

Equipment Financing Risks in Bankruptcy: Implications of Lease vs. Secured Transaction

Treatment of Equipment Leases in Bankruptcy and Recharacterization of Lease as a Sale

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Today's faculty features:

George K. Miller, Partner, **Mayer Brown**, New York

Craig M. Price, Partner, **Chapman and Cutler**, New York

Franklin H. Top, III, Partner, **Chapman and Cutler**, Chicago

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**EQUIPMENT FINANCING RISKS
IN BANKRUPTCY:
IMPLICATIONS OF LEASE VS.
SECURED TRANSACTION**

LEASE CHARACTERIZATION

IS IT A “TRUE LEASE” OR A “DISGUISED FINANCING”

- One of the most fundamental questions to ask when dealing with leases in bankruptcy is whether a transaction is a “true” lease (and therefore subject to § 365 of the Bankruptcy Code), or if it is instead a secured transaction disguised as a lease.
- Tax courts, the IRS, the accounting industry and bankruptcy courts have each created separate standards to determine whether a transaction should be treated as a lease or a secured financing.
- The distinction is critically important as true leases and secured financings have very different treatments under bankruptcy law.

CONSEQUENCES OF CHARACTERIZATION

- Why is characterization important: The determination of whether a purported lease transaction results in a true lease or a secured financing can have tremendous consequences in bankruptcy.

A debtor-lessee stands to obtain numerous benefits by having a lease characterized as a financing. For example:

- The debtor-lessee may retain possession of the leased property during the case without making postpetition rent payments;
- There is no deadline for the debtor-lessee to assume the lease, cure prepetition arrearages, or provide adequate assurance of future performance of the lease;
- If the secured party is undersecured (*i.e.*, the amount of the claim is greater than the value of the collateral), the debtor may use § 506 to bifurcate the loan into a secured claim to the extent of the value of the underlying collateral and an unsecured claim for the balance owed. The debtor-lessee can seek to “cram down” a plan of reorganization by reducing the lien to the value of the collateral and paying it off over a period of years, in essence altering the secured amount and term of the lease.

CONSEQUENCES OF CHARACTERIZATION (CONTINUED)

- If the secured party has failed to perfect its security interest (perhaps because it believed it was a lessor/owner and not a secured party), its security interest may be avoided in bankruptcy so that the debtor-lessee retains possession and the creditor is left with nothing more than a general unsecured claim for the entire balance owed. See 11 U.S.C. § 544.
- In a true lease, the lessor retains title to the leased property and any upside or downside of the property's value following the lease's term. Any recharacterization of the lease as a security interest would eliminate such residual recovery for the lessor.
- As we will discuss, with a true lease, debtor-lessee must commence making lease payments 61 days after a bankruptcy filing. Secured lenders must move before the bankruptcy court to obtain adequate protection payments.
- For these reasons and others, many lessees believe that challenging the characterization of a lease is a way to gain economic and legal leverage over a lessor.

BANKRUPTCY BASICS

- *Creation of Debtor's Estate:* Once a debtor files for protection, all of the debtor's property, including all of its unexpired leases, becomes property of the debtor's bankruptcy estate. 11 U.S.C. § 541(a)(1) ("The commencement of a case ... creates an estate" and "[s]uch estate is comprised of ... all legal and equitable interests of the debtor as of the commencement of the case.").
- *Automatic Stay:* Upon a bankruptcy filing, the automatic stay contained in § 362 of the Bankruptcy Code immediately precludes lessors from taking any action regarding property of a debtor's estate without first obtaining the bankruptcy court's approval. The automatic stay applies to all of a lessor's default remedies, including maintaining collection efforts, recovering the property or terminating a lease while the debtor is deciding whether to assume or reject it. See 11 U.S.C. § 362(a); *Eskanos & Adler, P.C. v. Leetien*, 309 F.3d 1210 (9th Cir. 2002) (creditor who continued collection efforts was fined \$1,000 as sanctions for willful violations of the stay).
- *Prepetition Amounts May Not Be Paid:* Unless otherwise required, debtor-lessee is specifically prohibited by the Bankruptcy Code from paying outstanding prepetition amounts prior to the approval of a chapter 11 plan without obtaining permission of the bankruptcy court. See 11 U.S.C. § 363(c)(2).

