Lease Recharacterization In Bankruptcy: United Air Lines Recharacterization Cases Bolster The Debtor-Tenant's Cause

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The United Recharacterization Cases demonstrate that lease recharacterization can be a powerful weapon in a debtor-tenant's arsenal, the author believes.

Lease recharacterization hit center stage in the In re UAL Corporation bankruptcy. In a series of cases, United Air Lines, Inc. successfully recharacterized approximately $248 million in special facility revenue bond financings, structured as lease-leaseback transactions, issued to construct improvements at the San Francisco International Airport ("SFO"), New York John F. Kennedy International Airport ("JFK"), and Los Angeles International Airport ("LAX").[1] A similar case remains pending on appeal with respect to the Denver International Airport. The result was the conversion of what would have been the payment of approximately $600 million in "rent" to just $248 million in prepetition indebtedness, which, to the extent unsecured, would be discharged in the bankruptcy proceeding as unsecured indebtedness. Though special facility revenue bonds (and bankruptcy for that matter) are by no

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means unique to the airline industry, United was the first airline to successfully recharacterize its special facility revenue bonds in bankruptcy. The United Recharacterization Cases create a new framework for approaching lease recharacterization and provide guidance where little previously existed.

Section 365 of the Bankruptcy Code requires the debtor to assume or reject its leases and make payments under such leases pending the rejection decision. By contrast, the debtor can discharge its unsecured financings, often for pennies on the dollar, and need not make interest payments on such unsecured financings during the pendency of the bankruptcy case. Thus, lease recharacterization can be a valuable weapon in shedding debt and repositioning the debtor's assets.

The Bankruptcy Code does not define what constitutes a "lease" for purposes of Section 365. However, every appellate court that has considered the issue, and the Seventh Circuit agrees that economic substance controls and that only a "true lease" counts as a "lease" under Section 365.[2] This view stems from a single passage in the legislative history of Section 365, stating "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."[3] Because the economic substance of the transaction trumps the form of the transaction, the courts look past the labels given to the transaction or the parties and simply look to its economic substance.[4]

Though the courts agree that the economic substance of a transaction prevails over its form, the courts are divided on whether state law or federal law provides the test for determining whether a transaction is a "true lease" or "disguised" financing.[5] The Seventh Circuit noted the split in the circuit courts on this question, and held that state law provides the test unless the state law test upsets the federal policy of employing a substance-based test.[6] That is to say, state law will be consulted to the extent that it too uses factors intended to glean the economic substance of the transaction. If, however, the state law test is form-based, as opposed to substance-based, then the state law must yield to the federal law.[7] Though the Seventh Circuit noted a split in authority on the source of the "true

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lease" test, this apparent "split" in authority may be largely academic.

Regardless of whether the "true lease" test stems from federal or state law, it is likely the case that the tests will be substantively the same. Since the underlying task is to seek out the substance of the transaction, it is hard to conceive of a scenario where the same transaction would be treated as a lease under state law and a loan under federal law. This is particularly true given that Article 9 of the Uniform Commercial Code, adopted in all 50 states, often serves as the court's backdrop for the economic substance test itself.[8] Though the labels of the factors may change, there are general categories of factors that should be consulted in determining whether a transaction is a true lease.

WHETHER THE AMOUNT OF RENT WAS CALCULATED TO COMPENSATE FOR USE OF THE LAND

Rent under a "true lease" is intended to compensate a landlord for future use of an asset. Relevant to this factor is whether rent is paid in advance or in arrears. Rent is typically paid in advance, while debt service is typically paid in arrears. The distinction is not trivial, but rather reflective of the basic principal that in a "true lease" the tenant is paying for future inputs (namely, the use of the asset), while in a financing the borrower is paying for prior inputs (namely, the cost of capital for loan proceeds previously advanced).[9] Other features associated with the "rent" stream will differentiate the transaction. A "lease" with a so-called "balloon" feature or pre-payment feature is more akin to a financing.[10] Indeed, it is inconceivable that a tenant would agree to prepay all of its lease obligations only to lose the right to occupy the leased asset on a go-forward basis.[11] Similarly, where rent decreases, fluctuates over time, or adjusts on a sporatic basis, the transaction begins to appear more like a financing with the interest rate adjusting according to some external benchmark. Rent under "true leases" is presumed to be based on the fair market rental value of the asset and, as such, parties would expect these rents to increase over time on a periodic basis.

