Selected Bankruptcy Issues for Equipment Lessors

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Forward: Bankruptcy Issues to Consider When Drafting an Equipment Lease

Often, when entering into a leasing transaction, bankruptcy issues are not considered until it's too late. While this handbook is intended to provide an in-depth analysis of the numerous issues affecting an equipment lessor when dealing with a lessee's bankruptcy, certain issues should be considered when initially drafting and entering into a lease agreement. To assist lessors and their counsel, below is a list of bankruptcy-related issues to keep in mind when initially drafting a lease agreement.

Timing of Lease Payments: Depending upon whether the lease is ultimately assumed or rejected, amounts accrued prior to a bankruptcy filing and those occurring following a bankruptcy filing may be treated very differently. Consider structuring payments so that amounts are paid in advance of each lease period (whether it be monthly or quarterly), so that lessors capture payments in advance of a bankruptcy filing. Leases can also be structured so that amounts accrue daily, so that its clear for all what is a prepetition versus a postpetition amount.

Fees and Expenses: Leases should always include specific provisions for the payment of fees and expenses, including attorneys' fees. Such provisions may also be structured so that such amounts accrue daily, so that should a bankruptcy occur, it is clear what are prepetition and postpetition expenses. To avoid a finding that fees and expenses are post-rejection damages, all such amounts should be required to paid as they are incurred, and not following the return of the equipment (and hence after a rejection when they would be deemed prepetition expenses).

Lift Stay Motion Costs: Once a bankruptcy filling occurs, the automatic stay will prevent any actions to recover the underlying assets without court approval. Lessors should consider specifically including provisions for the payment of any legal or other costs associated with filing a motion to lift the automatic stay as well as any and all costs associated with repossession of the equipment.

Adequate Protection Payments: After a bankruptcy filing, payments under the lease pursuant to § 365(d)(5) of the Bankruptcy Code often serve as a substitute for adequate protection payments. If a lease is recharacterized as a financing agreement, however, the lessor may be entitled to adequate protection payments. If there are recharacterization concerns, consider including specific requirements in the underlying lease regarding adequate protection in the event the lessee becomes a debtor. Such provisions may include: (i) specific time periods within which defaults must be cured; (ii) specific time periods within which other pecuniary losses (like attorneys' fees) must be paid; and (iii) a significant security deposit by any assignee. While there is no guarantee a court would enforce these terms, such provisions will be reviewed by the court and would provide evidence of the parties' intent at the time the lease was entered.

Terminate Possessory Interest following Default: Terminating a lease following a default (but before a bankruptcy filing) may not extinguish all of a debtor's rights in equipment to the extent lessee retains a possessory interest. Regaining possession following a lease termination and prior to a bankruptcy filing will serve to terminate all of a lessee's rights. Consider including a waiver of lessee's possessory rights following a default and termination of the lease. If the equipment is to be kept at a rented location or facility controlled by a third-party, consider obtaining a landlord waiver to allow for repossession at such site.

Recharacterization: A lease may be recharacterized as a financing agreement if its underlying economic terms resemble a loan more than a lease. While many issues will come into play in such a determination, the single most important issue will be if the lessee has the right to purchase the equipment for a nominal amount at the end of the lease term. Courts have held that purchase prices as low as 10% of the lease value or 25% of the market value of the equipment at lease term were not nominal. Discuss ways to structure the lease to avoid recharacterization.

Preparing for Assignment and Assumption: Section 365 of the Bankruptcy Code provides several requirements that must be satisfied in order for a debtor to assume or assume and assign a lease. These include curing any defaults that may have occurred under the lease (or providing "adequate assurance" that the default will be promptly cured),1 and "adequate assurance" of future performance under the lease.

- *Defining Cure:* In order to assume or assign a lease, the lessee must first cure all defaults. Lessors should include broad cure provisions to include any and all expenses, including default interest, attorneys' fees and other potential costs. The agreement should also specify that all amounts are due immediately upon any assumption or assignment so that debtor cannot "promptly" pay ("promptly" can mean up to 13 months or more in certain situations).

- *Defining Adequate Assurance:* Debtors must provide "adequate assurance" if they wish to assume or assign a lease to a third party. Given that the Bankruptcy Code does not define this term, parties may wish to define what adequate assurance will mean between them. This could take the form of a up-front payments, security deposits, providing certain additional financial information or other terms. While the court may not strictly enforce such terms, including such provisions will make it harder for the court to ignore the parties' intent.

Payments Should Be Required Following Attempt to Recharacterize a Lease: Lease should specify that to the extent a lease's characterization is challenged, all lease payments should continue to be made and placed into escrow until a determination on the issue is made. Requiring payments to be made to a escrow account will lessen lessee's leverage over the lessor to force a settlement.

Considering these issues may not allow lessors to avoid a lessee's bankruptcy, but they may assist in certain ways to avoid some of the pain that can result from a filing. The remainder of this handbook covers the various issues that arise following entry of a lease, especially after a lessee's default or bankruptcy filing.

1 Because the Bankruptcy Code allows a lessee simply to provide adequate assurance of a cure, it may not be necessary for the debtor to actually cure the default in order to assume the lease; the debtor may simply provide evidence that it will be able to do so promptly.

I. Rights Before a Bankruptcy Filing

Lease Review Should Be Conducted Upon or Before a Default: If a lessor becomes aware that a lessee is in financial distress, has defaulted or is possibly contemplating filing for bankruptcy, a review of the lease should be undertaken immediately to understand the various rights afforded to the lessor. Prior to a bankruptcy filing, the lease's specific terms will govern the parties' various rights. A review of the lease will reveal all possible remedies that exist prior to or upon a default. Depending on the lease's terms, possible remedies may include accelerating the balance, demanding the return of the equipment and/or terminating the agreement. Any disputes between the parties will be resolved pursuant to state law.

Lessor Has Choices: After a default and prior to any bankruptcy filing, a lessor is generally able to make a determination, subject to the terms of the lease, as to the best course of action to take: (1) do nothing and stick with the lessee, hoping circumstances will improve; (2) agree to a modification of the lease's terms; or (3) attempt to terminate the lease and seek remedies. A lessor should be aware that, to the extent certain equipment is valuable to a debtor, a bankruptcy filing may possibly not affect the economics of the lease. It is possible for a lessor to pass through a bankruptcy without incurring any loss. In other instances, however, a long, drawn-out bankruptcy can be expensive and lead to economic losses. While a lessor has some ability to take action prior to or upon a default, once a bankruptcy petition is filed, a lessor's various rights and obligations will be restricted and governed by the provisions of the Bankruptcy Code.

Termination Notice: Typically, upon a default, before a remedy can be effectuated, proper notice is required. Failure to follow the specific notice requirements in the lease and under the appropriate state law can result in loss of the right to elect certain remedies and can slow down any efforts to effect remedies. Therefore, before sending any notices to a distressed lessee, a lessor needs to ensure all notices are in compliance with the lease and/or applicable state law. Lessors may be subject to liability for exercising remedies without first providing proper notice.

Lease Termination: An important consideration for all lessors is a lease properly terminated prior to a bankruptcy filing is not considered property of the debtor's bankruptcy estate. *See In re Pagoda Intern., Inc.*, 26 B.R. 18, 20 (Bankr. D. Md. 1982) ("the bankruptcy court cannot act to resurrect a lease terminated prior to the filing of a petition"); *In re Opus Corp.*, 89 B.R. 9, 10 (Bankr. D. Md. 1988) (lessee of nonresidential real property waived its redemption rights and had no interest remaining after lease terminated prepetition); *In re Mako, Inc.*, 102 B.R. 814, 817 (Bankr. E.D. Okla. 1988) (state law governs lease termination, not bankruptcy law; bankruptcy court cannot revive lease properly terminated under state law).

Lease and State Law Govern Lease Termination: In determining whether a lease has been terminated prior to a bankruptcy filing, bankruptcy courts look at what constitutes termination under the terms of the lease and the governing state law. *In re Boll Weevil, Inc.*, 202 B.R. 762, 764 (Bankr. S.D. Cal. 1996) (finding no administrative claim existed where lease was terminated prepetition in accordance with state law).

Prepetition Return of the Equipment: If a lease has been properly terminated pursuant to its provisions and applicable state law, the lessor can pursue return of the equipment. State law and the lease

will govern the method by which the property can be obtained.[2] Once a lessee seeks protection under the Bankruptcy Code, however, no default or other notices may be sent, and no further efforts may be made to repossess or take control of the underlying collateral/equipment. *See* 11 U.S.C. § 362. Such actions will be deemed violations of the automatic stay and can subject the lessor to civil penalties and possible sanctions. *See In re Crysen/Montenay Energy Co.*, 902 F.2d 1098, 1105 (2d Cir. 1990) ("[A]ny deliberate act taken in violation of a stay, which the violator knows to be in existence, justifies an award of actual damages.").

Additional Prepetition Considerations: Merely terminating a lease prior to a bankruptcy filling does not, however, mean a bankrupt lessee will be deemed to have no interest in the leased equipment. Rather, two additional issues exist that may continue to cause a lessor difficulty:

- First, to the extent that a lessor has terminated a lease prepetition, but the lessee still has a possessory interest in the equipment (*i.e.,* the lessee still has possession) at the time of the bankruptcy filing, the lessor may first be required to seek relief from the automatic stay by way of a lift stay motion pursuant to § 365 of the Bankruptcy Code. *See Pagoda*, 26 B.R. at 20 (lessor had a "scintilla of equitable interest" when it remained in possession of an apartment, and action in court was required to terminate such interest); *In re Atlantic Business and Community Corp.*, 901 F.2d 327 (3d Cir. 1990) (possessory interest is sufficient to trigger protection of automatic stay). The contents of such a lift stay motion are described further below in Section IV.

Practice Tip: Regaining possession following a lease termination and prior to a bankruptcy filing will serve to terminate a lessee's possessory rights. If a lease is terminated, lessors should attempt to regain possession of the equipment as soon as practicable. It may also be possible for the lease to provide that the lessee waives any possessory rights following a default and termination of the lease, particularly where the equipment is difficult to move. However, there can be no guarantee that such a waiver will be effective.

- Second, if the lease is not a "true" lease, but rather determined to be a disguised financing or conditional sale agreement, then the lessee may assert an ownership interest in the equipment, thereby possibly making it property of the estate pursuant to § 541 of the Bankruptcy Code. As described further in Section VIII below, state law governs whether an agreement is regarded as a "true lease," a disguised financing or purchase agreement, and numerous factors may be reviewed in reaching such a decision. If a debtor asserts that the underlying lease is a disguised financing, the bankruptcy court will likely, at a minimum, require a determination regarding the nature of the lease before holding that the equipment is not property of the estate.

