

SYNTHETIC LEASES: BANKRUPTCY ISSUES

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INTRODUCTION

In the past several years many United States and foreign banks, as well as other capital sources, have become increasingly active in offering “off-balance-sheet” financing for corporate real estate acquisition, construction, and expansion. This method of structured financing is attractive to a corporate user of real estate because, if properly structured as a true “synthetic” leasing transaction, the lessee/corporate user will be able to expense the rental payments it makes to the lessor under the synthetic lease, and its balance sheet will not be “tainted” by a real property asset (and ownership) or by the existence of mortgage debt.¹ However, the lessee/corporate user will retain all the tax benefits and burdens of ownership, including the ability to depreciate the improvements located on the real property and obtain any appreciation in value upon a subsequent purchase of the real property from the lessor (or upon resale to a third party). Notwithstanding these significant economic benefits, the parties to a synthetic leasing transaction, as well as their counsel, should carefully consider and address the recharacterization and other risks inherent in such transactions in the event that a bankruptcy proceeding is subsequently filed by or against one of the parties.

WHAT IS IT AND WHO USES IT?

Synthetic real estate financing is a method used to provide off-balance-sheet financing to a corporate entity for the acquisition and development of a commercial facility or site, with a substantial credit support for debt issued by or through an investor or capital source, usually a bank. Off-balance-sheet financing has been used for many years as a source of capital financing for acquiring heavy equipment, especially airplanes, as well as for assets with a shorter economic

life, such as automobiles and inventory for retail operations. Recently, off-balance-sheet real estate financing has proliferated in connection with corporate acquisitions and with construction and development of commercial real estate facilities. This recent growth is a result of: (1) the collapse of traditional sources of commercial real estate financing during the real estate recession in the late 1980s and early 1990s; (2) the pressure on corporate entities to show strong debt-to-equity ratios and to increase stock values; (3) the desire of capital investors to diversify into areas other than equipment financing, while avoiding the operating and residual risks associated with traditional real estate transactions; and (4) the issuance of accounting, tax, and legal opinions, regulations, and pronouncements clarifying the circumstances under which real estate transactions qualify for off-balance sheet financing treatment.

Off-balance-sheet real estate financing is most attractive to large, publicly traded, creditworthy corporations and businesses, such as manufacturers, supermarket and drug store chains, food service businesses, computer, transportation, and energy companies, financial institutions, health maintenance operations, and retailers. Major users of commercial real estate seeking medium-term, revolving-credit financing, that have substantial and highly specialized build-out costs, and that seek an opportunity to maximize the value of their companies' stock, are likely to benefit from off-balance-sheet financing. This method of structured financing may also be employed in connection with a number of planned corporate acquisitions by developing a master lease facility for the inclusion of numerous properties, to be brought into the facility as they are identified and acquired or made ready for the construction of improvements. However, off-balance-sheet financing is less appropriate for smaller companies and smaller transactions because of the significant structuring, documentation, and compliance expenses.

A synthetic lease is characterized as an operating lease for financial accounting purposes. The lessee/corporate user retains the tax benefits and operating control associated with ownership and debt, but, for accounting purposes, does not have to book the lease obligation as a liability or the leased property as an asset. Therefore, the lessee/corporate user's asset ownership and

corresponding “mortgage” liability do not appear on the lessee/corporate user’s balance sheet. Rental payments are expensed annually on the lessee/corporate user’s income statement. Notwithstanding this treatment for accounting purposes, a synthetic lease qualifies as a loan for federal and state income tax, bankruptcy, and commercial purposes.

USE OF A SPECIAL PURPOSE ENTITY

1. Form of Special Purpose Entity

In recent years, many commercial mortgage lenders (especially in connection with multi-state, securitized, and structured-financing transactions) have required that the borrower be constituted as an independent bankruptcy-remote SPE, that is unlikely either to become the subject of a bankruptcy or to be substantively consolidated if a bankruptcy of a related person or entity occurs.

The SPE is often an intermediate holding company, which is separate from the borrowing entity that obtains the first-mortgage loan. To demonstrate the separate nature of the entities, a “non-consolidation” opinion is required along with assurance that the general partner (or member, if the borrower is a limited liability company) of a mortgage borrower is not liable for the debt. Lenders and credit-rating agencies commonly require the following covenants in SPE organizational and loan documents:

- (1) Prohibition against any business activity other than operation of the property and against owning any other property.
- (2) Prohibition against any merger with another entity or acquisition of any subsidiary.
- (3) Prohibition of any other debt other than lease financing, except for ordinary trade debt (fully subordinate financing *may* be permitted if the credit rating is not impaired).
- (4) Separate SPE books and records, stationery, bank accounts, tax returns, and office space.

- (5) Prohibition against contracts with affiliates, unless arms-length.
- (6) Prohibition against commingling of assets with affiliates.
- (7) Prohibition against the guarantee (or the pledge of assets to secure) the debt of an affiliate.
- (8) “Independent director” approval of major decisions such as a bankruptcy filing, a change in the SPE organizational or governing documents, and transactions with affiliates.
- (9) Disclosure, of any transfer of the assets from the borrowing entity to a new SPE, to the transferor’s other creditors.
- (10) A “lockbox” arrangement to monitor cash disbursements.²

As mentioned above, in many current forms of real estate financing, a lender commonly requires that the borrower or developer be an 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, and leases the property to the lessee/corporate user or its subsidiary.

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, 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.³ These separate tranches reflect different risk levels, yields, maturities, and other capital and risk attributes and objectives of the investors in the transaction.

2. Accounting Requirements

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 Financial Accounting Standards Board [hereinafter 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’.”⁴ 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.⁵ Under the current accounting rules and guidelines of the FASB and the Securities and Exchange Commission [hereinafter SEC] 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.⁶

In the bankruptcy context, substantive consolidation is an equitable, not statutory, doctrine that permits the bankruptcy court, in certain circumstances, to consolidate the debtor's assets and liabilities with those of other debtors or affiliates of the debtor, thereby creating a single, combined estate for the benefit of creditors. The court must make a factual determination on a case-by-case basis. A strong case must be made for substantive consolidation because of the risk of economic prejudice to, and unfair treatment of, creditors who have extended credit to the debtor without knowledge of the debtor's relationship with other entities.⁷ It may be difficult for a lawyer to give a non-consolidation opinion in connection with a synthetic leasing transaction. In a bankruptcy context, the opinion would state that the assets and liabilities of the corporate user/lessee would not be consolidated with those of the SPE lessor/mortgagee.⁸

Because the foregoing conditions almost always exist in connection with a typical synthetic 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 real estate 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 [hereinafter EITF] has consistently determined that a three percent equity contribution by the SPE is the "minimum acceptable investment" that will qualify as "substantial."⁹ Therefore, 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 failure to exercise the option are deemed remote. The FASB is currently reviewing its policy on consolidation rules relating to the creation and capitalization of single-purpose, shell SPEs. The EITF has recently issued an abstract regarding specific implementation issues in accounting for leasing transactions, such as synthetic leases, involving SPEs.¹⁰

3. Creation of Bankruptcy-Remote Entity

As is the case with most forms of structured financing, synthetic leasing transactions customarily utilize an SPE so legal ownership of assets can be structurally isolated, creating a financing vehicle that is legally independent of and removed from the bankruptcy risks 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. The SPE itself is structured as an independent bankruptcy-remote entity—an entity that 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.¹¹

As noted earlier, the bankruptcy-remote aspects of an SPE may be enhanced by requiring that one or more of the directors, general partners, or members of the SPE be independent, or by requiring a super-majority vote (which would necessarily include at least one of the independent parties) to approve a voluntary bankruptcy filing. An employee, officer, or representative of the lender could obtain a direct ownership or equity interest in the special-purpose entity, but this would invite subsequent challenges based on lender liability, equitable subordination, and violations of public policy.

Numerous courts have held that as an entity approaches insolvency, the directors owe a fiduciary duty to creditors of the entity. As the court stated in *In re Kingston Square Associates*,¹² “[I]t is universally agreed that when a corporation approaches insolvency or actually becomes insolvent, directors’ fiduciary duties expand to include general creditors. Nearly all states’ law is in accord . . .”¹³

The use of “bankruptcy remote provisions” in SPE and loan documents, especially those that require approval of certain entity actions by an independent director who is in actuality under the influence of a major secured lender, may later be determined by a bankruptcy court to run afoul of the Bankruptcy Code’s prohibition of provisions preventing an entity from commencing a bankruptcy reorganization. In the *Kingston Square* case, the debtor was unable to obtain its board of directors’ permission to file a voluntary bankruptcy proceeding because of the refusal of the “independent director” to authorize such a filing. The debtor then orchestrated an involuntary filing by certain unsecured creditors. The bankruptcy court found that the debtor reasonably believed that the best course of action for the entity was to file bankruptcy, and refused to grant the secured creditor’s motion to dismiss the involuntary filing. The court also appointed a Chapter 11 trustee, and held that the debtor’s board of directors had violated their fiduciary duties owed to the corporation’s unsecured creditors and interest holders. The court declined, however, to specifically nullify the debtor corporation’s bylaw provision containing the bankruptcy-proof provisions as against public policy.¹⁴

As a result of negative experiences involving bankruptcy filings by and against borrowers, real estate lenders have learned that creating a borrowing entity with very few creditors, such as a bankruptcy-remote SPE, makes it much more difficult for the borrower to file, or have filed against it, a bankruptcy proceeding or to avoid early dismissal. As the Ninth Circuit Court of Appeals has stated, in *Barakat v. Life Ins. Co. of Va.*,¹⁵ when the only bona fide, impaired claim in the bankruptcy case was the claim of the mortgage lender, the debtor “should [not] be able to cramdown a plan that disadvantages the largest creditor.”¹⁶