“TRUE LEASE” DEFINED

- A “true lease” has been commonly defined as an arrangement in which the risks and rewards of ownership are retained by the owner (the lessor) of the leased asset, while the lessee retains possession and use for the lease period only.
- The lessor claims the depreciation benefits and the lessee claims the lease payments as capital expenses.
- Called “true” because they pass the accounting requirements for the lessor to claim the tax benefits, such leases typically offer comparatively lower lease payments than a financing as lessor retains ownership at the end of the term.
- An operating lease is typically a true lease whereas a capital lease is not. A true lease may also be called a tax lease or tax-oriented lease.

RIGHTS AND DUTIES OF LESSORS AND LESSEES IN A TRUE LEASE FOLLOWING A BANKRUPTCY FILING

Section 365 Governs the Parties' Rights

- Following a bankruptcy filing, § 365 of the Bankruptcy Code governs unexpired leases. Section 365 is intended to “relieve the estate of burdensome obligations while at the same time providing ‘a means whereby a debtor can force others to continue to do business with it when debtor’s bankruptcy filing might otherwise make them reluctant to do so.’” *In re Chateaugay Corp.*, 10 F.3d 944, 954-55 (2d Cir. 1993).
- In chapter 9, 11, 12 or 13, the debtor may assume or assign, or reject, an unexpired lease anytime prior to confirmation of the plan. 11 U.S.C. § 365(d)(2). Creditors may hasten such timing by filing a motion to lift the stay or to shorten the time to determine whether to assume or assign.

RIGHTS AND DUTIES OF LESSORS AND LESSEES IN A TRUE LEASE FOLLOWING A BANKRUPTCY FILING (CONTINUED)

Rejection, Assumption and Assignment

- *Generally:* To the extent motions are not made to lift the stay or shorten the period during which a debtor may assume or reject a lease, prior to confirmation, a lessee-debtor must decide whether to:
 1. Reject the lease;
 2. Assume and retain the lease; or
 3. Assume and assign an unexpired lease to a third party.
- *Court Approval Required -- Applicable Standard -- “Business Judgment Rule”:* While the Bankruptcy Code does not expressly state the standard to be applied in determining whether or not to accept a debtor’s decision to assume, assume and assign or reject an unexpired lease, caselaw, however, generally holds that the proper standard to be applied is the “business judgment rule.” *In re Mingos*, 602 F.2d 38, 41 (2d Cir. 1979).

RIGHTS AND DUTIES OF LESSORS AND LESSEES IN A TRUE LEASE FOLLOWING A BANKRUPTCY FILING (CONTINUED)

Rejection

- *Measure of Damages from a Rejection:* The calculation of the amount due the lessor under the rejected lease is determined by examining the terms of the lease. Damages typically include all of the rent remaining under the lease (less any amount paid post-bankruptcy) plus applicable termination penalties, taxes, and other fees and expenses that are covered in the lease.
- *Status of Rejection Claim:* Damages from a rejection are generally deemed to be unsecured claims.
- *No Cap on Damages:* There is no cap on the damages assertable based on the rejection and breach of an equipment lease -- therefore lessors should always assert the highest amount possible as unsecured claims are often paid, if at all (but not always), with pennies on the dollar.

RIGHTS AND DUTIES OF LESSORS AND LESSEES IN A TRUE LEASE FOLLOWING A BANKRUPTCY FILING (CONTINUED)

Assumption

- *Assumption Generally:* An assumption binds the debtor to perform all of its obligations under the lease.
- Section 365(b)(1)(A) contains requirements that must be met by the lessee prior to any assumption, including the requirements that Debtors:
 - (1) cure, or provide adequate assurance of “prompt” cure, of prepetition defaults;
 - (2) provide “adequate assurance” of future performance by either the debtor or any assignee; and
 - (3) compensate the other party, or provide adequate assurance of prompt compensation, for any actual losses resulting from the breach.
- All defaults must be cured in order to assume an agreement. Certain defaults, such as failure to insure the equipment for a prior period, may never be cured.
- To the extent that a debtor fails to comply with any condition and is unable to cure such default, grounds exist to challenge the assumption. To the extent that a lessor does not raise an objection to a failure to cure a monetary and/or nonmonetary default, it may be forever barred from later raising such issue.