Benefits of Termination Prior to Bankruptcy: While careful effort must be made to properly terminate a lease and cut off a lessor's possessory rights in equipment prior to a bankruptcy filing, under certain circumstances, doing so can make a significant difference in minimizing a lessor's losses and avoiding the high costs associated with a bankruptcy case.

2 When equipment is located at a leased location, consent of the landlord may be required to the extent there is a claim that the equipment constitutes a fixture. To avoid such claims, a lessor may wish to seek a landlord's waiver in conjunction with the entry of the lease to ensure that lessor's efforts to recover its equipment are not delayed.

II. Equipment Leases Following a Bankruptcy Filing

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 by court, which found that Bankruptcy Code allows for actual and punitive damages, including costs and attorneys' fees, as sanctions for willful violations of the stay).

Continued Performance Required: After the automatic stay is imposed, the lessor generally must continue to perform its part of the bargain under the lease and, to the extent such performance is not given, the bankruptcy court can compel the lessor to continue performing under the lease. Generally, such performance merely entails allowing lessee to maintain possession of the equipment, but under certain instances, courts can require a lessor to provide repairs, parts or other services provided for under the lease. This will be true even if amounts are outstanding and unpaid during the prepetition period. The lease should be reviewed to make sure the lessor properly understands all its on-going obligations. A lessor's failure to perform under the lease may result in civil penalties.

Prepetition Amounts May Not Be Paid: Not only does the automatic stay preclude a lessor's collection efforts for prepetition amounts, but a debtor-lessee is also specifically prohibited by the Bankruptcy Code from paying any outstanding prepetition amounts prior to the approval of a plan of reorganization without first obtaining permission of the bankruptcy court. *See* 11 U.S.C. § 363(c)(2). Thus, a debtor-lessee is prohibited, absent court approval, from paying outstanding prepetition lease payments or other related prepetition amounts.

Section 365 Governs Leases in Bankruptcy: 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). Another purpose is to effect a breach of the debtor's agreements, thereby allowing the injured parties to file claims for damages in the bankruptcy case. *In re Register*, 95 B.R. 73 (Bankr. M.D. Tenn. 1989) (after rejection, covenant not to compete was unenforceable and remedy was limited to money damages).

Timing for Action: 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). *See* Section VI below for descriptions of assumption, assignment and rejection.[3] In a chapter 7 case, a lease must be "timely"

3 It should be noted that a debtor's inaction prior to the applicable statutory deadline for assumption or rejection of the lease will result in the lease being "deemed rejected." See 11 U.S.C. § 365(d)(4).

assumed or assigned (11 U.S.C. § 365(d)(1)) and is deemed rejected if it is not assumed within 60 days of the date of the order for relief (usually the filing date, although the 60 days may be extended for cause, if the motion for extension is heard/determined within the first 60 days). 11 U.S.C § 365(d)(1). As discussed below in Section V, a lessor can move before the court pursuant to § 363(d)(2) to have these time periods shortened.

III. Lessor's Postpetition Lease Payments Prior to Assumption/Rejection

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.

A. Section 365(d)(5)[4]

Lessor Entitled to Payment Starting upon Day 61: In a chapter 11 case, the debtor generally must commence making 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.[5] 11 U.S.C. § 365(d)(5). Specifically, § 365(d)(5) requires the debtor in a chapter 11 case to:

> timely perform all of the obligations of the debtor…first arising from or after 60 days after the order for relief in a case under chapter 11 of this title under an unexpired lease…until such lease is assumed or rejected notwithstanding section 503(b)…

The debtor's obligation to so perform continues until the lease is either assumed or rejected, unless the court orders otherwise.

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, holding that lessor was entitled to full amount of its claim and such amounts were administrative expenses). As discussed below, while amounts due following the 61st day are generally afforded administrative expense status, courts are divided regarding the priority status of postpetition amounts due for the first 60 days.

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4 The provisions requiring a debtor to timely perform all of its obligations under an unexpired lease of personal property was added to the Bankruptcy Code in 1994 as § 365(d)(10). This amendment was intended to make it substantially easier for lessors to recover postpetition lease payments. *See In re Midway Airlines Corporation*, 406 F.3d 229, 234 (4th Cir. 2005). The Bankruptcy Abuse Prevention and Consumer Protection Act (*"BAPCPA"*) amended § 365 by renumbering former § 365(d)(10) as § 365(d)(5). However, BAPCPA did not alter or amend the language of former § 365(d)(10). It should be noted, however, that in a chapter 7 case, the trustee does not have the same duty to commence making payments on the 61st day. In most cases, a chapter 7 trustee will immediately seek to reject the lease and eliminate the accrual of administrative lease obligations, since in almost all chapter 7 cases, the trustee is not operating the business.

5 Certain amounts, however, are not required to be paid — for instance, penalty rates resulting from a default. § 365(b)(2)(D). Also, the bankruptcy court has the ability, after notice and a hearing, to reduce the amounts due based upon the equities of the case. § 365(b)(5).

Amount of Administrative Claim: When determining the reasonable value of services for purposes of calculating an administrative expense claim, "there is a presumption that the contact 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.

Burden on Objector: Under § 365(d)(5), the entitlement to the administrative expense claim is automatic unless the debtor or objecting party can show that the court should order otherwise based on the equities of the case. In re Midway, 406 F.3d 229, 240-41 (4th Cir. 2005). ("This interpretation is consistent with the overall purpose of § 365(d)(10) [now § 365(d)(5)], which is to 'shift to the debtor the burden of bringing a motion while allowing the debtor sufficient breathing room after the bankruptcy petition to make an informed decision.'").

Timing of Payments: Section 365(d)(5) only requires that the lessor "timely" perform its obligations. Courts have held that "the time of payment … is within the discretion of the bankruptcy court." *In re Am. Mgmt. Res. Corp.*, 51 B.R. 713, 719 (Bankr. D. Utah 1985). The general rule is that all administrative creditors in a bankruptcy case must be treated equally. *See Cochise Coll. Park, Inc. v. Perry*, 703 F.2d 1339, 1356 n.22 (9th Cir. 1983). Therefore, where a chapter 11 debtor is operating its business after the 60th day postpetition and pre-rejection, it is required to perform its obligations under a lease, absent extraordinary circumstances. *See In re Lakeshore Construction Co. of Wolfeboro, Inc.*, 390 B.R. 751, 760 (Bankr. D.N.H. June 18, 2008). The Bankruptcy Code only requires, however, that administrative expenses be paid in cash on the effective date of a chapter 11 plan (*see* 11 U.S.C. § 1129(a)(9)(A)) or paid first upon a distribution of the assets in a chapter 7 proceeding (*see* 11 U.S.C. § 726(a)(1)). Where administrative creditors are not being currently paid, bankruptcy courts have wide latitude in deciding whether to order payment prior to these deadlines. *In re Midway Airlines Corp.*, 406 F.3d at 242 (holding that equipment lessor was not entitled to immediate payment where court had deferred payment of other allowed administrative payments). Accordingly, when a lessor will be paid its administrative expenses is case specific.

> *Practice Tip:* All practitioners should calendar the 60th day after a chapter 11 filing to determine whether a lessee will commence making regular payments. To the extent payments are not to be commenced, a motion should be filed to compel payment or to have the debtor make a determination that the lease is to be rejected. To the extent a debtor pays any administrative expenses to other parties — for amounts such as attorneys' fees or other expenses — lease payments should also be made pursuant to § 365(d)(5).

When Do Obligations Arise? — "Billing Date" vs. "Performance Date": After the initial 60-day period, the terms of the applicable lease provide for the required payments to be made by the lessor. However, a question arises as to what exactly is due, if anything, on the 61st day. For example, an equipment lease may only provide for a monthly payment on the first day of each month. If the 61st day after filing of the petition falls on the 15th of the month, the question exists as to whether a lessor is entitled only to what is due under the strict terms of the lease (to be paid upon the next billing date — the "billing date" method) or whether the payment for the next 15-16 days prior to the date of the next payment (known as the "stub period") should be pro-rated and paid to the lessor. Courts have examined this question primarily with respect to § 365(d)(3), which governs nonresidential real property leases.[6] Courts have been split as to the

6 The language in § 365(d)(5) was modeled on that found in § 365(d)(3), and accordingly courts often look to decisions construing § 365(d)(3) in cases involving § 365(d)(5). *See Lakeshore Construction*, 390 B.R. at 755-56 *citing Midway Airlines*, 406 F.3d at 234.

proper determination of what is due and whether the "stub" amounts should be deemed an administrative expense. Several important cases on this issue include:

- In *In re Koenig Sporting Goods, Inc.*, 203 F.3d 986 (6th Cir. 2000), the court held that rent on nonresidential real estate should not be pro-rated and that rent, which was due the first of the month, must be paid for the entire month when a debtor rejected a lease on the second day of the month. The debtor was therefore responsible for the entire month's rent, even though it rejected the lease early in the month. However, in *In re Stone Barn Manhattan LLC*, 2008 WL 5265739 (Bankr. S.D.N.Y. Dec. 17, 2008), the court held that the rent on nonresidential real estate would be pro-rated for the month in which payments were first due.

- The Third Circuit in *In re Montgomery Ward Holding Corp.*, 268 F.3d 205 (3d Cir. 2001), held that a lessor of nonresidential real property was obligated to pay an annual tax bill where the billing date occurred immediately after filing, even though most of the tax had accrued prepetition. The court held that the Congressional intent behind § 365(d)(3) required a debtor to perform all leasehold obligations as they came due. The court concluded that such an "obligation arises when one becomes legally obligated to perform." *Id*. at 209.

- In *In re MUMA Services Inc.*, 279 B.R. 478 (Bankr. Del. 2002), the bankruptcy court held that fees, expenses and attorneys' fees that arose after the 61st day and prior to rejection were given administrative expense status. As the applicable lease held that certain costs were only due following return of the equipment, the court held that such amounts — due following rejection — were not administrative expenses.

Practice Tip: Leases should always include provisions for the payment of fees and expenses. To avoid a finding that fees and expenses are post-rejection damages, all such amounts should be required to paid as they are incurred, and not following the return of the equipment (and hence after a rejection). Leases can also include requirements that amounts accrue daily, so that should a bankruptcy occur, it is clear that any stub period lease payments are required to be paid.

