

Recharacterization Issues in Sale-Leaseback Transactions

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Sale-leaseback transactions are subject, under certain circumstances, to recharacterization as either equitable mortgages or joint ventures (although to date no final, reported court decision has recharacterized a sale-leaseback transaction as a joint venture). See Thomas C. Homburger and 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, 488-489 (Fall 1995); Thomas C. Homburger and Gregory Andre, *Real Estate Sale and Leaseback Transactions and the Risk of Recharacterization in Bankruptcy Proceedings*, 24 REAL PROP. PROB. & TR. J. 95 (Spring 1995); Thomas Reynolds, *Recharacterization of Sale-Leaseback Transactions*, ABA Real Property, Probate and Trust Law Section, Seventh Annual Spring CLE and Committee Meeting (May 1996) (handout materials for Second Annual "World's Best Mortgage Financing" Program).

In a sale-leaseback transaction, the seller-lessee may attempt to have the sale and leaseback recharacterized as an equitable mortgage in order, among other things, to provide it with an opportunity to "redeem" the property at a foreclosure sale. The courts (including bankruptcy courts) have applied a fact-based analysis to determine whether the substance of the transaction is in accord with its form and the expressed intent of the parties. Although the issue of whether a transaction is characterized as a sale or a mortgage depends to a great extent on the expressed intention of the parties, the economic substance of the transaction, and not its label, will ultimately determine whether it is a true sale-leaseback or a financing transaction. Unfortunately, the courts are not consistent with respect to the relevance and weight of the factors that will determine whether a document designated as a lease will be recharacterized as a mortgage. The factors that the courts consider include the following:

1. The intent of the parties at the time of the execution of the documents, as determined by examining the language in the documents and (if there is an ambiguity) by the aid of parol evidence.
2. Whether there is continued evidence of a debt or liability.
3. The relationship of the parties.
4. Prior unsuccessful attempts to obtain a loan.
5. The circumstances surrounding the transaction.

6. The sophistication and circumstances of the parties.
7. The lack of legal counsel.
8. Whether the structure of the sale is unusual.
9. The adequacy of consideration and the value of the property.
10. How the consideration was paid.
11. Whether there is written evidence of the debt.
12. The belief that the debt remains unpaid.
13. Whether there is an option or agreement to repurchase.
14. The continued exercise of ownership privileges, responsibilities and/or possession by the seller.
15. Whether there is a trading of tax benefits for a fixed return.

See, e.g., *Schwartzentruber v. Stephens*, 8 Ill.2d 222, 228-29 (1956) (holding that question of whether conveyance is a mortgage depends on intent of parties and existence of debt or liability); *Robinson v. Builders Supply*, 223 Ill. App. 3d 1007, 1014-15 (1st Dist. 1992) (setting forth factors [including many of those listed above] considered by courts in determining whether conveyance should be recharacterized as a mortgage, and finding that “the record lacks conclusive evidence on the adequacy of consideration . . . and the value of the property”); *185 Wabash LLC v. Lake Wabash LLC*, No. 1-03-0751 (Ill. App. Dec. 24, 2003) (decision without published opinion), *appeal denied*, 809 N.E.2d 1287, 2004 Ill. LEXIS 621 (Ill. Sup. Ct. March 24, 2004) (holding that intent of parties is prime factor in determining whether sale-leaseback with option to purchase is an equitable mortgage; court refused to recharacterize transaction where seller-lessee could not satisfy burden of proof showing that parties intended security agreement and appraisal of property indicated that fair value was given).

Recharacterization is always an uphill battle – the party seeking to recharacterize the transaction is trying to argue that something is not what the parties said it is. Courts aren't particularly fond of these cases; they are equitable proceedings and courts generally will hold the party seeking to recharacterize the document or transaction to a high standard of proof. The question of valuation is often crucial (see *185 Wabash LLC, supra*). See, e.g., *Maryland, U.S. Bank N.A. v. Nielsen Enterprises, Inc.*, 232 F.Supp 2d 500 (D. Md. 2002). In this case (not involving an option) the plaintiff, a non-signatory who was attempting to alter the terms of an agreement to which it was not a direct party, sought to have a ground

lease transaction recharacterized as an equitable mortgage. The court refused to recharacterize the transaction, for the following reasons as stated by the court:

