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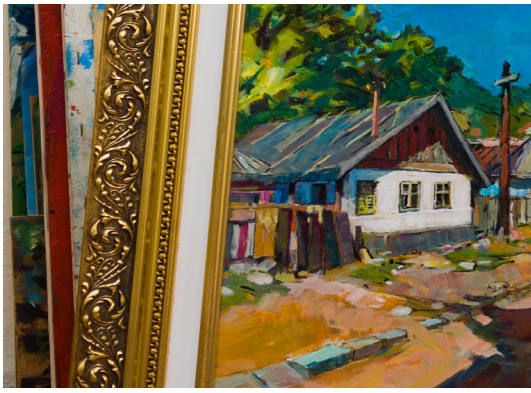
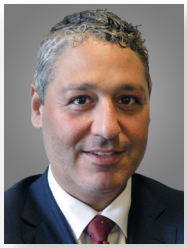


A Loan by Any Other Name…

Mathew Hoffman



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Mathew Hoffman is a senior litigator at Barton LLP who has represented such diverse clients as the National Basketball Association, Art Finance Partners, the American Society of Travel Advisors, Sauder Furniture, La-Z-Boy and Underwriters Laboratories.

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Like many mergers, the merger of sale-leasebacks and art financing looks irresistible from a distance. However, a recent New York appellate decision (*Shagalov v. Edelman*, 161 A.D.3d 455 (N.Y. App. Div. 2018) obtained by our firm not only highlights the danger of the merger, but also establishes a precedent that should caution financiers when using sale-leasebacks.

Sale-leasebacks are a well-accepted method of corporate financing, particularly for real estate and machinery. In sale-leaseback financing, the asset owner sells it to a financing source, which in turn leases the asset back to the original owner. The original owner becomes the lessee while the financier becomes the lessor. While corporate debt involves loans that impact the balance sheet or the sale of equity, which lessens ownership, a sale-leaseback avoids both drawbacks. It has been noted: "This is much like the corporate version of a pawnshop transaction."[1] However, there is a critical difference between a standard sale-leaseback and a pawnshop loan. If one pawns an item, the pawnshop keeps the item as collateral. In the standard sale-leaseback, the original owner traditionally maintains possession of the asset that he sells.

Since the sale-leaseback is a financing device, the lessor bears a risk. Should the lessee file for bankruptcy, the transaction could be recharacterized as a secured loan and the lessor's title to the property would be challenged. See *In re Ajax Integrated, LLC*, 554 B.R. 568, 577 (Bankr. N.D.N.Y. 2016). However, we are unaware of any case where the debtor himself ever challenged a transaction (until we did).

Like corporations that own real estate or machinery, many major art purchases require financing. Potential buyers who seek to acquire pieces beyond their present means may use financing to purchase pieces for their collections or hoping to flip the piece after an increase in value. Art dealers use loans to finance their inventories. Other owners use art as collateral to establish a line of credit. Indeed, various businesses and wealthy individuals have begun using art financing as a means of funding investments in more traditional businesses. With private lenders (like our client Art Finance Partners), banks and the auction houses all taking active roles, art financing has become an incredibly important component in the art market.

Like sale-leasebacks, art financing has been described as pawnshop transactions. In fact, the *New York Times* article about art financing was entitled "That Old Master? It's at the Pawnshop."[2] In art financing, art is collateral for a loan. The lenders seek to control the collateral. Art lenders are often lenders of last resort and defaults are not uncommon. If the lender can take possession of the art, it is available to be sold in the case of default. Further, if the lender takes possession of the art during the life of the loan, the risk that the art will be double pledged after the loan is made is minimized.[3]

There seemed to be a natural fit. Why not use the sale-leaseback structure to finance art purchases? The benefits for the entity providing financing are apparent. Where a sale-leaseback structure is used, the financier does not have to abide by the requirements of Article 9 of the Uniform Commercial Code which are applicable

to secured loans. According to Artemus, LLC, an art financier, the advantages to the art owner include lower interest rates than would ordinarily be charged on art loans, a higher loan-to-value ratio than was available on standard art loans and critically, that under a sale-leaseback (unlike an art loan), the original owner maintained possession of the art.

