IN-SUBSTANCE DEBT DEFEASANCE:

FADED FAD OR LATENT THREAT?†

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In the mid-1980s, in-substance defeasance attracted a great deal of attention from corporate management, the financial community, and accounting regulatory bodies. This paper explores the history of the controversy, what has been learned from empirical studies, and the continuing concerns about the use and misuse of defeasance as a financial maneuver and an accounting technique.

In-substance debt defeasance created quite a stir in the financial community in early 1982 when Exxon reported a massive debt restructuring that added a hefty after-tax gain of $130 million to its bottom line. With the new tool, previously used only by municipalities, Exxon removed six debt issues from its balance sheet, totalling in excess of $500 million, by setting up an irrevocable trust to pay the debt service. Since the trust, not Exxon, was now the primary obligor on the debt, the corporation argued that the debt should not appear on its balance sheet.

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Chief financial officers (CFOs) and investment bankers were enthralled by the idea of in-substance debt defeasance (ISDD hereafter), but the smoke and mirrors aspects raised red flags at the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB). These agencies are charged with the responsibility of seeing to it that investors and others are not misled by financial reports. Troubled by the departure from the legal reality of the underlying transactions, the SEC imposed a moratorium on the use of ISDD in August 1982 to give FASB time to carefully consider the matter. A sharply divided FASB approved the controversial accounting technique by a narrow four to three vote and FASB Statement No. 76 "Extinguishment of Debt" was issued in November 1983. CFOs were ecstatic but other others were not so thrilled. The SEC was not entirely pleased with the position taken by FASB and quickly issued its own guidelines to tighten the requirements a firm would have to meet in order to employ ISDD. Nevertheless, John Dingell, chairman of the House Subcommittee on Oversight and Investigations, rebuked the SEC for its rubber-stamp okay of "merely cosmetic accounting, which increases income without improving cash flow" (Calvert, 1985, p. 29).

The technique remains controversial because it presents opportunities for manipulation of reported earnings under certain interest rate environments. When interest rates are rising and a corporation has a relatively low-coupon debt outstanding, it will be able to buy government securities that pay sufficient interest to cover its debt payments at a cost considerably less than the book value of its debt. For example, if $500 million in debt can be offset by $400 million in government securities in a trust fund, the difference of $100 million is treated as an extraordinary gain on the income statement. Under certain rate circumstances, it may even be possible for corporations to borrow at less than the risk-free government securities rate--something FASB had not thought possible. Within a year of the issuance of FASB Statement No. 76, Business Week announced: "The Accounting Watchdogs Have Been Outfoxed Again" (Weiss, 1984).

International arbitrage opportunities had opened and Morgan Guaranty Trust Company clients like PepsiCo had already earned a quick $2 million in a "simultaneous defeasance" that did not appear anywhere on the balance sheet (Friar, 1984; Weiss, 1984). Unlike regular ISDD, which results in only paper profits and real economic costs, a simultaneous defeasance results in real economic gains and a positive cash influx. However, FASB banned further use of simultaneous defeasance after September 1984.

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It has now been nine years since in-substance debt defeasance accounting was approved by FASB and the SEC. The initial excitement has faded. Interest rates are now at historic lows. As they rise, can we expect increased use of ISDD to manipulate earnings? Now is the time to reexamine the concept and tighten restrictions on its use.

The purpose of this article is to bring together the concerns of the business and accounting communities with the empirical findings of finance and accounting academics. In the following sections, we discuss the reasons (real and conjured) why CFOs were so pleased with the new debt management tool. We then review the results of empirical studies on the effects of ISDD transactions on stockholder and bondholder wealth. We conclude with a discussion of the continuing concerns regarding the use and abuse of defeasance.

LIKELY USERS OF DEBT DEFEASANCE

The ideal candidate for an in-substance debt defeasance has an outstanding issue of low-coupon debt, a belief that interest rates have

peaked, a desire to increase earnings for a given quarter, a preference for the tax benefits of ISDD over conventional buy-backs, and excess cash that it is willing to tie-up (McGolderick, 1984; Roden, 1987).

