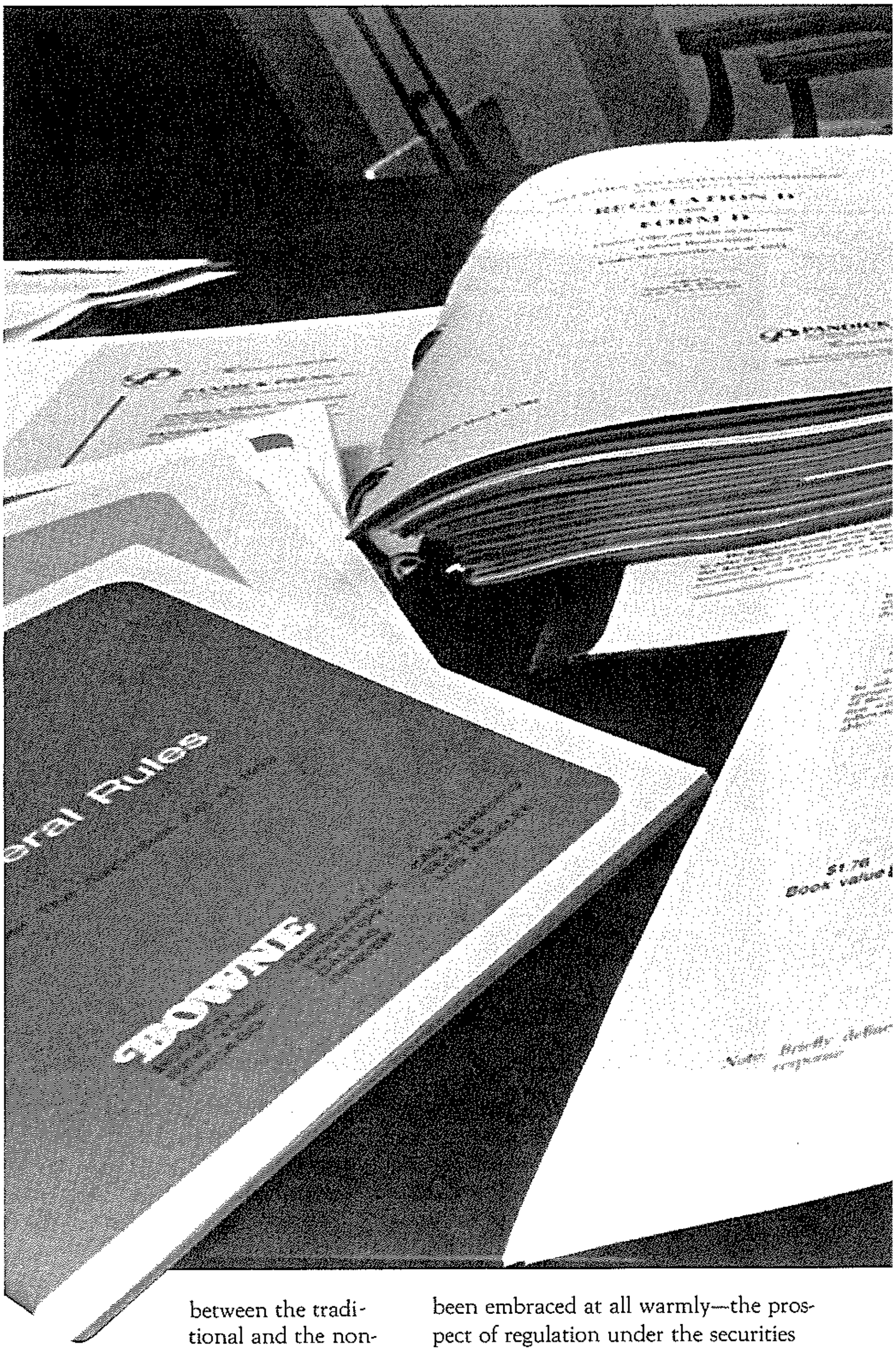
Another alternative which may be available is not doing a lease at all, but rather arranging a specially structured loan package with commercial lenders. Some lenders have shown a willingness to provide more risk-oriented loans. This ability, along with advanced equipment knowledge and credit analysis ability, gives such lenders a special edge in closing such transactions. As an additional facet of such a loan structure, the lender can take some degree of residual risk in exchange for getting a share in the cash flow from the project.

New tax legislation and the poor economy have created some adversity in the leasing industry. However, it seems clear that companies which are capable of innovative structuring, broad marketing and with strong client relationships will continue to be successful in arranging leases.



Leasing Brokers & the Securities Laws

by Michael Downey Rice, Esq.



While the courts have made no determinations in this area, certain interests in equipment lease transactions may be construed as securities under federal securities laws, thereby subjecting these interests and the lease brokers who handle them to federal regulations. This article reviews the determining factors inherent in classifying a lease as a security offering, and concludes that registration of lease brokers as broker/dealers under the Securities Exchange Act of 1934 is preferable to possible exposure to noncompliance.

For many years, equipment lessors and leasing brokers have positioned themselves as an alternative to traditional financing and investment sources. Leasing offers to users of capital a low-cost financing medium in certain circumstances, supplementing the usual sources of debt and equity capital. For investors, leasing provides yields not otherwise available in the investment marketplace.

Although the financial services offered by the leasing industry are different from those offered by traditional financial institutions, they do the same type of job, and they do it for many of the same customers. The similarities between the traditional and the non-traditional financial service houses are more important than the differences. Many leasing brokers and equipment lessors now characterize themselves as financial service companies in their corporate name and in their business approach. For leasing is not an end in itself, only a means to achieve financial goals.

While leasing brokers see themselves as having much in common with traditional financial institutions, one aspect of the financial services business has not been embraced at all warmly—the prospect of regulation under the securities laws. Leasing brokers have steadfastly denied that their activities should be regulated by this complex scheme of federal and state regulation, arguing that interests in lease transactions are not "securities." Otherwise, leasing brokers would be dealing in securities and would be required to register under section 15 of the Securities Exchange Act of 1934, submitting to SEC jurisdiction and baring their corporate soul in public filings.

Is this position correct? Suppose it is not? Many leasing companies have con-

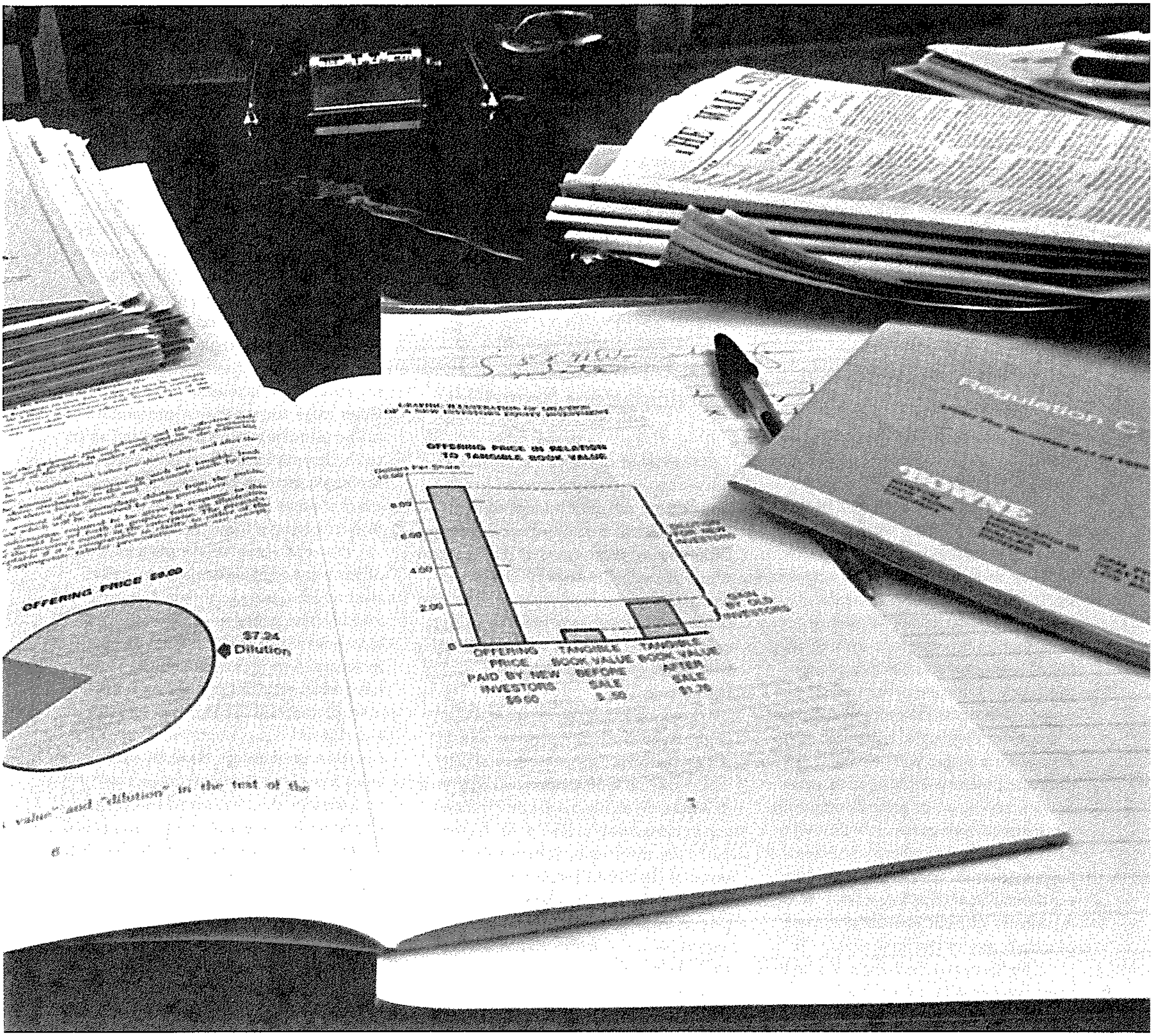


photo by Art Stein

cluded that there is enough merit in the proposition that interests in lease transactions are securities that the prudent course of action is registration under the broker-dealer registration provisions of the Securities Exchange Act of 1934, with concurrent compliance with state laws regarding dealers in securities.

What is there in a lease transaction that could be regarded as a security? Reviewing the structure of these transactions, we have a lessee who uses the equipment and undertakes to pay regular rents. The owner or owning group purchases the equipment as an investment and receives the rents as a return on the investment. The lessee is responsible for maintenance, taxes, and insurance, so the rent stream is "net" to the owners. Often the owner or owning group leverages the investment by borrowing a portion of the purchase price of the equipment and issuing notes or other obligations to a financial institution or institutions. The interests that may be regarded as securities are (a) the investment by the owner or owning group in the equipment and the interest in the lease rentals, and (b) the loan by the lender or lending group. The owner-

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ship interest is usually evidenced, not by a single instrument, but by a sheaf of papers including the lease instrument and ownership documents for the equipment, although in transactions involving a number of owners certificates evidencing the investment may be issued. The debt investment, the loan, is almost always evidenced by a note or notes.

What Is a Security?

The issue of applicability of the securities laws to these interests turns on the definition of "security." The primary definition is found in section 2 of the Securities Act of 1933: "unless the context otherwise requires—(1) The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."[1]

The Securities Exchange Act of 1934 uses a similar definition,[2] which is usually regarded as essentially the same as the '33 Act definition.[3]

It appears from the definition that the draftsmen of the '33 Act could not distill enough of the essence of the term "security" to develop an analytic definition,[4] but nevertheless wished to include within the scope of the term everything conceivable. Undue breadth was not regarded as creating a problem of regulation of activities that did not need regulation, because specific transactions and types of securities were exempted from the registration provisions of the '33 Act in subsequent sections (sections 3 and 4).

Turning to the applicability of this definition to lease transactions, it would be difficult to conclude that debt participations, evidenced by notes, are not securities.[5] Faced with this conclusion, leasing brokers often turn to investment banking houses to place the debt in leveraged lease transactions, and some have formed subsidiaries, registered under the '34 Act, to conduct this function.

Are Equity Participations Securities?

And what of the equity participations, the ownership interests? Lease transactions are the children of the investment tax credit and accelerated depreciation, creatures that did not exist when the men of the New Deal were writing securities laws. Nevertheless, the definition of security is broadly written, and there are plenty of words in that law that could be applied to lease transactions.

Looking through the examples of securities in the definition, we come across the term "investment contract." The Supreme Court explained that term in a case involving a scheme for investing in citrus groves, *SEC v. W.J. Howey, Inc.*[6] "An investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by a nominal interest in the physical assets employed by the enterprise."[7] The Court went on to suggest that a "flexible rather than a static principle" be used, and distilled the principle somewhat: "The test is whether the scheme involves an investment of money in a common enterprise with the profits to come solely from the efforts of others."[8]

The definition in the *Howey* case has received some judicial gloss in other decisions over the years. Often these cases involved some kind of swindle, and the aggrieved parties sought to use the securities laws to obtain the relief of rescission of the transaction, or damages for fraud; more often than not, courts accepted this approach. Parsing the *Howey* definition of an investment contract, courts have held that the requirement of profits "solely from the efforts of others" was not a limitation on the term;[9] although the term "common enterprise" suggests a collaboration of a group of investors at the same level,[10] the necessary commonality could also be derived from the simple relationship of the investor with the enterprise in which the investment is made.[11] The high-water mark for expansive interpretations of the term "investment contract," as far as the leasing business is concerned, was the application of the term to the interest of a single lessor in a lease transaction involving a franchise restaurant.[12]

However, courts have stopped short of permitting the securities laws to be used as a broad federal remedy for all fraud.[13] The remedies of the securities laws have been withheld from plaintiffs in several recent cases where the courts have felt that other remedies were available, or that the draftsmen of the Securities Act did not contemplate the situation in question. Some of these cases have held that instruments or transactions that seemed to be on the statutory list were not, in fact, securities of the type contemplated by the '33 Act.

Courts have used two excuses for taking a narrow view of the definition. The "context" theory is based on the introductory phase for all of the '33 Act definitions: "unless the context otherwise requires. . . ,"[14] and holds that the definition of "security" depends on the nature of the transaction in which the interest is transferred.[15] The "commercial/investment" test concludes from the legislative history of the securities laws that the primary aim of these laws is the protection of investors, and that transactions that are primarily of a commercial rather than investment nature were not intended to be covered.[16]

Using these tests and other rationale, courts have excluded from the coverage of the term "securities" various instruments seeming to be covered by the language of the definition in the '33 Act: notes and term loans in commercial transactions,[17] shares of stock in closely-held corporations,[18] and certificates of deposit.[19] With less analytic difficulty, the Supreme Court has withheld the remedies of the securities laws from application to shares in a cooperative apartment project[20] and interests in a pension plan.[21] Very recently, the Supreme Court has confirmed that the scope of the term has practical limits, and should not be applied to certain unique transactions negotiated "one-on-one" by the parties.[22]

Although the case law on this definition is extensive, and the literature on the point exhaustive, we cannot reach a firm conclusion as to whether an equity interest in a lease transaction is a "security" for the purpose of the securities laws, or what is more important, whether a court is likely to regard it so—for what the courts will do in the quest for justice does not always comport with the results of analytical investigation by scholars.[23] We can draw some conclusions about the outer boundaries of the question, however. If a broker brings a lessee together with a financial institution of some sophistication, and the parties work out, face-to-face and "one-on-one," a complex, specialized commercial transaction, we can be reasonably sure that the transaction is not a "security" for the purpose of the federal securities laws, and that the parties to this transaction will not allege that it is. This conclusion can be reached in the case of the equity interest in a lease, or the debt interest in a loan.

At the other extreme is an interest in a lease transaction, documented and packaged by a broker, and sold to a number of parties who take the deal as a passive investment. The promotional aspects[24] and the passive nature of the investment[25] suggest that this is the type of transaction that the securities laws were intended to reach, and reach it they will.

In between, we cannot be sure. While many transactions should not be construed as securities, we must consider carefully the effect on the business of a leasing broker if other transactions are, for some certainly have enough of the indicia of "investment contracts" to suggest that an affirmative conclusion on the point is a strong possibility.

What if Interests in Lease Transactions Are Securities?

Let us consider certain implications of the conclusion that the financial instruments in which a leasing broker deals are securities. The Securities Act of 1933 requires registration of an issue of securities, including the preparation of a prospectus, but a number of exemptions are available. Section 3 of the '33 Act exempts from registration a variety of instruments,[26] but the only exemption on this list that might be of interest to leasing brokers is that for railroad equipment obligations. The most important exemption to registration is that under section 4, covering transactions "not involving a public offering,"[27] the so-called private placement exemption. Most of the transactions in which leasing brokers participate would come under this exemption, because of the nature of the parties and the usual lack of need of the potential investors of lease transactions for the protection afforded by registration.[28] With a little care in selecting potential investors of sufficient financial strength and sophistication, a leasing broker should be able to rely on the private placement exemption, either by complying with the rules set forth for the "safe harbor" of Regulation D,[29] or by respecting the traditions of this exemption developed over the years.[30]

Utilization of the private placement exemption or another exemption from the registration provisions of the '33 Act provides relief from the need to prepare a prospectus and go through the registration process, but these exemptions do not extend to certain other provisions of the '33 Act—the section 12 rescission remedies and the section 17 prohibition against fraud; these sections cover securities whether required to be registered or not. The section 12 rescission remedies are particularly frightening to brokers—that section provides that any person offering or selling a security in violation of the registration provisions, or by means of a communication that is untrue or misleading, shall be liable for the amount paid for the security with interest thereon. The bite of these provisions can be avoided very simply, however—make no misrepresentations and commit no fraud.

