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Leasehold Recharacterization in Bankruptcy: A Review and Critique

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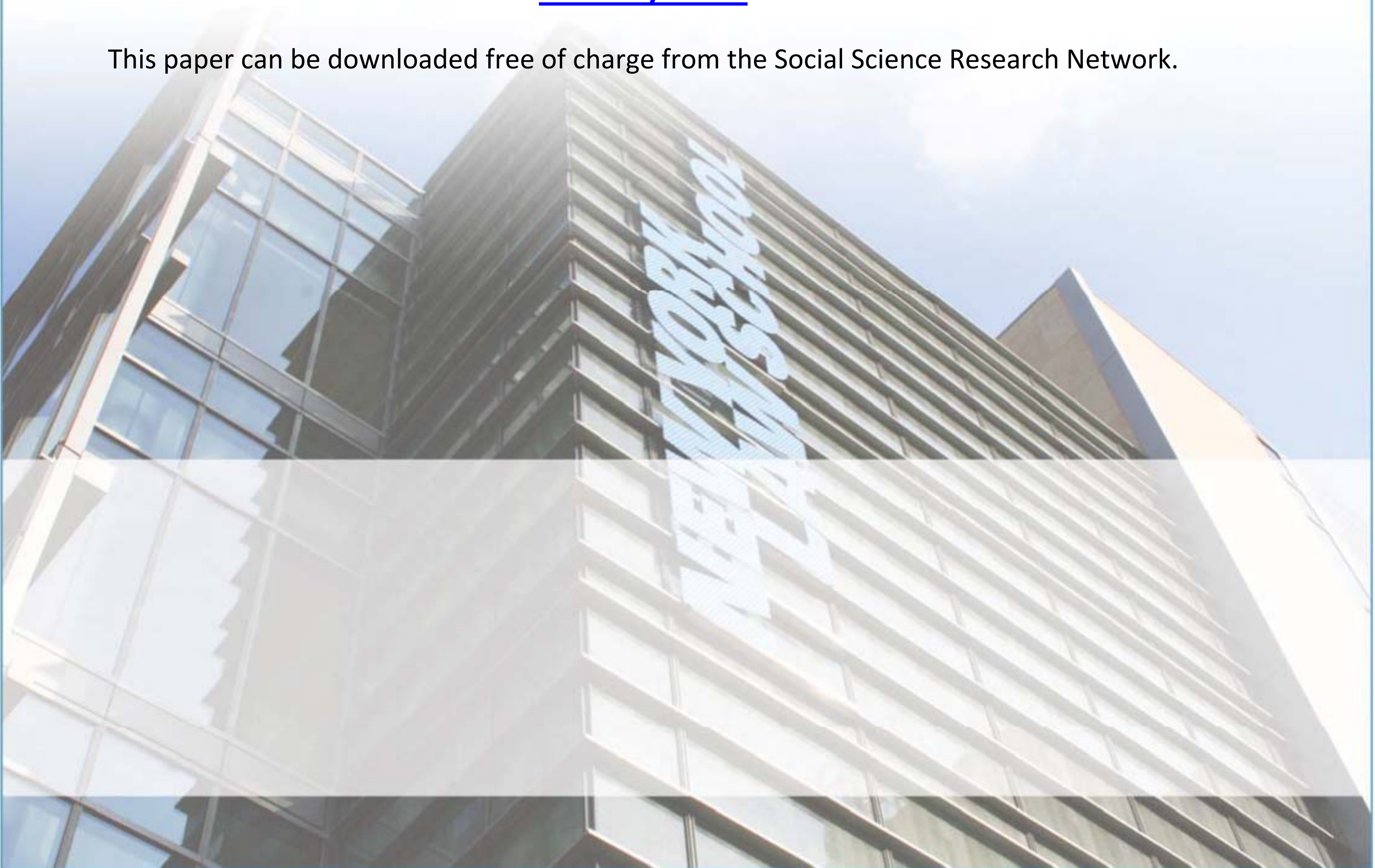

LEASEHOLD RECHARACTERIZATION IN BANKRUPTCY: A REVIEW AND CRITIQUE (FORTHCOMING IN THE ACREL PAPERS 2013)

Marshall E. Tracht[1]

The recharacterization of leasehold interests as mortgages has several hundred years of history and doctrinal development that focuses on the intent of the parties. Bankruptcy cases, however, have recently abandoned this body of law, replacing it *sub silentio* with a federal economic substance test derived from an amalgam of tax and personalty recharacterization cases. This test is not only inconsistent with established state property law but, worse, is inherently arbitrary, unpredictable and inconsistent. I advocate a return to a test based primarily on the expressed intent of the parties in order to respect the federalist structure of our property law and bankruptcy system, reduce forum shopping, and provide predictability for contracting parties as well as for third parties who rely on the recorded state of title.

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How many legs does a dog have if you call the tail a leg?
Four. Calling a tail a leg doesn't make it a leg.
- *Abraham Lincoln*

LOGICIAN: The cat has four paws. Isidore and Fricot both have four paws. Therefore Isidore and Fricot are cats.
OLD GENTLEMAN: My dog has got four paws.
LOGICIAN: Then it's a cat.
- *Eugene Ionesco*[2]

I. INTRODUCTION

Do labels matter? This is a common debate in the law, generally taken up under the rubric of form versus substance.[3] It is a constant issue in the bankruptcy setting, where millions of dollars may hinge on competing characterizations of a claim or interest. These debates include efforts to recharacterize sale transactions as secured loans, to fix the line between insider debt and equity contributions, and to challenge leases as mortgages or security interests. This article addresses one of these form versus substance problems, the lease/mortgage distinction, focusing primarily on its most vexing form, the purported sale-leaseback of real property. In so doing, it also examines the concept of "recharacterization" in various settings and explores how errors in recharacterization have arisen and been perpetuated through reliance on inappropriate bodies of law.

Sale-leaseback transactions have played a significant role in corporate and real estate finance the 1920s, expanding considerably after World War II[4] and again in the post-*Enron* world.[5] A few years ago, a deal of $30 million or $50 million would have been considered large, but more recently it has become common to see sale-leaseback transactions of $500 million or $1

[2] "Rhinoceros," Act 1, Scene 1.

[3] The tension between form and substance arises in nearly every area of commercial law. For useful discussions in other contexts, *see, e.g.*, Avery Weiner Katz, *The Economics of Form and Substance in Contract Interpretation*, 104 COLUM. L. REV. 486 (2004); Steven L. Schwartz, *Collapsing Corporate Structures: Resolving the Tension Between Form and Substance*, 60 Bus. Law. 109 (2004); Lewis R. Steinberg, *Form, Substance and Directionality in Subchapter C*, 52 Tax Law. 457 (1999); Larry E. Ribstein, *Form and Substance In The Definition of a "Security": The Case of Limited Liability Companies*, 51 WASH. & LEE L. REV. 807 (1994); Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859 (1982).

[4] Right after World War II, many states amended their laws to permit insurance companies to invest in real estate. *See generally* Note, *Some Economic and Legal Aspects of Leaseback Transactions*, 34 VA. L. REV. 686 (1948); John W. McPherson, *Some Economic and Legal Aspects of the Purchase and Lease of Real Estate by Life Insurance Companies*, 97 U. PA. L. REV. 482 (1949).

[5] The tightening of rules on off-balance sheet financing, such as synthetic leases, that has followed the collapse of Enron has encouraged the greater use of sale-leaseback financing. *See* Mike Fickes, *The Move to Sale-Leasebacks*, NATIONAL REAL ESTATE INVESTOR, July 1, 2002.

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billion or more.[6]

Despite their lengthy history and extensive use, however, the legal treatment of sale and leaseback transactions in bankruptcy remains unpredictable, with claims that these transactions are actually disguised mortgages frequently being raised by bankrupt seller-lessees.[7] The characterization of the claim can have tremendous ramifications for parties in the bankruptcy case; a purchaser-lessor will typically receive far better treatment than it would if the court found it was really a secured lender.[8] However, the case law on leasehold recharacterization is largely incoherent. Courts typically examine the "intent" of the parties, the "economic realities" of the transaction, or some combination of the two, but in any but the most straightforward of cases, these tests turn out to be complex exercises that lead only to arbitrary decisions.[9]

While states differed in details, the majority approach to recharacterization of sale and leaseback transactions traditionally depended on the intent of the parties. However, the intent test raises numerous problems, the most basic being the challenge of discerning an underlying intent that is allegedly belied by the express statements of the parties -- the agreements themselves. There are a host of subsidiary problems, including difficulty in determining just what intent is relevant: is it the parties' intent as to the legal form of the transaction? Their intent as to the economic terms of the transaction? Or perhaps their intent as to the transaction's "genuine nature"?

These problems with intent have led many bankruptcy courts to adopt an "economic realities" test, asking whether the economic terms are those of a sale and lease or those of a mortgage. This test has proven even less satisfactory. The factors that are considered in determining the "economic realities" are both underinclusive and overinclusive, and the case law provides no guidance on the relative weight to be given to factors that may point in different directions. Moreover, the factors and the inferences drawn from them are often inconsistent with modern commercial practices. A moment's reflection should show that this confusion is inevitable. Courts are presented with cases challenging the sale-leaseback as a mortgage specifically because these two transactions are often economically indistinguishable. To seek to distinguish them based on economic realities is akin to splitting a herd of zebras into two groups: those with black and white stripes, and those with the opposite.

This confusion is exacerbated by the varying bodies of precedent on recharacterization that have developed in different contexts. Recharacterization has a long history in state law, federal tax litigation, and personal property leasing. Bankruptcy courts often rely on cases from

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[6] For example, in 2007, Deutsche Bank entered into a sale-leaseback agreement with Paramount Group, selling its building at 60 Wall Street for $1.18 billion and leasing it back for 15 years, CVS Corp. initiated a sale-leaseback of 340 properties for $1.3 billion, and ShopKo conducted a sale-leaseback of 178 properties for $815 million. *See* Beth Mattson-Teig, *Bundling Sale-Leaseback Sales*, NATIONAL REAL ESTATE INVESTOR, June 1, 2007, at 59.

[7] The situation nearly always arises with a debtor lessee seeking to recharacterize a transaction, not a debtor lessor, and so throughout the article I will assume that the debtor is the seller-lessee.

[8] *See infra* Part II.B.

[9] See generally Thomas C. Homburger & Karl L. Marschel, *Recharacterization Revisited: A View of Recharacterization of Sale and Leaseback Transactions in Bankruptcy After Fifteen Years*, 41 REAL PROP. PROB. & TR. J. 123 (2006); James Gadsden, *Recharacterization of Industrial Bond Real Property Leases in Bankruptcy Cases*, 113 BANKING L.J. 466 (1996); Thomas C. Homburger & Gregory R. Andre*, Real Estate Sale and Leaseback Transactions and the Risk of Recharacterization in Bankruptcy Proceedings*, 24 REAL PROP. PROB & TR. J. 95 (1989); Thomas C. Homburger, et al., *Unresolved Questions in Sale-Leaseback Transactions: A Look at Real Estate, Tax, and Bankruptcy Law Issues*, 19 REAL PROP. PROB. & TR. J. 941 (1984); David Albenda & Daniel S. Lief, *Net Lease Financing Transactions Under The Proposed Bankruptcy Act of 1973*, 30 BUS. LAW. 713 (1975).

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these other areas even though recharacterization means different things in different settings; the standards for recharacterization should differ depending on the policies involved. The failure to recognize and examine the policies that underlie recharacterization, and to craft recharacterization tests appropriately while avoiding inapposite precedent, bedevils these cases in every sphere.

In the bankruptcy context, there is an even more serious problem with the precedent relied on by many courts. Bankruptcy courts are increasingly disrupting the federalist structure of the bankruptcy system, and generating needless uncertainty and litigation, by disregarding long established state law precedents on recharacterization and relying instead on bankruptcy court decisions that are often inconsistent with the applicable state law.

The result of this disarray in the law is that a common commercial form, used for billions of dollars in transactions each year, is hamstrung. Parties must structure their transactions to withstand the possibility that the form will be challenged under a largely incoherent body of law, and as result may limit the terms they are willing to use in their deals. This restricts the possibility of doing some economically efficient transactions, and drives up the cost of others. In so doing, it limits access to capital and it results in increased uncertainty, delay, and litigation costs upon default or bankruptcy, to the detriment of the bankruptcy estate and its creditors.

This article suggests that the jurisprudence has taken a wrong turn, and that bankruptcy recharacterization law can only be rationalized by ending the reliance on inappropriate precedent and returning it to its state law foundations.

Substantively, the starting point is to acknowledge that while there is a difference between a lease and a mortgage in a simple case, in many complex transactions either characterization is perfectly justifiable.[10] Two points follow from this: first, economic realities provide no basis for distinguishing between leases and mortgages in these cases; and second, if courts are to use an intent test, the characterization cannot depend on intent as to economic terms, but must rely on the parties' intent as to the legal form the transaction will take. The increasingly prevalence of the "economic realities" test in bankruptcy cases disregards these points – points that lie at the very foundation of the established law of recharacterization in most states.

The general approach under state law is to recognize that the parties have the right to agree not only on the "economic" terms of the transaction, but also on the legal form the transaction should take, because that form will determine the parties' rights vis-a-vis each other and as against third parties. However, it also recognizes that the parties are not free to attach a false label to a transaction, nor to enforce a putative form that has been adopted to avoid mandatory legal constraints such as usury laws. This traditional state law examination of intent allows courts to police fraud and other forms of mischief while respecting the parties' freedom of contract and the needs of commercial practice. It also minimizes litigation by disappointed parties seeking to rewrite their agreements after the fact. By returning to state recharacterization law, bankruptcy courts would reverse the largely-unacknowledged displacement of state law by a federal economic realities test that has no basis in the Bankruptcy Code. It would therefore reassert the balance between the state definition of contract and property rights, and the power of bankruptcy courts to then modify those rights in accordance with the Code, preserving the

[10] Although this article focuses on sale-leasebacks in the bankruptcy context, the analysis is equally applicable to leasehold recharacterization in general, and to recharacterization claims in state law proceedings as well.

federalist foundations of our bankruptcy system.

Part II explains the source of the confusion between sale-leaseback transactions and mortgages, setting out the legal and economic foundations for the two types of transactions. Each is a way for a company to use its real estate to obtain capital while retaining long-term use of the property as well. Thus, they serve essentially identical economic functions, although a variety of sub-factors may push the parties to adopt one legal form over the other. Part II then goes on to explain the treatment that a purchaser/lessor can expect in its seller/lessee's bankruptcy if the deal is respected as a sale-leaseback, compared with the treatment it would receive if the court characterizes the transaction as a mortgage.

Part III reviews the bankruptcy case law on recharacterizing real estate sale-leasebacks, recounting the unacknowledged and unjustified displacement of the traditional state law examination of intent with a new federal bankruptcy test focused on "economic realities." Part IV then puts the bankruptcy jurisprudence into a broader context by examining recharacterization law in two other areas: the state law of personal property leasing and federal tax law. Bankruptcy courts have often looked to these bodies of law for guidance, but neither courts nor commentators appear to have examined the ways in which the legal, factual and policy concerns in these areas differ from those in bankruptcy, making these bodies of law false guides for recharacterization of real property leases in bankruptcy. Exploring the nature of the recharacterization decision in these other contexts demonstrates the problems in using them as precedent in bankruptcy cases and the importance of using state real property cases as the source of law on recharacterization.

Finally, Part V offers guidance on how courts should address the recharacterization problem, providing a coherent framework for making the distinction in a manner consistent with the traditional jurisprudence and with fundamental bankruptcy principles. A starting point for this framework is to recognize that the characterization of the claim for bankruptcy purposes depends, first and foremost, on the legal effects of the transaction under state real property law, which typically differs in fundamental ways from the framework that has been cobbled together in the bankruptcy cases.

Assuming the court is not dealing with one of the "easy cases," in which the substance of the transaction falls easily into one camp or the other, the transaction can credibly be held to be either a sale and leaseback or a mortgage. If the selection between these two legal forms has been made by sophisticated commercial parties, state law generally establishes a strong presumption that the chosen form is valid. It is a fundamental part of the parties' bargain, on the basis of which other terms of the transaction are negotiated and on which third parties rely in dealing with the debtor and with the purchaser-lessor. State law recognizes that recharacterizing the transaction upsets the settled commercial expectations and contractual and property rights of the parties, and of third parties who have dealt with them and their property.

If the agreed form of the transaction would be upheld under the applicable state law, it should be upheld in bankruptcy unless it is incompatible with fundamental bankruptcy policies. In the bankruptcy context, the primary resistance to deferring to the parties' stated intent is that they may have selected the form to advantage themselves at the expense of other creditors and the bankrupt debtor. As some courts have argued, a secured creditor that can disguise its transaction as a lease gains an advantage over other creditors. However, this criticism assumes its conclusion: that the transaction "really" was a mortgage and is "disguised" as a sale and lease.

Put more fairly, the parties have entered into a transaction that might be characterized as either a sale and leaseback or a mortgage, and have chosen the legal form of a sale and lease to define their rights, obligations and remedies. Assuming these are sophisticated commercial parties, there is no paternalistic reason to deny this choice. As to the purported unfairness to the debtor's other creditors, there is no more unfairness here than in respecting the rights of secured creditors over unsecured creditors, permitting creditors to enforce offsets, or a host of other ways that the Bankruptcy Code begins with the premise that the parties' underlying state-law entitlements should be respected.

By returning the recharacterization analysis to state law, with its focus on intent, bankruptcy courts can bring order to this unsettled area of law, reducing commercial uncertainty and making bankruptcy proceedings fairer and more efficient. The correction of recharacterization standards also vindicates the underlying federalism concerns that inform the structure of our bankruptcy system, in which state law entitlements are honored except to the extent that bankruptcy policies mandate otherwise. As has often been noted, divergence between state law and bankruptcy law brings with it economic costs and forum shopping, and it also undercuts the sovereignty of the several states. These are costs that have been woven into this complex area of law by the rise of a federal bankruptcy test for recharacterization, without thought or justification.

II. SALE-LEASEBACK AND MORTGAGE FINANCING

A. The Legal and Economic Nature of Sale-Leaseback v. Mortgage Financing

Sale-leasebacks and mortgages are alternative ways that a company with real property can raise capital. In mortgage financing, the company receives a loan which it promises to repay with interest, and it secures the repayment obligation with a lien on its real property. If the loan is not repaid, the financier can foreclose on the property, causing it to be sold, and can apply the proceeds to the repayment of the debt. In a sale-leaseback, the company sells the real property to the purchaser/lessor, leasing it back. The lease term may be as short as 10-20 years, or may include renewal options for 75 or 100 years or even longer.[11] The lease payments are often calculated to provide the purchaser/lessor with an acceptable return on the purchase price, rather than by direct reference to market rents.

In either case, the company obtains funding, promising to make a stream of payments over a long period of time that returns those funds with the addition of a charge for the use of the financier's money. The primary difference in the basic structure is the ultimate ownership of the property. In the mortgage transaction, the property belongs to the company after repayment of the debt. In the sale and leaseback, the property belongs to the purchaser/lessor after the leasehold expires. However, given the low present value of that reversionary interest after a long-term lease, and the ability to shift the reversion back to the seller through a repurchase

[11] *See, e.g.*, *In re* PCH Assocs., 949 F.2d 585 (2d Cir. 1991) (33 year initial lease term with four 33-year options, for a total of 165 years); Woodmen of the World Life Ins. Soc. v. Knudsen, 275 F.2d 440 (5th Cir. 1960) (17 year initial term plus 19 renewal options of 5 years each, for total of 112 years); *In re* KAR Dev. Assocs., 180 B.R. 597 (Bankr. D. Kan. 1994), *aff'd*, 180 B.R. 629 (D. Kan. 1995) (24 year lease with four renewal options of five years apiece); *In re* SCCC Assocs., 158 B.R. 1004 (Bankr. N.D.Cal. 1991) (50 year initial term renewable for up to 99 years total).

option, even that is not much of a difference.

Research shows that sale-leaseback transactions are typically value-enhancing for seller-lessees, increasing the market value of their stock.[12] There is no evidence that the purchaser-lessor, however, realizes any abnormal profits from participating in the sale-leaseback transaction, implying that seller-lessees are getting the primary benefit from the transaction.[13] The reasons for the gain are not perfectly clear, and likely vary from deal to deal, but they may be related to tax advantages, a reduction in expected bankruptcy costs, or other economic efficiencies derived from the transaction.

