

Synthetic Leases: “Bankruptcy Proofing” the Lessee’s Option to Purchase

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Objective of a Synthetic Lease

The objective in a synthetic leasing transaction, for financial accounting purposes, is to have the lease treated as an operating lease, not a capital lease. If the lease is characterized as a capital lease, the lessee must record it as an asset on its balance sheet at the inception of the lease and show a corresponding liability equal to the minimum lease payments during the lease term, provided that the aggregate amount does not exceed the fair market value of the property. If the lease is classified as an operating lease, the lessee may treat the payment of rent as an expense item during the term of the lease and omit the lease asset and corresponding rental obligation from its balance sheet. (However, certain information with respect to the lease must be disclosed in the lessee's financial statements). Notwithstanding this treatment for accounting purposes, a synthetic lease qualifies as a loan for federal and state income tax, bankruptcy, and commercial purposes. The lessee/corporate user is treated as the owner of the leased property, which enables it to realize appreciation in the value of the property, take depreciation on the property for tax purposes, and characterize rental payments as payments of interest and principal. The Internal Revenue Service treats the transaction as a conditional sale, qualifying the transaction for the favorable tax benefits associated with depreciation. Another benefit of a synthetic lease to the lessee/corporate user is that it may not trigger financial covenants in bank loan documents that otherwise limit the incurrence of indebtedness by the lessee/corporate user. The lease between the parties will commonly state that they intend that the lease be treated as an operating lease for financial accounting purposes but as a financing arrangement, or loan, for federal and state income tax, bankruptcy, real estate and commercial purposes.

Accounting Requirements for Treatment as Operating Lease

Statement of Financial Accounting Standards No. 13 (Accounting for Leases), issued by the Financial Accounting Standards Board (“FASB”) in 1976, provides that a synthetic leasing transaction will *not* qualify as an operating lease for financial accounting purposes if any of the following criteria are met: (1) the lease automatically transfers ownership to the lessee at the end of the lease; (2) the lease contains a bargain price option to purchase; (3) the non-cancelable lease term is equal to, or greater than seventy-five percent of the estimated economic life of the property; or (4) the present value of the rents and other basic lease income equals or exceeds ninety percent of the leased property's fair market value.

To avoid automatic transfer of ownership to the lessee, the lease should provide the lessee with an option to either purchase the property at the end of the lease term or

cause it to be sold to a third party. To ensure that the lease does not contain a bargain price option to purchase, the lease should provide that the lessee is obligated to purchase the property at the expiration of the lease term for a fixed amount set at the inception of the lease, equal to the unamortized acquisition cost plus the additional costs advanced by the lessor in connection with the acquisition and development of the property, including debt financing. Alternatively, the lease could obligate the lessee to (1) sell or cause the property to be sold to a third party for a price equal to its then fair-market value, and (2) guarantee any deficiency caused by failure of the third-party purchase price to equal the amount originally advanced by the lessor. Since the amount paid by the lessee cannot constitute a bargain price, an appraisal of the property is usually obtained at the inception of the lease to verify that the option price set in the lease is not less than the expected fair market value of the property at the end of the lease term. If the property is sold to a third party for more than the amount required to repay the money advanced by the lessor, the lessee is entitled to retain the surplus proceeds, and thus realize any appreciation in the value of the property.

To ensure that the lease term does not exceed seventy-five percent of the estimated economic life of the property, the lease should be structured as a short-term lease, seldom exceeding ten years. Typical leases based on bank financing have three- to seven-year terms (one or more one-year renewal options may also be available). Private investors and insurance companies may make longer maturities available.

To prevent rental and lease income from equaling ninety percent of the leased property's fair market value, the lease is usually structured so that the present value of the base rental income, including the residual payment due on lease termination, is less than ninety percent of the fair market value of the property. The lessee also may have the option to sell the property or cause it to be sold to a third-party purchaser. Upon sale, the lessee would be liable for no more than 89.9% of the fair market value of the property as established by appraisal at the inception of the transaction.

