

**LEASE RECHARACTERIZATION IN BANKRUPTCY:
FINDING A WAY AROUND § 365**

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Section 365 of the Bankruptcy Code governs the rights of parties to executory contracts and unexpired leases. 11 U.S.C. § 365. The section sets the ground rules for lessors and lessees, including the duty to pay rent, the extent of the landlord's claim upon rejection of the lease, the debtor's ability to assume the lease, and the deadline for assumption or rejection, among other provisions. When Section 365's mandates pose a significant hurdle to a lessee's bankruptcy reorganization, some debtors have sought to clear the hurdle by recharacterizing the lease.

Recharacterization

Recharacterization occurs when the bankruptcy court exercises its equitable power to look beyond the form of a transaction and identify the transaction's true nature. A transaction that the parties have called a lease may be recharacterized to secured or unsecured financing, a joint venture, or something else. The power to recharacterize is generally recognized to flow from the courts' general equitable powers contained in Section 105(a), which states that the courts "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a); In re Mirant Corp., 327 B.R. 262, 268 (Bankr. W.D. Tex. 2005); see also In re Hoffinger Industries, Inc., 327 B.R. 389 (Bankr. E.D. Ark. 2005) (bankruptcy courts have power to recharacterize a loan from debt to equity); Aquino v. Black (In re Atlantic Rancher, Inc.), 279 B.R. 411 (Bankr. D. Mass. 2002) (recharacterization of purported loans to equity infusions).

Another argument in support of recharacterization is drawn from the legislative history of Section 365. The theory is that the Bankruptcy Code was intended to protect only “true leases”. The Code does not define what constitutes a “true lease” under Section 365. In the United Airlines bankruptcy, the litigants focused much of their arguments on the following passage:

The phrase “lease of real property” applies only to a “true” or “bona fide” lease and does not apply to financing leases of real property or interests therein, or to leases of such property which are intended as security.

[I]n a true lease of real property, the lessor retains all risk and benefits as to the value of the real estate at the termination of the lease ...

Whether 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.”

United Airlines, Inc. v. HSBC Bank USA, N.A., 416 F. 3d 609 (7th Cir. 2005),
citing Senate Report No. 989, 95th Cong., 2d Sess. 64 (1978).

The reasons a debtor would want to recharacterize a purported lease are often significant. For example, if a lease is to be assumed during the debtor’s bankruptcy, then any defaults must be cured and the debtor must provide the lessor with adequate assurance of future performance. 11 U.S.C. § 365(b). Further, during the bankruptcy, the trustee or debtor-in-possession must make the payments called for under the lease. 11 U.S.C. § 365(d)(10). The debtor also has the obligation to assume or reject the lease within a relatively short period of time, or the lease shall be deemed rejected. 11 U.S.C. § 365(d)(4). As a result of the 2005 amendments to the Bankruptcy Code, the debtor can be given a maximum of 210 days to assume or reject a lease of

non-residential real property. Any further extensions, however, may be granted only with the landlord's consent. Id.

In contrast, a secured claim does not entitle the creditor to an immediate stream of income and is subject to being reduced to the value of collateral under Section 506. Under a "cram down" plan under Section 1129(b)(2)(A), the debtor can retain the collateral and pay the creditor's secured claim over time. The differing results for both debtor and landlord can be dramatic.

The United Airlines Decisions

The United Airlines decisions¹ and other decisions involving airport facilities leases by airlines have in recent years addressed whether sale-leaseback or lease-leaseback transactions should be treated as true leases or recharacterized as financing agreements for treatment under the Bankruptcy Code. The debtor argued that its leases at the airports in New York (JFK), San Francisco (SFO), Los Angeles (LAX), and Denver were in reality disguised financing arrangements and, therefore, not subject to Section 365. The bankruptcy court agreed with respect to JFK, SFO and LAX. However, the court also held that the Denver lease was a true lease, not subject to recharacterization. In resolving the issues, the bankruptcy court relied on the "economic realities test." The court ignored the form of the transactions and, instead, looked at the substance of each lease.

¹ The United Airlines decisions are reported at Bank of New York v. United Air Lines, Inc., 2005 WL 670528 (N.D. Ill. 2005); HSBC Bank USA v. United Air Lines, Inc., 317 B.R. 335 (N.D. Ill. 2004); U.S. Bank v. United Air Lines, Inc., 331 B.R. 765 (N.D. Ill. 2005); and United Air Lines, Inc. v. HSBC Bank USA, 322 B.R. 347 (N.D. Ill. 2005). The Seventh Circuit affirmed the decisions in United Airlines, Inc. v. HSBC Bank USA, N.A., 416 F.3d 609 (7th Cir. 2005), cert. denied, 121 S. Ct. 1465 (2006).

The Seventh Circuit Court of Appeals ultimately agreed with the bankruptcy court's decision. The Circuit Court focused on several aspects of the transactions and concluded that the lease-leaseback arrangement was, in fact, a secured loan that was not subject to Section 365. In making its determination, the Circuit Court looked to several significant characteristics of the purported lease. The Court found the fact that the rental payments were tied to the amount borrowed from the bondholders to construct and maintain the airport facility favored recharacterization.² Further, the Court noted that the lease called for interest-only payments for thirty-six years, with a \$155 million balloon payment due at the end. At the time of the balloon payment, the airport facility would have little or no residual value for the purported lessor.

