

Capital Leases Are Dead; Long Live Finance Leases

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Starting in 2019, public companies will need to adopt the new lease accounting rules set forth in the new Financial Accounting Standards Board (FASB) standard ASC 842 (Leases).

The new rules eliminate the defined term “capital leases,” which many credit agreements rely on to distinguish leases that will be treated as indebtedness from those that will not, and requires all leases to be reflected on the balance sheet of the lessee company. These changes affect both the general business covenants restricting indebtedness and liens, as well as many financial covenants that are based on debt levels. Surprisingly, many credit agreements still fail to specifically anticipate this change. As a result, lenders and borrowers alike will need to evaluate whether changes are required to their existing credit facilities and will need to take a new approach to drafting credit agreements going forward.

Summary of the Changes to Lease Accounting

Under existing accounting rules, leases are mostly divided into “capital leases” and “operating leases.” Capital leases are capitalized — an asset and liability are entered on the balance sheet, and the leased asset is then amortized, with interest expense recognized over the life of the lease.

The result is essentially the same as if the lease were a loan secured by the leased asset. Operating leases are entirely off-balance sheet — no asset or liability is reflected on the balance sheet; the payments on the lease are expensed as they are paid.

Under the new accounting rules, all leases will appear on a company's balance sheet. However, there are still two kinds of leases that are treated somewhat differently.

Leases that historically would have been “capital leases” will now generally be known as “finance leases.” The accounting associated with finance leases is virtually identical to existing capital lease accounting.

The big change is that operating leases will now also be reflected on the lessee's balance sheet. Instead of the separate interest and amortization expense components attributable to a finance lease, there will be a single lease expense (usually on a straight-line basis) flowing through the income statement in connection with operating leases.

Common Credit Agreement Provisions and Impact of the New Rule

Capital leases defined as “leases required to be capitalized in accordance with GAAP”

Most credit agreements define “debt” or “indebtedness” to include capital lease obligations. A common definition of capital lease obligations is “obligations in respect of leases that are required to be capitalized in accordance with GAAP.”

Since the new rules will require all leases to be capitalized, all leases will be included in such definitions, resulting in operating leases being treated as “debt,” with the potential for breaches under negative covenants restricting indebtedness or under financial covenants that also tie to these defined terms.

Capital leases defined as “capital leases as defined in accordance with GAAP”

Some credit agreements will cross-reference to the definition of capital leases in GAAP, rather than referring to the general concept of a lease being required to be capitalized. The problem here, of course, is that there will no longer be any such definition under GAAP.

Static GAAP approach

The change in lease accounting has been coming for some time now, and, in anticipation of the change, many credit agreements lock in the existing accounting rules for purposes of determining whether a lease will be treated as a capital lease, and therefore as “debt” or “indebtedness.”

In theory, this would require the borrower to maintain separate books accounting for leases under the previous rules. In practice, however, it should generally work to treat leases that constitute “finance leases” (and only the leases that constitute “finance leases”) under the new GAAP rules as covered by the definition of “capital leases” in a credit agreement with this type of static-GAAP provision.

Also, attention must be paid to the exact wording of the credit agreement. The default wording of some lenders specifically references financial covenants only, and does not necessarily cover the categorization of leases for purposes of operating covenants like restrictions on indebtedness.

General provisions addressing changes in GAAP

Many credit agreements include a generalized provision addressing potential changes in GAAP.

There are many variations of this wording, but, as a rule, these provisions provide a mechanism for making amendments with just the agreement of the administrative agent and the borrower (i.e., without the need to obtain consent of the other lenders in a syndicated facility) to restore the original intent as closely as possible if there is a change in GAAP.

By their nature, these provisions require negotiation of an amendment so, if there is not a “static GAAP” provision that addresses the issue, administrative agents and borrowers should promptly discuss the issue so that any

changes required to accommodate the new lease accounting rules can be implemented before the first reporting date under the credit agreement.

And again, attention needs to be paid to the exact wording of the provision to confirm that it allows all of the required amendments. If, for example, the applicable language only references the impacts on financial covenants due to a change in GAAP, then it might not cover impacts on operating covenants restricting indebtedness.

Going Forward

Going forward, we would expect that the concept of a “finance lease” will simply be substituted in place of a “capital lease” in most credit agreements. Some (though surprisingly few) have already taken this approach.

Alternatively, in recognition of the reasons behind the change in GAAP, some lenders may actually want to treat all leases as indebtedness and have baskets or other carve-outs to accommodate the business needs of the borrower within agreed-on limits. Restricting operating lease obligations is already common in certain credits (especially retail), and this may be expanded more generally under the new standard.

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