"Actual and Necessary Use" Not Required. Prior to the 1994 amendments, § 503(b)(1)(A) limited administrative expense priority claims to an amount representing the bankruptcy estate's "actual and necessary use" of the property in question. Lessors were therefore only generally paid to the extent the equipment was used after the bankruptcy commenced. Section 365(d)(5) makes it clear that obligations incurred after the first 60 days are not subject to such limitations. *Midway Airlines*, 406 F.3d at 237. Rather, § 365(d)(5) imposes liability for lease payments on the debtor "notwithstanding section 503(b)(1) of this title." 11 U.S.C. § 365(d)(5). This language "relieves the lessor from proceeding under § 503(b), which would limit the recovery to an amount representing only the actual and necessary use by the estate." *Midway Airlines*, 406 F.3d at 237.

Court Order Not Required for Payment: Courts have held that the phrase "notwithstanding section 503(b)(1) of this title" also eliminates any requirement stemming from § 363(c) for a court order expressly authorizing payment of an administrative expense claim that becomes due between the 61st day after the filing of the bankruptcy petition and the acceptance or rejection of the lease. *See Lakeshore Construction*, 390 B.R. at 755. As a result, court permission is not required for a debtor to commence making payments after the 61st day.

Lease Payments Serve as Substitute for Adequate Protection Payments: Section 363(e) provides that equipment lessors may be entitled to adequate protection for the use of their equipment during a bankruptcy case. *See* H.R. REP. No. 103-834 at 31, 103d Cong., 2d Sess. (October 4, 1994); U.S.C.C.A.N. 1994, p. 3340 ("Section 363(e) is also amended to clarify that the lessor's interest is subject to 'adequate protection.' Such remedy is to the exclusion of the lessor's being able to seek to lift the automatic stay under section 363"). Courts have generally held that a lessor's adequate protection rights are defined by 11 U.S.C. § 365(d)(5), *i.e.*, the payments specified under the lease. *See In re Republic Technologies Int'l, LLC*, 267 B.R. 548, 554-555 (Bankr. S.D. Ohio 2001). As a result, adequate protection payments are typically supplanted by claims made pursuant to § 365(d)(5), and claims generally will not exist under both § 365(d)(5) and § 363(e). Adequate protection payments may, however, be sought to the extent that a lease is held to be secured financing, and not a true lease.

Nonperformance by Debtor and Lease Termination: Nonperformance following the 61st day by a debtor does not give a lessor automatic grounds to terminate a lease. Rather, the lessor's recourse for nonperformance by the lessee is, among other things, to file a motion before the relevant bankruptcy court seeking to compel: (a) payment of amounts due as an administrative expense; and (b) an earlier determination regarding assumption or rejection, if warranted and supportable by good cause. *Sturgis Iron & Metal Co., Inc.*, 2009 WL 3317286 at *20 (Bankr. W.D. Mich. 2009). Any determination will be based upon the specific facts of the case.

B. Initial 60-Day Period

Lessee's Performance During the Initial 60-Day Period: While § 365(d)(5) makes it clear that a lessee's performance is required following the 60th day, 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 an administrative expense claims, with most courts finding that such amounts are not administrative claims unless they also specifically qualify for payment under § 503(b).

- Most courts have held that claims for rent and other amounts that arise during the first 60 days postpetition do not constitute administrative claims. *In re Kyle Trucking, Inc.*, 239 B.R. 198, 202 (Bankr. N.D. Ind. 1999) (vehicle lessor not entitled to administrative expense claim for rents, attorneys' fees or other lease charges during first 60 days postpetition under § 365(d)(5)); *In re Rebel Rents*, 291 B.R. 534 (Bankr. C.D. Ca. 2003) (denying without prejudice request for administrative rent until decision on assumption or rejection was made); *In re Forman Enterprises, Inc.*, 2000 WL 1849672, at *2 (Bankr. W.D. Pa. Dec. 14, 2000) (a lessor under a personal property lease is not entitled to an administrative expense claim for rents during first 59 days postpetition under § 365(d)(5)).

- Other courts have determined that unpaid rent incurred in the first 60-day postpetition period could be entitled to administrative status, but only under § 503(b) and not § 365(d)(5). *See, e.g., In re Pan American Airways Corp.*, 245 B.R. 897 (Bankr. S.D. Fla. 2000) (finding that the lessor of two telephone systems was entitled to an administrative claim for rents during the first 60 days if the lessor could establish entitlement under § 503(b) that such rents represented the "actual, necessary costs and expenses of preserving the estate."); *In re D.M. Kaye & Sons Transp., Inc.*, 259 B.R. 114, 119 (Bankr. D.S.C. 2001) (holding that nothing in § 365(d)(5) expressly precludes a lessor from asserting an administrative expense claim under § 503(b)).

- Any § 503(b) showing would likely require an evidentiary hearing. This requires a showing that such amounts are an "actual" and "necessary" cost or expense of preserving the estate. Typically, such a showing requires proving that the debtor used the equipment or it provided some benefit to the debtor during this period. Therefore, to the extent amounts are not payable pursuant to § 365(d)(5), such amounts may still be obtained by a claim under § 503(b) to the extent such equipment was actually used or provided a benefit to the debtor.

C. Challenges to § 365(d)(5) Payment Requirement

Because § 365(d)(5) only provides for payment to lessors under a "lease," the issue of whether a transaction constitutes a lease as opposed to a security arrangement may have to be determined before a lessee is required to make any payments pursuant to § 365(d)(5).

- The Court in *In re Sylva Corporation, Inc.*, No. 14-6016 (B.A.P. 8th Cir. Nov. 26, 2014) 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 *In re Circuit-Wise*, 277 B.R. 460 (Bankr. D. Conn. 2002), the bankruptcy court held that a debtor-lessee need not make any payments until a determination was made as to whether a transaction was a true lease or a secured financing.

- This case appears to have had the unintended effect of encouraging debtors to challenge almost all lease contracts as disguised security agreements in the hopes of avoiding any § 365(d)(5) payments or, should the lease be held to be a disguised financing, making only modest "adequate protection" payments measured by the decline in value of the equipment during the case, not the full payment amount.

- *But see*, *In re Elder-Beerman Stores Corp*., 201 B.R. 759 (Bankr. S.D. Ohio 1996), where the 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, in case the debtor became administratively insolvent or the case was converted to a chapter 7 proceeding.

Practice Tip: To the extent a lease's characterization is challenged, and debtor-lessee attempts to avoid making required lease payments, try to have all lease payments put in escrow until a determination is made.

D. Section 503(b)

When § 503(b) Applies: Whether someone is entitled to an administrative claim under § 503(b) is determined by a two-part test: (1) the transaction must be between the creditor and the debtor and (2) the estate must receive a benefit from the transaction. *See In re O'Brien Environmental Energy, Inc.*, 181 F.3d 527, 532-33 (3d Cir. 1999). A lessor is generally entitled to an administrative claim under § 503(b) for the fair rental value of the lessor's property actually used by the debtor. *See, e.g.*, *Zagata Fabricators, Inc. v. Superior Air Products*, 893 F.2d 624, 627 (3d Cir. 1990); *In re Cornwall Paper Mills Co.*, 169 B.R. 844, 851 (Bankr. D. N.J. 1994). The fair rental value is not necessarily the rent provided in the lease, but "the rental

value fixed in the lease will control, unless there is convincing evidence that such rental rate is unreasonable." *In re F.A. Potts & Co., Inc.*, 137 B.R. 13, 18 (E.D. Pa. 1992).

Section 503(b) Claim Can Recover Amounts Incurred During First 60 Days: As noted above, § 365(d)(5) does not expressly provide for the payment of amounts due during the first 60-day period after a case is commenced. However, courts have generally held that nothing in § 365(d)(5) precludes a lessor from asserting an administrative claim for the use of its equipment under § 503(b) during this period. *In re MUMA Services Inc.*, 279 BR 478 (Bankr. D. Del. 2002); *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); *See also In re Double 6 Trucking of the Arlatex, Inc.*, 422 B.R. 684, 689 (Bankr. W.D. Ark. 2010). Rather, § 503(b) gives lessors the right 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 D.M. Kaye & Sons Transport, Inc.*, 259 B.R. 114, 119 (Bankr. D.S.C. 2001). Courts have awarded administrative expense claims at the contract rate where equipment was useful to the debtor during this period. As such, to the extent equipment is used by a lessee during the first 60-day period, a claim should be made to recover administrative expenses during this period under § 503(b).

Burden on Claimant: The burden of proof under § 503(b)(1) is on the claimant seeking an administrative expense claim. *Williams v. IMC Mortg. Co. (In re Williams)*, 246 B.R. 591, 594 (B.A.P. 8th Cir. 1999).

Facts Are Controlling: Whether the estate received a benefit from the use of the equipment will necessarily be a factual determination by the court.

Practice Tip: Because an administrative expense may only exist pursuant to § 503(b) during the first 60 days following a bankruptcy case to the extent that the equipment is used by the debtor, lessors should closely monitor the use of equipment during such period. To the extent a debtor uses such equipment, the use confers a benefit on the debtor's estate and an administrative claim may exist. Courts will rely on specific instances of use in making any factual determination on a § 503(b) claim.

E. Related Costs, Expenses and Attorneys' Fees

Related Costs, Expenses and Attorneys' Fees: Lessors may 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. Section 365(d)(5) requires payment of "all the obligations" under the lease. As a result, to the extent provided for in the lease, a lessee may be liable for damages for debtor's failure to maintain the property and other costs of enforcing the lessor's rights, such as transportation charges and legal expenses. *In re Hayes Lemmerz Int'l, Inc.*, 340 B.R. 461, 473 (Bankr. D. Del. 2006). However, to the extent such amounts are not covered by the lease, such amounts may not be allowed. *Lakeshore Construction*, 390 B.R. at 758 (costs of repossession not included in § 365(d)(5) claim as lease did not expressly specify that such expenses would be paid by lessee-debtor).

Timing Matters: Much like lease payments, many 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. The lessor has the burden of showing when the amounts in question were incurred. *Lakeshore Construction*, 390 B.R. at 757.

- One of the leading cases regarding costs and expenses is *In re Hayes Lemmerz Int'l, Inc.*, 340 B.R. 461 (Bankr. Del. 2006). In *Hayes*, the debtor leased numerous pieces of equipment from GECC, many of which had been damaged while in debtor's possession, and GECC incurred costs and attorneys' fees while attempting to repossess the equipment. The bankruptcy court held that an administrative claim under § 365(d)(5) would arise only if the damage in question occurred after the 60th day and prior to rejection. With respect to amounts incurred within the first 60 days after the filing date, the court held that where no benefit was conferred, no administrative expense had arisen under § 503(b). However, the court held that avoiding maintenance had benefited the estate, as it incurred no upkeep costs, so an administrative expense claim under § 503(b) existed for amounts arising in first 60-day period for damage. The lessor has the burden of proving when the damage to the equipment occurred if it is to include the costs of such repairs within its administrative claim under § 365(d)(5) or § 503(b). *Id*. at 5. Where a creditor presented no evidence of when the damage to the equipment occurred, the court held that the cost of such repairs may not be included in the § 365(d)(5) priority administrative claim.

