

# **Sale-Leasebacks: Things May Not Be What They Seem**

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*Things are seldom what they seem, skim milk masquerades as cream – W.S. Gilbert*

## **Introduction**

Sale-leaseback transactions, in which an owner sells real estate and then leases it back from the buyer (usually pursuant to a long-term net lease wherein the tenant bears responsibility for operating and maintaining the property), can be relatively simple, but they are especially advantageous to companies that have a large investment in real estate.<sup>1</sup> Proponents argue that sale-leasebacks allow these companies to generate cash to expand their core businesses, rather than staying the same size and owning all their real estate. Sale-leasebacks became popular in the 1970s, as large retailers sought a favorable economic and tax-advantaged method to finance store expansions. Also at that time, U.S. tax laws made leveraged real-estate investments attractive for wealthy individuals, who were able to use depreciation and interest-payment deductions to offset their income taxes. Sale-leasebacks are still popular and prevalent today, especially in connection with tax-deferred exchanges under § 1031 of the Internal Revenue Code.<sup>2</sup>

But if a sale-leaseback transaction is not carefully structured and documented, it may be subject to subsequent recharacterization by a court as an equitable mortgage, or as a joint venture.<sup>3</sup> This is especially true if a bankruptcy proceeding is filed by or against the seller-lessee, and the seller-lessee, as debtor in possession (or the bankruptcy trustee) claims that the transaction does not constitute a “true” lease. The buyer-lessor could suffer severe consequences if the transaction is treated as something other than a lease in the debtor-lessee’s bankruptcy

proceeding.<sup>4</sup> This article will examine the relevant bankruptcy law and the factors that bankruptcy courts consider when determining whether to recharacterize a transaction initially designated by the parties as a sale-leaseback including, in particular, the factors considered by the Federal District Court for the Eastern District of Michigan in a recent case that recharacterized a sale-leaseback as a disguised financing transaction. This article also will suggest certain preventive and protective measures that may be utilized by the parties to a sale-leaseback transaction to minimize the risk of subsequent recharacterization by a state or federal court.

### **Intention v. Economic Substance**

As mentioned above, a sale-leaseback transaction may be subject, under certain circumstances, to recharacterization as an equitable mortgage or some other form of investment vehicle.<sup>5</sup> The seller-lessee may attempt to have the sale and leaseback recharacterized as an equitable mortgage in order, among other things, to provide it with an opportunity to “redeem” the property at a foreclosure sale. The courts (including bankruptcy courts) have applied a fact-based analysis to determine whether the substance of the transaction is in accord with its form and the expressed intent of the parties. Although the issue of whether a transaction is characterized as a sale or a mortgage depends to a great extent on the expressed intention of the parties, the economic substance of the transaction, and not its label, will ultimately determine whether it is a true sale-leaseback or a financing transaction. The interpretation of an instrument as a lease or a mortgage presents a question to be decided from a consideration of the whole transaction, and not from any particular feature of it.<sup>6</sup>

Unfortunately, state and federal court decisions are not consistent with respect to the

relevance and weight of the factors that determine whether a document designated as a lease will be recharacterized as a financing transaction. The factors that the courts consider include the following:

- The intent of the parties at the time of the execution of the documents, as determined by examining the language in the documents and (if there is an ambiguity) by the aid of parol evidence.
- Whether there is continued evidence of a debt or liability.
- The relationship of the parties.
- Prior unsuccessful attempts to obtain a loan.
- The circumstances surrounding the transaction.
- The sophistication and circumstances of the parties.
- The lack of legal counsel.
- Whether the structure of the sale is unusual.
- The adequacy of consideration and whether the purchase price was related to the fair market value of the property.
- How the consideration was paid.
- Whether there is written evidence of the debt.
- The belief that the debt remains unpaid.
- Whether there is an option, right of first refusal, or agreement to repurchase.
- The continued exercise of ownership privileges, responsibilities and/or possession by the seller-lessee, including the obligation to pay operating expenses of the property such as property taxes and insurance.

- Whether there is a trading of tax benefits for a fixed return.
- Whether the rental payments were calculated to compensate the lessor for the use of the land or are in actuality are structured as a return on an investment.<sup>7</sup>

### **Bankruptcy Recharacterization**

Sections 365(d)(3) and (d)(4) of the Bankruptcy Code, which delineate the rights of the bankruptcy trustee to assume or reject “any unexpired lease of nonresidential real property,”<sup>8</sup> apply only to true or bona fide leases.<sup>9</sup> The focus is on whether the parties intended to impose obligations and confer rights significantly different from those normally found in ordinary lease transactions.<sup>10</sup> Section 502(b)(6), of the Bankruptcy Code, which limits the lessor’s claim for damages against the debtor-lessee, does not define “lease of real property,” as used in that section, but the legislative history is clear that it applies only to a true or bona fide lease.<sup>11</sup>

The terms “unexpired lease” and “lease of nonresidential property,” as used in § 365, also are not defined in the Bankruptcy Code. Section 365 governs the relationship between a lessor and a lessee when the lessee files a bankruptcy proceeding. Section 365(d)(4) requires that the debtor-lessee assume or reject an unexpired nonresidential lease within 120 days after the bankruptcy case is filed, unless the court extends the 120-day time period for cause.<sup>12</sup> To assume the lease and the right to continue as lessee, the debtor-lessee must cure all existing defaults under the lease, including delinquent rent, and provide adequate assurance that the debtor-lessee will perform all future lease obligations.<sup>13</sup> Section 365(d)(3) provides for the performance under the lease by the trustee or debtor in possession until the lease is assumed or rejected. Because the Bankruptcy Code requires that rent payments coming due after the filing of the bankruptcy petition must be brought current by the debtor-lessee within 120 days and

kept current, a bankruptcy court is especially concerned that only true leases provide this significant benefit to lessors.