The Court declines to recharacterize the Ground Lease for several reasons. The Landlord has not received a windfall. As discussed previously, the discrepancy between the value of the land conveyed to the Landlord and the Landlord's consideration is too small to be considered unfair or unjust. Also, this was a transaction among sophisticated parties, which reduces the likelihood of surprise or mistake. Like many real estate deals, the transaction at issue has characteristics of both a land sale and a loan. There is ample evidence, however, that the transaction was a true sale to the Landlord and not just a security device. For example, the Landlord granted Nielsen a 98-year term precisely because a 99-year term, under Maryland law, would make the lease redeemable. See Md. Code Ann., Real Prop. § 8-110 (Michie 1996). Moreover, the absence of a right to prepay is evident from a review of the papers. Metropolitan [Bank & Trust Co., the leasehold lender] had full access to the transaction documents prior to the closing and raised no objection. Finally, the Landlord did not cause Metropolitan's financial predicament. Rather, Metropolitan's failure to perform proper due diligence and its haphazard acceptance of income predictions are to blame.

Id. at 529.

The court also stated, in a footnote, that:

In addition, there are practical difficulties posed by an equitable recharacterization of the mortgage. For example, many commercial mortgages have prepayment penalties. To recharacterize the lease and allow the Bank to redeem it without paying a penalty would be to impose upon the Landlord a loan with commercially unreasonable terms. The Bank has not explained how this problem and others like it could be resolved.

Id. n. 7.

Furthermore, according to the court:

In the instant case, the parties intended a lease from the beginning. Furthermore, there is nothing illegal about the transaction . . . In short, there is no reason for equity to intervene and recharacterize the lease as a mortgage."

Id. at 530.

See also *Kassuba v. Realty Income Trust*, 562 F.2d 511, 515 (7th Cir. 1977) (transactions were bona fide sales and leasebacks and were not security agreements in nature of mortgages); *Uni-Rty Corp. v. Guangdong Bldg. (In re Uni-Rty Corp.)*, 1998 U.S. Dist. LEXIS 8426 ((S.D.N.Y. June 9, 1988), at *14-18 (finding that sale-leaseback transaction did not create mortgage because there was “no trading of tax benefits for a fixed return” and “Appellees assumed the risks and rewards associated with the ownership of real property, unlike the Appellees in *PCH*”); *Dabalneh v. Federal Deposit Ins. Corp.*, 971 F.2d 428, 438 (10th Cir. 1992) (“In all relevant respects in the record, the transaction has been called and treated like a lease”); cf. *Matter of Fabricators, Inc.*, 926 F.2d 1458, 1469 (5th Cir. 1991) (“The ability to recharacterize a purported loan emanates from the bankruptcy court’s power to ignore the form of transaction and give effect to its substance”); *U.S. v. Colorado Invesco, Inc.*, 902 F.Supp. 1339, 1347 (D. Colo. 1995) (transactions were properly considered loans rather than capital contributions).

But other courts have found, based on the facts of the case, that a purported sale-leaseback should be recharacterized as a mortgage. In *In re PCH Associates*, 949 F. 2d 585 (2d Cir. 1991), the court held that based on the substance as opposed the form of the transaction, which had been characterized by the parties as a sale-leaseback but which actually had all the economic features of a mortgage-financing transaction with the purchaser-lessor bearing few if any of the risks of ownership, the transaction was not a lease under § 365 of the Bankruptcy Code and the deed given to the purchaser-lessor was not an absolute deed but was instead an equitable mortgage. See also *In re Independence Village, Inc.*, 52 B.R. 715, 720 (Bankr. E.D. Mich. 1985) (rejecting § 365 application and holding that “lease” was in actuality an “equitable mortgage” in real property and a security interest in the debtor’s personalty); *In re Seatrain Lines, Inc.*, 20 B.R. 577, 582 (Bankr. S.D.N.Y. 1982) (recharacterizing purported sale and leaseback as an “equitable mortgage”); *In re Opelika Mfg. Co.*, 67 B.R. 169, 170-72 (Bankr. N.D. Ill. 1986) (purported lease agreement was in reality a “disguised security agreement”); *In re Ellis*, 674 F. 2d 1238, 1249 (9th Cir. 1982) (“in view of the absence any findings as to the actual intent of the parties, we must conclude that the characterization of this transaction as a sale rather than a mortgage was error”).

