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# Flawed Synthetic Lease Definition Infiltrates GM Bankruptcy

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The legal profession has been atwitter with the discussion of the Second Circuit's opinion regarding Simpson Thacher & Bartlett LLP inadvertently consenting to the release of JPMorgan's lien, as agent on behalf of a group of lenders, over certain equipment securing a term loan made in 2006 to General Motors.[1]

The inadvertent release of the lien over the collateral for the term loan occurred in 2008, prior to GM's bankruptcy filing. At the time of the inadvertent lien release, GM had sought to terminate a synthetic lease entered into in 2001 and obtain release of the liens over the equipment that had been the subject of that transaction.

GM asked its counsel, Mayer Brown LLP, to prepare the lien release. In the release, Mayer Brown listed the liens related to the synthetic lease and inadvertently listed the liens securing the term loan's collateral. Mayer Brown sent the overly inclusive list of liens to be released to Simpson Thacher. Simpson Thacher had acted on behalf of JPM in the synthetic lease transaction but not in the term loan transaction. GM did not have the authority under the term loan agreements to cause that lien to be released and did not give Mayer Brown authorization to request a release of the term loan collateral.

The bankruptcy court held that, since neither GM nor JPM had authorized its respective law firm to effectuate the release of the term loan collateral, such a release had not been effected; therefore, JPM still retained its lien over the collateral connected to the secured loan.[2]

Thus, the bankruptcy court denied GM's unsecured creditors the right to the collateral from JPM's secured loan to satisfy the amounts due the unsecured creditors. The unsecured creditors appealed to the Second Circuit. To aid it in deciding the case, the Second Circuit certified a question to the Delaware Supreme Court.

The Delaware Supreme Court characterized the certified question as:

whether [the creditor] reviewing the termination statement and knowingly approving it for filing has the effect specified in § 9-513 of the Delaware's version of the Uniform Commercial Code, which is that the financing statement to which the termination statement relates ceases to be effective.

The Delaware Supreme Court answered the question in the affirmative.[3] This answer caused the Second Circuit to hold that, despite the fact that neither JPM nor its counsel actually intended to release the lien for the secured loan, upon release of the lien, JPM lost its security interest in the financed equipment.

In addition to resolving an important issue under the Uniform Commercial Code, the case raises interesting ancillary issues regarding synthetic leases. First, the bankruptcy court quoted an inaccurate definition of "synthetic lease" that was supplied by a Reuters website; the Second Circuit's opinion does not address what a synthetic lease is, so it is silent as to the definition. Second, GM's selection of a synthetic lease as a financing vehicle in 2001 may have been a questionable business decision.

**The Definition of Synthetic Lease**

The source of the confusion over the term of art "synthetic lease" stems from the Reuters Financial Glossary. The bankruptcy court's opinion quoted the inaccurate Reuters definition. One can speculate that the bankruptcy judge turned to Reuters because the term of art is not defined in the Uniform Commercial Code, the Internal Revenue Code or the official pronouncements of the Financial Accounting Standards Board. The Reuters definition is as follows:

A lease which is arranged so that it is not shown as a liability on a company's balance sheet but as an expense on the income statement. The item or asset being leased is owned by a special-purpose vehicle (SPV) which then leases it to the company. The SPV is usually owned by the company. Synthetic leases have become markedly less common in the United States after the financial scandals of the early 2000s and the introduction of the Public Company Accounting and Investor Protection Act of 2002, better known as Sarbanes-Oxley.

From a financial accounting perspective, the first sentence of the definition is actually the definition of an "operating lease." Under current generally accepted accounting principles (GAAP), "operating lease" is a fundamental concept; however, Reuters has omitted a definition of it from its Financial Glossary.