Anatole Shagalov was a well-known art dealer and collector. Shagalov and his entity Nature Morte (together "Shagalov") and Artemus, LLC, entered into a series of transactions resulting in the financing of artworks that had been purchased by Shagalov worth millions of dollars. As is typical in sale-leasebacks, there were two agreements: a Purchase and Sale Agreement ("PSA") and a lease. The PSA referred to Shagalov as the "Seller" and Artemus as the "Buyer." Those terms, and not Borrower and Lender, were used over 100 times. Shagalov transferred all of his rights in the art to Artemus for a purchase price of several million dollars. Under the Lease and Possession Agreement, Shagalov agreed to pay Artemus monthly and had the right to repurchase the art. Superficially at least, the transaction looked as if it were a standard sale-leaseback – with at least one critical distinction. Until Shagalov repurchased the art, the art adorned the walls of Artemus' principal's home office.

In 2017, Artemus alleged that Shagalov defaulted and they began selling the art. Artemus did not give Shagalov notices of disposition and right to redeem the collateral under UCC Section 9-611, 9-613 and 9-623 that were required only if the transaction was a loan. These Sections were designed to do exactly what Shagalov wanted – give him the right to buy back his art and/or monitor any sales to third parties to ensure they were reasonable.

Shagalov sought a temporary restraining order (TRO) to stop Artemus from selling any more art. The TRO was denied, at which point our firm was retained. We were successful in obtaining a preliminary injunction to halt further art sales. The trial court found that, notwithstanding the fact that the parties referred to the transaction as a sale and leaseback, "It sounds like very much, much more so than it's a collateralized loan because who is enjoying the art? Certainly not the plaintiff but rather it is the defendant." NYSCEF No. 48 at 15.

Artemus appealed to the Appellate Division, which affirmed the injunction holding: "Plaintiffs demonstrated that the parties' arrangement may constitute a collateralized loan and that, therefore, they were entitled to notice concerning the disposition of the collateral under UCC article 9."

The Court did not explain the basis for its view that we had established the transaction was a loan. There are two possible grounds for the Court's holding. First, we argued the transaction was a loan under the "Bright Line Test" contained in UCC 1-203(b) "which requires the Court to determine whether the contractual terms of the Agreement … bear certain characteristics the statute defines as conclusive evidence that a security interest was created." *In re World Com, Inc.*, 339 B.R. 56, 64-65 (Bankr. S.D.N.Y. 2006). Alternatively, "[o]nce the court finds that the leases are not security interests per se, it is necessary to examine all the facts to determine whether the economic realities of a particular transaction nevertheless create a security interest." *In re Grubbs Constr. Co.*, 319 B.R. 698, 714 (Bankr. M.D. Fla. (2005); N.Y. U.C.C. § 1-203; *In re WorldCom, supra*). We simply do not know whether the Court agreed with us on one or both standards.

Where then does that leave the parties to a sale-leaseback? The financier needs to understand that the transaction needs to be a true lease. The language and intent of the parties are irrelevant. *In re ECCO Drilling Ltd.*, 390 B.R. 221, 226 (Bankr. E.D. Texas 2008); *In re Triplex Marine*, 258 B.R. 659, 666 (Bankr. E.D. Texas 2000).

If the "lessor" holds the "leased" property, if the value paid for the "purchased" property is much lower than the actual value of the property, if the option price to buy the property back is much lower than the value of the property, or if, at the end of the "lease," the only economically sensible thing for the lessee to do is buy the property, the lessor risks the transaction being successfully challenged as a loan and Article 9 of the UCC will apply.

There is a simple solution to all this, however. Temper aggressiveness and provide the notices required under Article 9 of the UCC and act in accordance with Article 9 standards, whether or not they apply. Even if this is beyond your obligations, the requirements are by no means draconian and simply encourage fairness. P

1 *Leasebacks* available at investopedia.com/terms/l/leaseback.asp retrieved on January 11, 2019.

2 Available at nytimes.com/2009/02/24/arts/design/24artloans.html.

3 Double pledging of art or pledging art the borrower does not actually own sadly are all too common. One of our client's borrowers was prosecuted for pledging works that he did not own, and another two borrowers asserted the protection of the Fifth Amendment when asked about collateral.