It is sometimes assumed that sale-leaseback transactions are all tax driven. If so, there is little lost if they are disadvantaged in their legal treatment, or if they are treated as secured loans in bankruptcy because their primary economic effect is to redistribute the tax burden from the participants onto other taxpayers rather than to increase the productivity of the economy. However, changes in the tax code since 1986 have significantly reduced the tax savings that can be realized through sale-leaseback transactions in the U.S., and while still important, tax savings are less central to the sale-leaseback market than they once were.[14]

Bankruptcy savings could be a second basic reason for parties to enter into sale-leaseback transactions rather than secured financings.[15] If the purchaser-lessor secured superior bankruptcy rights over those that would be enjoyed as a secured lender, this can result in a lower cost of capital for the firm – increasing investment and lowering the risk of financial distress, to the benefit of the firm and its creditors. To the extent that these bankruptcy savings emerge from reduced risk of insolvency and a more efficient proceeding, there would be a net benefit; to the extent they emerge from a redistribution of a static pool of assets upon bankruptcy, the costs of these distributive effects are simply transfers from existing creditors and future involuntary

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[12] *See* Tomi Gronlund, et al., *Corporate Real Estate Sale and Leaseback Effect: Empirical Evidence from Europe*, 13 EURO. FIN. MGMT. 371 (2007) (finding statistically significant positive abnormal returns for European companies announcing sale-leaseback transactions); Fayez A. Elayan, et al., *Evidence From Tax-Exempt Firms on Motives for Participating in Sale-Leaseback Arrangements*, 28 J. REAL EST. RES. 381 (2006); Lynn M. Fisher, *The Wealth Effects of Sale and Leasebacks: New Evidence*, 32 REAL EST. ECON. 619, 622-23 (2004) (finding average abnormal returns of approximately 1.85% for firms announcing shorter-term sale-leasebacks (15 year or less), but a negative abnormal return for firms entering into medium-term (15-25 year) transactions and no effect for long-term transactions); Myron B. Slovin, et al., *Corporate Sale-and-Leaseback and Shareholder Wealth*, 45 J. FIN. 289 (1990) (finding statistically significant 2-day abnormal return of 0.85% associated with announcement of a sale-leaseback); Ronald C. Rutherford, *Empirical Evidence on Shareholder Value and the Sale-Leaseback of Corporate Real Estate*, 18 AREUEA JOURNAL 522 (1990). Fisher and Elayan each found that returns are particularly positive for firms that are more credit-constrained, indicating that sale-leasebacks provides such firms with a better source of capital than otherwise available.

[13] *See* Rutherford, *Empirical Evidence*, *supra* note 13 (showing a negative impact on stock price of purchase-lessors, although the change was not statistically significant). Elayan, et al., suggest that real estate investment trusts may have particular incentives to overpay for properties in sale-leaseback transactions, because the depreciation deductions offset the rental income, resulting in strong cash flows that can be retained despite the tax requirement that REITs distribute at least ninety percent of their net income to their shareholders.

[14] *See* J.R. Alvayay, R.C. Rutherford and W.S. Smith, *Tax Rules and Sale and Leasebacks of Corporate Real Estate*, 23 REAL EST. ECON. 207 (1995) (finding positive returns to sale-leaseback announcements before the 1986 Tax Reform Act, but not after).

[15] *See generally* Elayan, *Evidence on Motives*, *supra* note 13; M.J. Barclay & C.W. Smith, Jr., *The Priority Structure of Corporate Liabilities*, 50 J. FIN. 899 (1995); V.S. Krishnan & R.C. Moyer, *Bankruptcy Costs and the Financial Leasing Decision*, 23 FIN. MGMT. 31 (1994); C.W. Smith, Jr., & J.B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979).

creditors to the purchaser-lessor and shareholders.

Reading the cases and commentary, it often seems as though the only real differences between mortgages and sale-leasebacks are questions of tax treatment and remedies upon default. Perhaps this is not surprising, in that lawyers may be more focused on these areas than on the economic differences between different means of carrying out similar transactions. It is true that the choice between these transactions can have important ramifications for the tax consequences of the deal,[16] and this has given rise to an extensive body of law on the distinction between mortgages and sale-leasebacks in the tax context.[17] As to remedies, the fundamental tenet of mortgage law is that a mortgage lender must foreclose on the collateral to apply it to the debt, and that the borrower has an equity of redemption that protects its interest in the property until foreclosure has been completed.[18] In contrast, a lessor can typically terminate the lease upon default and bring a summary proceeding to recover possession. In this way, a purchaser/lessor's state law rights upon default are typically superior to a mortgagee's.

However, there are also extremely important business differences between mortgages and sale-leasebacks. First, mortgage financing is generally limited to some fraction, typically 60% - 80%, of the value of the property; in the sale-leaseback, the sale will often be for the fair market value of the property, allowing 100% financing (and in exchange will carry a higher rate of return for the financier).[19] This increase is far from trivial, and can be a tremendous advantage to a company in need of operating funds. Second, the other terms on a sale-leaseback can vary considerably from what is available to a company on the mortgage market. A sale-leaseback can reduce risk by providing a corporation with fixed-cost long-term financing when its borrowing options are either short-term or based on floating rates.[20] The sale-leaseback may also provide a source of funding to a company during a "credit crunch," when firms (particularly those with weaker credit) find their access to bank loans limited. Sale-leaseback transactions allow capital constrained firms to reach sources of funding not otherwise available to them.[21]

A sale-leaseback can provide important accounting advantages as well.[22] By selling its real estate, a company that was carrying these assets on its books at a depreciated value may

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[16] *See generally* ALVIN L. ARNOLD, THE REAL ESTATE INVESTOR'S DESKBOOK (Thomson West, 3d ed. 2008) (1983).

[17] *See infra.* Part III.B.

[18] *See* Marshall E. Tracht, *Renegotiation and Secured Credit: Explaining the Equity of Redemption*, 52 VAND. L. REV. 599, 606-13 (1999).

[19] *See* Elayan, et al, *supra* note 13, at 384-85.

[20] *See* Stephan L. Hodge, *Sale-Leasebacks: A Search for Economic Substance*, 61 Ind. L.J. 721, 728 (1986).

[21] *See, e.g.*, Gronlund, et al., *supra* note 13, at 5 ("Sellers want to diversify their funding sources. By disposing of assets, which are then financed in the real estate debt market, the seller hopes to tap new sources of funding."); *see* also Elayan, et al., *supra* note 13.

[22] One important use of the sale-leaseback has been to create "synthetic leases," in which seller-lessee treats the transaction as a true sale with an operating lease for accounting purposes, but as a secured financing for tax purposes. In this way, the seller-lessee removes the property and the lease from its balance sheet, improving its debt ratios. For tax purposes, however, the seller-lessee treats the transaction as a secured loan, taking depreciation deductions on the property and bifurcating its lease payments into "interest" (deductible) and "principal" (nondeductible) components. *See, e.g.*, Michael A. Yuhas and James A .Fellows, *Sale-Leasebacks Revisited: The Old and The New of Federal Tax Law, 31 Real Est. L.J. 9, 22-30 (2002)* (explaining the use of synthetic leases). Synthetic leases depend on a difference in the rules for characterizing these transactions for tax and accounting purposes. In recent years, accounting reforms (particularly FASB Financial Interpretation No. 46), have made it more difficult to create synthetic leases. *See* Mindy Berman, *Synthetic Leases: Changed But Still Viable*, J. EQUIP. LEASE FIN., Oct. 1, 2004, B.

realize a large increase in income and net worth as a result of the sale. And the sale may allow a firm to demonstrate to investors the value of its "hidden" real estate assets, thereby boosting its stock price.[23] There is also evidence of economic gains from the ability of sale-leaseback transactions to solve problems related to contracting for future capital investments in the property.[24] Sale-leaseback transactions are also often used in specialized circumstances, such as when industrial development agencies (IDAs) issue bonds to finance private enterprises, in part because transferring title to the IDA, which is a state agency, may free the property from local property taxes.[25]

Some sale-leaseback transactions are relatively straightforward, but sale-leasebacks are often utilized in complex, multiparty transactions that are customized to address scores of interrelated concerns. The specific reasons for adopting the sale-leaseback form, and the other accommodations in the terms of the transaction that are made in light of that decision, may be hard to identify after the fact, and in many cases may be both involved and idiosyncratic to the transaction. The published cases show examples of sale-leaseback transactions tied to the provision of operating funds, construction financing,[26] commitments for future capital or improvements, and to contractual[27] or regulatory[28] restrictions. It is often the case that seller-lessees will borrow against its long-term leasehold estate, and that the rents and leases of sale-leaseback properties are pledged or assigned by the purchaser-lessor, thus creating multilayered webs of financial and commercial relationships.

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B. Comparative Treatment in Bankruptcy

Should the company file for bankruptcy, the financier has very different rights if the transaction is deemed a mortgage loan rather than a genuine sale-leaseback.[29] The differences have been laid out repeatedly in both the case law and the literature and will not be repeated here. A brief summary, however, may provide useful context.[30]

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[23] *See* Gronlund, et al., *supra* note 13, at 20.

[24] *See generally* Fisher, *supra* note 13. The term of the lease appears to be primarily related to the nature and extent of noncontractible investment that is required to optimize the value of the property and the firm-specificity of that investment. *See* Lynn M. Fisher, *The Wealth Effects of Sale and Leasebacks: New Evidence*, 32 REAL EST. ECON. 619, 622-23 (2004). In its simplest terms, if the tenant expects to make substantial investments in the property during the lease term, and if it cannot contract for the landlord to pay it for those improvements upon lease termination (likely because the investments have little value to other potential tenants), a longer term is likely.

[25] *See* Gadsden, *supra* note 9, *at* 470.

[26] *In re* San Francisco Indus. Park, 307 F.Supp. 271 (N.D. Cal. 1969); *In re* PCH Assocs., 949 F.2d 585 (2d Cir. 1991); *In re* Seatrain Lines, Inc., 20 B.R. 577 (Bankr. S.D.N.Y. 1982) (lease-leaseback transaction); *see also* Woodmen of the World Life Ins. Soc. v. Knudsen, 275 F.2d 440 (5th Cir. 1960) (sale-leaseback used to assure take-out financing in order to secure construction funds).

[27] *See, e.g.*, Hilton v. Comm'r, 74 T.C. 305, 311 (1980) (sale-leaseback transactions entered into to avoid violating covenants on permissible debt levels).

[28] *See, e.g.,* Frank Lyon Co. v. U.S., 435 U.S. 561, 98 S.Ct. 1291, 55 L.Ed.2d 550 (1978) (bank entered into sale-leaseback to finance its building because of regulatory restrictions on permitted investments).

[29] For discussions of these differences, *see e.g.,* Gadsden, *supra* note 9*, at* 472-78.

[30] *See, e.g.*, Homburger, *Recharacterization After Fifteen Years*, *supra* note 9 at 127-133; Kenneth Klee, *Recharacterizaiton in Bankruptcy*, *in* CHAPTER 11 BUSINESS REORGANIZATIONS, SK09 ALI-ABA 211 (ALI-ABA CLE 2005) at 232-34; *In re* Morande Enter., 346 B.R. 886, 889-90 (Bankr. M.D.Fla. 2006); KAR Assocs., 180 B.R. at 604-05.

Whether the transaction is a lease or a mortgage, the creditor will be stayed from taking any enforcement actions once the debtor files for bankruptcy.[31] If the transaction is considered a mortgage, then the creditor will generally not receive any payments during the pendency of the bankruptcy case. Ultimately, the creditor will be entitled to receive payments with a present value (as determined by the court) equal to the value of its interest in the collateral.[32] Thus, the amount and timing of the payments, and the interest rate on the debt, can all be rewritten in the bankruptcy case. If the debt exceeds the value of the collateral, the creditor will receive an unsecured claim for the difference,[33] which may result in a payment of only pennies on the dollar for that portion of the claim.

If the transaction is considered a lease, however, the debtor will be required to either assume or reject the lease.[34] If the debtor chooses to assume the lease, it must cure any defaults and provide "adequate assurance of future performance" of the lease terms.[35] To retain the property, therefore, the debtor will have to honor its lease obligations, paying rent even during the bankruptcy proceeding. If the debtor rejects the lease, it is treated as a breach and the property must be turned over the lessor, who may then file an unsecured claim for damages, subject to a statutory cap.[36] The debtor does not have the option of delaying payments while the bankruptcy is pending, nor can it rewrite the payment terms on the lease pursuant to a plan of reorganization, as it could with a mortgage.

Of course, most seller-lessees do not file for bankruptcy, so this difference in treatment will only become an actual issue in a small percentage of transactions. However, the rules bankruptcy courts use for distinguishing between sale-leaseback and mortgage transactions will affect the terms and documentation of most deals, as lawyers advise their clients on the optimal ways to protect their interests. This impact on the negotiation and structuring of deals is likely to far outweigh the direct effects on the relatively small number of parties who actually find themselves embroiled in recharacterization litigation.

IV. RECHARACTERIZATION LAW

Sections B and C of this part will explore the substantive reasoning applied in bankruptcy decisions categorizing sale-leaseback transactions as either true sale-leasebacks or as disguised mortgages. However, bankruptcy law generally depends on the state law effect of contracts and on the state law definition of property rights, so before examining the bankruptcy cases, we must understand the state law framework.[37]

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[31] 11 U.S.C. § 362(a).

[32] 11 U.S.C. § 1129(b)(2)(A)(i)(II).

[33] 11 U.S.C. § 506(a)(1).

[34] If the debtor does not assume -a lease of nonresidential real property within 120 days of the entry of the order for relief in the case, the lease is deemed rejected. 11 U.S.C. § 365(d)(4)(A). The court may extend this 120 day period for up to 90 days, but only one time unless the lessor consents to further extensions. 11 U.S.C. § 365(d)(4)(B).

[35] 11 U.S.C. § 365(b). The debtor is also required to honor its obligations under the lease while deciding whether to assume or reject. 11 U.S.C. § 365(d)(3).

[36] 11 U.S.C. § 502(b).

[37] Whether a transaction results in a lease, as that word is used in the Bankruptcy Code, must ultimately be decided as a matter of federal law. However, the Bankruptcy Code generally looks to the contract and property rights created by the applicable state law, unless that state law is inconsistent with the requirements of the Code. *See* Butner v. United States, 440 U.S. 48, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979). As the Seventh Circuit explained in

A. State Law

The state law on recharacterization is a branch of equitable mortgage doctrine, and the protection of the borrower's equity of redemption lies at its heart.[38] To take a mortgage loan and structure it so that the property is forfeited by the borrower upon breach violates the prohibition on clogging the equity of redemption. If this is done directly, the clog is unenforceable. If it is done indirectly, such as by calling a mortgage a sale-leaseback or an installment land contract, the anti-clogging principle is upheld by recognizing the transaction as a disguised mortgage.

State law typically provides that a deed, absolute on its face, is entitled to a strong presumption that it is in fact a deed and not a mortgage.[39] The party seeking to establish that a sale and leaseback is really a mortgage must show that the actual intent of the parties was to create a mortgage,[40] and must prove its case by clear and convincing evidence[41] – a difficult standard that determines the outcome in many cases. The focus on intent is universal in state law; research does not disclose a single state law real property case where the recharacterization analysis embraced an "economic realities" test like the one currently used by many bankruptcy

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United Airlines, Inc. v. HSBC Bank USA, N.A. (In re United Air Lines, Inc.), 416 F.3d 609, 615 (7th Cir. 2005):

> A state law that identified a "lease" in a formal rather than a function manner would conflict with the Code, because it would disrupt the federal system of separating financial from economic distress; a state approach that gives a little more or a little less weight to one of several "factors" does not conflict with any federal rule because there is none with which it *could* conflict.

[38] The equity redemption refers to the mortgage borrower's right to repay the debt even after default, and thereby free the property from the lien of the mortgage. The equity of redemption survives until the lender has completed a foreclosure action. *See* Tracht, *supra* note 19, at 606.

[39] *See, e.g.*, *In re* San Francisco Indus. Park, 307 F. Supp. at 276; Ministers Life & Cas. U. v. Franklin Park Towers, 239 N.W.2d 207, 210 (Minn. 1976); Flack v. McClure, 565 N.E.2d 131, 135 (Ill. App. 1990); Shusett, Inc. v. Home Sav. & Loan Ass'n, 231 Cal.App.2d 146 (Cal. App. 1965)

[40] *See, e.g.,* Jones v. Rees-Max, LLC, 514 F.Supp.2d 1139, 1145 (D. Minn. 2007) (under Minnesota law, "to overcome the presumption that a deed is a conveyance, it must be clear that both parties intended that the transaction result in a mortgage."); *Shusett v. Home Sav.*, 231 Cal.App.2d 146, 152, 41 Cal.Rptr. 622, 626 (Ct. App. 1965) (holding that lessee must show "that both parties *intended* that the deed, lease and option to purchase be a mortgage to secure such debt or obligation.") (emphasis in the original); Woodmen of the World Life Ins. Soc. v. Knudsen, 275 F.2d 440, 444 (5th Cir. 1960) (holding that under Florida law characterization depends on the intent of the parties); Swenson v. Mills, 198 Or.App. 236, 242, 108 P.3d 77, 80 (2005); Alber v. Bradley, 321 Mich. 255, 32 N.W.2d 454 (1948).

[41] *See, e.g.*, Seaboard Terminals Corp. v. Western Maryland Ry. Co., 108 F.2d 911, 915 (4th Cir. 1940) (holding that New York law requires "evidence that is clear, unequivocal and convincing" that deed was intended as mortgage); *In re* 716 Third Ave. Holding Corp., 340 F.2d 42, 44 (2d Cir. 1964) (stating that New York law requires "clear and convincing proof"); *San Francisco Indus. Park*, 307 F. Supp. at 276 (applying California law); Fox v. Peck Iron & Metal Co., 25 B.R. 674, 687 (Bankr. S.D. Cal. 1982) (California and Virginia law); Nitkey v. Ward, 199 Minn. 334, 344, 217 N.W. 873, 879 (Minn. 1937) (recharacterization requires "something more than a mere preponderance of the evidence . . . The proof must be clear, strong and convincing."); Adrian v. McKinnie, 639 N.W.2d 529 (S.D. 2002) (requiring clear and convincing evidence); Fry v. D.H. Overmyer Co., 525 P.2d 140, 145 (Or. 1974) (same); Iowa State Sav. Bank v. Coonrod, 66 N.W. 78, 80 (Iowa 1896) (same); *Flack v. McClure*, 206 Ill.App.3d 976, 565 N.E.2d 131 (1990) (same) . The "clear and convincing evidence" standard has also been adopted by the RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES), § 3.3(b). *Contra In re* Big Buck Brewery & Steakhouse, Inc., 2005 WL 1320165 (Bankr. E.D.Mich. 2005) (not reported in F. Supp.) (holding that under Michigan law recharacterization requires only a preponderance of the evidence).

courts.

The high burden of proof demonstrates a fundamental respect for private bargains and the free alienability of property, and judicial reluctance to rewrite the terms of a negotiated deal. However, at least where the borrower is desperate and unsophisticated, it runs at odds with the borrower protections that underpin so much of mortgage law. Mortgage law provides that the borrower's equity of redemption cannot be waived in the original mortgage, regardless of the parties' intent.[42] By providing the putative mortgagee with a remedy short of foreclosure – termination of the lease and suit for possession – a mortgage that is disguised as a sale-leaseback would run afoul of this prohibition on clogging the equity of redemption. [43]

The anti-clogging principle bars an express waiver of equity of redemption even by a sophisticated party, but it does not bar sophisticated parties from knowingly entering into transactions that have an effect similar to waiving the equity of redemption, such as a sale-leaseback.[44] When sharp lenders enter into one-sided transactions with unsophisticated individuals, however, courts are likely to invoke the anti-clogging principle, noting that while intent controls, in doubtful cases a transaction will be held to be a mortgage.[45] Many sale-leaseback cases involved desperate homeowners or farmers who sold their properties to avoid foreclosure, leasing them back with options to repurchase, and courts appropriately found many of these transactions to be disguised mortgages.[46] However, even in some of these cases, the lessee has been unable to meet the heavy burden of proving an equitable mortgage.[47]

The foreclosure-avoidance cases are an example of a broader phenomenon, judicial disregard for the form of an otherwise legitimate transaction when the purpose or motivation for selecting the particular form is deemed improper. Thus, a sale-leaseback used specifically to avoid the usury laws will be recharacterized as an illegal loan, and one created solely to generate tax deductions will be disregarded for tax purposes.

Even if the parties have not entered into the sale-leaseback for improper purposes, their intent could still be disregarded because of unwarranted harm done to third parties or because the agreement violates some strongly held public policy. As will be discussed in great detail in Part

[42] The specific justifications for this are debatable, but the most commonly asserted explanations are paternalistic (protecting desperate borrowers from overreaching lenders). *See* Tracht, *supra* note 19, at ____.