Creation of Special Purpose Entity

In many current forms of real estate financing (especially those that are securitized), the lender requires that the borrower or developer be a special-purpose, bankruptcy-remote entity ("SPE") with no assets or operations other than the real estate project providing the security for the loan. In many synthetic-lease-financing transactions, an SPE (usually a pass-through entity such as a business trust, special-purpose corporation, limited partnership, or limited liability company) is formed. The SPE then takes title to the property, either directly or by assignment of the purchase contract, constructs the building (usually with the lessee/corporate user acting as the construction agent), and leases the property to the lessee-corporate user or its subsidiary. As is the case with most forms of structured financing, a synthetic-leasing transactions customarily utilizes an SPE so that legal ownership of assets can be structurally isolated. The SPE itself is structured as an independent bankruptcy-remote entity - an entity that is unlikely is to become the subject of a bankruptcy or to be substantively consolidated if there is a subsequent bankruptcy of the lessee/corporate user. Structural isolation of the

SPE also creates access to increased investment and pricing advantages available through securitization and use of the capital markets. *See Implementation Issues in Accounting for Leasing Transactions Involving Special Purpose Entities*, EITF Bulletin 90-8 (Emerging Issues Task Force, Financial Accounting Standards Bd. 1996).

A synthetic lease of real estate using an SPE commonly requires rental payments from the lessee equal to the sum of the interest on the SPE's debt plus a return on the SPE's equity investment, with no amortization of the debt's principal or return of its equity during the term of the lease. The SPE, acting as lessor, obtains financing for the transaction with a small equity investment in the project, usually three percent (to comply with FASB requirements), and debt financing for the balance. The debt financing is generally in the form of commercial paper or commercial bank debt, often in combination with mortgage financing. Customarily, two separate classes, or tranches, are created for the debt portion of the financing. The first tranche holds from eighty-one to eighty-nine percent of the debt financing in the form of standard, corporate-credit-risk financing secured by a deficiency guarantee, with additional collateral required if the lessee does not maintain an investment-grade credit rating. The second tranche holds twelve to sixteen percent of the debt financing, usually in the form of a first mortgage to the SPE. These separate tranches reflect different risk levels, yields, maturities, and other capital and risk attributes and objectives of the investors in the transaction.

Consolidation Issues

Accounting rules generally require the consolidation of financial statements of a company with certain of its subsidiaries and with other entities over which it can exercise control. The FASB has stated that "[o]missions of large amounts of liabilities, especially those of finance and similar subsidiaries, have led to the criticism that not consolidating those subsidiaries is an important factor in what is often called 'off-balance-sheet financing.'" *Consolidation of All Majority-Owned Subsidiaries*, Statement of Financial Accounting Standards No. 94 (Financial Accounting Standards Bd. 1987).

Consolidated financial statements are required primarily in those instances in which resource providers (such as shareholders, creditors, members, and donors) would benefit from full disclosure of all relevant financial information to help them accurately assess an entity's financial information, performance, economic resources, and business activities. Courts have required substantive consolidation of one entity with another when one of the entities is a mere instrumentality or alter ego of the other, or when the entities' activities are hopelessly obscured. *See* The Committee on Bankruptcy and Corporate Reorganization of The Association of the Bar of the City of New York, *Structured Financing Techniques*, 50 Bus. Law. 527, 559, 598 (Feb. 1995).

Current Accounting Rules

Under the current accounting rules and guidelines of the FASB and the Securities and Exchange Commission with respect to leasing transactions when the SPE is the lessor, the SPE is deemed to lack economic substance, and the lessee is required to

consolidate the assets, liabilities, results of operations, and cash flows of the SPE in the lessee's financial statements (and thereby relinquish the economic and tax benefits of a synthetic leasing transaction) when all of the following conditions exist: (1) substantially all of the activities of the SPE involve assets that are leased to a single lessee; (2) the expected substantive risks and rewards of the leased asset and the underlying debt obligation of the SPE reside directly or indirectly with the lessee, through such means as a purchase option, a guarantee of the residual value, or a guarantee of the SPE's debt; (3) an option is granted to the lessee to purchase the asset at a fixed price (other than fair market value at the date of exercise) or to receive any of the sale proceeds of the asset in excess of a fixed amount; and (4) the owners of the SPE have not made a substantive equity investment that remains at risk throughout the lease term. *See Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions*, EITF Bulletin 90-15 (Emerging Issues Task Force, Financial Accounting Standards Bd. 1990).

Because the foregoing conditions almost always exist in connection with a typical synthetic-lease real estate transaction, it would appear difficult to structure such a financing transaction by creating an SPE to take title to the property and lease it to the lessee-corporate user. However, because *all* of the foregoing conditions must be satisfied, a synthetic lease transaction utilizing an SPE to own and lease the property can be structured to negate the fact that the SPE has not made an initial substantive equity investment. The SEC's Emerging Issues Task Force ("EITF") has consistently determined that a three-percent equity contribution by the SPE is the "minimum acceptable investment" that will qualify as "substantial." *See* EITF Issue No. 90-15, *supra* (which provides that to constitute an "initial substantive residual equity investment," the investment must remain at risk with respect to the leased asset for the entire term of the lease).