Primarily for this reason, bankruptcy court is the most common forum today for litigation of whether a lease designated as such by the parties is in reality a financing transaction. If the bankruptcy court determines that the document is in fact not a lease, the debtor-lessee is excused from the requirement of keeping the rent payments current. Also, there is generally less deference paid by bankruptcy courts to the general rule that sophisticated parties of relatively equal bargaining strength should be able to characterize their commercial business arrangements any way they wish. The debtor-lessee can rely on the strong public-policy argument that bankruptcy should provide “equality of treatment” of similarly situated creditors and not favor one creditor to the detriment of others, or unduly prevent or hinder the reorganization of the debtor-lessee’s business enterprise. The seller-lessee as debtor in possession (or the court-appointed trustee) is viewed by the bankruptcy court as being the representative of the estate and the interests of all the creditor constituencies, and will usually be supported in any attempt to recharacterize the sale-leaseback by powerful allies such as other secured creditors and the unsecured creditors’ committee.

If the lease is not affirmatively and timely assumed it is deemed rejected, and the lease is terminated.<sup>14</sup> Rejection of a lease in bankruptcy constitutes a breach of the lease.<sup>15</sup> The lessor is entitled to assert a general unsecured claim for damages resulting from the debtor-lessee’s rejection of the lease.<sup>16</sup> Section 502(b)(6) of the Bankruptcy Code limits the claim of the lessor for “rejection damages” arising from the termination of a lease of real property to an amount that does not exceed: (1) the rent reserved in the lease, without acceleration, for the

greater of one year, or 15%, not to exceed 3 years, of the remaining term of the lease following the date the bankruptcy petition was filed or the date the leased property was repossessed or surrendered, plus (2) any unpaid rent due under the lease, without acceleration, on the earlier of such dates. This amount of the lessor's damages, before application of the § 502(b)(6) cap, is ascertained by reference to the lease agreement and applicable state law.<sup>17</sup>

The buyer-lessor in a sale-leaseback transaction should be aware that if a bankruptcy petition is filed by or against the seller-lessee after the inception of the lease, the bankruptcy court may recharacterize the lease as a financing transaction and limit the rights and remedies of the buyer-lessor to the value of its collateral as a secured creditor.<sup>18</sup> This is because the bankruptcy process treats undersecured creditors differently from secured creditors. Under §§ 506(a) and (b) of the Bankruptcy Code, an undersecured creditor (i.e., a creditor whose debt exceeds the value of the collateral) has two claims against the debtor's estate: (1) a secured claim in an amount equal to the value of the collateral, and (2) an unsecured recourse claim for the remainder of the debt. Undersecured creditors have both of these claims under the Bankruptcy Code even if the loan is nonrecourse.<sup>19</sup>

If all the legal requirements of a reorganization plan are met, with the exception of a successful confirmation by creditors, the plan may still be confirmed over the objection of a dissenting class. Under § 1129(b)(1) of the Bankruptcy Code, if the plan does not discriminate unfairly and is fair and equitable to the dissenting class, it can be "crammed down" on the impaired class that votes against the plan. In accordance with §§ 506(a) and 1123(a)(5), (f), and (h), in a cramdown the debtor may (1) reduce the principal amount of the secured claim to the value of the collateral; (2) reduce the interest rate; (3) extend the maturity date; or (4) alter the

repayment schedule. The debtor also may make a minimal payment on the unsecured claim. Section 1129(a) provides that a cramdown is permissible when the plan provides a dissenting creditor with consideration equal to the amount of its claim or when no class below the dissenting unsecured class participates under the plan. If, on the other hand, the debtor's plan does not modify the loan terms in any way, § 1124 provides that the creditor will not be an impaired class and, therefore, will not have the right to vote for or against a plan.<sup>20</sup>

If the lease is subsequently recharacterized as a secured financing transaction rather than a true lease, then the lessor-lienholder's claim will be secured as mortgage debt rather than as rent, and the claim can be restructured by the debtor-lessee, with the secured claim of the lessor-lienholder limited to the fair market value of the property.<sup>21</sup> A bankruptcy court, when deciding whether to recharacterize a lease as a mortgage, will consider factors such as whether the rent bears a reasonable relationship to the market (or occupancy) value of the property or is in fact a fixed return on a security; whether the lessee has an option (or an obligation) to repurchase the property at end of the lease term for a fixed or nominal amount, and whether the tenant retains ownership privileges and responsibilities with respect to the property.<sup>22</sup> Bankruptcy courts are divided on the issue of whether state or federal law determines if an agreement designated as a lease by the parties actually constitutes a true lease for purposes of the Bankruptcy Code.<sup>23</sup>

### ***The Big Buck Brewery & Steakhouse Case***

In a recent decision by the Federal District Court for the Eastern District of Michigan, *Big Buck Brewery & Steakhouse, Inc. v. Eyde*,<sup>24</sup> the court affirmed the bankruptcy court's holding that a purported sale-leaseback transaction between the parties was in fact a disguised financing

arrangement and not a true lease. The debtor-lessee (“Big Buck”), a restaurant operator, filed a Chapter 11 bankruptcy proceeding and challenged a sale-leaseback transaction between Big Buck and Michael Eyde (“Eyde”), as buyer-lessor, with respect to Big Buck’s real property in the City of Auburn Hills, asserting that it constituted a fraudulent conveyance and was a disguised financing agreement that did not qualify as a bona fide lease under § 365 of the Bankruptcy Code.<sup>25</sup> Big Buck had originally approached Eyde for a \$4.4 million loan for the purpose of constructing a restaurant on the property, but the parties instead entered into a “Real Property Purchase and Leaseback Agreement,” which provided (among other things) that the parties agreed to enter into a sale-leaseback transaction with respect to the property.