An employee, officer, or representative of the lenders could obtain a direct ownership or equity interest in the SPE, but this would invite subsequent challenges based on lender liability, equitable subordination, and violations of public policy. Numerous courts have held that as a corporation approaches insolvency, the directors owe a fiduciary duty to the creditors of the corporation.¹⁷

An SPE created in the form of a trust to facilitate a synthetic leasing transaction may be a bankruptcy-remote entity, because the trust may be prevented from filing a voluntary bankruptcy petition, and creditors, including trust investors, may be prevented from filing an involuntary bankruptcy petition against the trust, unless the trust is characterized as a business trust. As a general matter, trusts are not eligible for relief under the Bankruptcy Code.¹⁸

The Bankruptcy Code does not define a business trust. Under § 109(a) of the Bankruptcy Code, only a person is eligible to file a bankruptcy proceeding.¹⁹ Section 101(41) defines a “person” to include an “individual, partnership, and corporation,” but not a trust, unless the trust is a “business trust” included within the definition of “corporation” set forth in § 101(9)(A)(v) of the Bankruptcy Code.²⁰ The definition of “corporation” in §101(9)(A) includes an “association having a power or privilege that a private corporation, but not an individual or a partnership, possesses,” and a “partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association.” Although the definition of a corporation includes a “business trust,” the Bankruptcy Code does not further define a business trust. Furthermore, under § 303(a) of the Bankruptcy Code, only a person may be an involuntary debtor under Chapter 7 or 11.²¹

Bankruptcy cases have defined what constitutes a business trust. In *Shawmut Bank Connecticut v. First Fidelity Bank*,²² the Second Circuit Court of Appeals held that a trust created to facilitate aircraft financing for Eastern Airlines did not qualify as a business trust under § 101(9)(A)(v) of the Bankruptcy Code and, therefore, could not be a debtor. The trust had entered into a “Secured Equipment Indenture and Lease Agreement” with Eastern Airlines as the

lessee. The trust then sold \$500 million in trust certificates to investors, and used the proceeds to purchase a portion of Eastern Airlines' fleet of aircraft. The aircraft were then leased back to Eastern Airlines in exchange for rental payments equaling the amount of the principal, premium, and interest on the certificates.²³ Under the lease agreement, Eastern Airlines was entitled to a return of any rental payments exceeding the amounts owed the certificate holders under the trust indenture. The lease agreement also stated that, upon full payment of the lease obligations, title to the leased aircraft would be reconveyed to Eastern Airlines. The court found "no dispute that [the lease transaction] was a secured financing."²⁴ After Eastern Airlines filed a Chapter 11 bankruptcy petition, holders of a portion of the trust certificates filed an involuntary Chapter 11 petition against the trust. The court, noting that it was deciding an issue of first impression, held that the trust was not a business trust within the meaning of the Bankruptcy Code because it was not created to generate a profit or transact business, but rather existed solely to preserve and protect the security interest of the certificate holders in the assets of the trust (*i.e.*, the aircraft collateral) and to facilitate the secured financing transaction sought by Eastern Airlines. In a strong dissent, Judge Kearse, believing that the trust qualified as a business trust under New York law, argued that the certificate holders "expected to earn a profitable return on their investment," and that "this trust is not a typical trust for the simple preservation of assets," and should, therefore, be deemed a business trust within the meaning of § 101(9)(A)(v) of the Bankruptcy Code.²⁵

In *In re Sung Soo Rim Irrevocable Intervivos Trust*,²⁶ the bankruptcy court held that the voluntary Chapter 11 bankruptcy petition filed by the trust, the only asset of which was a multi-unit retail project that was transferred to the trust shortly before an imminent foreclosure of the project, must be dismissed because (1) the trust did not qualify as a business trust under California law, (2) it did not conduct any business as that term is commonly understood, (3) it was controlled exclusively by the trustee, and (4) it had been created solely for the benefit of

family members). Judge Fenning explicitly rejected the reasoning of the Second Circuit from *Shawmut*.²⁷

At least two Illinois cases have analyzed the applicability of the Bankruptcy Code to land trusts, and held that a land trust may not be a debtor under the Bankruptcy Code.²⁸ The primary purpose of a land trust is to hold title to real property, not to operate a business or commercial activity for profit. As a result, a land trust does not conduct a business activity capable of being reorganized under Chapter 11. Florida, Hawaii, Indiana, North Dakota, and Virginia have statutes that permit land trusts, while states such as California and Kansas have permitted the creation of land trusts through court decisions. The majority of states do not permit the recognition and use of land trusts. Bankruptcy courts in Florida have held that a land trust may not be a debtor under the Bankruptcy Code.²⁹

Because of the availability of income tax deductions for investors and the simplicity of documentation in Massachusetts, the use of a nominee trust is common in connection with the ownership, development, and financing of commercial real estate. In *In re Medallion Realty Trust*,³⁰ the bankruptcy court, after observing that “the decisions are sharply, and perhaps hopelessly divided on the issue of the meaning of a ‘business trust,’”³¹ held that the trust in question was created for the purpose of transacting business and was, therefore, eligible for Chapter 11 relief. The court found that the traditional Massachusetts business trust (under which the trust’s day-to-day operations are run by directors elected by the certificate holder), as well as a nominee trust (under which the beneficiaries are investors in a business enterprise) are both eligible for treatment as a business trust under the Bankruptcy Code.

In *In re Gonic Realty*,³² the bankruptcy court held that a trust could be a debtor under Chapter 11. The court found that the trust in question undertook many operations relating to the property that constituted business activity, and that the trust was, therefore, engaged in more than just the ownership of real estate. As a result, this case appears to be distinguishable from the

Illinois and Florida cases cited above that held that a true passive land trust is not a business trust eligible for relief under the Bankruptcy Code.³³

It is also unclear whether a limited liability company [hereinafter LLC] is a person or a corporation under the Bankruptcy Code, because the Bankruptcy Code does not mention LLCs. However, the few bankruptcy cases involving LLCs have permitted bankruptcy filings and have analogized the LLC to a partnership. In *Broyhill v. DeLuca*,³⁴ the bankruptcy court considered the filing of a voluntary bankruptcy petition by a member of an LLC, and noted that “for the purpose of analyzing the effect of a member’s bankruptcy upon the continued exercise of membership rights, it seems most appropriate to treat the relationship among members of a limited liability company as analogous to that of [the relationship] among the partners of a partnership.”³⁵ The court further noted that the decision to file a Chapter 11 petition by an LLC member with a fifty percent membership interest on behalf of the LLC was improper as such an action was a major decision under the LLC’s operating agreement, which required the vote of all LLC members.³⁶

In *In re Daugherty Construction, Inc.*,³⁷ a bankruptcy court held that the LLC articles of organization and the operating agreements of the two LLCs of which the debtor was a member were executory contracts that the debtor could assume or reject. The court further held that language in the state LLC statute providing for dissolution of an LLC upon a bankruptcy filing violated the provisions of the Bankruptcy Code that prohibited the enforcement of *ipso facto* bankruptcy clauses and was, therefore, unenforceable against the debtor that filed bankruptcy.

THE SYNTHETIC LEASE DOCUMENT

A synthetic lease agreement is commonly structured as a triple-net lease, with the lessee/corporate user responsible for payment of basic rental, taxes and assessments, insurance, repairs, maintenance, management, and operation of the property.³⁸ The lease usually contains the

financial and reporting covenants typical of a corporate financing transaction in addition to the covenants and provisions customarily found in mortgage loan documents.

There are no standard forms or boilerplate covenants and provisions for synthetic lease documents. These documents are heavily negotiated by the lessor and lessee and are transaction specific, with significant input from counsel for the banks and other capital sources that arrange for and provide the financing for the transaction. The operative documents may include some or all of the following: participation agreement, lease or master lease, loan agreement, mortgage, trust agreement, guarantee, and construction agency agreement.

A lease in a synthetic lease transaction may be a simple lease, a master lease with a series of individual leases for additional properties that could eventually be brought into the facility, or a combination lease and open-end mortgage executed by the capital source, the trustee or SPE as lessor (or as lessor/mortgagee), and the corporate user as lessee (or as lessee/mortgagor). The lease is the most important document in characterizing the financing transaction as a synthetic leasing transaction.

The lease document will commonly include the following: (1) a statement that the transaction is between unrelated parties and that the parties intend that the lease be treated as an operating lease for financial accounting purposes, but as a financing arrangement, or loan, for tax, bankruptcy, and commercial purposes (although corporate auditors may have concerns about such an explicit recitation), and that the lessee will make such filings and take such actions as are required to evidence and further such an intent; (2) a provision that the lessee will be treated as the owner of the property and that the rental payments will be treated as payments of interest and principal on a loan; (3) a provision that the lessee is leasing the property on a triple-net and as-is basis, without representation or warranty by the lessor,³⁹ and that the lessee is solely responsible for the maintenance, operation, and improvements of the property, in addition to various risks associated with it, such as casualty losses, governmental impositions, environmental claims or liens, third-party tort claims, and all operating and ownership costs; (4) a prohibition against any

rights of setoff against the contractual rental payments; (5) a provision for the payment of a stipulated termination fee in the event of early termination or abandonment of the lease; (6) the grant of a security interest and mortgage or deed of trust lien on the leased property to secure the lessee's performance under the lease; (7) the grant of a security agreement, execution of a financing statement, and other evidence of a security interest under Article 9 of the Uniform Commercial Code [hereinafter UCC]; (8) the grant of an assignment of rents under applicable state law as additional security for the mortgage;⁴⁰ (9) enforcement provisions and remedies similar to those found in a mortgage or other real property loan financing transaction, including the right to foreclose the property under applicable state law by judicial sale or power of sale and to enforce the assignment of rents; (10) environmental warranties and indemnities by the lessee/corporate user; (11) a limit on the future advances available for funding under the construction loan or financing agreement; and (12) an option allowing the lessee to purchase the entire property at the end of the lease term in cash for an amount sufficient to cover the lessor's unamortized acquisition and debt costs incurred in connection with acquisition and development of the property, or, if no default exists, to have the property sold to a third party unaffiliated with the lessee for a price at least equal to the property's fair market value.