Courts will also look to the presence of a stringent "hell or high water clause" in the "lease."[12] That is, a provision stating that tenant's obliga-

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tion to pay rent is unconditional regardless of any intervening events. Though nearly all leases contain some form of "hell or high water clause" (i.e., most triple net leases restrict the tenant's ability to offset or abate rent), the courts will look to the relative breadth of the provision in determining whether it appears more as a financing provision. For instance, if the "tenant' is forced to continue to make rent payments following a complete casualty or condemnation, the transaction appears more as a financing. Borrowing on the logic set forth earlier, since the tenant under a true lease is paying in advance for future use of an asset it would be unusual that a "tenant" be forced to continue making payments on an asset that is completely damaged or, perhaps, no longer in existence.

Moreover, if the purported rent is paid directly to a lender or indenture trustee (as opposed to the purported landlord), the transaction appears more as a "disguised" financing.[13] Even where the landlord sets its rent based on the carrying costs of its building, it doesn't then ask its tenants to send the rent checks to its lender.

WHETHER THE RENT WAS RELATED TO THE FAIR MARKET VALUE OF THE LAND

Typically, rent is based upon the fair market rental value of the asset. As a general matter, the fair market rental value of an asset depends on the market rents for comparable assets within a defined market area. These rents are often expressed as a rental amount per square foot. By contrast, interest is typically based not upon the fair market rental value of the leased asset or comparable assets, but rather on the financial wherewithal of the borrower and/or the revenue stream generated by the collateral securing the financing. If the "rent" is structured to service debt, then the "rent" isn't compensating the "landlord" for the use of the land but rather is compensating the "landlord" or its lender for the use of money.[14] One would expect the "landlord" to argue that rents are always structured with debt service in mind and, thus, should not be made to suffer merely because the rents closely approximate the debt service on the asset. However, where "rents" are specifically designed to pay debt service, with "landlord" receiving nothing or only a nominal administrative fee

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beyond debt service, then the "rents" more closely resemble interest on debt.

WHETHER THE LAND WAS PURCHASED SPECIFICALLY FOR TENANT'S USE

A landlord in a "true lease" purchases an asset for its future value, which comes in the form of an anticipated future rental stream and a residual value. Landlords in sale-leaseback transactions can all be said to have purchased the asset with tenant's use in mind (in fact, most sale-leaseback transactions are underwritten primarily on the credit of the tenant and not on the residual value of the asset). However, the landlords in most sale-leaseback transactions are buying not only a future rental stream from its tenant but also a reversionary interest in the asset. Where a "landlord" purchases an asset solely for an amount sufficient to finance an investment and the "rent" is structured solely to ensure a return on the investment then the landlord has, in essence, purchased the asset specifically for "tenant's" use and nothing more.[15]

Stated otherwise, a purchaser of a landlord's interest in a "true lease" is buying for its own account, based upon its own considerations of the asset. Where the tenant initiates the transaction, selects and procures the asset for acquisition by its landlord (with landlord simply requiring a return on its invested capital), the transaction appears more as a loan than a lease.[16]

WHETHER THE LANDLORD RETAINS ANY MEANINGFUL REVERSIONARY INTEREST IN THE ASSET

The lack of a reversionary interest in the leased asset is an indication that a "lease" is a "disguised" financing. If the "tenant" has the right or obligation to purchase, or recover its original legal interest in the asset for a bargain purchase price ($1 for instance) or if title or the legal interest reverts automatically to the tenant upon expiration or termination of the lease, the lease appears more as a "disguised" financing.[17] Indeed, such would be the functional equivalent of a release of mortgage or deed of

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trust following the satisfaction of the underlying indebtedness.