RIGHTS AND DUTIES OF LESSORS AND LESSEES IN A TRUE LEASE FOLLOWING A BANKRUPTCY FILING (CONTINUED)

Assignment

- *Assignment Generally:* Section 365 also permits a debtor to assume and assign a lease to a third party. This is true notwithstanding any prohibitions contained in the lease restricting or prohibiting such assignment. 11 U.S.C. § 365(f)(1).
- *Statutory Requirements:* In addition to meeting the requirements found in § 365(b) for assumption (*i.e.*, curing all defaults), for an assumption and assignment, the Bankruptcy Code also requires that the debtor provide adequate assurance of future performance by the proposed assignee. *In re U.L. Radio Corp.*, 19 B.R. at 541. Adequate assurance of future performance by the assignee is determined by the circumstances of each case.
- *Provisions Restricting Assignment Are Generally Void:* Section 365(f)(3) of the Bankruptcy Code prohibits the enforcement of most clauses that modify or terminate the contract by virtue of its assignment.
- *Restrictions on Assignment Also Prohibited:* Similarly, the Bankruptcy Code prohibits enforcement of any lease clause creating a right to modify or terminate the contract because it is being assumed and assigned, thereby indirectly barring assignment by debtor. See § 365(f)(3).

PAYMENT ON A TRUE LEASE FOLLOWING A BANKRUPTCY FILING

- *Governing Sections:* Sections 365(d)(5) and 503(b) of the Bankruptcy Code are the primary provisions that govern payments by lessees to lessors during a bankruptcy case.

Section 365(d)(5)

- *Lessor Entitled to Payment Starting upon Day 61:* In a chapter 11 case, the debtor generally must commence making regular lease and other payments and otherwise comply with all lease terms (such as payment of taxes, etc.) under an equipment lease on the *61st day* after the bankruptcy petition is filed. 11 U.S.C. § 365(d)(5).
- *Amounts Arising after 60th Day Are Administrative Claims:* In accordance with § 365(d)(5), amounts that come due pursuant to the lease following the initial 60-day period are deemed administrative expense claims. *In re Midway Airlines Corp.*, 406 F.3d 229 (4th Cir. 2005) (Fourth Circuit upheld claim for full amount of lease payments to equipment lessor; reversed lower courts that allowed reduced claim because lessor had waited to pursue its claim).

PAYMENT ON A TRUE LEASE FOLLOWING A BANKRUPTCY FILING (CONTINUED)

- *Amount of Administrative Claim:* When calculating the administrative expense claim, “there is a presumption that the contract terms and rate represent the reasonable value of the services or goods provided under the contract.” *In re ID Liquidation One, LLC*, 503 B.R. 392, 399 (Bankr.D.Del. 2013). However, “[t]his presumption can be overcome if the objecting party provides convincing evidence to the contrary.” *Id.* at 399-400.
- *Nonperformance by Debtor and Lease Termination:* Nonperformance following the 61st day does not give a lessor automatic grounds to terminate a lease. Rather, the lessor’s recourse is, among other things, to file a motion seeking to compel: (a) payment of amounts due as an administrative expense; and (b) an earlier determination regarding assumption or rejection. *Sturgis Iron & Metal Co., Inc.*, 2009 WL 3317286 at *20 (Bankr. W.D. Mich. 2009).

PAYMENT ON A TRUE LEASE FOLLOWING A BANKRUPTCY FILING (CONTINUED)

Section 503(b)

- *Amounts Accrued During Initial 60-Day Period:* The Bankruptcy Code is silent as to all obligations incurred during the first 60-day period. Courts are divided regarding whether such claims (arising during the initial 60-day postpetition period) are entitled to priority as administrative expense claims.
- While most courts have held that claims for rent and other amounts that arise during the first 60 days postpetition do not constitute administrative claims, other courts have determined that unpaid rent incurred in the first 60-day postpetition period is entitled to administrative status, but only under § 503(b) and not § 365(d)(5). Section 503(b) allows lessors to assert an administrative claim for amounts during this period to the extent they can prove the debtor used their equipment and can quantify the benefit such use conferred on the estate. *See, e.g., In re Furley's Transport, Inc.*, 263 B.R. 733, 740-41 (Bankr. D. Md. 2001); *In re Sylva Corporation, Inc.*, No. 14- 6016 (B.A.P. 8th Cir. Nov. 26, 2014) (finding that request for administrative expenses claim for lease payments due during the first 60-day period is § 503(b)(1)(A).
- Any § 503(b) showing would likely require an evidentiary hearing.