- *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. The court also found that attorneys' fees incurred during first 60-day period did not benefit the estate and were therefore not payable under § 503(b)(1). The lessor was, however, entitled to fees related to prosecuting a motion to compel the debtor to pay its postpetition obligations arising on and after the 60th day of the case where the fees could be shown to relate to the breach and request for payment under § 365(d)(5).

- *In re Lakeshore Construction Co. of Wolfeboro, Inc.*, 2008 Bankr. LEXIS 1868 (Bankr. D.N.H. June 18, 2008). The equipment lessor was entitled to an administrative claim only for the monthly rental payments accruing under an unexpired lease after the 60th day of the bankruptcy through the date the equipment was repossessed; the lessor was not entitled to damages for repossession, repair and attorneys' fees where such amounts were not specifically required to be paid pursuant to the lease. In addition, the bankruptcy court held that the lessor did not present evidence that the lessee used the equipment during the first 60 days (so no § 503(b) claim).

Practice Tip: Maintain a list of all expenses and the date such amounts are incurred. Document any damage that occurs and the date such damage arises. Make sure lease provides for payment of repairs and attorneys' fees. Such amounts may be reimbursed to extent they are incurred following the first 60-day period.

Attorneys' Fees Still Must Be Reasonable. While § 365(d)(5) appears to allow a lessor to recover attorneys' fees as an administrative expense (*provided* they are incurred after the 60th day and required to be paid pursuant to the lease), the lessor still has the burden of proving the "reasonableness" of those fees. This requires information concerning the nature of counsel's services, the time devoted to the matter and counsel's hourly rate — the same type of information one expects in connection with any request for

attorneys' fees. *See, e.g., Matter of Hunt's Health Care, Inc.*, 161 B.R. 971, 980 (Bankr. N.D. Ind. 1993). Whether attorneys' fees are reasonable is a fact-based inquiry for the court.[7]

IV. Lift Stay Motions

Generally: While the automatic stay serves as a shield, protecting a debtor-lessee and prohibiting a non-debtor lessor from taking any action against property of the estate, § 362(d) allows parties to seek the court's permission to terminate, modify or condition the automatic stay: (1) for "cause," including the lack of adequate protection of an interest in the property or (2) if the debtor does not have equity in such property and such property is not necessary to an effective reorganization. Requests for lifting the stay must be made by motion to the court, with reasonable notice to the party against whom relief is sought.[8]

"For Cause": The phrase "for cause" is not defined in the Bankruptcy Code and, as a result, bankruptcy courts are required to conduct a case-by-case inquiry to decide when such discretionary relief is appropriate. *In re ABC Learning Centres Ltd.*, 445 B.R. 318, 337 (Bankr. D. Del. 2010) ("'Cause is a flexible concept and courts often conduct a fact intensive, case-by-case balancing test, examining the totality of the circumstances to determine whether sufficient cause exists to lift the stay.'"). "Cause" is generally a factual consideration that will be highly dependent on the actual facts of the case.

- *Lack of Adequate Protection:* Adequate protection is typically held to be payment for the use of lessor's property; therefore, where a lessor is complying with its § 365(d)(5) obligations under the lease — including regular payments — cause will often not be found to exist. *See, e.g., P.J. Clarke's Restaurant Corp.*, 265 B.R. 392, 403-08 (Bankr. S.D.N.Y. 2001) (finding that while a lessor was entitled to adequate protection, such protection was given where lessee is current on its § 365(d) obligations). To the extent a debtor-lessee fails to comply with § 365(d)(5), cause may be held to exist because of a lack of adequate protection, but all factors will be necessarily taken into account.

No Equity in the Equipment: Since "true" lessees generally have no equity in equipment by design, this issue is usually not dispositive with respect to leased equipment.[9] Rather, the chief issue in dispute centers on whether the equipment is necessary for an effective reorganization. Secured creditors, or leases that are recharacterized as disguised financings, will be required to show that the lessee has no ownership stake in the underlying equipment using valuations.

"Necessary" to an Effective Reorganization: The debtor-lessee has the burden of proving that the equipment is necessary to an effective reorganization. A lessor can rebut any claim by establishing that: (1) the property is not necessary to the debtor's business or (2) there is no likelihood of an effective reorganization. Thus, whether property is "necessary" to a business is fact intensive and will depend on the particular case.

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7 Reasonable attorneys' fees have been held to be those that "are necessary to accomplish the end sought considering the skill and experience of counsel, the magnitude, complexity and novelty of the litigation, the respective positions of the parties in the litigation and the extent of responsibility legitimately undertaken by counsel." *U.S. v. Bedford Associates*, 548 F. Supp. 748, 751 (S.D.N.Y. 1982).

8 Under certain circumstances, *ex parte* relief may be sought, including, among others, situations where there is waste, there is a lack of insurance, there is fraud or the lessor is absconding with the equipment.

9 Where the issue of equity in the equipment is at issue, as in a secured financing, the lessor has the burden of proving there is no equity in the collateral, and whether equity exists will come down to a question of valuation.

Practice Tip: To the extent that a debtor-lessee is not using equipment or is not insuring the equipment, or the equipment is subject to damage, a lift stay motion can be made immediately after a bankruptcy case is commenced. Absent an emergency, most courts will give the debtor a "breathing period" immediately after filing its case before the court will determine that the equipment is not necessary for a reorganization. Such a period usually coincides with the 60-day period under § 365(d)(5). Following a filing, lessors should pay careful attention to whether the equipment is being used, not only for purposes of making a § 503(b) claim, but also to establish that the equipment is not necessary to the lessee's reorganization.

Costs of Motion: Certain courts have held that any costs incurred following lifting of stay, including costs of repossession and related fees as well as attorneys' fees, are not part of the administrative expense claim under § 365(d)(5). Rather, such amounts were held to be only unsecured claims. *See Lakeshore Construction*, 390 B.R. at 758-59. It should also be noted that attorneys' and other fees associated with a lift stay motion will typically not be awarded if brought during the initial 60-day period (such costs will likely also not be allowed as an administrative expense under § 503(b)), but there is an argument that such amounts may be awarded pursuant to § 365(d)(5) following the 60th day if the underlying lease provides for their payment.

Practice Tip: Parties may include provisions in their lease providing that costs associated with lifting the stay be included as administrative expenses, but there can be no guarantee that a court would enforce such a provision.

V. Motion to Shorten Time to Assume or Reject

Generally: Another common motion made by equipment lessors following a bankruptcy filing is a motion to shorten the time period during which a debtor-lessee may determine to assume or reject a lease.

Applicable Authority: As noted above, in a case under chapter 9, 11, 12 or 13, a debtor may assume or reject an executory contract or unexpired lease at any time prior to confirmation of a plan. Notwithstanding this fact, § 362(d)(2) provides that, on the request of any party to a contract or lease, the court may order the debtor to determine whether to assume or reject such contract or lease on an expedited basis. *See In re Rebel Rents, Inc.*, 291 B.R. at 520, 529 (ordering debtor to decide whether to assume or reject a lease in 30 days).

"Reasonable Time": Courts generally have held that debtors should have a "reasonable time" to decide whether to assume or reject an unexpired lease. *See Theatre Holding Corp. v. Mauro*, 681 F.2d 102, 105 (2d Cir. 1982). What constitutes a "reasonable time" is left to the discretion of the court, based upon the specific facts and circumstances of the case. *In re Enron Corp.*, 279 B.R. 695, 702 (Bankr. S.D.N.Y. 2002) (stating that "the definition of a reasonable time should be interpreted in conjunction with the broad rehabilitative purpose of chapter 11"). Some pertinent cases include the following:

- In determining what constitutes a reasonable time, the Second Circuit in *Theatre Holding Corp.* considered several factors, including: (i) the damage the non-debtor will suffer beyond the compensation available under the Bankruptcy Code; (ii) the importance of the contract to the

debtor's business and reorganization; (iii) whether the debtor has had sufficient time to appraise its financial situation and the potential value of its assets in formulating a plan; and (iv) whether exclusivity has terminated. The court ultimately held that the period to determine whether to assume or reject could be shortened when a debtor failed to file a plan a year after filing its petition.

- In *Rebel Rents*, the bankruptcy court found that while certain equipment was important to a debtor's business and that it would be difficult for the debtor to secure replacement equipment, because the debtor had sufficient time to appraise its financial situation, the debtor's exclusivity period had expired without the filing of a plan, and lessor had received no compensation during the postpetition period, including payment of postpetition rents accruing 60 days after the bankruptcy filing in violation of § 365(d)(5), the time period could be shortened. Notwithstanding the facts and lessor's request for an immediate determination, the court gave the debtor an additional 30 days to determine whether to assume or assign the equipment leases at issue.

VI. 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: Any decision to reject, to assume or to assume and assign a lease is subject to court approval; the debtor must file a motion (or establish procedures for the rejection, assumption and/or assumption and assignment of contracts) giving lessors notice of the debtor's action and an opportunity to object. 11 U.S.C. § 365(a).

Applicable Standard — "Business Judgment Rule": 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. Case law, however, generally holds that the proper standard to be applied is the "business judgment rule." *In re Minges*, 602 F.2d 38, 41 (2d Cir. 1979). When applying this standard, the court looks to the terms of the underlying contract, as well as the circumstances of the debtor. Factors that courts have considered in applying the business judgment test to a motion for approval of a trustee's decision to assume or reject an unexpired lease include whether (i) the contract or lease burdens the estate financially; (ii) rejection would result in a large claim against the estate; (iii) the debtor has shown real economic benefit resulting from the rejection; and (iv) upon balancing the equities, rejection will do more harm to the other party to the lease than to the estate if the lease is not rejected. The fundamental, overriding question is whether the proposed assumption or rejection will benefit the estate. *In re G Survivor Corp.*, 171 B.R. 755, 757-8 (Bankr. S.D.N.Y. 1994).

A. Rejection

Effect of Rejection: Rejection frees the bankruptcy estate from the burden of ongoing performance under the lease. Rejection does not invalidate or terminate the lease (*see In re Continental Airlines*, 981 F.2d 1450, 1459 (5th Cir. 1993)) but, rather, rejection constitutes a breach of the lease. 11 U.S.C. § 365(g).

