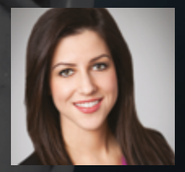
Form v Function: Recharacterisation of contracts in the UK and US

BY MARK ARNOLD QC & CO-AUTHORED WITH THE FOLLOWING TEAM FROM WEIL, GOTSHAL & MANGES

MARK LAWFORD
Partner – London

PETER ISAKOFF
Partner – Washington

ALINTA KEMENY
Associate – London



ELISABETH SPERLE
Associate – New York

PATRICK STEEL
Associate – New York

Apart from being divided (supposedly) by a common language, the laws of the UK and the US take a different approach to the recharacterisation of contracts.

In particular, it is said that the UK takes the *formal* approach, while the US adopts the *functional* approach. Typically, the question arises when the true character of a financing agreement falls to be determined: assuming it matters, is the transaction one which creates an absolute interest (e.g. by way of sale) or one which is less than absolute (e.g. a security interest)? But what does it mean to adopt a functional, as opposed to a formal, approach in this context? In this article, we propose to explore that distinction.

The formal approach: recharacterisation in English law

In English law, characterisation in this context is the process whereby the court determines the legal nature of a particular transaction. Recharacterisation occurs where the parties to the transaction have purportedly characterised it as creating one kind of interest but the court characterises it, as a matter of law, as creating a different kind of interest. In such instances, recharacterisation does not actually change the legal nature of the transaction, which remains the same throughout; rather it corrects mischaracterisation, and associated mislabelling, by the parties.

Typically, the English Courts have had to embark on the process of recharacterisation in circumstances where, usually by virtue of the provisions of a statute, the transaction will be void unless registered if, for example, it is to be characterised as creating a security interest. Such questions have arisen in the context of determining the application and effect of the provisions of the Companies Act 2006 and its predecessors, the Bills of Sale Acts 1878 and 1882 (in relation to individuals) and the Moneylenders Act 1927 (since repealed). In addition, however, recharacterisation becomes relevant if, while not void, the rights conferred by the transaction may be less effective if, for example, it is to be characterised as a floating rather than a fixed charge.

There are many ways of raising cash besides borrowing

In the financing context, English law recognises that there are many ways of raising cash besides borrowing. Merely to recognise a transaction as a financing transaction, therefore, does not assist in the task of characterising that transaction because, under English law, financing can perfectly well be effected in different ways. As Lord Devlin once said[1]: *"There are many ways of raising cash besides borrowing … If in form [the transaction] is not a loan, it is not to the point to say that its object was to raise money … or that the parties could have produced the same result more conveniently by borrowing and lending money."*

Substance over form means looking at the words used in the context of the transaction as a whole

Judges have often said, as Romer LJ did,[2] that the English Court is concerned with substance rather than form, but this must be understood in its proper context. In ascertaining the substance of a transaction, the English Court is concerned initially and – unless it is found to be a sham – almost exclusively with the provisions of the written agreement entered into by the parties. In other words, it is concerned with the language used by the parties considered in the context of the transaction as a whole.[3] The only apparent exception to this approach to date is that which was adopted by Knox J in *Re Curtain Dream plc*,[4] but it is suggested that this decision is now of questionable authority and it seems unlikely that it would be followed.

The English law approach in summary

The approach adopted under English law when recharacterising a transaction may be summarised as follows:

- The English Court will first ascertain whether the written agreement between the parties is a sham;[5] that is, it neither accurately reflects the true agreement between them and nor is it intended by the parties to do so.[6]
- If the agreement is found to be a sham, the English Court will ignore the written agreement and seek to ascertain the real agreement between the parties by reference to other extraneous evidence instead.[7]
- If the agreement is found not to be a sham, the English Court will construe its provisions for the purpose of ascertaining the legal rights and obligations they create and impose. As this involves questions of interpretation, the Court is concerned to determine the intentions of the parties, ascertained objectively, by reference to the words they have used taking into account the relevant factual matrix where appropriate.
- Having determined the rights and obligations created and imposed by the written agreement, the English Court will then classify, or characterise, the agreement. That is a matter of law, rather than being dependent on the intentions of the parties.[8] If, in other words, the parties have characterised and labelled