Improving profits and capital structure are the two obvious purposes of defeasing debt. With the advent of ISDD accounting, a de facto or in-substance defeasance is accounted for in exactly the same manner as a conventional buy-back. Therefore, either event would improve reported profits and capital structure.

Most of the reasons expounded in the business press to support ISDD instead of buy-backs revolve around the potential problems with an actual repurchase. The following sections discuss both the valid and the not-so-valid motivations for entering into defeasance transactions.

Disadvantages of Straight Buy-Back[1]

Many corporate bonds are privately placed. Hence, there is no secondary market for the issues, and ISDD is a logical approach. Even for most publicly traded bonds, the market is thin. Consequently, a company may find its bond prices rising if it attempts to repurchase significant amounts of its outstanding debt. In addition to this "price pressure," the corporation may also find it difficult to round up its bonds for purchase. Not only may the holders be hard to find, they may deliberately hold out for a better price once they learn of the repurchase plan. Some bondholders may be unwilling to relinquish the bonds at all, either because they consider the bonds a good investment or because they would have to recognize a loss on the sale. Using in-substance debt defeasance, a company can retire its bonds without ever notifying its bondholders. The company can also retire all the bonds at the same time.

There are also some tax benefits from defeasing versus buy-back: an in-substance defeasance is a non-event for tax purposes.[2] Buying

old debt outright for cash is a taxable event and can be costly since any gain is immediately taxed as ordinary income. With an in-substance defeasance, the tax on the gain is deferred until the matching securities mature (Izard and Williams, 1986).

Other Considerations

Avoiding problems with sinking fund requirements is another benefit of ISDD occasionally mentioned. For example, a CFO may be aware that 75% of the company's bonds are in the hands of a single institutional investor. Even worse, there are bond trading "syndicates" who may try to hold a company hostage by purchasing large blocks of bonds due for a sinking fund payment. In either case, the company may be forced to buy the bonds back at an above market premium. Consequently, outmaneuvering sinking fund speculators can be a prime objective of an in-substance defeasance: any sinking fund requirements are automatically satisfied by the trust arrangement (Johnson, Pari, and Rosenthal, 1989; McGolderick, 1984). Of course, defeasance can help avoid other restrictions associated with debt covenants, such as those which prohibit early retirement or make it costly, since the bonds are not really retired.

In-substance defeasance can also be a defensive tactic in fighting off a hostile take-over attempt. If the company has a large amount of liquid assets, it makes itself much less attractive when it ties up those assets in the irrevocable defeasance trust. The boost in reported earnings associated with defeasance might also help stockholders resist the raider's offer (Roden, 1987).

Berick (1986), discusses the use of defeasance in refinancing real estate loans. Lenders are often reluctant to make second mortgages because they prefer to be the senior lender. Existing mortgages may have provisions which make it impossible or expensive to prepay. In such situations, real estate investors cannot realize the equity in their

property without selling it. Defeasance offers a way around these difficulties. The investor retains title to the property, extinguishes the existing mortgage, and secures new financing at more attractive first mortgage rates.

Cosmetic Reasons

Regardless of the varied justifications for defeasance, the fact remains that it is a potent tool for "cooking the books," given the appropriate economic environment. ISDD can improve the balance sheet by removing the book value of debt. It also provides a wonderful way to smooth earnings by permitting a discretionary gain to be posted to offset a nonrecurring loss, since the existing debt can be retired for less than book value. Unfortunately, the result is hardly earnings in any meaningful sense.

Some CFOs are quite honest about their motivations: defeasance provides a way to clean up their balance sheets (Roden, 1987). The defeasance can reduce financial leverage and financial risk, at least as demonstrated in ratios typically used by analysts. But some academics suspect that management may choose to enter into a defeasance transaction because of its favorable affect on the bottom line, and hence their incentive compensation plans (Johnson, Pari and Rosenthal, 1989).

ISDD can also be an income-smoothing device. Managers are not completely convinced that the market is efficient and may believe that investors want to see a relatively stable pattern of earnings. It is entirely possible that an ISDD would involve retiring low coupon debt with higher coupon debt. This results in a "paper gain." However, it is also possible to retire high interest debt with lower interest debt. Genuine long-term savings in interest costs might be achieved in this situation but the company would have to record an immediate "paper loss" on its income statement.