[43] The opinion in *Kassuba* was incorrect, or a best imprecise, in stating that a sophisticated party could agree to a transaction "intended to avoid foreclosure requirements." 562 F.2d at 515. If the parties' intent was to do a financing transaction with the property as security, then "foreclosure requirements" – meaning the equity of redemption – cannot be waived. This error is somewhat surprising given the court's reliance on *Conway v. Alexander*, where the Supreme Court had expressly recognized this limitation: "But it is insisted that he intended to take a security for money, and to avoid the equity of redemption; an intention which a Court of Chancery will invariably defeat." Conway v. Alexander, 11 U.S. at 14.

[44] For an excellent discussion of the limits of the clogging principle as applied to commercial transactions, *see* Lawrence G. Preble, *Convertible and Shared Appreciation Loans: Unclogging the Equity of Redemption*, 20 REAL PROP. PROB. & TR. J. 821 (1985).

[45] *See, e.g., Conway*, 11 U.S. at 237; *In re* Kassuba, 562 F.2d at 515 (citing *Conway*); *Flack v. McClure*, 206 Ill.App.3d 976, 565 N.E.2d 131 (1990) (noting that relevant factors include "the relationship of the parties, whether legal assistance was available, [and] the sophistication and circumstances of each party").

[46] *See, e.g.*, Rowland v. Haven Properties, LLC, 2005 WL 1528264, (N.D. Ill. 2005) (not reported in F. Supp.); Essex Property Services v. Wood, 587 A.2d 1337 (N.J.Super. 1991); Collins v. Isaacson, 158 N.W.2d 14 (Iowa 1968); Allen v. Mut. Acceptance Corp., 215 N.E.2d 784 (Mass. 1966); Beeler v. American Trust Co., 24 Cal.2d 1, 147 P.2d 583 (1944); Westberg v. Wilson, 241 N.W. 315 (Minn. 1932).

[47] *See, e.g.*, Iowa State Sav. Bank v. Coonrod, 66 N.W. 78 (Iowa 1896).

V, however, there is nothing inherently unfair or suspect about the desire of commercial parties to use a sale-leaseback structure for a transaction, and while sale-leasebacks raise some concerns about harm to third parties, they are neither unusual nor worse than the concerns raised by a host of other accepted commercial practices and legal rules.

The protection of desperate or unsophisticated seller-lessees is not a significant concern in the present context, focusing on commercial transactions between sophisticated parties.[48] The presumption of validity and the "clear and convincing evidence" standard would typically guide the analysis if these cases were brought in state courts.

B. The Bankruptcy Jurisprudence

Unfortunately, the bankruptcy jurisprudence cannot be so easily summarized. In commercial disputes, the bankruptcy recharacterization cases go in different directions, using two overlapping approaches and often blending them together. Some courts attach primary importance to the intent of the parties, while others focus on the economic substance of the transaction. These differing approaches are not based on differences in state real property law; rather, they have developed over time from other sources, primarily tax and Uniform Commercial Code (personalty) cases. We can best trace this evolution by starting with the intent-test cases, followed by an exploration of the economic reality cases.

1. The Intent Test

The characterization of sale-leaseback transactions is a branch of a much older area of law concerned with the true nature of land transactions. There are centuries of cases on whether a deed, absolute on its face, is actually a mortgage. Despite the depth of the case law, there is little certainty on the treatment that will be accorded many transactions. As illustrated by John Marshall's opinion in *Conway v. Alexander*,[49] however, the parties' intent has always been the touchstone in determining the legal effect given a transaction.

In *Conway*, Robert Alexander had sold certain land to William Lyles, with the land to be put in trust for two years. If Alexander repaid the purchase price to Lyles with interest before the end of those two years, the trustees were to deed the property back to Alexander; if not, they were to deed it to Lyles.[50] The issue for the Court was whether this transaction was actually a mortgage, in which case Alexander's successor would have an equity of redemption unless and until Lyles foreclosed, or a conditional sale with no equity of redemption.

Certain facts argued in favor of declaring the transaction a mortgage. At the time of the transaction, Alexander was in debtors' prison and was in desperate need of cash, and there is always a concern that a lender will compel a desperate borrower to agree to disguise a mortgage

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[48] *See, e.g.*, *In re* San Francisco Indus. Park, 307 F.Supp. at 274 n.6 (distinguishing equitable mortgage cases that "involved 'sellers' with little or no business experience."); U.S. Bank Trust Nat'l Ass'n v. Nielsen Enters. MD, 232 F.Supp.2d 500 (D. Md. 2002), *aff'd in part*, 92 Fed. Appx. 948 (4th Cir. 2004) (finding that sophisticated commercial party did not fall within the intended class of beneficiaries of a state statute on recharacterization as an equitable mortgage); *In re* OMNE Partners II, 67 B.R. at 797 ("I do not believe however that bankruptcy judges have a warrant from Congress to run roughshod over the economic landscape recharacterizing commercial transactions entered into by sophisticated parties . . .").

[49] *Conway*, 11 U.S. (7 Cranch) 218 (1812).

[50] *Id.* at 235-36.

transaction in absolute form.[51] There was also some indication that the purchase price might have been substantially below the market value of the property, which would tend to indicate a loan rather than a sale.[52]

Thus, the nature of the transaction was uncertain, but the court was very clear that the question before it was whether the parties had *intended* a conditional sale, or whether they had *intended* a mortgage:

> To deny the power of two individuals, capable of acting for themselves, to make a contract for the purchase and sale of lands defeasible by the payment of money at a future day, or, in other words, to make a sale with a reservation to the vendor of a right to repurchase the same land at a fixed price and at a specified time, would be to transfer to the Court of Chancery, in a considerable degree, the guardianship of adults as well as of infants. Such contracts are certainly not prohibited either by the letter or the policy of the law. But the policy of the law does prohibit the conversion of a real mortgage into a sale. And as lenders of money are less under the pressure of circumstances which control the perfect and free exercise of the judgment than borrowers, the effort is frequently made by persons of this description to avail themselves of the advantage of this superiority, in order to obtain inequitable advantages. For this reason the leaning of Courts had been against them, and doubtful cases have generally been decided to be mortgages. But as a conditional sale, if really intended, is valid, the inquiry in every case must be, whether the contract in the specific case is a security for the re-payment of money or an actual sale.[53]

The testimony clearly established that the parties had never discussed the possibility of a loan or a mortgage and that both parties had consistently negotiated about and treated the transaction as a conditional sale.[54] Accordingly, the parties did not intend to create a mortgage, and there was no equity of redemption.

This emphasis on the intent of the parties continued in pre-Code bankruptcy cases. For example, in a Fourth Circuit decision from 1940, *Seaboard Terminals v. Western Maryland Railway Co.*[55] the debtor was desperately in need of funds and approached Western Maryland Railway for a mortgage loan. Western refused, but the parties entered into a deal in which Seaboard sold a property to Western, leasing it back for six years on a net lease with rent equal to six percent of the purchase price.[56] The lease included an option for Seaboard to repurchase the property at the end of the lease term for the original purchase price.[57]

Economically, this could easily be construed as a secured loan, oparticularly given the option to repurchase, but the Fourth Circuit found that the economic factors were outweighed by the lack of any contractual obligation for Seaboard to repay the purchase price and by the fact

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[51] *Conway*, 11 U.S. at 240.
[52] *Id.* at 241.
[53] *Id.* at 236-37.
[54] *Id.* at 238-39.
[55] Seaboard Terminals Corp. v. Western Maryland Ry. Co., 108 F.2d 911 (4th Cir. 1940).
[56] *Id.* at 913.
[57] *Id.*

that "Western Maryland Railway never regarded the transaction as anything but a sale."[58] Citing New York precedent, the court held that the seller-lessee had failed satisfy its burden to prove "by evidence that is clear, unequivocal and convincing"[59] that the deed and lease really effected a secured transaction.

In *In re San Francisco Industrial Park*,[60] the debtor had approached an insurance company seeking construction financing. The insurance company offered instead to do a sale-leaseback of the land, under which the seller would have an option to repurchase (after 25 years) for the greater of the original purchase price or seventy-five percent of the fair market value.[61] There was evidence that the land was worth twice the purchase price, and the "rent" was calculated as 6.5% of the purchase price.[62] The insurance company also provided a construction loan for the improvements.[63]

Again, the economics could easily be described as a secured financing, but the court upheld the referee's finding that the debtor had failed to overcome California law's "strong presumption that a deed and a lease with an option to repurchase are what they purport to be."[64] These were sophisticated parties who had negotiated for a sale and leaseback of the property, had documented it as a sale-leaseback, and had carried it that way on their books.[65] The opinion concludes with what is likely the court's ultimate rationale for upholding the agreed form of the transaction.

> The sale and leaseback is a commercially acceptable device which affords significant advantages to both purchaser-lessor and seller-lessee. As the Referee pointed out in his opinion, if this sale and leaseback is not valid, every such transaction could later be upset by a dissatisfied party.[66] (Footnote omitted.)

This emphasis on the controlling effect of the parties' intent rather than the economic terms of the transaction continued in the Seventh Circuit's decision in *Kassuba v. Realty Income Trust*,[67] which relied expressly on *Conway v. Alexander* in holding the transaction a sale-leaseback rather than a disguised mortgage. The debtors had sold the land beneath two large residential apartment complexes to Realty Income Trust (RIT), taking back ground leases with options to repurchase the land for specified amounts.[68] The leases expressly provided that upon termination, ownership of the buildings and improvements would vest in RIT.[69]

When the debtor filed for bankruptcy, RIT sought to terminate the leases and assert ownership of the land and the buildings.[70] The debtor argued that the sale-leasebacks were

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[58] *Id.* at 915.
[59] *Id.*
[60] *In re* San Francisco Indus. Park, 307 F. Supp. 271 (N.D. Cal. 1969).
[61] *Id.* at 273.
[62] *Id.*
[63] *Id.*
[64] *Id.* at 276.
[65] *Id.* at 274.
[66] *Id.* at 276.
[67] *In re* Kassuba, 562 F.2d 511 (7th Cir. 1977).
[68] *Id.* at 512-13.
[69] *Id.* at 513.
[70] *Id.*

actually mortgages and it therefore still had an equity of redemption.[71] The bankruptcy referee, district court, and finally the Court of Appeals held that these were true sales and leases and ruled for RIT, despite the substantial forfeiture this worked on the debtor.[72] Applying Illinois law, the Seventh Circuit held that "the real intention of the parties" determines whether it is a true sale and leaseback or a mortgage.[73] Citing *Conway*, the court stated:

> Thus, the parties by contract may create a set of mutual economic benefits that is similar to a mortgage without conferring on each other the rights and liabilities of judicial foreclosure, if that is what they actually intend. The substance of the transaction that a court of equity will examine is not its economic effect, which the parties determine by their agreement, but instead it is what their agreement is.[74]

Nor did the court appear troubled by the forfeiture – the loss by the debtors not just of the land, but of all of the improvements on the land – holding that while equity abhors a forfeiture, the court will nonetheless give effect to a forfeiture for which the parties have expressly contracted.[75]

The court acknowledged that the sale-leaseback was extremely similar to a mortgage and that, if the parties' intent were ambiguous, these similarities would tend to lead a court of equity to find a mortgage.[76] However, with the intent clear, no such analysis was fitting:

> [A]ppellants have admitted that they were sophisticated in matters of real estate financing at the time of these transactions. They have conceded that RIT intended to avoid foreclosure requirements when it offered to enter into the transaction on the terms and conditions stated in the documents. And they have admitted that they intended to enter into the transactions under those terms and conditions. Appellants have removed any doubt about the intent of the parties. They have not shown any basis in equity for restraining the legal effect of the deeds and leases.[77]

Kassuba is similar to other cases that have upheld sale-leasebacks by focusing on intent.[78] These cases typically rely on two elements: a conviction that a contract negotiated between sophisticated commercial parties should not lightly be recast by the court,[79] and the heavy burden of proof (typically "clear and convincing evidence") state law usually puts on a party who seeks

[71] *Id.*

[72] *Id.*

[73] *Id.* at 514.

[74] *Id.*

[75] *Id. See also* Fry v. D.H. Overmyer, 525 P.2d at 150-51 (upholding forfeiture upon termination of lease portion of sale-leaseback under Oregon law). *In re* SCCC Associates, 158 B.R. 1004 (recognizing validity of windfall for lessor on termination of ground lease for default).

[76] *In re* Kassuba, 562 F.2d at 514.

[77] *Id.* at 515.

[78] *See, e.g.*, *In re* San Francisco Indus. Park, 307 F. Supp. 271, 276 (N.D.Cal. 1969); *In re* OMNE Partners II, 67 B.R. 793 (Bankr. D.N.H. 1986); Woodmen of the World Life Ins. Soc. v. Knudsen, 275 F.2d 440 (5th Cir. 1960).

[79] *See, e.g.*, *San Francisco Indus. Park*, 307 F.Supp. 271; *OMNE Partners*, 67 B.R. 793; Ministers Life & Cas. v. Franklin Park Towers, 239 N.W.2d 207.

to recharacterize a transaction.[80]

B. Defining "Intent"

The underlying assumption in the intent-focused recharacterization cases is that the parties actually had an intent to engage in a "secured transaction" or in a "sale-leaseback," and that this intent can be uncovered. Certainly, there are cases in which the parties adopt a transactional form that reflects their actual intent, and there also sale-leaseback cases where the parties actually intend to enter into a secured lending relationship, but engage in a deliberate subterfuge, perhaps for tax reasons[81] or to avoid usury restrictions.[82] More often, however, the parties engage in the transaction in a particular form because they believe it will best carry out the agreed business terms. Often those business terms are a complex mix of rights and obligations that do not fit clearly into either pigeonhole.

A prime example is *Liona Corp. v. PCH Associates (In re PCH Associates)*, where a series of opinions focusing on economic substance vacillated on whether the parties had entered into a lease, a secured loan, or a joint venture.[83] It is impossible to know if the parties themselves shared any specific intent as to which was the "real" form of the transaction, although it was a complex deal that was negotiated and documented at great length by sophisticated lawyers. The parties' rights to share in earnings, tax attributes, obligations to contribute funds, control rights, remedies, residual values and countless other items were specified in great detail. The bankruptcy issue, however, arose under a statute that provides different rights for lessors than for secured creditors or equity interest holders, so it became necessary to put this irregular polyhedron into a round, triangular or square hole. Whichever was picked, it was bound not to truly fit.

Can intent help us to make the categorization decisions demanded by the statute? If so, we would have to start by determining what "intent" we are seeking. The cases tend to be vague on this fundamental question, and to have answered it in various potentially inconsistent ways. Some courts seem to be seeking the parties' intent as to the "genuine nature" of the transaction. Others have focused on the parties' intent as to the legal form of the transaction.[84] Others have

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[80] *See San Francisco Indus. Park*, 307 F. Supp. at 276; *OMNE Partners*, 67 B.R. at 795; Fox v. Peck Iron & Metal Co., 25 B.R. at 688.

[81] *See, e.g., Fox v. Peck*, 25 B.R. 674 (Bankr. S.D. Cal. 1982) (secured loan disguised as a sale and leaseback so that lender could use "purchase" to complete a like-kind exchange under I.R.C. § 1031).

[82] *See, e.g.*, Kawauchi v. Tabata, 413 P.2d 221 (Ha. 1966) (usurious loan disguised as sale and leaseback); Moran v. Kenai Towing and Salvage, Inc., 523 P.2d 1237 (Al. 1974) (same); Golden State Lanes v. Fox, 232 Cal.App.2d 135, 42 Cal.Rptr. 568 (Cal.App. 1965) (usurious loan structured as sale and leaseback of leasehold estate).

[83] Liona Corp. v. PCH Assocs. (*In re* PCH Associates), 55 B.R. 273 (Bankr. S.D.N.Y. 1985) (holding that purported sale and leaseback created a joint venture), *aff'd*, 60 B.R. 870 (S.D.N.Y. 1986), *judgment aff'd*, 804 F.2d 193 (2d Cir. 1986) (affirming that transaction did not create "true lease" without deciding "[w]hether these contracts created a joint venture, a security agreement, or some other form of investment vehicle"), *on remand to* 122 B.R. 7 (S.D.N.Y. 1990) (holding transaction created joint venture), *judgment vacated*, 949 F.2d 585 (2d Cir. 1991) (holding transaction created a mortgage).

[84] *See, e.g.*, Conway v. Alexander, 11 U.S. 218; *In re* Kassuba, 562 F.2d 511, 514 (7th Cir. 1977) ("The substance of the transaction that a court of equity will examine is not its economic effect, which the parties determine by their agreement, but instead it is what their agreement is.") ; *OMNE Partners*, 67 B.R. at 795 ("There is no question that these parties, both being sophisticated in such complex financing transactions, negotiated and intended the transaction to be a lease rather than a loan transaction."); *In re* Nite Lite Inns, 13 B.R. 900 (Bankr. S.D..Cal. 1981)

focused on the parties' intent as to the economic terms of the transaction, in which case the examination typically morphs into the "economic realities" test discussed in section C, below.[85] The question is sometimes phrased as whether the intent was to transfer an interest to secure an obligation,[86] and other times whether the parties intended to create a "true" landlord/tenant relationship.[87] Some cases are simply not clear about the intent they are seeking to discern.[88]

Consider some of these alternatives. Some courts appear to be seeking the parties' intent as to the "genuine nature" of the transaction, but mortgages and sale-leasebacks are too economically similar to say with any confidence that the sale-leaseback has a "genuine nature" different from that of a mortgage.[89] There may be no intent as to the "genuine nature" of the transaction, just an agreement on the economic terms and means of expressing and documenting them. Moreover, even if one party has an intent as to the "genuine nature" of the transaction, there is no assurance that any other party shared that intent.

An alternative way of couching the inquiry is to ask whether the parties really intended to create a mortgage, using the common definition that a mortgage is an interest in property given to secure the performance of an obligation (usually payment of a debt). Under this framework, if the purpose for the transaction is to secure payment of a debt, then the parties' real intent was to create a mortgage. For this inquiry, the court would be expressly disregarding the parties' intent as to legal form if it is inconsistent with the parties' purpose in entering into the transaction. This approach is helpful in a small number of cases, primarily those in which there is a pre-existing debt and the parties enter into a sale-leaseback to refinance the original obligation.[90] However, in the cases we are addressing, there is no pre-existing debt; if the court concludes it is a mortgage, then the purchase price created a debt, and otherwise, there is just a lease.[91] The

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(stating that under the intent inquiry, "the Court must determine what the parties believed the legal effect of their transaction to be," *citing* Oesterreich v. C.I.R., 226 F.2d 798, 801 (9th Cir. 1955) and M & W Gear Co. v. C.I.R., 446 F.2d 841, 844 (7th Cir. 1971)); Ministers Life & Cas. v. Franklin Park Towers, 239 N.W.2d at 210 ("The parties have an absolute right to bargain for a sale or a loan. Either form of transaction, if intended in good faith, will be upheld.").

[85] *See, e.g., Fox v. Peck*, 25 B.R. at 688 ("In deciding just what the true intent of the parties was when the deal was arranged . . .[t]he significant consideration is the substance of the transaction, rather than its form or the terminology used by the parties." (citations omitted). Commentators in the realm of personal property leasing have generally held that intent is an objective, rather than subjective, matter, and that the relevant intent is the agreement as to the economic terms of the transaction. *See, e.g.*, Corinne Cooper, *Identifying A Personal Property Lease Under The UCC*, 49 OHIO ST. L.J. 195 (1988). This presumes that economic terms can be used to distinguish between lease and security interests, a matter addressed below. However, it also depends on a decision that the parties's intent as to legal form is not relevant in characterizing the transaction.

[86] *See, e.g.*, *In re* SCCC Assocs., 158 B.R. at 1012; Nitkey v. Ward, 217 N.W. 873, 876 (Minn. 1937).

[87] The Ninth Circuit has phrased the inquiry as whether "the parties intended to impose obligations and confer rights substantially different from those arising from the ordinary landlord/tenant relationship." *In re* Moreggia & Sons, Inc. 852 F.2d 1179, 1184 (9th Cir. 1988). This approach has been followed by some other courts, such as *Int'l Trade Admin. v. Rensselaer Polytechnic Inst.*, 936 F.2d 744 (2d Cir. 1991), *In re PCH Assocs.*, 804 F.2d 193 (2d. Cir. 1986), *In re Lunan Family Restaurants*, 194 B.R. 429 (Bankr. N.D.Ill. 1996), and *In re Barney's, Inc.*, 206 B.R. 328 (Bankr. S.D.N.Y.,1997). As should be apparent, this inquiry quickly turns the intent test into a particular version of the economic substance test, because the relevant intent is determined by examining the "obligations" and "rights" negotiated by the parties, rather than intent as to the legal form of the transaction.

