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4 Things Attys Need To Know About Lease Accounting Rules

By **Andrew McIntyre**

Law360, Minneapolis (April 20, 2016, 3:11 PM ET) -- The Financial Accounting Standards Board recently finalized new rules that require commercial tenants to put leases on their accounting books, and although the rules don't go into effect until 2019, tenants, banks and attorneys are already scrambling to figure out how to navigate the coming sea change.

The rules, which starting Jan. 1, 2019, would change Generally Accepted Accounting Principles to require companies to put leases on the books, are designed to create more transparency and give investors and other interested parties a fuller picture of companies' financial health.

Companies typically report much of their leasing on an "off balance sheet" basis, treating the leases more like footnotes. With the new rules, companies will no longer be able to report their leases in such fashion.

But while the new reporting requirements would indeed create more transparency, lawyers say the rules would also have various other effects.

Here are four things lawyers need to know.

Tenants May Seek Shorter Leases

The new rules will require all leases — whether for two, five, 10 or 15 years — to go on the books. But one way for companies to have fewer lease obligations on their balance sheets is to shorten leases, because under the new rules the longer the lease, the more liability for the business.

Obligations like leases on balances sheets can have wide-ranging implications, from the ability to get a loan to the way in which a potential investor in a public company decides to buy stock.

Steven R. Schneider of Baker & McKenzie LLP said lenders might even give some thought to the question of whether they would require their borrowers to shorten leases, to take some lease liability off the books.

But while some tenants may be able to shorten their leases, those that require significant tenant improvements may encounter difficulty doing so because it would typically require higher monthly rent to pay for the improvements over a shorter time, said Barbara E. Schmitt of Dain Torpy Le Ray Wiest & Garner PC.

Debt Covenants Need to Be Carefully Reviewed

When companies borrow money from banks, they typically enter into a debt-service coverage ratio, which will become significantly skewed if companies have to put lots of leases on the books. And violating such covenants could spell big trouble for borrowers.

"What you don't want is a covenant that will be accidentally tripped because they changed the [Generally Accepted Accounting Principles] rules," Schneider said.

The rules, Schneider said, will affect net lessees such as retailers and service firms, and even law firms, which have a substantial number of leases.

Companies need to be aware of all their covenants and understand the effects of putting leases on the books to those covenants.

"Lawyers draft loan documents which may contain financial covenants relating to the level of debt of a borrower," Schneider said in an email. "If the borrower's debt changes because of the new GAAP rules, this could impact how these financial covenants are articulated."

Sale-Leasebacks May Become Less Attractive

Sale-leasebacks have been a popular way for companies to bring in a large chunk of change by selling and leasing back a property, and such leases in the past didn't have to go on the books.

But now those deals will become less attractive, lawyers say.

"Leases are being treated much more closely like mortgages," Schmitt said. "That particular reason is no longer compelling."

Indeed, sale-leasebacks in a way closely resemble mortgages since the deal involves getting a large payment then making small monthly payments while staying at a property.

But now that the new rules require such "leases" to go on the books, companies may think twice about doing such transactions, lawyers say.

"Sale-leasebacks are heavily impacted by this," Bruce D. Hickey of Dechert LLP said.

Banks May Change Their Metrics

Banks often require a 1.25:1 debt-service coverage ratio, and when the new rules go into effect, many borrowers will be unable to hit that mark because they will have added many leases to their books.

Of course, banks aren't going to simply stop lending, so they'll have to come up with a new way of evaluating debt.

"My guess is that the banks will start using a different ratio," Schmitt said

Indeed, a company that had a 1.25:1 ratio might, after putting all its leases on the books, bring that ratio down to 1.1:1, Schmitt said.

And under the current rules, that would spell default.

"Instead of being the absolute whole picture profit and loss, it will be the entire picture minus leases," Schmitt said, of one possible way banks could resolve the issue.

--Editing by Jeremy Barker and Edrienne Su.

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