The parties subsequently executed a lease for the property, which provided for a term of 25 years with two 10-year renewal options and a base rental of \$400,000 per year, as well as a rental adjustment every five years during the term based on the then prime commercial lending rate established by NBD Bank. The lease also contained a provision for the payment of percentage rent, including a “repurchase obligation” upon the request of Eyde if the gross sales from the restaurant to be constructed on the property fell below a certain level, based on a repurchase price of \$4 million plus \$200,000 for each full lease year (plus a pro-rata portion of a partial lease year) measured from the lease commencement date to the date of receipt of Eyde’s request. The lease further granted Big Buck a right of first refusal to purchase the property if Eyde received a bona fide offer from a third party, and an option to purchase the property after the end of the seventh lease year for the sum of \$4 million plus \$200,000 for each full lease year (plus a pro-rata portion of a partial lease year) measured from the lease commencement date to the date of the exercise of the purchase option. In addition, the lease provided Eyde with a “sale

option,” whereby it could require Big Buck to purchase the property at any time before the end of the third lease year for the sum of \$4 million plus \$200,000 for each full lease year (plus a pro-rata portion of a partial lease year) measured from the lease commencement date to the date of exercise of the sale option; this right was protected by an option in Big Buck’s stock if it did not pay the required purchase price. The original deed to the property from Big Buck to the property apparently was lost and never recorded, but a “replacement deed” was subsequently entered into and recorded.

After analyzing the factors for determination of a true lease set forth in an Illinois bankruptcy case, *United Airlines, Inc. v. HSBC Bank USA*,<sup>26</sup> the bankruptcy court made specific findings that the following seven factors, when taken as a whole, established by a preponderance of the evidence that the transaction was in fact a disguised financing arrangement and not a true lease:

1. The transaction involved the purchase of the land only, and not the building on it.
2. The parties clearly intended that the \$4 million “purchase price” was to be used to fund the construction of the restaurant, and the funds were so used.
3. The base rent under the lease was based on a 10% return on Eyde’s \$4 million investment, instead of the market rental value for the property.
4. The right granted to Eyde to repurchase the property (for \$4 million plus an escalator) if the percentage rent threshold rental was not achieved, protected Eyde from any decrease in the market value of the property.
5. The right granted to Eyde to require Big Buck to repurchase the property at

the original purchase price (plus an escalator) also protected Eyde from any decrease in the value of the property.

6. The option granted to Big Buck to purchase the property at any time after the seventh lease year for the original purchase price (plus an escalator) protected Big Buck's ability to realize any appreciation in the market value of the property.
7. The right of first refusal granted to Big Buck with respect to any valid third-party offer to purchase the property was inconsistent with the benefits and burdens of ownership that normally would be retained by Eyde as the true owner of the property.

The Federal District Court first noted that Michigan law applied as to the question of whether a security interest exists in property, and stated that "Big Buck was required to prove by a clear preponderance of the evidence that Eyde and Big Buck intended to create a financing transaction rather than a true lease."<sup>27</sup> The court also noted that, as a matter of Michigan law, the bankruptcy court "was required to discern the parties' intent from the totality of the circumstances."<sup>28</sup> The Federal District Court held that the bankruptcy court correctly decided that, taking all seven factors considered by the bankruptcy court as a whole, the transaction resulted in Big Buck's taking all the risks associated with the ownership of real property, and that the parties "*intended* to create a financing transaction disguised as a lease and not a true lease."<sup>29</sup>

Eyde argued that Big Buck was estopped to deny that Eyde was not the true owner of the

property, based on a representation that Big Buck had made in a letter to a pension-fund lender (from which it was seeking additional loan funds) that Eyde was the sole owner and no other party had any right, title or interest in the property. But the Federal District Court agreed that the bankruptcy court had properly rejected this argument, and ruled that because the parties clearly intended to create a disguised financing agreement Eyde could not reasonably have relied upon the representations in the letter.<sup>30</sup>

The holding of the Federal District Court in the *Big Buck* case is not surprising, as the lease and other documents executed by the parties contained virtually every “red flag” that would lead a bankruptcy court to recharacterize the transaction as an equitable mortgage; i.e., the purchase price was clearly intended (and documented) to fund the cost of the improvements to the property; the base rent and percentage rent had no relation to the value of the property and were set to provide a fixed return to the purchaser-lessor and protect it from any downside and enable the seller-lessee to obtain the full benefit of any upside in the value; and the repurchase, right-of-first-refusal, and option-to purchase and option-to-sell provisions clearly left the seller-lessee with all the risks and rewards of real property ownership.<sup>31</sup>

Also telling was the uncontradicted testimony of two certified public accountants, which clearly established that the transaction was treated as a capital lease, with the seller-lessee treated as the owner of the improvements and the lease obligations treated as a long-term financing liability (it was even recorded on the seller-lessee’s books as a financing transaction). The only fact in Eyde’s favor was expert appraisal testimony (which apparently was not disputed) that the market value of the property at the time of the transaction was equal to the \$4 million purchase

price. But according to the court, the bankruptcy judge was entitled to assess the credibility of this witness “and the record as a whole” in deciding what weight to give to this testimony.<sup>32</sup> And as noted above, the court ruled that in Michigan a “preponderance of the evidence” standard is sufficient, and that it is necessary to look at all the documents and actions of the parties and not just any one factor in isolation.