The lease or the lease coupled with an open-end mortgage, should be recorded upon execution in the appropriate mortgage or real estate records, and the UCC security interest perfected by filing a financing statement in the appropriate locations.

BANKRUPTCY COURT RECHARACTERIZATION

1. Awareness of legal issues and risks

Synthetic leasing transactions involving billions of dollars have been successfully completed during the past decade. The average transaction is very large and complex and usually involves a multimillion-dollar corporate acquisition of real estate and the construction of

substantial improvements. Possible disadvantages of a synthetic lease transaction include the difficulty and time, as well as the significant legal, tax, accounting, securities registration, and other expenses required to structure and document the transaction properly. All applicable accounting and Service rulings, regulations, and pronouncements, as well as bankruptcy and other court decisions regarding this type of financing, must be scrupulously reviewed and analyzed to avoid an inadvertent loss of the intended benefits provided by synthetic real estate transactions.

2. Code Provisions Applicable to Leases

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,”⁴¹ apply only to true or bona fide leases.⁴² The focus is on whether the parties intended to impose obligations and confer rights significantly different from those normally found in ordinary lease transactions.⁴³

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 makes clear that it applies only to a true or bona fide lease. 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.⁴⁴

The terms “unexpired lease” and “lease of nonresidential property,” as used in 11 U.S.C. § 365, 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. It requires that the lessee assume or reject an unexpired nonresidential lease within 60 days after the bankruptcy case is filed, unless the court extends the 60-day time period for cause.⁴⁵ 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 it will perform its future lease obligations.⁴⁶ 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.

If the lease is not affirmatively and timely assumed, it is deemed rejected, and the lease is terminated.⁴⁷ Rejection of a lease in bankruptcy constitutes a breach of the lease.⁴⁸ A lessor is entitled to assert a general unsecured claim for damages resulting from the debtor’s rejection of a lease.⁴⁹ Section 502(b)(6) limits the claim of a 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 11 U.S.C. § 502 cap, is ascertained by reference to the lease agreement and applicable state law.⁵⁰

3. Effect of Recharacterization as Mortgage

The lessor in a synthetic leasing transaction should be aware that if a bankruptcy petition is filed by or against the lessee after the inception of the lease, the bankruptcy court may recharacterize the synthetic lease as a financing transaction and limit the rights and remedies of the lessor to the value of its collateral as a secured creditor.

The bankruptcy process treats undersecured creditors differently from secured creditors. Under §§ 506(a) and (b) of the Bankruptcy Code, an undersecured creditor, 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.

If all of 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 may also 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.

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.⁵¹ In *In re Waldoff's, Inc.*,⁵² the bankruptcy court held that the agreement between the debtor and an equipment financing company, although structured as a lease, was in fact a secured financing agreement. Upon the filing of a Chapter 11 bankruptcy petition by the lessee, the assignee of the lessor's interest (arguing that the transaction should be characterized as a true lease) was secured only to the extent of the value of the collateral, based upon its filing of UCC financing statements, and was an unsecured creditor for the balance of its claim. The court stated that "whether a transaction qualifies as a security agreement must be determined from the intent of the parties," and found that the evidence presented to the court supported a finding that the agreement was a secured financing agreement.⁵³ When deciding how to classify the agreement, the court took into account the lessee's obligation for all repairs and replacements of the 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.⁵⁴ The court further held that

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.⁵⁵

4. State or federal law?

Bankruptcy courts are divided on whether state or federal law controls as to whether an agreement designated as a lease by the parties actually constitutes a lease for purposes of the Bankruptcy Code.⁵⁶

The legislative history of 11 U.S.C. § 101(51), which defines "security interest," states: "[w]hether . . . a lease constitutes a security interest under the Bankruptcy Code will depend on whether it constitutes a security interest under applicable state or local law."⁵⁷ The same language appears in the report of the Senate Judiciary Committee.⁵⁸

Some courts hold that “the rights of the parties under a lease of real estate are to be determined by state law.”⁵⁹ However, other courts have held that federal law determines whether an agreement is a lease for purposes of treatment under the Bankruptcy Code, reasoning that 11 U.S.C. § 365 and 11 U.S.C. § 502(b)(6), when read together, along with their legislative history, provide a sufficient basis for a federal court in bankruptcy proceedings to exercise its equity power to carry out bankruptcy objectives, as well as “an adequate foundation for applying a federal rule rather than state law to define property interests when the situation demands.”⁶⁰ Other courts hold that a federal interest, requiring use of federal rules, arises in determining how to characterize the transaction consistent with bankruptcy objectives.⁶¹

5. Factors considered by courts

Bankruptcy courts will closely examine the substance of the transaction, not the form, to determine whether it is an operating lease or a financing transaction and if the lessee is actually the beneficial owner of the property.⁶² The courts will disregard the characterization or label that the parties have used to describe the agreement and the nature of their relationship, and will often employ an economic realities test to determine whether the transaction should be characterized as a true lease or as a financing transaction.⁶³ This test requires the court to determine whether “the parties intended to impose obligations and confer rights significantly different from those arising from the ordinary landlord/tenant relationship.”⁶⁴

The following factors are commonly considered to be relevant in determining whether the agreement constitutes a true lease under the economic realities test: (1) whether the amount of rental payments was calculated to compensate the lessor for the use of the land, as opposed to being structured for some other purpose, such as ensuring a particular return on an investment; (2) whether the purchase price is related to the fair market value of the property, or is calculated as the amount necessary to finance the transaction; (3) whether the property was purchased by the lessor specifically for the lessee’s use; (4) whether the transaction was structured as a lease to

secure certain tax advantages; (5) whether the lessee assumed the obligations normally associated with outright ownership of the property, including the payment of taxes and insurance; and (6) whether the agreement permits or requires the lessee to purchase the property at the expiration of the lease term for a nominal consideration.⁶⁵

6. Drafting suggestions

The documents evidencing a synthetic leasing transaction must specifically address the possibility that the transaction may be subsequently recharacterized as a mortgage loan for bankruptcy or other purposes. The lease should contain mortgage provisions and features, in case a court subsequently recharacterizes the lease as a mortgage loan transaction. If the loan provisions and features are described solely in the lease, as opposed to a separate mortgage document, a memorandum of lease or short-form lease should be properly recorded. This document should specifically recite, among other things, that the lessee grants a lien on the real property, and should also contain enforcement rights and remedies provisions, and proper state statutory references, similar to those found in mortgage documents. Furthermore, the lease (and any recorded memorandum of lease) should state the parties' intention that for all purposes other than financial accounting purposes, including state, real estate, commercial law, bankruptcy, and federal, state and local income tax purposes, the transaction contemplated in the document is a financing arrangement and preserves ownership of the property in the lessee.

TITLE INSURANCE PROTECTION

1. Recharacterization Endorsement

Under certain circumstances, the title insurer may be persuaded to issue a limited endorsement in connection with an owner's policy issued to the lessor in a synthetic real estate transaction, which would protect the lessor against the risk of subsequent recharacterization. If such an endorsement is issued, the title insurer should closely investigate and analyze the facts of the transaction and the underlying documentation. The level of inquiry would depend on: (1) the

structure of the transaction, (2) the form and content of the transactional documents, (3) the identity of the parties, (4) the authorization of designated individuals to act on behalf of those parties, (5) the size and scope of the transaction, (6) the amount of the policy (or policies) to be issued, and (7) whether any unusual risks are inherent in the transaction. Furthermore, the parties would need to supply the title company with written statements, certifications, or affidavits that fully disclose and explain all risks, including any so-called off-record risks associated with the transaction. Written indemnifications in favor of the title insurer might also be required.

The recharacterization tests applied by the bankruptcy courts can serve as useful guidelines for title insurers when analyzing the risks of the transaction and evaluating whether, and under what circumstances, to issue a recharacterization endorsement and evaluate claim exposure.⁶⁶ Any such endorsement could be awkward for the title insurer because it would need to provide for a change in the nature of the interest insured under Schedule A of the policy from a fee interest to a mortgage interest (or vice versa) in the event of a subsequent recharacterization. The title insurer should avoid any construction of the endorsement that provides a right in the insured lessor to make a claim that, as the result of a subsequent recharacterization of the transaction as a loan, title to the insured estate is vested other than as set forth in Schedule A of the policy.⁶⁷

2. Evolving Forms of Coverage

Some lenders may claim that the parties in a synthetic real estate transaction do in fact intend to create a mortgage. These lenders argue that, therefore, the title insurer should not raise an exception stating that the transaction might be recharacterized as a mortgage. The title insurer may then be concerned that the transaction could be recharacterized as something other than a mortgage. In some instances the lessor, especially if it is an SPE lessee. The lessor, or the lessee, may also ask the title insurer to issue a separate endorsement insuring the option right of the lessee to purchase the property at the end of the lease term.

The availability, form, and cost of such an endorsement would necessarily depend on the regulatory and statutory provisions and restrictions of the state where the property is located, applicable state statutory and case law with respect to the validity, enforceability, and priority or relation back, of such an option, the specific, may request that the title insurer issue both an owner's and a lender's policy of title insurance (which could be alternative policies) at the inception of the transaction, or that the title insurer provide an alternative estates endorsement⁶⁸ with each policy. This could minimize or possibly eliminate the risk to the title insurer of insuring the lessor's interest as that of a lessor only, subject to a future recharacterization of the transaction as a loan with title in the text of the option, and an overall analysis of the transaction and all the other relevant documentation.

