

Caveat Emptor: Let the Buyer Beware A "Sale" May Not Really Be a Sale

State and federal laws regulate loan interest rates in a variety of contexts. This simple, unsurprising concept should not be news to anyone engaged in business, whether as a lender or borrower. What may be news however is that there are a wide array of circumstances in which parties document a sale of something - be it accounts receivable, stock, inventory, or other property - and later learn that legally, their sale was not a sale at all. Instead, they learn (perhaps from a court, in which case it may be too late) that the sale was, in substance, a loan. In such an event, the purported buyer may have cause for concern.

Penalties for violation of laws regarding disclosures and lender licensing are but a few of the issues that can arise when an alleged sale is recast as a loan. Where a buyer/lender finds that a sale may in fact be a loan, they may also have the displeasure of learning the legal meaning of a host of new phrases, like "contrivance to evade," "economic duress," and "usury."

Understandably, buyers are keen to try to eliminate risk from investments. For this reason, buyers increasingly seem to want to keep an escape hatch nearby - something that says if the investment doesn't work out, they can unwind the deal and get their money back. Keeping in mind however that a court may be underwhelmed by the labels parties and their attorneys ascribe to a sale transaction, it is important for parties to any financing arrangement that is not intended as a loan to ensure that the financing structure they are erecting functions, in substance, as a sale. Here are some basics:

A. General Distinctions Between a Loan and True Sale

1. How Important Are Transactional Labels?

Whether the parties intended outright sales or loans for security is determined from all the facts and circumstances surrounding the transactions at issue. Case law is rather clear that labels ascribed by the parties to the transaction cannot change the true nature of the transaction. While consideration of the labels placed on the transaction is a factor to be considered by a court, such labels frequently carry little weight, particularly where the labels are conflicting -- in some places suggesting a sale and in other places suggesting a loan.

2. The Importance Of The Allocation Of Risk

Courts consider a number of factors in ascertaining the true nature of a transaction. In the end, the analysis will be directed in large

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measure towards a determination of which party bore contractually, the economic risk of loss, and how the parties conducted themselves during the life of the subject agreements.

Some of the factors courts commonly consider in ascertaining whether a transaction is a loan include, among other things, whether the agreement provides for a guaranteed rate of return; whether the agreement calls for the repayment of principal and interest; whether periodic payments are contemplated; the availability of recourse against the "seller"; any indemnification of the buyer by the seller; whether repayment of principal extinguishes liability on the part of the seller; whether, in fact, the assets purportedly "sold" were, in fact, transferred to the buyer; which party is entitled to any surplus of funds; and treatment of the transaction for tax purposes as a loan rather than a purchase.

On the other hand, factors that might be more suggestive of a true sale can include, among other things, the buyer's ability to sell what it has acquired; that the conveyance of the thing sold extinguishes the seller's liability; whether the buyer bears the risk that the value of the acquired assets is not realized; and whether buyer has rights to surplus.

3. Conduct During The Life Of The Transaction

Courts considering whether to recast a purported sale as a loan may also be interested in how the parties behaved during performance of the subject contracts. Whether, for example, mechanisms for effectuating leasebacks or puts was documented, and actually followed, may be an important indicator that the labels bore either great or little meaning to the parties. It may also color the court's analysis accordingly, as might documentation reflecting the actual transfer of title to, and control over, the thing sold.

B. What Difference Does It Make Whether a Transaction Was A Loan Or A Sale, So Long As It Was A Contract?

What difference does it make whether a transaction was a loan or a sale, so long as it was a contract? The answer to this question is stated at the outset of this article: State and federal laws regulate loan interest rates in a variety of contexts. For instance, under the so-called "time-price doctrine" (which, in a nutshell provides that a seller can sell and a buyer can buy for whatever consideration they agree to, including any interest rate they like), a sale would not be subject to usury restrictions. A loan on the other hand may be. In a state where usury penalties are severe, the end result may mean that the escape hatch that was intended to enable the investor to get its money back may turn the tables on a lender/buyer by eliminating all income on their investment, or in some instances, even a loss of principal.

For those firms involved in receivables financing under documents reflecting a purchase/put option regime, the recharacterization of a sale as a loan may also expose the erstwhile "buyer" to banking and lending licensing requirements, perhaps in every state in which they operate. There are a host of other laws and regulations that may apply on a case by case basis depending on the jurisdictional law governing the transaction, the nature of the collateral pledged, the identity of the seller/borrower (whether consumer or commercial for instance), the need for certain statutory disclosures to be made, and the list goes on.

C. Bankruptcy Considerations

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There are of course buyers/lenders who may feel secure in their relationship with their seller and consequently give short shrift to the risks of recharacterization of a transaction. To do so is at one's own peril. In the event of a bankruptcy, whether forced on the "seller" or commenced voluntarily, the "buyer" can rest assured that creditors facing a severe loss, or a trustee, may press the matter.

D. Conclusion

Parties considering entering into a financing transaction calling for the purchase, and later leaseback or other reconveyance, of the real property, stock, accounts receivable, or other assets they purport to buy should be mindful that doing so can be a delicate endeavor. Ensuring both that a true sale is documented, effectuated and performed, and that the parties comport themselves in a manner consistent with a transfer of title during the life of the transaction, can be of paramount significance, particularly in the event that the investment eventually underperforms.

