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Recharacterization Risks: Beware!

By John P. Amato

This is the first of a two-part article

To the unwary, Revised Article 9 of the Uniform Commercial Code may pose significant risks. The Article is intended to cover all transactions, *regardless of form*, that in economic substance create a security interest. Using this broad policy mandate, courts have frequently disregarded many different transaction forms that, on their face, were documented to appear to be outside the scope of Revised Article 9. When this occurs the party that is deemed a secured lender in the recharacterized transaction will face losing substantial rights — unless that party complied with Article 9's perfection rules, which typically require the filing of a financing statement.

This article (Parts one and two) discusses two separate and distinct recharacterization risks inherent in certain commonly structured tripartite lease transactions. This type of tripartite lease transaction consists of two elements and three parties: the first element involves the transfer of equipment that is transferred from a supplier (the first party) to a finance lessor (the second party) and the second element consists of the lease of such equipment from the finance lessor to the lessee (the third party), with a supplier support guarantee. (For purposes of this article, a supplier support guarantee means a written agreement in which the supplier guarantees the finance lessor either the credit of the lessee or provides residual support for the equipment at the end of the lease term.)

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One risk is well known, but the other is not. While both risks are discussed herein, this article also highlights the less apparent risk for the finance lessor to consider in these post-Enron days when numerous off-balance sheet transactions and the accounting rules that facilitate them are being attacked and reconsidered.

The Known Risk

The substance over form rule dictates that just because a transaction is documented as a "lease" does not mean that a reviewing court will treat it as such. Instead, courts are required by the rule, codified in the definition of "security interest" found in UCC §1-201(37), to look at the economic substance of a transaction to determine whether the lease is in reality an operating lease, or if it should be treated as a disguised security device. For purposes of this article, the term "operating lease" is used to mean an operating lease under GAAP, as well as a true lease for tax, bankruptcy and UCC purposes.

One of the main features of UCC § 1-201(37) is to ascertain which party in a lease transaction bears the real benefits and burdens of asset ownership. If a transaction that is documented as a lease squarely places the benefits and burdens of asset ownership on the lessee, then UCC §1-201(37) requires a reviewing court to characterize the transaction as a loan by the purported lessor to the lessee, secured by the leased equipment, irrespective of the form chosen by the parties. Financial transactions that are documented as leases and characterized as loans under UCC §1-201(37) are often referred to as "disguised security devices."

There are four bright-line tests contained in UCC § 1-201(37) that can be isolated to determine whether a lease will be considered a disguised security device. If a lease transaction that is not terminable by a lessee, it will be recharacterized as a secured loan if:

- The original term of the lease is equal to or greater than the remaining economic life of the equipment;
- The lessee is bound to renew the lease for the remaining economic life of the equipment or is bound to become the owner of the equipment;
- The lessee has an option to renew the lease for the remaining economic life of the equipment for no or nominal consideration; or
- The lessee has an option to become the owner of the equipment for no or nominal consideration.
- The focus of these four tests is to determine whether the lessee will enjoy the possession and use of the equipment for its entire economic life. Conversely stated, if any one of the four tests is met, then the finance lessor really has no significant residual interest in the equipment. Accordingly, a properly advised finance lessor will always file a financing statement against its lessee when the lease transaction is structured in away to be treated as a disguised security device so as to protect its superior rights to the equipment and lease payments as against the lessee's other creditors and/or trustee in bankruptcy.

Many operating lessors will file "protective" financing statements against their operating lessees as a prophylactic measure, given the recharacterization risk when lessees default.

Part two, appearing next month, discusses the Hidden Risk.

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Recharacterization: The Hidden Risks

By John P. Amato

This is the second of a two-part article.