Any such endorsement would likely exclude from coverage any loss occurring as the result of any taxes or assessments levied by any governmental agency or authority subsequent to the recording of the option or the lease agreement containing the option. The endorsement would also contain a creditor's rights exception or exclusion (excluding from coverage under the endorsement any loss arising or occurring as the result of any federal bankruptcy proceeding or any state or federal insolvency proceeding) because of the risk that such an option could constitute an executory contract under 11 U.S.C. § 365(a) that may be rejected by a bankruptcy trustee.⁶⁹ The Bankruptcy Code does not define "executory contract." An executory contract has been generally described as a contract in which obligations remain to be performed by both parties.⁷⁰

With respect to the issue of whether an option to purchase constitutes an executory contract that can be rejected under section 365(a) of the Bankruptcy Code, see *In re Helms*,⁷¹ in which the Ninth Circuit Court of Appeals held that whether an option is an executory contract depends on whether the option requires further performance from each party at the time the bankruptcy petition is filed, and that performance that is due at the sole discretion of the optionee (*i.e.*, the decision by the optionee whether or not to exercise the option), "doesn't count unless he

has chosen to exercise it.” The court stated that an option to purchase may on occasion be deemed an executory contract “where the optionee has announced that he is exercising the option, but [has] not yet followed through with the purchase at the option price.”

Section 1234 of the Internal Revenue Code, and the regulations issued thereunder, govern the general tax treatment of an option granted to the tenant under a lease agreement to purchase the property on or before a specified date at a predetermined price. If the lease were recharacterized as a sale (which would occur in a synthetic lease transaction because the Service treats such a transaction as a conditional sale), none of the lease payments would be deductible by the tenant.⁷²

Under § 365(h)(1)(A)(ii) of the Bankruptcy Code, a lessee is specifically entitled to retain “rights under [a] lease . . . that are appurtenant to the real property” if the lessor files bankruptcy and rejects the lease. It would appear that, based on this language, an option to purchase granted to the lessee in a synthetic lease document would, if a bankruptcy court characterized the document as a true lease, be a right appurtenant to the real property and would, therefore, survive the lessor’s rejection of the lease. However, there are as yet no courts that have ruled on this issue.

It is also becoming common for both the mortgage lender providing financing to the lessor, as well as the lessee, to seek a mortgagee’s title insurance policy and a leasehold policy, respectively, with regard to their respective interests in the synthetic leasing transaction, and to seek endorsements continuing their respective coverages in the event that their interests in the transaction are subsequently recharacterized.

Such requests pose unique - and difficult - legal and underwriting issues for title insurers. For example, if a court subsequently determines that the lessor is in fact a mortgagee and not the true owner of the property, does the mortgage lender who provided financing to the lessor then have, in effect, a “mortgage on a mortgage,” or an assignment of a mortgage? Should the mortgage lender that provides mortgage financing to the lessor require that the lessee also execute

the mortgage and other loan documents or execute some other recordable security interest acknowledging and evidencing the lien of the lessor's mortgage lender on the property and the lessee's interest therein? (Would the lessee's auditors object to such a direct mortgaging of the lessee's interest as increasing the risk of the lease being recharacterized for accounting purposes as a capital lease instead of an operating lease?). Should the mortgage lender require a separate and direct assignment (or reassignment) of all the lessee's interests in the lease document, including its potential ownership interest in the property and all the rents, issues and profits generated therefrom? With respect to the interest of the lessee, can the title insurer issue a single combined leasehold/owner's policy, with an alternative estates endorsement, because both interests constitute a form of owner's coverage?

There may also exist a legal or regulatory problem for title insurers with respect to the rates and premiums initially charged for policies issued to the respective insured parties based on the specified legal interests of such insured parties, when there exists a substantial possibility that such interests may be subsequently recharacterized (and in which case different rate schedules and premium charges would apply). In addition, special coverages and endorsements for synthetic leasing transactions, such as mentioned above, may be unavailable in any event in those states (such as Texas and Florida) where the availability and form of title insurance coverages and endorsements are strictly regulated by statute or administrative regulations, or the issuance of such coverages and endorsements may not be approved by the state or regulatory agency or agencies when requested by the title insurer or the insured party.

LEASE-LEASEBACK FINANCING

An innovative form of real estate financing involving a leasehold interest in the property is beginning to be utilized by some creative real estate developers and investors. Known as "lease-leaseback" financing, the transaction is structured so that, instead of the developer-ground lessee obtaining a leasehold mortgage to finance the improvements to the real property, the

developer/ground lessee assigns its leasehold interest to an investor, which assignment is recorded in the public real estate records. The investor then subleases its interest in the ground-leased property back to the developer-ground lessee, with the sublease payments designed to enable the investor to recover its investment in the project along with a reasonable profit. The developer-ground lessee then constructs the improvements. The landlord, tenant (the original ground lessee) and the investor then enter into a tri-party agreement which provides that (among other things), notwithstanding the assignment of the ground leasehold interest to the investor, the landlord will look solely to the original ground lessee (the investor's subtenant) for the rent and all of the other tenant obligations under the ground lease and not hold the investor liable for any ground lease defaults (other than the investor's own negligence and wrongful acts) unless and until the investor takes possession of the property or terminates the sublease and takes certain specified actions.

The same bankruptcy and recharacterization issues exist in these types of transactions as occur in connection with synthetic-leasing and sale-leaseback transactions, including the risk that a court could subsequently treat the lease/leaseback transaction as a security device rather than an operating lease. If the investor is treated as a leasehold mortgagee, and the tenant rejects the lease in a bankruptcy proceeding, the law is not clear as to whether such rejection terminates only the tenant's, but not the mortgagee's rights, or whether both parties' rights are terminated.⁷³

Careful drafting of the language in both the sublease between the original ground lessee and the investor (e.g., stating the intention of the parties that the transaction is an operating lease and not a financing transaction) and the tri-party agreement (e.g., stating that the investor has the right to enter into a new lease with the landlord (or assign its interest in the new lease to a third party) in the event that the ground lessee rejects the lease in bankruptcy or is otherwise ousted from possession as the result of an uncured default under the ground lease).

In the event of a bankruptcy by the original ground lessee, the bankruptcy court recharacterize the lease-leaseback transaction as a financing transaction. As is the case with sale-

leaseback and synthetic-leasing transactions that are recharacterized as loans, the investor would then be subject to the “cramdown” provisions of the Bankruptcy Code and could be deemed to be an unsecured creditor for the portion of the loan in excess of the current market value of the leasehold interest, as determined by the court. In order to even be entitled to a secured claim for the value of the ground leasehold interest, the investor would need to have properly perfected the assignment of the ground lease in the public records to avoid a challenge by the bankruptcy trustee or debtor in possession that the transaction is subject to avoidance under the “strongarm” provisions of § 544 of the Bankruptcy Code.

Even absent a bankruptcy, if a default occurred under the sublease and the investor sought to foreclose its interest in the sublease as an “equitable mortgage” against the property, the sublease would have to contain language sufficient under state law to provide for such foreclosure. The inclusion of such language would also seem to contradict language of the parties contained elsewhere in the sublease agreement that the intention of the parties that the transaction is an operating lease and not a loan financing transaction.

If the original ground lessor defaults in its obligations as sublessee under the sublease and the investor attempts to exercise its statutory and contractual remedies for a lease default in order to obtain summary possession of the subleased premises and recover the unpaid rental, the original lessor may claim that the lease constitutes a clog on the equity of redemption. Under the clogging doctrine, as discussed earlier, there can be no provision in a mortgage document that will prevent the mortgagor from redeeming and retaining ownership of the mortgaged property upon full payment of the indebtedness, prior to entry of a valid foreclosure decree, or any provision that allows the mortgagee to obtain a collateral advantage.

CONCLUSION

Because of the tax, accounting, financial, and marketing advantages available through the use of synthetic lease transactions, as well as the increasing willingness of capital sources to

arrange for and supply funding for such transactions, this type of structured financing (including variations such as lease-leaseback financing) for the acquisition and construction of corporate real estate facilities will continue to increase.⁷⁴ Synthetic leasing transactions require attention to the needs and concerns of multiple parties including the lessor, lessee, SPE, lending agent, co-funding and equity participants, trustee, securities underwriters, certificateholders, and investors, and involve an interdisciplinary approach utilizing a working familiarity with, and knowledge of, legal issues with respect to the real estate, securities, bankruptcy, accounting, tax, commercial, and environmental aspects of the transaction. Consideration of and attention to bankruptcy issues and risks is especially important because of the significant difference in the rights and remedies available to the parties to a synthetic lease, depending on how their relationship is characterized by a bankruptcy court. Synthetic lease transactions are heavily negotiated and vary greatly in form, structure, scope, and documentation. Additional innovative variations of this type of structured financing are sure to be created and implemented by creative lawyers and other professionals, subject only to the constraints of existing and future state and federal case, statutory, and regulatory restrictions.⁷⁵

Endnotes

¹ See *Unocal Corp. v. Kaabipour*, 177 F.3d 755, 765 n. 8 (9th Cir. 1999) (“[w]hile the arrangement is treated as an operating lease for accounting purposes under Generally Accepted Accounting Principles, a synthetic lease is viewed as a secured loan by the IRS for tax purposes”). See also Paul. T. Clark et al., *Regulation of Savings Associations Under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989*, 45 BUS. LAW. 1013, 1036 n.191 (1990) (“Off-balance sheet items refer generally to contingent obligations . . . that do not appear on either the asset or liability side of a balance sheet.”). Off-balance sheet financing is discussed generally in a number of works. See David L. Landsittel & John E. Stewart, *Off-Balance-Sheet Financing: Commitments and Contingencies*, in HANDBOOK OF MODERN ACCOUNTING 26-1 to 26-4 (Sidney Davidson and Roman L. Weil, eds., 3d ed. 1983); James D. Bridgeman & Nancy R. Little, *The Synthetic Lease—Is It a Lease or Is It a Loan?* D-1 (May 15-17, 1997) (unpublished manuscript from the CLE and Committee Meeting of the ABA Section of Real Property, Probate & Trust Law Second Annual Non-Traditional Real Estate Forum); Ellen E. Jamason, *Basics of Synthetic Leases*, Tab-D (1997) (unpublished manuscript from the Real Estate Finance: Hot Tips and Workshop, American Bar Association Section of Real Property, Probate & Trust Law Annual Meeting); David Holmes, *The Use of Synthetic Leases to Finance Build-to-Suit Transactions*, REAL EST. FIN. J., Winter 1996; John C. Murray, *Off-Balance-Sheet Financing: Synthetic Leases*, 32 REAL PROP. PROB. & TRUST J. 193 (1997); Andrew Ratner, *Synthetic Leasing: Too Good to be Ignored*, Real Estate Finance, NATIONAL REAL EST. INVESTOR (August 1996), at 104; William D. Egler, *Financing Structures: A Primer of Synthetic Lease Transactions*, EQUIPMENT LEASING, (June 1997), at 5; Nancy R. Little, *What Do You Need to Know About Financing With Synthetic Leases*, 15 THE PRACTICAL REAL EST. LAWYER 35 (March 1998).