1. *Chow Yoong Hong v Choong Fah Rubber Manufactory* [1962] AC 209 (PC).
2. *In re George Inglefield* [1933] 1 Ch 1 (CA).
3. *McEntire v Crossley Brothers Limited* [1895] AC 457 (HL); *Lloyds & Scottish Finance Ltd v Cyril Lord Carpets Sales Ltd* [1992] BCLC 609 (HL); *Welsh Development Agency v The Export Finance Company Limited* [1992] BCLC 148 (CA).
4. [1990] BCLC 925.
5. *Welsh Development Agency v The Export Finance Company Limited* [1992] BCLC 148 (CA).
6. *AG Securities v Vaughan* [1990] *1 AC 417 (HL); Snook v London and West Riding Investments Ltd* [1967] 2 QB 786 (CA).
7. *Orion Finance Limited v Crown Financial Management Limited* [1996] BCLC 78 (CA).
8. *Agnew v Commissioner of Inland Revenue* [2001] 2 AC 710 (PC); *Smith (Administrator of Cosslett (Contractors) Ltd) v Bridgend County Borough Council [2002]* 1 AC 336 (HL).

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their written agreement inconsistently with its true legal character having regard to the rights and obligations for which it provides, the parties' own label will be ignored.

- That is not to say that the labels adopted by the parties will be ignored in all circumstances. If it is found that the true character of the transaction, as a matter of law, is consistent with the label used by the parties, the English Court will accept the parties' label.[9] Indeed, it will generally be slow to reject the label when considering a *bona fide* mercantile document issued in the ordinary course of business.[10]

Legal substance over economic effect

When the English Court speaks of substance in this context, it refers to the legal substance of the transaction. It is emphatically not concerned with its economic substance or commercial effect, but rather with its legal nature. The economic or commercial effect of the transaction is irrelevant to the process of determining its legal character, as a matter of English law.[11]

Thus, under English law, the sale and leaseback arrangement, for example, is a well-recognised financing transaction, the purpose of which is to raise funds. In the absence of any evidence that such an arrangement is a sham, or unless it can be demonstrated that no absolute transfer of title by way of sale has taken place, the English Court will generally not recharacterise it as a loan arrangement, whether secured or unsecured. The mere fact that the economic or commercial effect of a sale and lease-back arrangement is the same as that of a secured lending arrangement is insufficient to justify its recharacterisation as such, as a matter of English law. As already stated, these matters are irrelevant to the process of determining the legal character of the transaction under English law.

Objective determinative legal criteria

In some contexts, without there being any question of sham, there are objective criteria by reference to which English law will determine whether or not the agreement made by the parties does fall into the legal category in which they have sought to place it. For example:

- A lease will be distinguishable from a licence if the agreement, properly understood, confers on the grantee an exclusive right of occupation of the property.[12]
- A fixed charge over book debts will be distinguishable from a floating charge according to whether the chargor retains the ability to collect them and use their proceeds in the ordinary course of its business.[13]

Despite attempts, however,[14] no such determinative indicia have so far been identified which serve determinatively to distinguish a sales transaction from secured lending arrangements. In particular, the existence of what is effectively a right of redemption may not be determinative as the parties to a contract of sale can lawfully provide that, in certain circumstances and for a sum ascertained or ascertainable, the seller may repurchase from the buyer the property originally sold.[15] The same apparently holds true even if the seller is obliged to repurchase the property (e.g. as part of a repo transaction).[16]

So much, then, for the approach to recharacterisation under English law. Time now to contrast it with the approach adopted under US law.

The functional approach: recharacterisation under US law

Recharacterisation under US law specifically applies to lease agreements and often arises in the context of US bankruptcy proceedings. In particular, a debtor in bankruptcy may seek to recharacterise a lease agreement as a security interest by establishing that the economic substance of the transaction is consistent with a security agreement as opposed to a true lease.[17] In doing so, the US court takes a "*functional*" rather than a "*formal*" approach to the interpretation of the agreement. In contrast to the position under English law, recharacterisation by the US court changes the legal nature of the transaction.

The context of applications to recharacterise

The issue of recharacterisation often arises in the context of real estate transactions, equipment leasing and financing. In a bankruptcy context, the characterisation of the agreement is relevant as:

- if an agreement is a true lease, then the debtor would be obliged to assume the lease (i.e. continue to perform its obligations under the lease) or reject the lease; and
- if an agreement is a secured financing, then the debtor would own the property and the relevant creditor (or lessor) would have a secured or unsecured claim against the debtor.