CHALLENGES TO TRUE LEASE CHARACTERIZATIONS AND THE § 365(d)(5) PAYMENT REQUIREMENT

- Because § 365(d)(5) only provides for payment to lessors under a “lease,” whether a transaction constitutes a lease or a security arrangement may have to be determined before a lessee is required to make any payments:
 - *In re Sylva Corporation, Inc.*, No. 14-6016 (B.A.P. 8th Cir. Nov. 26, 2014), the court held that issue of whether a lease was a ‘true’ lease or financing arrangement must be determined prior to a decision on whether an administrative expense was due.
 - *In re Elder-Beerman Stores Corp.*, 201 B.R. 759 (Bankr. S.D. Ohio 1996), lessor sought to compel payment under § 365(d)(5) five months after petition was filed. The debtor countered by filing an adversary proceeding to declare the lease a secured transaction. The court held that payment should have been automatic and ordered payment of rent into escrow pending a resolution of the adversary proceeding.
- Parties should seek to have rent escrowed if characterization is challenged.

PAYMENTS OF COSTS AND EXPENSES UNDER A TRUE LEASE

- *Related Costs, Expenses and Attorneys' Fees:* Section 365(d)(5) requires payment of “all the obligations” under the lease. Lessors may therefore also be entitled to recover not only lease payments, but also related costs, expenses and attorneys’ fees, *provided* that such amounts are contemplated in the underlying lease.
- *Timing Matters:* As with lease payments, courts have held that whether attorneys’ fees and other expenses are required to be paid as an administrative expense, claim is determined by the exact time during which the costs were incurred.
- *In re Forman Enterprises, Inc.*, 2000 Bankr. LEXIS 1529 (Bankr. W.D. Pa. Dec. 14, 2000), certain fees were incurred due to litigating during the first 60 days of a case related to senior liens. The bankruptcy court held that because the costs were incurred during first 60 days after the bankruptcy filing, § 365(d)(5) did not provide for payment as an administrative claim. No claim under § 503(b) was available as attorneys’ fees did not “benefit the estate.”

TREATMENT FOLLOWING CHARACTERIZATION OF A LEASE AS A SECURED FINANCING

- If a lease is recharacterized as a secured financing, it is treated like a loan.
- To the extent the “lessor” is properly perfected:
 - If the lender is oversecured, the “lessor” may be paid in full upon confirmation of plan, with interest, unless otherwise agreed, and possibly entitled to adequate protection (often in the form of cash payments or additional security) against potential diminution of the value of the collateral (although the period of the payoff may be extended significantly without the lessor’s consent) during the case.
 - If the lender is undersecured, the lessor’s claim will be bifurcated. The lessor will receive, at best, a secured claim equal to the value of the collateral, and an unsecured claim in the amount of the deficiency.
- If the lessor is not properly perfected, the entire claim will be an unsecured claim, likely without recourse either to meaningful payment or to the collateral itself.

TREATMENT OF SECURED LOANS

“ADEQUATE PROTECTION”

- To the extent a lease is recharacterized and treated as a loan, the lender will not be entitled to payments per § 365(d)(5). Rather, a secured lender may be entitled to adequate protection:
 - “[t]he purpose of adequate protection is to guard the secured creditors' interest from a decline in the value of the collateralized property.” *In re Panther Mountain Land Development, LLC*, 438 B.R. 169, 190 (Bankr. E.D. Ark. 2010)
 - Sections 362, 363, and 364 of the Bankruptcy Code require, in certain instances, that a court determine whether the interests of a secured creditor are adequately protected.
 - While not defined in the Bankruptcy Code, adequate protection is generally accepted as some form of relief that will preserve the secured creditor’s interest in the collateral, pending the outcome of the bankruptcy proceeding.