Broker-Dealer Registration Requirements

Turning to the '34 Act, however, we encounter a situation that can expose a broker to liability even in the absence of fraud or misrepresentation—a technical violation of the broker-dealer registration provisions may provide remedies for an investor against the broker if a deal goes sour. If an interest in a lease transaction is construed as a "security," then the broker arranging the transaction will be regarded as a "broker" for the purposes of the '34 Act.[31] And section 15 of that act says that "it shall be unlawful for any broker . . . to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security . . . unless such broker . . . is registered in accordance with subsection (b) of this section."[32]

The danger in the violation of this section is not so much that the sleuths of the SEC will seek you out and subject you to administrative sanctions,[33] but that a private litigant will allege a violation of the registration provisions and attempt to unwind a transaction and recover the investment from the broker. Section 15 does not provide for specific private remedies for failure to register as a broker, but private remedies are generally available for violation of the securities laws,[34] and section 29(b) of the '34 Act provides that "Every contract made in violation of any provision of this title . . . shall be void . . . ."[35] Courts have held that violation of the registration provisions of the securities laws by a broker can give to an investor the remedy of recovery of its investment from the broker—not just the broker's fee, but the investment.[36]

In a world where lessees are not immune to business difficulties, the prospect of recovery of a transaction investment from a broker suggests that a defensive strategy be established.

The business of some brokers may permit the good faith conclusion that transactions in "securities" are not being effected. In the limited business of bringing together parties for "one-on-one" negotiations leading to "commercial," rather than investment transactions, it may be sufficient for the broker to fasten disclaimers to its documents and correspondence, and put the parties on notice that it is not a registered broker and does not regard the transactions as coming under the purview of the securities laws. Many leasing brokers, however, have taken a more cautious (and probably more realistic) view of the business that they are in and taken the steps necessary to comply with the broker registration requirements of the '34 Act.

Registration

The conclusion of these brokers has been that the difficulty and expense of compliance is not terribly onerous, and that it is well worth the trouble to limit the exposure to private remedies for noncompliance. The principal initial steps involved are the registration application to the SEC and qualification of certain officers and employees by testing. The most expeditious way to handle the testing is membership in a self-regulatory organization, such as the National Association of Securities Dealers. Qualification under state blue-sky laws can be handled simultaneously, with little additional difficulty. The job should not be beyond the capacity of house counsel, if some extra time is available.

After the initial registration, regular compliance with SEC rules[37] requires some care, but except for the reporting requirements, little more than prudent business practice is required. The net capital rules, recently softened,[38] do not require significant capitalization when customer securities are not in the custody of the firm, and the "suitability" rule (relating to suitability of investment recommendations for a customer) and other rules for the conduct of business would cause greater headaches in a retail securities business than in a leasing brokerage.

Nevertheless, compliance with the requirements for brokers involves some diligence, and many firms feel that it is easier to police such compliance if the firm's activities are compartmentalized, with a subsidiary or division registering as a broker and conducting those activities that run the risk of being treated as effecting transactions in securities. It is not necessary to form a separate corporation; a "separately identifiable department or division" may register.[39]

Bank-affiliated leasing companies that choose to register as brokers may seem to be acting inconsistently with the Glass-Steagall Act. That act, which decreed the divorce of commercial banking from investment banking, prohibits parties that are "engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities . . ." from engaging at the same time in the business of receiving checking or passbook deposits.[40] Fortunately, the definition of securities in the Glass-Steagall Act receives a less broad construction than that under the '33 and '34 Acts, and interests in lease transactions are not likely to be regarded as securities under Glass-Steagall. Bank-affiliated leasing companies have registered as brokers under the '34 Act, without undue concern that the Comptroller of the Currency will regard this, alone, as stepping out of bounds. The risk in not registering is considered greater.

Thus the problem has a solution, even if it does not have an answer. It is not necessary to find the answer to the question of whether lease participations, in whatever circumstances, are securities. The risk to leasing brokers of an adverse answer to that question can be substantially mitigated, with only slight administrative burden, by registering as a broker under federal and state securities laws.

Footnotes

1. Pub. L. No. 22, ch. 38, 48 Stat. 74 (1933), section 2(1); 15 U.S.C. 77b(1).

2. Pub. L. No. 291, ch. 404, 48 Stat. 881 (1934), section 3(a)(10); 15 U.S.C. 78c(a)(10).

3. Marine Bank v. Weaver, __ U.S. __ n. 3 (1982), 50 U.S.L.W. 4285; United Housing Foundation, Inc., v. Forman, 421 U.S. 837, 847 n. 12 (1975).

4. The legal literature is full of efforts to develop an analytic definition, or at least an analytic method of determining what is and is not a security, but courts continue to construe the term on an ad hoc basis. *E.g.* Marine Bank v. Weaver, *supra* note 3. For a recent survey, see Dillport, Restoring Balance to the Definition of Security, 10 Sec. Reg. L.J. 99 (1982); *see* FitzGibbon, What is a Security—A Redefinition Based on Eligibility to Participate in Financial Markets, 64 Minn. L. Rev. 893 (1980); Lowenfels, Recent Supreme Court Decisions under the Federal Securities Laws: The Pendulum Swings, 65 Georgetown L.J. 891 (1977); Coffey, The Economic Realities of a "Security": Is There a More Meaningful Formula? 18 Case W. Res. L. Rev. 367 (1967).

5. But some courts have: *e.g.* Great Western Bank & Trust v. Kotz, 532 F. 2d 1252 (9th Cir. 1976). See Sonnenschein, Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions, 35 Bus. Law. 1567 (1980).

6. 328 U.S. 293 (1946).

7. Id. at 298.

8. Id. at 299, 301.

9. SEC v. Glenn W. Turner Enterprises, 474 F. 2d 476 (9th Cir. 1973), *cert. denied*, 414 U.S. 821.

10. Milnarik v. M-S Commodities, Inc., 457 F. 2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972).

11. SEC v. Glenn W. Turner Enterprises, *supra* note 9. *See* Savino v. E.F. Hutton & Co., 507 F. Supp. 1225 (S.D. N.Y. 1981).

12. Huberman v. Denny's Restaurants, Inc., 337 F. Supp. 1249 (N.D. Cal. 1972). *See* Note, The Expanding Definition of "Security": Sale Leasebacks and other Commercial Leasing Arrangements, 1972 Duke L. J. 1221.

13. Great Western Bank & Trust v. Kotz, *supra* note 5.

14. 15 U.S.C. 77b.

15. Lino v. City Investing Co., 487 F. 2d 689 (3d Cir. 1973).

16. *See generally* Dillport, *supra* note 4, at 109.

17. *See* Lizzul, The Evolution of Bank Term Lending and the Status of Term Notes Under the Federal Securities Laws, 31 Syracuse L. Rev. 959 (1980).

18. *See* Dillport, *supra* note 4, at 113, note 48.

19. Marine Bank v. Weaver, *supra* note 3.

20. United Housing Foundation, Inc. v. Forman, *supra* note 3.

21. International Brotherhood of Teamsters v. Daniel, 439 U.S. 551 (1979).

22. Marine Bank v. Weaver, *supra* note 3.

23. For a thorough analysis in the context of lease transactions, see Bedford, Equity Interests in Leveraged Leasing: Are They Securities under the Federal Securities Laws, paper delivered at the Law Forum of the American Association of Equipment Lessors, Itasca, Illinois, May 20, 1982.

24. *See* Rapp, The Role of Promotional Characteristics in Determining the Existence of a Security, 9 Sec. Reg. L. J. 26 (1981).

25. One analyst points out that an element of participation by the investor in management of the enterprise or transaction reduces the likelihood that a lease transaction would be regarded as a security. Manwell, Federal Securities Aspects of Leasing, in T. Ford & S. Odell, Creative Leveraged and Operating Leases 161 (1979).

26. Securities issued or guaranteed by government agencies, securities of banks, interests in common trust funds, industrial development bonds, interests in qualified pension and profit-sharing plans, notes maturing in nine months or less (the "commercial paper" exemption), securities of non-profit organizations, securities of savings and loan associations and certain farmers' cooperatives, securities or regulated motor carriers, railroad equipment obligations, certificates issued by a trustee or debtor in possession in a case under the Bankruptcy Code, insurance policies, securities issued in intra-state transactions, and such other securities as the SEC may decide to exempt (as under Regulation A). 15 U.S.C. 77c(a).

27. 15 U.S.C. 77d.

28. SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

29. 17 C.F.R. 230.501—6; SEC Release No. 33-6339 (1980); SEC Release No. 33-6389 (1982).

30. *See* Kinderman, The Private Offering Exemption: An Examination of Its Availability under and outside Rule 146, 30 Bus. Law. 921 (1975).

31. "The term 'broker' means any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank." Securities Exchange Act of 1934, section 3(a)(4), 15 U.S.C. 78c(a)(4). *See* Murdock, Tax Sheltered Securities: Is there a Broker-Dealer in the Woodwork? 25 Hastings L. J. 518 (1974).

32. Securities Exchange Act of 1934, section 15(a)(1), 15 U.S.C. 78o(a)(1).

33. That is a hazard not to be taken lightly, even though Stanley Sporkin has been neutralized, because the SEC can put a broker out of business for a period of up to twelve months, or revoke the registration altogether. Securities Exchange Act of 1934, section 15(b)4, 15 U.S.C. 78o(b)4. In the case of firm that had been effecting transactions in securities without registering, and then sought registration, the SEC accepted the application, but immediately suspended the rights of the firm. Kauma Investment Corp.; Elden Roy Kauma, SEC Release No. 34-9743 (1972); *see also* Gregory &

Co., SEC Release No. 34-5680, 38 S.E.C. 304 (1958).

34. E.g. Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979).

35. Securities Exchange Act of 1934, section 29(b), 15 U.S.C. 78cc(b).

36. Eastside Church of Christ v. National Plan, Inc., 391 F. 2d 357 (5th Cir.), *cert. denied*, 393 U.S. 913 (1968); American General Insurance Co. v. Equitable General Corp., 493 F. Supp. 721 (E.D. Va. 1980). *See* Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970).

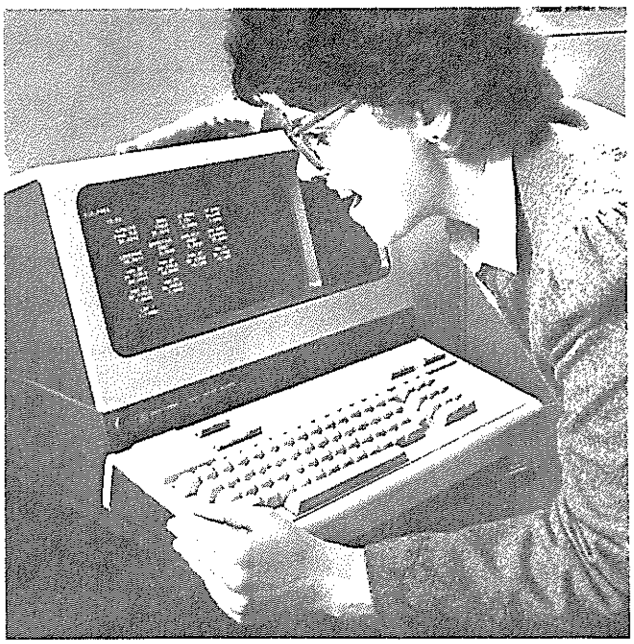
37. 17 C.F.R. 240.15b.

38. SEC Release Nos. 34-18417—18420, 47 Fed. Reg. 3512 (1982); *see* Kibler & Molinari, The SEC's Recent Revisions to its Uniform Net Capital Rule and Customer Protection Rule, 10 Sec. Reg. L. J. 141 (1982).

39. Securities Exchange Act of 1934, section 15(a)(2)(B), 15 U.S.C. 78o(a)(2)(B).

40. Pub. L. No. 66, ch. 89, 48 Stat. 162 (1933); 12 U.S.C. 378.

One look at the way TXL goes about analyzing lease investments, and



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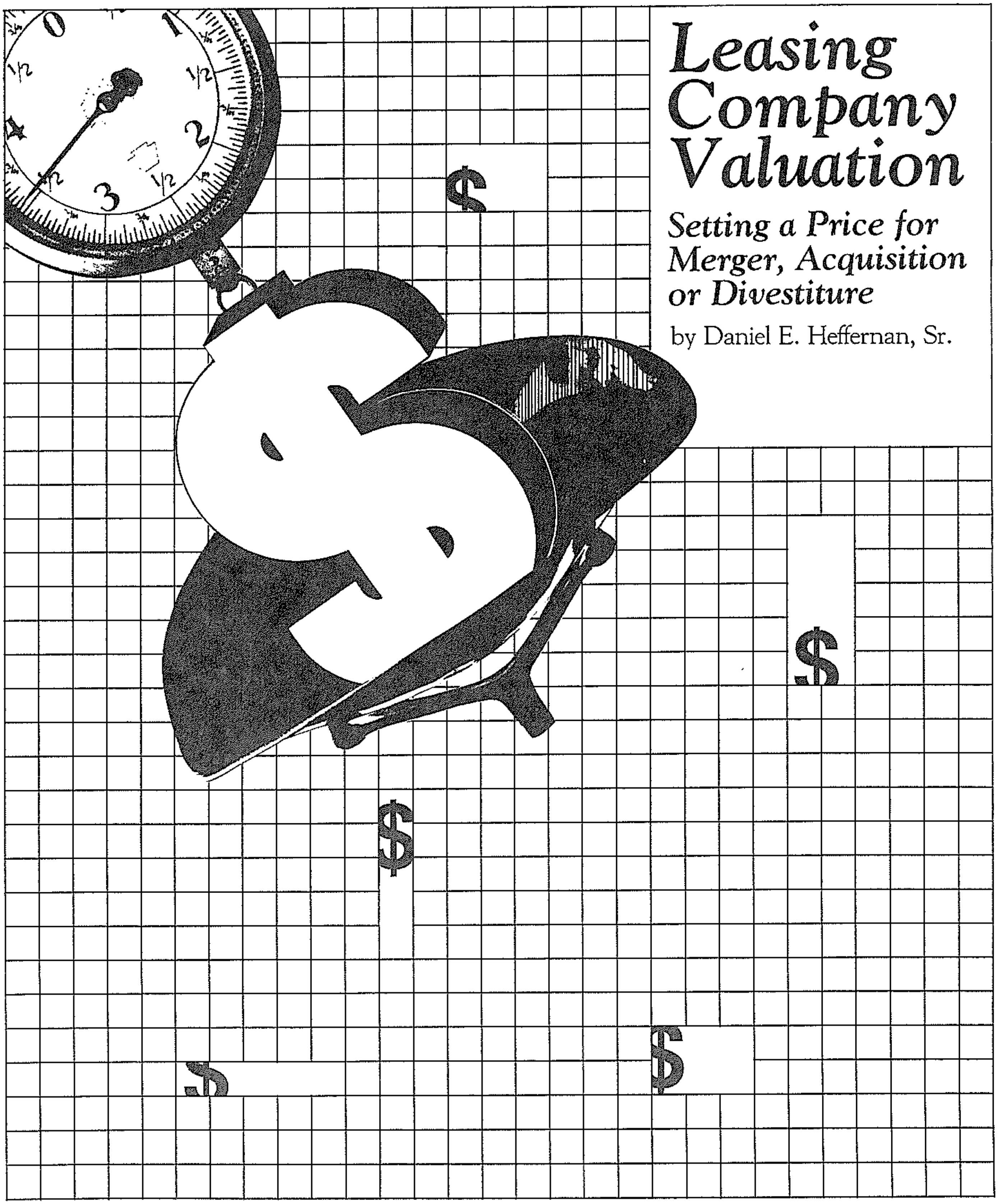


Leasing Company Valuation

Setting a Price for Merger, Acquisition or Divestiture

by Daniel E. Heffernan, Sr.

A major corporate industrial company announces the unexpected sale of its respected leasing subsidiary including its asset portfolio, personnel and offices, to a (choose one):

A. Commercial bank
B. Savings and loan
C. Insurance company
D. Management
E. Industrial corporation
F. Investment banking and brokerage firm
G. Major retailer
H. Foreign bank

The list of buyers and sellers, of course, could go on. However, the scenario above has been observed by participants within the leasing industry for about fifteen years with varying degrees of frequency and, to some, perhaps with varying degrees of wisdom. This latter point is significant, particularly with regard to the issue of valuation.

In the present climate—where leasing once again has been "discovered" due to ERTA, TEFRA, and a trend to build broad product line financial services companies—how is a leasing company's value established and translated into an acceptable price between both buyer and seller? Who are the key participants in this process? What are their roles? What are the generally accepted financial elements and valuation techniques used within this process? Finally, are these techniques different from other valuation procedures?