The presence or lack of a reversionary interest in the leased asset is not dispositive. Several courts have mentioned in dicta that the lack of an option to purchase does not necessarily preclude a finding that the lease is a "disguised" financing.[18] Likewise, several courts have found disguised financing arrangements despite the absence of purchase rights.[19]

The lack of a reversionary interest is omnipresent in industrial revenue bond financing, which supplies a large source of lease recharacterization precedent. It is important to carry away the *principles* of the industrial revenue bond recharacterization precedent, and *not* the *precise facts*. Under the typical industrial revenue bond financing, the "tenant" owns the asset prior to the financing, sells the asset to the municipal agency which then issues bonds. At the end of the financing, the "tenant" purchases title to the asset back from the municipal agency for little or no consideration. The "tenant" has the right to purchase title, because it was title that it held prior to the financing. The industrial revenue bond recharacterization precedent does not stand for the bold assertion that an option or obligation to purchase title must be present. Rather, the precedent illustrates a borrower that is recovering the same legal interest in the asset that it had prior to the financing. That is to say, if the borrower held a leasehold interest in an asset prior to the financing, one should look to whether the borrower has a right or obligation to recover a leasehold interest in the asset following the financing. If an option or obligation to purchase title were required, then all lease-leaseback financings (and special facility revenue bond financings, for that matter) would forever be immune from recharacterization.

Included within this factor, or perhaps serving its own factor, is whether the duration of the term covers the useful life of the leased asset.[20] In industrial revenue bond financing, the term of the lease is tied not to the useful life of the asset, but rather to the maturity of the bonds issued. In those instances, term has little to do with the landlord's preservation of a valuable reversionary interest and everything to do with retiring the bonds. Thus, where the term of the lease is tied directly to the maturity date on the landlord's financing, the lease takes on the appearance of a loan agreement.

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WHETHER THE AGREEMENT IS REFERRED TO AS "LEASE" FOR CERTAIN TAX ADVANTAGES

The lease-leaseback transactions in the United Recharacterization Cases and many of the sale-leaseback transactions which comprise the body of case law on lease recharacterization were all structured so as to procure tax exempt financing.[21] Revenue bond financings are typically structured as sale-leaseback or lease-leaseback transactions with a municipal or quasi governmental entity serving as "landlord" solely to take advantage of the "landlord's" ability to issue tax exempt bonds or other debt instruments in favor of the "tenant."[22] The "landlord" and issuer typically must, by law, hold title to the asset in order to issue the tax exempt financing. The "tenant" then enjoys the benefits of the tax exempt financing in the form of lower "rent" under a "lease" from the issuer.

WHETHER TENANT ASSUMES OBLIGATIONS NORMALLY RESERVED FOR LANDLORDS

Courts will also consider whether the "tenant" takes on all maintenance and repair obligations, insurance obligations, and real estate taxes, and other obligations that a typical owner would assume.[23] This factor may be of little probative value in light of the widespread use of triple-net leases, whereby the landlord passes most, if not all, of these obligations through to its tenant. However, certain obligations may push the boundaries of what a tenant would typically encounter in a triple net lease. Perhaps the most obvious would be a guarantee by the tenant of the residual value of the asset. Here, the "tenant" is behaving more as a borrower that has committed to retire indebtedness notwithstanding any diminution in the value of the collateral. Another, less obvious provision, would be a provision requiring the tenant to indemnify its landlord for any deficiency in casualty proceeds in rebuilding a damaged asset. As another example, if the tenant were forced to make capital expenditures at any time during the lease (including in the last couple of years of the lease) without reimbursement from landlord for any portion of the cost, then (putting aside, perhaps, the poor advice received by the client) the "tenant" is

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behaving more as a borrower that expects to recover the reversionary interest in the asset.

WHEN TO SEEK RECHARACTERIZATION

The United Recharacterization Cases have paved the way for other debtors (and, most notably, other airlines) to consider recharacterization as a means to shed burdensome debt obligations shrouded in "lease" clothing. Before rushing to court, however, debtor-tenants should fully understand the lease recharacterization process and the benefits that can be achieved.

There are two key questions that the debtor must answer prior to engaging in the lease recharacterization process. First, the debtor must determine whether it wants to hold or dispose of the asset subject to the lease on a going-forward basis. Second, the debtor must make certain assumptions as to whether and the extent to which the landlord would be deemed to hold a security interest in the asset subject to the lease, if such lease were deemed a "disguised" financing. As a rule of thumb, debtors should not pursue lease recharacterization unless the debtor intends to hold on to the asset *and* the landlord is deemed to be unsecured or undersecured.