### **Conclusion**

The *Big Buck* case provides important guidelines and lessons for parties contemplating entering into a sale-leaseback transaction. The case apparently involved sophisticated real estate investors and businesspeople and sophisticated legal counsel, and the documents prepared by counsel and entered into by the parties described the transaction solely in terms of a sale and leaseback. But the court, based on its analysis of *all* the relevant factors, including the actions of the parties leading up to the sale-leaseback transaction and the presence of the seven factors set forth in the bankruptcy court’s opinion (which, according to the Federal District Court, left the debtor-lessee with all the risks and rewards associated with ownership of the property), found that the parties’ “conduct and relative economic positions indicated that a financing transaction was intended.”<sup>33</sup>

As evidenced by *Big Buck* decision, accounting testimony can be crucial in determining the internal treatment of the transaction by each of the parties, which in turn is crucial to the issue of whether a true lease was intended. *Big Buck*’s expert witnesses testified (and the court agreed) that the transaction constituted a “classic ground lease” and that “the purchase prices set forth in the written documents could not be tied to the property’s market value, and . . . Eyde incurred no financial risk associated with the value of the land, as the transaction provided for an

assured yield on his investment.”<sup>34</sup> Appraisal evidence also can be crucial in determining the value of the property, which in turn is crucial to the issue of whether the consideration for the transaction is fair and sufficient to prevent recharacterization.<sup>35</sup>

Because the intention of the parties is perhaps the most important factor in determining whether a sale-leaseback transaction should be recharacterized, it may have been helpful to Eyde, as the seller-lessor, if the Sale-Lease Agreement and the lease itself contained specific language (perhaps bolded and in caps) expressly negating and disclaiming any construction of the transaction as a security instrument or equitable mortgage, or any intention to create any relationship between the parties, either express or implied, other than as explicitly stated in the documents. But although this language may have been of benefit to Eyde to establish the intent of the parties, it is doubtful that the *Big Buck* case would have been decided differently based solely on the presence of such language, because of the existence of the other factors described by the bankruptcy court and affirmed by the Federal District Court. On the other hand, recharacterization is always an uphill battle – one of the parties is trying to argue that something is not what they said it is. Courts are not particularly fond of these cases; they are equitable proceedings and courts generally will hold the party seeking to recharacterize a document or transaction to a high standard of proof.<sup>36</sup>

## Endnotes

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<sup>1</sup> A sale-leaseback transaction has been described as “a relatively modern, and clever, structure of financing which affords significant advantages to both purchaser-lessor and seller-lessee.” *Fox v. Peck Iron & Metal Co.*, 25 Bankr. 674, 688 (Bankr. S.D. Cal. 1982).

<sup>2</sup> In a “1031 exchange,” a real estate seller can defer capital gains taxes by reinvesting in a similar property. The seller has 45 days to identify a suitable asset and 180 days to buy it. In some cases, 1031 exchange buyers prefer to swap their properties with credit-tenant sale-leaseback properties, because they do not require active management. Section 1031 of the Internal Revenue Code of 1986 (the “Code”) provides an exception to the general rule that gain or loss is recognized upon the sale or exchange of property. Pursuant to Code § 1031, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for like kind property to be held for productive use in a trade or business or for investment.

<sup>3</sup> Although certainly within the realm of possibility, the author is not aware of any final reported decision that has recharacterized a sale-leaseback transaction as a joint venture. See *Liona Corp. v. PCH Associates*. (*In re PCH Associates*), 804 F.2d 193, 201 (2<sup>nd</sup> Cir. 1986) (holding that, with respect to adversary bankruptcy proceeding seeking to recharacterize real estate lease transaction as joint venture, “the Ground Lease and Sale-Leaseback Agreement [entered into by the parties] do not constitute a true lease. Therefore section 365(d)(3), (4) of the Bankruptcy Code has no application here. . . We do not reach the issue of whether the Ground Lease and Sale-Leaseback Agreement create a joint venture”).

<sup>4</sup> Recharacterization also could have an impact on liability for environmental contamination. In *Monarch Title, Inc. v. City of Florence*, 212 F.3d 1219 (11<sup>th</sup> Cir. Ala. 2000), the court held that the city held bare legal title to the contaminated property solely for the purpose of securing repayment of the development bonds that financed the property’s acquisition, and thereby held a “security interest” within the meaning of 42 U.S.C. § 9601(20)(A), which exempted the city from liability for environmental contamination as a person who, without participating in the management of the facility, holds indicia of ownership primarily to protect its security interest in the facility. Furthermore, the recharacterization of a sale-leaseback transaction also could affect the parties’ (and the Internal Revenue Service’s) tax treatment of the transaction. The Internal Revenue Service has, for tax purposes, determined that in characterizing a transaction the substance of the transaction, rather than its legal form, is controlling. Whether a transaction is a sale and leaseback for income tax purposes, or a financing transaction, is a question of fact, and depends on the intent of the parties as gathered from all the facts and circumstances, and whether the benefits and burdens of ownership have passed to the purported buyer-lessor. See, e.g., *Helvering v. Lazarus & Co.*, 308 U.S. 252 (1939); *Larsen v. Comm’r*, 89 T.C. 1229, 1267 (1987); *Sun Oil Co. v. Comm’r*, 562 F.2d 258 (3<sup>rd</sup> Cir. 1977), cert. denied, 436 U.S. 944 (1978); *Haggard v. Comm’r*, 24 T.C. 1124, 1129 (1995); *Torres v. Comm’r*, 88 T.C. 702, 720-21 (1987); *Grodt v. McKay*, 77 T.C. 1221, 1237 (1981). See also E. Carolyn Hochstadter Dicker and John P. Campo, *FF&E and the True Lease Question: Article 2A and Accompanying Amendments to UCC Section 1-201(37)*, 7 ABI L. Rev. 517, 532-52 (Winter 1999); John C. Murray, *Off-Balance-Sheet Financing: Synthetic Leases*, 32 REAL PROP. PROB. & TRUST J. 193, 196-97 (1997); John Andre LeDuc, *Fundamental Federal Income Tax Considerations in Current United States Leasing Transactions*, 432 PLI/Tax 1241, 1255-56 (1998); IRS Field Service Advisory, FSA 199920003, 1999 WL 319513 (I.R.S.) (May 21, 1999) (“Where there is a genuine multi-party transaction with economic substance that is compelled or encouraged by business realities, contains tax-independent considerations, and is not shaped solely by tax avoidance features, the government should honor the allocation of rights and duties effectuated by the parties” (internal quotation and citation omitted)); cf. Tech. Adv. Mem. 98-02-002 (Jan. 9, 1998); Rev. Proc. 75-21, 1975-1 C.B. 715; Rev. Proc. 75-28, 1975-1 C.B. 752; Rev. Proc. 76-30, 1976-2 C.B. 647; Rev. Proc. 79-48, 1979-2 C.B. 529.