TREATMENT OF SECURED LOANS

“ADEQUATE PROTECTION” (CONTINUED)

- Section 361 of the Bankruptcy Code states that it may be provided (i) by making periodic cash payments to the secured creditor; (ii) granting the secured creditor an additional or replacement lien in other property of the debtor; or (iii) granting the secured creditor such other means of relief.
- There is no precise formula as to how to ascertain what the value to be protected is, and this is left to be determined on a case by case basis.
- With respect to equipment, to the extent a lender can prove a decrease in value of the secured creditor’s interest in the collateral owing to its use by the debtor, the lender may be entitled to periodic cash payments. However, an “equity cushion” may also satisfy the requirement, and displace need for ongoing cash payments.

TREATMENT OF SECURED LOANS

SALE OF EQUIPMENT

- Debtor-Lessee may also be able to sell financed equipment “free and clear” without permission:
 - Bankruptcy courts can grant a debtor-lessee permission to sell equipment under Section 363(f), “free and clear” of all “liens” and other “interests.”
 - Even if the lessor objects, the lessor’s “interest” may be found to be subject to a “bona fide dispute,” which is one of the five instances when a Section 363(f) “free and clear” sale permissibly can occur.
 - The sale proceeds for it might be escrowed, pending the outcome of the lawsuit or a settlement.
 - If the court approves the sale, the equipment belongs to the buyer free and clear. Even if the lease is ultimately not characterized as a financing agreement, the lessor’s recovery may be limited to the sale amount if a blanket lien covers all of debtor’s other assets.
 - Parties may attempt to avoid this solution by prohibiting any sales or requiring the lessor be given a right of first refusal. However, it is not certain whether such provisions will be honored in a bankruptcy.

Different Treatment of Some Types of Equipment

- Transportation Equipment
 - Sections 1110 and 1168 of the Bankruptcy Code treat alike leases of and security interests in aircraft, vessels and rolling stock.
 - Partially override Sections 362 and 365.
 - A lessor *or* secured lender is free to repossess the equipment after 60 days following a Chapter 11 filing notwithstanding the automatic stay *unless* the debtor agrees, subject to the approval of the court, to perform its obligations under the contract and cures all non-bankruptcy defaults.
 - The parties may agree, subject to the approval of the court, to extend the foregoing 60-day period.
 - Failing timely agreement or cure, the debtor must immediately surrender the equipment on written demand of the creditor.

Different Treatment of Some Types of Equipment (continued)

– Eligible equipment:

- Aircraft, aircraft engine, propeller, appliance or spare part owned by or leased to a debtor that holds, at the time the loan or lease is entered into, an air carrier operating certificate for aircraft capable of carrying 10 or more persons or 6,000 or more pounds of cargo.
- A vessel documented under the US Code owned by or leased to a water carrier holding , at the time the loan or lease is entered into, a certificate of public convenience and necessity or permit from the US DOT.
- Rolling stock equipment and accessories, including superstructures or racks, and, with respect to equipment first placed in service after October 22, 1984, substantially rebuilt equipment, owned by or leased to a railroad.
- Includes all documentation required to be returned with the equipment.

Different Treatment of Some Types of Equipment (continued)

- Other distinctions still apply:
 - The right to repossession doesn't affect, *e.g.*, a lender's, as opposed to a lessor's, duty to account to the debtor for any surplus on any sale of the equipment.
 - On repossession, a lease is deemed rejected, and may still be rejected notwithstanding an agreement to perform the lease or to extend the period for doing so.
 - Prior to October 22, 1994, for purposes of these provisions:
 - A lease was defined as any written agreement which the parties agreed was a lease for tax purposes.
 - A security interest was defined as a purchase money interest.

Different Treatment of Some Types of Equipment (continued)

- Facility leases
 - Will typically contain a provision “severing” the leased facility from the real property on which it is located, in order to avoid the limit in Section 502(b)(6) of the Bankruptcy Code on damages for rejection by the lessee of a lease of real property.
 - Severance isn’t relevant to a mortgage, as opposed to a lease, of the facility.