Under GAAP, a lease of equipment is an "operating lease" to the lessee if there is no bargain purchase option, the present value of the obligatory payments is less than 90 percent of the fair market value of the equipment at the outset, the term is less than 75 percent of the useful life of the equipment, and there is no automatic transfer of ownership of the equipment to the lessee.[4]

The Reuters definition of "synthetic lease" is, at best, half complete. The other half of the definition is that the referenced transaction is treated as "debt" for federal income tax purposes.[5] That means that the purported "lessee" for tax purposes depreciates the financed property, and the payment of "rent" is a payment of principal and interest. Similarly, for income tax purposes, the purported "lessor" is a

lender, rather than the owner of the financed property. That is from an income tax perspective, the transaction, rather than being a “true lease,” is a financing.[6]

To avoid further confusion, Reuters needs to amend its Financial Glossary by first adding the definition of “operating lease” (i.e., a GAAP term of art that refers to a transaction that, when used in the context of a lessee, is off balance sheet to the lessee and, when used in the context of a lessor, results in the property in question being classified on the lessor’s balance sheet as “equipment leased to others” that it depreciates for GAAP purposes; however, a transaction can be an “operating lease” to one party to the transaction, but not the other, based on the application of the multifactor test specified in GAAP).

Then, Reuters needs to revise the definition of “synthetic lease” to be a transaction that is an “operating lease” to the purported “lessee” and, for income tax purposes, is characterized as a loan resulting in the “lessee” depreciating the financed property for income tax purposes (but not for GAAP purposes) and treating the payment of the purported rent as a payment of principal and interest.[7]

In addition, the phrase that the SPV “is usually owned by the company” seems inaccurate, because, if the SPV consolidated for GAAP purposes with the company, the asset would be back on the company’s balance sheet. The GAAP standards of consolidation have been adjusted over time, but the SPV would have to obtain its equity funding from a financier unrelated to the “company.”[8] In the GM/JPM synthetic lease, GM did not own the SPV.

Finally, the phrase the “asset being leased is owned by a SPV” is overly restrictive. Many synthetic lease transactions involve an SPV; in the GM/JPM synthetic lease the SPV was a Delaware trust, but a synthetic lease could be executed without an SPV.

The bankruptcy court may not be the only governmental body led astray by the Reuters definition. In 2014, the Missouri Department of Revenue released a ruling that purported to address the sales tax consequences of a “synthetic lease” transaction,[9] but misapplied the term “synthetic lease,” without referencing the Reuters definitions, since the transaction described in the ruling appeared to be a garden-variety “operating lease” for GAAP purposes and a true lease for federal income tax purposes.[10] As the transaction did not appear to be debt for federal income tax purposes, it did not meet the second prong of the term of art.

**Why Did GM Select a Synthetic Lease as its Financing Vehicle?**

Arguably, the first mistake made in this transaction occurred when GM selected a synthetic lease as its financing facility. In 2001, when the synthetic lease was executed with JPM, GM already had a large deferred tax asset (i.e., more income tax deductions and credits than it had been able to use). GM’s Form 10-K for the 2001[11] period provides that it had $3.993 billion of “tax carryforwards,” which was up from $3.125 billion for the 2000 period. The 10-K provides further that “other tax credit carryforwards, consisting primarily of research and experimentation credits, will expire in the years 2004, 2011-2012, and 2018-2021 if not used.” With sizable federal income tax credit carryforwards a portion of which were expiring in three years, it is not clear why GM decided on a synthetic lease that

would permit it to claim the accelerated tax depreciation associated with the equipment and create an interest deduction.

Thus, if GM sought an off-balance-sheet financing, it could have entered into a sale leaseback treated as "operating lease" for financial accounting purposes and a "true lease" for income tax purposes. GM, upon selling the equipment to JPM, would have recognized a taxable gain for the difference between the sales price and its adjusted tax basis in the equipment.

Further, one would typically expect the payment stream under a true lease to be lower, because the financier, as the lessor, is entitled to claim the accelerated depreciation; therefore, the lessor can achieve a comparable after-tax return while charging lower rents.

Nonetheless, possibly, there was something about the nature of the financed equipment that made JPM concerned about its eligibility for true-lease characterization. For instance, JPM was possibly concerned the equipment would be difficult for GM to return at the end of the lease term and difficult for it to be operated by a party other than GM; thus, there could have been a concern that the equipment had a tinge of "limited-use property," for which the IRS takes the position that it is not able to be the subject of a true lease. [12]

Therefore, JPM may have proposed a "synthetic lease" to GM that would deliver the off-balance-sheet accounting treatment while being treated as debt for tax purposes and avoiding a true-lease/limited-use property debate with the IRS.