Will (and should?) the title insurance company that is asked to insure a sale-leaseback transaction create a special exception in the title insurance policy as the result of any subsequent recharacterization of the interest of the insured party in the land described in Schedule A -- or is it not necessary to raise any exception in the first place because the risk of recharacterization is excluded from coverage under the policy exclusions in any event because it is a matter “created, suffered, assumed or agreed to” by the insured, or a “[d]effect, lien, encumbrance, adverse claim or other matter. . . attaching to or created subsequent to Date of Policy” (based on the conduct of the parties after the

transaction has closed), as set forth in Exclusions 3(a) and 3(d), respectively, of the ALTA Loan Policy (10/17/92)?

Title insurance insures against defects in title or in the mortgage itself; it does not insure against problems arising from or relating to the underlying debt or the relationship between the insured and other parties to the transaction. In *Lawyers Title Ins. Corp. v. JDC (America) Corp.*, 52 F. 3d 1575, 1583 (11th Cir. 1995), the court held that the title insurer had no duty to defend a claim that the insured's mortgage was unenforceable due to the insured mortgagee's status as a partner in a joint venture for which the mortgaged property was held in trust, because of the exclusion in the mortgagee's policy of title insurance for matters "created, suffered, assumed or agreed to" by the insured, which exclusion applied to the claims of the lender because the claims involved actions of the insured in entering into various relationships with the borrower. The court further held that the provision of the policy providing coverage against the "invalidity and unenforceability of the insured mortgage" did not apply because the "the provision insures against defects in the mortgage itself, but not against problems arising from or related to the underlying debt," and noted that "[t]he defenses asserted by [the insured] on behalf of the joint venture . . . all explicitly related to the effect of the parties' relationship or the collectability of the debt rather than the validity of the mortgage itself."

In *Ticor Title Ins. Co. of California v. FFCA/IIP 1988 Property Co.*, 898 F. Supp. 633, 640-641 (N.D. Ind. 1995), the court held that, in connection with a sale-leaseback transaction, the seller-lessee's claim that the purchaser-lessor's ownership interest in the property was in fact a mortgage security interest necessarily required proof of the insured party's intent and was therefore not a matter covered by title insurance because of the policy exclusion for matters "created, suffered, assumed, or agreed to by the insured claimant." See also *Transamerica Title Ins. Co. v. Alaska Federal S. & L. Assoc.*, 833 F.2d 775, 776 (9th Cir. 1987) ("if [the insured] intended to obtain only an equitable lien . . . [it] will be deemed to have 'created' this 'defect' in title."); *Bidart v. American Title Ins. Co.*, 734 P. 2d 732,734 (Nev. 1987) (holding that a deed could be recharacterized as an equitable mortgage only if the claimant could "prove that [the insured] intended the deed to operate as a mortgage," and that an equitable mortgage claim was therefore excluded from coverage under the title policy as a matter "created" by the insured); *Flack v. McClure*, 565 N.E. 2d 131 (Ill. App. Ct. 1990) (holding that the burden of proof rests with the party asserting a mortgage when a deed absolute has been conveyed; the court listed six factors that should be evaluated in determining the existence of an equitable mortgage and held that the evidence, especially that demonstrating the existence of a debt relationship and grossly inadequate consideration, clearly supported the trial court's finding of an equitable mortgage); John C. Murray, *Deeds in Lieu of Foreclosure: Practical and Legal Considerations*, 26 REAL PROP. PROB. & TR. J. 459, 473-474 (Fall 1991); 765 ILCS 905/5 (MICHIE 1996) ("Every deed conveying real estate, which shall appear to have been intended only as a security in the nature of a mortgage,

though it be an absolute conveyance in terms, shall be considered as a mortgage”).