² See STANDARD & POORS, STRUCTURED FINANCE CRITERIA 68-70, 109-14 (1988); Committee on Bankruptcy and Corporate Reorganization, Association of the City of New York, *Structured Financing Techniques*, 50 BUS. LAW. 527, 553-60 (1995); Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 23-30 (1996); Thomas E. Plank, *The Outer Boundaries of the Bankruptcy Estate*, 47 EMORY LAW JOURNAL 1193, 1281-84 (1998); Stephen I. Glover, *Structured Finance Goes Chapter 11: Asset Securitization by Reorganizing Companies*, 47 BUS. LAW. 611, 613-14 (1992); Deborah L. Fletcher and Jeffrey L. Tarkenton, *Protecting the Lender: Lock Boxes and Bankruptcy Remote Entities*, Fifth Annual Mortgage Financing Program, Real Property, Probate and Trust Law Section (American Bar Association 1999), Volume 2, Tab J at 2-6; William L. Myers, *The Use of Bankruptcy-Remote Entities in Real Property Securitizations and Structured Financings*, 15 CAL. REAL PROP. J. 24 (1997); Carl J. Senecker, *How to Document Securitized Commercial Real Estate Mortgage Loans*, 15 THE PRACTICAL REAL ESTATE LAWYER 41, 44-46 (1999).

³ See Andrew Ratner & Steven Marcussen, *The Synthetic Lease Strategy*, CORP. REAL EST. EXECUTIVE, Sept. 1996, at 37.

⁴ CONSOLIDATION OF ALL MAJORITY-OWNED SUBSIDIARIES, Statement of Financial Accounting Standards No. 94 (Financial Accounting Standards Bd. 1987).

⁵ 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).

⁶ 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). The Financial Accounting Standards Board has also issued an abstract regarding specific implementation issues in accounting for lease transactions (including synthetic leases) involving SPEs. See also *Implementation Issues in Accounting for Leasing Transactions Involving Special-Purpose Entities*, EITF Bulletin 96-21 (Emerging Issues Task Force, Financial Accounting Standards Bd. 1996), which sets forth the conclusions of the EITF with respect to a series of issues related to the use of SPEs in structured financing. These issues include the following: multiple properties within a single SPE-lessee; multi-tiered SPE structures; payments made by the lessee prior to the beginning of the lease term; payment of SPE earnings to SPE equity owners during the lease term; fees paid by to the lessor by the lessee for structuring the lease; the use of nonrecourse debt to fund the SPE owners' equity investment; the form of the equity investment and whether it is “at risk” during the entire lease term; payments made to the equity owners of the SPE during the construction period; and the incurrence by the lessee of hard costs (or soft costs in excess of 10% of the expected fair market value of the property) during the construction period. If a synthetic leasing transaction does not satisfy the tests set forth in EITF Bulletin 96-21, it would be subject to and covered by *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sale-Type Leases of Real Estate, Definition of the Lease Term, and Initial Direct Costs of Direct Financing Leases*, Statement of Accounting Standards No. 98 (Financial Accounting Standards Bd. 1988), and would be treated as a sale-leaseback transaction because the lessee would be considered the owner of the project. On February 23, 1999, the Financial Accounting Standards Board released Exposure Draft No. 194-B, *Consolidated Financial Statements: Purpose and Policy* [hereafter Exposure Draft]. The Exposure Draft provides that

a “parent” must consolidate each entity that it controls and, once it is consolidated, continue to include it in the consolidated financial statements of the parent until such control ceases. Control, as defined in no. 10 of the Exposure Draft, “involves the presence of two essential characteristics: (a) a parent’s nonshared decision-making ability that enables it to guide the ongoing activities of its subsidiary and (b) a parent’s ability to use that power to increase the benefits that it derives and limit the losses that it suffers from the activities of that subsidiary. The Exposure Draft discusses consolidation issues regarding synthetic leasing structures as well as other transactions. It also indicates that a synthetic leasing transaction involving an SPE lessor that is created by a sponsor or lessee, pursuant to contractual provisions, to acquire, construct and use property, and primarily or exclusively serves the economic or business purpose of the sponsor, would require consolidation of the financial statements of the financial statements of the SPE and the sponsor because of the virtually total operational and decisional control exercised by the sponsor over the activities and operations of the SPE lessor, including the property and its ultimate residual risks, benefits, and disposition, i.e., the sponsor would control the SPE lessor because it has the required (a) nonshared ability to guide the ongoing activities of the SPE lessor and (b) the ability to increase the benefits it can derive and limit the losses it can suffer from the way it has directed and continues to direct those activities.

⁷ See *Reider v. FDIC (In re Reider)*, 31 F.3d 1102, 1106-07 (11th Cir. 1994); *In re Giller*, 962 F.2d 796, 798 (8th Cir. 1992); *Eastgroup Properties v. Southern Motel Assoc.*, 935 F.2d 245, 250-51 (11th Cir. 1991); *In re Augie/Restivo Banking Co.*, 860 F.2d 515, 518 (2d Cir. 1988); *In re Auto-Train Corp.*, 810 F.2d 270, 276 (D.C. Cir. 1987); *FMC Fin. Corp. v. Murphree*, 632 F.2d 413, 422 (5th Cir. 1980); *Chemical Bank N.Y. Trust Co. v. Kheel*, 369 F.2d 845, 847 (2d Cir. 1966); *Anaconda Bldg. Materials Co. v. Newland*, 336 F.2d 625, 628 (9th Cir. 1964); *Fish v. East*, 114 F.2d 177, 189-91 (10th Cir. 1940); *Central Claims Servs. v. Eagle-Richer Indus. (In re Eagle-Picher Indus.)*, 192 B.R. 903, 905-06 (Bankr. S.D. Ohio 1996); *In re Standard Brand Paint Co.*, 154 B.R. 563, 570 (Bankr. C.D. Cal. 1993); *In re Crown Mach. & Welding, Inc.*, 100 B.R. 25, 25 (Bankr. D. Mont. 1989); *In re DRW Property Co.*, 54 B.R. 489, 495 (Bankr. N.D. Tex. 1985); *In re Snider Bros.*, 18 B.R. 230, 233-34 (Bankr. D. Mass 1982); *In re Vecco Constr. Indus., Inc.*, 4 B.R. 407, 409-10 (Bankr. E.D. Va. 1980); Barry J. Dichter et al., *GUIDE TO “BANKRUPTCY-REMOTE” STRUCTURES IN COMMERCIAL MORTGAGE LOAN CONDUIT PROGRAMS AND THE PREPARATION OF NON-CONSOLIDATION OPINIONS* 14-21 (4th ed. 1996).

⁸ See James K. Stillman, *A No Substantive Consolidation, No Fraudulent Conveyance Opinion Letter From Counsel to the Bankruptcy Remote Entity*, Tab 24 at 19-25 (April 4-5, 1997) (American College of Real Estate Lawyers Midyear Meeting on Finance Topics); Portia O. Morrison, *Financial Covenants and Bankruptcy Remote Structures in Real Estate Loan Transactions*, Real Estate Financing Documentation: Coping With the New Realities, ALI-ABA Course of Study, Jan. 16-18, 1997 (available from the American Law Institute).

⁹ EITF Issue No. 90-15, *supra* note 6, 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.

¹⁰ See EITF Issue No. 96-21, *supra* note 6.

¹¹ See The Committee on Bankruptcy and Corporate Reorganization, *supra* note 5; Tribar Opinion Committee, *Opinions in the Bankruptcy Context: Rating Agency, Structured Financing, and Chapter 11 Transactions*, 46 BUS. LAW. 717, 724-30 (1991); Myers, *The Use of Bankruptcy-Remote Entities in Real Property Securitization and Structured Financings*, 14 CAL. REAL PROP. J. 24 (1997).

¹² 214 B.R. 713 (Bankr. S.D.N.Y. 1997).

¹³ *Id.* at 735.

¹⁴ See also John C. Murray, *The Lender’s Guide to Single-Asset Real Estate Bankruptcies*, 31 REAL PROP. PROB. & TR. J. 393, 461-71 (1996); Gregory Varallo & Jesse A. Finkelstein, *Fiduciary Obligations of Directors of the Financially Troubled Company*, 48 BUS. LAW. 239 (1992); James R. Stillman, *Real Estate Mezzanine Financing in Bankruptcy*, Tab 24 at 3 (April 4-5, 1997) (transcript available from the American College of Real Estate Lawyers Midyear Meeting on Finance Topics).