<sup>5</sup> See Thomas C. Homburger and Brian P. Gallagher, *To Pay or Not to Pay: Claiming Damages for Recharacterization of Sale Leaseback Transactions Under Owner’s Title Insurance Policies*, 30 REAL PROP. PROB. & TR. J. 443, 488-489 (Fall 1995); Thomas C. Homburger and Gregory Andre, *Real Estate Sale and Leaseback Transactions and the Risk of Recharacterization in Bankruptcy Proceedings*, 24 REAL PROP. PROB. & TR. J. 95 (Spring 1995); Thomas Reynolds, *Recharacterization of Sale-Leaseback Transactions*, ABA Real Property, Probate and Trust Law Section, Seventh Annual Spring CLE and Committee Meeting (May 1996) (handout materials for Second Annual “World’s Best Mortgage Financing” Program).

<sup>6</sup> The recharacterization tests applied by bankruptcy courts often serve as a useful guideline when analyzing the risks of the transaction. See, e.g., *Barneys, Inc. v. Isetan Co. (In re Barney’s, Inc.)*, 206 B.R. 328, 332-33 (Bankr. S.D.N.Y. 1997) (stating that the “[t]he appropriate inquiry is whether the parties intended to impose obligations and

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confer rights significantly different from those arising from the ordinary landlord/tenant relationship;” the court also noted that where the purported “lease” involves rental payments that are actually payments of principal and interest on a real estate loan, there is no “true” or “bona fide” lease); *In re PCH Associates*, *supra* note 3, 804 F.2d at 200 (holding that, in assessing whether a transaction styled as a lease is indeed a true lease, the presumption that an agreement is what it purports to be gives way to an ultimate determination based on “the economic substance of the transaction and not its form”).

<sup>7</sup> For example, in *185 Wabash LLC v. Lake Wabash LLC*, No. 1-03-0751 (Ill. App. Dec. 24, 2003) (decision without published opinion), *appeal denied*, 809 N.E.2d 1287, 2004 Ill. LEXIS 621 (Ill. Sup. Ct. March 24, 2004), the court held that the intent of the parties is a prime factor in determining whether a sale-leaseback with an option to purchase is an equitable mortgage. The court refused to recharacterize the transaction where the seller-lessee could not satisfy its burden of proof that the parties actually intended a security agreement, and persuasive appraisal testimony indicated that fair value was given. *See also Robinson v. Builders Supply*, 223 Ill. App. 3d 1007, 1014-15 (1<sup>st</sup> Dist. 1992) (setting forth factors [including many of those listed by the bankruptcy court in the *Big Bucks* case] considered by courts in determining whether a conveyance should be recharacterized as a mortgage, and finding that “the record lacks conclusive evidence on the adequacy of consideration . . . and the value of the property”); *In re PCH Associates*, *supra* note 3, 804 F.2d at 200-201 (also setting forth many of the relevant factors listed by the bankruptcy court in the *Big Bucks* case).

<sup>8</sup> 11 U.S.C. § 365(d)(3).

<sup>9</sup> *See In re Barney’s, Inc.*, *supra* note 6, 206 B.R. at 333 (holding that “[t]he phrase ‘lease of real property’ does not apply to lease financing transactions or to leases intended as security, but rather applies only to a “true” or “bona fide” lease); *In re Labrum & Doak, LLP*, 227 B.R. 383, 389 (Bankr. E.D. Pa. 1998) (establishing, in connection with a lease that was an operating lease and not a capital lease for accounting purposes, a *per se* rule that future rent obligations are excluded for bankruptcy insolvency valuation purposes).

<sup>10</sup> *See, e.g., Int’l Trade Admin. v. Rensselaer Polytechnic Inst.*, 936 F.2d 744, 748 (2d Cir. 1991); *In re PCH Associates*, *supra* note 3, 804 F.2d at 198. Bankruptcy courts generally have the ability to recharacterize any type of transaction. *See Matter of Fabricators, Inc.*, 926 F.2d 1458, 1469 (5<sup>th</sup> Cir. 1991) (“The ability to recharacterize a purported loan [as an equity contribution] emanates from the bankruptcy court’s power to ignore the form of transaction and give effect to its substance”).

<sup>11</sup> The legislative history states that:

[W]hether a “lease” is a true or bona fide lease or, in the alternative, a financing “lease” or a lease intended as security, depends upon the circumstances of each case. The distinction between a true lease and a financing transaction is based upon the economic substance of the transaction and not, for example, upon the locus of title, the form of the transaction or the fact that the transaction is denominated as a “lease.” The fact that the lessee, upon compliance with the terms of the lease, becomes or has the option to become the owner of the leased premises for no additional consideration indicates that the transaction is a financing lease or lease intended as security. In such cases, the lessor has no substantial interest in the leased property at the expiration of the lease term. In addition, the fact that the lessee assumes and discharges substantially all the risks and obligations ordinarily attributed to the outright ownership of the property is more indicative of a financing transaction than of a true lease. The rental payments in such cases are in substance payments of principal and interest either on a loan secured by the leased real property or on the purchase of the leased real property.