If the title insurer is aware of the nature of and the facts surrounding a sale-leaseback transaction, is this enough to cause it to be deemed to have provided coverage to the insured under a title policy against the risk of recharacterization unless the title insurer has raised a specific recharacterization exception? It has been suggested that, in connection with recharacterization issues involving sale-leaseback transactions, “[a]n investigation by the insurer of the facts surrounding a sale leaseback transaction may create a sufficient level of knowledge through which the insurer would be deemed to have assumed the obligation to insure or defend against loss from a recharacterization. This result would follow whether the inquiry was undertaken voluntarily by the insurer or in response to a request by the insured that the policy expressly insure against loss due to a sale leaseback recharacterization. Similarly, an insurer may be deemed to assume such an obligation through a failure of an insurer to respond to information specifically disclosed by the insured which made it obvious that a recharacterization risk was possible... . [T]he title insurer is well advised to disclaim specifically any obligation to indemnify the insured against loss from a sale-leaseback transaction recharacterization. The alternative is for the insurer to run the risk of assuming this kind of indemnification obligation.” Homburger and Gallagher, III.A., *supra*, at 488-89.

Title insurers are justifiably reluctant to issue policies in connection with sale-leaseback transactions without a specific recharacterization exception and the insured parties in such transactions will commonly agree to an exception in the owner’s title policy containing language similar to the following: “Any defect in, or lien or encumbrance on the title resulting from an allegation or determination that the interest of the insured as evidenced by any or all of the following documents, either jointly or severally, should be or has been recharacterized in any manner,” or, “Any assertion or determination that the vesting of title in [the insured] is, or is part of, a loan transaction, including without limitation any assertion or determination that all or any of the following documents, either jointly or severally, constitute a mortgage or other security device(s) or instrument(s).”

The purchaser-lessor in a sale-leaseback transaction may request a “recharacterization” endorsement to the owner’s policy, which may or may not be available depending on the particular facts of each transaction and applicable legal and regulatory restrictions. The title insurer may, under certain circumstances, be persuaded to issue such an endorsement. The recharacterization tests applied by federal and state courts (including bankruptcy courts, as set forth above, can serve as a useful guideline for title insurers when analyzing the risks of the transaction and evaluating whether and under what circumstances, if any, to issue a recharacterization endorsement and evaluate claim exposure. If the title insurer agrees to issue such an endorsement, it would need to closely investigate and analyze the facts of the transaction and also the

underlying documentation, with the level of inquiry depending on factors such as the identity of the parties and the authorization of designated individuals to act on behalf of those parties, the size and scope of the transaction and amount of the policy (or policies) to be issued, and any unusual risks inherent in the transaction. The parties would need to supply the title company with written statements, certifications, and/or affidavits that fully disclose and explain all of the details and risks of the transaction, and written indemnifications in favor of the title insurer may also be required. As mentioned earlier, the recharacterization tests applied by the bankruptcy courts can serve as a useful guideline for title insurers when analyzing the risks of the transaction. A copy of a recharacterization endorsement is attached hereto as **Exhibit "A."**

EXHIBIT "A"

RECHARACTERIZATION ENDORSEMENT

ATTACHED TO POLICY NO.

ISSUED BY

First American Title Insurance Company

Notwithstanding exception _____ of Schedule B, the Company hereby assures the insured that, in the event of a final determination by a court of competent jurisdiction that the deed dated _____ and recorded as Instrument No. _____ and the lease shown as exception ____ of Schedule B, create a mortgage as of Date of Policy from the lessee in favor of the lessor under the lease with a priority date as of Date of Policy, the insured shall have (in place of and instead of the rights and obligations under this policy) all of the rights and obligations of an insured under an ALTA Loan Policy (Rev. 10-17-92), insuring said mortgage as a lien against the land as of Date of Policy with an amount of insurance of \$ _____, subject to no exceptions other than those set forth in Schedule B and any statutory lien or right to a lien for services, labor or material heretofore or hereafter furnished for an improvement or work related to the land.

This endorsement is made a part of said policy and is subject to all of the terms and provisions thereof and of any prior endorsements thereto. Except to the extent expressly stated, it neither modifies any of the terms and provisions of the policy and any prior endorsements, nor does it extend the effective date of the policy and any prior endorsements, nor does it increase the face amount thereof.

First American Title Insurance Company

BY: _____
AUTHORIZED SIGNATORY

FA Special Recharacterization Endorsement (2-2-98)
ALTA Owner's Policy (10-17-92)