By requiring the SPE to make an initial equity investment of at least three-percent at the inception of the lease, the transaction will qualify for the desired economic and tax benefits. The three-percent equity interest may be contributed directly by the beneficiary, controlling partner, or member of the SPE, or loaned to the SPE. The loan may be secured by obtaining a subordinate assignment of the lease and a security interest in the beneficiary or controlling party of the SPE. Alternatively, the lender may decide not to secure the loan because the risks associated with a decline in the residual value of the property, default by the lessee, or the lessee's failure to exercise the option are deemed remote.

Proposed Accounting Rules

Since the mid-1990's, the FASB has been reviewing its policy on consolidation rules relating to the creation and capitalization of single-purpose, shell SPEs. On February 23, 1999, the FASB Emerging Issues Task Force issued for comment Exposure Draft (Revised) 194-B, *Consolidated Financial Statements: Purpose and Policy* ("EITF 194-B"). The proposed rules would require business enterprises and not-for-profit organizations that control other entities to include those subsidiaries in their consolidated financial statements. "Control" is defined as "the nonshared decision-making ability of one entity to direct the policies and management that guide the ongoing activities of

another entity so as to increase its benefits and limit its losses from that other entity's activities." EITF 194-B contains an example ("Example 7") of a situation involving a typical synthetic-leasing real estate structure. In this example, the lessee arranges to obtain investment capital for an SPE from a group of independent third-party investors, who will own all of the SPE's voting shares. The charter and bylaws of the SPE (which cannot be changed without the consent of the lessee corporation) provide that the sole purpose of the SPE is to construct, own, and lease commercial properties to the lessee corporation. Example 7 states that because of the "significant involvement" of the lessee corporation in forming the SPE-lessor corporation, and the provisions of the SPE corporation's charter and bylaws that "limit its ongoing activity and use of assets solely to transactions with [the lessee corporation]," these circumstances "suggest that [the SPE-lessor] may have 'obtained' control of [the lessee]." Based on these facts, Example 7 concludes that the lessee controls the SPE-lessor because it has the nonshared ability to guide the ongoing activities of the SPE-lessor and the ability to increase the benefits it can derive and limit the losses that it can suffer "from the way it has directed and continues to direct those activities."

However, EITF 194-B also contains an example ("Example 8"), in which an SPE can be created to invest in and lease real property in compliance with the criteria set forth in the proposed rules. In this scenario, a bank ("Bank") creates an SPE in the form of a business trust, which is funded by two unrelated independent investors that own all of the beneficial interests in the SPE. One of the investors holds a 60 percent interest in the SPE and the other investor holds a 40 percent interest. At any time, the investors may agree to permit additional investors to acquire interests in the SPE. The SPE then enters into an agreement with a retailing company ("Lessee") to construct one or more locations to be owned by the SPE and leased to the Lessee upon completion. Based on these facts, Example 8 concludes that the Bank does not control the SPE. Although the Bank established the SPE and received a one-time fee for its services, "it has no ongoing decision-making or economic relationship [with the SPE]." Example 8 further concludes that consolidation will not be required because the Bank "cannot direct the policies and management that guide the ongoing activities of [the SPE] to increase its benefits and limit its losses from the activities of [the SPE]." In addition, the investors in the SPE are not deemed to have acquired the "nonshared decision-making ability" to control the SPE because no single party has the nonshared ability to direct the actions of the SPE and the investors may direct the SPE trustee to engage in other business activities from time to time. Example 8 also concludes that the Lessee does not control the SPE because it must follow the direction of the investors in the SPE (indirectly through the SPE trustee), and the lease rights it has obtained are limited to a particular leased property and not to all of the assets or activities of the SPE. The SPE is free to acquire other properties or assets and engage in other activities.

In the situation described in Example 8, *supra*, it does not appear necessary for the SPE to actually have entered into a lease agreement with another lessee; rather, it is enough that it is *possible* for the SPE to do so. Therefore, this would permit an SPE (consisting of two or more independent and unrelated investors) that merely had the "nonshared" ability, under its charter, partnership or operating agreement, or bylaws, to

enter into development and leasing relationships in the future with third parties without fear of violating EITF 194-B. The utilization of a bona fide ownership structure that permits the lessor entity to enter into additional transactions and relationships with other parties – even if they do not currently exist – would therefore be acceptable under EITF 194-B.