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A recent example of this "paper loss" effect is the federal court case, *Guernsey Memorial Hospital v. Sullivan.*[3] A hospital defeased two bond issues in 1985 and recorded a $672,581 loss as a result of the transaction. While it claimed to be motivated by the possibility of saving approximately $12 million in debt service over the life of the defeased bonds, it is possible to imagine less savory motives for the transaction since the entire loss was factored into its service costs billed to Medicare. Since the cost-reimbursement system was being phased out at that time (in favor of the Medicare Prospective Payment System which pays a flat rate for each patient based on his or her discharge diagnosis), one might be tempted to guess that the transaction was an attractive way to generate additional revenue for the hospital that would not be available in future years.

REACTIONS FROM THE BOND AND STOCK MARKETS

In this section we review the empirical evidence from studies on investor reactions to ISDD, because any wealth effects are expected to be reflected in the defeasing company's bond and stock prices. Bondholders normally have little influence over whether or not a company defeases the issue they hold. However, they should be delighted: in effect, the establishment of the trust with its government securities converts the company's bonds into the equivalent of a risk-free investment. Thus, the investors of the defeased bond are obvious winners in this transaction.

Two studies by Johnson, Pari and Rosenthal (1989) and Hand, Hughes and Sefcik (1990) seem to support this bond risk-reduction hypothesis. (For the sake of brevity, we refer to these two studies as JPR and HHS, respectively.) The JPR study examined monthly bond price changes, and found a positive and statistically significant increase (+0.734%) in the price of the defeased debt during the month of the defeasance transaction. The HHS study, using daily price data, also found a positive but small price reaction on the day the defeasance is announced. HHS reported that the majority of the defeased bonds were rated AA or better, and that the vast majority of the defeased bonds' ratings remained at their pre-defeasance levels after the transaction. Although the market may have perceived the defeased debt to be less risky, the small price reaction may suggest that the bonds were not completely risk free.

Who bears the brunt of the bondholders' windfall? Is there a transfer of wealth from stockholders to bondholders? Using cash to establish a trust reduces the corporation's ability to service any remaining undefeased debt as well as future fixed charges. Thus, although in-substance debt defeasance may reduce the company's debt ratios, the reduced liquidity may act as a countervailing force (Peterson, Peterson and Ang, 1985). Are both forces given equal weight by stockholders? The answer is an empirical issue that has been examined by several researchers.

Roden and Karafiath (1987) analyzed a sample of nineteen companies that defeased their debt during the period 1983-1985. Their analysis of the daily stock price changes, adjusted for general market movements, revealed that ISDD had no significant impact on the stock prices of the companies in the sample. They concluded that ISDD is a "financial nonevent with no implication for investors and no impact on stock price and shareholders' wealth" (96).

JPR also studied the price reaction of companies defeasing debt during the period 1980-1985. Uncertainty regarding the exact

announcement day forced them to aggregate the daily excess stock returns into monthly equivalents. Their analysis of the full sample revealed a negative stock price return (-1.432%) during the announcement month; however, it was not statistically significant. They too inferred that ISDD has no impact on stockholders' wealth.

The most extensive examination of the stock price reaction of in-substance defeasance was conducted by HHS. To resolve the uncertainty regarding the exact announcement date, HHS sent a questionnaire to defeasing companies to request information on the date of the defeasance and specific bond issues defeased. From their sample of thirty-five announcements, they found that some firms defeased in order to avoid restrictions in existing debt covenants, whereas other firms defeased because of lack of investment opportunities and defeasance provided "the best use for excess cash on hand" (25). These corporate explanations are consistent with lower stock prices, and that is, indeed, what HHS found. They analyzed the stock price reaction on the two-day period consisting of the announcement and the next day. Like the previous studies, daily price changes were also adjusted for changes in the aggregate stock market. Unlike the previous studies, however, by focusing on the exact announcement dates, HHS found a statistically significant negative stock price reaction of -0.86%. This finding provided confirmation for the stockholder wealth reduction hypothesis.