[88] *In re* San Francisco Indus. Park, 307 F.Supp. 271 (N.D. Cal. 1969).

[89] *See, e.g.*, Frank Lyon Co. v. U.S., 435 U.S. 561; *PCH Assocs.*, 804 F.2d 193 (2d Cir. 1986).

[90] *See, e.g.*, Beeler v. American Trust Co., 24 Cal.2d 1.

[91] Courts have often said that the existence of a debt is a necessary condition for the transaction to be a mortgage, and have sometimes held a transaction not to create a mortgage where the "borrower" has no binding

analysis is circular.

If intent as to remedy is not necessarily controlling, intent as to the "genuine" form of the transaction may not exist, and intent as to economic substance is (as shown below[92]) problematic, then what factual finding should a court be looking for – what is the underlying intent that a court should seek? This is the first problem in the intent test. The second is the difficulty of uncovering intent if the parties deliberately crafted documents to obscure it. If the intent analysis is supposed to be more than the straightforward acceptance of the words used in the document, then the court is seeking an intent purportedly different from the one expressly set forth by the parties. How can this secret intent be determined?

These difficulties have led some bankruptcy courts instead to examine the "economic reality" – the allocation of economic rights and obligations chosen by the parties. This is not the only direction courts could go, however, and this derogation of intent flies directly in the face of state law.

The parties may not have had an intent as to the inherent nature of the transaction or whether the documents would create a "true" landlord/tenant relationship, but they did come to an actual agreement – an objective manifestation of intent – on the legal form to be used to carry it out. State laws generally accord this agreement substantial weight. The form selected by the parties may be of great importance in terms of the consideration paid by the purchaser/lessor, the state, federal and local tax ramifications, the ability to secure future financing or comply with covenants under existing financing, the accounting treatment given the transaction, the rent set in the lease, and numerous other factors. The mutual intent to adopt a particular transactional form, for any of these reasons, is typically within the parties' discretion. This is the "intent" that is available for examination and that governs in cases like *San Francisco Industrial Park* and *Kassuba*.[93] Note the focus: it is not the intent as to the *inherent nature* of the transaction, or as to the *economics* of the transaction, but the intent as to the *legal effect or form* of the transaction.[94]

If intent as to form is not going to control, then it is presumably intent as to economic substance that the court is seeking. In such cases, the characterization problem is less one of interpretation (determining the parties' intent) than construction (determining the legal effect that will be given to that intent).[95] The intent is not ambiguous, only the legal conclusion is: what category of property and/or contractual rights is created from the ascertained intent of the parties? The assumption behind this question, of course, is that the parties' allocation of rights and obligations – the "economic reality" or "economic substance" – can provide a sound basis for categorizing the transaction. It is to this problematic assertion that we are about to turn.

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obligation to repay. This misses the point that a mortgage can, and often does, secure a nonrecourse obligation.

[92] *See infra* Part III.C.

[93] *See also* Westberg v. Wilson, 241 N.W. 315, 317 (Minn. 1932) ("The established test – intention – for the solution of the question involved recognizes that the parties have a right to make the agreement so that such a transaction might be either an equitable mortgage or a conditional sale. That is why we look for the intention. The parties had a right to make the bargain either way as they in good faith intended.")

[94] Other impermissible motivations, besides the clogging of the equity of redemption, would be to disguise an agreement under which the parties in fact have agreed to make a loan secured by the property, to disguise a transaction to avoid usury restrictions, or otherwise to perpetrate a fraud on third parties. The desire to structure the transaction to minimize taxes should not be considered impermissible in the bankruptcy context, even though it would enter into a recharacterization analysis in a tax proceeding.

[95] *See* RESTATEMENT (SECOND) OF CONTRACTS, § 201, Reporter's Note (explaining that "'interpretation' relates to meaning [rather than] the ascertainment of legal operation or effect, sometimes called 'construction.'")

First, though, we should note that the "intent" and "economic substance" approaches are not mutually exclusive. Many courts using an economic substance analysis claim to be doing so in order to establish the actual intent of the parties.[96] In practice, however, there is a fairly deep divide between these two approaches. Often, courts that rely heavily on the parties' intent all but ignore the economic substance of the transaction. Thus, in cases like *Kassuba* and *OMNE Partners*, the opinions fail to set out the terms of the sale-leaseback in any but the most cursory fashion, making it impossible to determine, at least from the published opinions, whether the outcome would be the same under an economic substance analysis.[97] Similarly, many bankruptcy courts employing the economic realities approach have entirely abandoned any inquiry into the parties' intent as to the form of the transaction.[98]

C. The Economic Realities Test

Despite its long history, the intent test has largely been displaced in bankruptcy by an "economic realities" test. As Judge Easterbrook explained in the *United Airlines* case, "[i]It is unlikely that the [Bankruptcy] Code makes big economic effects turn on the parties' choice of language rather than the substance of their transaction; why bother to distinguish transactions if these distinctions can be obliterated at the drafters' will?"[99] Thus, bankruptcy courts have been inclined to follow the economic substance route rather than relying on the transactional form or the parties' stated intentions.

Bankruptcy courts vary in the precise factors they examine to determine the "economic realities", but common elements, and their rationales, include:

1. Whether the seller-lessee has an option to repurchase the property and, if so, at what price. An option to repurchase the property at a nominal price leaves the entire residual value in the lessee, not the lessor, which may indicate a loan rather than a true sale-leaseback.[100]

2. Whether the sales price for the property reflected its fair market value. If the property is worth substantially more than the purchase price, this might indicate that the property is serving as collateral for the recovery of the funds advanced and that the seller did not actually intend to part with ownership.[101]

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[96] *See, e.g.*, Fox v. Peck Iron & Metal Co., 25 B.R. at 688.

[97] In *Kassuba*, the opinion does not discuss the relationship of the purchase price to the fair market value of the property, the manner in which the rentals were set, nor the price in the repurchase option. In *OMNE Partners*, the opinion does not disclose critical factors such as whether there was a repurchase option of any kind, who would receive the proceeds from insurance or condemnation.

[98] In the UAL cases, the Seventh Circuit described this as a "functional" test to determine whether a transaction is a lease. 447 F.3d at 507; 416 F.3d at 615-16. Other cases that focused on the specific terms of the transaction to the virtual or complete exclusion of the parties' intent as to form include *In re* Dena Corp., 312 B.R. 162 (Bankr. N.D.Ill. 2004); *In re* Lunan Family Restaurants, 194 B.R. 429 (Bankr. N.D.Ill. 1996); Matter of Lansing Clarion L.P.., 132 B.R. 845 (Bankr. W.D.Mich. 1991); *In re* Opelika Mfg., 67 B.R. 169 (Bankr. N.D.Ill. 1986) and *In re* Picnic 'N Chicken, Inc., 58 B.R. 523 (Bankr. S.D.Cal. 1986).

[99] United Airlines, Inc. v. HSBC Bank USA, N.A., 416 F.3d 609, 612 (7th Cir. 2005).

[100] *See, e.g.*, *In re* Lunan Family Restaurants, 194 B.R. 429 (Bankr. N.D. Ill. 1996) (nominal option price indicative of financing transaction); *In re* KAR Dev. Assocs., 180 B.R. at 610 n. 64 (same).

[101] *See, e.g.*, *UAL*, 447 F.3d at 508; *In re* 716 Third Avenue Holding Corp., 340 F.2d 42, 46 (2d Cir. 1964); *In re*

3. Whether the rent under the lease reflects fair market rent for the property, as opposed to providing a particular rate of return to the purchaser-lessor.[102] Rent that is calculated to provide a return on the capital invested by the purchaser-lessor looks more like "interest" than rent, supposedly indicating a loan transaction.

4. Whether the tenant can end the lease, and with it the obligation to pay rent, or whether the obligation to pay rent is absolute. An absolute obligation to make the payments despite the termination of the leasehold seemingly indicates an obligation to repay a debt rather than payment for the use of the property.[103]

5. Whether the lessor is responsible for the obligations "normally" required of a landlord, such as making repairs, purchasing insurance and paying property taxes.[104] If not, then the transaction would seem not to be a lease, but a loan.

6. Whether the lessor had purchased the property for the lessee's use.[105] If the lessor already owned the property, then the transaction looks more like a traditional lease, but if the lessor purchased the property specifically for this lessee to use, then it looks more like the lessor is financing the lessee's acquisition of an asset. (This element is always present in a sale-leaseback, of course.)

These factors have a superficial plausibility, but the economic "substance" identified by these factors often melts away on closer examination.

Consider *In re Dena Corp.*,[106] where the debtor had sold property for $850,000, taking back a five-year lease with an option to repurchase the property for $850,000 at the end of the lease term. This could be viewed as a mortgage transaction, with rent serving as interest and a balloon payment in five years. Applying an economic substance analysis, however, the court found that it was actually a true sale and leaseback. The reasoning is instructive.

First, the debtor argued that the rents were calculated to provide compensation based on the purchase price, but the court found that it "failed to prove this theory by the preponderance of evidence."[107]

Nor was the presence of a repurchase option convincing, because "the fact that the

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San Francisco Indus. Park, 307 F. Supp. at 274-75; *Fox v. Peck*, 25 B.R. 674 (Bankr. S.D.Cal. 1982).

[102] *See, e.g.*, *PCH*, 804 F.2d at 200; Kemp Ind. v. Safety Light Corp, 857 F. Supp. 373, 391 (D.N.J. 1994); *KAR Assocs.*, 180 B.R. at 639; Dena, 312 B.R. at 170; *Fox v. Peck*, 25 B.R. at 688; *In re* Nite Lite Inns, 13 B.R. at 909; *In re* Picnic 'N Chicken, 58 B.R. at 527.

[103] *UAL*, 416 F.3d at 617; First Nat'l Bank of Chicago v. Irving Trust, 74 F.2d 263 (2d Cir. 1934).

[104] *See, e.g.*, *KAR Assocs.*, 180 B.R. at 639; *Picnic 'N Chicken*, 58 B.R. at 527; *Fox v. Peck*, 25 B.R. at 688; *Nite Lite Inns*, 13 B.R. at 909.

[105] *See, e.g.*, *Kemp Ind. v. Safety Light*, 857 F. Supp. at 390 ("USR's control over the selection and use of the property indicate Prudential took title to the property not to obtain the conventional benefits of ownership but to protect its financing of USR's expansion");

[106] *In re* Dena Corp., 312 B.R. 162 (Bankr. N.D.Ill. 2004).

[107] *Id.* at 170.

purchase option is not nominal or token suggests a customary lease with options to buy at the end."[108] That might be – if the property had not originally belonged to the debtor and had not been "sold" for precisely the same price as the repurchase option. These factors could as plausibly indicate that the "repurchase" was actually repayment of the debt.[109]

Third, the court reasoned that the short lease term, five years, showed that the purchaser had not "purchased the property for [the lessee's] use." This completely misunderstands the purpose of this element. The question is not whether the lessor ever intends to use the property or rent it to some third party, but whether the property was selected by the lessee in the first place, which this property obviously had been. If so, then the lessor appears to be financing the acquisition of an asset by the lessee, rather than charging the lessee to use an asset that belongs to the lessor.

Fourth, the court noted that the debtor had not gained any tax advantages from doing the transaction as a sale-leaseback.[110] The implication is that tax motivation might have explained dressing up a mortgage as a sale-leaseback, so the absence of tax motivation implies a genuine sale-leaseback. This neglects the possibility that the tax motivation may have been on the purchaser-lessor's side (and then been reflected in a lower rent), rather than on the debtor's side, and that there are other reasons (like avoiding the equity of redemption and securing better bankruptcy treatment) for costuming a mortgage as a sale-leaseback.

Fifth, the court reasoned, the transaction "confers rights typical of those arising out of an ordinary landlord-tenant relationship." This was a triple net lease – meaning that the tenant had all repair, insurance and tax obligations – which most courts count as *not* being typical of a landlord-tenant relationship.[111] Both sides are right: the "traditional" landlord-tenant relationship put these obligations on the landlord, but triple-net leases have become extremely common in modern real estate leasing transactions involving single-tenant properties.[112]

In short, the economic substance test would seem, at least to me, to point precisely the other way. The point is not that this case was wrongly decided; most economic substance cases are susceptible to similar critique. The point is that the "economic reality" test is conceptually unsound, and therefore generates arbitrary results. Consider in a bit more detail some of the more important factors that courts examine:

1. Whether the rent being charged reflects the rental value of the property as opposed to a negotiated return on the purchaser-lessor's investment.

Suppose a tenant is seeking to enter into a 30-year triple net lease for a warehouse facility. How will the rent be established? It will be a percentage of the current market value of the property that is sufficient to compensate the lessor for the use of its capital asset, the

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[108] *Id.*

[109] *See, e.g.*, *In re* Seatrain Lines, Inc., 20 B.R. at 582 ("The fact that the amount of the purchase option . . .was equivalent to the amount advanced . . .also is strong evidence that the transaction was intended for security."); *see also* RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES), comment c. and illustration 3 (showing that a repurchase option tied to the acquisition price rather than fair market value of the property may indicate a mortgage).

[110] *Id.*

[111] See, e.g., Westship, Inc. v. Trident Shipworks, Inc., 247 B.R. 856 (M.D.Fla. 2000).

[112] *See* Homburger & Marschel, *supra* note 9, at 157-58; Westship, Inc. v. Trident Shipworks, Inc., 247 B.R. 856, 863 (M.D. Fla. 2000); *In re* SCCC Assocs., 158 B.R. 1004,1013 (Bankr. N.D. Cal. 1993); *In re* Integrated Health Servs., 260 B.R. 71, 77 (Bankr. D. Del. 2001).

property. This can be described as "compensation for the use of the property" or "a percentage return on the lessor's investment," and each is equally true. In the triple net scenario, the lessor is making a passive investment; its economic contribution is providing the capital asset, without providing services or taking any risks other than default by the lessee and potential fluctuations in the property's residual value. Thus, in a triple net lease, the rent is simply the return required on a capital investment given the risk level of the transaction,[113] but it is no less a lease for that fact.[114] The same is true in a sale-leaseback; the fact that the "rent" is calculated to yield an appropriate return on the purchase price is no indication that the sale-leaseback is not a "true lease."

2. Whether the tenant can end the lease and with it the obligation to pay rent, or whether the obligation to pay rent is absolute. A tenant's absolute obligation pay the rent despite any termination of the leasehold is said to indicate a debt, rather than payment for the use of the property. Again, this is superficially plausible but turns out to be inconsistent with current industry practices.[115] A lessor entering into a long-term lease will rely on both the value of the real estate and the lessee's contractual obligation to pay rent when considering the deal, and will most likely be seeking to use both the property and the lease as collateral when it raises financing. To maximize the value of the lease as collateral, a lessor may insist on a "bondable lease", meaning that the tenant's obligation to pay rent is absolute, even if the property is destroyed or taken by eminent domain or the leasehold otherwise terminates. With a bondable lease, the credit of the tenant becomes an asset to the lessor in seeking its financing, lowering the rent the lessor must charge the tenant. The absolute obligation to pay the rent is a common term in modern leases, not evidence that the lease is really a loan.

3. Whether the lessee has an option to repurchase the property at a bargain price.

The presence of a repurchase option is sometimes identified as the single most important factor in separating a true sale-leaseback from a financing transaction.[116] It is often said that an option for the seller-lessee to repurchase the property for a bargain price indicates a financing transaction, because the lessee will be economically compelled to repurchase. Thus, it leaves the lessee with the benefit of any increase and risk of any decrease in the reversionary value of the asset.

The basic reason for using the right to the reversionary value as the distinguishing

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[113] *See, e.g.*, *Bundling Sale-Leaseback Sales*, *supra* note 6, at 62 ("Solid investment grade credits with a typical 10- to 15-year lease term are generating cap rates below 7%. Those deals with stellar credit and 'A' real estate are generating even lower cap rates of around 6% or even sub-6%."); Beth Mattson-Teig, *Hands-Free Investments: Today's Commercial Real Estate Clients Seek High-Quality, No-Hassle Deals*, CIRE MAGAZINE (discussing the cap rates (investment returns) demanded by triple-net landlords in different areas of the country).

[114] *See, e.g.*, *SCCC Assocs.*, 158 B.R. 1004, 1013 (Bankr. N.D. Cal. 1993) (in ground lease situation, fact that rents are calculated as percentage of value of the land is not inconsistent with true lease).

[115] Ironically, nonrecourse financing has been the common in real estate transactions for decades, so in many typical commercial mortgage transactions there isn't an absolute obligation to repay.

[116] *See, e.g.*, *Westship v. Trident*, 247 B.R. 856, 863 (M.D. Fla. 2000) ("[T]the most significant factor in determining whether a transaction is a lease or a sale is whether the lessor has retained a residual interest at the end of the lease term.*); In re* Seatrain Lines, Inc., 20 B.R. 577. For an excellent example of this argument in the context of personal property leasing, *see* Corinne Cooper, *Identifying A Personal Property Lease Under The UCC*, 49 OHIO ST. L.J. 195 (1988).

characteristic is to deal with the forfeiture problem. If the reversion belongs to the lessee, then any remedy upon breach by the lessee that permits the lessor to simply recover the property, without returning the excess value to the lessee, may result in a forfeiture. Thus, if the reversionary value belongs to the lessee, a procedure like foreclosure is desirable to avoid forfeiture. If the reversionary value belongs to the lessor, forfeiture is not an issue and simple termination of the lease and repossession by the lessor seems acceptable.

However, the location of the reversionary value is simply not an accurate indication of the likelihood of forfeiture when a lease lasts for decades.[117] Any breach that occurs with considerable time to run will result in forfeiture if the use value of the property has increased over the required rent payments, and will not if the use value has decreased below the rent payments, regardless of who owns the reversionary interest or any options to purchase it. In a long-term lease, the use value so swamps the present value of the reversion that ownership of the reversion is no longer an accurate measure of the potential for forfeiture.[118] (Moreover, the forfeiture concern is less important in bankruptcy than other contexts because the Bankruptcy Code contains specific provisions to avoid forfeiture of any net lease value by authorizing the debtor to cure defaults, assume the lease, and if necessary assign the lease to a purchaser.

It might be argued that the relevance is not the value of the reversionary interest, but the incentive effects and sense of "ownership" that it creates. Whoever owns the reversionary interest has the incentive to maintain and invest in the property. But this, too, is a misleading oversimplification. The benefit from maintaining and investing in the property accrues to whoever has the right to use the property. If the rent is fixed (or increases based on external factors like an inflation measure) then any increase in the value of the property flows largely to the tenant, through its possessory right, until the late stages of the lease.

The incentive effects play an even greater role in debunking the residual value analysis, however. If the transaction contains a repurchase option, the central question in residual value analysis is whether the option price is equal to, above, or below the expected residual value. The argument is that with an option price below the expected residual value, the lessee is "economically compelled" to exercise the option and so is the real owner of the residual interest. However, this assumes that the residual value exists independent of the existence and price of the option itself. In fact, the option serves an important role in maximizing the residual value.

Consider a situation where the seller-lessee is entering into a thirty year lease. At the end

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[117] It is certainly debatable whether the right to the residual is meaningful in personal property leasing, either, given the rate of depreciation of the assets. *See, e.g.*, Homer Kripke, *Book Review*, 37 BUS. LAW. 723, 728 (1982) ("The fact is that the residual at the end of an eight, ten or fifteen-year lease of equipment has so little present value at the inception of the lease . . . that it can make no sense for any determinations for legal, accounting, or tax purposes to turn on characterization of its ultimate value at the end of the lease.")

[118] For a long-term lease the repurchase option may have only a minimal economic substance, because the present value of the right to acquire the property decades from now is only a small fraction of the value of the deal. Consider a sale-leaseback of a retail store worth $10 million, with the rent set at 8% of the purchase price, or $800,000 per year for a 30-year term. Further assume that land appreciation precisely offsets the economic depreciation of the building and improvements, so that the property will be worth the same $10 million at the end of the lease term. Assuming a discount rate for the expected future sale value of 10% (reflecting a higher degree of risk than that associated with the rent flows during the lease term), the present value of the right to own the property at the end of the lease term is roughly $573,000 or just 5.7% of the total of the deal. The parties could structure the deal as rent of $800,000 per year plus a nominal option to repurchase at the end, or as rent of $753,000 per year without an option, and the value of the deal would be the same to the parties

of that time, the value of the property will depend on the level of care and investment that the seller-lessee has put into it. If the lessee makes minimal investments, the property will be worth $10 million at the end of the lease term. However, if it makes roughly $2 million in investments (some related to maintenance and repairs, some financial, some managerial, and so on), the property will be worth $15 million. Specifying these investments in the lease is difficult, both because of the need to anticipate issues that may not arise for decades and because proving breach of such lease provisions is difficult. If there is no purchase option, the lessee will forgo the investments, and the lessor will receive a property worth $10 million at the end of the term. If the lease provides the seller-lessee with an option to purchase the property for $12 million at the end of the lease term, the lessee will make these investments, and the lessor and lessee will both be better off.