This article will provide some insight to the above questions and other issues surrounding this valuation process which the author has directly observed or participated in over the past nine years. The first significant issue is the valuation computation process utilized in most situations involving merger, acquisition or divestiture. That process is identical to pricing procedures utilized and, to some extent, developed within the leasing industry. Simply stated, valuation or price, is the present value of projected cash flows to be received over time, discounted at a target rate.

This basic concept is illustrated in Figure 1.

Theoretically, assuming a no-tax world, the buyer would pay $335.2 million or $299.1 million depending on its current capital yield (return) requirement. The seller would sell now at its valuation threshold or hold the asset until liquidation.

This simple process is a final step in the development of final value or price in any rational transaction involving merger, acquisition or divestiture.

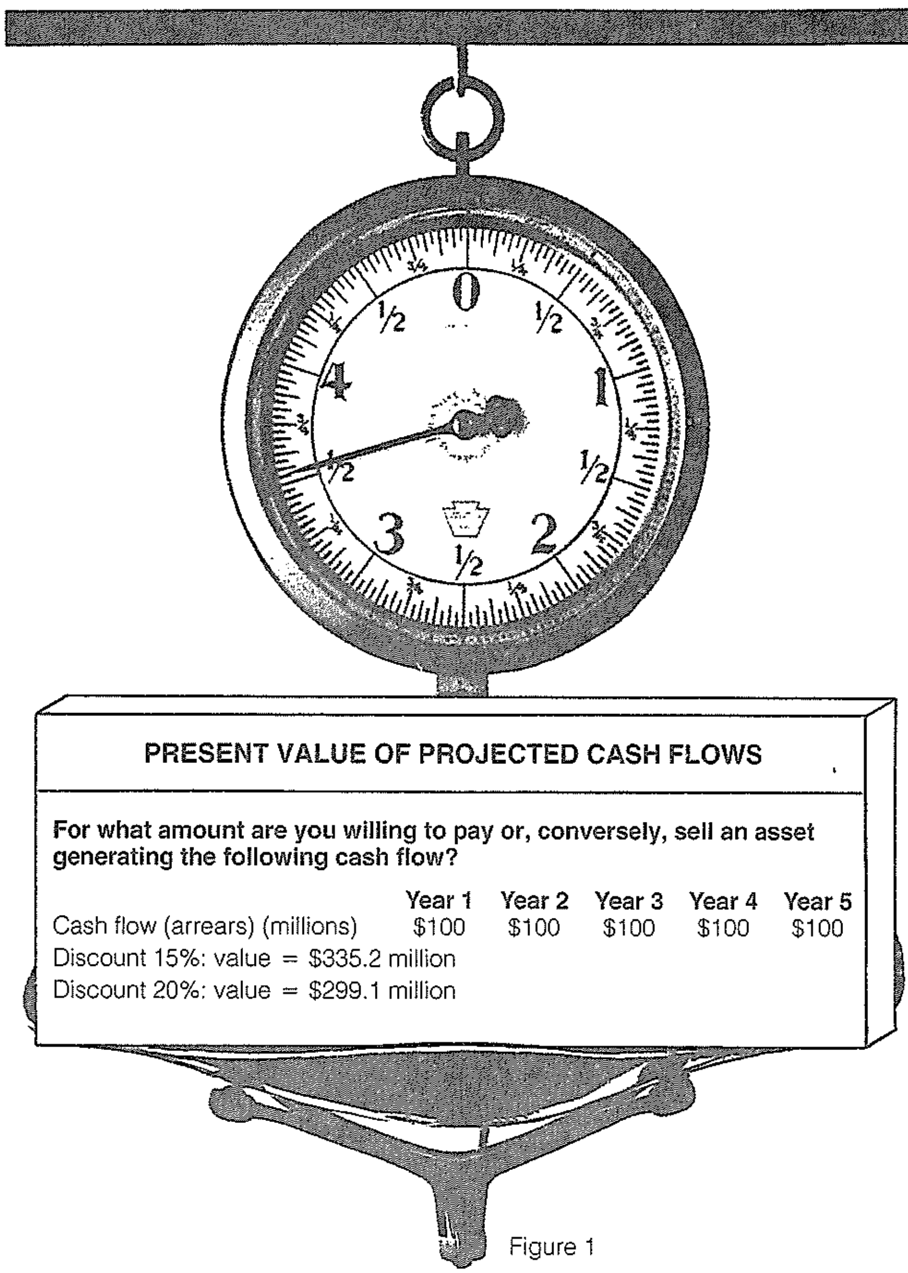


Figure 1

The author is an investment banker and principal with Allen & Company Incorporated, a private New York investment banking firm. Currently heading the merger and acquisition area for Allen & Company Incorporated, during the last eight years he has been active in various capacities in the leasing industry as a director, officer, and commercial and investment banker to both public and privately held leasing companies.

Among all the issues of buying and selling assets or companies, most participants will ultimately focus on the cash flow generation characteristics of the entity being bought or sold. Price or value will ultimately settle around this core concept. The process of deriving acceptable cash flows is the basic objective of both buyer and seller, and the most difficult part of any analysis. It is a process driven by historical data and future assumptions. The key here, of course, is determining future cash flows and their certainty because it is here that the buyer and seller meet to strike a price. This is the point where a leasing company valuation becomes very different from an industrial or manufacturing operation due primarily to the asset characteristic of the leasing company versus the aforementioned. Briefly, the leasing company for sale today has created a core asset base consisting of perhaps: (a) Finance lease receivables; (b) Operating lease receivables; (c) Leveraged lease receivables; (d) Loan receivables (money on money); (e) Other assets.

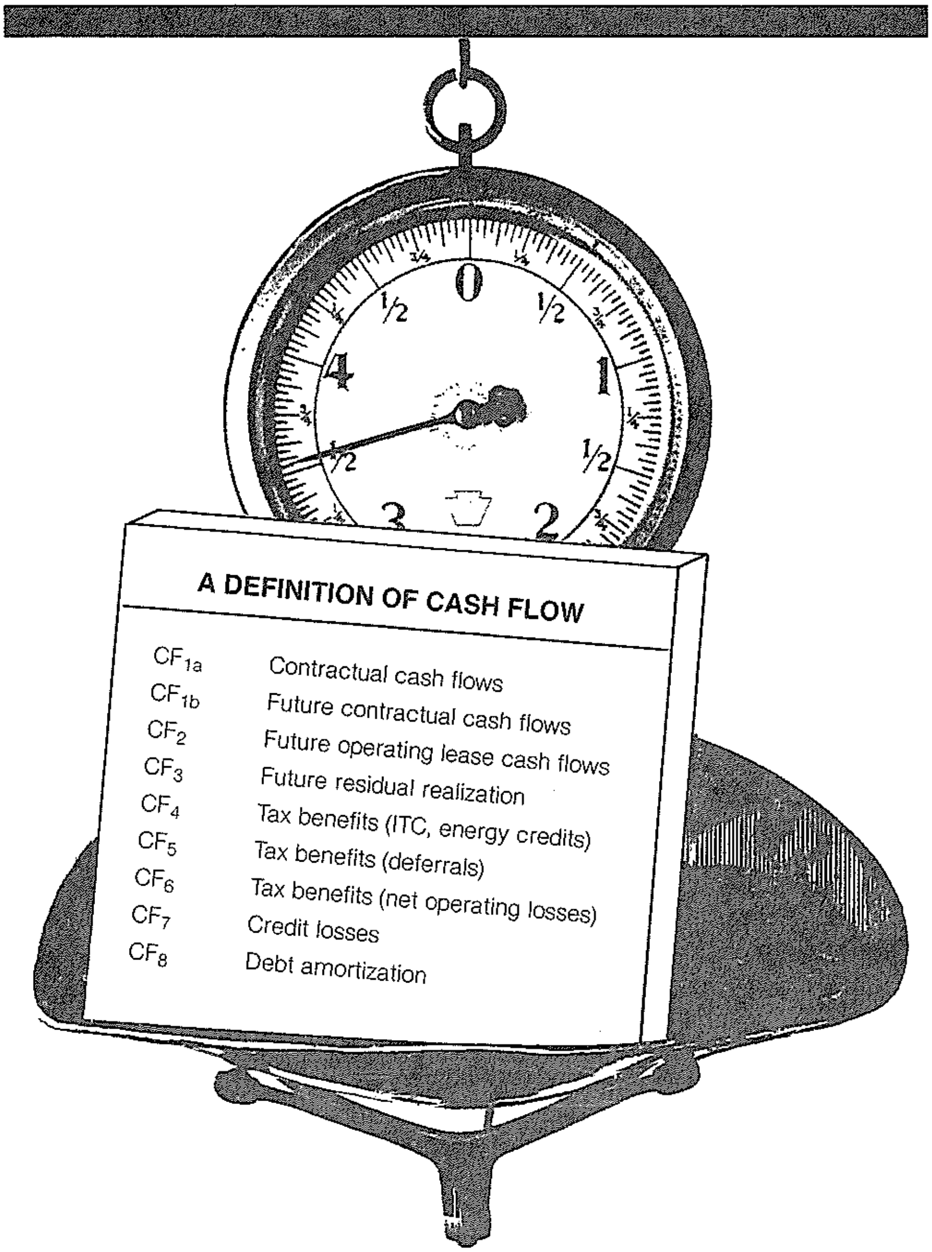


Figure 2

The above assets will generate an inflow of cash over a period of time with degrees of certainty such as contractual firm term receivables, as well as projected continuing rentals of operating lease assets, residual value realization, utilization of tax benefits, etc. On the liability side, certain cash outflows will occur with ranges of cost and certainty—the result being a net cash flow upon which to base valuation.

Unlike the industrial or high-tech manufacturer for sale today, the leasing company has relatively certain future cash flows, can theoretically shut down and expect to receive the contractual flows in its core portfolio.

If, on the liability side, the contractual debt is less than the contractual revenue, the problem of valuation with certainty, theoretically, is easier. However, this is not often the case. Therefore, residual value expectation and valuation of future cash flows in those instances wherein a significant assumed residual inflow awaits, the new owner needs to investigate any operating lease business dependent upon future-year rentals to produce cash flows. This latter point should require an analysis of each manufacturer in the case of operating lease programs contracted by the leasing company being bought or sold.

Why? So as to determine the reality of future operating lease rental expectations. A bankrupt vendor or one with clearly defined rental equipment problems should be a negative, identified and defined in the valuation process. Conversely, a quality vendor program should be a plus.

If, on the other hand, the industrial is theoretically shut-down today, an orderly liquidation of its assets such as receivables, inventory and fixed assets would occur—hopefully in amounts and in a time frame sufficient to cover outstanding debts.

Each of the above actions requires a distinct liquidation transaction which might yield in cash a portion of the asset's book value. The going-concern industrial valuation problem, therefore, is focused on the future activity of management and assets.

This analysis assumes a future world wherein the process of building, pricing and selling of product will yield probable future cash flows upon which to base the valuation.

The leasing company valuation, given an existing portfolio of assets, focuses with a greater degree of certainty upon the present asset base as well as the future asset generation characteristics of the leasing company.

This process of analyzing a leasing company's asset base, credit quality, product and equipment mix, residual assumptions, and operating lease expectations could subsequently be reduced to a definition of cash flows as shown in Figure 2.

A pre-tax valuation matrix can then be developed as shown in Figure 3.

Various discount rates are then applied to the resultant cash flows to derive, for example, a pre-tax value matrix. Subsequent adjustments of above cash flows by existing and projected debt amortization and interest cost assumptions, add-backs of ITC realization and other tax benefits such as interest deductions, deferrals, and net operating losses allow a valuation matrix to be derived that resembles a leveraged operating lease cash flow analysis.

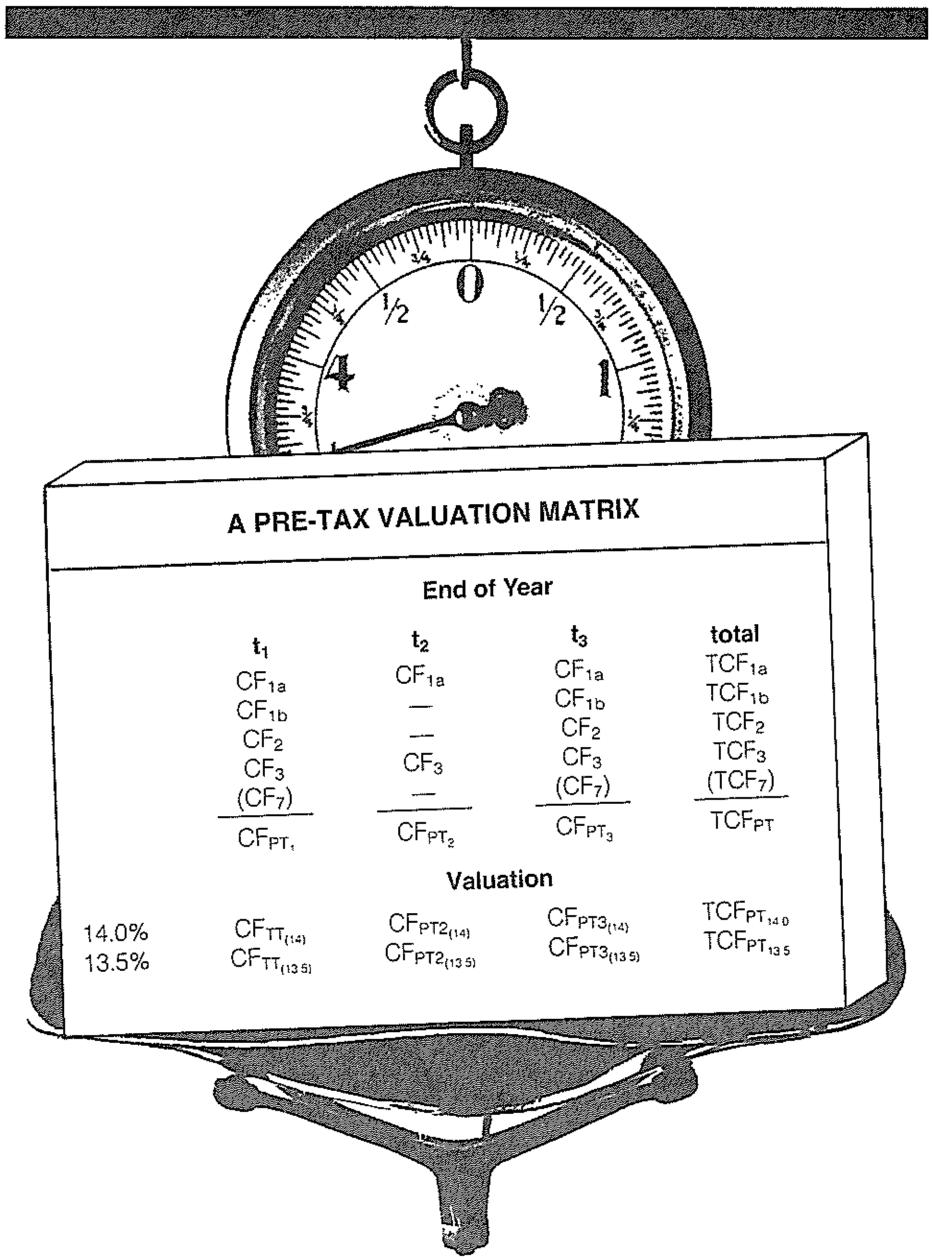
Clearly, this is a process driven both by fact and assumption—assumptions which, given the very nature of a leasing company, are credit-driven. However, there are several other important elements to be considered within this "assumptive" process including liability management; namely, capital sources and cost, and risk factors such as people, offices, industry or equipment specialization, tax position, to name just a few of the major areas to be included within this process.

This above-described process will properly culminate in a very detailed credit write-up. This, in turn, becomes a part of an offering memorandum relating to the company being sold.

So far, a basic valuation model and a description of quantifying cash flows has been presented. The schedules of cash flows derived in leasing company valuations must of course include the projected results of sophisticated sales programs, credit policies and practices, operational controls, and complicated flow projections generated from the leasing portfolio.

It is now appropriate to comment on the key participants in this leasing company valuation process. They are the key members of the leasing company itself. Whether the leasing entity is being bought or sold, key leasing company personnel are responsible for creating the data base upon which the offering memorandum will be prepared. They will answer the questions, provide additional data, and, generally, by their actions/reactions, provide the basis upon which price, terms and conditions are negotiated.