If in-substance defeasance resulted in the reduction of stockholders' wealth, then why did companies engage in this transaction? HHS found evidence that firms defeased to manage their annual earnings. JPR reported that twenty-two of the twenty-eight defeasing firms indicated that management compensation was determined, at least in part, by earnings. This suggests that defeasance may be motivated by management incentive compensation agreements rather than strictly for enhancement of stockholder wealth.

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Conditions in the bond market provided an excellent opportunity for management to increase reported income through ISDD. HHS reported a positive association between the general level of interest rates and the number of defeasances, especially from the beginning of the third quarter of 1983 through the fourth quarter of 1986 when the correlation coefficient was 0.71. The high levels of interest rates presented an opportunity for management to purchase United States government securities at a discount, yet still provide sufficient cash inflows to service the defeased debt. Hence, by establishing a trust consisting of discounted United States government securities, management was able to recognize an increase in reported profits.

CONTINUING CONCERNS

After nearly a decade of defeasance, there are still concerns about the economics of the debt extinguishment. In other words, is defeasance used appropriately to facilitate debt retirement that would have occurred anyway, or misused as simply an income-smoothing device? In other words, is defeasance accounting under the current standards misleading to investors and creditors? Some people remain concerned about the accounting standard which gave the arrangement FASB's seal of approval and believe it should be abolished or changed. The following sections discuss both types of concerns.

Does In-Substance Debt Defeasance Make Economic Sense?

The availability of the defeasance "tool" may encourage its use for the wrong reasons. With ISDD, the company's liquidity position is diminished, and, in consequence, its risk of default increases. To compensate, management might attempt to improve its cash conversion cycle by increasing inventory and receivables turnover or lengthening the deferral period on its payables (Roden, 1987). Unfortunately, this may be difficult or impossible for some companies. Having given up liquid assets to establish the irrevocable trust, a company is less able to service its other debt and fixed charges. If, instead, the company had purchased the T-bills without using the trust arrangement, it could reap the same economic benefits (assuming there are any) and still be able to sell the securities if necessary. Many, like Gaumnitz and Thompson (1987), believe that squirreling away the riskless securities increases the company's risk while providing no compensating benefits.

The defeasance arrangement may also be costly because the investment banker and the trustee have to be paid for their services. Furthermore, the taxes the corporation will ultimately pay on the gain could have been avoided altogether by simply holding the bonds to maturity. The defeasance can even be economic nonsense if the corporation has to borrow at a high interest rate to fund the purchase of the trust securities. Other than the investment bankers and trust company, the bondholders are the only beneficiaries of the defeasance: they give up nothing but get increased security.

In fact, from a financial perspective, ISDD is usually pointless--a nonevent. Since the firm is acquiring risk-free securities, the net present value of the transaction is zero. But the investment banking firm and trustee don't work free, so that supposedly zero present value to the firm is actually a negative present value. Most of the time, the cash could have been better used to buy productive assets that would have a positive net present value (Roden, 1987). Gaumnitz and Thompson (1987) point out that if the returns on riskless securities are

the company's best bet, management is an unnecessary burden to the stockholders. The corporation might as well distribute the excess funds so that existing stockholders could decide for themselves whether riskless assets were their most attractive investment opportunity.

These arguments certainly make the economics of ISDD seem questionable. What is the apparent opinion of investors? In other words, what has been learned from market reactions to in-substance defeasance announcements? We know that investors do react to the announcement of ISDD: bond prices rise whereas stock prices drop, although the increase in the former is less than the decrease in the latter. This suggests that stock price reaction reflects another factor, most notably the impact of unfavorable information about the prospects of the company. After all, what must investors surmise about the company's investment opportunities if government bonds are the best use of the company's funds? On the other hand, the stock price reaction is really quite small (less than one percent). If the economics are as poor as they seem to be, can we speculate that the investment community is fooled by the "improved" balance sheet and the paper profits?