S. REP. NO. 95-989, at 64 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5850.

<sup>12</sup> *See* 11 U.S.C. § 365(d)(4). The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”), 2005 (P.L. 109-8), 119 Stat. 23, was enacted into law on April 20, 2005, and applies to all bankruptcy cases filed on or after October 17, 2005 (with limited exceptions as to certain provisions). The BAPCPA amended § 365(d)(4) to extend the time to assume or reject a lease from 60 days (before the amendment) to 120 days (or confirmation of a plan, if earlier). The court can extend this time period for an additional 90 days for “cause” (210 days total) but only the lessor can authorize further extensions, and the debtor-lessee can no longer extend the time to assume or reject leases beyond confirmation of the plan. One of the factors considered by bankruptcy courts in determining whether to extend the 120-day (formerly 60-day) period for cause is the need for a judicial determination of whether the lease is in fact a disguised security device. For a discussion of the factors considered to constitute “cause,” *see Willamette Water Front, Ltd. v. Victoria Station, Inc. (In re Victoria Station, Inc.)*, 875 F.2d 1380, 1385-86 (9<sup>th</sup> Cir. 1989); *Escondido Mission Village L.P. v. Best Products Co.*, 137 B.R. 114, 116-17 (S.D.N.Y. 1992).

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<sup>13</sup> See 11 U.S.C. § 365(b)(1). See also *In re Copeland*, 238 B.R. 801, 803 (Bankr. E.D. Ark. 1999) (“If the transaction is a true lease and the Debtor desires to keep the property, then the Debtor must assume the lease, cure all defaults, and perform the lease according to its terms and in compliance with 11 U.S.C. § 365”).

<sup>14</sup> See 11 U.S.C. § 365(b)(1). The debtor-lessee must perform all of its obligations under the lease in a timely manner, unless and until the lease is rejected, unless the bankruptcy court extends the time for performance. But § 365(d) permits the court to postpone the obligation of performance by the debtor until the end of the 120-day period (60 days before enactment of the BAPCPA) following the filing of the bankruptcy petition. The debtor-lessee also has the right, during this period, to seek an injunction to require the non-debtor party to perform its lease obligations. After the initial 120-day period (60 days before enactment of the BAPCPA), both parties must perform their respective lease obligations in a timely manner unless and until the debtor-lessee rejects the lease.

<sup>15</sup> See 11 U.S.C. § 365(g).

<sup>16</sup> See 11 U.S.C. §§ 365(g)(1), 502(g). Under § 365(g)(1) and § 502(g), as limited by § 502(b)(6), the lessor is also entitled to an administrative priority claim for postpetition lease obligations until the date the effective date of rejection of the lease by the debtor-lessee.

<sup>17</sup> See *In re Steven Windsor, Inc.*, 201 B.R. 133, 135 (Bankr. D. Md. 1996); *Fifth Ave. Jewelers v. Great E. Mall (In re Fifth Ave. Jewelers)*, 203 B.R. 372, 377 (Bankr. W.D. Pa. 1996); *In re Gantos*, 176 B.R. 793, 795 (Bankr. W.D. Mich. 1995); *In re Goldblatt*, 66 B.R. 337, 345 (Bankr. N.D. Ill. 1986); Lisa Sommers Gretchko, *Coping With Rejection: § 502(b)(6) The Evolving Law of Lease Rejection Damages*, ABI J. (April 1996) at 36. Many courts limit the amount of recovery by the landlord to one year of future rent. In addition, some courts may require the landlord to mitigate the damages caused by rejection of the lease. The case law is not consistent as to whether the 15% limit on the landlord’s damages under § 502(b)(6) is a function of the remaining term of the lease or the amount of rent due. Compare *In re Gantos, supra*, 176 B.R. at 795 (holding that 15% cap refers to remaining rent due under lease); *In re Farley, Inc.*, 146 B.R. 739, 747 (Bankr. N.D. Ill. 1992) (same); *In re Andover Togs, Inc.*, 231 B.R. 521 (Bankr. S.D.N.Y. 1999) (referring to this interpretation as “the majority one”); with *Sunbeam Oster Co. v. Lincoln Liberty Avenue, Inc. (In re Allegheny Int’l, Inc.)*, 136 B.R. 396 (Bankr. W.D. Pa. 1991) *aff’d* 145 B.R. 823, 828 (W.D. Pa. 1992) (basing damages on 15 percent of total amount of time remaining as opposed to amount of rent reserved under lease); *In re Iran-Oak Supply Corp.*, 169 B.R. 414 (Bankr. E.D. Cal. 1994) (same).

<sup>18</sup> See, e.g., *In re Pacific Express, Inc.*, 780 F.2d 1482, 1487 (9th Cir. 1986) (“A ‘lease’ which is really a disguised security agreement does not require assumption or rejection under section 365. Courts have declined to apply section 365 to security agreements, even where those agreements have taken on the surface formalities of contracts or unexpired leases that might otherwise come within the apparent reach of that section”).

<sup>19</sup> See 11 U.S.C. § 1111(b) of the Bankruptcy Code, which permits nonrecourse secured claims to be treated as recourse or to continue to be treated as fully secured, notwithstanding § 506(a).

<sup>20</sup> See 11 U.S.C. § 1124 of the Bankruptcy Code, which provides that a class of claims or interest is impaired under a plan unless the plan “leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest.”