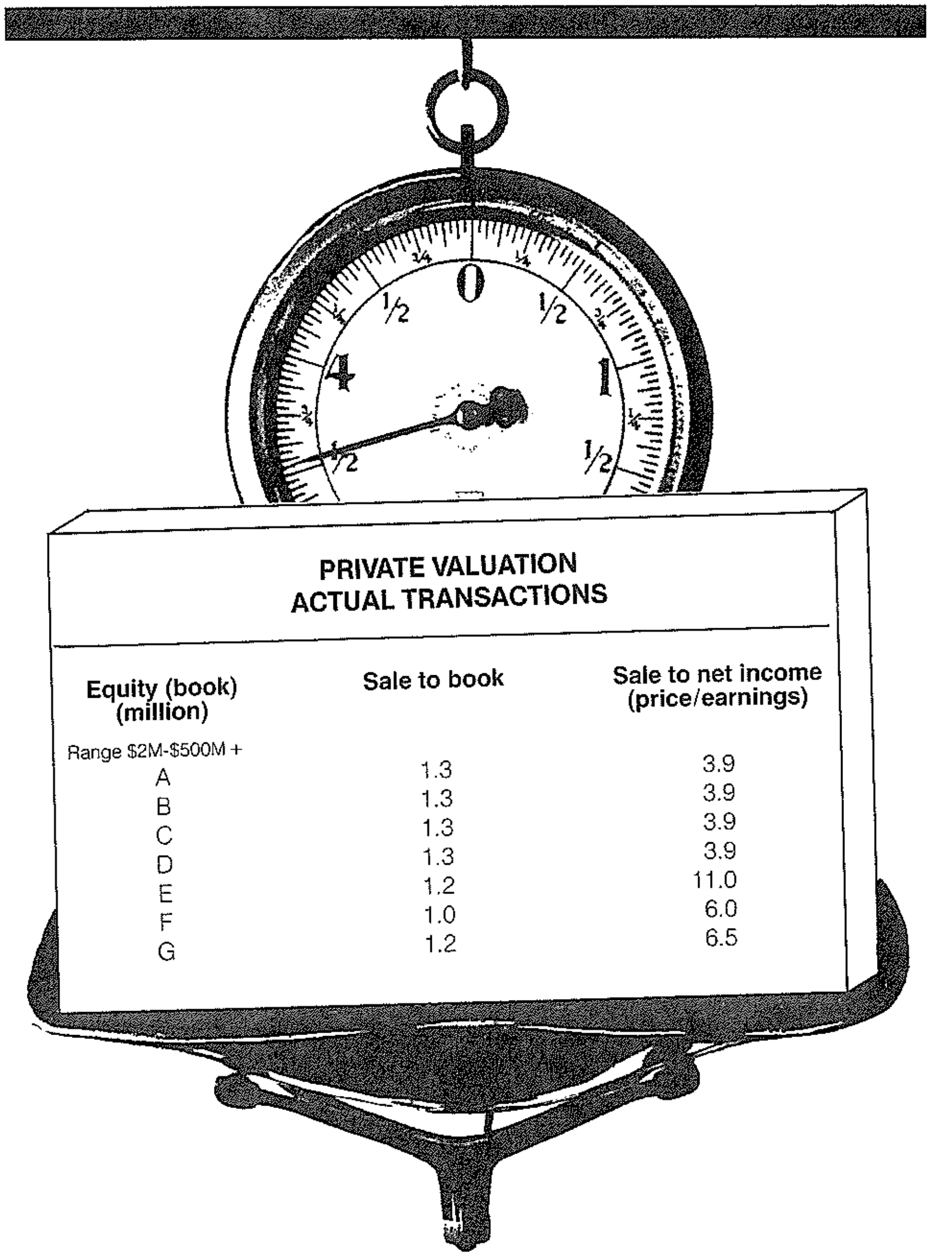
The valuation process is credit and operational intensive in that it tests the soundness of past credit decisions by examining the historical performance of the receivable base, and reviewing pricing efficiency by measuring the spread and operating cash characteristics of the historical and projected portfolios. The valuation process measures the soundness of controls, documentation, and delinquency management. Marketing and sales historical results and future



A PRE-TAX VALUATION MATRIX

	End of Year			
	t_1	t_2	t_3	total
	CF_{1a}	CF_{1a}	CF_{1a}	TCF_{1a}
	CF_{1b}	—	CF_{1b}	TCF_{1b}
	CF_2	—	CF_2	TCF_2
	CF_3	CF_3	CF_3	TCF_3
	(CF_7)	—	(CF_7)	(TCF_7)
	CF_{PT_1}	CF_{PT_2}	CF_{PT_3}	TCF_{PT}
	Valuation			
14.0%	$CF_{TT_{(14)}}$	$CF_{PT2_{(14)}}$	$CF_{PT3_{(14)}}$	$TCF_{PT_{14.0}}$
13.5%	$CF_{TT_{(13.5)}}$	$CF_{PT2_{(13.5)}}$	$CF_{PT3_{(13.5)}}$	$TCF_{PT_{13.5}}$

Figure 3



PRIVATE VALUATION
ACTUAL TRANSACTIONS

Equity (book) (million)	Sale to book	Sale to net income (price/earnings)
Range $2M-$500M +		
A	1.3	3.9
B	1.3	3.9
C	1.3	3.9
D	1.3	3.9
E	1.2	11.0
F	1.0	6.0
G	1.2	6.5

Figure 4

growth, given past performance, is evaluated. Past liability management strategies, their results, and existing credit relationships are reviewed and evaluated. Future financial strategy becomes a potential negotiating card for either buyer or seller for obvious reasons. Past tax planning and knowledge of the tax environment is reviewed and evaluated—the future tax position is again a potential negotiating card for the participant buyer and seller.

Key leasing company personnel are integral to this valuation process along with investment bankers, accountants, lawyers and equipment or industry specialists.

The finance professional who is retained to develop or analyze an offering memorandum plays a critical role in determining the establishment of an acceptable price relating to the sale. But, first, in developing the offering memorandum, the advisor typically should strive to understand completely the data collection process and test the resultant data and methods used to develop the base. That data should be tied to both the financial record and the planning system employed by the leasing entity to test the validity and coordination of operating and financial data within the system.

In summary, the financial advisor in concert with the key leasing company personnel, supported by outside accountants, lawyers and industry specialists (i.e. computer peripheral staff, transportation equipment analysts, to name but a few) can, prior to formal preparation of the final offering memorandum, report factually the ranges of probable price to be received; the terms; the assumptions; the value of retention and liquidation of the assets; the discount or premium (from book value) to expect upon sale; the probable buyers; the placement procedure; the notification of potential buyers; the contents of confidentiality agreements; and other vital pieces of information that should be understood by the selling entity before it begins the search for a buyer.

From the buyer's standpoint, the financial advisor or investment banker must strive to know what its counterpart knows. For example, in addition to the economic benefit of the subject sale, can the buyer fit with the people acquired? What are the weak assumptions relating to the buy? What are the strengths of the transaction? What is the value the buyer should expect to pay and why?

In summary, the questions and answers developed in the valuation process should be reflected on both the buyer's and seller's side of the transaction.

We now arrive at the point where buyer and seller agree on price. However, given a full range of leasing company products, all the risk variables associated therewith (particularly with regard to operating lease rental levels, residual value realization, tax benefit utilization, credit performance, etc.), the question is now raised as to payment terms.

This is where negotiation typically occurs. But again, several prices can and are typically offered pursuant to terms. Returning to the valuation matrix, higher or lower discount rates can attempt to capture the risk difference between an all-cash deal now or a part cash, part note cash later, or residual performance (ultimate realization) deal. The variations are as numerous as innovative leveraged lease pricing.

Theoretically, a *rational* buyer will pay a greater price for greater certainty as to cash flow expectation, and a *rational* seller will demand a greater price for that certainty. This is the point where premiums or discounts are derived. But how do you measure premium or discount involving the value of a leasing company?

Traditionally, premium or discount is measured against book value. For example, there have occurred over the past several years sales of leasing companies that are set forth in Figure 4.

Reported premiums or discounts are the resultant product of the valuation process. Cash flows drive price; and if cash flows drive price, the above correlation to book value implies that FASB-13 isn't as bad as rumor would have it.

Currently, there have been several instances in the marketplace wherein sales price bore little relationship to an examination of current book value. Therefore buyers and sellers of leasing companies, particularly in those instances where liquidation is not the motive, will both concentrate efforts on deriving their value matrix and applying discounts or premiums to cash flows resulting from people, office locations, product capabilities, etc. within that matrix.

The above schedule and comments represent about 10 instances of sales or attempted sales of leasing companies (portfolio, offices, people, etc.) on a private basis.

Figure 5 shows what the public stock market valuation of several full-service leasing companies has been over the last several years.

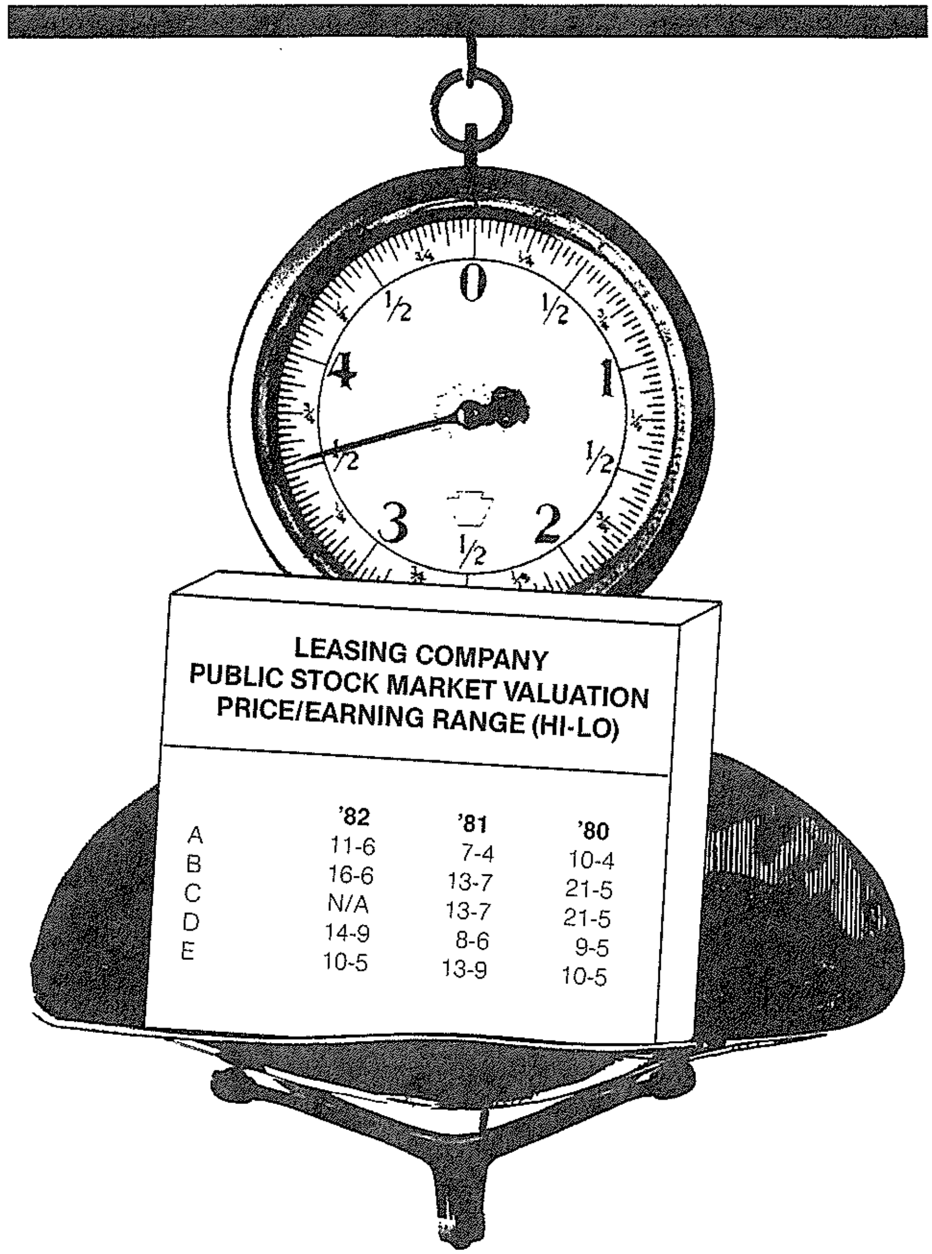


Figure 5

The hi-lo price/earnings reported do not correlate with the reported private valuations cited in Figure 4 which are more conservative. Presently, three of the five are trading at premiums over book. The two which have portfolio concentrations in depressed industries are selling at discounts. This is what one would expect. Valuation reflects quality, stability and even conservatism. The public market valuation tends, by the nature of the information flow, to be more volatile than a private valuation, as might be expected.

The private valuation, particularly with regard to pricing a going-concern leasing company, tends to support a premium over book. Secondly, it tends to support a price that is a multiple of earnings. However, the driving force in determining price valuation is the underlying lease portfolio, with its cash flows and the people who have created it and will manage it into the future.

Premium, discount, or price/earnings observations are the result, not the cause, of valuation. There is no right answer when it comes to valuing a leasing company until the buyer and seller, based on informed fact and advice, agree on that certain price and the terms under which that price will be paid.

The Enforceability of Leveraged Lease Income Tax Indemnities in Bankruptcy

by Ted W. Harris, Esq.

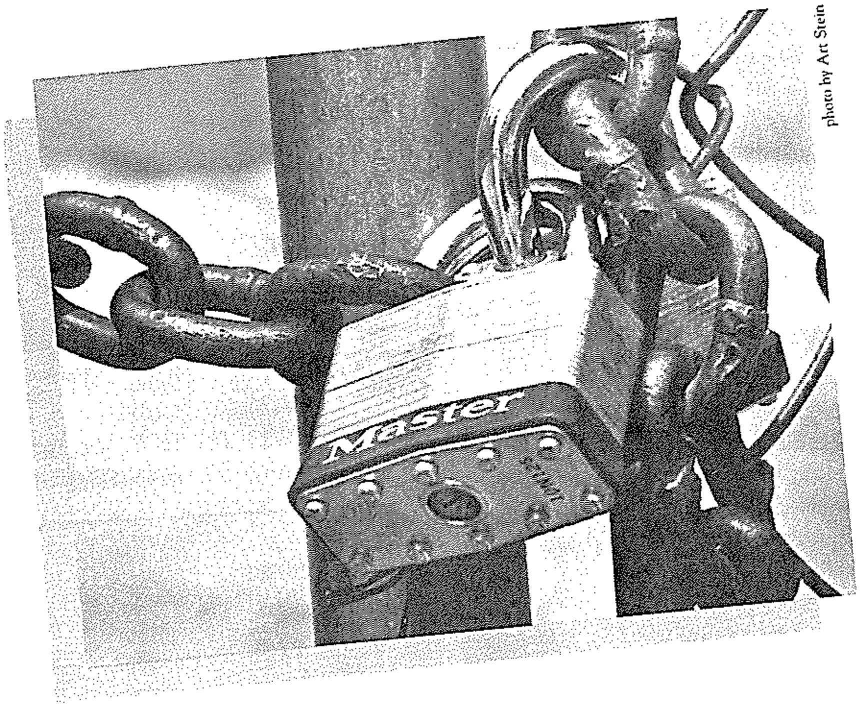


photo by Art Stein

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Introduction

Leveraged lease transactions are arranged for a variety of reasons, including the availability of 100 percent financing for the lessee, and the lessor's ability to earn a profit on the residual value of the equipment. In addition, the transaction allows for the effective transfer of income tax benefits attributable to the equipment from the lessee, who cannot fully use such benefits, to the lessor, who can. The lessee gains from this transfer of tax benefits through a lower effective cost for the equipment.

Although the tax impact of the leveraged lease transaction is usually fully examined before the transaction is consummated, the lessor always runs the risk that its anticipated tax benefits will be lost through, for example, an act of the lessee, a structural problem in the transaction itself or a change in law. To guard against this possibility, lessors have typically required lessee indemnification against the loss of anticipated tax benefits arising from certain events, such as actions, inactions, misrepresentations or breaches by the lessee.

However, this tax indemnity obligation is usually unsecured, and is therefore only as valuable as the lessee's ability to make an indemnity payment in the event of a loss of tax benefits. In particular, if the lessee goes into bankruptcy, there is a substantial question as to whether the lessee's tax indemnity obligation will be of actual benefit to the lessor. This article will examine the enforceability of tax indemnity agreements in lessee bankruptcy proceedings under the Bankruptcy Reform Act of 1978 (referred to hereafter as the Bankruptcy Code).

The discussion will proceed in three stages. First, a typical leveraged lease transaction will be described, including a summary of the lease and the tax indemnity provisions important to the bankruptcy context. Second, an overview is presented of the provisions of the Bankruptcy Code which will most directly affect the tax indemnity in bankruptcy. Finally, specific planning considerations for the lessor are discussed, focusing on the practical alternatives at the time of bankruptcy.

Tax Indemnities & Bankruptcy: A Scenario

Leveraged lease transactions may be structured in a number of ways. A fairly straightforward transaction is assumed for this discussion, so as to isolate the bankruptcy impact on tax indemnities.[1]

Assume that a large manufacturer needs equipment in one of its plants. However, the company is currently generating tax losses, and does not anticipate having taxable income (after the effect of net operating loss carryforwards[2]) for the next several years. As a result, it will be unable currently to use the federal investment tax credits and depreciation deductions arising from the equipment acquisition.