One implication is that comparing the option price with the expected value of the reversion may result in a false outcome because there is no single "expected value" if that value is actually a function of the option rights. A second is that to force the parties to use the placement of the reversion to signal to the court the desired characterization may deprive the parties of the ability to use it create optimal incentives in the transaction. With all of these caveats to the importance of a repurchase option, we should not be surprised that the cases on this are all over the map [119]

The economic substance test is not devoid of all content. It can certainly be helpful outside the sale-leaseback context. For example, if a lease or deed is given, which will be cancelled upon the payment of a pre-existing debt, the economic substance is clearly that of a mortgage and the form can be disregarded.[120] It can also provide guidance in some of the "easy" sale-leaseback bases. For example, a sale-leaseback with a short-term market rate lease and no repurchase option is clearly not a secured financing. The present value of the payments by the seller-lessee will be dramatically lower than the price paid by the purchaser, and the major economic value to the purchaser is the value of the property (realized through market rate rents plus a substantial reversion). The purchase price can also be extremely useful in identifying some mortgage transactions that have falsely been labeled sale-leasebacks. If the purchaser acquires the property for substantially less than its fair market value and gives the seller an option to repurchase it at a price substantially below the expected value at the time of repurchase, the

[119] The cases have been clearest – but still not unanimous – in holding that a nominal purchase price indicates a mortgage rather than a true lease. *See, e.g.*, *Lunan Family Restaurants*, 194 B.R. 429 (nominal option price indicative of mortgage transaction); *In re* Kar Dev. Assocs., 180 B.R. at 610 n. 64 (same). When the seller-lessee has an option to repurchase at the same price as the purchaser had paid, courts have split. *See* Atlas Motor Inns v. All American Holding Corp., 8 B.R. 459 (repurchase option at amount of purchase price indicates mortgage); *Seatrain Lines*, 20 B.R. 577 ("The fact that the amount of the purchase option was equivalent to the amount advanced . . . is strong evidence that the transaction was intended for security."); *see also In re* San Francisco Indus. Park, 307 F. Supp. at 275 (option to repurchase at greater of purchase price or 75% of fair market value is indicative of financing, but fact that option could not be exercised for 25 years is indicative of true sale-leaseback); *contra In re* Dena Corp., 312 B.R. at 170 (option to repurchase at sale price does not indicate mortgage transaction); Nitkey v. Ward, 199 Minn. 344, 271 N.W. 873 (Minn. 1937) (sale-leaseback not equitable mortgage despite right of lessee to repurchase the property for the purchase price at any point over next fifty years); *cf. In re* Morande Enter., 346 B.R. 886 (Bankr. M.D. Fla. 2006) (lease with requirement that tenant purchase property at termination of lease held a true lease, not purchase money mortgage).

[120] *See, e.g.*, *In re* Litwiller, 357 B.R. 523 (Bankr. N.D. Iowa 2006); Cagliostro v. Galgano, 69 Misc. 321, 125 N.Y.S. 523 (Sup. Ct. 1910).

transaction is almost certainly a loan: the seller has no intention of actually parting with ownership of the asset for a payment far below its value, and the purchaser has no expectation of retaining or benefitting from the asset unless the purchaser fails to repay the advance.[121]

However, the economic realities of the transaction do not provide meaningful guidance in cases of any real doubt or complexity. In these cases, different courts give the same factors different import and weight, and within a case different factors are likely to point in conflicting directions with no way to balance their relative importance. The result is a complex and expensive inquiry, with unpredictable and arbitrary outcomes. This should come as no surprise. The recharacterization issue exists because sale-leasebacks and mortgages are close substitutes with highly similar economic effects; how, then, could we expect the economics to distinguish between them?[122]

There is a second fundamental level on which the economic realities test fails, at least as it is often applied. By using a checklist of factors to determine the economic realities, the court tend to disregard business purposes served by the chosen form of the transaction other than those on the checklist. If the transaction was structured as a sale-leaseback for accounting reasons, or to comport with regulatory restrictions or loan covenants that bar borrowing but not leasing, these important business reasons are simply ignored in the "economic reality" cases. The "economic reality" that is examined in many cases is limited to the terms of the transaction, while ignoring the *business purposes* that cause parties to structure transactions in the way they do. A proper examination of the economic realities would encompass all of the legitimate reasons why businesses choose one form or another, not a limited subset of of the attributes of the deal.

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To summarize, the bankruptcy law on recharacterization is a largely incoherent mix of cases on intent and economic reality. Within each strand, the questions being asked are unclear, the import of the factors examined is questionable, and the outcomes are unpredictable. Moreover, the bankruptcy cases are using a melange of prior bankruptcy cases, state law cases, federal tax cases, and personal property leasing cases as precedent from which to derive their analyses. Part IV takes on this question – the applicability of various strains of precedent – before returning the question of recharacterization standards in Part IV.

IV. Recharacterization Under Non-Bankruptcy Law

Part III examined the case law on recharacterization of sale-leaseback transactions in bankruptcy cases, finding that the law fails both conceptually and pragmatically. The issue regularly arises in other contexts, however, and there are several other bodies of law to which bankruptcy litigants and courts can and do turn for arguments and guidance. Perhaps these bodies of law can provide a path through the thicket.

[121] *See, e.g.*, Fox v. Peck Iron & Metal Co., 25 B.R. 674 (Bankr. S.D.Cal. 1982); Swenson v. Mills, 108 P.3d 77 (Or. App. 2005); Flack v. McClure, 565 N.E.2d 131 (Ill. App. 1990); Moran v. Kenai Towing and Salvage, Inc., 523 P.2d 1237 (Al. 1974); Beeler v. American Trust Co., 147 P.2d 583 (Cal. 1944).

[122] For more on this point in the context of personal property leases, *see* John D. Ayer, *On the Vacuity of the Sale/Lease Distinction*, 68 IOWA L. REV. 667 (1983); Kripke, *Book Review*, *supra* note 117.

We should first note, however, that the characterization of a transaction for one purpose need not determine its character for other purposes. A transaction may be treated differently for tax, accounting, state commercial law, bankruptcy law, or other purposes, as determined by the policy concerns at issue in each setting.[123] We cannot simply assume that the recharacterization law from some other area provides appropriate guidance for the determination in bankruptcy, but must identify the specific factors that make one body of precedent more or less valuable than another.

The recharacterization question has haunted leases of personalty every bit as much as leases of real property, so perhaps the law of personal property leasing is relevant. Indeed, courts often rely on state and federal precedent from personal property leasing cases in analyzing real property sale-leasebacks. While this is tempting, because the two situations are factually and economically so similar, the presence of Article 2A of the Uniform Commercial Code renders this precedent highly problematic. Although the cases consistently seem to ignore this fact, Article 2A has basically created a tripartite categorization scheme that is incompatible with the lease/mortgage distinction in real property law.

We might also seek guidance from federal tax cases. As we will see, however, the recharacterization problems in bankruptcy and tax differ in their underlying concepts, factual settings, and policy concerns. While it would be nice if tax recharacterization could provide a road map for rationalizing bankruptcy recharacterization, this turns out not to be the case.

The goal in the following sections is not to probe the substantive law applied in these other contexts, although it is useful to have some sense of this. Rather, the point is to examine the relevance and applicability of these bodies of law when the recharacterization of real property sale-leasebacks arises in bankruptcy. There are significant differences between the law of personal property leasing and real property leasing, and powerful arguments that tax precedent is inappropriate in the bankruptcy context. Bankruptcy law cannot rely heavily on either of these bodies of law in leasehold recharacterization cases without importing inappropriate policies and standards.

A. UCC Article 2A

The growth of the equipment leasing market over the last half century led to an effort to deal with the lease/security interest distinction (among other issues) by legislation, Article 2A of the Uniform Commercial Code.[124] Article 2A provides a framework for the relative rights of personal property lessors and lessees.

Article 2A governs only true leases, excluding leases created as security, a distinction

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[123] This point has too often been missed or glossed over, but for a comprehensive examination of the issues involved, *see* Shu-Yi Oei, *Context Matters: The Recharacterization of Leases in Bankruptcy and Tax Law*, 82 AM. BANKR. L.J. 635 (2008).

[124] *See, e.g.*, Richard L. Barnes, *Distinguishing Sales and Leases: A Primer on the Scope and Purpose of UCC Article 2A*, 25 U. MEM. L. REV. 873 (1995); William L. Teague, *A Security Interest By Any Other Name: Resolving the True Lease Versus Lease Intended as Security Question Under the Amended Version of Uniform Commercial Code Section 1-201(37)*, 49 Cons. Fin. L.Q. Rep. 270 (1995); Edwin E. Huddleson, III, *Old Wine in New Bottles: Article 2A – Leases*, 39 ALA. L. REV. 615 (1988); Amelia Boss, *Lease and Sales: Ne'er or Where the Twain Shall Meet?*, 1983 ARIZ. ST. L. J. 357; John D. Ayer, *Further Thoughts on Lease and Sale*, 1983 ARIZ ST. L.J. 341; Peter Coogan, *Is There a Difference Between a Long-Term Lease and an Installment Sale of Personal Property?*, 56 N.Y.U. L. REV. 1036 (1981); William Hawkland, *The Impact of the Uniform Commercial Code on Equipment Leasing*, 1972 U. ILL. L.F. 446.

drawn through the definition provided in section 1-201(37). The revision of U.C.C. section 1-201(37) that accompanied the creation of Article 2A made a very important change in the concept behind the characterization question. Old section 1-201(37) had asked whether the lease was "intended" as security, resulting in a hodge-podge of decisions comparable to what we now face in the real property context. The revised section 1-201(37) removed all mention of intent; it directs the court to examine the objective economic terms of the transaction instead.

Section 1-201(37) does not, however, provide a bright line for distinguishing between leases and security interests. Rather, it instructs courts to look at "the facts of each case."[125] Still, it narrows the inquiry considerably, because the key element under 1-201(37) is the parties' allocation of the residual interest in the property.[126] Under the new definition, if the lessee has no right to terminate the lease, and the lease encompasses the entire economic life of the asset or the lessee is economically compelled to purchase the residual interest, the transaction is a security interest rather than a lease. In other words, if the lease leaves the residual interest in the lessee, it is a security interest. However, there is still plenty of room for litigation under section 1-201(37), because the converse is not true; a transaction which leaves the lessor with the residual interest is not necessarily a lease. It can be construed as a security interest, depending on other factors. The definition also provides that a lease is not a security interest "merely because" of a variety of specific factors of the sort examined under the real property economic

[125] U.C.C. Section 1-201(37) provides in relevant part:

"Security interest" means an interest in personal property or fixtures which secures payment or performance of an obligation. . . .

Whether a transaction creates a lease or security interest is determined by the facts of each case; however, a transaction creates a security interest if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee, and

* (a) the original term of the lease is equal to or greater than the remaining economic life of the goods,
* (b) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods,
* (c) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement, or
* (d) the lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement. . . .

[126] *See, e.g.*, Huddleson, *supra* note 131, at 631 ("The important principle recognized in amended section 1-201(37) is that lessors under a true lease are economic investors possessing a real economic stake in the residual value of the lease goods.");

realities test discussed in Part III.C.[127] Thus, the personalty lease/security interest distinction continues to generate tremendous legal fees and consume large amounts of judicial time and energy.[128]

By its own terms, of course, the Uniform Commercial Code does not apply to leases or mortgages of real property. Nonetheless, the situations are analogous, and courts have sometimes looked to section 1-201(37) for guidance in deciding in real property sale-leaseback cases.[129] Unfortunately, the distinction drawn in the U.C.C. is fundamentally flawed as a basis for real property recharacterization.

The test offered by section 1-201(37) can and has been challenged by asserting the general invalidity of the sale/lease distinction on economic grounds, as laid out in Part II.D. above.[130] However, there are several other important reasons why it is problematic as precedent for real property recharacterization cases.

First, putting aside its merits, the U.C.C. test has simply not been adopted by most states as their law on real property recharacterization. While Article 2A has abandoned intent as the touchstone of the inquiry, intent remains at the center of real property recharacterization in most states. Despite the similarities that may be drawn between the leasing of real and personal property, the state law frameworks remain distinct, and to the extent that bankruptcy courts are required to apply the law of the underlying jurisdiction it is the real property framework that remains applicable. While state legislatures have partly clarified and partly supplanted the

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[127] "A transaction does not create a security interest merely because it provides that:

(a) the present value of the consideration the lessee is obligated to pay the lessor for the right to possession and use of the goods is substantially equal to or is greater than the fair market value of the goods at the time the lease is entered into,

(b) the lessee assumes risk of loss of the goods, or agrees to pay taxes, insurance, filing, recording, or registration fees, or service or maintenance costs with respect to the goods,

(c) the lessee has an option to renew the lease or to become the owner of the goods,

(d) the lessee has an option to renew the lease for a fixed rent that is equal to or greater than the reasonably predictable fair market rent for the use of the goods for the term of the renewal at the time the option is to be performed, or

(e) the lessee has an option to become the owner of the goods for a fixed price that is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed. . . ."

It is not clear from the text whether the statute is simply saying that no one of these elements is adequate by itself to justify the conclusion that the agreement is a security interest, or if it is saying that these factors are irrelevant, alone or together, to the inquiry. *See* JAMES J. WHITE AND ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE §30-3 (4th ed. 1995).

[128] *See, e.g.*, JAMES J. WHITE AND ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE §13-2 (4th ed. 1995) (noting that distinguishing between leases and security interests "is one of the most frequently litigated [issues] under the entire Uniform Commercial Code.") White & Summers provide a detailed discussion of the issue, *id.* at § 30-3.

[129] *See, e.g.*, Kemp Ind. v. Safety Light Corp., 857 F. Supp. 373 (D.N.J. 1994) (relying on the principles of the UCC to determine whether a real property sale-leaseback fell within CERCLA's security interest exemption); *In re* Opelika Mfg., 67 B.R. 169 (relying in part on Georgia's U.C.C. provisions); *In re* Central Foundry, 48 B.R. 895, 898-899 (looking to Alabama UCC for guidance); *In re* Winston Mills, Inc., 6 B.R. 587 (Bankr. S.D.N.Y. 1980) (relying in part on Tennessee U.C.C.'s definition of security interest to hold sale-leaseback a financing lease rather than a true lease).

[130] *See, e.g.*, John D. Ayer, *An Unrepentant View of the Sale-Lease Distinction*, 4 J. BANKR. L. & PRAC. 291 (1995); Homer Kripke, *Book Review*, 37 BUS. LAW. 723, 727 (1982) (arguing that "there is no true distinction between true leases and a purchase of property in installment payments.")

common law on personal property leasing by adopting Article 2A, absent a comparable statutory command there is no basis for using the Article 2A framework to replace the law of real property.

Moreover, the U.C.C. is fundamentally unable to guide us in making the leasehold/mortgage distinction because the U.C.C. does not just distinguish between true leases and security interests, but implicitly recognizes a third, "hybrid" category, the true financing lease.[131] The true financing lease permits a leasing company to acquire title to property and lease it to the user without the lease being deemed a security interest. The parties can thus use the lease as a financing device despite numerous factors that might previously have caused it to be recharacterized as a security interest – and that might cause a bankruptcy court using the economic realities test to recharacterize a real property lease as a mortgage. For example, the financing lease is a lease of an asset selected by the lessee; the risk of loss upon destruction can be placed on the lessee; and the lease may have a "hell or high water" provision, so that the lessee's obligation to pay rent becomes irrevocable once the goods have been accepted.[132] Under a financing lease, none of these factors transform it into a security interest, and the creditor's remedies are those of a lessee, which offers advantages over those accorded to a secured creditor.[133]

Thus, the basic categories under the UCC are simply different, and where the line is drawn in the essentially tripartite scheme that applies to personalty has little direct relevance to the dichotomous world of real property lease/mortgage characterizations. However, it is worth noting that the UCC has validated the use of the financing lease as an intermediate category between a true operating lease and a security interest, and has simplified the distinction by discounting many factors that might previously have caused a financing lease to be deemed a security interest. In essence, the U.C.C. has, in the context of personalty, vindicated the rights of lessors *qua* lessors in many transactions similar to those recharacterized as mortgages in the real property context.

B. Sale-Leaseback Recharacterization under Federal Tax Law

1. Tax Law on Recharacterization

The Supreme Court addressed sale-leaseback recharacterization as a tax issue in the 1939 case of *Helvering v. Lazarus*,[134] holding that the allocation of depreciation deductions did not have to follow legal title to the property. As the Court wrote, "[i]n the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities and formal documents are not rigidly binding."[135] This approach was followed again in *Frank Lyon Co. v.*

[131] *See generally* White & Summers, *supra* note 126, §13-3.

[132] U.C.C. §2A-407(1) ("In the case of a finance lease that is not a consumer lease the lessee's promises under the lease contract become irrevocable and independent upon the lessee's acceptance of the goods.")

[133] In particular, a secured creditor who chooses to retain the collateral or who disposes of the collateral in a manner that is not commercially reasonable typically loses its right to a deficiency and may even be held liable for damages. U.C.C. §§ 9-504, 9-505(2), 9-507(1). The same is not true in the case of a financing lessor, who may re-lease the property at less than fair market rental and suffers only the remedial sanction of being limited to suing for the difference between the contract rent and the market rent. U.C.C. §§ 2A-527, 528.

[134] Helvering v. F. & R. Lazarus & Co., 308 U.S. 252, 60 S. Ct. 209, 84 L. Ed. 226 (1939).

[135] *Id.* at 255.

U.S.,[136] a 1978 case in which the Court examined the economic substance of the challenged transactions, ultimately upholding the taxpayers' claim of a true sale-leaseback. The analysis was factually intense, and concluded with the following:

> In short, we hold that where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes. What those attributes are in any particular case will necessarily depend upon its facts. [137]

Thus, in the tax context, it seems that the economic substance, rather than the intent of the parties, governs the categorization of the transaction. That said, the recharacterization test under federal tax law is no clearer than under bankruptcy law, and has continued to elicit comment, critique and consternation from both the bar and the academy.[138]

There is a twist in the tax context, however, that we do not see in the bankruptcy cases. According to at least some courts, even if it is concluded that the seller-lessee really retained economic ownership (and it is therefore a secured transaction), the sale-leaseback will be upheld for tax purposes if that form was selected for *any* bona fide business purpose.[139] Thus, if the deal

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[136] Frank Lyon Co. v. U.S., 435 U.S. 561, 98 S.Ct. 1291, 55 L.Ed.2d 550 (1978).

[137] *Id.* at 584, 98 S.Ct. at 1304.

[138] *See, e.g.*, David P. Hariton, *Sorting Out The Tangle of Economic Substance*, 52 TAX LAW. 235, 240 (1999) (describing the recharacterization jurisprudence as "confused, ambiguous, and contradictory."). For specific discussions of recharacterization of real estate sale-leaseback transactions for tax purposes, *see*, *e.g.*, Yoram Keinan, *The Many Faces of the Economic Substance's Two-Prong Test: Time For Reconciliation?*, 1 N.Y.U. J. L. & BUS. 371 (2005); Michael A. Yuhas and James A. Fellows, *Sale-Leasebacks Revisited: The Old and The New of Federal Tax Law*, 31 REAL EST. L.J. 9 (2002); Stephan L. Hodge, *Sale-Leasebacks: A Search for Economic Substance*, 61 IND. L.J. 721(1986).

[139] *See, e.g.*, Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 91-92 (4th Cir. 1985); Yuhas and Fellows, *supra* note 23; *see generally* Keinan, *id.*; Kevin M. Keyes, *Evolving Business Purpose Doctrine, in* TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 142 (Practising Law Institute Tax Law and Estate Planning Course Handbook Series No. 9062, 2006). A leading treatise has summarized the law in this way:

> It has been held that in order to disregard a transaction for Federal Income tax purposes, the court must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering into the transaction and that the transaction has no economic substance because no reasonable possibility of profit exists. Once a business purpose is established, the transaction should not be classified as a sham.

MERTEN'S LAW OF FEDERAL INCOME TAXATION, § 6A:79 (West 1999). This addresses the possibility that a court will hold the sale-leaseback to be a "sham transaction," an analysis that should be distinguished from an examination of whether the transaction, though not a sham, is properly classified as sale-leaseback or as a financing. Unfortunately, the case law and commentary often combine and/or confuse the two analyses, and there is little if any doctrinal clarity in the distinction.

was structured as a sale-leaseback to satisfy regulatory restrictions,[140] or because more funds could be secured through the sale-leaseback,[141] the form will be honored.

