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Lease Recharacterization *Financial Leases in the Coming Wave of Restructurings*

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Overview

- Sale-leaseback transactions have become a significant source of alternative financing for ship owners
- Take place frequently through bareboat charter arrangements
- In the event that the party chartering the vessel (seller-lessee) files for bankruptcy protection in the United States, the sale-leaseback may be challenged
- The bankruptcy court would evaluate whether the charter represents a “true” lease or a disguised financing
- Recharacterization can have a significant negative impact on an owner-lessor
 - If a bankruptcy court determines that a sale-leaseback is a disguised financing, it would deem the vessel to be the property of the seller-lessee (i.e., the debtor), rather than the owner-lessor (i.e., the creditor)
 - The vessel would then be subject to the automatic stay in the bankruptcy proceeding, which means the former owner-lessor would be prohibited from pursuing collection efforts throughout the pendency of the case (absent relief from the bankruptcy court)
 - The purchase price paid for the property would be deemed a loan to the seller-lessee, limiting the owner-lessor to a claim for repayment against the bankruptcy estate
 - If the owner-lessor did not perfect a security interest in the property (which seems likely, given that the owner-lessor generally relies on title as security), that claim could be deemed unsecured

Lykes Bros. Steamship Co.

- The seminal case considering lease recharacterization in the shipping industry is American President Lines, Ltd. v. Lykes Brothers Steamship Co., 216 B.R. 856 (M.D. Fla. 1996)
- Debtor Lykes Bros. Steamship Co. (“Lykes”) had purchased 4 vessels from Mitsubishi (1) and Mitsui (3), each with a construction cost of \$41mm
- Lykes financed the purchase, and owed Mitsubishi and Mitsui \$198mm over 15 years (\$49.5mm/vessel, \$8.5mm greater than purchase price per vessel)
 - The court noted that Lykes was essentially compelled to find financing
- It could not sell; sale was not economically compelling, plus had chartered vessels on to a third party (APL) which was operating the vessels on a MARAD subsidy, which only APL could continue
- Lykes entered into sale-leaseback transaction with certain financing institutions, collectively referred to as Blue Water

Lykes Bros. Steamship Co.

- Agreements with Blue Water were titled “Bareboat Charters”
- The transaction contemplated that:
 - Lykes conveyed title to a trustee for the benefit of Blue Water
 - Blue Water chartered vessels back to Lykes
 - Blue Water assumed the M&M debt, and loaned \$14.2mm to Lykes
 - Lykes was to make 178 monthly payments to Blue Water which matched exactly the debt owed to M&M
 - At the beginning of month 179, Lykes had two options
 - Continue making daily charter payment until the end of the charter period (5 years) for a total of \$91 million (\$4.5 million per year per vessel) or
 - Exercise a purchase option for the vessels equal to the greater of (i) \$44 million or (ii) the FMV of the vessels

Lykes Bros. Steamship Co.

- Other terms included:
 - Lykes bore risk of total loss; Blue Water could reconvey vessels to Lykes in exchange for payment of balance of M&M debt plus a stipulated loss payment
 - Lykes could not purchase the vessels during the first 178 months, and had no right to terminate during that period
 - Lykes entered into tax indemnity agreement in favor of Blue Water, guaranteeing Blue Waters net economic return after taxes (including indemnification for any increase in the federal income tax rates)
- Lykes filed bankruptcy, and ultimately asserted that the transaction between Lykes and Blue Water was a financing transaction and not a true lease
- Sought to quiet title on four vessels and deem them owned by Lykes

Lykes Bros. Steamship Co.

- The court reviewed the transaction under New York state law, the governing law under the documents
- Court noted that NY courts usually utilize a two part test
 - First, can lessee become owner for little or no additional consideration?
 - If no, court looks to other factors, i.e., the “economic substance” of the transaction
- Part 1: Is option to purchase nominal?
 - One dollar option is nominal
 - Nominal compared to total rental payments
 - Nominal compared to original purchase price
 - Nominal if lessee has no sensible alternative but to exercise the option
 - Nominal compared to FMV at time of exercise

Lykes Bros. Steamship Co.

- Court conceded that amount at bar was not facially nominal, but had to be viewed in the context of the entire deal
- However concluded that “it would have made no sense for Lykes to pay \$91 million in rent for the five years...when it could purchase the vessels...for the greater of their fair market value or \$11.1 million each.”
- While the court seemingly concluded that the purchase option was nominal, it proceeded to consider other factors indicative of the true nature of the Blue Water transaction
- Part 2: What is the economic substance of the transaction?
 - Which party bore the risk of loss during the term of the lease?
 - Did the “lessor” have input on the selection of the equipment and its purchase?
 - Which party was required to pay taxes and maintain the equipment?
 - Whether the agreement grants the “lessor” the right to accelerate the rents, to sell the collateral, and to hold the “lessee” liable for the deficiency?
 - Whether the “lessor” was in the business of leasing
 - Whether the “lessee” was required to indemnify the “lessor”
 - Whether the “lessee” was required to insure the property
 - Whether the equipment was custom designed for the “lessee’s” use
 - Whether the equipment would have value to other users
 - Whether the payments were designed to guarantee a rate of return
 - Whether the initial purchase price was related to the value of the assets
 - Whether the transaction was structured as a lease to secure tax advantages

Lykes Bros. Steamship Co.

- In sum, the court considered all of the relevant factors, and determined that Lykes was entitled to judgment as a matter of law
- It is notable that in this case, virtually every fact weighed against finding that the transaction was a true lease
- While the purchase price was not nominal in amount, Lykes was economically compelled to purchase the vessels at the end of the lease term
- All other terms favored a financing
- The court took particular note of the origins of this transaction, mentioning that Lykes had no choice but to find financing
 - Appears as though this was a compelling fact to the court

Recent Mention

- Recharacterization is frequently raised, although clearly infrequently litigated
- Recently framed the settlement in the In re Prospector Offshore Drilling cases
- Debtors stated in their motion to approve the settlement agreement that
 - “In addition, the settlement allows the Debtors to avoid the costs and delay associated with a potentially fact-intensive and protracted litigation to realize the true nature of the Sale-Leaseback Agreements by recharacterizing them as secured financings. Such a litigation would involve substantial submissions and debate as to (1) the approach English law takes on the issue of whether and when a lease may be recharacterized as a secured financing transaction, (2) whether the English law approach to that issue is inconsistent with the functional approach to that issue required under the Bankruptcy Code, and (3) whether under that multi-factor functional approach that focuses on the economic substance of the transaction, recharacterization of the leases at issue here as secured financing transactions would be warranted.”



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