As described last month, the lease is the second element of the tripartite lease transaction. (The tripartite transaction in question consists of two elements and three parties: the first element involves the transfer of equipment from a supplier to a finance lessor, and the second element consists of the lease of such equipment from the finance lessor to the lessee with a supplier support guarantee.) The hidden recharacterization risk is embedded in the first element, that is the transfer of title of the equipment from the supplier to the finance lessor. Depending upon the nature and extent of a supplier guarantee that may be required to support the lease in these tripartite transactions, this transfer may be considered by a reviewing court as a loan instead of a sale.

The following example of a common commercial leasing transaction illustrates the hidden risk. Assume that a supplier finds an end-user to lease a piece of equipment. The supplier then transfers title of the equipment to a finance lessor in a transaction that is documented as a sale, at a purchase price that is: 1) stated to be the full retail price of the equipment; and 2) used to compute the lease payments to the end-user. The finance lessor then enters into an operating lease with the end-user. In an effort to provide economic support or credit enhancement, the supplier executes a written guaranty of the lessee's lease obligations under the operating lease to the finance lessor. The supplier also agrees to repurchase the equipment at the end of the lease term at the scheduled residual price fixed at the inception of the lease, which residual is computed as the retail price paid by the lessor to the supplier at the inception of the transaction, plus accrued interest, less the amount of the lease payments made by the lessee under the operating lease.

Now, let us further assume that the supplier files for bankruptcy before the end of the lease term, and the supplier's trustee learns of the existence of the supplier's support obligation. The trustee then discovers that because of the nature and extent of the supplier's guarantee, the supplier's accounting firm advised the supplier that it was precluded from recognizing the profit from the purported sale under generally accepted accounting principles.

The trustee then retains an expert accountant to provide advice about whether the supplier was permitted to book the transaction as a sale and recognize the income. The expert advises that on May 22, 2002, the Financial Accounting Standards Board issued an exposure draft on "Proposed Interpretations on Guarantor's Accou- nting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others," which provides that a guarantee of an operating lease would have to be booked at its fair value on the supplier's balance sheet. The expert also discusses in its report that Paragraph 21 of SFAS 13, entitled "Accounting for Leases," states:

"The sale of property subject to an operating lease, or of property that is leased by or intended to be leased by the third-party purchaser to another party, *shall not be treated as a sale if the seller — or any party related to the seller retains substantial risks of ownership in the leased property.*" (Emphasis added.)

This accounting rule, the expert opines, is directly applicable to the type of tripartite lease transaction under consideration because: 1) the supplier "sold" the equipment that either was subject to an operating lease or was intended to be leased to the end-user and 2) the supplier retained a substantial risk of ownership of the equipment by reason of the existence of the supplier support guaranty. (The trustee's expert would also opine that the supplier's recourse guarantee is a form of ownership under SFAS 13, paragraph 21, based upon the announcement to that effect made by members of the staff of the United States Securities and Exchange Commission at the American Institute of Certified Public Accountants' Conference on Current SEC Developments held in late 1999. Applying the rule to the facts, the trustee's expert opines that the purported sale element of our tripartite lease transaction must be accounted for as a secured loan from the finance lessor to the supplier under GAAP.)

Armed with this expert opinion and the substance over form rule, the supplier's trustee then commences a bankruptcy adversary proceeding against the finance lessor seeking to recharacterize the "sale"

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element of the tripartite lease transaction as a disguised security device. Supporting the trustee's case is the fact that after the operating lease ends, either through early termination or at maturity, the terms of the recourse guarantee require that the supplier reacquire ownership of the equipment. In its truest sense, the trustee argues, the finance lessor economically only made a loan to the supplier in the amount of the retail price of the equipment, secured by an assignment of the lease proceeds and title to the equipment. Surely, since the supplier will own the equipment at the end of the lease, the finance lessor never really had any residual risk exposure (other than the credit risk of the supplier, which risk may be too contingent to be taken into account especially since that same risk exists in a financing transaction).