This is only the roughest and most imprecise of summaries of the tax law on recharacterization, but neither the details, disagreements, and uncertainties of the federal tax cases nor the criticisms of those cases are important for our immediate purpose; our concern is with applicability of this body of precedent in bankruptcy determinations. Some courts have relied on tax precedent in determining bankruptcy recharacterization cases,[142] while others have indicated that the difference in context requires a different analysis.[143] However, it does not appear that any case has actually explained why the test might be different in the bankruptcy context, nor expressly discussed how the test might differ.[144] To do so, we must understand the significance of recharacterization in each context.

2. The Nature of Recharacterization in Tax Determinations

There is a fundamental difference between two meanings of "recharacterization," and bankruptcy disputes and tax disputes are using that word to describe very different concepts. In bankruptcy, “recharacterization” might better be called “characterization”, because we are actually determining the result between the parties (and on third parties bound by the parties’ agreement) of the transaction into which they entered. It is only “re”characterization in that we are questioning whether the original characterization – the parties’ manner of documenting the transaction – is correct. Recharacterization, in this sense, does not change the character of a transaction, it just determines the nature of the transaction that the parties carried out.[145]

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[140] *See Frank Lyon*, 435 U.S. at 564, 98 S.Ct. at 1293-94; *Shusett*, 231 Cal. App. 2d at 152, 41 Cal. Rptr. at 626.

[141] *See* Hilton v. Comm’r, 74 T.C. 305 (1980), *aff’d*, 671 F.2d 316 (9th Cir. 1982).

[142] *See*, *e.g.*, United Air Lines, Inc. v. HSBC Bank USA, N.A., 416 F.3d 609; *In re* OMNE Partners II, 67 B.R. at 797 (citing *Frank Lyon*); *In re* Nite Lite Inns, 13 B.R. 900 (Bankr. S.D..Cal. 1981); *In re* Outboard Marine, 2003 WL 21697357 (N.D.Ill.) (Not reported in F. Supp. 2d).

[143] The court declined to follow state law tax precedent in *In re Opelika Mfg. Corp.*, 67 B.R. 169, 172 (Bankr. N.D. Ill. 1986). Beyond this, there do not appear to be any significant discussions of this issue in the sale-leaseback recharacterization context, but it has been addressed in several other types of recharacterization cases. *See In re* Pacific Exp., Inc., 69 B.R. 112, 115 (9th Cir. B.A.P. 1986) (declining to apply tax precedent in determining whether to recharacterize loans as equity contributions or equitably subordinate those loans); Long Island Lighting Co. v. Bokum Resources Corp., 40 B.R. 274 (Bankr. D.N.M. 1983) (finding tax precedent irrelevant in determining whether agreements resulted in joint venture or whether claim should be equitably subordinated); Matter of Rego Crescent Corp. 23 B.R. 958 (Bankr. E.D.N.Y. 1982) (declining to apply tax precedent in determining whether to recharacterize shareholder loans as equity contributions in bankruptcy case).

[144] *See In re* Outboard Marine, 2003 WL 21697357 (N.D.Ill.) (Not reported in F.Supp.2d):

> Some courts have argued that the policy considerations around recharacterization of a debt as equity in a tax case are distinct from the considerations in a bankruptcy case. *See* Rego Crescent Corp. v. Tymon (*In re* Rego Crescent Corp.), 23 B.R. 958, 962 (Bankr. E.D.N.Y.1982). No court, however, has identified what those different policy considerations are, let alone why those differences should preclude a bankruptcy court that is determining whether recharacterization is appropriate from relying on the factors that tax courts employ in conducting the same type of analysis. These factors serve their purpose; they enable the finder of fact to assess the true nature of a transaction. The Court will not jettison this effective set of factors simply because the factual inquiry occurs in a bankruptcy setting.

[145] For this reason, it would seem that a decision by a bankruptcy court recharacterizing the sale-leaseback as a mortgage might preclude relitigation of that issue by the purchaser-lessor in a subsequent tax proceeding. The

In the tax context, a decision to "recharacterize" does not establish the legal relationship between the parties to the transaction; it merely holds that the transaction will be taxed *as if* it were something else.[146] The fact that the transaction should be taxed as something different does not mean that its substance will be changed or disregarded between the parties to the transaction or as to third parties who may somehow be affected.

For this reason, there is much broader scope to recharacterize a transaction for tax than for bankruptcy: in bankruptcy, it is only a secured transaction if the parties entered into a secured transaction, and the court has no power to determine that policy requires a true sale-leaseback to be treated as a secured transaction.[147] In tax, however, the deal can be treated as a secured transaction either if the parties entered into a secured transaction, or if the parties entered into some other type of transaction (such as a sale-leaseback) that should *for tax purposes* be treated like a secured transaction.

This conceptual difference leads directly to different ramifications if a transaction is recharacterized. Tax recharacterization creates a financial obligation on the part of the losing taxpayer, but does not change the terms of the parties' agreement as to rental obligations or events of default or remedies or any other element of the negotiated transaction. Of equal or perhaps even greater importance, a decision that a sale-leaseback should be treated as a mortgage for tax purposes does not disrupt the reliance on land records and title by third parties who may have dealt with the debtor or with the purchaser-lessor after the sale-leaseback transaction. For example, a decision that the transaction was really a mortgage for tax purposes, and the purchaser-lessor is therefore not entitled to depreciation deductions, will not affect the rights of a mortgagee to whom the purchaser-lessor mortgaged the property.

In contrast, bankruptcy recharacterization is likely to have myriad ill effects on third parties who relied on the record state of title. The purchaser-lessor's mortgagee, to continue the example, may find that it has only a pledge of the purchaser-lessor's mortgage (which may or may not be properly perfected), not a lien on the property itself.[148] Perhaps even more problematic is the position of any lender who provided funds to the debtor, taking a mortgage in the leasehold. Will the mortgage of this now-recharacterized leasehold translate into a security interest in the property itself? As these simple examples show, recharacterization in the bankruptcy context disrupts commercial relations far more significantly, and for many more parties, than tax recharacterization does.

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problem with this, however, is that the purposes of recharacterization, and thus the law applied, are not necessarily the same in tax law ass in bankruptcy. *See infra Part IV.B.*

[146] *See, e.g.*, Nebraska Dept. of Revenue v. Loewenstein, 513 U.S. 123, 136, 115 S.Ct. 557, 565, 130 L.Ed.2d 470 (1994) (noting, in decision on the taxation of repurchase agreements ("repos"), that certain problems "might develop if repos were to be characterized as secured loans for purposes of federal bankruptcy and banking law or of commercial and local government law. Our decision today, however, says nothing about how repos should be characterized for those purposes."); Yuhas and Fellows, *supra* note 23, at 11 ("Federal tax law seeks to answer the question of who is the 'tax owner' of the property, as opposed to who is the legal owner of the property under local law. It can, of course, be the same, but it is not always so.")

[147] *See* U.S. v. Noland, 517 U.S. 535, 116 S.Ct. 1524, 134 L.Ed.2d 748 (1996) and Reorganized CF & I Fabricators of Utah, 518 U.S. 213, 116 S.Ct. 2106, 135 L.Ed.2d 506 (1996) (holding that principles of equitable subordination do not empower courts to categorically reorder the priority of claims).

[148] *See, e.g.*, Matter of Lansing Clarion L.P., 132 B.R. 845 (Bankr. W.D.Mi. 1991) (recharacterization litigation between debtor-lessee and mortgage lender to whom lessor assigned lease);

3. The Function of Recharacterization in Tax v. Bankruptcy

In tax law, the underlying concept is that taxes should be based on economic reality, and to this end substance should prevail over form.[149] It is legitimate for parties to include tax implications as a factor in planning and structuring a transaction, but the IRS still has the authority to challenge whether the form adopted by the parties should govern for tax purposes in order to prevent parties from gaming of system by structuring transactions for tax avoidance. A transaction that accomplishes nothing but reduction in taxes has no independent economic reality and should not be recognized. The question is where the line should be drawn between legitimate planning and illegitimate tax avoidance.

It is instructive to initially put aside any fine distinctions and consider the extreme case. Under tax law, is it not permissible to engage in a sham transaction – one with no economic substance or business purpose – in order to secure a reduction in tax obligations.[150] Such transactions would introduce problems with both horizontal and vertical tax fairness, be a drain on the Treasury, and be a net economic loss to society (due to the transaction costs). The IRS can disregard such a transaction and levy taxes as if it had not occurred because tax reduction in and of itself is not a social objective or goal of the tax code.

Now consider less extreme cases. If a transaction does have economic substance, the IRS can still challenge whether the transaction should be taxed according to the form selected by the taxpayers (e.g., sale-leaseback), or whether it should be recharacterized for tax purposes as some other type of transaction (secured loan). In almost every business transaction, especially one of the magnitude of a sale-leaseback or major financing, the form of the transaction will have significant tax implications, and these will weigh heavily in deciding how to structure the deal. It is important that the IRS be able to challenge the taxpayer's choice of form after the fact, because all of the parties in the negotiation and structuring of the transaction are likely to be working to minimize the tax owed.

Should we have a similar concern for "bankruptcy avoidance" in the sale-leaseback context? Generally not; there can be significant societal benefits to bankruptcy protections that are not present in tax avoidance, and there are also many more constraints that limit inappropriate bankruptcy avoidance. Granting bankruptcy protections to a creditor should result in a lower cost of credit, benefitting the debtor, its other creditors, and the overall economy. Indeed, assuming one goal bankruptcy law is to reduce the cost of capital, this purpose is furthered by permitting the debtor to offer some level of bankruptcy protection to a creditor in

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[149] *See, e.g.*, Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859, 863 (1982) ("As a starting point, there is almost universal assent among tax lawyers and theorists that the revenues should not be defeated by certain entirely artificial maneuvers. We are assured-and it would be hard to demur-that the 'substance' of events should determine their tax consequences and that any other principle would expose the Treasury to obvious manipulations.") Even this, however, does not mean that form is irrelevant in tax cases. *See, e.g.*, Lewis R. Steinberg, *Form, Substance and Directionality in Subchapter C*, 52 Tax Law. 457, 459 (1999) ("[S]ubstance does not always control in Subchapter C . . . because, where the substance of a transaction is ambiguous or capable of being achieved through more than one transactional approach, form frequently becomes the dispositive factor in determining the tax treatment . . .")

[150] Similarly, transactions may be planned and structured so as to reduce the costs to one or both parties of a later bankruptcy filing, but certain types of activities engaged in *solely* to avoid the effects of bankruptcy or bankruptcy law are not permitted. Thus, a creditor may take collateral to increase the likelihood of repayment should the debtor later declare bankruptcy; on the other hand, it is highly unlikely that a debtor can waive the ability to later challenge a transaction as a preference or as a fraudulent conveyance.

exchange for a lower cost of credit.[151] (This is precisely why we allow secured credit in the first place.) Thus, while tax avoidance is an inherently negative element (if sometimes permissible) in a transaction from a societal point of view, the same cannot be said for bankruptcy protection.

Further, the parties face no negative effects from reducing their tax burden; any "excess" reduction in taxes accrues to their benefit and all the costs are externalized onto other taxpayers. Oversight by the IRS is therefore needed to prevent the parties from manipulating the tax rules to reduce their taxes inappropriately. In contrast, the choice between mortgage financing and a sale-leaseback transaction must be recorded in the land records (and disclosed in securities filings, where appropriate), putting on notice any other parties entering into transactions with the debtor. Granting inefficient bankruptcy protections to the purchaser-lessor will tend to increase the company's overall cost of capital through its effects on future transactions with other consensual creditors.[152] This forces the company to internalize those costs, so that inefficient structuring is less of an issue in the bankruptcy context than in the tax context.

Finally, while tax issues loom large in structuring nearly every commercial transaction, default and bankruptcy is only a remote possibility at the time of most financings. Thus, while the parties can be expected to give remedies and bankruptcy effects some weight in their structuring, these concerns are much less likely than tax issues to be allowed to distort otherwise important economic factors in the transaction (such as the amount of the financing, rights to income and appreciation, control over the property, and tax implications). Thus, where both bankruptcy rights and other substantive economic rights and obligations are affected by the choice of form it is likely that the nonbankruptcy aspects will drive the decision and that respecting the parties' choice of form will foster an economically efficient transaction. For this reason, recharacterization claims should be viewed with much less favor in the bankruptcy setting than they are in the tax setting.

4. Tax and Bankruptcy Recharacterization: Policy Concerns

Not only do these factual differences warrant a different standard in bankruptcy as opposed to tax cases, but there are also different policy concerns. Recharacterization in tax cases is primarily about ensuring that taxpayers do not avoid their fair share of the tax burden and preventing parties from wasting resources by conducting transactions that generate tax benefits without real economic gains. Bankruptcy concerns itself largely with preserving the going concern value of insolvent but viable firms, and ensuring the fair and equal treatment of creditors. These policy concerns are addressed in Part ___, below, but for now we should just note that the policy concerns in bankruptcy and tax recharacterization are completely unrelated, rendering the tax standards inherently suspect as precedent for bankruptcy decision making.

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[151] Some have suggested that this should be the primary goal of corporate bankruptcy law. *See, e.g.*, Alan Schwartz, *A Normative Theory of Business Bankruptcy*, 91 VA. L. REV. 1199 (2005). One does not have to go that far to recognize that this is at least one important goal.

[152] The assertion that bankruptcy protections extended to one creditor will result in offsetting increases in capital costs from other creditors and the likely extent of those offsetting increases -- are, of course, disputed and has been discussed at length in the ongoing debates over securitization and bankruptcy proofing. *See, e.g.*, Edward J. Janger, *The Reliance Interest in Insolvency Law: A Response to Harris and Mooney*, 25 Cardozo L. Rev. 1895 (2004); Lois R. Lupica, *Asset Securitization: The Unsecured Creditor's Perspective*, 76 TEX. L. REV. 595 (1998) .

To summarize, differences in the legal frameworks involved, the factual settings and the underlying policies all argue against the reliance on UCC cases or tax precedent in determining whether a sale-leaseback should be recharacterized for bankruptcy purposes, and for a stronger presumption in bankruptcy cases in favor of honoring the form chosen by the parties. How this prescription can and should be implemented is addressed below.

V. A RETURN TO FIRST PRINCIPLES

A. The Rise of the Economic Realities Test

It is worth a brief recitation of the development of the current "economic realities" test, under which the case law has narrowed its focus to a selected range of economic elements as defining the legal nature of the transaction. Although aspects of this change can certainly be found in the earlier case law, the critical turn was *In re Nite Lite Inns*, in which the court held that an involved series of transactions financing the construction of a motel was a secured loan rather than the sale-leaseback it purported to be. While recognizing that some courts had applied an intent-based analysis, the court in *Nite Lite Inns* adopted an "economic realities" test by looking at tax[153] and personal property leasing[154] cases. Although it was applying California law, the court relied particularly heavily on the Supreme Court's then-recent tax recharacterization decision in *Frank Lyon Co. v. U.S*, which examined the economics of the transaction – and the overall circumstances of its negotiation – in great detail.[155]

The analysis in *Nite Lite Inns* begins by noting that the nature of the transaction depends on the parties' intent, defined as "what the parties believed the legal effect of their transaction to be."[156] In other words, the relevant test was what body of law (lease or mortgage) the parties intended and expected to have applied to the transaction. However, the court abandoned this test when it actually looked at intent:

> The evidence of the parties intent in this transaction is somewhat equivocal. On the one hand, throughout their negotiations, Nite Lite and Burke Investors referred to their agreement as a sale-leaseback. Furthermore, all the documentation created by their lawyers reinforced this preference.
>
> On the other hand, individuals bent on disguising the true nature of their business dealings can hardly be expected to disclose their unstated intentions, especially in the writings they create.[157]

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[153] Among the tax cases cited in *Nite Lite Inns* are *Frank Lyon Co. v. United States*, 435 U.S. 561, 98 S.Ct. 1291, 55 L.Ed.2d 550 (1978); *Helvering v. Lazarus & Co.*, 308 U.S. 252, 60 S.Ct. 209, 84 L.Ed. 226 (1939); *In re Berez*, 646 F.2d 420 (9th Cir. 1981); *Sun Oil Co. v. C.I.R.*, 562 F.2d 258, 263-67 (3rd Cir. 1977); *American Realty Trust v. United States*, 498 F.2d 1194 (4th Cir. 1974); *M & W Gear Company v. C.I.R.*, 446 F.2d 841, 844 (7th Cir. 1971); *Oesterreich v. C.I.R.*, 226 F.2d 798, 801 (9th Cir. 1955); and *Universal Drilling Co. v. United States*, 412 F.Supp. 1231, 1235 (E.D.La.1976).

[154] For its analysis of California law, *Nite Lite Inns* relied primarilyon *Rochester Capital Leasing Corp. v. K & L Litho Corp.*, 13 Cal.App.3d 697, 91 Cal.Rptr. 827 (1970), an equipment leasing case, and *Golden State Lanes v. Fox*, 232 Cal.App.2d 135, 42 Cal.Rptr. 568 (1965), a case involving a sale-leaseback of a leasehold estate that focused on usury issues and did not examine California real property law.

[155] *Id.* at 907.

[156] *Id.* at 907.

[157] *Id.* at 908-09.

The court continued not by a closer examination of the parties' intent as to the"legal effect of their transaction," but by focusing on their motivations in entering into the transaction:

> [The seller-lessee's] testimony contains several references to his overriding concern to obtain "100% financing" for his motel project. In this respect, [the seller-lessee] viewed the sale-leaseback as a convenient device to procure the "loan" he required to develop the motel property. Also, Burke characterized the intent of Burke Investors [the purchaser-lessor] in this transaction as that of a "passive investor", looking only for a secure and profitable return on their invested capital. These remarks indicate that Burke Investors was not interested in obtaining any of the attributes of ownership which traditionally attend to landlord status. Burke Investors was simply concerned with effecting a tax-deferred exchange which would result in a profitable investment. Converting the exchange properties into cash and then "lending" the money to Nite Lite looked like a convenient way to achieve this end.[158]

The court then concluded that the intent was ambiguous, and essentially abandoned intent as the criteria. The court characterized the transaction by examining the motivation of the parties (which, despite the court's analysis, were in no way inconsisent with a sale-leaseback) and the transaction's economic terms, such as the fact that the lease was triple net and the rent was calculated to provide a return on the purchaser's investment.[159] The court also chose, without explanation, to disregard the fact that the seller-lessee did not obtain a nominal or bargain repurchase option (just a right of first refusal)[160] and that any condemnation awards would be paid to the purchaser-lessor[161] – economic factors normally considered indicative of a true sale and leaseback. Thus, while the court stated that the intent as to "legal effect" should be examined, in the end it relied on the parties' purposes in entering into the transaction and the specific economic terms adopted, basing its analysis largely on federal tax precedent.

Nite Lite Inns could have been decided on the basis of established California real property law, but the court completely ignored that entire body of law. In numerous cases, California courts had followed the majority approach: a party challenging a sale and leaseback must show by clear and convincing evidence that the parties actually intended to create a mortgage, and the court should examine all of the circumstances surrounding the transaction in determining the intent of the parties.[162] However, not one of these California cases was analyzed or even

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[158] *Id.* at 908-09.

[159] *Id.* at 909.

[160] *Id.* at 908 fn.12.

[161] *Id.* at 909 fn.14.

[162] *See, e.g.*, Beeler v. American Trust Co., 147 P.2d 583 (Cal. 1944); Couts v. Winston, 96 P. 357 (Cal. 1908); Develop-Amatic Engineering v. Republic Mortgage Co.,12 Cal.App.3d 143, 91 Cal.Rptr. 193 (Cal. App. 1970); Shusett, Inc. v. Home Sav. and Loan Ass'n, 231 Cal.App.2d 146, 41 Cal.Rptr. 622 (Cal. App. 1965); Mealy v. Sunland Refining Corp., 96 Cal.App.2d 700, 216 P.2d 59 (Cal. App. 1950). California does not follow the "functional" or "economic realities" test, despite the faulty conclusion to that effect in *United Airlines v. HSBC Bank USA (In re United Air Lines)*, 416 F.3d 609 (7th Cir. 2005). The Seventh Circuit relied largely on two cases for its conclusion, *Burr v. Capital Reserve Corp.*, 71 Cal.2d 983, 80 Cal.Rptr. 345, 458 P.2d 185 (1969), and *Beeler v. American Trust Co.*, 24 Cal.2d 1, 147 P.2d 583 (1944). *Burr* was a personal property leasing case, in which a sale leaseback was

mentioned. *Nite Lite Inns* did not even turn to any prior bankruptcy recharacterization cases – although there was one from the very same district that specifically addressed California law.[163] Instead, the court adopted an analysis based on economic factors that had been developed in completely different – and analytically distinct – settings, primarily federal tax law.