It is uncertain when - or if - EITF 194-B will become effective, and whether it will be promulgated in its present form. On January 11, 2001, the FASB issued a news release, <http://www.rutgers.edu/Accounting/raw/fasb/news/nr011101.html> (“News Release”), stating that it had determined that “at this time, there is not sufficient Board member support to proceed with either a final statement on consolidation policy, or an exposure draft on entities with specific limits on their powers.” The News Release further states that the FASB “staff is expected to present its assessment of and proposal about the Consolidation project for Board consideration in the third quarter of 2001.”

Enforcement of Lessee’s Option to Purchase

Some commentators have expressed the belief that, if EITF 194-B is promulgated in its present form, lessees in synthetic lease transactions will justifiably become more concerned about addressing the possibility that a multi-project lessor SPE will file (or have filed against it) a bankruptcy proceeding. They reason that, as the result of liabilities to other lessees related to events occurring at other properties, the lessor could be forced into a voluntary or involuntary bankruptcy due to events beyond the individual lessee’s control. Although this risk to the individual lessee can be minimized by carefully analyzing the financial strength and stability of the multi-project lessor (which is usually a bank leasing company), as well as the quality and operating history of its past transactions, these commentators are concerned that the lease - or certain key lease provisions such as the lessee’s option to purchase the property – may be unenforceable if a subsequent bankruptcy proceeding is filed by or against the lessor and the lessor, or the bankruptcy trustee, elects to reject the lease.

In a paper by Daniel M. McRae, Clint Shouse, and Mary Elizabeth Brennan entitled *Off-Balance-Sheet Financing: Adapting it for Real Estate* (“OBS Paper”), which was prepared in connection with a joint presentation of the American Bar Association’s Business Law Section Committees on Developments in Business Financing, Commercial Financial Services, and Law and Accounting, at the 1999 ABA Annual Meeting in Atlanta, Georgia, the authors state as follows, at page 43:

Another consideration is the risk of a multi-property lessor’s bankruptcy. With a traditional SPE, this risk is mitigated by making it bankruptcy-remote. Under the proposed consolidation rules, at best a limited purpose entity, or LPE, will be used, as discussed above. Thus, whether the lessor is a bank leasing company or an LPE, the bankruptcy concern is a valid one. One way to mitigate this concern is for the lessor to grant a lien to the lessee against the property leased by the lessee to secure the lessee’s option to purchase the property. The idea is to insure that no bankruptcy

trustee or other party controlling the lessor will ever have an incentive to reject the lessee's purchase option in bankruptcy. Without the lien, such a rejection could deprive the lessee of the benefit of any appreciation in the leased property. But with such a lien, the lessee should have a *fully secured* claim for damages caused by any such rejection.

(Emphasis in original text)

The author has recently – and only recently – encountered synthetic leasing transactions where the lessee's counsel has requested that the lessor grant the lessee a secured interest in the lessee's option right. This request can be accommodated, from a title insurer's perspective, but it further complicates what is already a complex and heavily documented transaction. (The author has also recently encountered a situation where the lessee's attorney, in a synthetic leasing transaction, insisted that a document entitled "Precautionary Mortgage" be executed by the parties and recorded, in addition to a Memorandum of Lease). The negotiation, drafting, insuring, and recording of such a security interest also require additional time and expense.

Counsel for lessees in synthetic leasing transactions should carefully consider and evaluate the various legal and title issues that must be confronted, in order to reach an informed decision as to whether it is advantageous and cost-effective to follow the advice set forth in the excerpt from OBS Paper set forth above. These considerations include the following:

- As noted above, it is not certain when EITF 194-B will be promulgated, or whether it will be enacted in its present form. Furthermore, it is possible that EITF 194-B may not be enacted at all. Traditional bankruptcy-remote SPEs, which have been used – and are currently used – in many synthetic leasing transactions, are structured to comply with existing FASB statements and rules. Until and unless the rules are formally and finally changed – and unless the lessor is a bank leasing company or other entity that is currently acting as a "conduit lessor" for multiple lessees and properties - the parties to these transactions may continue to do "business as usual." The lessee in these transactions should not need to take any special steps to assure its right to exercise its purchase-option right at the end of the lease term, because the possibility of the lessor's bankruptcy would be highly unlikely, based on the lessee's ability to effectively control the actions and activities of the SPE lessor and the bankruptcy-remote nature of the SPE.
- Under § 365(h) of the Bankruptcy Code, a lessor who files for reorganization has the right to reject any lease, subject to bankruptcy court approval. The lessee then has the right, under § 365(h)(1)(A), either to (1) treat the lease as terminated and vacate the space, or (2) remain in possession for the balance of the lease term and any renewal or extension. Before the enactment of the 1994 Bankruptcy Reform Act (Pub. L. No. 103-394, § 202, 108 Stat. 4106, 4121 (1994), codified as amended in scattered sections of Title 11 of the United States Code) ("Reform Act"), there was uncertainty concerning the nature and extent of the lessee's right to remain in possession.