¹⁵ 99 F.3d 1520 (9th Cir. 1996).

¹⁶ *Id.* at 1526.

¹⁷ See *In re Andreuccetti*, 975 F.2d 413, 421 (7th Cir. 1992); *Clarkson Co. v. Shaheen*, 660 F.2d 506, 512 (2d Cir. 1981); *In re Kingston Square Assocs.*, 214 B.R. 713, 735 (Bankr. S.D.N.Y. 1997); *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787-89 (Del. Ch. 1992); *Credit Lyonnais Bank, Nederland, N.V. v. Pathe Communications Corp.*, Civ. A. No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991); *Tampa Waterworks Co. v. Wood*, 121 So. 789 (Fla. 1929); *Francis v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981).

¹⁸ See *In re John M. Cahill, M.D. Assocs. Pension Plan*, 15 B.R. 639, 639-40 (Bankr. E.D. Pa. 1981).

¹⁹ See 11 U.S.C. § 109(a) (1994).

²⁰ See 11 U.S.C. §§ 101(41), 101(9)(A) (1994); *Hunt v. TRC Properties (In re Hunt)*, 160 B.R. 131 (Bankr. 9th Cir. 1993); *In re Westgate Village Realty Trust*, 156 B.R. 363 (Bankr. D.N.H. 1993).

²¹ See 11 U.S.C. § 303 (1994). Under § 303(d) “a general partner in a partnership debtor that did not join in the [filing of an involuntary bankruptcy petition] may” challenge the petition and seek to have it denied. Under §303(b) only the creditors of a corporation may file an involuntary petition against the corporation.

²² (*In re Secured Equip. Trust of Eastern Air Lines, Inc.*), 38 F.3d 86 (2d Cir. 1994). Bankruptcy courts customarily consider the following factors, among others, in determining whether or not a trust is a business trust

eligible for filing under the Bankruptcy Code: whether the trust conducts business; whether its purpose is to generate profits; whether it has the attributes of a corporation; and whether the beneficial interests in the trust are transferable. See *In re Margaret E. DeHoff Trust 1*, 114 B.R. 189-92 (Bankr. W.D.Mo. 1990).

²³ See *id.* at 87.

²⁴ *Id.*

²⁵ See *id.* at 91-92., 103 B.R. 8, 10-13 (Bankr. D. Mass. 1989). See also *In re Ophir Trust*, 112 B.R. 956, 960 (Bankr. D. Wis. 1990) (noting that “[t]he Ophir Trust may look like a duck, but it neither walks nor quacks like a duck,” the court held that, based on the history of the debtor’s operations, the trust was not a business trust for purposes of eligibility for relief under the Bankruptcy Code); *Morrissey v. Comm’r*, 296 U.S. 344, 357, 56 S.Ct. 294, 295 (1935) (“In what are called ‘business trusts’ the object is not to hold and conserve particular property, with incidental powers, as in the traditional type of trusts, but to provide a medium for the conduct of a business and sharing its gains”).

²⁶ 177 B.R. 673, 675-76 (Bankr. C.D. Cal. 1995). See also *In re Morgantown Trust No. 1*, 177 B.R. 673, 676 (Bankr.C.D.Cal. 1995) (although not dispositive, characterization under state law is a significant factor in determining whether a trust is eligible to be a debtor under the Bankruptcy Code).

²⁷ See also *In re G-2 Realty Trust*, 6 B.R. 549, 554 (Bankr. D. Mass. 1980) (dismissing the debtor’s bankruptcy petition as a bad faith filing where the debtor transformed itself from a nominee trust to a business trust solely to meet the Bankruptcy Code’s eligibility requirements); *In re Mohan Kutty Trust*, 134 B.R. 987, 989 (Bankr. M.D.Fla. 1991) (examining whether the trust at issue was created in compliance with state law); *In re Eagle Trust*, 1998 WL 635845 (E.D.Pa., Sept. 16, 1998), at *5 (not reported in F.Supp. 2d) (finding that the trust in question was not a business trust because it did not possess any of the common attributes of a business trust, and was not established for the purpose of carrying on a commercial activity or business); *In re St. Augustine Trust*, 109 B.R. 494, 495-96 (Bankr. M.D. Fla. 1990) (finding that trust was family trust intended for personal needs, use, and benefit of family members rather than any business purpose, and was therefore ineligible for relief under the Bankruptcy Code).

²⁸ See *In re Dolton Lodge Trust No. 35188*, 22 B.R. 918, 923 (Bankr. N.D. Ill. 1982); *In re Old Second Nat’l Bank*, 7 B.R. 37, 38 (Bankr. N.D. Ill. 1980); *In re North Shore Nat’l Bank of Chicago, Land Trust No. 362*, 17 B.R. 867, 869-70 (Bankr.N.D.Ill. 1982); *In re Citizen Bank & Trust Co. of Park Ridge*, 8 B.R.812, 815 (Bankr.N.D.Ill. 1981).

²⁹ See *In re Treasure Island Land Trust*, 2 B.R. 332, 336 (N.D. Fla. 1980); *In re Cohen*, 4 B.R. 201, 208 (N.D. Fla. 1980) (also ruling that trustee of a trust that is found not to be a business entity eligible for filing for bankruptcy relief cannot file for bankruptcy as the trustee, even if the trustee is a “person” as defined in the Bankruptcy Code). These cases used reasoning similar to the Illinois bankruptcy courts *In re Old Second Nat’l Bank* and *In re Dolton Lodge Trust No. 35188*, *supra*. But cf. *In re Metro Palms I Trust*, 153 B.R. 922, 923-24 (Bankr. M.D. Fla. 1993) (holding that a trust, the sole business activity of which consisted of leasing and managing its only asset, a commercial office building, was not created to preserve the trust res for the beneficiaries and was, therefore, not a land trust, but a business trust eligible for relief under Chapter 11); *In re Star Trust*, 1999 WL 635525 (Bankr. M.D. Fla. 1999) (“It appears that the trusts were created not simply to hold and conserve the properties for the beneficiary, but to develop and maintain the properties, to rent and manage the properties, and ultimately to retain or dispose of the properties at a profit. The Court concludes that the trusts qualify as business trusts for relief under Chapter 11”).

³⁰ 103 B.R. 8, 10-13 (Bankr. D. Mass. 1989).

³¹ *Id.* at 10.

³² 50 B.R. 710 (Bankr. N.H. 1985).

³³ See also Klein, *Airline Finance: How Trusts Provide Bankruptcy-Proof Vehicles*, BANKRUPTCY STRATEGIST, Sept. 1995, at 7; James B. Clark, *Resisting Bankruptcy: Selected Developments In Structured Financing and Similar Techniques*, Tab A at 5 (1997) (unpublished manuscript from the Real Estate Finance: Hot Tips and Workshop, American Bar Association Section of Real Property, Probate and Trust Law 1997 Annual Meeting).

³⁴ (*In re DeLuca*), 194 B.R. 65 (Bankr. E.D. Va. 1996).

³⁵ See *DeLuca*, 194 B.R. at 74.

³⁶ See *id.* at 78-79. Limited liability companies are permitted by statute in every state and the District of Columbia.

³⁷ 188 B.R. 607 (Bankr. D. Neb. 1995). See also *In re GP Express Airlines*, 200 B.R. 222, 232 (Bankr. D. Neb. 1996) (citing *In re Daugherty*, the court stated that “the Bankruptcy Code will not enforce provisions in private agreements or under nonbankruptcy law which terminate a debtor’s interest in property or an executory contract merely because of a voluntary bankruptcy filing”).

³⁸ The rent is completely “net” to the lessor because the lessee assumes full responsibility for taxes, operating expenses, and all other expenses of operating and maintaining the property, thus assuring that the lessor will actually receive the lease’s stated profits. See *Kuske v. McSheridan (In re McSheridan)*, 184 B.R. 91, 94 (B.A.P. 9th Cir. 1995); *International Trade Admin. v. Rensselaer Polytechnic Inst.*, 936 F.2d 744, 751 (2d Cir. 1991); *James v. Commissioner*, 899 F.2d 905, 906 (10th Cir. 1990); see also *Barney’s, Inc. v. Isetan Co. (In re Barney’s, Inc.)*, 206 B.R. 328, 336 (Bankr. S.D.N.Y. 1997) (the court noted that the *Rensselaer* court specifically rejected the assertion that a lease specifically designated as triple-net should be conclusively established, based on this fact alone, to be something other than a true lease, due to the increasingly common utilization of this feature in commercial real estate leases).

³⁹ There may be exceptions to this provision with respect to certain limited and specific matters such as title, parties in possession, or existing violations of law.

⁴⁰ The lease document may also include a separately executed and recorded assignment of leases and rents, characterized as either an absolute or security assignment of the rents, and the lessee's consent to the assignment. The mortgage document executed by the trustee/owner/lessor in favor of the lender or lenders providing financing for the project may, in turn, contain a reassignment of the rents to such lenders.

⁴¹ 11 U.S.C. § 365(d)(3) (1994).

⁴² See *Barney's, Inc. v. Isetan Co. (In re Barney's, Inc.)*, 206 B.R. 328, 333 (Bankr. S.D.N.Y. 1997) (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).

⁴³ See *Int'l Trade Admin. v. Renesselaer Polytechnic Inst.*, 936 F.2d 744, 748 (2d Cir. 1991); *Liona Corp. v. PCH Assocs. (In re PCH Assocs.)*, 804 F.2d 193, 198 (2d Cir. 1986).

⁴⁴ S. REP. NO. 95-989, at 64 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5850.