Nite Lite Inns was a critical turning point in the development of bankruptcy recharacterization law. Thereafter, a number of crucial cases relied on *Nite Lite Inns* in adopting the economic realities test, solidly establishing the test in the bankruptcy caselaw.[164] In many of these cases, the examination of the economic terms of transaction completely displaced intent as the basis for the decision.[165] Other cases claimed to seek the intent of the parties, but did so primarily by examining the economic terms of the transaction.[166]

Under state real property law, the "intent" test typically requires an examination of the *totality of the circumstances* – which includes but is not limited to the economic terms of the deal – to help ascertain the parties' true intent.[167] As the bankruptcy case law has developed since *Nite Lite Inns*, focus on a narrow list of specific economic terms has displaced the broad examination of the circumstances and expressions of intent demanded under the law of most states – without any clear rationale for the change, or even indication that the change was noticed or intentional.

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used to evade usury laws; it does not address the state's standards for recharacterization of a real property transaction. *Beeler* relied heavily on the extensive negotiations between the parties over restructuring a loan to prove the parties' *intent*: a sale-leaseback was used with the intention of serving as a security arrangement for the preexisting debt. 147 P.2d at 20. It does allude to some economic terms, but only for minor support.

[163] *In re* San Francisco Indus. Park, 307 F.Supp. 271 (N.D. Cal. 1969). A subsequent case from the Bankruptcy Court of the Northern District of California has also looked to California law. *See In re* SCCC Assocs. *II*, 158 B.R. 1004 (Bankr. N.D.Cal. 1993) (stating that California law looks to "the intention of the parties based on all evidence including evidence of the circumstances under which the agreement was entered into," *quoting* Gronenschild v. Ritzenthaler, 81 Cal. App. 2d 138, 145, 183 P.2d 720 (1947).)

[164] *Nite Lite Inns* was followed most quickly by *Fox v. Peck Iron & Metal Co., Inc.*, 25 B.R. 674 (Bankr. S.D. Cal.1982), which was written by the same judge as *Nite Lite Inns*, and then by *In re Picnic 'N Chicken, Inc.*, 58 B.R. 523 (Bankr. S.D.Cal. 1986) and *In re Opelika Manufacturing Co.*, 67 B.R. 169 (Bankr. N.D.Ill.1986). The Second Circuit reinforced theimportance of these cases by repeatedly cited *Nite Lite Inns*, *Fox v. Peck* and *Opelika* in its leading decisions in *In re PCH Associates*, 804 F.2d 193 (2d. Cir. 1986) and 949 F.2d 585 (2d Cir. 1991).

[165] *In re* Dena Corp., 312 B.R. 162 (Bankr. N.D.Ill. 2004); Lunan Family Restaurants, 194 B.R. 429 (Bankr. N.D.Ill. 1996); Matter of Lansing Clarion Ltd. 132 B.R. 845 (Bankr. W.D.Mich. 1991); *In re* Opelika Mfg., 67 B.R. 169 (Bankr. N.D.Ill. 1986); *Picnic 'N Chicken*, 58 B.R. 523 (Bankr. S.D.Cal. 1986).

[166] *See, e.g.*, Int'l Trade Admin. v. Rensselaer Polytechnic Inst., 936 F.3d 744 (2d Cir. 1991) (examining economic substance to determine whether intent was to create a landlord/tenant relationship); Syracuse Hotel, 155 B.R. at 838 (same); *Fox v. Peck*, 25 B.R. at 688.

[167] *See, e.g.*, *San Francisco Indus. Park*, 307 F. Supp at 274 (under California law, intent is determined by "all of the facts and circumstances surrounding the transaction"); *Fox v. Peck*, 25 B.R. at 688 ("In deciding just what the true intent of the parties was when the deal was arranged, all facts and circumstances must be weighed, reviewed and considered by the Court.") Jones v. Rees-Max, 514 F. Supp.2d 1139, 1145 (D. Minn. 2007); Adrian v. McKinnie, 639 N.W.2d 529, 533 (S.D. 2002); Allen v. Mut. Acceptance Corp., 215 N.E.2d 784, 785 (Mass 1966); Blue River Sawmills, Ltd. v. Gates, 358 P.2d 239 (Ore. 1960) (the parties' "intent must be sought in all the circumstances surrounding the transaction, the pecuniary relations of the parties, their previous negotiations and their acts contemporaneously with the making of the deed, as well as by the written memorials of the deal."); Westberg v. Wilson, 241 N.W. 315, 316 (Minn. 1932) (court must consider "all pertinent facts having a tendency to fix and determine the real nature of [the parties'] design and understanding."); Iowa State Sav. Bank v. Coonrod, 66 N.W. 78, 80 (Iowa 1896) (holding that court must consider "all the facts and surrounding circumstances" and that lessee must prove "by clear and convincing evidence that the deed was intended as a mortgage.").

B. The Federalization of Recharacterization Law

While a few bankruptcy cases have continued to look to state law, whether applying the intent test, analyzing economic realities, or using some combination of the two approaches,[168] the move to an economic realities test has been made largely by abandoning state real property law in favor of a federal bankruptcy recharacterization test built on personal property leasing and federal tax precedents. It has become common for bankruptcy courts to disregard state law, relying on bankruptcy cases without even an allusion to the law of the jurisdiction that governs the underlying transaction.[169] This may be fitting where state law is expressly found inconsistent with the requirements of the Bankruptcy Code,[170] but it has expanded to many cases where no such determination has been made.

In this change, a critical factor has been almost entirely overlooked. This change applies not just to the substantive inquiry – economic realities versus intent of the parties – but also to the burden of proof. As we have seen, state law typically maintains that the form of the transaction is entitled to a presumption of validity that can only be overcome by "clear and convincing" evidence to the contrary.[171] This standard respects the choices made by the parties and provides a level of certainty in transactional planning, while still allowing a party to rebut the characterization if the form was adopted as a subterfuge or was otherwise not "really" what the parties intended.

However, the normal burden of proof in bankruptcy court is a preponderance of the evidence, and at least one Court of Appeals has rejected the state law burden of proof in favor of this preponderance standard.[172] To the extent that bankruptcy courts continue to federalize recharacterization law, looking only to other bankruptcy cases and disregarding state law, we can expect the preponderance standard to continue to displace the higher standard that applies under nonbankruptcy law. In an area where the law is this confused, and the cases so arbitrarily decided, this shift in the burden makes a huge difference in outcomes – probably more than the substantive change in the law that has occurred.

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[168] *See, e.g.*, *In re* Martin Bros. Toolmakers, 796 F.2d 1435 (applying Alabama law); U.S. Bank Trust Nat'l Ass'n v. Nielsen Enters. MD, 232 F. Supp.2d 500 (D. Md. 2002), *aff'd in part*, 92 Fed. Appx. 948 (4th Cir. 2004) (examining Maryland law); *SCCC Assocs.*, 158 B.R. 1004 (applying California law); Atlas Motor Inns v All American Holding Corp. (*In re* All American Holding Corp.), 8 B.R. 459 (Bankr. S.D. Fla. 1981) (examining the law of the Virgin Islands).

[169] *See, e.g.*, *In re* Dena Corp., 312 B.R. 162 (Bankr. N.D.Ill. 2004); Barney's Inc. v. Isetan Co. Ltd. (*In re* Barney's, Inc.), 206 B.R. 328 (Bankr. S.D.N.Y. 1997); *Matter of Lansing Clarion Ltd.,* 132 B.R. 845 (Bankr. W.D.Mich. 1991); *Picnic 'N Chicken*, 58 B.R. 523 (Bankr. S.D.Cal. 1986).

[170] *See, e.g.*, *United Airlines*, 416 F.3d at 615 ("A state law that identified a "lease" in a formal rather than a functional manner would conflict with the Code, because it would disrupt the federal system of separating financial from economic distress; a state approach that gives a little more or a little less weight to one of several "factors" does not conflict with any federal rule, because there non with which it *could* conflict."); *In re* Moreggia & Sons, Inc. 852 F.2d 1179 (9th Cir. 1988) (declining to apply California law to characterize a highly-unusual right to occupy a stall in a produce terminal for fifty years at minimal rent unrelated to market value); *KAR Assocs.*, 180 B.R. 629 (holding that, while Kansas law would uphold industrial development agency transaction as a lease, federal law controls the meaning of lease under section 365 and mandates an economic realities test under which the transaction is actually a mortgage). *KAR Associates* found that a federal rule should apply because accepting the state law characterization of the transaction would contravene the Code's objectives of equality of creditors and fostering reorganization. 180 B.R. at 637-38.

[171] *See infra*Part IV.A..

[172] *United Airlines*, 416 F.3d at 615.

This shift in the burden of proof is simply wrong. As the Supreme Court has held, the burden of proof is part of the substantive law, and when state law is applied in a bankruptcy proceeding it is applied with the burdens of proof used in the state courts.[173] This state law placement of the burden is not arbitrary or accidental. The presumption that the documents, having been executed and recorded, mean what they say, and the insistence on clear and convincing evidence before they are held to mean something different, is critical to the stability of land titles and to the reliance interests of parties who deal with the debtor and the purchaser-lessor; to reject the standard of proof is to reject the underlying policy choices that have been made by the states.

This move to a federal recharacterization law is inconsistent with the underlying structure of our bankruptcy system. One of the fundamental premises of our system is that state law defines most entitlements. By deferring to state law, the bankruptcy system furthers a number of important goals. It allows states to adopt commercial and economic policies, and develop property and contract law, in ways that recognize local preferences and economic conditions. It also discourages parties from filing bankruptcy proceedings purely to change the terms of their contractual agreements, thereby avoiding the costs of forum shopping and the increase in commercial uncertainty and contracting costs that accompany it.[174]

For these reasons, the Bankruptcy Code recognizes the debtor's and creditors' state law contractual and property rights "unless some federal interest dictates a different result."[175] State law governs the parties' rights unless that law is inconsistent with the Code, and such inconsistency is not to be found lightly. As the Supreme Court has directed, the Bankruptcy Code should not be read to displace state regulation over "the essential sovereign interest in the security and stability of title to land,"[176] unless "the federal statutory purpose [is] 'clear and manifest.'"[177] Courts have sometimes noted that if a state makes a purely nominal determination

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[173] In *Raleigh v. Illinois*, the Court held that the burden of proof on a tax claim, which state law placed on the taxpayer, could not shifted to the taxing authority merely because the claim was being adjudicated in a bankruptcy proceeding: "Given its importance to the outcome of cases, we have long held the burden of proof to be a 'substantive' aspect of a claim. . . . That is, the burden of proof is an essential element of the claim itself; one who asserts a claim is entitled to the burden of proof that normally comes with it." 530 U.S. 15, 20-21, 120 S.Ct. 1951, 1955, 147 L.Ed.2d 13 (2000) (citations omitted).

[174] *See, e.g.*, Charles W. Mooney, *A Normative Theory of Bankruptcy Law: Bankruptcy As (Is) Civil Procedure*, 61 WASH. & LEE L. REV. 931, 938 (2004) (arguing that bankruptcy should be recognized as a procedural system that "should take substantive legal entitlements of rightsholders as it find them, honoring both powers and limitations under nonbankruptcy law."); Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 822-28 (1987) (discussing the importance of respecting nonbankruptcy entitlements in bankruptcy).

[175] *See* Butner v. United States, 440 U.S. 48, 55, 99 S.Ct. 914, 918, 59 L.Ed.2d 136 (1979):

> Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.... The justifications for application of state law are not limited to ownership interests; they apply with equal force to security interests, including the interest of a mortgagee in rents earned by mortgaged property.

[176] *In re* BFP, 511 U.S. 531, 544 n.8, 114 S.Ct. 1757, 1765 n.8 128 L.Ed.2d 556 (1994).

[177] *Id.* at 544, 114 S.Ct. at 1765 128 L.Ed.2d 556 (citations omitted). In *BFP*, the Court held that a foreclosure sale properly conducted under state law could not be set aside under the Bankruptcy Code's fraudulent transfer provisions:

on the lease/mortgage issue, without examining the substance, such a determination could be inconsistent with the need under the Code to identify whether there is a "true lease,"[178] but even assuming this is correct, apart from this narrow circumstance state law should govern.

States have proven themselves willing and able to regulate questions recharacterization where they have deemed such regulation appropriate. Not only is there an extensive common law on equitable mortgages, but in areas where states have been particularly concerned that mortgage law has been improperly bypassed statutory controls have often been put in place. For example, many states have an extensive framework for dealing with installment land contracts as equitable mortgages; other states have felt it important to give parties the flexibility to select between the installment land contract and the mortgage, maintaining them as separate transactional forms.

To the extent that states are troubled by the overlapping elements of mortgages and sale-leaseback transactions, we can expect them to address those concerns, and bankruptcy law should not preempt the authority of the states on the issue. States in fact do address these concerns, both through their direct law on recharacterization and through laws that grant protections to lessees that address some of the same concerns as mortgage law. For example, Maryland has a statutory right of redemption which permits a tenant to cure its default and reinstate a lease even after termination, but expressly excludes from the statute any nonresidential lease for a term of less than 99 years.[179] In other words, the state has made a specific determination that some lessees should be afforded additional protections, and others should be held to their contractual agreement.

Most disputes over recharacterization of sale/leasebacks occur in the context of section 365 of the Code, which governs the assumption or rejection of leases. Courts have generally held that "lease," as used in section 365, means only a "true lease" and not some other transaction, like a mortgage, created in form of a lease.[180] The issue, however, is what body of law to use to distinguish an equitable mortgage from a true lease.

Several courts have begun with the observation that the Bankruptcy Code does not define

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> It is beyond question that an essential state interest is at issue here: We have said that "the general welfare of society is involved in the security of the titles to real estate" and the power to ensure that security "inheres in the very nature of [state] government." *American Land Co. v. Zeiss*, 219 U.S. 47, 60, 31 S.Ct. 200, 204, 55 L.Ed. 82 (1911). Nor is there any doubt that the interpretation urged by petitioner would have a profound effect upon that interest: The title of every piece of realty purchased at foreclosure would be under a federally created cloud. . . . To displace traditional state regulation in such a manner, the federal statutory purpose must be "clear and manifest," *English v. General Elec. Co.*, 496 U.S. 72, 79, 110 S.Ct. 2270, 2275, 110 L.Ed.2d 65 (1990). Cf. *Gregory v. Ashcroft*, 501 U.S., at 460-461, 111 S.Ct., at 2400-2401. Otherwise, the Bankruptcy Code will be construed to adopt, rather than to displace, pre-existing state law.

511 U.S. at 544-45, 114 S.Ct. at 1764-65 (footnote omitted)

[178] *See, e.g.*, United Airlines, Inc. v. HSBC Bank USA, N.A., 416 F.3d 609, 615 (7th Cir. 2005); *In re* Moreggia & Sons, Inc. 852 F.2d 1179, 1183-84 (9th Cir. 1988) ("Simply meeting the state law definition of a lease will not necessarily mandate the mindless application of section 365. Rather, the substance of the agreement must properly fall within the scope of the type of agreement anticipated by Congress in enacting section 365."); *KAR Assocs.*, 180 B.R. at 636-39; Matter of Historic Macon Station Ltd. Partnership, 152 B.R. 358 (Bankr. M.D.Ga. 1993); Gadsden, *Recharacterization of Industrial Development Bond Leases*, *supra* note 9, at 487-89.

[179] *See* Md. Code, Real Property, section 8-110.

[180] See, e.g., In re KAR Assocs., 180 B.R. 629, 636-39. (D. Kan. 1995).

the word "lease," but that the legislative history to Section 502(b)(7), which puts a cap on landlords' damage claims upon termination of a lease, explains that "[a]s used in section [502(b)(7)], the phrase "lease of real property" applies only to a "true" or "bona fide" lease and does not apply to financing leases of real property or interests therein, or to leases of such property which are intended as security." Reasoning that section 365 and section 502(b) are part of an integrated system, a number of courts have concluded that the limitation to "true leases" applies to section 365 as well.

There are at least two major problem with this analysis. First, Section 365(m) does provide express guidance on the meaning of the word "lease", at least in the case of real property: "For purposes of this section 365 and sections 541(b)(2) and 362(b)(10), leases of real property shall include any rental agreement to use real property." The Code provides, therefore, that "leases of real property" has a specific meaning in several sections, including section 365 – but that this meaning does not apply to 502(b). The legislative history on the meaning of "lease" in section 502(b) therefore has no direct relevance to the meaning of "lease of real property" in section 365.

According to the legislative history, the cap on damages contained in section 502(b) was specifically limited to "true leases" and does not apply to a financing lease. If state law does not draw this distinction in manner consistent with section 502(b), a federal rule must apply when determining whether or not damages for breach of "lease" are capped under section 502(b)(7). However, it does follow that "leases of real property" as used in section 365 is limited to 'true leases," or that, if it is, this requires the application of a federal rule rather than state law to draw the distinction. As one commentator has written,"If section 365 applies to 'any rental agreement,' the terms or substance of a lease should be irrelevant to the application of that section."[181]

Second, the legislative history is equally clear in establishing that "[w]hether a ... lease constitutes a security interest under the bankruptcy code will depend on whether it constitutes a security interest under applicable State or Local law."[182]

If section 365 applies only to "true leases", the applicable state law should govern the recharacterization question if the bankruptcy court finds that state law distinguishes between nominal and "true" leases in a manner consistent with the Code. If state law does not draw such distinctions, the bankruptcy court would then have to make the distinction as a matter of federal law, but with no statutory guidance beyond the rather unilluminating "any rental agreement to use real property" in section 365(m). This section could be read to apply to any lease, but it is also perfectly plausible to argue that a putative lease that is actually a mortgage is therefore not a "rental agreement." Given the lack of statutory clarity, the body of law developed in the several states can and should guide bankruptcy courts in making the determination. This is consistent with the general deference to state law entitlements that is embodied in the Code as well as the specific legislative history. [183]

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[181] Homburger and Andre, supra note 9, at 130.

[182] H.R.Rep. No. 95-595, at 314 (1977), U.S.Code Cong. & Admin.News 1978, pp. 5787, 6271.

[183] The alternative, that bankruptcy law determines whether a sale-leaseback is a true lease but state law governs whether it is a security interest, is nonsensical. Suppose the court holds that it is not a "true lease", but state law provides that it is not a security interest. The lender/lessor would find itself in the awkward position of being entitled neither to the Bankruptcy Code's protections for landlords nor those provided to secured creditors. Moreover, the real property is only property of the bankruptcy estate to the extent of the debtor's interest in the property, as

C. Refining Recharacterization: Recognizing State Law, Bankruptcy Policies and Commercial Realities

The "intent" test relied upon by most states is far from clear in its application to any given set of facts (although the high burden of proof does provide at least some predictability). This means that both state and bankruptcy courts face a difficult determination when a recharacterization case comes up. If state law is determined to be inconsistent with the Bankruptcy Code, then the court is in an even more difficult position because the Code does not provide any clear guidance on what a federal recharacterization test should look like. The economic realities test that has developed is one option, but even apart from its questionable merit, we should be troubled that it diverges so severely from the majority rule in the states.

How, then, should courts approach a recharacterization decision? The one thing that the court always has available as a starting point is the fact that parties agreed upon a particular form for their transaction. Despite any disdainful cries of "empty labels" and "mere form", the transactional form provides a direct indication of the parties' agreement as to the legal rights that they would each have under the transaction. We do a disservice when we discount the form selected by the parties.

Most sale-leasebacks, even when the parties' intent is clear, could be recast as mortgages if examined through the lens of the economic realities test, simply because the two transactions are so similar in their fundamental economics. Assuming there is value to allowing parties to engage in sale-leaseback transactions, the sale-leaseback could be saved from arbitrary recharacterization in any of three basic ways. First, when parties negotiate sale-leaseback transactions, they can voluntarily limit the economic terms to those blessed by the economic realities test [e.g., a short lease term without renewal or purchase options]. In fact, this is the route that some parties currently take, trying to limit the terms to those likely to be sustained upon later attack. Second, the sale-leaseback could be protected by giving determinative force to the allocation of the residual interest or creating some other 'safe harbor' which will ensure treatment as a sale-leaseback despite other potentially 'conflicting' factors. This is the direction the U.C.C. went, albeit incompletely, for personal property leasing. Third, courts could permit the intent of the parties (defined as "what legal structure did the parties intend to create") to control.

