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Covenants Reconsidered In Preparation for New Lease Accounting Rules (ASC 842; IFRS 16)

A joint effort by the Financial Accounting Standards Board ("FASB") and the International Financial Reporting Standards Foundation ("IFRS") will fundamentally reset the accounting treatment of leases under both US-GAAP and IFRS. Under legacy rules, "operating" leases could avoid balance sheet treatment applied to "capital" leases, as operating and capital leases were thought to result from different underlying motivations. Under the new lease accounting rules — codified as Accounting Standards Codification No. 842 ("ASC 842") and IFRS No. 16 ("IFRS 16") — the distinction between operating and capital leases will be significantly reduced and all leases with terms in excess of one year will be included on the balance sheet as "right to use" assets and lease liabilities (in the case of the lessees) or capital assets (in the case of lessors). The net effect of this change in accounting principles will be to increase indebtedness of net lessees and increase the capital assets of net lessors. During the upcoming implementation period, it is imperative for users of financial statements to understand the scope and implications of these changes. In particular, contractual covenants typical in debt financing arrangements will need to be carefully analyzed and crafted to avoid adverse consequences such as inadvertent default.

ELIMINATION OF OFF-BALANCE-SHEET LEASES

The implementation of new lease accounting rules under US-GAAP and IFRS will have the effect of eliminating off-balance sheet treatment of operating leases and will increase the lease balance sheet liabilities of net lessees.

Under legacy rules, operating leases were presumed to solely represent a payment for the right to use an asset and not a method of financing the purchase of such asset. As a result, operating leases were treated as a rent expense without significantly implicating the balance sheet (other than small accruals for rent past due at the end of a period). In contrast, a capital lease was viewed as a financing arrangement secured by a leased asset. As a result, the entire capital lease obligation was accrued as a liability upon the beginning of a lease and was subsequently amortized as payments were made over several years.

Under the new lease accounting rules, operating leases (other than operating leases with terms less than one year – including renewals) and capital leases will both be reflected as lease liabilities to be amortized over the life of such leases. The new rules will significantly increase the amount of lease liability on a lessee's balance sheet as the long-term obligation of an operating lease is moved from a borrower's explanatory footnotes to the face of the balance sheet. Under the new lease accounting rules, components of a lease contract that constitute services will be expensed and excluded from balance sheet treatment. Also under the new lease accounting rules, while operating leases will be treated similarly to how capital leases have been treated historically, operating leases and capital leases will continue to be separately identified and quantified in companies' financial statements.

The aggregate impact of the new lease accounting rules is astounding. Studies have estimated that the new lease accounting rules will add an additional $2 trillion in liabilities on U.S. public companies alone.

TIMELINE OF IMPLEMENTATION

The new lease accounting rules will have a staggered implementation requirements. Public companies applying US-GAAP will be required to implement ASC 842 for fiscal years beginning on or after December 15, 2018 (generally, calendar year 2019) and private companies applying US-GAAP will be required to implement ASC 842 for fiscal years beginning on or after December 15, 2019 (generally, calendar year 2020). All companies applying IFRS will be required to implement IFRS 16 for fiscal years beginning on or after January 1, 2019. Companies also have the discretion to early-adopt ASC 842.

IMPACT ON DEBT-FACILITY COVENANTS

Contractual covenants that measure compliance according to financial measures such as total indebtedness are at risk of falling out of compliance as a result of the implementation of new lease accounting rules as balance sheet indebtedness will generally increase significantly. Various credit arrangements, including term loan facilities, revolving facilities, high yield notes and other arrangements, typically provide for debt covenants and financial compliance covenants that could be impacted.

Financial Ratio Covenants. Often in credit agreements and high-yield notes, companies will need to periodically comply with certain financial ratios such as a net leverage ratio. Compliance with such covenants can be measured either at the end of each quarter or pro forma upon the incurrence of new indebtedness. For example, a typical ratio will measure the amount of consolidated indebtedness at period end to consolidated EBITDA over the past four fiscal quarters. Depending on the applicable definition of indebtedness, the new lease accounting rules may result in a substantial increase in balance sheet indebtedness (with limited impact on EBITDA) for many borrowers and, as a result, compliance with financial ratios could become problematic.