Bankruptcy court decisions were divided as to whether restrictive lease covenants binding on the lessor (for example, an exclusive business use granted to the lessee) would continue if the lessor rejected the lease. Section 365(h) was amended by the Reform Act to eliminate these uncertainties. Section 365(h)(1)(A)(ii) now provides that the lessee may retain those rights in the lease that are in or appurtenant to the real property, “including rights such as those relating to the amount and timing of the payment of rent and any right of use, possession, quiet enjoyment, subletting, assignment or hypothecation,” to the extent that such rights are enforceable under applicable nonbankruptcy law.

Accordingly, it is now clear that a lessee under a rejected lease may “retain its rights” under the lease, which (assuming that an option to purchase contained in a lease is a right “in or appurtenant to the real property”) would apply to a lessee’s option right to the extent it is enforceable under applicable state law. It would therefore not be necessary for the lessee in a synthetic leasing transaction to obtain a security interest in the option right, because that right will survive the landlord’s rejection of the lease by the lessor-debtor or the bankruptcy trustee. Although an option right is not explicitly listed among the surviving lessee rights stated in § 365(h)(1)(A)(ii), the language in this section is clear that it is only listing those specific rights as examples and not as an exclusive list of such rights.

However, it may be difficult to obtain an attorney’s opinion that the option right in fact survives the landlord’s rejection of the lease. This is so not only because of the lack of absolute certainty in the aforementioned language in § 365(h)(1)(A)(ii), but also because if the lease is recharacterized by the bankruptcy court as a mortgage (in accordance with the intent of the parties, as stated in the lease document, that the lease be treated as a financing arrangement or loan in a subsequent bankruptcy proceeding), the protections afforded to the lessee by § 365(h)(1)(A)(ii) would not be available because the lessee would be deemed to be the owner of the property. Moreover, title insurance will not provide coverage for any loss occurring as the result of a subsequent bankruptcy filing by or against the lessor in connection with a synthetic leasing transaction, because of the title-policy exclusions for post-policy matters and matters “created, suffered, assumed, or agreed to” by the insured party.

Assuming the lessee has obtained and perfected a security interest in the option to purchase (whether through a UCC financing statement, a mortgage, or both), would a merger of estates occur upon recharacterization so that the bankruptcy trustee could claim, on behalf of the lessor-mortgagee and other creditors, the right to avoid the security interest? Also, assuming a recharacterization of the lessee’s interest by the bankruptcy court, what would be the nature and priority of the lessee’s security interest? Would the lessee have a mortgage (or a UCC financing statement) on a mortgage? An assignment of a mortgage? If the lessor had itself obtained a mortgage on its interest at the inception of the transaction (which is common in synthetic leasing transactions), would the lessee’s security interest be deemed to be a third-priority interest, behind both the lessor’s mortgage and the lease between the lessor and lessee (as recharacterized by the bankruptcy court as a mortgage)? What would

be the recording order (and therefore the priority) of each of these documents? Would the relative priorities of the respective security interests depend on intercreditor or subordination provisions contained in the respective recorded security instruments or as evidenced by separately executed and recorded intercreditor agreements? Is it likely that the lessor's mortgagee would agree to subordinate its security interest to the lessee's security interest in its option to purchase? Should the option to purchase be contained in an instrument separate from (and recorded separately from) the lease, or would this tactic negatively affect the desired accounting treatment of the lease, unduly increase the complexity and cost of the transaction, and result in the creation of a "naked option" (see discussion below) that may pose additional legal risks? These are all difficult questions to answer, and there is as yet no body of bankruptcy case law to provide guidance in connection with these specific fact situations in real-estate synthetic leasing transactions.

- If the lessee obtains a security interest in its purchase-option right contained in the synthetic lease document, the secured obligation will not be a right to payment but rather the lessor's obligation to convey the property at the time the lessee exercises the option. Section 101(5) of the Bankruptcy Code defines a "claim" as a right to payment or "a right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, secured, or unsecured." The legislative history with respect to § 101(5) indicates that all legal obligations of the debtor, no matter how remote or contingent, will be considered by the court in a bankruptcy proceeding, and that the definition is intended to permit the broadest possible relief for potential claimants. The legislative history states that "[t]he definition also included as a claim an equitable right to performance that does not give rise to a right to payment." House Report No. 95-595, 95th Cong. 1st Sess. 309 (1977); Senate Report No. 95-989, 95th Cong., 2nd Sess. 21 (1978).