⁴⁵ See 11 U.S.C. § 365(d)(4) (1994). One of the factors considered by bankruptcy courts in determining whether to extend the sixty-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 *Willmette Water Front, Ltd. v. Victoria Station, Inc. (In re Victoria Station, Inc.)*, 875 F.2d 1380, 1385-86 (9th Cir. 1989); *Escondido Mission Village L.P. v. Best products Co.*, 137 B.R. 114, 116-17 (S.D.N.Y. 1992). As of May, 1999, the U.S. Senate and House Judiciary Committees had approved a proposal to amend the Bankruptcy Code to provide for a maximum 240-day period within which a commercial lease could be accepted or rejected. The ultimate fate of this proposal is uncertain.

⁴⁶ See 11 U.S.C. § 365(b)(1). See *In re Copeland*, 1999 WL 711403 (Bankr. E.D.Ark., Sept. 29, 1999) at *2 ("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").

⁴⁷ See 11 U.S.C. § 365(b)(1). The debtor must perform all of its obligations under the lease in a timely manner, until and unless the lease is rejected, unless the bankruptcy court extends the time for performance. However, 11 U.S.C. § 365(d) permits the court to postpone the obligation of performance by the debtor until the end of the sixty-day period following the filing of the bankruptcy petition. The debtor 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 sixty-day period, both parties must perform their respective lease obligations in a timely manner until the debtor rejects the lease.

⁴⁸ See 11 U.S.C. § 365(g) (1994).

⁴⁹ See 11 U.S.C. §§ 365(g)(1), 502(g) (1994). Under § 365(g)(1) and § 502(g), as limited by § 502(b)(6), a landlord 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 tenant.

⁵⁰ See *In re Steven Windsor, Inc.*, 201 B.R. 133, 13 (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*, 176 B.R. 793 (Bankr. W.D. Mich. 1995) (holding that the 15% cap refers to the remaining rent due under the lease); *In re Farley, Inc.*, 146 B.R. 739, 747 (Bankr. N.D. Ill. 1992) (same) *In re Andover Toggs, Inc.* (1999 WL 150873) (Bankr. S.D.N.Y., March 12, 1999) (same), with *Sunbeam Oster Co. v. Lincoln Liberty Avenue, Inc. (In re Allegheny Int'l, Inc.)*, 145 B.R. 723 (W.D. Pa. 1992) (holding that the 15% cap applies to the remaining term of the lease); *In re Iran-Oak Supply Corp.*, 169 B.R. 414 (Bankr. E.D. Cal. 1994) (same).

⁵¹ See *In re Wilcox*, 201 B.R. 334, 336-37 (Bankr. N.D.N.Y. 1996) (holding that since the "Land Contract" agreement between the debtor, as lessee/purchaser, and the lessor/mortgagor, provided that the debtor was to lease the property for two years and then commence payments on the principal and interest accruing on the purchase price to be paid over the 18-year balance of the contract, was more like a mortgage than a lease, the debtor could cramdown the claim of the lessor/mortgagor arising from the 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), which provides that until an unexpired lease of personal property is assumed or rejected the trustee or debtor is required to "timely perform all of the obligations of the debtor . . . first arising . . . 60 days after" the order for relief, the debtor 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 the court makes a determination whether the contract is a true lease, as claimed by the lessor/creditor, or a financing obligation, as claimed by the lessee/debtor); *In re Waldoff's, Inc.*, 132 B.R. 325, 327 (Bankr. S.D. Miss. 1991).

⁵² 132 B.R. 325, 327-28 (Bankr. S.D. Miss. 1991).

⁵³ *Id.* at 328.

⁵⁴ See *id.*

⁵⁵ *Id.* (referring to 11 U.S.C. § 365(a) (1994)). Section 365(a) provides that “the trustee, subject to the court’s approval, may assume or reject any executory contract or unexpired lease of the debtor.” *See* *Barneys, Inc. v. Isetan Co. (In re Barney’s, Inc.)*, 206 B.R. 328, 332-33 (Bankr. S.D.N.Y. 1997) (holding that whether an agreement constitutes a “true lease” for bankruptcy purposes must be determined by reference to federal law, and stating that the “[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 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 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 the sublease between a corporate sublessee and an SPE sublessor, which was an affiliate of the 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); *In re PCH Associates*, 804 F.2d 193, 199-201 (2nd Cir. 1986) (ruling that a transaction described as a “Sale-Leaseback Agreement” and a “Ground Lease” was in fact a joint venture and therefore no landlord-tenant relationship existed under § 365). Determination of whether an agreement covering personal property or fixtures is a lease or in reality a security agreement is generally held to be a question of state law. *See, e.g., In re Kim*, 232 B.R. 324, 328-29, (E.D.Pa. 1999) (holding that, under Pennsylvania statute that deems a lease to be a disguised security interest if the lessee is granted an option to purchase the property at the end of the lease term for a nominal sum, the document would be considered a security interest as a matter of law; the court also noted that the lease provided that the lease required the tenant “to, *inter alia*, assume the risk of loss, pay for insurance, taxes, maintenance and repairs on the equipment”); *In re Continental Airlines, Inc.*, 932 F.2d 282, 294 (3rd Cir. 1991) (holding that question of whether an agreement that is designated a lease is in fact a security agreement is to be determined by reference to state law); *In re Homeplace Stores, Inc.*, 228 B.R. 88, 92 (Bankr. D. Del. 1998) (same); *In re Murray*, 191 B.R. 309, 313 (Bankr. E.D. Pa. 1996) (same); *Morreggia & Sons, Inc. v. Walsh (In re Moreggia & Sons, Inc.)*, 852 F.2d 1179, 1182-84 (9th Cir. 1988) (ruling that “the underlying purpose of § 365(d)(4) of the Bankruptcy Code would not be served” by including the agreement of the parties within its provisions where “[n]o true landlord/tenant relationship was ever intended or created”); *In re Independence Village*, 52 B.R. 715, 718-20 (Bankr. E.D. Mich. 1985) (holding that, based on the intentions of the parties and the economic substance of the transaction, the “Lease Purchase Contract” executed by the parties created a security device and not a lease); *In re Pacific Exp., Inc.*, 780 F.2d 1482, 1487 (9th Cir. 1986) (holding that even if the agreement is designated by the parties as a lease, the court will require assumption or rejection of the agreement where it is substance a security agreement); Edwin S. Barbre, Annotation, *Equipment Leases as Security Interest Within Uniform Commercial Code*, 76 A.L.R. 3d 11 (1977). The Internal Revenue Service for tax purposes generally treats a synthetic lease transaction as a secured loan, although in characterizing a transaction the substance of the transaction, rather than its legal form, is controlling. Whether a transaction is a sale or a lease for income tax purposes 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 purchaser. *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 (3rd 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,” citing *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978)); *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.

⁵⁶ *See, e.g., In re Challa*, 186 B.R. 750, 755-756 (Bankr. M.D. Fla. 1995) (stating that “[c]ourts are split on whether state law or federal law should be used to determine whether a particular rental agreement is a lease”).

⁵⁷ H.R. REP. NO. 95-595, at 314 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6271.

⁵⁸ *See* S. REP. NO. 95-989, at 26 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5812.

⁵⁹ *In re Q-Masters, Inc.*, 135 B.R. 157, 159 (Bankr. S.D. Fla. 1991). *See also* *BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994) (stating that, absent more explicit direction by Congress, traditional state law governs); *Barnhill v. Johnson*, 503 U.S. 393 (1992) (noting that property rights are determined by state law even though federal bankruptcy law determines what constitutes a preferential transfer and when it is complete); *Butner v. United States*, 440 U.S. 48, 55 (1979) (“Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is

involved in a bankruptcy proceeding.”); *MNC Commercial Corp. v. Joseph T. Ryerson & Son, Inc.*, 882 F.2d 615, 619 (2d Cir. 1989) (using state law to determine right of set-off because automatic stay had been lifted prior to the initiation of the litigation); *Morton v. National Bank*, 866 F.2d 561, 563 (2d Cir. 1989) (stating that bankruptcy courts must recognize state law extension requirements in determining the validity of a judgment lien); *In re Rosenshein*, 136 B.R. 368, 372 (S.D.N.Y. 1992) (“[i]n determining what interest the debtors in the instant case had in the escrow fund, reference must be made to state law”). Several cases have specifically held that the question of whether a document designated as a lease is in fact a financing device should be determined by state law. See *In re Kim*, 232 B.R. 324, 328 (E.D.Pa. 1999); *In re Continental Airlines, Inc.*, 932 F.2d 282, 294 (1991); *In re Homeplace Stores, Inc.*, 228 B.R. 88, 92 (Bankr. D.Del. 1998); *In re Murray*, 191 B.R. 309, 313 (Bankr. E.D. Pa. 1996); *In re Harris Pine Mills*, 862 F.2d 217, 220 (9th Cir. 1988); *In re Copeland*, 1999 WL 711403 (Bankr. E.D.Ark., Sept. 29, 1999) at *2).

⁶⁰ *City of Olathe v. KAR Dev. Assocs. (In re KAR Dev. Assocs., L.P.)*, 180 B.R. 629, 637 (Bankr. D. Kan. 1995).

⁶¹ See Int’l Trade Admin. v. Rensselaer Polytechnic Inst., 936 F.2d 744, 750 (2d Cir. 1991); *In re Moreggia & Sons, Inc.*, 852 F.2d 1179, 1186 (9th Cir. 1988); *In re PCH Assocs.*, 804 F.2d 193, 201 (2d Cir. 1986); *Barney’s, Inc. v. Isetan Co. (In re Barney’s, Inc.)*, 206 B.R. 328, 352 (Bankr. S.D.N.Y. 1997); *Hotel Syracuse, Inc. v. City of Syracuse Indus. Dev. Agency*, 155 B.R. 824, 838-39 (Bankr. N.D.N.Y. 1993); *In re Tak Broadcast Corp.*, 137 B.R. 728, 732-33 (W.D. Wis. 1992); *In re Starr*, 113 B.R. 481, 483-84 (Bankr. S.D. Ill. 1990); *In re MCorp Fin. Inc.*, 122 B.R. 49, 53 (Bankr. S.D. Tex. 1990); *In re Enters., Inc.*, 237 B.R. 268, 272-73 (Bankr. E.D.Pa. 1999)..