If so, the CFO and other members of corporate management are the real winners. They win because ISDD or buy-back has a favorable impact on their bonuses under incentive compensation plans. However, we don't really know this for a fact. Existing studies have not yet delved into the details of compensation plans and the decision to defease. Without careful analysis of compensation packages, management's motivation may be misconstrued. For example, the compensation plan may base bonuses on income before taxes or income before extraordinary items. If so, the gains from ISDD would have no effect on the wealth of corporate management.

Are there other stakeholders who might be adversely affected? The holders of non-defeased debt of a company comprise one plausible group. To the best of our knowledge, the plight of other bondholders

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has not been formally examined. The potential "agency problem" arising from misuse of ISDD by management and ISDD's potential for harming other creditors of the company are two areas which may warrant additional research.

The SEC has attempted to protect investors and others from being mislead by ISDD by issuing regulations that are more stringent than those in FASB's Statement No. 76. A company which borrows the funds to be used for purchase of the trust securities is really worse off after the defeasance even though certain ratios or other traditional measures may indicate that it has improved its financial position. In subsequent years, it will be incurring decreased cash flows because the interest on the new debt is at a higher rate than the interest on the defeased debt. Whether or not defeasance is being abused is an empirical question which has not been resolved.

Is In-Substance Debt Defeasance Accounting Misleading?

Of course, accounting standards are not designed to prevent companies from entering into economically irrational transactions. Rather, the standards should enforce reporting practices that make any such transaction obvious to the users of financial statements. So, the underlying question about ISDD accounting centers around whether the technique is misleading to investors and creditors.

Most investors and creditors are probably not aware of either the real economic impact of ISDD or its potentially deceptive repercussions on financial statements. For example, creditors have recently been warned about the potentially misleading impact of an in-substance debt defeasance by Phillips and Moody (1989). They point out several pitfalls in cash flow analysis, credit analysis, and risk assessment. For one thing, the use of net income plus depreciation as a proxy for cash flow overstates cash flow for several reasons including defeasance's effect on income tax cash flows.[4] Phillips and Moody also warn of problems in using financial distress scoring systems like Altman's discriminant model: Many, if not all, of the financial ratios used in such models are affected by ISDD accounting. Consequently, the models may not be valid for companies with defeased debt.

The legal ramifications of defeasance also remain unclear. Holders of other debt securities, especially in the face of corporate bankruptcy, could attack the irrevocable trust arrangement. Since ISDD does not provide a legal release from the debt, they could question the asset allocation. In other words, the other creditors may object to the preferential treatment given to one group of creditors and not another.

Investors and creditors who suffer in bankruptcy or other insolvency cases or claim losses due to the erosion of earnings may also allege misrepresentation in their attempt to recoup their losses through litigation. Such litigation may well extend to the accounting firm which has certified the financial statements, particularly as the accounting firm may be the only solvent entity capable of satisfying a judgment. Strict adherence to generally accepted accounting principles (GAAP) may not be an adequate defense. In the leading case of *United States v. Simon*[5], the court held that compliance with GAAP and generally accepted auditing standards (GAAS) does not automatically result in a finding of no negligence. In addition, the AICPA Code of Professional Ethics, Rule 203, requires adherence to FASB's standards only if doing so does not cause financial statements to be misleading.

Have any court cases challenged ISDD accounting? To find out, we conducted a computer search (Westlaw) of all federal cases to October 1992 using the key terms (1) "FASB No. 76," (2) "Financial Accounting" and "76" within the next seven words, and (3) "defeasance" and "trust" in the same sentence. This search yielded the single case on ISDD discussed earlier (*Guernsey Memorial Hospital v. Sullivan*) and it was not related to bankruptcy. The lack of litigation in this area might be a result of the decreased popularity of ISDD in the face of the generally less favorable interest rate trends since 1983. On the other hand, a company able to take advantage of the in-substance debt defeasance rules may be in a relatively strong financial position since it would need substantial cash assets to be able to purchase the government securities needed for the trust fund. Thus, firms with ISDD may be unlikely candidates for insolvency or bankruptcy. If this were uniformly true, there would be little cause for auditors and their insurance companies to be concerned about ISDD.