Essentially, the US Bankruptcy Code distinguishes between financial versus economic distress, effectively treating the date of bankruptcy as the creation of a new firm unburdened by its predecessor's debts. "*The new firm must cover all new expenses, while debt attributable to former operations is adjusted.*"[18] Leases are treated as "*new*" expenses while debt service is treated as an "*old*" expense and adjusted for financial distress.[19]

Considering the US policy of affording disparate treatment to leases versus security interests, courts generally frown on attempts by parties to avoid the intended consequences of the Bankruptcy Code by entering a lease to cover what in economic substance is a secured financing. As one court put it, "[W]*hy bother to distinguish transactions if these distinctions can be obliterated at the drafters' will?*"[20] Another court noted that *"refusing to defer to the intent of contracting parties in resolving whether their agreement is a lease is particularly appropriate in bankruptcy"* because *"every dollar that is used to pay a purported lessor depletes the pool of assets available to pay other constituencies of the estate."*[21]

> "US courts generally frown on attempts by parties to avoid the intended consequences of the Bankruptcy Code by entering a lease to cover what in economic substance is a secured financing"

Benefits of recharacterisation

There are myriad circumstances that may result in a party seeking to recharacterise a lease as a secured financing, particularly to gain a strategic advantage by using or avoiding an aspect of the Bankruptcy Code. While this article does not purport to discuss all strategic advantages, recharacterisation could accomplish any number of goals:

- By recharacterising a lease into a security interest, the debtor-lessee is now deemed to have legal title to and ownership of the asset. Conversely, the creditor-lessor would no longer have purported ownership of the asset. Instead, the creditor-lessor is left with a secured claim, or possibly even an unsecured claim.
- By owning the asset outright, the debtor-lessee could, among other things and with varying degrees of creditor consent and payment to the creditor, (1) sell the asset free and clear of all liens and interests, (2) retain the asset and devise a plan of reorganization to cram down or otherwise impair the creditors' claim, or (3) retain the asset but refinance the "*financing arrangement*" on better terms with another lender. These strategies could essentially permit the debtor to restructure the "*financing arrangement*" provisions unilaterally if advantageous, in contrast to a lease which generally cannot be modified without lessor consent.
- Without recharacterisation, a debtor-lessee is required under the Bankruptcy Code to eventually assume or reject the leased asset. This ties in directly to whether the debtor could maintain control of the leased asset: assumption would allow the debtor to keep the asset, whereas if the debtor rejected the asset, they would have to relinquish control back to the lessor.[22]

9. *Welsh Development Agency v The Export Finance Company Limited* [1992] BCLC 148 (CA).
10. *MacWilliam Inc v Mediterranean Shipping SA* [2005] AC 423.
11. *Lloyds & Scottish Finance Ltd v Cyril Lord Carpets Sales Ltd* [1992] BCLC 609 (HL); *Welsh Development Agency v The Export Finance Company Limited* [1992] BCLC 148 (CA); *Polly Peck International plc (in administration)* [1996] 2 ALL ER 433; *Socimer Bank Ltd v Standard Bank Ltd* [2008] Bus LR 1304.
12. *Street v Mountford* [1985] AC 809.
13. *Agnew v Commissioner of Inland Revenue* [2001] 2 AC 710 (PC); *Smith v Bridgend County Borough Council* [2002] 1 AC 336 (HL); *In re Spectrum Plus Ltd (in liquidation)* [2005] 2 AC 680 (HL).
14. *In re George Inglefield* [1933] Ch 1 (CA), per Romer LJ at 27-8.
15. *Welsh Development Agency v The Export Finance Company Limited* [1992] BCLC 148 (CA); *Manchester, Sheffield and Lincolnshire Railway Co v North Central Wagon Company* (1888) 13 App Cas 554 (HL, citing *Alderson v White* (1858) 2 D&J 97).
16. *Mercuria Energy Trading Pte Ltd v Citibank NA [2015] 1 CLC 999.*
17. *United Airlines, Inc. v. HSBC Bank USA, N.A.*, 416 F.3d 609, 612-15 (7th Cir. 2005) ("United Airlines I").
18. Id. at 613.
19. Id. at 612-14.
20. Id. at 612.
21. *In re Pillowtex, Inc.*, 349 F.3d 711, 722 (3d Cir. 2003).
22. Assumption and rejection each could carry material risks. Under some circumstances, assumption could lead to litigation over an amount required to cure any of the lessor's potential damages claims in connection with the lease, and could be vigorously contested—this is particularly true if the asset is essential to the debtor's business operations, and the creditor is aware of this. Alternatively, rejection could result in an outsize rejection damages claim, as rejection constitutes a prepetition breach of contract, that would have to be litigated to avoid eclipsing other claims against the debtor. This latter risk would be compounded with the fact that the debtor would no longer have control of the asset, and therefore, could no longer use the asset going forward as a method of generating income or value to the estate.