Properly advised, the trustee will inform the bankruptcy court that neither Revised Article 9 nor Article 2 of the UCC contain any provision that directly addresses when a sale is a "true" sale as opposed to a disguised security device. Instead, the trustee will point to broad policy statements, such as the one contained in UCC §2-102 that provides "this Article applies to transactions in goods; it does not apply to any transaction which although in the form of an unconditional contract to sell or present sale is intended to operate only as a security transaction." Similarly, UCC §9-109(a)(1) provides that Article 9 shall apply to any "transaction, regardless of form, that creates a security interest in personal property or fixtures." In fact, the only UCC provision that provides guidance on the recharacterization issue is contained in the definition of "security interest" set forth in UCC §1-201(37). While the substance over form rule is also contained in that section, its only focus is on lease recharacterization issues, not sale recharacterization issues.

The finance lessor will argue that: 1) UCC §1-201 (37) does not have any application to the sale element of our tripartite lease transaction; 2) the intent of the parties to conclude an equipment sale governs the analysis; and 3) the fact that accounting rules may forestall income recognition from such sale is irrelevant to the issue under consideration by the court.

In response the trustee will argue that UCC §1-201(37) was enacted to: 1) avoid the subjective intent of the parties controlling such determination; and 2) provide a more objective test of the true economic substance of a transaction. To show the court how UCC §1-201(37) is properly applied to this type of tripartite lease transaction, the trustee will proceed to demonstrate how the transaction can easily be cast into a sale-leaseback transaction that will have the same economic substance as our tripartite lease transaction.

The recast transaction starts with the supplier transferring title to the equipment to the financing company-lessor, followed by a lease of the equipment back to the supplier that requires the supplier to repurchase the equipment at the end of the lease term. To fully analogize the substance of the two forms, the trustee documents a supplier sublease of the equipment to the end-user and assignment of the sublease payments to the finance lessor as security for the supplier's lease obligations.

Economically, the trustee will argue, the tripartite lease transaction re-documented as a sale-leaseback transaction places each of the supplier, finance lessor and lessee in the same financial position as they were in when the deal was originally documented. First, the lessee is a party to a lease, and must pay the same lease payments to the same party. Second, the finance lessor paid the same amount at the inception of the transaction and it will receive the same amount from the lessee during the term of the lease and from the supplier at termination of the lease. Finally, the supplier receives the same "sale" proceeds at the inception of the transaction, and will be obligated to buy the equipment back and repay the same amount of monies to the finance lessor as it was obligated to pay in the tripartite lease transaction.

With the economic transaction recast as a sale-leaseback transaction, the trustee shows the bankruptcy judge the ease in which UCC §1-201(37) may be properly applied to the transaction under consideration. Clearly, the sale-leaseback transaction meets the definition of a disguised security device. First, the supplier does not have the right to terminate the lease early. The supplier also must repurchase the goods for no additional consideration beyond what it agreed to pay at the inception of the lease. The supplier therefore will enjoy the possession and use of the equipment for its entire economic life and the finance lessor has no meaningful residual interest in the equipment. In economic substance, therefore, the proceeds received by the supplier were nothing more than a loan from the finance lessor to the supplier, secured by a lien on the equipment and an assignment of the accounts receivable due from the lessee on the sublease.

For the above reasons, a finance lessor must be cognizant of the hidden risk of recharacterization when it requires a supplier guarantee in a tripartite lease transaction. Analyzing the hidden risk is best accomplished by 1) recasting the transaction first as a sale-lease transaction and applying the objective tests contained in UCC §1-201(37) and 2) ascertaining if the supplier must account for the transaction as a financing. If the objective test is met following such recasting of the transaction as a sale-leaseback, or if the transaction must be characterized as a financing under GAAP, then the finance lessor should mitigate its hidden risk by filing a financing statement against the supplier. Sometimes, this may not be sufficient to fully protect the finance lessor's rights, especially where the supplier has previously granted a security interest to another party, such as an asset based lender. In such a case an intercreditor agreement is advisable to mitigate the hidden risk of recharacterization.

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