SUMMARY AND CONCLUSION

Was the popularity of ISDD a one-time phenomenon resulting from the high interest rates in the mid-1980s? Will the next interest rate cycle resurrect the popularity of defeasance? We believe that the low interest rates of the early 1990s will provide renewed opportunities for the use and misuse of in-substance debt defeasance in the coming decade. Rising interest rates may tempt firms into making irrational decisions to remove low interest debt from their balance sheets just to get a quick boost in earnings. Nevertheless, ISDD is a useful technique that can help solve many legitimate problems encountered when a firm wants to buy back its own bonds. Such an actual buy-back of debt would be no better and no worse than a similar ISDD arrangement. ISDD just makes it easier.

Those who support the current accounting rules for in-substance debt defeasance argue that a strictly legalistic approach toward ISDD

is not warranted. Both FASB's conceptual framework definition of a liability and the accounting profession's traditional emphasis on "substance over form" argue for the removal of defeased debt from the balance sheet. The trust assets make it highly unlikely that the company will have to make any more payments. Removing both assets and liabilities from the accounts, in this case, is not much different from removing real estate and its associated mortgage from the balance sheet when the property is sold and the mortgage is assumed by the new owner. In both cases, the original borrower remains contingently liable. Thus, ISDD's offsetting of assets and liabilities is probably not as disturbing as ISDD's effect on reported earnings.

Amortization of the extraordinary gain over the remaining life of the debt would defuse some of the objections to ISDD and would be consistent with the court's ruling in the *Guernsey* case.[6] Implementation of FASB's conceptual framework might also help if the gain or loss related to the extinguishment of debt was removed from a statement of "earnings" and appeared only in a separate statement of "comprehensive income."[7] Another way around the dilemmas caused by ISDD would be market-value accounting for financial instruments, an idea that is receiving careful consideration from FASB. Market value accounting would solve the problem of having to recognize a substantial gain all at once just to balance the accounts when debt is extinguished. If liabilities were carried at market values instead of amortized historical amounts, there would be no material gain or loss to be recorded when the debt was extinguished.

We conclude that some modification of FASB Statement No. 76 is probably warranted to make ISDD less tempting as a recipe for cooking the books. Market-value accounting seems to be the best long-run solution. With market-value accounting there would be no misleading gains or losses for either ISDD or an actual buy-back of outstanding debt. Thus, ISDD would be simply a valuable technique for avoiding the problems encountered by those who want to retire outstanding debt for legitimate reasons.

NOTES

1. For an excellent discussion of bond refunding, including defeasance, see John D. Finnerty, Andrew J. Kalotay, and Francis X. Farrell, Jr., ***The Financial Manager's Guide to Evaluating Bond Refunding Opportunities***, Cambridge, MA: Ballinger Publishing Co. (1988), pp. 94-112. Lovata, Nichols, and Philipich (1987) develop an analytical model to demonstrate that in-substance debt defeasance should be chosen over an outright purchase of discounted debt when the resulting wealth transfer from stockholders to bondholders is less than the difference between the present value of the income taxes associated with the defeasance transaction.

2. Rev.Rul. 85-42, issued in April 1985, specifies that since the corporation is not legally released from the debt, the corporation is still the legal owner of the assets transferred to the trust. Taxes are due on income earned on the assets, and the interest paid on the defeased debt is tax deductible.

3. 796 **F.Supp** 283 (SD Ohio, 1992).

4. Now that a statement of cash flow is mandatory for all businesses, we would advise bankers and other creditors to use reported cash flow information rather than the popular net income plus depreciation proxy.

5. 425 **F.2d** 796 (2d Cir. 1969, *cert. denied*, 397 U.S. 1006).

6. Bradbury suggests that any gain or loss on a defeasance transaction be amortized consistent with "the company's existing policy on fixed interest investment losses which arise through interest rate fluctuations." Mike Bradbury, "Debt Defeasance: Financial Tool or Window Dressing?", ***Accountants' Journal*** (New Zealand) (February 1987), pp. 30-31

7. The terms "comprehensive income" and "earnings" have been tentatively defined in FASB's conceptual framework project but are not yet part of generally accepted accounting and reporting standards.

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