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[1] Official Comm. of Unsecured Creditors of Motors Liquidation Co. v. JPMorgan Chase Bank NA (In re Motors Liquidation Co.), 777 F.3d 100 (2d Cir. 2013).

[2] Official Comm. of Unsecured Creditors of Motors Liquidation Co. v. JPMorgan Chase Bank NA (In re Motors Liquidation Co.), 486 B.R. 596 (Bankr. S.D.N.Y.2013).

[3] Official Comm. of Unsecured Creditors of Motors Liquidation Co. v. JPMorgan Chase Bank NA 103 A.3d 1010 (Del. S. Ct. 2014).

[4] This is a test for an operating lease under FASB Accounting Standards Codification 840 (formerly known as Financial Accounting Standard No. 13).

[5] See W. Kirk Grimm et al., Synthetic Leasing in Equipment Leasing-Leveraged Leasing (I. Shrank & A. Gough, Jr. eds.), Apr. 2013 § 15:1; Brown, Iris, Synthetic Lease off Balance Sheet Financing Before and After Enron, 17 No. 1 Prac. Tax Law. 19 (Fall 2002); Tom Erlandson, Synthetic Lease Could Provide Advantages, PUGET SOUND BUSINESS J., Sept. 13, 1998.

[6] In a synthetic lease, it is the end-of-term options that make the transaction somewhat unusual and are intended to enable a tax adviser to conclude the transaction is debt for federal income tax purposes. At the end of the term, the user of the equipment (i.e., the purported lessee) has the option to either (1) purchase the equipment for a fixed price or (2) return the equipment to the financier (i.e., the purported lessor) and pay the financier the difference, subject to a cap on the maximum payment, between the fixed-price purchase option amount and the actual value of the equipment. See Grimm at § 15:2.1. Thus, the purported lessee has captured the upside benefit through the fixed-purchase option and bears almost all of the downside risk as a result of the payment obligation described in clause (2). With exposure to neither the equipment's upside nor significant downside in conjunction with language in the documentation that the transaction is intended to be debt for federal income tax purposes with the parties treating the payment stream as principal and interest, it is intended that the parties can appropriately report the transaction for tax purposes as a loan. See, e.g., FSA 199920003 (Jan. 12, 1999) (concluding a purported synthetic lease was debt for tax purposes but noting the "the factual situation in this case makes characterization for tax purposes difficult").

[7] See footnote 5, supra.

[8] See, e.g., FSA 199920003 (Jan. 12, 1999) (which refers to the synthetic lease transaction as being "between the Taxpayer [(i.e., the user of the property and the purported lessee)] and an unrelated third-party special purpose entity"); Brown, Iris, Synthetic Lease off Balance Sheet Financing Before and After Enron, 17 No. 1 Prac. Tax Law. 19 (Fall 2002) (citing U.S. GAAP Emerging Issues Task Force 90-15).

[9] Mo. Dept. of Revenue , LR 7395 (July 2, 2014).

[10] See Burton, David, MO DOR Bungles Synthetic Lease Reference in Sales Tax Case, State Tax Notes 405 (Aug. 11, 2014).

[11] Available at http://www.getfilings.com/o0000040730-02-000026.html .

[12] See Rev. Proc. 2001-28, 2001-1 C.B. 1156, §5.02 ("In the case of such "limited use" property, at the end of the lease term, there will probably be no potential lessees or buyers other than members of the lessee group. As a result, the lessor of limited use property will probably sell or rent the property to a member of the lessee group, thus enabling the lessee group to enjoy the benefits of the use or ownership of the property for substantially its entire useful life."). This aspect of Rev. Proc. 2001-28 is a re-issuance of the IRS's limited use property guidelines first promulgated in Rev. Proc. 76-30, 1976-2 CB 647.

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