⁶² See *United States v. Colorado Invesco, Inc.*, 902 F. Supp. 1339, 1342 (D. Colo. 1995) (stating that “[t]he ability to recharacterize a purported loan emanates from the bankruptcy court’s power to ignore the form of a transaction and give effect to its substance”) (quoting *In re Fabricators, Inc.*, 926 F.2d 1458, 1469 (5th Cir. 1991)); *Shawmut Bank Connecticut v. First Fidelity Bank (In re Secured Equip. Trust of Eastern Air Lines, Inc.)*, 38 F.3d 86, 87 (2d Cir. 1994) (finding that “there is no dispute that [the lease transaction] was a secured financing”); *Lunan Family Restaurants v. Bank of America Illinois (In re Lunan Family Restaurants)*, 194 B.R. 429, 450-51 (Bankr. N.D. Ill. 1996) (finding that whether a lease is a bona fide lease or a disguised financing arrangement “depends on the circumstances of each case”; the court held that based on all the evidence, including a nominal rent not related to the value of the properties involved, an option to purchase at the end of the lease for a nominal consideration, and the responsibility of the tenant for all utilities, taxes, insurance, repairs and maintenance, the lease in question was a financing agreement and not a true lease); *In re Eagle Enters., Inc.*, 237 B.R. 269, 274 (E.D. Pa. 1999) (disregarding the decision of the parties to call the contract a “lease,” the court held that under Pennsylvania law “a ‘lease’ transaction in which the ‘lessee’ cannot terminate the ‘lease’ during its term but may thereafter become the owner of the ‘leased’ goods for no additional or nominal additional consideration does not create a lease, but rather creates a security interest”); *In re Village Import Enters., Inc.*, 126 B.R. 307, 308 (Bankr. E.D. Tenn. 1991) (“The practical effect of the agreement determines whether it was intended to create a security interest”) (citing cases); *In re Best Products Co.*, 157 B.R. 222, 229-30 (Bankr. S.D.N.Y. 1993).

⁶³ The factors cited in the Senate Judiciary’s report, No. 95-989, *supra* note 49, comprise what is commonly referred to as the economic realities test.

⁶⁴ *In re PCH Assocs.*, 804 F.2d 193, 200 (2d Cir. 1986). See also *In re Copeland*, 1999 WL 711403 (Bankr. E.D.Ark., Sept. 29, 1999) at *3 (discussing revised § 1-201(37) of the Uniform Commercial Code with respect to whether a transaction is a true lease or a sale, the court stated that “its detailed list of factors . . . demonstrates a shift away from focusing on the intent of the parties and towards an emphasis on the economic realities of the transaction”).

⁶⁵ See *Barney’s, Inc. v. Isetan Co. (In re Barney’s, Inc.)*, 206 B.R. 629, 639 (Bankr. S.D.N.Y. 1987) (citing *In re PCH Assocs.*, 804 F.2d at 200-01); *In re Challa*, 186 B.R. 750, 758 (Bankr. M.D. Fla. 1995); *City of Olathe v. KAR Dev. Assocs. (In re KAR Dev. Assocs., L.P.)*, 180 B.R. 629, 639 (Bankr. D.Kan. 1995); *Hotel Syracuse, Inc. v. City of Syracuse Indus. Dev. Agency*, 155 B.R. 824, 838-39 (Bankr. N.D.N.Y. 1993).

⁶⁶ See, e.g., *Ellis v. Corey (In re Ellis)*, 674 F.2d 1238 (9th Cir. 1982); *Kassuba v. Realty Income Trust (In re Kassuba)*, 562 F.2d 511 (7th Cir. 1977); *Chicoine v. Omne Partners II (In re Omne Partners II)*, 67 B.R. 793 (Bankr. D.N.H. 1986). See also Thomas C. Homburger & 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 (1995); Thomas C. Homburger & Gregory R. Andre, *Real Estate Sale And Leaseback Transactions And The Risk Of Recharacterization In Bankruptcy Proceedings*, 24 REAL PROP. PROB. & TR. J. 95 (1989); Joel Simpson Marcus, *Real Estate Purchase-Leasebacks as Secured Loans*, 2 REAL EST. L.J. 664 (1974)

⁶⁷ The insuring provisions of the ALTA Owner’s Policy provide coverage against any loss or damage by reason of “[t]itle to the estate or interest described in Schedule A being vested other than as stated therein . . .” American Land Title Association [ALTA] Loan Policy Oct. 17, 1992, at 1.

⁶⁸ See Robert S. Bozarth, *The Title Insurance Perspective*, D 31 (May 15-17, 1997), unpublished manuscript from the CLE and Committee Meeting of the ABA Section of Real Property, Probate & Trust Law Second Annual Non-Traditional real Estate Forum), at 19-21.

⁶⁹ See 11 U.S.C. § 365(a).

⁷⁰ See *National Labor Relations Board v. Bildisco & Bildisco*, 465 U.S. 513, 522-23 n.6 (1984) (holding that an executory contract is one “on which performance remains due to some extent on both sides”); *Griffel v. Murphy (In re Wegner)*, 839 F.2d 533, 536 (9th Cir. 1988) (ruling that a contract is executory if “the obligations of both parties are so

unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other”); *In re Anchor Resolution Corp.*, 1998 WL 300577 (Bankr. D. Del. 1998) at *6 (citing *Enterprise Energy Corp. v. United States (In re Columbia Gas Sys. Inc.)*, 50 F.2d 233, 239 (3d Cir. 1995)); Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973). The Ninth Circuit in *In re Helms* expressly overruled its previous decision in *Gill v. Easebe Enters. (In re Easebe Enters.)*, 900 F.2d 1417, 1419 (9th Cir. 1990), which held that all options are executory. Cases holding that an option to purchase is an executory contract under section 365 of the Bankruptcy Code include *Steffan v. McMillan (In re Coordinated Fin. Planning Corp.)*, 65 B.R. 711, 713 (9th Cir. B.A.P. 1986); *Horton v. Rehbein (In re Rehbein)*, 60 B.R. 436, 441 n.6 (9th Cir. B.A.P. 1986); *Rivercity v. Herpel (In re Jackson Brewing Co.)*, 567 F.2d 618, 623-24 (5th Cir. 1978); *In re A.J. Lane & Co.*, 107 B.R. 435, 437 (Bankr. D. Mass. 1989); *In re Hardle*, 100 B.R. 284, 287 (Bankr. E.D.N.C. 1989); *In re G-N Partners*, 48 B.R. 462, 465 (Bankr. D. Minn. 1985); *In re Waldron*, 36 B.R. 633, 6360-40 (Bankr. S.D. Fla. 1984), *rev'd on other grounds*, 785 F.2d 936 (11th Cir. 1986). Other bankruptcy court decisions, however, hold that an option contract is not an executory contract. *See, e.g., Brown v. Snellen (In re Geising)*, 96 B.R. 229, 232 (Bankr. C.D. Mo. 1989); *In re Lewis*, 94 B.R. 478, 495 (Bankr. D. Mass. 1988); *Travelodge Int'l, Inc. v. Continental Properties, Inc. (In re Continental Properties II, Inc.)*, 15 B.R. 732, 736 (Bankr. D. Haw. 1981). *See also* 1 WILLISTON ON CONTRACTS § 5:16 (4th ed. 1990) (“The traditional view regards an option as a unilateral contract which binds the optionee to do nothing, but grants him the right to accept or reject the offer in accordance with its terms within the time and in the manner specified in the option.”); Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding Rejection*, 59 COLO. L. REV. 845, 898-99 (1988) (discussing problems surrounding a bankruptcy trustee’s option to reject any executory contract); Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law 105-08* (1986) (discussing executory contracts for bankruptcy purposes as a mixed asset/liability).

⁷¹ 139 F.3d 702, 706 (9th Cir. 1997) (en banc),

⁷² *See* 11 U.S.C. § 365(a). *See* Treas. Reg. § 1.1234-1(b) (as amended in 1979).

⁷³ *See, e.g., Eastover Bank v. Sowashee Venture (In re Austin Dev. Co.)*, 19 F.3d 1077, 1084 (5th Cir. 1994) (holding that lessee’s deemed rejection of the ground lease, due to the lessee’s failure to assume the ground lease within 60 days of date of the lessee’s bankruptcy filing, did not terminate the leasehold mortgagee’s interest); *cf In re Gillis*, 92 B.R. 461, 465 (Bankr. D. Haw. 1988) (ruling that termination of lease extinguished mortgagee’s security interest in the lease since there was no remaining leasehold interest to which the security interest could attach).

⁷⁴ *See* The Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *supra* note 11, at 6.

[S]tructured financings may permit off-balance sheet financing—both the assets and the source of funding are removed from the balance sheet—and thus a structured financing transaction may be a possible method of financing in some circumstances where a secured financing would be prohibited by pre-existing restrictions in outstanding credit documents of the party benefiting from the financing or where the benefited party for other reasons (such as capital requirements) does not want to undertake on-balance sheet financing.

⁷⁵ As the court noted succinctly, and perhaps cynically, in *In re Winston Mills, Inc.*, 6 B.R. 587, 596 (Bankr. S.D.N.Y. 1980) “[s]o long as people do not mean what they say or do not say what they mean, there will be enough uncertainty to keep everyone busy hiding intent and obfuscating meaning.” In *In re Best Products, Inc.*, 157 B.R. 222, 224, after discussing whether a transaction denominated by the parties as a lease should be recharacterized, the court quoted *Winston Mills* and stated, “[n]ot a lot has changed since Judge Roy Babitt wrote those words.”