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Legal Update
August 13, 2018

Operating Leases and Credit Agreements in the US: What You Need to Know Before January 1

Beginning January 1, 2019, public-company borrowers will face a change to the treatment of leasing transactions under US Generally Accepted Accounting Principles ("GAAP") that could extraordinarily affect their balance sheets. Those that are private companies will face similar changes on January 1, 2020. For companies that use International Financial Reporting Standards (IFRS), the new changes will apply to public and private companies alike on January 1, 2019. On February 25, 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update No. 2016-02, *Leases* (Topic 842) ("ASU No. 2016-02") establishing new guidelines regarding the financial reporting of leasing transactions.[1] These new guidelines seek to establish a new level of consistency in the realm of lease accounting, but affected borrowers must consider, if they have not already, how the accounting change will affect and be treated under their credit agreements.

Currently, under both GAAP and IFRS, the recognition and measurement of cash flows and expenses arising from a lease are treated differently depending on the classification of the lease as either a "capital lease" (or, in the case of IFRS, a "financing lease") or an "operating lease." Today, lease assets and lease liabilities related to capital leases are included in a balance sheet, while the assets and liabilities related to operating leases are not. However, with the new change effectuated by ASU No. 2016-02, operating leases with terms greater than one year[2] will require lessees to recognize assets (the right to use the item being leased) and liabilities (the present value of future rent) for the rights and obligations created by those leases on their balance sheets, similar to the treatment of capital leases today. The lessor, in turn, will be required to treat the leased asset as two separate assets on its balance sheet: (1) the present value of rent owed under the lease and (2) the present value of the residual value of the asset at the end of the term of the lease. This treatment of leases by the lessee will be similar to the treatment of an interest-bearing loan, where the rent payments are treated as the interest payments.

Impact on Loan Documentation

Because ASU No. 2016-2 will have a significant impact on the amount of assets and liabilities required to be listed on a borrower's balance sheet, the lease accounting changes have the potential to push borrowers out of compliance with any covenants in their loan documentation that are based on GAAP. First, most credit agreements have limitations on the amount of debt borrowers and/or their subsidiaries can have. The definition of what constitutes "debt" or "indebtedness" often refers to leases that are treated as capital leases or financing leases under GAAP, which, absent an express provision to the contrary, could be read to include operating leases once the new guidelines are in place. In that case, unless borrowers have existing exceptions or baskets in their debt covenants that would permit those operating leases, those borrowers with significant operating leases may be in default (and, even if the leases could fit under such a basket, the basket would not be available for other debt the borrower likely

wanted the flexibility to incur when it negotiated the credit agreement).

Second, many credit agreements also have financial ratio tests, which are tested either on a quarterly basis or on an "incurrence" basis in order to determine whether new debt can be incurred. The most common such test is a leverage ratio, the ratio of consolidated debt of the borrower and its subsidiaries at a point in time to the consolidated EBITDA of the borrower for the period of the four fiscal quarters most recently ended. If operating leases were to count as debt under a borrower's credit agreement, that borrower's leverage ratio would increase, causing it to default or have less wiggle room under any quarterly tests and to have less capacity to incur further debt under any incurrence tests.

So What Happens Under Existing Credit Agreements?

Many, if not most, existing credit agreements have provisions that will allow borrowers to avoid the effects of ASU No. 2016-2. Most recently, it has become typical for credit agreements to say that notwithstanding any changes in GAAP, leases that are treated as operating leases under GAAP as of the date of the credit agreement will continue to not be treated as debt (essentially automatically "freezing" GAAP for this purpose). Under these credit agreements, no action needs to be taken once the rule changes go into effect for the borrower to ignore the changes for purposes of the credit agreement.

Many credit agreements also have provisions saying that the borrower has the right to request an amendment to the credit agreement in order to eliminate the effects of any changes in GAAP. Any such amendment would, typically, need to be approved by the borrower and the "Required Lenders" (usually lenders holding over 50 percent of the credit facilities governed by the credit agreement). But, until such amendment is passed, these provisions usually say that the effects of the change in GAAP are ignored (i.e., GAAP is frozen) for purposes of credit agreement calculations. It is important to note, however, that these provisions require the borrower to give notice to the administrative agent or lenders. Borrowers that do not have an "automatic" freezing of GAAP and intend to rely on these "freezing by notice" provisions will need to be ready to provide these notices on or before January 1 of 2019 or 2020, as applicable, and, depending on whether the credit agreement in question specifies when such notices can or must be delivered, in order to avoid their operating leases being automatically treated as debt under their credit agreements on or after those dates.

While most existing credit agreements have a version of the GAAP-freezing provisions described above, there are certainly some that do not. In those cases, borrowers will need to request amendments to their credit agreements in order to avoid beginning to treat their operating leases as debt and, in many cases, to avoid imminent defaults.

Potential Borrower-Friendly "Loopholes"

Alternatively, two more nuanced implications of the lease accounting changes could actually serve to benefit borrowers. First, since "debt" or "indebtedness" is typically defined to include leases classified as capital leases under GAAP and, under ASU No. 2016-2, GAAP will no longer contain a distinct definition of "capital lease" (and this separate category will no longer show up in the borrower's financials), such credit agreements could be read to no longer treat capital leases as debt and, therefore, not to restrict the incurrence of capital leases or include them in any leverage ratio calculations. Second, many credit agreements include "grower" baskets in the negative covenants whereby a borrower can incur certain types of debt, pay dividends or sell assets in an amount up to the lesser of a fixed dollar amount and a grower component, where the grower is typically based on a percentage of EBITDA or of consolidated total assets. The lease accounting changes will increase the borrowers' availability under

these baskets by the applicable percentage of the borrowers operating lease-related assets.