The first two options, limiting the use of the sale-leaseback to economic terms that are unquestionably different from a secured transaction or requiring the compliance with specified safe harbor terms, deprive the parties of the ability of structure the transaction in the manner that may best suit their economic, tax, accounting, regulatory and strategic objectives. For example, giving determinative effect to the allocation of the residual interest would allow the parties to secure sale-leaseback treatment whenever desired. However, it requires the parties to direct one economic factor in a potentially inefficient manner simply to signal to the courts the desired

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determined by state law. Thus, the estate would include only the leasehold, not the fee, arguably precluding the sale of the real property pursuant to section 363 – a power that would be available if the property were owned subject to a security interest. A host of other potential conflicts could arise from using a federal test for recharacterization and a state test for the existence and perfection of a security interest.

treatment. The direct economic value of the residual interest may be modest, but allocation of the residual interest affects the incentives that the parties have for future investment, maintenance, repairs, and improvements to the property.[184] To tie this single factor to the bankruptcy categorization of the transaction will render the sale-leaseback unavailable in some circumstances where it would otherwise be desirable. This might be justified if the sale-leaseback were an inherently unfair or inappropriate transaction, or if it somehow harmed third parties in a manner distinct from or disproportionate to other ordinary commercial transactions. But, as discussed immediately below, this is not the case.

Rather than having economic terms drive the characterization, it would be possible to allow the parties' chosen transactional form to control. This brings us back to Judge Easterbrook's comment from the *United Airlines* case: "[i]It is unlikely that the Code makes big economic effects turn on the parties' choice of language rather than the substance of their transaction; why bother to distinguish transactions if these distinctions can be obliterated at the drafters' will?"[185] This statement has an intuitive appeal, but actually ducks the critical issues.

To say that the outcome should depend on the "substance of the transaction" rather than on "the parties' choice of language" requires several false assumptions. The first is that one can meaningfully draw distinctions based on the "substance of the transaction"; we have seen that this is often not true.[186] The second is that the parties are not entitled, in establishing the "substance of the transaction," to define their legal rights by selecting a particular transactional form. As a general matter, that assumption is obviously not correct. Contracting parties are given many opportunities to define their legal rights, with respect to state law enforcement actions or a subsequent bankruptcy case or a host of other matters, by selecting a transactional form. To take the most basic examples, a loan can be made on a secured or unsecured basis, or parties can enter into a transaction as tenants in common, general partners, members in an LLC or shareholders in a C or S corporation. In each case, if the formalities are properly honored the chosen structure is binding on the parties, on third-parties, and in any subsequent bankruptcy case.

Does something distinguish the sale-leaseback choice from these other choices of transactional structure that bankruptcy law upholds? To the extent there is truth behind Judge Easterbrook's *dicta* – that empty labels cannot be allowed to control the legal treatment under the Bankruptcy Code – it does not arise from a general determination that substance governs over form. Form *is* substance if we respect it, because it controls the parties rights.

Judge Easterbrook is right, however, that parties cannot be permitted to undercut the Bankruptcy Code through the arbitrary application of false labels to their transactions. Where the parties attach a false label to a transaction to avoid legal requirements or subvert the statutory structure of the Bankruptcy Code, that label can and should be disregarded. Thus, courts can and should recharacterize the transaction where the economic substance is clearly that of a loan and not a lease,[187] or the parties actually intended a loan but adopted the form of a sale-leaseback in

[184] *See supra* text accompanying notes 118-19.

[185] United Airlines, Inc. v. HSBC Bank USA, N.A., 416 F.3d at 612.

[186] *See supra* Part III.D.

[187] *See, e.g.*, Fox v. Peck Iron & Metal Co., 25 B.R. 674 ("purchaser-lessor" paid less than half the value of the assets, permitted "seller" to select the specific assets "sold", and gave "seller" the right to repurchase for the sale price); *In re* Seatrain Lines, Inc., 20 B.R. 577 (Bankr. S.D.N.Y. 1982); Moran v. Kenai Towing and Salvage, Inc., 523 P.2d 1237 (Al. 1974) (the parties structured an initial loan as a sale and leaseback; when borrower needed additional

order to avoid usury laws or commit some other fraud or deceit.[188]

However, where transactional elements blend along a spectrum so that multiple characterizations are credible, the parties have not adopted a false label and the court has no basis for recharacterizing the transaction unless the selection of this form was somehow inconsistent with fundamental policies. This is essentially the position that state law takes through its presumption of validity and high burden of proof for those who would seek recharacterization. As discussed above, permitting the expressed intent of the parties, as shown by the transactional form adopted, to control the categorization of close cases furthers two fundamental bankruptcy policies – efficient commercial financing and honoring parties' state law entitlements – without unduly burdening any others.

This point is critical, and must be understood: there is no fundamental problem with the sale-leaseback which should make it a disfavored transaction in bankruptcy cases. Two primary policy concerns are often identified for commercial bankruptcy law: facilitating the reorganization of firms that are financially distressed but economically viable, and ensuring equal treatment of equally situated creditors.[189]

The risks to these policies posed by a sale-leaseback are no different in kind or quantity than other risks routinely accepted by bankruptcy law. For example, treating the purchaser-lessor as a true lessor might inhibit reorganization by limiting the ability to restructure the obligation the way a secured debt could be restructured. But this restriction is no greater than if the enterprise had leased the facility in the first place, a common occurrence — and is far less than the burden on the estate posed by the rise of securitization.[190] Further, the protections given to a lessor are similar to those accorded other suppliers and contracting parties, who need not continue to supply assets to the debtor's enterprise without ongoing payment.

It is true that the debtor is more constrained in dealing with a lessor than with a secured creditor, but the Code deals with this expressly, giving the debtor powerful tools for dealing with

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funds, lender made further loan and parties re-set the "rental" payments; "purchase price" totaled less than $20,000 on property valued at more than $75,000, and upon payment of the rents for the full term of the lease title was to be automatically reconveyed to borrower).

[188] *See, e.g.*, *Moran v. Kenai Towing*, 523 P.2d 1237 (Al. 1974) (usurious loan structured as sale and leaseback); Kawauchi v. Tabata, 413 P.2d 221; Golden State Lanes v. Fox, 232 Cal.App.2d 135, 42 Cal.Rptr. 568 (Cal.App. 1965) (usurious loan structured as sale and leaseback of leasehold estate).

[189] *See, e.g.*, *KAR Assocs.*, 180 B.R. 629, 638 ("The purpose of Chapter 11 is to restructure a business' debts so that the business may continue in operation. In addition, the equitable distribution of assets is an overriding purpose of the Code." (citations omitted)); Raymond T. Nimmer, *Executory Contracts in Bankruptcy: Protecting the Fundamental Terms of the Bargain*, 54 U. COLO. L. REV. 507, 509-10 (1983) ("The bankruptcy system serves two primary objectives. The first concerns economic rehabilitation of debtors by restructuring the ratio between debts and assets or income. . . .The second, general goal of bankruptcy is to establish a forum for an orderly and equitable distribution of assets that optimizes recovery by the creditors. ")

[190] The benefits accorded to a purchaser-lessor over a secured creditor are shamed by those enjoyed by the purchasers of asset-backed securities. In a securitization, the company sells assets to a special purpose entity ("SPE"). The SPE sells securities that represent either interests in the assets now owned by the SPE or bonds or other securities backed by those assets. *See generally*, Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133 (1994). If the sale from the company to the SPE is a "true sale", then those assets are not part of the company's bankruptcy estate, and the securities holders are protected from the bankruptcy risks faced by a secured lender or even a purchaser-lessor. *See generally* Stephen J. Lubben*, Beyond True Sales: Securitization and Chapter 11, 1 N.Y.U. J. L. & BUS. 89 (2004);* Michael J. Cohn, *Asset Securitization: How Remote Is Bankruptcy Remote?*, 26 Hofstra L. Rev. 929 (1998)

its lease obligations. It has the option of assuming the lease, either to retain or assign it, or rejecting the lease if it is burdensome. In addition, the Code caps the damages that a lessor can claim for breach of the lease in its lessee's bankruptcy case.

The debtor might prefer to be able to withhold all payments during the bankruptcy case or reduce the obligation through "cram down," as it sometimes can with secured debt, but the constraints imposed on the debtor by honoring the parties' agreement to structure the transaction as a sale-leaseback are all well within the norm of commercial and legal relations that exist in almost any bankruptcy proceeding.

Some courts situate the recharacterization issue as one of fairness and equality among creditors. As the Second Circuit wrote in *PCH*: ""If [secured] transactions, loans and other financing arrangements can be couched in lease terms, and can thereby be assumed by the bankrupt estate, the 'lessor' gains a distinct advantage at the expense of other creditors without a concomitant benefit to the bankrupt estate."[191] It is unquestionably true that if any creditor can disguise its claim as one entitled to better rights, the creditor will secure an improper advantage. However, this is only true if the claim is pretending to be something it is not.

This point of view starts with the assumption that lease transactions are "financing arrangements" that should be treated like secured loans – that is, it assumes its conclusion. The Bankruptcy Code does not require that all creditors be treated equally, just that comparably situated creditors be treated similarly.[192] Whether creditors are comparably situated is typically a matter of the state law effect of the agreements of the parties. Thus, the Bankruptcy Code does not insist that secured creditors abandon the benefits of their security, that creditors with offsets give up those offsets, or that contractual subordination agreements be disregarded. It recognizes the unique features of a letter of credit, despite the fact that the letter of credit serves a similar function to a guaranty.[193] Honoring a sale-leaseback structure does no more harm to the equality principle than any of these other state law distinctions that are left undisturbed by the Code.

In fact, recharacterization is far more likely to lead to unfair treatment among creditors than honoring the sale-leaseback, because the purchaser/lessor has accepted a position that is not comparable to that of a mortgagee. First, the purchaser/lessor is likely to have advanced more money than a mortgagee would, to the direct benefit of the debtor and at much greater risk to the purchaser/lessor. Second, the choice of a sale-leaseback is often encouraged by the value to the purchaser-lessor of the depreciation deductions for the improvements on the real property. These

[191] *In re PCH*, 804 F.2d at 800; *see also* Westship Inc. v. Trident Shipworks, Inc., 247 B.R. at 863 ("executory contracts and leases that benefit the bankruptcy estate are favored while other financing arrangements that are couched in lease terms and extend a distinct advantage for the "lessor" at the expense of other creditors without benefit to the estate are to be avoided."); *see also In re* Wedtech Corp. 72 B.R. 464, 467 (Bankr. S.D.N.Y. 1987);

[192] *See, e.g.*, 11 U.S.C. § 1122 (a) (requiring that all claims put in the same class, for purposes of voting on and treatment under a plan of reorganization, be "substantially similar to the other claims . . . in that class."); 11 U.S.C. § 1123(a)(4) (providing that all claims within a class receive "the same treatment" unless the holder of the claim has agreed otherwise); 11 U.S.C. § 1129(b)(1) (providing that a plan of reorganization may not "discriminate unfairly. . . with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.").

[193] "A letter of credit always serves as a guaranty. This does not mean that it is a guaranty. A letter of credit is an identical twin to a guaranty, but the fact that two things look alike and may be used for the same purpose and are difficult to distinguish one from the other does not mean they are the same thing, and does not mean there are not differences, which, however subtle, are of major importance." Harfield, *Uniform Commercial Code Symposium: Code Treatment of Letters of Credit*, 48 CORNELL L.Q. 92, 93 (1963).

deductions reduce the taxes of the lessor, which in turn shares these savings with the debtor through lower lease payments.

Recharacterizing the sale-leaseback for bankruptcy purposes is likely to lead to tax recharacterization, in which case the purchaser-lessor may be severely harmed without commensurate benefit to the estate. Where the debtor has filed for bankruptcy and now seeks to recharacterize, it has already benefitted from the lower lease payments but now threatens to deprive the purchaser-lessor of the tax savings on which those rent levels were predicated. Recharacterization by the bankruptcy court thereby deprives the purchaser-lessor of the benefit of its bargain with the debtor in a manner disproportionate to the losses shared by the debtor's other creditors as a result of the debtor's insolvency.

Moreover, we should recognize that the fundamental concern behind state law recharacterization – the desire to avoid forfeiture of the borrower/lessee's equity in the property upon a default – is of much less significance in a bankruptcy proceeding than it is in other fora because the Bankruptcy Code itself provides extensive protections against forfeiture. The automatic stay prevents the lessor from declaring a default or seeking to take possession of the property after the filing. The debtor then has a window in which to determine whether to accept or reject the lease. If the value of the debtor's interest in the leased property exceeds the future performance owed under the lease – in other words, if termination of the lease would work a forfeiture – the debtor can assume the lease, keeping all of the economic value. Moreover, even if the debtor can no longer use the leased property in its own operations, the Bankruptcy Code allows the debtor to sell its interest in the lease, thereby retaining the economic value of its rights, even if the lease itself prohibits subleasing and assignment. In the face of these direct protections for the debtor's rights, it is hard to see why a sale-leaseback transaction structured by the parties should be subjected to the arbitrariness and inconsistency of current recharacterization law.

Upholding the chosen form of the transaction also reduces or eliminates litigation over the characterization issue, and ensures transparency and certainty so that third parties can rely on the recorded transaction documents. This last point deserves additional attention. Respecting the form of the transaction not only permits the parties to enter into efficient transactions, but it also allows third parties to rely on the record state of title. When a purchaser-lessor records a deed to the property, and the seller-lessee records its lease, that is notice to the world of their respective interests. Thereafter, no creditors of the seller should expect the value of the real property (beyond the leasehold interest) to be available to satisfy their claims.[194]

Creditors of the purchaser-lessor expect title to be valid as against the seller, and will rely on that title. The purchaser in many cases will secure funding by borrowing against the property and pledging the lease as additional security. If the original transaction is recharacterized, the interests of the purchaser's mortgagee are seriously threatened. And if the seller-lessee pledges its leasehold as security for a mortgage, which is not uncommon, that leasehold mortgagee may find its interests terminated or degraded by recharacterization.

Moreover, consider the practical problems engendered by recharacterization. If the form of the sale-leaseback is rejected, and the deal is characterized as a mortgage loan, what are the terms of that mortgage? Is there a prepayment right? If so, is any prepayment premium due? Is the mortgage due upon a transfer of the property? Upon junior financing? The court is placed in

[194] *See* Homburger and Andre, *Risk of Recharacterization*, *supra* note 9, at 130.

the position of rejecting the express agreement of the parties and replacing it with the "real" transaction – vital terms of which were never negotiated and so are completely unknowable.

Thus, where the economic substance of the transaction is not definitively one or the other, the express intent of the parties should govern the bankruptcy characterization of their transaction. This is essentially the inverse of the *Kassuba* rule, which stated that unambiguous intent controls, and economic substance will be examined only where the intent is unclear.[195] Unambiguous substance should control over a contrary stated intent, but if the substance is reasonably susceptible to alternative characterizations, as it often is, then it does not provide an adequate basis for rejecting the parties' expressed intent, as evidenced by the choice of transactional form.[196]

We still must consider the possibility that this transactional form was selected for improper purposes, however. The most important step courts could take to rationalize leasehold recharacterization law in bankruptcy would be to recognize that intent can be shown by the parties by demonstrating any *bona fide* purpose for adopting the particular form of the transaction. This is essentially what is done in some tax cases, through the "business purpose" test. A business purpose test recognizes that the parties may have good reasons for adopting a particular transactional form over an alternative that a third party or a court sees as equivalent, and that barring strong policy concerns that choice should be respected as much as any other contractual allocation of rights, risks and benefits.

The value of the business purpose test can be seen most clearly in a number of cases where bankruptcy courts have recharacterized industrial revenue bond sale-leaseback transactions as mortgages,[197] despite the fact that the state law creating the industrial development agency prohibits it from making mortgage loans. (State courts, of course, have been much less likely to recharacterize these transactions.[198]) These courts have recharacterized transactions entered into between these public agencies and sophisticated third parties based on the "economic realities" of the transactions despite the fact that this recharacterization was inconsistent with applicable state law and rendered the transactions *ultra vires*. The outcome is extremely troubling as a policy matter, but is also unavoidable under an "economic realities" test that refuses to acknowledge that the selection of the legal form is, in many cases, an essential part of the economic realities.

While the business purpose test has not been expressly applied in the bankruptcy recharacterization context, this proposal is not some sudden departure in the law; rather, it is

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[195] *See text* accompanying notes 67-77, *supra*. For a similar argument in the context of the federal securities laws, *see* Larry E. Ribstein, *Form and Substance In The Definition of a "Security": The Case of Limited Liability Companies*, 51 WASH. & LEE L. REV. 807 (1994).

[196] Cases that are consistent with approach include *Seaboard Terminals Corp. v. Western Maryland Ry. Co.*, 108 F.2d 911, 915 (4th Cir. 1940) and *In re* San Francisco Indus. Park, 307 F.Supp. 271 (N.D. Cal. 1969).

[197] *See, e.g.*, United Air Lines, 447 F.3d 504; United Airlines v. HSBC Bank, 416 F.3d 609; *In re* KAR Dev. Assoc., 180 B.R. 629; *In re* Opelika Mfg., 67 B.R. 169; *In re* Hotel Syracuse, 155 B.R. 824; *In re* Wingspread Corp., 116 B.R. 915; *In re* Central Foundry, 48 B.R. 895; *In re* Winston Mills, Inc., 6 B.R. 587; *see also In re* Downingtown Ind. & Ag. School, 172 B.R. 813 (Bankr. E.D. Pa. 1994) (denying motion to dismiss action to recharacterize sale-leaseback with industrial development agency). In some IDB cases the recharacterization issue has been decided in favor of true lease status. *See, e.g.*, *In re* United Air Lines, Inc., 453 F.3d 463; *In re* Martin Bros. Toolmakers, 796 F.2d 1435; *In re* SCCC Assocs., 158 B.R. 1004; *In re* 207 Montgomery Street, Inc., 160 B.R. 181 (Bankr. M.D. Ala. 1992); *In re* Petroleum Products, Inc., 72 B.R. 739 (Bankr. D. Kan. 1987).

[198] *See, e.g.*, Sunwest Bank of Clovis, N.A. v. Clovis IV, 704 P.2d 699 (N.M. 1987).

consistent with the understanding embodied in the structure of the law in most states. The transactional form selected by the parties is presumed to be valid, and that presumption can be overcome only by "clear and convincing evidence" that the parties really "intended" the transaction to be something else.[199] That intention can be ascertained by an examination not just of the documents or specific terms of the deal, but of the totality of the circumstances. If the parties have a *bona fide* reason for adopting the form of a sale and leaseback over secured loan for the transaction, the form should be honored even if the transaction appears to be a secured loan as a matter of "economic reality"; in such a case, notwithstanding the court's perception of the economics of the transaction, the intent of the parties was clearly to use a sale and leaseback for these other *bona fide* reasons.

Some will reject the recommended approach as elevating form over substance, providing an unfair advantage to some creditors over others and burdening the potential reorganization of the debtor. But as in so much of commercial law, this is a situation where form is not a matter of attaching empty labels, but is inevitably intertwined with substance. While bankruptcy courts, as courts of equity, can look to the substance of the transaction, they should not be free to disregard the form if the chosen form is a inherent part of the transaction negotiated by the parties and creates rights enforceable under nonbankruptcy law.

VI. CONCLUSION

Problems of form versus substance plague many areas of the law, and are endemic in regulating commercial transactions. The conflict would not be so common if it were not for the fact that in many circumstances, form *is* substance. Form determines the legal rights and obligations of the parties. In bankruptcy, the effects on the parties of the distinction between a lease and a mortgage can be tremendous, but the distinction has been as elusive as any in the catalogue of form versus substance debates. The problems come from a failure to carefully define the distinction that is being drawn, failure to identify the reasons why that distinction is being drawn, and failure to identify the policy issues at stake.

We have to acknowledge that many transactions are not "truly" one thing or the other. They are hybrids that define and allocate myriad factors --tax attributes, fixed and contingent payments, managerial control, the definition of default or breach, remedies, options, and so on – in a manner that satisfies the parties' perceived business needs. The legal form is selected to facilitate the agreed transaction and the deal is also tailored in many ways to reflect the form that has been selected. The form is not a "mere label", but a substantive part of the agreement that affects rent levels, responsibilities and risk allocations, financial commitments, tax obligations, and state law rights, among other issues. That legal form also has a public component, being relected in land records that are relied upon by third parties. Once this reality is acknowledged, courts can truly give effect to the "intent" and "economic reality" of the transaction by respecting the chosen form as long as it was selected for a *bona fide* business purpose, and limiting recharacterization to cases where there is clear and convincing proof that the form is a subterfuge adopted for improper purposes.

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[199] *See* Part IV.A., *supra*. *See also* RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 3.3, comment b (1997) (endorsing the clear and convincing evidence standard).