However, if the lessee intends to seek specific performance of the option to purchase in the lessor's bankruptcy proceeding, this goal may be difficult to achieve even if the lease is not recharacterized as a mortgage. According to the National Bankruptcy Review Commission Final Report, October 20, 1997, 2.4.1, *Clarifying the Meaning of "Rejection,"* which can be found in Appendix G, App. Pt. 44, Bankruptcy – The Next Twenty Years (15th ed. rev. 1999):

Specific performance may be available under state law, but it is rarely permitted against the trustee. Thus, state contract law generally defines a party's rights, while federal bankruptcy law determines how those rights are enforced in a bankruptcy case. The most important example, which is the choice between damages and specific performance, has powerful distributional consequences and must be governed by a uniform policy in a bankruptcy case; otherwise, state laws providing very broad rights to specific performance would have the inequitable effect of granting preferential treatment to certain contract creditors, to the detriment of all other general unsecured creditors.

However, in a recent bankruptcy court decision, *In re Bergt*, 241 B.R. 17 (Bankr. D. Alaska 1999), the court ruled that a right of first refusal to purchase real property granted to a non-debtor party by the debtor-owner was not terminated by the debtor's rejection of the contract, and was enforceable by specific performance if and when the debtor subsequently decided to sell the property. The court found that, based on the holding of the Ninth Circuit Court of Appeals in *Unsecured Creditors' Committee of Robert L. Helms Construction & Dev. Co. v. Southmark Corp. (In re Robert L. Helms Construction & Dev. Co., Inc.)*, 139 F.3d 702 (9th Cir. 1998), an option agreement (or at least one that was not in the process of being exercised at the time of the bankruptcy filing) is not an executory contract that can be rejected by the debtor. The court in *Bergt* noted that "[t]he trend of the law is . . . that rights created by state law in a specific asset (for example, the right of a nondebtor optionee to purchase land) are not avoidable by rejection under 11 U.S.C. § 365(a) alone." *In re Bergt*, 241 B.R. at 21. The court also stated that "bankruptcy law recognizes third parties' equitable interests in property, including interests the essence of which is the right to obtain the specific property" and "rejection protects the estate from the financial obligation of affirmatively performing the debtor's obligations – but, this does not mean that the nondebtor's property rights in estate property should be cut off, and if necessary, enforcement of thus [*sic*] rights may be by specific performance." *Id.* at 23. The court further stated that "nondebtors' rights are protected in other situations – e.g., secured creditors' rights trump the equality of distribution policy." *Id.* at 24.

The court distinguished other cases holding that rejection is the equivalent of termination, because these cases involved debtor-lessees and not debtor-lessors who had granted rights to a nondebtor in the debtor-lessor's property. However, the court acknowledged that "a few cases . . . hold that a rejection of an executory contract or lease terminates it, and any rights a nondebtor may have had under state law in the property involved," including the avoidance of an option or contract to sell (at least in those situations where no security interest existed in the option agreement or other executory contract). For example, in *In re Gillis*, 92 B.R. 461 (Bankr. D.Haw. 1988), the debtor-lessee failed to assume the commercial lease within the statutorily mandated 60-day period, and the lease was deemed rejected. The debtor-lessee had made a pre-petition assignment of its interest in the lease, as evidenced by a recorded Assignment of Lessee's Interest in Lease and Consent (which document was consented to by the lessor), to a bank lender in return for a \$125, 000 loan from the bank. The court - completely disregarding the bank's rights in the collateral - held that the deemed rejection terminated the lease, and that the rejection related back to the commencement of the bankruptcy proceeding. Therefore, the court ruled, there was nothing for the bank's assignment to attach to and the bank's security interest was "completely extinguished" because the bank "cannot hold a security interest in property in which the debtor has no interest." *Id.* at 465. *See also Kaonohi Ohana, Ltd. v. Sutherland (In re Kaonoi Ohana, Ltd.)*, 873 F.2d 1302, 1306, fn.5 ("specific performance of a rejected executory contract cannot be required").