STANDARD FOR RECHARACTERIZATION

- Whether an agreement will be found to be a true lease or a secured financing arrangement will be determined in bankruptcy court by examining applicable state law. See *In re Pillowtex, Inc.*, 349 F.3d 711, 716 (3d Cir. 2003); *In re Continental Airlines, Inc.*, 932 F.2d 282, 294 (3d Cir. 1991).
 - Under state law, most true lease cases turn on whether the lessor retains meaningful residual value or a reversionary interest in the leased property.
 - Courts typically first look to the UCC, which sets forth the definition of a “lease,” and § 1-201(37), which contains standards for characterizing a lease.
 - Should a transaction pass the “per se” rule in § 1-201(37), courts will next examine whether such transaction passes the “economic realities” test.
 - Only upon passing both tests will a transaction be deemed a true lease.

“PER SE” TEST UNDER UCC § 1-201(37)

- Section 2A-103(1)(j) of the UCC defines a “lease” as “a transfer of the right to possession and use of goods for a term in return for consideration, but a sale ... or retention or creation of a security interest is not a lease.” The definition of “lease” thus excludes secured financings.
- Section 1-201(37) of the UCC includes a “per se” or “bright-line” test to determine whether a transaction should be treated as a true lease or disguised security agreement.
- The key is whether any residual value will be retained by the lessor.
- A buy out right for “nominal” or no consideration is often a trigger for recharacterization.

“PER SE” TEST UNDER UCC § 1-201(37) (CONTINUED)

- A transaction will be deemed a secured financing if it passes both parts of the test under § 1-201(37), which provides:
 - (a) ... transaction creates a security interest if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee, **and:**
 - (i) the original term of the lease is equal to or greater than the remaining economic life of the goods,
 - (ii) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods,
 - (iii) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement, or
 - (iv) the lessee has an option to become the owner of the goods for *no additional consideration* or *nominal additional consideration* upon compliance with the lease agreement.

RELEVANT CASE LAW

- *In re Sankey*, 307 B.R. 674 (D. Alaska 2004), the court found leases to be “true” leases rather than security arrangements despite the fact that the arrangements provided options to purchase leased equipment for 10% of the purchase price at the end of lease terms. Inquiring under UCC § 1-201(37), the court concluded that the arrangements was not a security interest because the leases were not subject to early cancellation and the lessor held a *meaningful reversionary interest* (even though there was a purchase option for 10% of the original lease value).
- *In re ES2 Sports & Leisure, LLC*, 519 B.R. 476 (Bankr. M.D.N.C. 2014). Equipment lease in which payments exceeded cost of equipment, was non-cancelable and had a \$1 nominal purchase option at its end was “per se” a secured financing.
- *CIT Technology Financing Services, Inc. v. Tricycle Enterprises, Inc.*, 787 N.Y.S.2d 133 (App. Div. 2004). A lease with a five-year term and a purchase option of “10% of Total Cash Price” was held to be a true lease. Ten percent of that aggregate amount equaled 30% of the anticipated remaining market value of the equipment at the end of the lease term. The court determined that the lease was a true lease based upon a “rule of thumb” employed by Massachusetts courts that a purchase option price greater than twenty-five percent of market value at the end of the lease term was not “nominal.”

“ECONOMIC REALTIES TEST”

- In addition to the “Per Se” test, current law also includes a second level of analysis, an “economic realities” test which is designed to evaluate the facts of each transaction to determine whether the transaction is a lease or a secured financing.
- Thus, even if a transaction passes the “per se” test, a court can still determine that such transaction is a secured financing under the economic realities test. See *Pillowtex*, 349 F.3d at 720-23 (despite finding that the none of the residual value factors in § 1-201(37) were met, the court held that the transaction was a secured financing under the “economic realities” test).
- In evaluating the “economic reality” of the transaction, courts will look at a number of factors, including whether the purchase option is nominal; whether the lessee is required to make aggregate rental payments having a present value equaling or exceeding the original cost of the leased property; and whether the lease term covers the total useful life of the equipment.

PILLOWTEX DECISION

- The *Pillowtex* decision is one of the most preeminent recharacterization cases and serves to set forth the current standard regarding recharacterization. Decided under New York law, the transaction at issue did not involve a “lease” but rather involved a master energy services agreement (MESA). The MESA provided for an eight-year contract under which Duke agreed to acquire, hold title to, and install certain energy-savings equipment in nine Pillowtex facilities. Pillowtex specifically booked the MESA as a true lease on its books and attempted to comply with the standards of FASB 13, which sets the accounting standards for leases.
- The court first evaluated whether the MESA “created an interest in personal property or fixtures which secures payment or performance of an obligation” under § 1-201(37) of the UCC and created a security agreement rather than a lease. The court concluded that the transaction did not create a security interest under the “per se” test. It then analyzed the transaction under the “economic realities” test. Under this test the court determined that the MESA was not a true lease but instead constituted a secured financing.
- The court based its conclusion on the fact that the rent exceeded the cost of the equipment as an indication that Duke intended to sell rather than lease the energy equipment to Pillowtex. Therefore, Duke was not entitled to payments under § 365(d)(5).