Instead of purchasing the equipment, the company enters into a lease with a national bank, which is currently paying substantial federal income tax and anticipates such status to continue for the next several years. The lease arrangement is evidenced by three primary documents. First, the bank enters into a typical full-payout net lease agreement with the company under which the bank, as lessor, will purchase the equipment from the respective vendors and lease it to the company, as lessee. The lease extends for seven years and provides that the lessee is responsible for all operation and maintenance of the equipment, as well as for insurance and all taxes other than those based on or measured by the lessor's net income. If the equipment is destroyed before the end of the lease term, the lessee is required to pay the lessor the "casualty loss value" of the equipment, which is an amount set out in advance in the lease. The casualty loss value is computed to reimburse the lessor for the sum of the outstanding debt, the additional taxes to be paid as a result of the casualty, the lessor's remaining investment in the equipment (plus accrued earnings to date) and the residual value of the equipment. In the event of a default under the lease, the lessor is entitled (in addition to any other available remedies) to the return of the equipment and a liquidated damages payment equal to the casualty loss value of the equipment, reduced by its current value.[3] One of the events of default defined in the lease is the voluntary or involuntary bankruptcy of the lessee, whether or not the lessee is in default in performance of any of its other obligations under the lease (the so-called *ipso facto* clause).

Assume the lessor borrows 75 percent of the equipment cost on a nonrecourse basis from an insurance company (referred to hereafter as the lender) under a finance agreement. The nonrecourse notes are secured by a security interest in the equipment and in the lease, which security interest is duly perfected against the claims of third parties under local law. The finance agreement provides, among other terms, that (1) an event of default under the lease constitutes an event of default under the finance agreement and the notes, (2) the lessor has a right to cure (correct) not more than two consecutive defaults under the lease arising solely from the lessee's failure to pay rent and (3) the lessor may, in the event of a default by the lessee under the lease, prepay the nonrecourse notes, whereupon the lender's security interest in the equipment terminates.

Finally, the lessor and the lessee enter into a tax indemnity agreement with respect to the federal income tax consequences of the transaction.[4] Although this agreement could be included in the lease, it is stated as a separate agreement primarily because of its length and special nature. The tax indemnity agreement sets forth the lessor's anticipated federal income tax benefits in the transaction. The most important benefits for purposes of the bankruptcy discussion are (1) the treatment of the lease as a true lease, resulting in the lessor being considered the owner of the equipment for federal income tax purposes,[5] (2) the availability of the investment tax credit, equal to ten percent of the cost of the equipment[6] and (3) the availability of depreciation deductions under the Accelerated Cost Recovery System (ACRS) over a five-year period.[7] The lessee makes certain representations concerning the tax consequences of the transaction, including that the equipment is and will continue to be eligible for the investment credit, and agrees that it will take no action which is inconsistent with the lessor's anticipated tax benefits.

The agreement specifies that, if the lessor loses or is required to recapture any of the enumerated tax benefits because of a "trigger" event, the lessee is required to pay the lessor an amount which, after payment of all applicable taxes by the lessor on receipt of the indemnity payment, maintains the lessor's after-tax yield on, and after-tax cash flow from, the transaction assuming availability of the tax benefits. The relevant "triggers" in the lease which give rise to an indemnity payment are (1) the incorrectness of lessee tax representations or the breach of any of its agreements relating to the anticipated tax benefits, (2) any other act or failure to act by the lessee, (3) the sale of the equipment by the lessor or lender after an event of default under the lease, and (4) a casualty occurrence, unless the lessor receives full payment of the casualty loss value.

If the Internal Revenue Service challenges any of the anticipated tax benefits, and the respective benefits could be lost because of a trigger event, the lessor is required to notify the lessee. At its own expense, the lessee may then require the lessor to contest the matter. If the lessee decides not to contest the issue, or if the "final determination" is that the lessor loses the anticipated tax benefits, the lessee is required to make an indemnity payment. The payment is specifically excluded from the security under the finance agreement.

The lessee thereafter suffers serious financial reverses and, in the third year of the lease, files a voluntary bankruptcy petition under either Chapter 7 of the Bankruptcy Code, involving liquidation, or Chapter 11, providing for reorganization. On the date the petition is filed, the lender has a perfected security interest in the equipment and the lease, which is valid as against the lessee and the trustee in bankruptcy.

Events may already have occurred which would result in an indemnity payment by the lessee, although the lessor may not yet be aware of them. For example, the equipment may not have been "new" at the time of purchase, thereby making the investment credit unavailable,[8] or may have subsequently been used predominantly outside the United States, resulting in "recapture" of the credit to the lessor.[9] In addition, if the equipment is sold during or after bankruptcy, the tax indemnity agreement will require the lessee to make an indemnity payment to the lessor to compensate for the resulting loss of tax benefits.[10] As described below, bankruptcy may well alter or eliminate lessee obligations set forth in the tax indemnity agreement.

Overview of Rights and Obligations in a Lessee Bankruptcy

There are two major provisions of the Bankruptcy Code which directly affect the enforceability of a tax indemnity agreement in a lessee bankruptcy.[11] The first is the statutory option afforded the lessee, or its trustee, to assume or reject the unexpired lease and tax indemnity agreement, even if the lease itself provides otherwise. The exercise of this option may attenuate or otherwise alter the contractual rights of the parties to the lease, and may even of itself cause the lessor tax problems if its interest in the equipment is sold by a foreclosing lender after rejection of the lease.[12] The second provision is the procedure for submission and substantiation of claims against the lessee's estate if the lease is rejected. The status of the lessor's claims (as a general, unsecured creditor) and the contingency of many of these claims may radically diminish the reimbursement for loss of tax benefits contemplated in the tax indemnity agreement.

ASSUMPTION OR REJECTION OF AN UNEXPIRED LEASE

Section 365(a) of the Bankruptcy Code provides generally that ". . . the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."[13] The prerogative of the "trustee" to assume or reject an unexpired lease is also available to a "debtor in possession" in a Chapter 11 reorganization case,[14] since a debtor in possession exercises the rights and powers of a trustee.[15] Thus, the lease and the tax indemnity can be assumed or rejected by the trustee or debtor in possession, provided bankruptcy court approval can be obtained.

It is a well-established principle of bankruptcy law that a trustee who assumes or rejects an unexpired lease must assume or reject the entire lease with all its benefits and burdens. Neither the trustee nor the nondebtor party to the lease can select individual covenants for assumption or rejection.[16] If the tax indemnity is an integral part of the equipment lease, then the obligations of the indemnity must stand or fall with the other rights and obligations of the lease itself.

Notwithstanding this principle of total assumption or rejection, the lessee might argue that the tax indemnity is a wholly separate contract from the lease itself, and that the lessee should be permitted to assume the lease and reject the indemnity contract.[17] The lessor also might argue the severability of the indemnity from the lease in an attempt to persuade a court that the indemnity should, as a matter of contract law, survive the rejected lease.[18] Although the arguments for severability of the lease from the tax indemnity have some plausibility, and might yet be articulated in a future case, the better view is that the lease and indemnity, as parts of a single negotiated transaction, must be construed together and must be assumed or rejected as one "unexpired lease."[19]

The statutory option of the trustee to assume or reject the unexpired lease is unaffected by any provision in the lease allowing the lessor to terminate or modify the lease upon the bankruptcy or insolvency of the lessee. One of the major changes effected by section 365 is the invalidation of the so-called *ipso facto* clause which provides that lessee bankruptcy is an event of default enabling the lessor to terminate or modify the lease. Under the superseded Bankruptcy Act, such *ipso facto* clauses were enforceable by lessors, often depriving debtors of valuable rights under unexpired leases which could have aided rehabilitation.[20] Section 365(b)(2) provides generally that the trustee's right to assume the lease is not prevented by a purported default based upon: (1) the insolvency or financial condition of the debtor at any time before the closing of the bankruptcy case; (2) the commencement of a bankruptcy case; or (3) the appointment or taking possession by a trustee in a bankruptcy case or a custodian before such commencement. To similar effect is section 365(e)(1), which provides that a contractual right of termination or modification of a lease based on the insolvency or bankruptcy of a lessee or upon the appointment of a trustee is to be given no effect in bankruptcy proceedings.

The significance of this statutory invalidation of *ipso facto* default clauses resides in the trustee's absolute right to assume an unexpired lease with no preexisting defaults, other than the fact itself of bankruptcy, *without* fulfilling the requirements of cure, compensation and adequate assurance of section 365(b)(1). Whether the lessee's statutory protection against enforcement of the *ipso facto* clause also protects the lessor from a purported foreclosure by the lender of lessor interest in the lease and equipment upon bankruptcy is not entirely clear. Since lessee bankruptcy is an event of default under the finance agreement, the lender may attempt to foreclose against the lessor's interest immediately upon commencement of a lessee bankruptcy while leaving the lessee's possession of the equipment undisturbed. This problem is considered further in a following section on preventing foreclosure sale of the equipment.

The time period within which the trustee must exercise the option to assume or reject differs with the relief sought by the debtor. In a Chapter 7 liquidation case, an unexpired lease is deemed rejected if not assumed within 60 days after the order for relief.[21] In a Chapter 11 reorganization, the trustee may exercise the option "at any time prior to confirmation of a plan."[22] A party in interest (i.e. the lessor or the lender) may request the court to order the trustee to make an earlier determination, but the court is usually liberal in allowing the trustee adequate time to make a reasoned decision.[23]

The lessor and the lender have the right to petition the court under section 363 for "adequate protection" of their respective interests in the leased equipment (security and reversionary interests) on a showing that these interests may be impaired during the time allowed the trustee to exercise his option.[24] The definition and forms of "adequate protection" are set out in section 361.[25] The right of the lessor and the lender to petition for protection of property interests which may deteriorate over time is a statutory balance to the inability of the lessor and the lender to reclaim the property due to the automatic stay of section 362 and the invalidation of the *ipso facto* clause.[26]

A lease under which the lessee has committed material (i.e. nonbankruptcy related) defaults can be assumed only if the trustee meets the requirements of section 365(b)(1). The trustee must: (1) cure, or provide adequate assurance of prompt cure of, existing defaults; (2) compensate, or provide adequate assurance of prompt compensation, for actual pecuniary loss resulting from the default; and (3) provide adequate assurance of future performance under the lease.[27]

With regard to the first two conditions, cure and compensation, if a prior default is purely monetary, either tender of the delinquent payment by the trustee or proof to the court's satisfaction that sufficient unencumbered funds are immediately available to the trustee for cure and compensation satisfies the conditions.[28] On the other hand, if it is clear that the prior monetary defaults cannot be cured in a timely fashion, the court will order rejection of the lease on the motion of an interested party.[29] If the prior default is other than purely monetary (e.g. a lapse of insurance), it must either be converted to "pecuniary loss" and cured as a monetary default or, if not convertible, must be cured according to the terms of the lease, if possible.[30] With regard to the last condition for assumption of a lease with a prior default, it is clear from the cases decided under the Bankruptcy Code that "adequate assurance of future performance" is a pragmatic term, left by Congress to the courts to define on a case by case basis.[31] This problem is further considered in a following section on planning considerations for the lessor at the time of bankruptcy.

If the trustee assumes an unexpired lease, it may also assign the lease.[32] Section 365(f)(1) invalidates antiassignment clauses in leases, and section 365(f)(3) invalidates purported rights of termination or modification by the nondebtor upon assignment.[33] In order to assign an unexpired lease, the trustee must first assume the lease (having first fulfilled the conditions of section 365(b)(1) if the lease is in default), and provide adequate assurance of future performance by the assignee regardless of whether there has been a default.[34] The criteria for adequate assurance of performance by an assignee are the same as those for a trustee who assumes a lease previously in default.[35]

The discussion to this point has been predicated on the exercise by the trustee of his option to assume or assign the unexpired lease. Unless the lessor has economic reasons for wishing to prevent assumption, some of which are considered in a following section on influencing assumption or rejection, the lessor usually will view assumption as the best protection for its right to reimbursement under the tax indemnity, since lessee obligations thereunder survive unimpaired upon assumption. But the trustee may wish to reject the lease and tax indemnity, in which case the lessor may face undesirable economic consequences. There are severe limitations to the lessor's ability to prevent rejection.

Upon application to the court, a trustee who chooses to reject the unexpired lease will be allowed to do so unless a party in interest (i.e., the lessor or the lender) opposes the application and persuades the court that rejection should not be permitted.[36] Prior to the Supreme Court's opinion in *Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pacific R.R. Co.*,[37] the standard applied in bankruptcy to determine whether rejection should be allowed was the "burdensome test."[38] Under this test, in order to justify a rejection which was opposed by a party in interest, the trustee was required to show that continued performance under the lease would result in a net loss to the estate. This early test was consistent with the evolution of the right to disaffirm executory contracts from the principle that the trustee could abandon property profitless to the estate.[39] Although the "burdensome test" has been superseded, as noted below, it remains true that a lease which represents a drain of the assets of the debtor's estate may be rejected even over the opposition of a party in interest.

The modern test for rejection of executory contracts and unexpired leases derives from *Group of Institutional Investors* and is styled the "business judgment" test. Under this test, an unexpired lease can be rejected even though profitable if, in the business judgment of the trustee supported by a sound basis in fact, rejection is in the best interests of the estate (e.g., a more profitable lease is available to the reorganizing entity). The argument that the business judgment test should be confined to cases affected with a public interest has been rejected, and the business judgment test is firmly entrenched.[40] A nondebtor party to the lease (i.e., the lessor or the lender) who has reason to oppose rejection must therefore be prepared to demonstrate that the business judgment of the trustee is unsound; the trustee need only show that the assets of the estate previously devoted to the lease could yield a greater return if expended in another way.

There is, however, one countervailing argument potentially available to the nondebtor party even if the trustee can demonstrate the soundness of its business judgment. Some courts have articulated a criterion which can be styled the "equitable principles" standard; this standard is not a separate test, but rather is a balancing of the trustee's business judgment against the magnitude of the unfavorable consequences of rejection to the nondebtor parties to the contract or lease.[41] Although this standard has been most often applied in cases with some public interest,[42] it also has been applied in a lessor bankruptcy concerning rejection of a commercial lease.[43]

As a final note, the trustee option to assume or reject an unexpired lease may not result simply in assumption or rejection but rather in modification of the lease. Some cases have suggested that it is not only proper but desirable for a trustee to exert his bargaining power to negotiate a modified contract or lease in lieu of rejection.[44] A lessee in bankruptcy could, on the basis of this authority, force the lessor to choose between total rejection of the lease and tax indemnity and assumption with an agreed modification of the indemnity obligations less onerous to the lessee.

LESSOR CLAIMS FOR BREACH UPON LESSEE REJECTION

If the unexpired lease is rejected, the rejection operates as a statutory breach of the lease deemed to have occurred immediately prior to the filing of the bankruptcy petition, unless the lease had been previously assumed, in which case the breach is deemed to have occurred at the time of the rejection.[45]

The statutory breach occasioned by rejection gives rise to a nonpriority (unsecured) claim on the part of the nondebtor parties.[46] The lessor and the lender must file a proof of claim setting forth the amount claimed, if known, and the claim will be allowed to share in the distribution of assets to nonpriority creditors of the estate unless a party in interest objects.[47] A claim need not be liquidated, fixed or matured in order to be filed, as long as the claim is characterized as a "right to payment."[48] If these claims are not filed, they will usually be forfeited, as the discharge of the debtor in a Chapter 7 liquidation or the confirmation and performance of a plan in a Chapter 11 reorganization operates in the usual case as a final release of the debtor from these claims.[49]

A lessor claim for damages for breach of the tax indemnity can present difficult problems of proof, as discussed more fully in the following section on planning considerations for the lessor at the time of bankruptcy. Generally, lessor claims will be, in descending order of certainty, for final determinations which have actually occurred, for suspected or threatened future loss of tax benefits, and for unsuspected but possible loss of tax benefits after discharge of the lessee.

Under the superseded Bankruptcy Act, claims too contingent or remote to be liquidated were, due to the interworkings of the concepts of allowability and provability, disallowed and not entitled to share in distribution of debtor assets.[50] Section 502(c)(1) changed this rule, providing that contingent or unliquidated claims which would unduly delay the closing of the case will be estimated. While it is clear from this section that all claims not otherwise objectionable will be allowed, because estimation is now permitted under the Bankruptcy Code, the Code nowhere articulates guidelines for estimation, and case law on the issue is sparse. One recent case invoking the estimation provisions, *In re White Motor Credit Corp.*, addressed the estimation problem by appointing a special master to supervise the disposition of 160 products liability suits pending against the reorganizing debtor.[51] Other suggestions for estimation await development in the case law under the Bankruptcy Code. The claim of the lessor under the tax indemnity, whether liquidated by estimation or by proof, is unlikely to yield a satisfactory payout to the lessor, since it will be subordinated to all secured claims and to the priority claims listed in section 507.[52] One study conducted prior to the enactment of the Bankruptcy Code calculated that the average unsecured creditor received 6.5% of his total claim from the estate of his debtor.[53]

Planning Considerations for the Lessor at the Time of Bankruptcy

INFLUENCING ASSUMPTION OR REJECTION

Upon commencement of a case by or against a lessee, the initial consideration for the lessor is the consequences of assumption or rejection of the unexpired lease (including the tax indemnity) by the trustee. If the equipment has value far in excess of the unpaid principal and interest on the loan and if the lessor is confident that there is only a remote possibility of a "trigger event" under the tax indemnity, the lessor may welcome rejection (in which case the lessor must repay the nonrecourse notes to benefit from the upside residual). At the other extreme, if the value of the equipment is much lower so that the lender will get most or all of the value of the equipment through foreclosure, or if the lessor perceives a strong possibility of a claim under the tax indemnity, the lessor may much prefer assumption. The lessor's tactics will depend on whether it wants the lease assumed or rejected.