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The test for recharacterisation

The burden of demonstrating that a lease is a financing agreement rests with the party challenging the lease.[23] Typically, "[w]*hether an agreement is a true lease or a secured financing arrangement under the Bankruptcy Code is a question of state law.*"[24] To determine which state's laws apply, US courts look first to the underlying contract at issue for provisions specifying what law governs.[25]

While resorting to state law might seem to create the potential for different approaches to addressing this issue – US bankruptcy courts almost invariably take a functional approach with respect to the issue of recharacterisation.[26] This is because (1) state law is largely consistent in this regard, and (2) if state law provided for a non-functional approach, a court would likely find such approach to conflict with the US Bankruptcy Code and disregard it.

With respect to state law, one reason for such uniformity—at least as it pertains to goods—is state adoption of Section 1-203 of the Uniform Commercial Code ("UCC")[27], which provides for determination of whether a transaction is a lease or a security interest based on a functional analysis of the economic substance of the transaction.[28] In particular, the UCC states that whether a nominal "*lease*" creates a lease or security interest is to be "*determined by the facts of each case.*"[29] It also provides a two-part test to determine if a lease creates a security interest per se: a transaction creates a security interest "*if the consideration that the lessee is to pay the lessor for the right to possess and use goods is an obligation for the term of the lease and is not subject to termination by the lessee*"[30] and one of four other factors exist. Those four factors relate to whether residual value remains for the lessor at the end of the lease. To the extent that the property has little or no remaining value at the end of the lease, the transaction is more likely to be deemed a sale of property by the lessor to the lessee that is financed by the lessor (i.e. recharacterised as a financing transaction rather than a true lease).

Where lease transactions do not create a security interest per se under the particular state's version of the UCC or if the transaction at issue is not subject to the particular state's version of the UCC, courts generally look to the economic reality of the transaction.[31] Although the precise nature of the approach, including the factors to consider and weight to afford them vary, courts will typically look for *indicia* of a security interest by considering factors such as whether the lessee assumes and discharges substantially all the risks and obligations usually associated with outright ownership and whether rental payments are essentially payments of principal and interest rather than designed to compensate for the value of the property.[32] The issue of whether the lessor has a meaningful residual interest in the goods or property at the end of the lease term will often remain a central focus.[33]

Moreover, if state law required a formal, rather than a functional approach, it would likely not be followed in the bankruptcy context because of the federal policy in favour of treating such arrangements differently. Indeed, a number of courts have stated that if state law is inconsistent with federal law and the Bankruptcy Code, federal common law will apply.[34]

Recharacterisation in practice

A pair of cases in the context of the United Airlines bankruptcy demonstrate how recharacterisation works in practice in the United States. In each instance, the parties disputed whether the transactions at issue were loans or leases, and the Seventh Circuit determined that based on the substance of the particular transactions, they were appropriately characterised as secured loans and not leases.[35] The same five factors supported the court's ruling in each case:[36] First, United's "*rent*" was linked at least indirectly to the amount borrowed, making it more like a loan payment than a traditional rent payment where rent is based on the market value of the property.[37] Second, the transactions at issue both involved balloon payments – the Seventh Circuit noted that "*the balloon payment has no parallel in a true lease, though it is a common feature of secured credit.*"[38] Third, the agreements contained "*hell or high water*" clauses – which stand in contrast to typical lease provisions that might provide for rent to be abated if property is uninhabitable or unuseable.[39] Fourth, the arrangements provided that the lease would terminate in the event of prepayment. Notably, "*such a prepayment/termination provision would be superfluous in the context of a lease*" because "*[i]t would make little economic sense for a lessee to prepay its full rental obligations and thereby cause its lease to terminate and the value of its prepayment to evaporate.*"[40] Finally, the court considered the fact that the lessor would not have any remaining interest in the property at the end of the transaction as further indication that the true nature of the arrangements were akin to those of a loan.[41] As the United Airlines cases demonstrate, US courts will look to the facts of the case to see whether what was nominally a lease transaction appeared in substance to be a secured financing.