Timing of Rejection:

- *In Chapter 11 Cases:* If the rejection occurs prior to any assumption, the breach is deemed to have occurred immediately prior to the date of the filing of the petition. 11 U.S.C. § 365(g)(1). The effect of this legal distinction is that all rejection damages become unsecured, prepetition claims. To the extent any rejection occurs after an assumption, then the breach of the agreement is deemed to occur at the time of rejection. 11 U.S.C. § 365(g)(2)(A).

- *In Chapter 7 Cases:* The lease is deemed rejected if not timely assumed or assigned. 11 U.S.C. § 365(d)(1). If a case has been converted to chapter 7 and the assumption had occurred prior to conversion, the breach occurs immediately before the date of conversion. 11 U.S.C. § 365(g)(2)(B)(i). If a case has been converted to chapter 7 and the assumption occurred after conversion, the breach occurs at the time of the rejection. 11 U.S.C. § 365(g)(2)(B)(ii).

Measure of Damages from a Rejection: Under § 502 of the Bankruptcy Code, a claim is allowed in the amount determined to be due as of the petition date "except to the extent such claim is unenforceable against the debtor." 11 U.S.C. § 502. Unless there is a conflict with a provision of the Bankruptcy Code, the calculation of the amount due the lessor under the rejected lease is determined under the terms of the lease and applicable state law. *Giant Eagle, Inc. v. Phar-Mor, Inc.*, 528 F.3d 455, 461 (6th Cir. 2008). Damages include all of the rent remaining due 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. Lessees are also responsible for any amounts due pre-rejection, up until the rejection date including any administrative amounts due under § 365(d)(5). While lessors have a duty to mitigate any damages, actual damages under the leases, including the future rent due discounted to present value, should only be reduced by the amounts "actually or reasonably mitigated." *Id.* at 466. There is no cap on the damages assertable based on the rejection and breach of an equipment lease (for real property leases, there is a cap, equal to the greater of one year's rent or 15% of three years' rent).

Status of Rejection Claim: Damages stemming from a rejection are generally deemed to be an unsecured claim. *In re Minges*, 602 F.2d at 38, 41. As noted above, however, amounts incurred after the 60th day following a bankruptcy filing are entitled to administrative expense status up to the date of the formal rejection of the leases, calculated based on the monthly lease payments provided for under the lease. *Giant Eagle*, 528 F.3d at 461. In addition, if a lease is assumed with the consent of the bankruptcy court and then later rejected, any damages from such rejection, including amounts for future rent, are entitled to administrative expense status. *In re Klein Sleep Products*, 78 F.3d 18, 28 (2d Cir. 1996) (the fact that the lease was later unprofitable does not negate that rejection damages are administrative expenses).[10]

10 *In re Merry - Go - Round Enterprises, Incorporated*, 180 F.3d 149, 156 (4th Cir. 1999) (same); *but see In re Johnston, Inc.*, 164 B.R. 551, 554 (Bankr. E.D. Tex. 1994), which allowed an administrative claim for amounts due prior to rejection, but did not allow a priority claim to exist for future rents, holding that "unlike the other courts which have addressed the issue, this Court is not convinced that the loss of future rents should be preferred over general unsecured claims."

Retroactive Rejection: Typically, the required notice period for the filing of a motion and need for a hearing before the court ensures that a lease is not rejected immediately. Such delay typically means that a lease will not be rejected until 20-25 days after a motion is filed, depending on the district. Recently, however, a number of circuits have begun to allow bankruptcy courts to approve rejection retroactively upon equitable grounds. *In re At Home Corp.*, 392 F.3d 1064 (9th Cir. 2004) (lease rejected retroactively to the filing date of the motion); *In re Thinking Machines*, 67 F.3d 1021, 1028 (1st Cir. 1995) (court may upon equitable grounds approve a rejection retroactive to the filing date of a motion; rejection need not only be effective upon court's order). Thus, a lease may be deemed rejected as of the date the motion was filed. As not all districts provide for such equitable relief, a lessor may object to any attempt to reject a lease retroactively to the extent they are in a circuit that does not permit retroactive rejection.

Practice Tip: To the extent a debtor attempts to reject a lease retroactively or without sufficient notice, grounds exist for a possible objection, depending on the district.

Status of Equipment Following Rejection: Once a lease is deemed rejected, the automatic stay under § 362(a) is automatically terminated, allowing a lessor to recover the underlying equipment. 11 U.S.C. §365(p)(1).

Computer Equipment: There are special rules contained in Bankruptcy Code § 365(n) regarding licenses to use intellectual property. Computer lessors should be aware that computers may contain intellectual property, such as software, to which these rules apply. Such estate property may be deemed separate and apart from the computer equipment itself and may need to be turned over or risk violating the stay.

Must File Proof of Claim: To the extent any amounts are outstanding on account of a lease rejection or some other reason, a proof of claim must be filed either prior to the bar date and/or in accord with the rejection order. Bankruptcy Rule 3002(c)(4) gives bankruptcy courts the discretion to set a separate bar date for lease rejection claims to the extent a lease is rejected after the bar date.

Practice Tip: Always calendar any bar dates established in the case. Failure to observe such date may result in a claim being voided.

B. Assumption

Assumption Generally: Upon an assumption, the debtor receives all the benefits of the lease but must assume all the burdens of the lease as well; *i.e.*, assumption binds the debtor to perform all of its obligations under the lease. *In re Nitec Paper Corp.*, 43 B.R. 492, 498 (Bankr. S.D.N.Y. 1984). Once a lease is assumed, future obligations under the lease are administrative expense obligations, even if the lease is later rejected. *In re Klein Sleep Products, Inc.*, 78 F.3d 18 (2d Cir. 1996).

Statutory Predicate: As with any rejection, assumption of a lease by a chapter 11 debtor also requires court approval.[11] Further, § 365 contains additional requirements that serve as protections for a lessor that must be met by the lessee prior to any assumption. Specifically, § 365(b)(1)(A) requires that:

11 A debtor in a chapter 7 case is not similarly required to seek court approval or other court action when assuming a lease pursuant to 11 U.S.C. § 365(p)(2). Rather, under this subsection, the debtor may notify the lessor of its desire to assume the lease. The lessor may accept or decline the request; if it accepts, the lessor may insist that all outstanding defaults be cured as a condition of assumption. If assumed, the debtor and not the chapter 7 estate will become obligated going forward under the forward lease. In all other instances, a debtor is required to seek court approval to assume a lease.

> If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee — (A) cures, or provides adequate assurance that the trustee will promptly cure, such default….

Requirements for Assumption: The language of § 365(b)(1)(A) can be broken down to the following requirements. A debtor must:

(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.

Cure Payments:

Monetary Defaults: The lessee must pay the lessor all amounts that are outstanding under the lease. These amounts necessarily include any defaults of the obligations which were to be performed during the first 60 days following the petition. *See* 11 U.S.C. § 365(b).

Nonmonetary Defaults: In the past, it was uncertain whether debtors were required to cure both monetary and nonmonetary defaults, and a split developed among certain circuits regarding the language of § 365(b). *See In re BankVest Capital Corp.*, 360 F.3d 291 (1st Cir. 2004) (finding that nonmonetary defaults need not be cured as statute was ambiguous), *cert. denied*, 124 S. Ct. 2874 (2004). To answer such question, in 2005 Congress revised § 365(b)(2)(D), leaving most nonmonetary defaults subject to the otherwise operative core requirements of § 365(b).

Ipso Facto Clauses Need Not Be Cured: As described further below in Section VII(B), clauses that automatically terminate or modify a lease upon the lessee's bankruptcy filing are invalid pursuant to § 365(e)(1). As such, no cure of this type of default is necessary prior to assumption. *See* § 365(b)(2).

Practice Tip: Courts routinely hold that lessees must cure all defaults 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. As a result, leases must be fully examined to make sure any and all defaults are cured prior to any objection deadline.

Adequate Assurance of "Prompt" Cure: A cure is not necessarily immediate; § 365(d) provides that a debtor may give adequate assurance of a "prompt" cure. Whether a cure of a default will be deemed to be "prompt" depends on the facts and circumstances of each case. The Bankruptcy Code does not define or give other guidance on what it means to provide assurance of a "prompt" cure. Case law on this issue varies greatly — periods as long as five years have been found to be "prompt." *See In re Coors of North Mississippi, Inc.*, 27 B.R. 918 (Bankr. N.D. Miss. 1983) (cure amount paid over 36-month period was found to be "prompt"); *In re Embers 86th St., Inc.*, 184 B.R. 892, 901 (Bankr. S.D.N.Y. 1995) (debtor's proposal to cure default over 29-month period was not "prompt"). While the time periods vary, for the most part it appears that courts find "[a]dequate assurance of a prompt cure requires that there be a firm commitment

to make all payments and at least a reasonably demonstrable capability to do so." *Id., citing In re R.H. Neil, Inc.*, 58 B.R. 969, 971 (Bankr. S.D.N.Y. 1986); *accord Matter of World Skating Center, Inc.*, 100 B.R. 147, 148-49 (Bankr. D. Conn. 1989).

Adequate Assurance of Future Performance: While the Bankruptcy Code discusses what constitutes adequate assurance of future performance with respect to shopping center leases, it does not define what constitutes adequate assurance for other types of leases. Adequate assurance of future performance is essentially a feasibility test and whether or not a debtor has provided "adequate assurance of future performance" is a factual question for the court. *See In re U.L. Radio Corp.*, 19 B.R. 537, 542 (Bankr. S.D.N.Y. 1982) ("[w]hat constitutes 'adequate assurance' is to be determined by factual conditions."); *In re Tama Beef Packing Inc.*, 277 B.R. 407, 412 (Bankr. N.D. Iowa 2002) ("court must look to the unique circumstances of each case to determine whether the criteria of § 365(b) are satisfied").

How Adequate Assurance Is Provided: Adequate assurance of future performance can usually be provided by showing the creditworthiness of the debtor-lessee and its ability to perform the contract in the future. If the lease to be assumed is assigned to a third party, the debtor will be required to show the creditworthiness of the debtor's proposed assignee and the party's ability to perform the assigned contract. The "primary focus of adequate assurance is the assignee's ability to satisfy financial obligations under the lease." *In re U.L. Radio Corp.*, 19 B.R. at 542. A demonstrated intent to set aside money for cure payments, or other non-speculative demonstrations of intent to pay, can also establish adequate assurance of future performance.