The benefits of a successful recharacterization need to be fully examined prior to engaging the legal machinery. The greatest magnitude of benefits can be achieved if the debtor desires to retain the asset and the landlord/lender is fully unsecured. In that situation, the debtor would be able to retain the asset, be relieved of making "rent" payments during the pendency of the bankruptcy case, and discharge the entire debt upon exit, leaving the landlord/lender holding the bag for an unsecured claim for the principal amount of the debt.

If the landlord/lender is undersecured (that is, the principal amount of the debt exceeds the value of the secured collateral), Section 506(a) of the Bankruptcy Code requires a bifurcation of such claim into separate and independent secured and unsecured components, and the claim will not continue to accrue post-petition interest.[24] Thus, the debtor would be able to retain the asset and discharge that portion of the principal amount of the debt by which the landlord/lender is undersecured. Moreover, the debtor

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would typically not be required to make the rent/loan payments (but may be forced to make adequate protection payments to preserve the collateral)[25] during the pendency of the bankruptcy case.

The debtor-tenant has little to gain, and may in fact be hurting itself, by pursuing lease recharacterization if it desires to abandon or dispose of the asset. Typically in that situation, the better course of action is to abandon the recharacterization argument altogether and take advantage of the powers under Section 365 of the Bankruptcy Code to reject the lease. In doing so, the debtor-tenant can shed itself of the burdensome lease obligations and avail itself of the statutory damages cap accorded by Section 502(b)(6) of the Bankruptcy Code, which caps a landlord's claim for lease rejection damages at the rent reserved under the lease for the of one year or 15 percent, not to exceed three years, of the remaining term of the lease. The only conceivable advantage to recharacterization in this scenario is the potential to avoid post-petition rent/loan payments if the landlord/lender is unsecured or undersecured (the debtor in that case may still be forced to make adequate protection payments to preserve the collateral). However, that modicum of advantage (which can be rendered nil if the debtor-tenant rejects the lease on the first day of the bankruptcy case) is substantially outweighed by the Section 502(b)(6) statutory cap that would be applicable to a lease rejection claim.

If the landlord/lender is oversecured, the debtor-tenant may also have little to gain in pursuing the lease recharacterization argument. Though the debtor-tenant would want to avoid having to make rent payments during the pendency of the bankruptcy case, the debtor-tenant may end up having to make post-petition interest payments to the creditor to the extent that the creditor is oversecured such that a so-called "equity cushion" exists.[26] And, since the creditor is over-secured, the creditor's lien will typically "ride through" the bankruptcy without discharge. Thus, the debtor-tenant would be faced with having to make the rent/loan payments post-bankruptcy under either scenario. In sum, the treatment of the oversecured creditor and landlord would be substantially similar, leaving the debtor-tenant with little incentive to make the investment in lease recharacterization.

Recharacterization can be a double-edged sword. For the same reasons that the debtor-tenant may chose to avoid the recharacterization argu-

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ment, the landlord/lender may chose to take up the recharacterization argument. Where the debtor-tenant attempts to reject the lease, the landlord/lender would argue that the debtor-tenant cannot reject the lease because it is, in substance a disguised financing. In doing so, the landlord could force the debtor to remain saddled with the "disguised" financing arrangement. The magnitude of the advantage to the landlord/lender in this instance is precisely opposite the advantage to the debtor-tenant and, thus logically, depends upon the existence and extent to which the "disguised" financing is security by collateral held by the landlord.

CONCLUSION

In sum, lease recharacterization can be a powerful weapon in a debtor-tenant's arsenal. The United Recharacterization Cases are assuredly a positive development for debtor-tenants seeking to rid themselves of burdensome debt obligations that just so happen to be cast on paper as a lease. Debtor-tenants, however, must fully understand the process, their goals and objectives, and the potential benefits to be derived, prior to engaging the lease recharacterization argument. For it may indeed be the landlord/lender that is wanting to take on the argument.