Debt Covenants. Often in credit agreements and high-yield notes, the amount of indebtedness or secured liens permitted by obligors is limited subject to certain permitted baskets, including a basket specifically for leases treated as a capital lease or liability on the face of a borrower's balance sheet under GAAP. As the new lease accounting rules take effect and operating leases are reflected on the balance sheet, borrowers with significant operating leases should pay particular attention to the criteria for the previously negotiated lease basket and may need to amend these provisions to increase the basket or exclude operating leases, reclassify existing indebtedness to find additional capacity, or risk a potential default.

COVENANT WORK-AROUNDS

In order to avoid the adverse consequences of the new lease accounting rules, recent credit agreements and high-yield covenant packages have been including certain borrower-favorable protections.

"Freezing" GAAP for Operating Leases. Recently, certain borrowers have been negotiating for a carve-out from the definition of indebtedness for leases treated as operating leases prior to the implementation of ASC 842, thereby "freezing GAAP" as of the date of the facility and avoiding implementation of the new lease accounting rules for purposes of covenant compliance. This would have no impact on the presentation of financial statements but would provide a permanent adjustment to allow for covenant evaluation under legacy rules.

"Freezing GAAP" is consistent with the approach generally taken in many high yield covenant packages, where GAAP is defined to mean the generally accepted accounting principles in effect on a given date (either the issue date or the issue date of an earlier debt facility). In light of the new lease accounting rules, borrowers should be especially mindful that they are entitled to an adjustment from their audited financial statements to revert to calculations permitted under legacy rules in measuring covenant compliance. Depending on the exact terms of a particular debt facility, "freezing GAAP" may resolve potential issues in financial covenants, but may not address the inclusion of operating leases in a capital lease basket or other related complications.

Amendment Provisions. Typically in credit agreements (and occasionally in high yield notes), permissive amendment provisions will allow amendments to address changes in GAAP to be requested by the borrower, subject to the approval of the agent and a threshold quorum of lenders. Borrowers intending to address changes in GAAP through such amendment provisions should submit notices to lenders as required by the terms of the facility. Generally, the adverse impact of changes in accounting will be suspended while awaiting approval of such an amendment.

In contrast to loans under credit agreements, the mechanics of amending high-yield notes may prove too cumbersome to apply effectively in this manner.

Thoughtful Negotiation of Ratios and Baskets. Going forward, borrowers and lenders under credit arrangements will need to factor into their thresholds the amount of additional indebtedness resulting from the new lease accounting rules. Especially during the implementation period beginning next year, the appropriate quantification of indebtedness ratios, coverage ratios and capital lease obligation baskets will need to factor in the projected effect of the new lease accounting rules to avoid inadvertently hamstringing a borrower or applying a covenant without sufficient teeth to protect a lender. Lenders should also ascertain the true underlying financial health of a borrower through due diligence and pro forma adjustments that fairly compare pre- and post-ASC 842 financial statements. Due to the effect of frozen GAAP provisions, similarly situated borrowers may differ in which lease accounting rules will be applied in assessing covenant compliance. Reliance on prior year financial statements, industry comparables or old rules of thumb in setting limits could have unintended and adverse consequences.

EVOLVING THINKING ABOUT LEASES

Beyond contractual mechanics, the implementation of the new lease accounting rules will necessitate an evolution of how the financial community thinks about lease financing generally. Borrowers may try to reduce the impact of the new lease accounting rules by negotiating lease terms that present less indebtedness on the balance sheet. For example, because the length of a lease will directly relate to the magnitude of a lease liability, lessees may opt for shorter terms with options for renewal, or even terms that are less than a year to qualify for off-balance-sheet treatment. Lessees may also negotiate for triple net leases, where a smaller amount of fixed rent will be carried as indebtedness on the balance sheet, with the lessee then paying a pro-rata share of ongoing expenses (i.e. taxes, insurance, and maintenance) that are captured off-balance-sheet. The projected impact of the new lease accounting rules and the impact of borrowers' mitigation strategies will need to be evaluated carefully.

CONCLUSIONS

Proponents of ASC 842, and its IFRS counterpart, IFRS 16, believe that the new lease accounting rules will create transparency and comparability of a company's assets and liabilities and will avoid disparate balance sheet treatment for similar transactions. While thoughtful implementation will likely achieve this result, transition to the new rules will present a dynamic environment with traps for the unwary, particularly in crafting workable credit covenant packages.

Certain issues and considerations are beyond the scope of this brief alert; please contact us if you would like to explore the implications of the new lease accounting regime on your business.

Special thanks to law clerk Leo Liu for his research in preparation of this Client Alert.

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