Opposing Rejection

The lessor may well conclude that rejection by the trustee poses an unacceptable economic loss for the lessor in terms of unreimbursed tax liability. For example, the lessor may not have a "claim" as defined by the Bankruptcy Code in that the lessor is unaware of any trigger events which require an indemnity payment and the Service has not, as of the filing of the petition, threatened a challenge of previously realized tax benefits. In such a setting, rejection of the unexpired lease by the lessee would terminate the tax indemnity agreement and yet leave the lessor exposed to possible future liability with no compensation for the loss of the valuable right to indemnification which was an essential part of the deal for the lessor.

Alternatively, the lessor may have a claim under the tax indemnity which would be allowable upon rejection but which is not yet definite.[54] A threatened challenge by the Service to past tax benefits which has not yet ripened into a final determination, and may never do so, would constitute a claim subject to estimation under section 502(c)(1). Given the lack of judicial experience in the implementation of the estimation procedures, and the consequent uncertainty of full valuation, the lessor may prefer assumption by a reorganizing lessee with a prospect of rehabilitation and a possible future ability to respond to the indemnity, if and when required.

Under the circumstances, if the trustee proposes to reject the lease, the lessor must be prepared to show either that rejection does not conform to sound "business judgment"[55] or that rejection would offend "equitable principles."[56] Usually, this showing will be extremely difficult for the lessor to make.

In a Chapter 7 liquidation case, the trustee's choice to reject could rarely, if ever, be successfully opposed. By the nature of the proceeding, there will be no surviving entity to assume the unexpired obligations of the lease. However, a showing that assumption and subsequent assignment to a willing and identified assignee would entail a net benefit to the unsecured creditors of the liquidating lessee could be sufficient to oppose rejection.[57] If a prospective assignee is willing to pay the estate a premium for the unexpired portion of the lease, and if the assignee is acceptable to both lender and lessor, the trustee would have no sound reason to reject the lease (thus multiplying the unsecured claims) rather than assume and assign, unless the cure of previous defaults under the lease would drain the assets of the estate.[58] If the cure of prior defaults is the only barrier to an assumption and assignment desired by all parties to the lease, a negotiated compromise or partial waiver of prior defaults may be considered by the lessor.[59]

In a Chapter 11 reorganization, a lessor opposing rejection could similarly attempt to demonstrate that sound business judgment required assumption of the unexpired lease as a first step to an assignment profitable to the estate. Alternatively, a lessor could claim that assumption represented a more sound economic choice for a lessee than rejection, in an attempt to controvert the trustee's stated "business judgment." In this case, the lessor would be required to show that the trustee's alternative to assumption (e.g., entering into a new lease with a third party) was an economically inferior choice for the reorganizing lessee as compared to the terms of the existing lease.

If the trustee's proposal to reject is unassailable on the ground of business judgment, as will usually be the case, then an objecting lessor must fall back on the argument that the slight economic advantage of rejection to the lessee is outweighed, in equity, by the severe economic consequences of rejection to the lessor. Under the "equitable principles" standard, a nondebtor party can oppose rejection on a showing of the disproportion between gain to the estate and loss to itself, but it should be noted that only a few reported cases have denied a trustee's exercise of the rejection option on this ground.[60]

Opposing Assumption

A lessor may have sound reasons for preferring that the unexpired lease be rejected, for instance where the lessor is confident that rejection will not lead to a tax loss due to past use of the equipment or structural problems in the lease, and where a credit-worthy third party is ready to re-lease the equipment, obviating the problem of a subsequent foreclosure sale initiated by the lender. A lessor who wishes to oppose assumption of an unexpired lease in which a prior lessee default[61] has occurred has a fair chance of success, given the statutory requirements of cure, compensation and adequate assurance of future performance which the trustee must satisfy.[62] If the lessor's economic analysis indicates that rejection (with a possible re-leasing of the equipment to a more solvent lessee) is the preferable outcome, then the lessor could take the position that adequate assurance of future performance is simply not a possibility, given the magnitude of the contractual tax indemnity obligations measured against the demonstrated inability of the lessee to manage its affairs on a sound footing.

If prior defaults under the tax indemnity itself exist, for instance a recapture of realized tax benefits for which the lessor has not been reimbursed, then the lessor can and should demand strict cure as a condition of assumption. If the lessor has suffered other pecuniary loss as a consequence of lost tax benefits, then compensation for such loss can equally well be demanded as a condition to assumption. Finally, as noted above, the lessor should demand assurances of future performance predicated on maximum liability under the tax indemnity agreement in an attempt to persuade the court that assumption should be denied.[63]

In the hard bargaining atmosphere of a lessee reorganization under Chapter 11, a lessor should be prepared to negotiate and compromise. If the lessor's own economic analysis of the consequences of assumption or rejection indicates a clear preference, and if the lessor has any bargaining leverage, compromise rather than insistence on the strict terms of the statute may yield the better result for the lessor.[64] The judicial encouragement of negotiation in lieu of rejection, noted in the previous section on rights and obligations in a lessee bankruptcy, applies as well to the nondebtor parties to an unexpired lease.

PREVENTING FORECLOSURE SALE OF THE EQUIPMENT

If the trustee rejects the lease and the lender forces the equipment to be sold, significant tax problems may arise for the lessor. Depending on the circumstances, the lessor may wish to prevent the sale and arrange to lease the equipment to a third party.

As noted earlier, the lender may attempt even prior to rejection to foreclose its security interest in the lease and equipment against the lessor. The lender would be unable to disturb the trustee's possession of the leased equipment prior to rejection, due to the automatic stay of section 362 as well as to the statutory right to assume the lease afforded the trustee by section 365. However, the lender could argue that it should be allowed to foreclose the lessor's interest in the lease and equipment (including the reversionary interest) immediately upon commencement on the grounds that commencement of the lessee bankruptcy is a defined event of default in the security agreement and the statutory invalidation of *ipso facto* clauses is strictly a protection for the party in bankruptcy with no application to nondebtor parties (lessor and lender).

A lessor should oppose an immediate lender foreclosure by arguing that the same considerations which require treatment of the lease as an integrated whole for assumption purposes require evenhanded application of the automatic stay and invalidation of *ipso facto* default clauses.[65] A lessor could further claim that the *ipso facto* clause in the security agreement is dependent on the validity of the same clause in the lease itself, and thus is necessarily invalidated by section 365(b)(2). Finally, the lessor should argue that recognition by the court of lessee bankruptcy as an incurable default is inequitable and would work a forfeiture.[66]

Whether or not the act of lessee bankruptcy alone is sufficient, a rejection under section 365 clearly constitutes a default under the lease which permits the lender to declare a default under the finance agreement and the promissory notes. Such a declaration causes payment of the outstanding principal balance of the notes to be accelerated, thereby enabling the lender to cause the equipment to be sold to pay off the notes.

A foreclosure sale of the equipment may give rise to immediate investment tax credit recapture and taxable gain to the lessor. If property on which the investment credit has been claimed has been disposed of, the taxpayer must "recapture" or pay additional taxes based on the credit taken in the year of the disposition.[67] The amount recaptured starts at the full ten percent credit if the sale occurs in the first year of the lease, decreasing two percentage points each year so that after five years, no amount is recaptured if a sale takes place.[68] The additional tax liability can be quite significant. For example, if the foreclosure sale takes place in the fourth year of the lease, and the original equipment cost was $10 million, the lessor would be required to pay an additional $400,000 in income taxes (four percent of the $10 million cost).

In addition to this investment credit recapture, the lessor will be required to recognize as a gain an amount equal to the outstanding principal balance of the debt at the time of sale (plus any proceeds the lessor receives from the sale), reduced by lessor's tax basis in the equipment.[69] All of this gain will be taxed as ordinary income because of the depreciation recapture rules,[70] again potentially resulting in a large tax burden to the lessor. As a result, the lessor may, depending on the surrounding economics, wish to prevent a foreclosure sale of the equipment following rejection of the lease.

In theory, a lessor is automatically protected from the adverse tax consequences of a foreclosure sale by either the tax indemnity agreement or the remedies section of the lease. In particular, the remedies section contains a liquidated damages clause under which, in the event of a default, the lessor is entitled to the return of the equipment and a payment equal to the casualty loss value of the equipment reduced by its fair value. The casualty loss values are computed so as to maintain the lessor's net yield in the transaction despite the early termination, including reimbursement for the recaptured investment credit and earlier recognition of income.

There is substantial doubt that the liquidated damage clause in the lease or the comparable damage provision in the tax indemnity will, as a legal and practical matter, fully protect a lessor following a foreclosure sale of its interest in the equipment. Rejection of the lease gives rise to an unsecured claim by the lessor under the remedies provision which may be subject to challenge by unsecured creditors of the lessee as not fully allowable.[71] Even if allowed, such a claim will entitle the lessor only to share *pro rata* with other unsecured creditors.[72] As a result, a lessor may suffer significant and unreimbursed tax liability upon a foreclosure sale of the equipment following rejection of the lease.

It may therefore be in the lessor's best interests to try to prevent the foreclosure sale and arrange for leasing the equipment to another party. The finance agreement contains a provision which would allow the lessor to stop the sale. In the event of a default, the lessor is permitted to repurchase the notes for their outstanding principal balance (plus accrued interest and costs), thereby paying the lender in full and terminating its security interest. If interest rates have fallen below the rate set forth in the notes, or the equipment has a sale or rental value in excess of the debt, the lessor may wish to elect this procedure even if tax considerations are not paramount. However, if another favorable lease can be arranged, repurchase of the notes will be even more attractive, since the lessor can avoid any investment credit recapture and immediate recognition of gain caused by a sale of the equipment. If the lessor is unwilling or unable to repurchase the notes in full, it may try to reach an accommodation with the lender under which the sale is postponed and the equipment is leased to a third party.

In summary, a lessor may suffer significant additional tax expense if equipment is sold following rejection of the lease. Although the lease and tax indemnity purportedly require a lessee to compensate the lessor for this expense, the lessor will probably not receive more than a small fraction of the reimbursement from the estate. Depending on a number of other variables at the time of rejection (including the current level of interest rates, the value of the equipment and the presence of other potential lessees), the lessor may find it advisable to prevent the foreclosure sale of the equipment and arrange for re-leasing it to a third party.

FILING PROOF OF LESSOR CLAIMS

At the time a lessee bankruptcy is either imminent or an accomplished fact, the lessor should protect its interests under the tax indemnity by gathering as much information as possible. All claims, either for prior defaults or for unmatured lessee obligations under the unexpired lease, must usually be asserted by the lessor in the bankruptcy proceeding or be forfeited. A lessor's sole protection against involuntary waiver of a claim is accurate information both as to prior acts of the lessee which may trigger loss of tax benefits and as to other factors (e.g. changes in interpretation of the tax laws) which may similarly entail loss or recapture of tax benefits.

Assumption of the Unexpired Lease

When the trustee proposes to assume an unexpired lease with prior defaults, there is strictly speaking no occasion for a lessor to file a "proof of claim."[73] Until the unexpired lease is rejected, the lessor is neither a creditor nor a claimant, but rather is the holder of a right to demand cure, compensation and adequate assurance of future performance as a precondition to assumption.[74]

Whether a lessor intends to support or oppose the trustee's proposed assumption of the lease, full protection of the lessor's interests requires knowledge of all past defaults under the tax indemnity and prior acts of the lessee which may give rise in the future to tax liability for the lessor. If the tax indemnity agreement provides that the lessee's obligation to reimburse the lessor matures only after a "final determination" of tax liability has occurred, only the lessee's failure to respond to such a prebankruptcy final determination would constitute a default requiring cure under section 365(b)(1)(A).

A lessor can demand, however, that the lessee provide "adequate assurance" of its ability to reimburse the lessor for future "final determinations" which are certain, likely or only possible due to past acts of the lessee or another trigger giving rise to an indemnity payment.[75] The more information a lessor can bring to bear on its own tax exposure after assumption of the lease, the more assurance will the lessor be able to demand from a reorganized lessee.

A court would surely require adequate assurance of lessee ability to discharge an obligation which was certain to arise during the term of the tax indemnity,[76] and would likely require assurance of some sort of lessee ability to discharge an obligation which would probably arise in the future. Whether the court would compound the lessee's burden by demanding assurance of performance of obligations which may never arise is unclear, but counsel for the lessor is not foreclosed by any provision of the Bankruptcy Code from requesting such assurance.[77]

Rejection of the Unexpired Lease

If a legitimate demand for adequate assurance prior to assumption has been involuntarily waived by a lessor due to inadvertence, the lessor will have another opportunity to make itself whole in the future by demanding its contractual reimbursement from the reorganized lessee when and if the contingency occurs. The case is otherwise with a rejected lease—claims which are not filed do not share in the distribution of assets and are usually discharged upon liquidation or confirmation.[78] A lessor should protect itself in the event of the rejection of the unexpired lease, including the tax indemnity agreement, by assembling all its claims for filing under section 502(g) so that its distribution will be as large as possible.

The Rules of Bankruptcy Procedure provide a statutory tool for a lessor to obtain information concerning past acts of a lessee which may trigger loss of tax benefits.[79] Rule 205 provides that a "party in interest"[80] may obtain a court order to examine "any person" (including the debtor) on "any matter which may affect the administration of the bankrupt's estate."[81] As a supplement to the lessor's independent efforts to determine its maximum allowable claims under the breached tax indemnity, the Rule 205 examination, conducted under oath, may prove useful.

Rejection of the unexpired lease constitutes a statutory breach, deemed to have occurred prior to the petition and on a par with other nonpriority, unsecured claims.[82] Upon approval of rejection by the court, a lessor should file proof of all claims pursuant to section 501(a) and (d).[83] A claim filed under section 501 is "deemed allowed" unless a "party in interest" objects.[84] If an objection is made to the lessor's claims, the court, after a hearing on the issue, will determine the amount of claim and allow such amount for *pro rata* distribution.[85]

A lessor can anticipate objections to its more speculative claims both from the trustee and from the other unsecured creditors. Since distribution to the unsecured creditors is made *pro rata* after payment of priority claims,[86] all unsecured creditors have a direct economic interest in disputing large claims which will diminish their own participation in the limited assets available for distribution.

Lessor claims after rejection will likely fall into one of the following categories: (1) Claims for final determinations which have occurred prior to the filing of the proof of claim. Since these claims, if they exist, are liquidated and noncontingent, they should be allowed. (2) Claims for suspected or threatened loss of tax benefits. Examples of this class would be a preliminary assertion by the Service that the lessor was not the first user or that the lease was not a true lease. A threatened foreclosure sale of the equipment also falls within this class. Since these claims are both contingent and unliquidated, the estimation procedure of section 502(c)(1) will be invoked to assign a value. A lessor can and should submit its own valuation to counter the low valuations or absolute objections likely to be submitted by objecting creditors. (3) Claims for liabilities which are neither threatened nor suspected but which may, nonetheless, attach after discharge due to predischarge acts of the lessee. This class of claims, which the lessor cannot support with proof, might well be disallowed as simple speculation. A lessor should, however, submit a claim for loss of indemnity against the unknown and should attempt to persuade the court that absolute disallowance of this claim would work an inequity.

The uncertainty of allowance of lessor claims which are unsupported in the factual record suggests that only thorough and complete investigation of the lessee's prior activities under the lease and use of the leased equipment will ensure the allowance of all lessor claims under the tax indemnity agreement breached by rejection of the unexpired lease.

Conclusion

Tax indemnity agreements are generally enforceable in lessee bankruptcy proceedings, but they will not always be effective to protect lessor's tax benefits. This effectiveness depends in large part on whether the trustee assumes or rejects the lease, of which the tax indemnity should be considered an inseparable part. A lessor will usually be entitled to the full benefit of the tax indemnity if the lease is assumed, in which event past defaults must be cured and adequate assurance of future performance must be given. If, on the other hand, the lease is rejected, the lessor may face additional tax liabilities through foreclosure sale of the equipment, may remain totally uncompensated for losses of tax benefits not yet liquidated by the time the case is closed and, in any event, will only be entitled to recovery of a small fraction of its allowable claims as an unsecured creditor of the lessee. Each of these potential consequences should be considered by a lessor in addressing the broader questions of whether to support or oppose assumption or rejection of the lease, how to deal with the lender and the manner of identifying and pressing claims for loss of tax benefits in lessee bankruptcy proceedings.

FOOTNOTES

1. The example used includes only a single lessor, lessee and lender. In many transactions, the equity participant (or participants) forms a grantor trust to act as lessor. If there are multiple lenders, an indenture trustee may also be used to administer their role in the transaction. *See generally* B. Fritch & A. Reisman, Equipment Leasing-Leveraged Leasing 235 (1980). In addition, performance of lessee obligations under the lease and/or tax indemnity agreement could be secured through the grant of other collateral to the lessor, a guarantee of lessee obligations by its corporate parent, if any, or the issuance of a standby letter of credit by a bank.
2. The Internal Revenue Code of 1954, as amended, generally permits a taxpayer to carry net operating losses in a particular year back to earlier years, and forward to later years, to offset taxable income in those years. I.R.C. § 172 (C.C.H. 1983).
3. A number of measures are commonly used in ascertaining current value, including "fair market value" or "discounted fair market rental value," determined in either case by agreement or by appraisal, or the sales price if the equipment is in fact sold.
4. The lessee may or may not indemnify the lessor against state and local

income or franchise taxes incurred by the lessor in connection with the lease. The lessee typically also indemnifies the lessor (and the lender) against other liabilities, including all other tax liabilities arising from the purchase or use of the equipment (except for taxes based on or measured by the lessor's net income) and all other liabilities of any kind arising out of the use or operation of the equipment.