<sup>21</sup> See, e.g., *In re Wilcox*, 201 B.R. 334, 336-37 (Bankr. N.D.N.Y. 1996) (holding that since “Land Contract” agreement between debtor, as lessee-purchaser, and lessor-mortgagor, provided that debtor was to lease property for two years and then commence payments on principal and interest accruing on purchase price to be paid over 18-year balance of contract, was more like a mortgage than a lease, debtor could cramdown claim of lessor-mortgagor arising from land contract); *In re Elder-Beerman Stores Corp.*, 201 B.R. 759, 764 (Bankr. S.D. Ohio 1996) (holding that under 11 U.S.C. § 365(d)(10) [before enactment of the BAPCA], which provides that until an unexpired lease of personal property is assumed or rejected, trustee or debtor-lessee is required to “timely perform all of the obligations of the debtor . . . first arising . . . 60 days after” the order for relief, debtor-lessee must fully perform all obligations arising under 11 U.S.C. § 365(d)(10) under an equipment lease agreement unambiguously titled as a lease until court makes determination whether contract is a true lease, as claimed by creditor-lessor, or a financing obligation, as claimed by debtor-lessee). In *In re Waldoff’s, Inc.*, 132 B.R. 325 (Bankr. S.D. Miss. 1991), the court ruled that the agreement between the debtor-lessee and an equipment financing company, although structured as a lease, was in fact a secured financing agreement. The court took into account the lessee’s obligation for all repairs and replacements of equipment and parts, payment of all taxes, insurance, license, registration fees, and other charges, and the fact that the debtor-lessee’s accountant treated the transaction as a financing transaction for tax purposes. According to the court, “Whether or not an agreement is considered a lease or a security agreement will determine the type of treatment that may be given to the holder of the claim under the Bankruptcy Code. A lease [that was not terminated pre-petition] must be either assumed or rejected as specifically provided under 11 U.S.C. § 365. A creditor’s secured claim may be subject to a modified treatment under a plan of reorganization.” *Id.* at 328.

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<sup>22</sup> See, e.g., *In re Barney's, Inc.*, *supra* note 6, 206 B.R. at 332-33 (holding that whether an agreement constitutes a “true lease” for bankruptcy purposes must be determined by reference to federal law, and stating that “[t]he appropriate inquiry is whether the parties intended to impose obligations and confer rights significantly different from those arising from the ordinary landlord/tenant relationship;” the court also noted that where purported “lease” involves rental payments that are actually payments of principal and interest on a real estate loan, there is no “true” or “bona fide” lease and §§ 365(d)(3) and (d)(4), as well as § 502(b)(6), of the Bankruptcy Code do not apply); *In re Best Products Co.*, 157 B.R. 222, 229-30, (Bankr. S.D.N.Y. 1993) (holding that sublease between corporate sublessee and an SPE sublessor, which was an affiliate of sublessee, should be recharacterized as a financing vehicle and not a lease where (1) the lender and the corporate sublessee ignored the separateness of the SPE structure by providing that the sublease payments would be made directly by the sublessee to the lender and the ground lessor, (2) the terms of the sublease bore no relationship to a fair market lease, and (3) the SPE was created at the request of the lender for the sole purpose of facilitating the financing transaction and served merely as a conduit); *n re PCH Associates*, *supra* note 3, 804 F.2d at 199-201 (ruling that transaction described as “Sale-Leaseback Agreement” and “Ground Lease” was not true lease under § 365).

<sup>23</sup> See, e.g., *In re Challa*, 186 B.R. 750, 755-56 (Bankr. M.D. Fla. 1995) (“[c]ourts are split on whether state law or federal law should be used to determine whether a particular rental agreement is a lease”).

<sup>24</sup> (*In re Big Buck Brewery & Steakhouse, Inc.*), 2005 U.S. Dist. LEXIS 10754 (E.D. Mich. May 25, 2005).

<sup>25</sup> The fraudulent conveyance claim was dismissed by the bankruptcy court, and the dismissal of this claim was not appealed to the Federal District Court.

<sup>26</sup> (*In re UAL Corp.*), 307 B.R. 618 (Bankr. N.D. Ill. 2004). The factors considered by the court in this case included the lack of risk at lease termination where the debtor-lessee has an option to become the owner for no, or nominal, additional consideration, and the fact that the lease lasted for the useful economic life of the property with the debtor-lessee bearing the risk of changes in value and the lessor having no risk other than nonpayment of the fixed rental (similar to the risk of a secured lender under a mortgage loan). The bankruptcy court in *Big Buck* subsequently issued a supplemental opinion, based on the reversal of the *UAL Corp.* decision by the Federal District Court. *HSBC Bank USA v. United Airlines, Inc. (In re UAL Corp.)*, 317 B.R. 335 (N.D. Ill. Nov. 16, 2004) (“*UAL II*”). But the bankruptcy court reaffirmed its ruling and distinguished *UAL II* as relying on a presumption arising under California law that does not exist under Michigan law. Interestingly, the Seventh Circuit Court of Appeals subsequently reversed the Illinois Federal District Court and ruled that the leasing arrangement entered into by the parties failed to qualify as a true lease under § 365 of the Bankruptcy Code. *United Airlines v. HSBC Bank USA*, 416 F.3d 609 (7<sup>th</sup> Cir. 2005) (“The [sale-leaseback] transaction . . . is not a ‘true lease’ under California law”).

<sup>27</sup> *In re Big Buck Brewery & Steakhouse, Inc.*, *supra* note 24, 2005 U.S. Dist. LEXIS 10754 at \*28.

<sup>28</sup> *Id.* at \*31.