Lease Drafting Implications

- In a single-investor or leveraged lease, the desire of the lessor to enjoy the tax benefits of ownership will drive the inclusion of provisions that will support lease treatment.
- Recite the parties' intent that the lease be treated for all purposes as a true lease.
- “At all times during the term of this Lease, full legal title to the Aircraft shall remain vested in the Lessor to the exclusion of the Lessee notwithstanding the possession and use thereof by the Lessee or any other Person.”
- Provide for precautionary security perfection filings in case the lease is recharacterized as a secured loan.

Lease Drafting Implications (continued)

- Lessee purchase and renewal options must be based on fair market value at the time of exercise or on a reasonable estimate of future fair market value. There can be no compulsion, either contractual or economic, on the lessee to exercise these options.
- In a leveraged lease, the lessee must not directly assume obligations in respect of the loan to the lessor, so that the lessee isn't treated as the owner and the lease isn't collapsed into the loan.

COMMON QUESTIONS

While no one factor will be entirely determinative, in deciding whether a transaction qualifies as a lease or a secured financing, a number of commonly considered factors will include:

- What happens to the equipment at the end of the lease? Does the agreement permit (or require) the lessee to purchase the goods at the end of the lease term for nominal consideration? Is the lessee required to purchase the property upon occurrence of certain events?
- What is the anticipated useful life of the equipment? Does the term of the lease exceed the useful economic life of the goods? Is the lessee required to renew the lease for the full economic life of the goods?
- What is the total amount of the lease payments in relation to equipment value? Are “rent” payments calculated to compensate the lessor for the lessee’s ongoing use of the lessor’s property, or are they really payments of principal and interest?

COMMON QUESTIONS (CONTINUED)

- Did the lessee assume the typical risks and obligations of ownership (such as responsibility for paying insurance, taxes, maintenance and upkeep)?
- Did the lessor manufacture or purchase the property specifically for the lessee's use?
- Did the lessor obtain credit to purchase the leased equipment in order to lease it to the lessor?
- What is the economic benefit to each party if the transaction is structured as a lease rather than as a sale? Was the deal structured that way to secure tax or other benefits?

In general, if the property has little or no value at the end of the lease's term, or the lessee is able to purchase the property for nominal value, the transaction is likely to be deemed a secured financing rather than a true lease.

Other Typical Lease Provisions

- Default remedies include the ability to “put” the equipment back to the lessee against payment of “stipulated loss value,” calculated to recover the balance of the lessor’s cost for the equipment and any recapture of tax benefits.
- Rule of thumb for tax ownership is that the lease term including renewals not exceed 80% of the equipment’s useful life, well within the cases finding true leases.
- Net lease—the lessee assumes all risks/obligations except debt payment (though rent must cover, and secures, debt service) and residual value.

Other Typical Lease Provisions (continued)

- In a leveraged lease, the lessor borrows approximately 80% of the cost of the equipment.
- A lease is used to enable the lessor to enjoy the tax benefits of ownership (*e.g.*, depreciation deductions).
- As long as there is significant useful life/residual value at the end of the lease and the lessee is not compelled to renew or purchase during or at the end of the term for less than fair market value, the lease characterization should be upheld.

BURDEN IS ON PARTY CHALLENGING THE CHARACTERIZATION

- The burden is upon the lessee to demonstrate by a preponderance of the evidence that the lease is not what it purports to be. *See In re Rebel Rents*, 291 B.R. 520, 524, *citing In re Murray*, 191 B.R. 309, 316 (Bankr. E.D. Pa. 1996).

QUESTIONS?

Craig M. Price
cprice@chapman.com

Franklin H. Top, III
top@chapman.com

George K. Miller
gmiller@mayerbrown.com



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