Practice Tip: One way to ensure that a lessee provides the type of "adequate assurance" required by the lessor is to include specific requirements in the underlying lease in the event the lessor becomes a debtor in a bankruptcy case. Such provisions may include (without limitation): (i) specific time periods within which defaults must be cured; (ii) specific time periods within which other pecuniary losses (like attorneys' fees) must be paid; and (iii) a significant security deposit by any assignee. While there is no guarantee a court would enforce such provisions, such provisions will surely be reviewed by the court and would provide evidence of the parties' intent at the time the lease was entered.

C. Assignment

Assignment Generally: Section 365 permits a debtor not only to reject or assume a lease, but also to assume and assign a lease to a third party. Further, a lease may be assigned notwithstanding any prohibitions contained in the lease restricting or prohibiting such assignment. 11 U.S.C. § 365(f)(1). Lease assignments are permissible to assist the debtor's reorganization or liquidation efforts. *In re Jamesway Corp.*, 201 B.R. 73, 78 (Bankr. S.D.N.Y. 1996). Upon an assignment, the third party takes the lease "as is" and must comply with all terms unless some alternative consensual agreement is reached with the lessor.

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 of the assumed lease. *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. *In re Sapolin Paints, Inc.*, 5 B.R. 412, 421 (Bankr. E.D.N.Y. 1980).

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. Similarly, clauses that condition assignment of the lease on the lessor's receiving a portion of the debtor's profit from the assignment are prohibited. 11 U.S.C. § 365(f)(1).

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); *In re Jamesway Corp.*, 201 B.R. at 77-78.

Only Certain Types of Lease Are Non-Assignable: Although 11 U.S.C. § 365(f) specifically invalidates restrictions on assignment, some types of contracts may still not be assumed or assigned. The most common examples are contracts for unique personal services, to extend credit, to make loans or to issue securities. All of these types of agreements are generally non-assignable under state law. *In re U.L. Radio Corp.*, 19 B.R. at 541.

VII. Other Lease Issues

A. Severability and Prohibition Against "Cherry-Picking"

Entire Contract Must Be Assumed: When a lessor determines to assume or reject a lease, it must do so *in toto* — it must assume or reject the entire agreement, both the benefits and the burdens. Issues regarding partial assumption or partial rejection of a lease often occur where an equipment lease consists of a master lease and several different equipment schedules. In certain circumstances, a debtor may wish to retain certain equipment while rejecting other equipment on the same or different schedules, and will move before the bankruptcy court to assume or reject individual equipment or only part of the lease. Lessors must be aware of any efforts that would seek to "cherry-pick" only certain equipment, as courts have typically held that a debtor who assumes a lease must assume the lease in its entirety, or *cum onere*, that is, subject to existing encumbrances.

Section 365 Governs: Section 365 of the Bankruptcy Code requires that if a debtor assumes an unexpired lease, in so doing the debtor must assume all of the benefits and the burdens of the contract; the debtor may not pick and choose from the desirable and undesirable portions. *In re Holland Enterprises, Inc.*, 25 Bankr. 301, 303 (E.D.N.C. 1982) (debtor must assume or reject *in toto*; it cannot reject one part of an agreement and reject another part). Importantly, interdependent provisions of a lease agreement may not be restructured into a series of separate agreements. *Holland Enterprises*, at 303; *In re Diamond Head Emporium*, 69 B.R. 494 (Bankr. D. Haw. 1987).

To the extent that a single document contains separate and distinct contracts that may be enforced separately, however, a debtor may choose to assume any one of those contracts without assuming the others. *In re Gardinier, Inc.*, 831 F.2d 974 (11th Cir. 1987), *aff'd*. 50 Bankr. 491 (Bankr. M.D. Fla. 1985) (brokerage agreement and sale agreement were two separately enforceable agreements; brokerage agreement was not an executory agreement subject to assumption or rejection); *see In re Pacific Exp., Inc.*, 780 F.2d 1482, 1488 (9th Cir. 1986) (disguised financing agreement separate agreement from maintenance and software agreements); *In re LG Philips Displays USA, Inc.*, 2006 Bankr. LEXIS 1092 (Bankr.D.Del. June 21, 2006) (where multiple contracts are intended to comprise one agreement, a party may not sever them for purposes of assumption or rejection).

How to Determine If Contract Is Severable? Whether a lease is an entire contract or severable into various different agreements is not a question of federal bankruptcy law; rather, it is determined by the

intention of the parties as evidenced by the terms of the contract and is a matter of the state law governing the agreement. *In re Gardinier*, 50 B.R. 491, 493 (Bankr. M.D. Fla. 1985) (finding non-executory brokerage agreement separate, distinct and severable from sales agreement). Specifically, courts will examine the intent from the language used by the parties, *In re Charles W. Dowdy*, 2015 Bankr. LEXIS 266 at *4 (Bankr. S.D. Miss. Jan. 28, 2015) (whether a contract is severable is a question of intention, to be determined from the language which the parties have used). Courts will also examine the subject matter, nature and purpose of the agreements at issue, the apportionment of consideration and whether the agreements are interconnected and reliant on one another.

- In *In re Gardinier*, 831 F.2d 974 (11th Cir. 1987), the Eleventh Circuit developed a test to determine whether a contract or lease may be separated into more than one contract or lease for the sake of assuming one part and rejecting another. The subject agreement contained a provision to pay a brokerage commission as well as a purchase and sale agreement. The issue was whether the agreement constituted separate obligations or if the agreement was a complete agreement that would need to be rejected or assumed in its entirety. The court held that the brokerage commission provision constituted a separate agreement between the parties. In so finding, the court identified three factors it considered in determining severability: (i) whether the nature and purpose of the obligations differ, (ii) whether the consideration for the obligations is separate and distinct, and (iii) whether the obligations of the parties are interrelated.

Using a Master Lease May Curtail "Cherry-Picking": When lessors consider structuring leases, an important consideration is whether to use a master lease and several schedules as new equipment is leased or to use individual leases for each piece of equipment. Utilizing a master lease often makes it more difficult for a lessee to cherry-pick the more attractive equipment while walking away from the less attractive or burdensome equipment. To the extent that a drafter wishes an agreement to be unseverable, it should include explicit provisions to that effect. While other considerations will be also reviewed by the court, inclusion of language stating that the various parts of the agreement constitute one indivisible agreement will likely prove important to the court.

Practice Tip: Use a master lease agreement and include language making clear that several pieces of equipment or different obligations are part of an agreement to avoid a debtor-lessee's attempts to "cherry-pick" only certain parts of an agreement.

Parties Can Consensually Agree to Split Agreements: Lessors and lessees may agree to a partial assumption or partial rejection of a lease. *In re Storage Technology Corp.*, 53 Bankr. 471, 476 (Bankr. D. Colo. 1985) (while debtor-lessees must assume agreements in full, parties can consensually agree to modifications of such agreements).

Practice Tip: Often a lessee will threaten to reject a lease if certain terms are not amended or a lease is not broken down into severable parts that can be separately rejected or assumed. Lessors should be prepared for such requests. Whether to deny such requests depends on the specific facts of the case. However, once part of an agreement is allowed to be assumed or rejected, lessors will find it difficult to say later that it is one non-severable agreement. Concessions may be necessary where equipment and costs associated with entering into a new lease are low.

B. Ipso Facto Clauses

"Ipso Facto" Contract Clauses Are Void: Many leases contain provisions that automatically terminate or modify an agreement upon the filing of a bankruptcy petition by or against the debtor, the appointment of a trustee, a custodian's taking possession of the debtor's assets, the termination of a debtor's operations or a debtor's insolvency. Following a bankruptcy filing, however, these clauses, commonly referred to as *"ipso facto"* provisions, are made invalid pursuant to § 365(e)(1). *See Reloeb Co. v. LTV Corp. (In re Chateaugay Corp.)*, 1993 WL 159969 at *4 (S.D.N.Y. May 10, 1993) (no default existed under agreements where only default was debtor's bankruptcy filing; "Section 365 abrogates the power of *ipso facto* clauses. No default may occur pursuant to an *ipso facto* clause and no reliance may be placed upon an alleged default where the only cause for default is the debtor's commencement of a bankruptcy case."); *Bruder v. Peaches Records & Tapes, Inc.*, 51 B.R. 583, 587 n.6 (B.A.P. 9th Cir. 1985) (contract provision that attempted to terminate lease when debtor ceased doing business was found to be an unenforceable anti-assignment clause); *In re Texaco*, 73 B.R. 960, 965 (Bankr. S.D.N.Y. 1987) (finding that a bankruptcy filing may not serve as an event of default that would modify rights and accelerate underlying debt). Therefore, even though a lease may contain a provision terminating the agreement upon the lessor's bankruptcy filing or other similar event or occurrence, such agreement may not be so terminated or modified, and a debtor may still be able to assume such lease or assume and assign such lease to a third party.

C. Sale Motions

Debtors Often File Motions to Assume and Assign in Connection with a § 363 *Sale Motion:* Given the cost of an extended chapter 11 case, it is becoming commonplace for a debtor to seek to sell all, or part, of its assets in a sale conducted under § 363 of the Bankruptcy Code rather than attempt a plan reorganization. In many instances, purchasers are looking for a turnkey operation or a business segment and, as a result, the sale motion will often be accompanied by a motion seeking to assume and assign critical leases to the prospective buyer. Typically, this motion or attached schedules will identify all of the potential contracts and leases that may be assumed and assigned to the buyer.

- The motion often will also state that the buyer will have a given number of days, either prior to the hearing on the sale or after the hearing on the sale, to designate a final list of the contracts and leases it wishes to have assigned to it.
    - *Possible Objection* — Each district specifies a notice period that must be given. To the extent sufficient notice is not given to the lessor, an objection can be raised on such grounds. Typically, such an objection will be of limited utility as the relief is only to give more notice; however, in certain circumstances where a transaction must close, such an objection gives the lessor additional leverage.
- Given the requirement to cure any defaults prior to assumption, the motion will typically also contain a proposed list of cure amounts, which the debtor will assert constitutes the past-due amounts owing to each lessor, needed to "cure" any existing defaults under the leases.
    - *Possible Objection* — It is critical to make sure the cure amount is correct.
    - *Possible Objection* — Lessors should make sure that the lessee cures monetary as well as nonmonetary defaults. Failure to cure a nonmonetary default — such as a failure to carry

insurance in the past — may make assumption impossible without first obtaining the lessor's consent.

- *Possible Objection* — Make sure that the debtor-lessee is assuming the entire agreement and not attempting to cherry-pick only part of the leased items.