<sup>29</sup> *Id.* at \*35 (emphasis in text).

<sup>30</sup> See also *In re Independence Village, Inc.*, 52 B.R. 715, 718-20 (Bankr. E.D. Mich. 1985) (rejecting § 365 application and holding that, based on intentions of the parties and economic substance of transaction, “Lease Purchase Contract” executed by the parties was in actuality an equitable mortgage in real property and security interest in debtor’s personalty); *In re Seatrain Lines, Inc.*, 20 B.R. 577, 582 (Bankr. S.D.N.Y. 1982) (recharacterizing purported sale and leaseback as an equitable mortgage); *In re Opelika Mfg. Co.*, 67 B.R. 169, 170-72 (Bankr. N.D. Ill. 1986) (holding that purported lease agreement was in reality a “disguised security agreement”); *In re Ellis*, 674 F. 2d 1238, 1249 (9<sup>th</sup> Cir. 1982) (“in view of the absence any findings as to the actual intent of the parties, we must conclude that the characterization of this transaction as a sale rather than a mortgage was error”); *U.S. v. Colorado Invesco, Inc.*, 902 F.Supp. 1339, 1347 (D. Colo. 1995) (ruling that transactions were properly considered loans rather than capital contributions). *Cf. Brown v. Grant Holding, LLC*, 394 F. Supp. 2d 1090, 1099 (D. Minn. 2005) (because parties disputed what their intentions were and factors were “split,” court refused to rule as matter of law that sale and leaseback transaction resulted in equitable mortgage).

<sup>31</sup> In a recent state court decision that recharacterized a sale-leaseback transaction as an equitable mortgage, *Swenson v. Mills*, 198 Ore. App. 236 (2005), *review denied*, 399 Ore. 156 (2005), the court summarized the following findings leading to its holding:

These are the factors that weigh in favor of our conclusion that the transaction was, in fact, a security agreement: At the relevant time, Pyromid [the seller-lessee corporation] and Hait [the owner of the seller-lessee corporation] were experiencing serious financial difficulty. Plaintiff and Hait were close personal friends, and plaintiff was strongly motivated to help Hait through the financial crisis and to help Pyromid succeed. The purchase price for the subject property was only half the property’s market value. The general terms of the agreement were reached in a single

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telephone conversation between plaintiff and Hait and without the benefit of an appraisal. The broker listing the property received no commission for the sale. Pyromid retained possession of the property and continued in operation and had an obligation under the lease agreement to pay taxes and make lease payments of \$ 6,000 per month. The lease amount was below the property's actual market lease value and was determined based on a 12 percent rate of return on plaintiff's investment. The sale was conditioned on Pyromid's option to repurchase the property during the lease on terms favorable to Pyromid, including a repurchase price the same as plaintiff's purchase price of \$ 600,000, substantially below the property's market value. The parties contemplated that Pyromid would continue to list the subject property for sale and that the proceeds of any sale in excess of \$ 600,000 would be shared between Pyromid and plaintiff.

*Id.* at 242.

<sup>32</sup> *In re Big Buck Brewery & Steakhouse, Inc.*, *supra* note 24, 2005 U.S. Dist. LEXIS 10754 at \*35.

<sup>33</sup> *Id.* at \*28. The court stated that “it was never undisputed that the unrecorded deed and recorded Warranty Deed did not represent the entirety of the transaction.” *Id.* at \*29.

<sup>34</sup> *Id.* at \*14.

<sup>35</sup> But interestingly, as noted earlier, both the bankruptcy court and the Federal District Court in the *Big Buck* case discounted the undisputed testimony of Eyde’s appraisal expert that the value of the land at the time of the transaction was \$4 million (which was consistent with the \$4 million purchase price), because both courts determined that the transaction constituted a financing agreement based on the totality of the circumstances.

<sup>36</sup> As noted by the court in the *Big Buck* case, “the party who asserts that an absolute conveyance is a mortgage bears a ‘higher degree of proof than this’ and must make it ‘very clear’ to the fact finder that the parties did not contemplate an absolute sale” (internal quotations and citation omitted). *In re Big Buck Brewery & Steakhouse, Inc.*, *supra* note 24, 2005 U.S. Dist. LEXIS 10754 at \*25. For other cases that have declined to recharacterize a sale-leaseback transaction as an equitable mortgage, see *U.S. Bank N.A. v. Nielsen Enterprises, Inc.*, 232 F.Supp 2d 500, 529 n.7 (D. Md. 2002) (refusing to recharacterize ground lease transaction as equitable mortgage, and stating that “there are practical difficulties posed by an equitable recharacterization of the mortgage. For example, many commercial mortgages have prepayment penalties. To recharacterize the lease and allow the Bank to redeem it without paying a penalty would be to impose upon the Landlord a loan with commercially unreasonable terms. The Bank has not explained how this problem and others like it could be resolved”); *Kassuba v. Realty Income Trust*, 562 F.2d 511, 515 (7<sup>th</sup> Cir. 1977) (holding that transactions were bona fide sales and leasebacks and were not security agreements in nature of mortgages); *Uni-Rty Corp. v. Guangdong Bldg. (In re Uni-Rty Corp.)*, 1998 U.S. Dist. LEXIS 8426 ((S.D.N.Y. June 9, 1988), at \*14-18 (ruling that sale-leaseback transaction did not create mortgage because there was “no trading of tax benefits for a fixed return” and “Appellees assumed the risks and rewards associated with the ownership of real property, unlike the Appellees in *PCH*”); *Dabalneh v. Federal Deposit Ins. Corp.*, 971 F.2d 428, 438 (10<sup>th</sup> Cir. 1992) (“In all relevant respects in the record, the transaction has been called and treated like a lease”).