NOTES

[1] *See United Air Lines, Inc. v. HSBC Bank USA, N.A.,* 416 F.3d 609,615 (7th Cir. 2005) (SFO), cert. denied 126 S. Ct. 1465 (Mar. 6, 2006); *United Air Lines, Inc. v. U.S. Bank National Association,* No. 05-1460, 05-1461, 05-1462, 2006 WL 1171899 (7th Cir. May 4, 2006) (LAX); *United Air Lines, Inc. v. Bank of New York,* No. 04 C 2838, 2005 WL 670528 (N.D. Ill. 2005) (JFK) (the foregoing cases are collectively referred to herein from time to time as the "United Recharacterization Cases").

[2] *See United Air Lines, Inc. v. HSBC Bank USA, N.A.,* 416 F.3d 609,612 (7th Cir. 2005), *cert. denied* 126 S. Ct. 1465 (Mar. 6, 2006) (citing *In re PCH Associates,* 804 F.2d 193, 198-200 (2d Cir. 1986); *In re Pillowtex, Inc.,* 349 F.3d 711, 716 (3d Cir. 2003); *In re Moreggia & Sons, Inc.,* 852 F.2d 1179, 1182-84 (9th Cir. 1988); *In re Pacific Express, Inc.,* 780 F.2d 1482, 1486-87 (9th Cir. 1986)); *see also In re KAR Development Assocs., L.P.,* 180 B.R. 629,

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639 (D. Kan. 1995).

3 S.Rep. No. 989, 95th Cong., 2d Sess. 64 (1978) (internal quotations omitted).

[4] *See In re Opelika Mfg. Corp.,* 67 B.R. 169 (Bankr. N.D. Ill. 1986).

[5] *Compare In re PCH Assocs.,* 804 F.2d 193, 198-200 (2d Cir. 1983), and *In re Moreggia & Sons, Inc.,* 852 F.2d 1179, 1182-84 (9th Cir. 1988), with *United Air Lines, Inc. v. HSBC Bank USA, N.A.,* 416 F.3d 609,615 (7th Cir. 2005), *cert. denied* 126 S. Ct. 1465 (Mar. 6, 2006), *In re Pillowtex, Inc.,* 349 F.3d 711, 716 (3d Cir. 2003), and *In re Continental Airlines, Inc.* 932 F.2d 282, 287-88 (3d Cir. 1991).

[6] *See United Air Lines, Inc. v. HSBC Bank USA, N.A.,* 416 F.3d 609,615 (7th Cir. 2005), *cert. denied* 126 S. Ct. 1465 (Mar. 6, 2006).

[7] *See id.*

[8] *See id.*

[9] *See United Air Lines, Inc. v. HSBC Bank USA, N.A.,* 416 F.3d 609,613 (7th Cir. 2005), *cert. denied* 126 S. Ct. 1465 (Mar. 6, 2006).

[10] *See United Air Lines, Inc. v. HSBC Bank USA, N.A.,* 416 F.3d 609, 617 (7th Cir. 2005), *cert. denied* 126 S. Ct. 1465 (Mar. 6, 2006).

[11] This is not to say that lease termination payments would automatically convert a lease into a loan. However, where *all* lease obligations are prepaid (and not some lesser termination payment), one would expect the lease to remain in effect.

[12] *See United Air Lines, Inc. v. HSBC Bank USA, N.A.,* 416 F.3d 609, 617 (7th Cir. 2005), *cert. denied* 126 S. Ct. 1465 (Mar. 6, 2006); *In re Opelika Mfg. Corp.,* 67 B.R. 169, 171 (Bankr. N.D. Ill. 1986).

[13] *See In re Central Foundry Co.,* 48 B.R. 895, 898 (Bankr. N.D. Ala. 1985).

[14] *See In re Integrated Health Services, Inc.,* 260 B.R. 71, 76 (Bankr. D. Del. 2001); *In re KAR Dev. Assocs., L.P.,* 180 B.R. 629, 639 (D. Kan. 1995); *In re Hotel Syracuse, Inc.,* 155 B.R. 824, 838-39 (Bankr. S.D. Cal. 1981).

[15] *See PCH Assocs.,* 804 F.2d 193, 200 (2d Cir. 1986).