If the lessee in a synthetic lease transaction has taken a security interest in its purchase-option right contained in the lease, and is prohibited by a bankruptcy court from obtaining specific performance of the option right from the lessor, what will be the measure of the lessee's damages and the amount of its allowed claim in the landlord's bankruptcy proceeding? If the lease is recharacterized by the bankruptcy court as a mortgage, this issue may become moot because the lessee will be deemed to be the owner of the property; however, the lessee may still be subject to the superior rights of the lessor's mortgagee as well as to the claim by other creditors that the lessee's security interest should be voided because of the merger of estates. *See, e.g., In re Gillis, supra*, 92 B.R. at 466 (“[t]he Bank cannot hold a security interest in property in which the debtor has no interest”); *In re Bernard*, 69 B.R. 13, 14-15 (Bankr. D.Haw. 1986) (allowing leasehold mortgage to exist after rejection of lease would frustrate purpose of Section 365(d)(4)); *Anjo Restaurant Corp. v. Sunrise Hotel Corp.*, 414 N.Y.S.2d 265, 268, 98 Misc.2d 597, 600 (1979) (where lease is terminated, secured party with assignment of lease is precluded from asserting any right in leasehold estate). The debtor-lessor or the bankruptcy trustee may also argue that the lessee's secured claim should be equitably subordinated (or even disallowed) under § 510(c) of the Bankruptcy Code, because of the degree of control exercised by the lessee over the SPE lessor. If the lease is not recharacterized as a loan transaction by the bankruptcy court, and the court refuses to grant the lessee the remedy of specific performance, the lessee's monetary damages, and the amount of its claim, may depend on the priority, validity and enforceability of its security interest. These issues are dealt with elsewhere in this paper. If the lessor-debtor rejects the lease, normally the nondebtor party (i.e., the lessee) would be entitled to a claim for money damages, and the lessor's contract obligations under the lease would be discharged. According to the National Bankruptcy Review Commission Final Report, *Clarifying the Meaning of Rejection, supra*, at 2.4.1:

The claim would be paid in the bankruptcy pro rata with other unsecured creditors. With a few important exceptions, bankruptcy law accepts the nonbankruptcy substantive law applicable to a contract, but bankruptcy adjusts the form of the remedies available upon breach. Damages may be calculated under state law, but they are paid out according to bankruptcy priorities and principles.

The amount of the lessee's claim for monetary damages for rejection of the lease (and the option to purchase), would normally be estimated and classified along with other unsecured claims in the debtor-lessor's bankruptcy proceeding. Should the lessee be entitled to damages based on the option price for the property as set forth in the lease, the value of the property at the time of exercise of the option, or the difference between the stated option price and the value of the property at the time the option may be exercised? These issues may need to be litigated. Even if the lessee has obtained a security interest in, and lien on, its lease purchase option it is at best uncertain, contrary to the assertion in the excerpt from the OBS Paper, *supra*, that the lessee will be able to prevent the lessor from “depriv[ing] the lessee of any appreciation in the leased property” if the lease is rejected by the lessor. *See Barnett*

v. Blachura, 242 Mich.App. 395, 618 N.W.2d 777, 780-81 (Mich.App. 2000) (holding, in case of first impression in Michigan, that land contract vendor's rejection of executory contract did not amount to termination of contract, and if valid contract existed under state law then "plaintiff has the option to pursue his unsecured claim for prepetition damages through the normal bankruptcy process").

- If an entity acquires an option from the owner of a parcel (or parcels) of real estate to purchase such real estate, what interest does it actually own? If, following the entity's acquisition of such an option to purchase, it grants a third-party creditor a security interest in the option, what is the nature of the security interest and what steps must the secured creditor take to assure that such interest is timely and properly perfected to avoid the claims of subsequent purchasers, creditors and lienholders, including a debtor-in-possession or trustee in bankruptcy? Furthermore, what is the value of the creditor's interest in the option? Normally, if an entity acquires a "naked" option to purchase real estate (i.e., an option unrelated to any recorded interest, such as a mortgage, that it may otherwise have in the property), it does not acquire any actual interest in the property that is the subject of the option. This is because the entity obtaining the option to purchase can only obtain an interest in the real estate at such time as the option is exercised according to its terms. Any security interest granted in such an option to purchase would be considered personalty rather than realty, and the interest would be deemed to be a "general intangible" under § 9-106 of the Uniform Commercial Code ("UCC"). (Under § 9-106, "general intangibles" means "any personal property (including things in action) other than goods, accounts, chattel paper, documents, instruments, and money"). Such an interest would normally be perfected, under § 9-103 (3)(b), by filing a UCC financing statement with the Secretary of State's office in the jurisdiction in which the debtor is located. If the entity that owns the option right sells that right to a third party, the secured creditor's perfected security interest would attach to the proceeds of such sale under § 9-306(1) of the UCC. (Under § 9-306(1), proceeds are defined as "whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds"). On the other hand, if the option subsequently expires by its terms, or is terminated because of failure to exercise the option, default, or by operation of law, the security interest would be rendered valueless because the holder of the option would no longer have any legal or property rights to which the interest could attach.