5. The lessor generally will be considered the owner of the equipment for federal income tax purposes if it bears significant and genuine attributes of ownership. *Frank Lyon Co. v. United States*, 435 U.S. 561, 584, (1978); *cf. Oesterreich v. Comm'r.* 226 F.2d 798, 802 (9th Cir. 1955); Rev. Rul. 55-540, 1955-2 C.B. 39 (each setting forth a number of factors to consider). Solely for purposes of deciding whether it will issue an advance ruling with respect to a leveraged lease transaction, the Service has issued a set of guidelines containing much stricter rules than set forth in the cases and published rulings. Rev. Proc. 75-21, 1975-1 C.B. 715; Rev. Proc. 75-28, 1975-1 C.B. 752; Rev. Proc. 76-30, 1976-2 C.B. 647; Rev. Proc. 79-48, 1979-2 C.B. 529.

6. Code section 38 permits a lessor an investment tax credit equal to ten percent of the tax basis of most kinds of new personal property placed in service during the year. I.R.C. §§ 46(a)(2)(B), 46(c)(1), 46(c)(7) & 48(b) (C.C.H. 1983). Code section 48(q) requires the depreciable basis of property with respect to which the ten percent investment credit has been claimed to be reduced by one-half of the credit, or five percent. However, the lessor is not required to reduce its basis in this manner if it claims only an eight percent, rather than ten percent, credit. The Code also allows an additional "energy credit" in the case of certain kinds of "energy property." *Id.* § 46(a)(2)(A)(ii). Although the extra energy credit will not be discussed further, its availability in a particular transaction will increase the lessor's tax benefits, as well as the potential risk if the benefit is required to be recaptured.

7. Code section 168 prescribes allowable depreciation deductions for most kinds of tangible property acquired after December 31, 1980. I.R.C. § 168 (C.C.H. 1983). Eligible property is classified into five "recovery classes," with each class having its own specified schedule of depreciation deductions. *Id.* § 168(c). It is assumed here that the property under lease is "5-year property," the class into which most leased personal property will fall.

8. The full ten percent investment credit is available to the lessor only if the equipment is "new section 38 property," or property owned by the taxpayer at the time it is first used, or ready or available for use. *Id.* § 48(b). If the equipment had been used by the lessee (or had been ready for use) before having been acquired by the lessor, the equipment would constitute "used section 38 property," only $125,000 of the cost of which qualifies for the investment credit each year. *Id.* § 48(c). Given the cost of the equipment under lease, the lessor would obviously lose a significant portion of the investment credits if the equipment were deemed "used" at the time the lease was entered into.

9. With certain exceptions, property used predominantly (more than 50 percent of the time) outside the United States does not qualify for the investment credit. *Id.* § 48(a)(2)(A). If property initially eligible for the investment credit is used in a manner which would have made it ineligible (such as by using the property predominantly outside the United States in a subsequent year), or if the property is sold or transferred, all or a portion of the investment credit claimed is recaptured, i.e., required to be paid as additional tax in the year of such use or sale. *Id.* § 47. See section on preventing foreclosure sale of the equipment, *infra.*

10. See section on preventing foreclosure sale of the equipment, *infra.*

11. Bankruptcy Reform Act of 1978, Pub.L.No. 95-598, 92 Stat. 2549 (codified at 11 U.S.C §§ 101-151326).

12. See section on preventing foreclosure sale of the equipment, *infra.*

13. 11 U.S.C. § 365(a). All future references to sections are to 11 U.S.C. §§ 101 *et seq.* unless otherwise indicated. The language of section 365(a), quoted in the text, overrules cases decided under the superseded Bankruptcy Act by establishing that any unexpired lease, whether or not it meets the criteria developed for executory contracts, may be assumed or rejected by the trustee. Leases of personal property, as well as of real property, are controlled by this section. *See, e.g., In re OPM Leasing Services, Inc.*, 21 B.R. 993 (S.D.N.Y. 1982).

14. 11 U.S.C § 1107(a). Chapter 7, governing liquidation, does not provide for a debtor in possession.

15. Except for the right to compensation for its services. *Id.*

16. *In re LHD Realty Corporation*, 9 B.C.D. 361 (S.D. Ind. 1982); *In re Italian Cook Oil Corp.*, 190 F.2d 994 (3d Cir. 1951).

17. If the tax indemnity is not incorporated into the lease instrument but is a separate document with its own recitals and covenants, the lessee could argue that the indemnity is in fact a related but separate undertaking which the lessee should be allowed to reject, thus relegating the lessor to its allowable claims for damages, while assuming the unexpired term of the lease itself. This argument should fail in light of the principle that the trustee assumes a lease *cum onere* [with all of its obligations] (see cases cited in note 16, *supra*) and in light of the fact that the indemnity clearly forms an integral part of the consideration passing to the lessor for executing the lease. Careful draftsmanship by the lessor could preclude even the possibility of the lessee's

attempted severance of the lease and the indemnity. The indemnity could be integrated into the lease document itself or, if a separate document, could clearly cross-reference the lease and recite that the consideration for lessee indemnity obligations is the execution of the lease.

18. The lessor could argue that the indemnity necessarily survives lessee rejection of the lease on the ground that it is analogous to a guaranty executed by the lessee in return for an obligation of the lessor (execution of the lease) which has been fully performed. On this theory, the lessor would attempt to sever the executory obligations of the lease (payment of rents by the lessee in consideration of quiet enjoyment of the leased equipment) from the fully performed obligation (execution of the lease) for which the indemnity was the agreed consideration. A version of this argument was unsuccessfully attempted by a franchisor in *In re Rovine Corp.*, 6 B.R. 661 (W.D. Tenn. 1980), who claimed that a noncompetition covenant necessarily survived rejection of a franchise agreement by the trustee of the bankrupt franchisee. The court in *Rovine* simply reiterated that a lease must be rejected or assumed in its entirety, and included the noncompetition covenant with the rejected franchise.

19. The case authority supports this result. *See* cases cited in notes 16 and 18, *supra.* A concise statement of the judicial insistence on totality of rejection or assumption is contained in *In re A.R. Dameron & Associates, Inc.*, 1 C.B.C.2d 1110, 1113 (N.D. Ga. 1980): ". . . the lease contract must be construed as a whole by the court and not torn apart and construed in pieces" [citations omitted].

20. *See, e.g., Finn v. Meighan*, 325 U.S. 300 (1945).

21. 11 U.S.C § 365(d)(1). In a voluntary case, the filing of the petition constitutes the order for relief. *Id.* § 301. In an involuntary case, an order for relief must be entered by the court either upon default of the debtor or upon proof of the prerequisites for involuntary relief. *Id.* § 303(h).

22. *Id.* § 365(d)(2).

23. *Id. See, e.g., In re New England Carpet Co.*, 8 B.C.D. 1121 (D. Vt. 1982); *Theatre Holding Co. v. Mauro*, 9 B.C.D. 263 (2d Cir. 1982); *In the Matter of Russell Johns*, 1 C.B.C. 2d 174 (D. Nev. 1979).

24. 11 U.S.C. § 363(e) provides that an "entity" with an interest in property used by the estate may request "adequate protection" of its interest.

25. *Id.* § 361. The details and interworkings of sections 361 and 363 are beyond the scope of this article.

26. *Id.* § 362 provides, in brief, that acts, whether judicial or private, against property in which the debtor has an interest (including a leasehold interest), which acts would be otherwise proper, are stayed by the filing of a petition in bankruptcy. A party may petition for relief from the stay (section 362(d)), but such relief would be denied pending trustee exercise of the option to assume or reject.

27. *Id.* § 365(b)(1).

28. *In re Lafayette Radio Electronics Corp.*, 4 C.B.C. 2d 220 (E.D.N.Y. 1981); *In re A.R. Dameron & Associates, Inc.*, 1 C.B.C.2d 1110 (N.D. Ga. 1980).

29. *In re Greco*, 1 C.B.C.2d. 619 (D. Hawaii 1980); *In re Luce Industries, Inc.*, 4 C.B.C.2d 355 (S.D.N.Y. 1981).

30. 2 Collier on Bankruptcy, ¶ 65.04[1] (15th ed. 1979). If the lease contains no cure provision for a nonmonetary default, or if the default is literally incurable, the court is free to approve a cure which gives the nondebtor party the benefit of its bargain. *Id.*

31. *See, e.g., In re Belize Airways, Ltd.*, 5 B.R. 152 (S.D. Fla. 1980); *In re Taylor Manufacturing, Inc.*, 6 B.C.D. 1161 (N.D. Ga. 1980).

32. 11 U.S.C. § 365(f).

33. The trustee may neither assume nor assign a contract in the nature of a personal services contract or a financial accommodation. 11 U.S.C. § 365(c), 365(e)(2). Since the usual equipment lease falls outside both of these categories, this limitation will not be further considered.

34. *Id.* §§ 365(f)(2)(A), 365(f)(2)(B).

35. *In re Sapolin Paints, Inc.*, 5 B.R. 412 (E.D.N.Y. 1980). One peculiarity of an assignment of a lease with a tax indemnity is the uncertain status of the lessor's future claims for loss of tax benefits triggered by pre-assignment acts of the lessee. Since it is doubtful that any assignee would consent to indemnify the lessor against tax liability which may attach after assignment but be triggered by pre-assignment activity of the lessee, the lessor may attempt to require a continuing indemnification from the lessee, in the nature of a bond, against such liability as an element of "adequate assurance."

36. 11 U.S.C. § 365(a).

37. 318 U.S. 523 (1943).

38. *E.g., American Brake Shoe & Foundry Co. v. New York Rwys.*, 278 F. 842 (S.D.N.Y. 1922).

39. *Dushane v. Beall*, 161 U.S. 513 (1896).

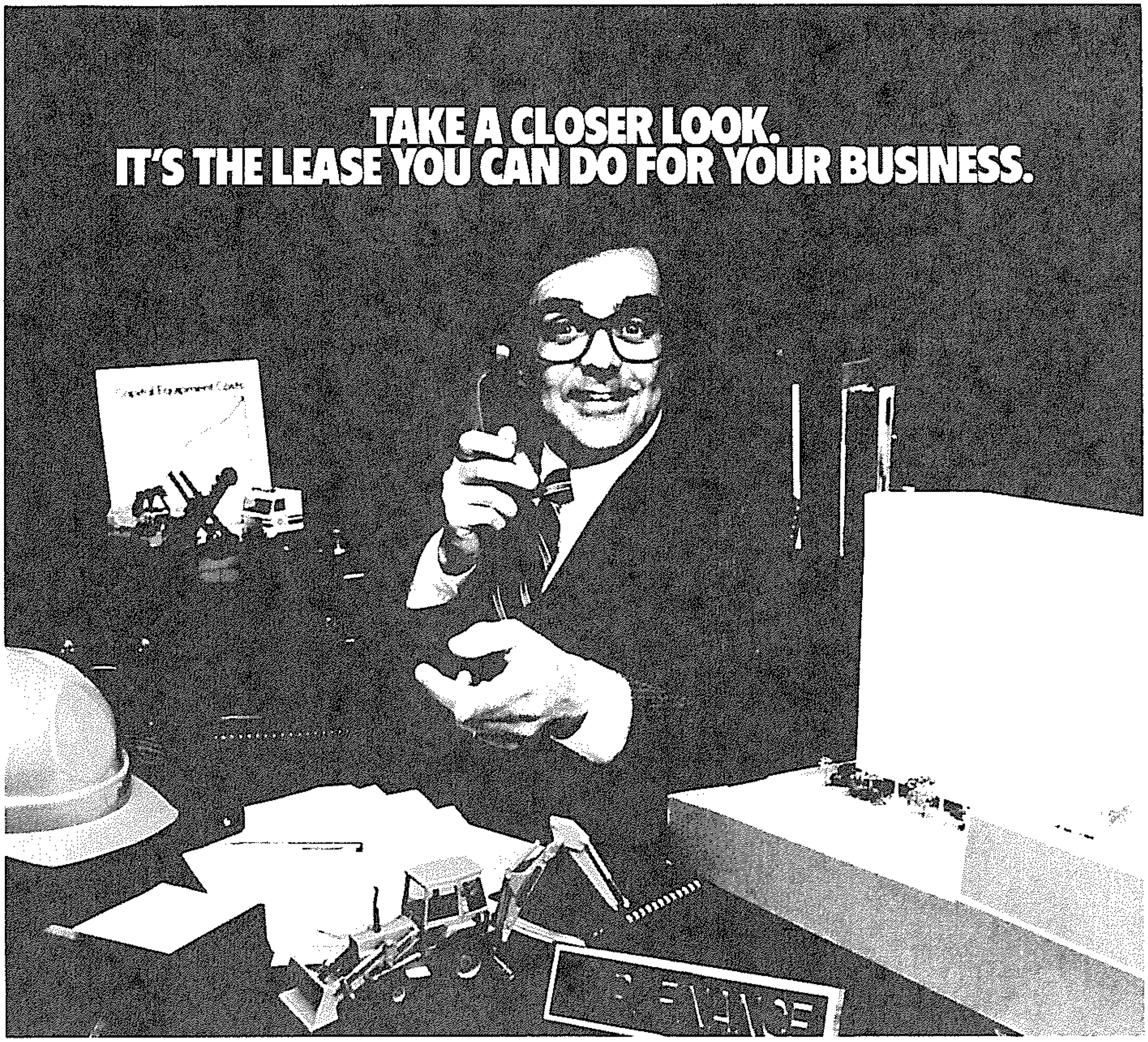
40. *Group of Institutional Investors*, note 37, *supra*, was a railroad reorganization case. The argument that only cases similarly affected with the public interest should apply the business judgment test was rejected in *In re Minges*, 602 F.2d 38 (2d Cir. 1979). The following cases all have applied the business judgment test. *In re J.H. Land & Cattle Co.*, 3 C.B.C.2d. 695 (W.D. Okla. 1981); *In re Marina Enterprises, Inc.*, 8 B.C.D. 59 (S.D. Fla. 1981); *In re High Fliers, Ltd.*, 7 B.C.D. 747 (S.D. Cal. 1981).

41. *In re Minges*, 602 F.2d 38 (2d. Cir. 1979); *In re Penn Central Transportation Co.*, 458 F.Supp. 1346 (E.D. Pa. 1978); *Matter of U.L. Radio Corp.*, 6 C.B.C.2d 430 (S.D.N.Y. 1982).

42. *In re Penn Central*, note 41, *supra*, [rejection by lessor of leases in railroad reorganization]; *Brotherhood of Railway, etc. v. REA Express, Inc.*, 523 F.2d 164 (2d. Cir. 1975) *cert. den.*,

423 U.S. 1017 (1975); *Shopman's Local 455 v. Kevin Steel Products, Inc.*, 519 F.2d 698 (2d. Cir. 1975) [rejection of collective bargaining agreements].