- The motion will establish a date by which each lessor must object to the cure amount. If no objection is raised, the amount designated by the debtor will be deemed to be the only past-due amount that must be cured in order for the lease to be assumed and assigned.

Practice Tip: It is critically important that lessors pay close attention to the contents of any § 363 sale motion, as it may designate the applicable leases to be sold to a third-party purchaser and possibly assert the related cure amount to be paid. Failure to object prior to the objection deadline will leave the lessor with little recourse if the cure amount set forth therein is incorrect. If the lessor fails to object, it may also be precluded from raising other objections. These can include, among others, an objection to only part of a lease being assumed and assigned.

D. Guarantees

To the extent that a non-debtor affiliate has guaranteed the lease, the lessor may pursue any and all claims against the guarantor notwithstanding the bankruptcy. A guarantee can therefore often be used to place pressure on the debtor-lessee to assume the lease.

E. Letters of Credit

As third-parties issuing letters of credit are similarly not debtors, the automatic stay does not apply to them. *See, e.g., In re Tricord Systems, Inc.*, 2004 WL 2066817 (U.S. Dist.Ct. D. Minn 2004. Lessor drew on a letter of credit while its lessee was in bankruptcy. The District Court affirmed that letters of credit are not assets of the bankruptcy estate and that drawing on them is not a violation of the automatic stay.

Practice Tip: The automatic stay does not prevent actions against non-debtor guarantors or prohibit draws on letter of credit.

F. Lease Restructuring During Chapter 11 Proceedings

Rather than having the debtor-lessee reject the lease, the lessor may determine that it is better to consensually restructure the terms of the lease. The parties may generally agree to restructure a lease in any way, including the amount of the cure payments. Any amendment may be evaluated by the court and any creditors' committee. The standard to agree to amend an agreement, or to enter into an entirely new agreement, is typically the debtors' "business judgment." Additional scrutiny may be given depending on the amounts involved with the new agreement or amendment.

Following an agreement to amend the lease, the debtor-lessee will be required to move before the bankruptcy court to assume the underlying lease, as amended. Following assumption, the debtor-lessee will be obligated to perform under the amended lease throughout and after the bankruptcy case.

VIII. Lease Recharacterization

One of the most litigated issues under § 365 is whether a transaction is a "true" lease and subject to § 365, 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 deemed a secured financing. The distinction is critically important as true leases and secured financings have very different treatments under both tax and bankruptcy law.[12] Moreover, many lessees believe that challenging true lease status is a way to gain economic and legal leverage over a lessor.

A. 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 or property, whereas the lessee retains possession and use for the lease period. 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 or rent. 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.

B. Consequences of Recharacterization

The determination of whether a purported lease transaction results in a true lease or a disguised financing can have tremendous consequences in bankruptcy. If the lease is recharacterized as a loan, the lessee-debtor may not assume or reject the lease; rather, the underlying equipment will be treated as if it were the subject of a secured financing.

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

- The debtor-lessee may retain possession of the leased property during the case without having to comply with the ongoing postpetition rent payment requirements of § 365(b)(5);
- The debtor-lessee does not need to assume the lease to retain possession of the property; the debtor need not cure prepetition arrearages, commit to administrative expense priority treatment for future rent obligations under the assumed lease or contract, 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. *See* 11 U.S.C. § 506(a)(1). 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.

12 To this point, the discussion herein has focused on "true" leases.

- 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 it is left with nothing more than a general unsecured claim for the entire balanced 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.

- The lessor/lender may also be liable to the extent that the secured financing violates state usury laws. Consequences of such a violation vary by state but can result in the loss of interest and principal of the loan (on top of the loss of rights as a lease).

C. Standard for Recharacterization

While courts have looked to a hodgepodge of laws, including accounting, tax and state laws, to decide the issue, causing great confusion, whether an agreement is 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 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 realties" test. Only upon passing both tests will a transaction be deemed a true lease.

1. "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. This test (also known as the "residual factors test" because it tests to see if any residual value will be retained by the lessor) requires an objective analysis that is supposed to disregard the documents' labels and the parties' intent. Specifically, 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 8 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. The court first determined that "total cash price" should be read to mean the total of all payments to be made over the five-year term of the lease (rather than the price of the equipment at the beginning of the 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. Because the lease stated that it was governed by Massachusetts law, 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 should not be considered "nominal" and thus not did create a security interest under § 1-201(37).

- *In the matter of Sanford*, 2005 WL 629022 (Bankr. M.D.La. Jan. 31, 2005), the lessee had entered into an equipment rental agreement providing for no specific term, month-to-month rental payments, and a purchase option that would apply a portion of the rental payments made toward the purchase price. Because the lease was terminable at any time by the lessee, the court held that the lease did not create a security interest, denied the lessee's claim that it had purchased the equipment and held that the lessor had terminated the lease before the lessee filed for bankruptcy and thus had the right to recover the equipment.

- *In re Chance Industries, Inc.*, 2002 WL 32653678 (Bankr. D. Kan. March 29, 2002). Four lease agreements were held to be secured transactions under § 1-201(37). After finding an early termination right (at month 12 in a 36-month term) to be economically harsh — rendering the agreement effectively not subject to termination by the lessee for 36 months and thus satisfying

one aspect of the circumstances deemed to create a security interest — the court examined the purchase options at the 36th month and found that they could be exercised for "nominal additional consideration." In determining what is "nominal," the court compared the purchase option prices with both the original purchase price of the equipment and the total lease payments during the initial term.

Practice Tip: When determining whether to recharacterized a lease as a secured financing, Courts will closely examine any purchase rights that are given to a lessee. This is especially true where the lessee can purchase the underlying equipment for a 'nominal' amount. State law governs what is 'nominal,' but Courts have held that purchase prices as low as 10% of the lease value and 25% of the market value of the equipment at lease term are not 'nominal'.

2. "Economic Realties Test"

In addition, 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 disguised 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 realties" 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. *In re Edison Bros. Stores, Inc.*, 207 B.R. 801, 809-10 and n.8, 9, 10 (Bankr. D. Del. 1997); *In re Fleming Companies, Inc.*, 308 B.R. 693 (Bankr. D. Del. 2004) (bankruptcy judge held that the equipment lease was a disguised security agreement, not subject to § 365, because the lease term covered the equipment's entire economic life and the debtor's valuation expert established that the equipment would have little or no value at the end of the lease term).

Courts have also identified various other factors as indicative of the economic substance of an agreement, with no one factor controlling. The following factors are those most frequently cited:

- whether rent payments are payments of principal and interest rather than mere compensation for the use of the property;
- whether the lessee is required to purchase the property upon the occurrence of certain events or the lease provides the lessee with an option to purchase the assets for nominal or minimal consideration;
- whether the agreement transfers to the lessee the risks and obligations of ownership — such as the responsibility for payment of property taxes, maintenance and repair of the property, and maintenance of insurance — which normally are possessed by the lessor;
- whether the lessor purchased the property specifically for the lessee's use; and
- whether the transaction was structured as a lease instead of a loan to secure tax or other benefits.

While none of these factors alone is determinative, courts will look to these and other various factors and not to the intent of the parties.

Practice Tip: Courts will also look to the "economic realities" to discover if a lease should be recharacterized — the mere intent of the parties will not be determinative.

D. *Pillowtex* Decision[13]

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 standards for accounting 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).[14]

E. 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?

13 *Duke Energy Royal, LLC v. Pillowtex Corporation (In re Pillowtex, Inc.)*, 349 F.3d 711 (3d Cir. 2003).

14 In deciding that the agreement was not a true lease, but instead created a security interest, the court emphasizes a factor enunciated in a prior bankruptcy case as evidence of non-true lease status — the present value of the scheduled lease payments being greater than the cost of the leased property (*i.e.*, a full-payout lease). Since the date of this case, this factor has been explicitly enumerated in the latest version of § 1-201(37) as a factor that does not in and of itself create a security interest.

- 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.

F. Tax Code Definition and Accounting Rules, While Persuasive, Are Not Controlling

Revenue Procedure 2001-28 (Rev. Proc. 2001-28) was established with respect to three-party leveraged leases, setting forth a criteria for classifying a lease as a true lease for federal income tax purposes as contrasted with a conditional sale. While it serves as a guide for tax purposes, Rev. Proc. 2001-28 does not control the definition of a true lease as a matter of law, especially with respect to single investor leases, but merely provides criteria by which the IRS decides a lease's character of a transaction for advance income tax ruling purposes only. With respect to accounting, the basic criteria for recognizing a capital lease appear in Paragraph 7 of FAS 13.21. As with the tax code provisions, such treatment may be persuasive to a bankruptcy court, but will not be dispositive. Rather, bankruptcy courts will examine the merits of each transaction in line with state law and the above two tests.

G. 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).

H. Following Recharacterization of a Lease as a Secured Financing

To the extent the "lessor" is properly perfected:

- If the lender is oversecured, the "lessor" may be paid in full, 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).

- 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.

Practice Point: To avoid having the lease recharacterized and becoming unsecured, lessors should always perfect the underlying equipment.

IX. Additional Lease Issues

A. Leases of Rolling Stock, Railcars and Aircraft Pursuant to §§ 1110 and 1168[15]

The Bankruptcy Code contains a number of distinct protections for specific types of lessors. The most important of these sections are: (i) § 1110, with respect to aircraft equipment; and (ii) § 1168, with respect to rolling stock and rail cars.

1. Section 1110

Overview of § 1110: Section 1110 of the Bankruptcy Code provides an important exception to the automatic stay provision of § 362 for secured parties with a security interest in, lessors and conditional vendors of aircraft, aircraft engines, propellers, appliances or spare parts as defined in 49 U.S.C. §40102 (collectively *"Aircraft Equipment"*). Pursuant to § 1110, to continue to receive the protections of the automatic stay (which prevents remedies from being taken without court approval) with respect to Aircraft Equipment, a debtor must "agree to perform all obligations of the debtor" under the financing agreement by the 60th day after the bankruptcy filing (make an "*1110(a) Election*"). Such agreement requires that the debtor, subject to court approval: (a) perform all pre-petition obligations under the security agreement, lease or conditional sale contract; and (b) cures any pre-petition default. The absence of such a consensual extension of this 60-day period voids the automatic stay and allows the aircraft financier to exercise its contractual remedies against the Aircraft Equipment, which usually give it the right to repossess. All § 1110(a) Elections must be approved by the court. *Matter of Florida Airlines, Inc.*, 73 BR 64 (Bankr. M.D. Fla. 1987) (Mere payment of monthly charges on an unexpired lease by a debtor in possession does not constitute an implied assumption of such lease under §1110 giving rise to an administrative expense inasmuch as court approval is required).