In *In re Merten*, 164 B.R. 641 (Bankr. S.D. Cal. 1994), which appears to be a case of first impression on the issue, the bankruptcy court addressed a third situation, namely, where the debtors (husband and wife) held two options to purchase entered into with different lessors (one option agreement was separate from the lease agreement; the other was contained in the lease) and exercised the options after filing a Chapter 11 bankruptcy petition. The debtors had granted a creditor, Imperial-Yuma Production Association ("IPA"), a pre-petition security interest in all of their contract rights and general intangibles, which security interest had been perfected pre-petition by IPA by filing a UCC financing statement with the California Secretary of State. IPA held deeds of trust on certain lands held by the debtors, but not with respect to the property that was the subject of either of the lease options.

The court found that under applicable California law, a security interest in an unexercised option by the debtor to acquire real estate is a general intangible subject to the UCC (the court noted that “ ‘general intangibles’ for purposes of secured transactions include contract rights and rights to performance”) and that a security interest in an unexercised option is personalty rather than realty. The court also found that, because IPA had properly filed a pre-petition UCC financing statement with respect to its interest in the option, it had obtained a perfected security interest in the unexercised option right. However, the court permitted the debtors to exercise their options to purchase the respective properties post-petition, and held that upon the occurrence of such exercise the creditor was thereupon divested of any security interest it had in the collateral under the U.C.C. because the option rights no longer existed. As the court eloquently stated, “on proper and timely acceptance or exercise, an option as such becomes ‘functus officio’ and ceases to be a mere option.”

The court also held that, upon exercise of an option to purchase real estate, the transaction is converted to “a sale or a bilateral executory contract of purchase and sale, whereby the optionee acquires an equitable interest in the land.” Therefore, the court ruled, because a sale had occurred pursuant to which the holder of the options acquired an actual interest in the real property (i.e., equitable title) that was the subject of each of the options, whatever security interest IPA may have had in the option rights was abrogated and transferred to the real estate. However, because the creditor’s transferred interest, which was now exclusively an interest in real estate (and therefore came within the meaning of the terms “conveyance” and “transfer” as used in the California statute governing recordation) was not properly recorded and perfected in the county recorder’s office as an interest in the real estate, the court further held that it was not enforceable, under the “strong arm” provisions of § 544 of the Bankruptcy Code, against the debtor in possession (or a bankruptcy trustee), or against subsequent purchasers or creditors without notice. The court, having authorized the debtors to exercise the options, also authorized the debtors to resell the properties, through a double escrow, to a third party free and clear of IPA’s security interest. The court rejected IPA’s motion to compel turnover of the proceeds from the debtors’ sale of the properties (which proceeds had been segregated in a “blocked” account) based on its allegation that its security interest in the option contract rights should have survived the sale and attached to the proceeds.

This case clearly illustrates the importance to a creditor that obtains a security interest in a “naked” option of perfecting its security interest in the option by not only filing a UCC financing statement with the Secretary of State’s office in the jurisdiction in which the debtor is located, but by also recording an instrument with the county recorder’s office evidencing its interest in the real property to which the option relates. *See, e.g.*, Steven O. Weise, “U.C.C. Article 9: Personal Property Secured Transactions,” 50 *Bus. Law.* 1553, 1554 (1995) (stating, in connection with the author’s discussion of *In re Merten*, that “[i]t seems that the option to acquire the property is so related to the property that real property law ought to govern an interest

in the option. The secured party should have had the debtor record the option and then should have recorded a deed of trust or mortgage against that interest”).

Conclusion

The use of a multi-property lessor in a synthetic leasing transaction may cause the lessee to seek to take special precautions to minimize the negative implications of a subsequent lessor bankruptcy. However, requiring the multi-project lessor to grant a security interest in the lessee's option right to purchase the property, in order to prevent rejection of the lease or the option right by the lessor-debtor, may prove to be an illusory benefit. It simply may not be justifiable from a cost-benefit standpoint, given the additional time, expense and complexity involved, and the lack of clear statutory and case-law guidelines as to the efficacy of this strategy.