[16] *See In re Winston Mills, Inc.,* 6 B.R. 587, 598 (Bankr. S.D.N.Y. 1980); *see also In re Keydata Corp.,* 18 B.R. 907, 909 (Bankr. D. Mass. 1982).

[17] *See United Air Lines, Inc. v. HSBC Bank USA, N.A.,* 416 F.3d 609, 617 (7th Cir. 2005), *cert. denied* 126 S. Ct. 1465 (Mar. 6, 2006); *In re Integrated Health Services, Inc.,* 260 B.R. 71, 76 (Bankr. D. Del. 2001); *In re Pittsburgh Sports Assocs. Holding Co.,* 239 B.R. 75, 85 (Bankr. W.D. Penn. 1999); *In re Opelika Mfg. Corp.,* 67 B.R. 169 (Bankr. N.D. Ill. 1986); *In re Central*

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Foundry Co., 48 B.R. 895, 898 (Bankr. N.D. Ala. 1985).

[18] *See Fox v. Peck Iron and Metal Co., Inc.,* 25 B.R. 674, n. 17 (Bankr. S.D. Cal. 1982); *see also In re Nite Lite Inns,* 13 B.R. 900, n. 12 (Bankr. S.D. Cal. 1981); *In re Waldoff's, Inc.,* 132 B.R. 325 (Bankr. S.D. Miss. 1991).

[19] *See International Trade Administration v. Rensselaer Polytechnic Institute,* 936 F.2d 744 (2d Cir. 1991) (finding the 99 year lease term and the rent prepaid over the initial three years "transformed the agreement from a lease into a pre-paid right of possession for a substantial future term"); *In re MCorp Financial, Inc.,* 122 B.R. 49 (Bankr. S.D. Tex. 1990) (finding five factors (not including purchase rights) to contribute to its conclusion that the economic substance of the transaction created a financial arrangement); *In re Moreggia & Sons, Inc.,* 852 F.2d 1179 (9th Cir. 1988); *In re Picnic 'N Chicken, Inc.,* 58 B.R. 523 (Bankr. S.D. Cal. 1986) (considered five factors (not including purchase rights) to conclude that the lease was a financing transaction).

[20] *See In re Pillowtex, Inc.,* 349 F.3d 711, 718 (3d Cir. 2003); *In re Integrated Health Services, Inc.,* 260 B.R. 71, 76 (Bankr. D. Del. 2001); *In re Opelika Mfg. Corp.,* 67 B.R. 169, 171 (Bankr. N.D. Ill. 1986); *In re Central Foundry Co.,* 48 B.R. 895, 898 (Bankr. N.D. Ala. 1985).

[21] *See See In re PCH Assocs.,* 804 F.2d 193, 201 (2d Cir. 1986); *In re Integrated Health Services, Inc.,* 260 B.R. 71, 76 (Bankr. D. Del. 2001); *In re Pittsburgh Sports Assocs. Holding Co.,* 239 B.R. 75, 82 (Bankr. W.D. Penn. 1999).

[22] *See* James Gadsden, *Recharacterization of Industrial Development Bond Real Property Leases in Bankruptcy Cases,* 113 Banking L. J. 466, 470 (May, 1996) (noting that the structure of industrial revenue bonds "reflects no more than the historical antecedents in qualifying for the tax exemptions available to municipalities.").

[23] *See In re KAR Dev. Assocs., L.P.,* 180 B.R. 629, 639 (D. Kan. 1995); *In re Opelika Mfg. Corp.,* 67 B.R. 169, 171 (Bankr. N.D. Ill. 1986); *Burke Investors v. Nite Lite Inns (In re Nite Lite Inns),* 13 B.R. 900, 907-08 (Bankr. S.D. Cal. 1981).

[24] 11 U.S.C. § 506(b); *see also In re Ionosphere Clubs, Inc.,* 134 B.R. 528, 531 (Bankr. S.D.N.Y. 1991).

[25] *See* 11 U.S.C. § 363(e).

[26] *See* 11 U.S.C. § 506(b); *see also In re United Merchants and Manufacturers, Inc.* 674 F.2d 134, 138 (2d Cir. 1982); *In re Woodmere Investors Ltd. Partnership,* 178 B.R. 346, 354 (Bankr. S.D.N.Y. 1995).

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