43. *In re Minges*, note 40, *supra*.
44. *Group of Institutional Investors v. Chicago Milwaukee, St. Paul & Pacific R.R. Co.*, 318 U.S. 523 (1943); *Brotherhood of Railway etc. v. REA Express, Inc.*, 523 F.2d 164 (2d Cir. 1975).
45. 11 U.S.C. §§ 365(g)(1), 365(g)(2)(A).
46. *Id.* § 502(g).
47. *Id.* §§ 501, 502(a).
48. *Id.* § 101(4)(A).
49. *Id.* §§ 726, 727, 1141(d)(1)(A). The plan will ordinarily include provision for *pro rata* payment of allowed claims.
50. See discussion in 3 Collier on Bankruptcy, ¶ 502.03 (15th ed. 1979).
51. 11 B.R. 294 (N.D. Ohio 1981). The pending Johns-Manville bankruptcy could require similar estimation. *In re Johns-Manville Corp.* (Bk. Ct. S.D.N.Y. Aug. 26, 1982).
52. 11 U.S.C. § 507.
53. *See* D. Epstein & J. Landers, Debtors and Creditors 629 (1978).
54. 11 U.S.C. §§ 101(4), 502(g).
55. This is the usual test for rejection. *See* note 40, and authorities there cited.
56. This is the standard applied by some courts in cases involving extraordinary hardship for nondebtor parties.
57. 11 U.S.C. § 365(f).
58. Cure of previous defaults, other than *ipso facto* defaults, is a precondition for assumption and assignment. *Id.* §§ 365(b)(1), 365(f).
59. Since prior defaults would usually be in the nature of delinquent rentals, any compromise may of necessity involve satisfaction of the lender, the assignee of the rents.
60. *See* notes 41-43, *supra*, and accompanying text.
61. If there has been no prior lessee default, or if the only default has been the bankruptcy itself, then the lessor is powerless to prevent assumption.
62. 11 U.S.C. § 365(b)(1).
63. The lessor will be handicapped in this attempt by the lack of any "experience rate" developed by the industry which could serve as support for a lessor claim that loss of tax benefits will occur in the future.
64. Section 365(b)(1), the conditions for assuming an unexpired lease in default, may be partially waived to effectuate such a compromise.
65. If the lender attempts to foreclose the lessor's interest in the lease and equipment, it will probably file an action in the proper state court. The lessor could either defend in the state court or, more likely, seek injunctive relief from the bankruptcy court where the lessee's case is pending.
66. *See, e.g., Brown v. Avemco Inv. Corp.*, 603 F.2d 1367 (9th Cir. 1979).
67. I.R.C. § 47 (C.C.H. 1983).
68. *Id.* § 47(a)(5)(B).
69. *Id.* § 1001; Treas. Reg. § 1.1001-2(a).
70. Code section 1245 requires that any gain recognized on sale of an asset will be treated as ordinary income to the extent of past allowable depreciation deductions. I.R.C. § 1245 (C.C.H. 1983).
71. If the lessor attempts to submit a claim for a threatened sale of the equipment by a foreclosing lender after rejection, such a claim could be opposed by the trustee and the unsecured creditors of the lessee on two grounds: First, the damage on which this claim would be grounded (loss of tax benefits) is avoidable by the lessor, in that the lessor has the contractual option to repurchase the notes from the lender and thus avoid the sale. The unsecured creditors could claim that the future damages will be, if they occur at all, self-inflicted, and that the lessee's estate should not be diminished by inclusion of such a claim. Second, those opposing the claim could characterize the threatened sale in foreclosure as essentially a workout between the lessor and the lender which should not be allowed to impact on the distribution of the lessee's assets to creditors who have no similar options.
72. See discussion on allowance of claims in the section on filing proof of lessor claims, *infra*.
73. "Proof of claim" is a term of art in the Bankruptcy Code, a description of the means by which creditors and equity security holders present their claims or interests to the bankruptcy court so that such claims may be allowed for purposes of distribution of the debtor's assets. *See* 11 U.S.C. §§ 501, 101(4).
74. *Id.* § 365(b)(1).
75. *Id.* § 365(b)(1)(C).
76. The usual tax indemnity agreement will, by its terms, survive the expiration of the lease itself.
77. The problems of estimating the quantum of assurance required for obligations which are probable or possible is not treated in the Bankruptcy Code. The procedure for estimating contingent and unliquidated claims, 11 U.S.C. § 502(c)(1), might be relevant for this purpose.
78. *Id.* §§ 727, 1141(d)(1)(A).
79. The Bankruptcy Reform Act of 1978 provides, in section 405(d), that the Bankruptcy Rules, to the extent not inconsistent with the Reform Act, remain in effect until superseded or repealed.
80. "Party in interest" is undefined in the Bankruptcy Code, but is in practice given a broad scope.
81. Rule 205(a), (d).
82. 11 U.S.C. §§ 365(g), 502(g).
83. Prior defaults are transformed into claims by rejection, and all remaining unperformed obligations of the lessee under the lease are also "claims." See 11 U.S.C. § 104(4).
84. 11 U.S.C. § 502(a).
85. A claim otherwise allowable may fail if it falls into one of the enumerated categories of section 502(b).
86. *Id.* §§ 726, 1123, 507.



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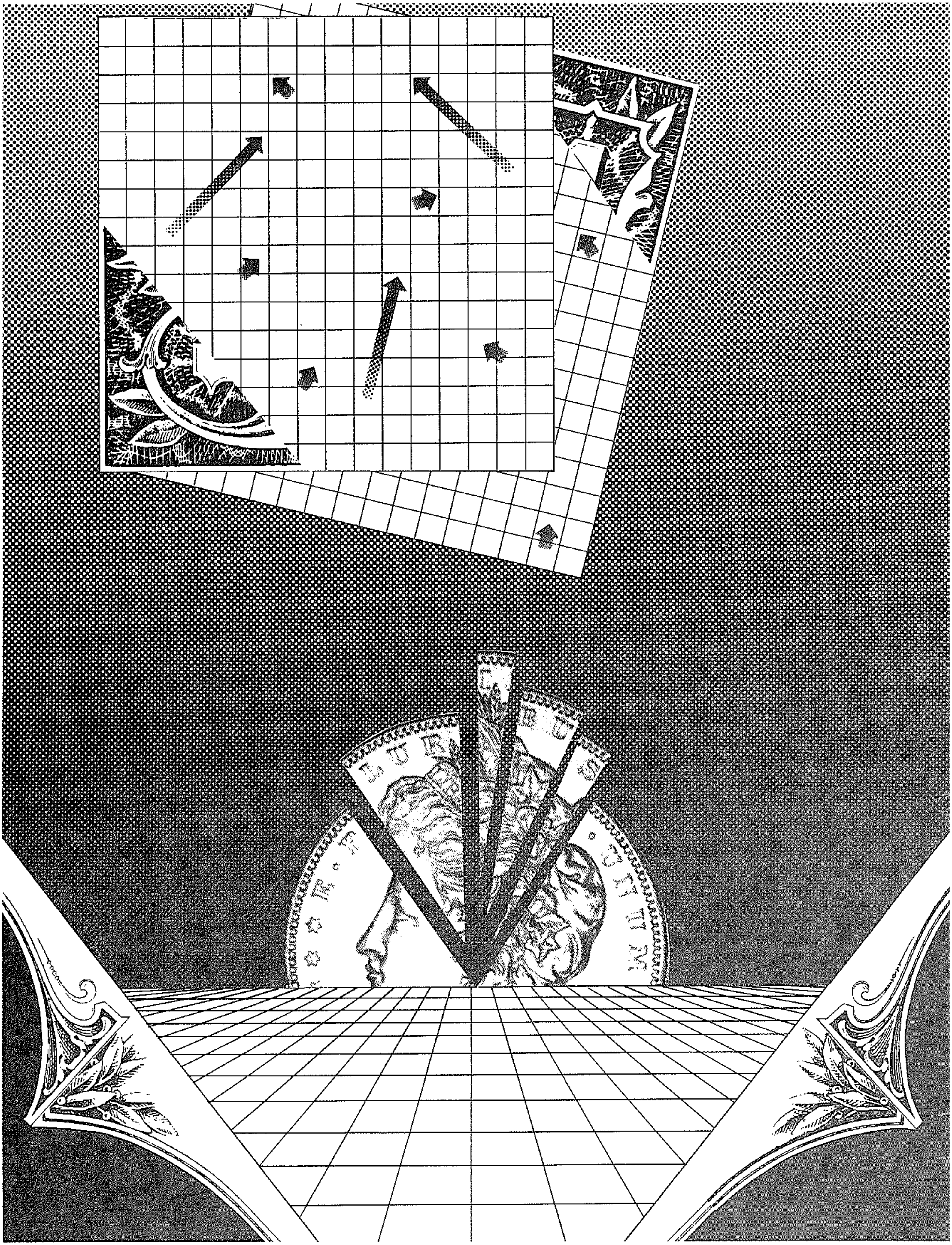

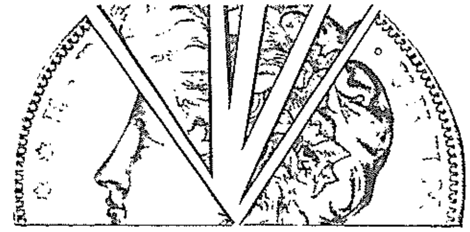

Managing a Diversified Portfolio

by S. Ronald Stone

This article offers observations regarding management of a diversified portfolio and comments upon the problems and opportunities dealt with by a multi-product leasing and finance organization on a day-to-day basis.

First, let us define a multi-product portfolio as lease/secured-loan receivables which include (i) commercial, industrial, professional, and municipal lessee/debtors located throughout the U.S. involving leased assets/collateral consisting of all types of equipment (and in some cases real estate), from the so-called big-ticket items (i.e. aircraft) down to items under $10,000; (ii) all types of transactions such as working capital loans, leases (both tax-oriented and lease/ purchase transactions), sale lease-backs, portfolio acquisitions,[1] revolving loans[2] and vendor programs all written at rates which are fixed, floating or a combination of both.

Defining the Market

By definition then, a diversified company can theoretically undertake *any type* of term *financing* with *any customer*. As a practical matter, however, such is not the case. Several factors may affect where effort is placed. In the case of a corporate subsidiary or division, various *corporate objectives* must also be considered, such as realizing a specified rate of return on the assets employed within the subsidiary or division. Also, inherent in every company are factors which limit the areas in which it can *effectively compete* in order to meet its *corporate objectives*. For example, (i) the cost of funds (or the cost that a division is charged for use of company funds); (ii) a company's need for tax shelter; (iii) legal restrictions (such as those that restrict subsidiaries of a one bank holding company from entering into operating leases); (iv) company policies (i.e. thou shall not enter into transactions in excess of five years *or* offer fixed rate financing or book residuals or have more than 10% of your outstandings invested in any one customer or fix purchase options as a percentage of equipment cost). Illustratively, a company policy that precludes booking residuals of any amount will severely limit its ability to *effectively compete* in the leasing of equipment with high residual values (i.e. aircraft).

To summarize, then, the diversified leasing/financing company, while theoretically a "full-service" organization, in fact is not, and its first objective is to *identify those areas in which it can effectively compete*, taking into consideration corporate objectives and company limitations.

Prioritizing Efforts

Having defined, in a general way, the areas in which you can effectively compete, the next step is to prioritize those areas in order *to concentrate efforts and resources. This is an ongoing process* and priorities can and should change. Always:

(a) Consider corporate objectives; for example, if a corporate goal is to increase the return on assets, the generation of *fee* income may take on added importance; on the other hand, if the immediate corporate goal is to build assets or dollar earnings, portfolio growth may take priority.

(b) Analyze the markets having the most growth potential keeping in mind that entry into a market at the wrong time can prove costly and counterproductive.

(c) Consider existing strengths. For example, if a company has traditionally been successful as a big-ticket lessor, this market would ordinarily continue to enjoy a top priority *viz a viz* that company's total activities unless there is a compelling business reason to redirect efforts. In other words, identify strengths and exploit them.

Organizing

Having identified the products that are intended to be offered and the areas in which the firm can effectively compete, it's obvious that the company must obtain and organize the people and other resources needed to meet its objectives. As an example, a broad product mix could include among other items, (i) tax-oriented leasing transactions and money on money transactions; (ii) municipal lease/purchase financing; (iii) specialized financing in the communications areas (cable, T.V. and radio); and (iv) a variety of fee income programs.

The author is vice president/operations, of the Heller/Chandler division of Walter E. Heller & Company, a diversified financial services firm.

Sales

One strategic approach for firms with a variety of products to sell, requires that salespersons although specialists, must also be generalists. The sales staff should have a detailed knowledge of the products they are primarily responsible for selling and a working knowledge of the total products offered by their own and other divisions of the parent company. They should be trained to spot opportunities in every area and, when appropriate, to refer the matter to the particular salesperson that specializes in that area. A sales compensation program can be designed to encourage such referrals. Training, initially, and on an ongoing basis, is an ingredient crucial to the development of an effective multi-product sales force. Establishing a comprehensive in-house training program for new sales personnel is a must, providing an overall perspective of product mix, an exposure to the credit philosophy of the company, as well as documentation policies and procedures. Equally important, the salesperson who may ultimately be in the field far from the workings of the home office should have the opportunity during the training program to meet the people in the home office who will ultimately be handling his transactions and to follow the flow of paperwork with respect to a deal.

Sales territories are often divided geographically with a regional manager heading each region. Sales personnel can specialize by product line or industry or they can be organized to reach a broader spectrum of clients. In any event, even a nonspecialist will tend to develop a product expertise in a market in which he is particularly successful. For example, if a sales person penetrates the machine tool market with good results, an expertise in that area will naturally develop.

A word about incentive sales compensation programs: While you should strive to maintain a consistency in the plan from year to year, the incentives can be varied depending upon the direction toward which you desire to move the company. Thus, if you desire to penetrate a certain industry, or emphasize a particular kind of business, you may increase the salesperson's compensation in that area, perhaps on a temporary basis, to redirect his efforts.

Credit

Credit responsibility may be centralized, localized or a variation of both. In many companies, credit decisions are made at the regional level within certain dollar limitations and thereafter at corporate headquarters. Likewise, credit personnel often qualify as generalists. This usually works well, except in certain areas, such as agricultural lending which is an area requiring a particular expertise. For a diversified company, it's important that the sales and credit mesh. For example, it's a waste of resources for the sales force to generate agricultural transactions if you lack the credit expertise to properly evaluate those applications.

Specialists

It is impossible to effectively compete as a middle-market diversified leasing company without a number of other specialists and specialties.

A sophisticated legal and tax capability is a must. Lawyers are required to grasp and document a wide variety of transactions within short time frames. Practicing preventative law is equally important. Fulfilling these tasks require an intimate knowledge of the business as well as the law, and therefore, I believe these needs are best served by in-house professionals, supplemented when required by outside lawyers. An in-house tax capability is also indispensable to leasing activities. The tax department, among other things, must manage tax appetite, handle compliance matters (i.e. personal property tax and sales/use tax returns for *all kinds* of equipment located throughout the U.S.) and should be constantly available to sales, legal, and credit personnel regarding all of the other tax aspects incident to tax-oriented leasing.

An in-house equipment department should also constitute an integral part of a leasing/financing operation. The department serves a number of indispensable functions. First, it should provide with each transaction a collateral[3] evaluation of each piece of equipment to be financed or leased. This evaluation should establish the liquidation value of the equipment throughout the term of the transaction, and, with respect to leased assets, an estimated fair-market value[4] of the equipment at lease end. The department also should handle the storage and disposition of all repossessed equipment and negotiates with existing lessees the purchase, re-lease, or return at lease end of all leased equipment. Managing the disposition of equipment at lease end is critical. The idea, of course, is to maximize income. Toward that end, companies can alternatively encourage the lessee to purchase the equipment or make it attractive to renew the lease. The value of the equipment at lease end and its remaining expected useful life determines which of these alternatives is marketed to the lessee.

A sophisticated electronic data processing system and an accounting department that understands the system are indispensable. Such a system should have the capability to generate billings, agings, financial statements, budget comparisons, payment histories, and a variety of other management reports (i.e. bookings broken down by type of transaction, salesman and area; equipment classification; equipment location; etc.) Naturally, a company must have the resources available to analyze, according to its specific criteria, the profitability inherent in any leasing transaction under consideration, be it a single investor transaction or a leveraged lease.

Controls

A brief word about controlling collateral: Different kinds of transactions require different checks. A leasing transaction, once booked, requires little administration, except perhaps an annual inspection of the leased asset. A revolving loan to a leasing company, on the other hand, requires hands-on management. This may include an analysis of periodic reports submitted by the borrower (including, but not necessarily limited to, financial statements), surprise examinations by a staff of field auditors, or a combination of both. The point to remember is that the "back room" (administration) must also mesh with your business objectives.

Additional Considerations

Let me briefly mention a few other important items. A subsidiary is often funded by the parent corporation on a matched funding basis. That is, if the division enters into a floating-rate[5] transaction with a lessee/borrower, the division borrows on a floating-rate basis from the parent. Likewise, for fixed-rate transactions, a division often borrows from the parent on a fixed-rate basis. The importance of matching assets and liabilities in an era of dramatic changes in the cost of funds is obvious.

Budgeting is also an important management tool. Budgets should be prepared on an annual basis for each profit/cost center, and budget-to-actual comparisons should be made on a monthly basis. Variations are, therefore, quickly identified so that corrective action can be taken.

This article attempts to deal with a broad topic with a broad brush. Management can sometimes be a maze with trial and error being the only alternative. Being ever cognizant of your objectives and the few basic principles outlined above will hopefully increase the chance of success.

Footnotes

1. *A portfolio acquisition* is the purchase, from a lessor, vendor, or finance company, of equipment lease receivables and/or installment sale contracts. The purchase can be with or without recourse to the selling party.

2. *Revolving loans* are periodic loans secured by the borrower's equipment lease receivables (as well as the underlying leased asset) and/or installment sale contracts. The loan is referred to as a "revolver" because it is paid down as the lease/installment receivables liquidate and is increased as new advances are made against new receivables generated by the borrower.

3. *Collateral value* is the value to the lessor/secured party of the leased/financed asset. This asset represents a source of recovery to the lessor/secured party if the lessee/debtor is unable to pay its obligation in full and, consequently, a lessor-secured party will ordinarily be concerned with the asset's liquidation value (what the asset will sell for in a distressed sale—usually a public auction). The anticipated value of the asset at the end of the lease, assuming a disposition in the ordinary course of business (i.e. not a distressed sale) is also important to the lessor.

4. *Fair market value* is the price for which a lessee usually can purchase the equipment at lease expiration. Lease agreements typically provide that the fair-market value of the equipment may be agreed upon between the lessee and lessor, or be decided by a third party by appraisal of the asset if the parties cannot agree.

5. *Floating rates* are rental/ installment payments that fluctuate throughout the term of the transaction depending upon movements in the prime rate of interest.