Who May Utilize § 1110: In order to enjoy the benefits of an § 1110(a) Election, creditors typically must have a perfected security interest in the underlying Aircraft Equipment. Some courts, however, have held that a creditor may still benefit from the protections of § 1110, including repossession of aircraft collateral, even if its security interest was not properly perfected, by recording with the FAA registry or filing a UCC financing statement.

Section 1110 Stipulation: During the initial 60-day §1110 period, the automatic stay of the Bankruptcy Code remains in effect. Section 1110(b) provides that the debtor and the aircraft financier may agree to extend the 60-day period pursuant to a §1110(b) agreement (a "*Section 1110 Stipulation*"). This

15 It is important to note that BAPCA amended and clarified both § 1110 and § 1168 to expand the protections of secured creditors with respect to certain aircraft equipment, vessels, and railroad rolling stock equipment. Prior to the reform act, these sections provided only a limited exception to the automatic stay for secured creditors with purchase-money security interests in or lessors of such equipment. BAPCA removes the purchase-money security interest requirement and as such, the distinction between leases and loans are no longer relevant in determining whether § 1110 or § 1168 protection applies.

allows a debtor to retain the equipment, while the parties determine whether to enter into an 1110(a) Election.

Debtor Must Perform Under the Financing Documents. Section 1110 is consistent with the requirement of §365(d)(5), which provides that, with respect to personal property leases, the debtor must generally perform the debtor's obligations under the relevant lease until the lease is rejected. The first requirement under §1110 therefore is that the debtor agrees (subject to court approval) to perform all obligations under the lease, security agreement or conditional sale contract. *11 U.S.C.A. 1110(a)(2)(A)*. The debtor must continue to operate in the same manner and meet the same terms as originally prescribed by the documents. *See In re Airlift Int'l., Inc.*, 761 F.2d 1503, 1508 (11th Cir. Ct. App. 1985) (under §1110, the debtor agrees to perform the obligations as they become due); *see also In re Trans World Airlines, Inc.*, 145 F.3d 124 (3rd Cir. 1998); *In re Western Pacific Airlines, Inc.*, 221 B.R. 1 (D. Colo. 1998), *appeal dismissed*, 181 F.3d 1191 (10th Cir. 1999). In addition to perform obligations as they become due, when an airline debtor makes an §1110(a) election, the airline debtor must also cure any and all defaults under the underlying financing agreement. §1110(a)(2)(B)(i).

Defaults Under § 1110: Any defaults following the initial 60-day period are to be treated in accordance with the terms of the underlying financing agreement. If the obligations are not met under the underlying financing agreement, such failure constitutes a breach of the §1110 agreement, giving rise to an administrative claim in bankruptcy. *Trans World Airlines*, 145 F.3d at 142. *See also GATX Leasing Corp. v. Airlift International Inc.* (*In re Airlift Int'l., Inc.*) 761 F.2d 1503 (11th Cir. 1985). The amount of the administrative claim is determined by looking to the amount due under the relevant agreement. In addition to administrative claims for use of the collateral prior to repossession, a lessor is entitled to administrative expense claims for breaches of other terms of the §1110 agreement. For example, in *In re TWA*, damages stemming from the debtor's failure to meet return maintenance conditions specified by the lease for a subsequently rejected aircraft lease were held to be an administrative expense claim rather than a pre-petition unsecured claim, since the debtor's failure to meet maintenance conditions was a breach of the §1110 Agreement which permitted it to maintain the aircraft without assuming the lease. *In re TWA*, 145 F.3d 124.

Section 1110 Election Differs from an Assumption Under § 365: It is important to note that while an 1110(a) Election keeps the automatic stay in place, the making of a §1110(a) Election is clearly distinct from the assumption of a lease under §365. Section 1110(a) Elections and §1110(b) Stipulations are not the same as an assumption of the financing. When a debtor fulfills the requirements of §1110, it is still free to assume or reject an unexpired lease, even though by meeting the requirements of §1110 it is now liable for obligations under the lease as they come due. In contrast to §365, where upon assuming a lease a debtor is liable for all future obligations under the lease, under §1110, the debtor agrees only to perform the obligations *as they become due*. Thus, in the event of a post-petition breach under §1110, only the amounts that are due are a priority administrative expense, whereas the entire amount due under the lease would be an administrative expense upon breach of a contract or lease which has been assumed under §365. *See In re Airlift Int'l., Inc.*, 761 F.2d 1503, 1509.

Payments Under the Agreement Serve as Adequate Protection: Section 1110 (in contrast to §§362 and 363) essentially rewrites the concept of "adequate protection" to require strict compliance and payment in accordance with the terms of the underlying contract. In essence, such compliance is the adequate protection itself, and provides the secured creditor or lessor with precisely what he or she bargained for:

compliance with the terms of any relevant security agreement or lease, or return of the property. *Airlift*, 761 F.2d 1503, 1508.

2. Section 1168

Section 1168 operates with respect to rolling stock much in the same way that § 1110 operates with regard to aircraft. The automatic stay only remains effective with regard to the rolling stock equipment to the extent that the debtor agrees to perform all obligations under the pertinent agreement and cure all defaults thereunder. The performance of obligations and any cure must occur within 60 days of the petition date or the automatic stay is automatically lifted, unless the parties reach an agreement to extend the operative deadlines pursuant to § 1168(b). Section 1168 similarly only applies to parties that have a security interest in the underlying equipment.

B. TRAC Leases

A TRAC lease is a true lease for tax purposes, meaning the lessor owns the equipment for tax purposes, depreciates the equipment, and passes a portion of the tax depreciation to the customer (lessee) in the form of a lower payment. "TRAC" is an acronym for "terminal rent adjustment clause," a term of art in the leasing industry which refers to a lease which provides for the adjustment of the rents based on the variance of the value of the leased property from the stated "residual value" in the initial lease agreement.

At the end of a typical TRAC lease, the lessee will either agree to purchase the equipment for a specified residual amount set forth in the initial agreement or agree to the sale of the equipment in a commercially reasonable manner. If more is received from the sale than the pre-determined residual amount when selling the equipment, the lessee would receive the difference. If the lessor does not get the full pre-determined residual when selling the equipment, the lessee is responsible to make up the difference. TRAC leases are generally used for "over-the-road" vehicles like trucks, tractors and trailers.

TRAC leases are subject to the same provisions of the Bankruptcy Code as all other leases. Furthermore, just as with other types of leases, TRAC leases are commonly challenged as to whether they constitute a true lease or a disguised financing. Many states have enacted TRAC-neutral statutes that provide, in essence, that the presence of a TRAC clause has no bearing on whether a transaction is a security interest or a true lease. (*See, e.g.*, Tex. Transp. Cod Ann. § 501.112; Kan Stat. Ann. § 84-2a-110(a)). Courts will analyze this issue in the same manner as any other agreement. *See In re Charles*, 278 B.R. 216 (Bankr. Kan. 2002) (finding a TRAC leases was a true lease, and not a disguised financing, because, among other things, the purchase price at the end of the lease was not nominal). In *Charles*, the bankruptcy court reviewed the TRAC leases under both the UCC "per se" test as well as the economic realities test and held that the lease was a "true" lease because the purchase price at the end of the lease was not nominal, the agreement was non-terminable and lessee had no significant equity in the vehicles. In another case, also from Kansas, In re HP Distribution, LLP, 436 B.R. 679 (Bankr. D. Kan. 2010), the court held that a TRAC lease was a "true" leases where it passed both the UCC bright line test and economic realities test as lessor did retain a meaningful reversionary interest in the leased equipment.

Summary of Deadlines

While the handbook spells out the various rights of lessors following a default or bankruptcy, to help lessors, below is a quick summary of specific deadlines:

After a Default:

Deliver Default Notice: Check the terms of the lease for notice and other default provisions. If the lessee has not filed for bankruptcy, and lease requires a notice of default, send immediately. No notice may be sent following a bankruptcy filing.

Following a Bankruptcy Filing:

Immediately Contact the Lessee About Its Intentions: In certain instances, lessee may abandon the equipment - be prepared to retake it.

Closely Monitor and Document the Use of Equipment. An administrative expense may only exist pursuant to § 503(b) during the first 60 days following a bankruptcy case to the extent that the equipment is used by the debtor. Courts rely on specific instances of use in making any factual determination on a § 503(b) claim. Such information will also establish whether the equipment is necessary to the lessee's reorganization for lift stay motion purposes.

Document All Costs and Expenses: If lease provides for payment of repairs and attorneys' fees, maintain a list of all expenses, costs and any damage that occurs and the date such amounts are incurred and/or damages arises. Such amounts may be reimbursed to extent they are incurred after the first 60-day period. Parties may wish to delay incurring expenses until after the 60-day period if possible, as such amounts may not be reimbursable.

Check the Insurance Clause: Determine whether lease requires insurance and whether insurance is being maintained. To the extent that a debtor-lessee is not insuring the equipment and the equipment is subject to damage, a lift stay motion can be made immediately after a bankruptcy case is commenced.

Check Lease Regarding Maintenance: Debtors often curtail proper maintenance due to the cost involved. If a debtor is not properly maintaining equipment, a lift stay motion can be filed immediately to either force the debtor to properly maintain the equipment or to repossess the equipment.

60 Days After a Bankruptcy Filing:

Payment Should Commence: Section 365(d)(5) requires lessees commence making regular payments under the lease 60 days after a filing. To the extent payments are not to be commenced, a motion may be filed to compel payment or to have the debtor make a determination that the lease is to be rejected. To the extent a debtor pays any administrative expenses to other parties — such as attorneys' fees or other expenses — lease payments should also be made pursuant to § 365(d)(5).

Bar Date: Calendar any bar dates established in the case.

Assumption/Assumption and Assignment: If a lessee seeks to assume or assume and assign a lease: (i) Calculate everything that is owed under the lease. (ii) Inspect the equipment. Make sure that the

equipment is in good condition. If there is any damage which is the lessor's responsibility under the lease, require that this damage is cured prior to the lease assumption. (iii) Make sure entire lease is being assumed.

Other Considerations:

Guarantors: If the obligations under the lease are guaranteed by non-bankrupt individuals or companies, actions can be taken against the guarantors without violating the automatic stay.

Letter of Credit: If a letter of credit exists to secure payments, contact counsel. Different rules exist with regard to letters of credit, and you may be able to draw on the letter of credit despite the bankruptcy filing.

For More Information

If you would like further information concerning any of the matters discussed in this article, please contact Frank Top, Steve Tetro, or any other Chapman and Cutler attorney with whom you regularly work.

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