Conclusion

Recharacterisation under both English law and US law, therefore, requires analysis of the substance of the transaction and, to that extent, they share a common approach. Where they differ, however, is in identifying what constitutes the substance for these purposes. While the US court will closely investigate the economic substance, its English counterpart will focus instead on legal substance to the exclusion of economic or commercial effect. ■

23. *In re Montgomery Ward*, 469 B.R. 522, 528 (Bankr. D. Del. 2012).

24. *Pillowtex*, 349 F.3d at 716; see also *Montgomery Ward*, 469 B.R. at 528-29.

25. See, e.g., *Pillowtex*, 349 F.3d at 716.

26. Although one commentator has argued that the Third Circuit does not consider substance to control, such conclusion seems questionable. See 3 *Collier on Bankruptcy* ¶ 365.02[3] (16th ed. 2018). The only authority cited by *Collier* on this point is *Revel AC, Inc. v. IDEA Boardwalk LLC*, 802 F.3d 558 (3d Cir. 2015). In that case, the Third Circuit never stated that form controlled over substance. Rather, after stating that the debtor had failed to present any argument that created an objective dispute that a "*true lease*" was absent, the Third Circuit pointed out that a provision of the applicable agreement stated that nothing in the lease should be read as creating a relationship other than that of landlord and tenant. See *Revel*, 802 F.3d at 574. Moreover, the Third Circuit has historically followed state law requiring consideration of the economic reality of the transaction. See Pillowtex, 349 F.3d at 719.

27. The UCC, which may be adopted by states with or without modification, covers a range of commercial transactions, including transactions pertaining to goods. "Goods" are defined under the UCC to mean "all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities [] and things in action" and include "the unborn young of animals and growing crops and other identified things attached to realty as described in the section on goods to be severed from realty." UCC § 2-105. With limited exception, the UCC generally does not apply to real estate transactions. See David Frisch, Lawrence's Anderson on the Uniform Commercial Code § 1-101:44 (3d. ed.).

28. See *In re WorldCom, Inc.*, 339 B.R. 56, 63-64 (Bankr. S.D.N.Y. 2006) (noting that the UCC is intended as a uniform law, permitting courts to consider decisions from other courts).`

29. UCC § 1-203(a).

30. Id. at § 1-203(b).

31. *Pillowtex*, 349 F.3d at 717-20; *Montgomery Ward*, 469 B.R. at 529-30; *In re Grubbs Const. Co.*, 319 B.R. 698, 711, 715 (Bankr. M.D. Fla. 2005).

32. *Montgomery Ward*, 469 B.R. at 529-30; In re *PCH Assocs.*, 804 F.2d 193, 199-200 (2d Cir. 1986); S. Rep. No. 95-598, 64, 95th Cong., 2d Sess. (1978).

33. See *In re Lasting Impressions Landscape Contractors, Inc.*, 579 B.R. 43, 51-54 (Bankr. D. Md. 2017).

34. See, eg, *United Airlines I*, 416 F.3d at 615; *Montgomery Ward*, 469 B.R. at 528-29 n.3.

35. In analysing the complex series of transactions at issue in these cases, the Seventh Circuit did not analyze California's UCC; however, it noted that an approach similar to the UCC is taken under state common law in United Airlines I: "To find state law we must examine California's statute books and the decisions of its judiciary. California has enacted the UCC; there can be no doubt that it uses a functional approach to separating leases from secured credit with respect to personal property. California takes a similar approach for real property as a matter of common law." United Airlines I, 416 F.3d at 616.

36. See *United Airlines I*, 416 F.3d at 617; I*n re United Airlines*, 447 F.3d 504, 507 (7th Cir. 2006) ("*United Airlines II*").

37. *United Airlines II*, 447 F.3d at 507-08.

38. Id. (quoting *United Airlines I*, 416 F.3d at 617) (internal quotation marks omitted).

39. Id. at 508-09.

40. Id. at 509.

41. Id.