In addition to the foregoing factors, courts have looked to whether the rent payable was consistent with market rates or, rather, to provide a rate of return on investment (In re Integrated Health Services, Inc., 260 B.R. 71, 76 (Bankr. D. Del. 2001); In re Hotel Syracuse, Inc., 155 B.R. 824, 839 (Bankr. S.D. Cal. 1981), whether the tenant had the right to buy the property for a nominal amount at the end of the lease, or the obligation to purchase the property (United Airlines, 416 F.3d at 617; Pummill v. McGivern (In re American Eagle Coatings), 353 B.R. 656, 668 (Bankr. W.D. Mo. 2006); In re Morande Enterprises, Inc., 346 B.R. 886 (Bankr. M.D. Fla. 2006), whether, as in United Airlines, the property was purchased specifically for the tenant's use, and whether the parties intended "to enter into a typical landlord/tenant relationship." In re Moreggia & Sons, Inc., 852 F.2d 1179, 1183 (9th Cir. 1988).

² This factor is unlikely to carry the day alone, however, as many lease payments are set with an eye toward covering the landlord's mortgage debt.

The Impact of Recharacterization

If the “lease” is recharacterized, a number of consequences may follow. The debtor will not be obligated to make timely rental payments starting within sixty days of the bankruptcy petition as a lessee would under Section 365(d)(3). Instead, the landlord/lender is entitled only to adequate protection designed to compensate it for the decline in value of its collateral during the Chapter 11 proceeding, and then only to the extent that it holds a perfected security interest. In re Grubbs Construction Company, 319 B.R. 698, 711 (Bankr. M.D. Fla. 2005) (dealing with personal property leases). If the landlord/lender failed to perfect its security interest, its secured claim may be avoided by the debtor under Section 544. Id.

If the landlord/lender is found to have a secured claim, that claim will be limited to the value of the collateral. The debtor will be able to retain the collateral by paying only the secured claim, rather than curing all lease defaults and providing for payment in full of the balance of the lease obligations. Further, if the landlord/lender has a claim under a loan facility (rather than a lease), but failed to perfect its security interest, it will be entitled only to a general unsecured claim and will receive the same dividend that trade creditors receive under the debtor’s plan of reorganization. Accordingly, recharacterization may mean the difference between the landlord/lender being paid in full and receiving close to nothing under the debtor’s plan.

The possibility of recharacterization may also be utilized by debtor/tenants to avoid the impact of one of the most talked about provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”). BAPCPA amended Section 365(d)(4) to provide that leases must be assumed within 120 days or they are deemed rejected. That deadline may be extended by the court for an additional 90 days for cause. Thereafter, the landlord must assent to any extension. 11 U.S.C. § 365(d)(4). This provision gives the landlord significant

power and may put extreme pressure on the debtor/tenant to assume the lease prematurely and run the risk of a significant administrative claim if the lease is later rejected.

A debtor faced with the deadline to assume or reject may seek to buy time by challenging the nature of the lease itself – if the lease is recharacterized, the debtor need not assume it and need not pay timely rent. An excellent article examining recharacterization suits in this light points out that in several cases the debtor was able to gain months or even years beyond the original deadline for assumption by seeking to recharacterize the lease into something else.³ For example, in the pre-BAPCPA Mirant bankruptcy proceedings, the debtor sought to recharacterize lease transactions involving energy plants. The debtor sought extensions of the deadline to assume or reject those leases arguing, in part, that the leases may be subject to recharacterization. Although the debtor ultimately lost the recharacterization fight, the debtor successfully extended the deadline to assume or reject the leases for many months while the adversary proceeding played out. In re Mirant Corp., 327 B.R. 262, 268-273 (Bankr. N.D. Tex. 2005).

The Mirant case was decided under the pre-BAPCPA Bankruptcy Code. The debtor's assertion that the lease transactions were actually loans was "cause" to extend the deadline to assume or reject the leases. Section 365(b)(4) no longer allows the bankruptcy courts to grant extensions beyond 210 days absent the landlord's consent. As the authors of *Defining True Character* point out, however, debtors may still bring recharacterization claims prior to the assumption deadline in the hopes that the Court will agree to toll the deadline to assume until the nature of the obligation is resolved. Given the statute's rigid language, however, the debtor may

³ *Defining True Character: Implications of the Bankruptcy Code Amendments of 2005 on Lease Recharacterization*, Ronald J. Silverman, Jeffrey T. Kirshner and Scott K. Seamon, 2006 Annual Survey of Bankruptcy Law Part I § 6 (September 2006) ("Defining True Character").

run the risk that rejection will be deemed to have occurred on the 210th day if the recharacterization suit fails months, or even years, later.

Conclusion

Lease recharacterization may produce dramatic results in bankruptcy proceedings: relieving a struggling debtor from the duty to make timely lease payments, allowing the debtor to retain the leased property without the cost of assumption and, possibly, giving the debtor additional time to make the critical decision to assume what are ultimately deemed “true leases.” Although the 2005 amendments to the Bankruptcy Code were designed to give landlords more certainty with respect to the treatment of their leases, landlords and debtors will test the new boundaries with claims for recharacterization and other tactics. Until the courts resolve some of those new issues and lessors refine their leases to account for those decisions, litigation between landlords and their debtor/tenants is likely to increase.