While lenders and borrowers are generally aware of the need to address the ongoing treatment of operating leases, there has not been a similar discussion in the market of the need to ensure that capital leases continue to be treated as debt nor that grower baskets based on consolidated total assets are calculated without giving effect to the asset portion of operating leases. Most likely, borrowers and lenders will continue to treat capital leases as debt after giving effect to the change. But a borrower in default or in distress could try to argue that its capital leases are not, in fact, debt and to incur additional debt, or to avoid a default, on that basis. A borrower intending to make such an argument would be better able to do so if it reports capital leases as not being debt in connection with the first compliance certificate it delivers after the accounting changes go into effect because, if it does not immediately make that change but tries to do so later, lenders would have an argument that the borrower by its course of conduct agreed that capital leases should continue to be treated as debt. It may be premature to predict what a court would say in this situation, but this is certainly a question that could arise. With respect to grower baskets, it is likely that lenders will, in fact, allow their borrowers to realize the benefit of such baskets being increased as a result of the change in accounting standards.

In many credit agreements, the provision described above that permits a borrower to request an amendment in order to freeze GAAP would also give the right to the administrative agent and/or the required lenders to request such an amendment and to freeze GAAP until the amendment is passed. In the event a borrower argues that its capital leases should not be treated as debt under its credit agreement after giving effect to the lease accounting changes, the lenders could elect to invoke this provision in order to continue treating capital leases as debt. In a syndicated deal, however, this would require the lenders holding a majority of the facility to affirmatively agree to such election, which, depending on the credit and the size of the syndicate, could create issues.

Frozen Forever?

While the “GAAP-freezing” provisions described above will allow borrowers to avoid immediate defaults, they may not solve all issues likely to arise for borrowers and lenders under credit agreements from the lease accounting changes. First, borrowers’ total assets and total liabilities on their balance sheets will suddenly balloon and, in the case of liabilities, will look very different from the total debt used to calculate their leverage ratios, so it may become more difficult for lenders to determine a company’s compliance with covenants based on balance sheets (and more difficult for borrowers to calculate such compliance). While this issue is not unique to lending transactions and credit agreements, lenders will need to adjust how they think about borrowers’ balance sheets in this respect.

Second, most GAAP-freezing provisions in current credit agreements rely on operating leases not being treated as debt as of the date of those credit agreements. Once operating leases are, in fact, treated as debt, this language will need to change. Likely the market will quickly adopt new language to address this issue, either by expressly describing the types of leases currently treated as operating leases and saying that these leases are not debt or by continuing to look back to before the lease accounting changes were made in order to link the GAAP-freezing provisions to that date. The former seems a more viable long-term solution, since looking back to “old” GAAP would eventually seem outdated.

Lastly, it remains to be seen whether credit facilities will continue to exclude operating leases from calculations of debt or whether, at some point, lenders and borrowers will begin factoring operating leases into their projections and adjust covenants accordingly.

Borrowers will push back, as they will not want operating leases to be restricted under their credit agreements and, in the current borrower-driven market, will likely be successful. Such a change would also have disparate effects on borrowers, as those with relatively significant operating leases will be more materially affected. And, optically, borrowers and lenders both will want to avoid higher leverage ratios that would result from such a change. But, at some point, particularly if the market changes and as GAAP and financial analysts begin treating capital leases and operating leases similarly, it seems likely that this will change. Even traditional GAAP-freezing provisions are meant to be temporary; these provisions contemplate that borrowers and lenders will agree to amend credit agreement covenants to reflect the change in GAAP (and, in this case, to reflect the resulting additional actual and projected debt on the borrower's balance sheet).

Conclusion

While the aim of the lease accounting changes effectuated by ASU No. 2016-2 was to respond to existing issues in how leases were treated in financial statements and to provide a clear path forward with respect to their treatment, various new issues may arise for companies and investors as a result of the implementation of the new accounting regime, including under companies' credit facilities. While some of these issues may be fairly simple for borrowers to anticipate and, for many borrowers, can be avoided under their current agreements, many others will need to take action on January 1 of 2019 or 2020 in order to avoid going into default as a result of operating leases causing them to breach financial covenants and debt limitations. Accordingly, companies that have existing credit facilities containing such covenants should review their loan documentation prior to the implementation of ASU No. 2016-2 and be aware that certain negotiations with their agents and lenders may be required, or at least that notices may need to be delivered, to avoid such unintended consequences.

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Endnotes

[1] ASU No. 2016-2 comes into effect on January 1, 2019 for all public entities and on January 1, 2020 for non-public entities. The International Accounting Standards Board ("IASB") also issued IFRS 16 *Leases* on January 13, 2016, which generally mirrors ASU No. 2016-2. Generally, this

Legal Update will only discuss the details of ASU No. 2016-2 and changes in GAAP, but a similar analysis can be applied to IFRS.

[2] The new rules will not apply to short-term leases of 12 months or less and leases of intangible assets.