



Bankruptcy Desk Reference for Equipment Lenders and Lessors

October 2018 Update



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**BANKRUPTCY DESK REFERENCE
FOR
EQUIPMENT LENDERS AND LESSORS**

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Foreword: Bankruptcy Issues to Consider When Drafting an Equipment Lease — Lessons Learned from the Past

This handbook is intended to provide an in-depth analysis of the numerous issues affecting an equipment lessor when dealing with a lessee after it has filed for bankruptcy protection. However, in many cases, a lessor can set the stage for a successful restructuring and preserve the value of its equipment by considering the implications of a lessee bankruptcy at the outset of the transaction. By considering the drafting points below, lessors can help avoid some of the common pitfalls and bankruptcy traps for the unwary. Also, by having a team in place to spot troubled lessees, lessors can help minimize or even eliminate losses in some cases.

Below is a list of bankruptcy-related issues to keep in mind when initially drafting a lease agreement. The bankruptcy implications of these items are discussed in detail later in this handbook.

- *What Kind of Lease Is It?* In all cases, parties should consider whether the transaction is intended to be a “true lease” or a finance lease, include a protective lien grant and ensure that security interests are properly perfected. While there is no guarantee that the parties’ intent will be respected by a bankruptcy court, a significant amount of costly litigation can potentially be avoided by structuring the lease with this analysis in mind.
- *Fees and Expenses:* Leases should always include specific provisions for the payment of fees and expenses, which should expressly include attorneys’ fees and related professional fees. The lease should make clear that these fees and expenses are due and owing in any proceeding involving the lease, including bankruptcy, even if that proceeding is later dismissed. These provisions should also be structured so that payment for the applicable fees and expenses accrue daily. This will strengthen a lessor’s subsequent efforts to maximize the portion of fee and expense amounts that should be deemed accrued postpetition as opposed to prepetition. To avoid a finding that payments of fees and expenses are post-rejection damages, all such amounts should be required to be paid as they are accrued, *not* following the return of the leased equipment (and hence after a rejection when they would be deemed prepetition expenses). The importance of the timing of the accrual of fees, expenses and other payments is explained in greater detail in this handbook.
- *Possession and Enforcement Costs:* Once a bankruptcy filing occurs, the automatic stay will prevent any actions to recover the underlying assets without court approval. Lessors should consider specifically including lease 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 or the exercise of any other post-default remedies provided for in the lease or applicable law.

- *Adequate Protection Payments:* The Bankruptcy Code generally requires the debtor to make interim payments to its secured creditors and equipment lessors to ensure that the equipment maintains the value it had as of the day the bankruptcy was filed. The type and amount of these payments are a fact question and often subject to litigation. In equipment leases, payments under the lease pursuant to Section 365(d)(5) of the Bankruptcy Code (discussed extensively below) 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 other types of adequate protection payments as regular lease payments would then no longer be required under Section 365(d)(5). Importantly, as detailed below, adequate protection payments may only be available in recharacterized leases if the lessor is properly perfected and secured in the equipment. 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 that a court would enforce these terms, these provisions would be reviewed by the court and would provide evidence of the parties' intent at the time they entered into the lease.
- *Termination of Lease and 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 that the debtor-lessee retains a possessory interest in the equipment. Regaining possession following a lease termination but prior to a bankruptcy filing will serve to terminate all of a lessee's rights under most circumstances. 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 secured loan more than a lease. While courts consider, among other things, whether the term of the lease covers the entire useful life of the equipment and whether the lessee assumes many of the obligations of outright ownership, many courts have identified as the single most important issue whether 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 percent of the lease value or 25 percent of the market value of the equipment at lease term were not nominal. Discuss with counsel ways to structure the lease to reduce recharacterization risk. If there are any recharacterization concerns, lessors should consider negotiating for a grant of a lien on the equipment and the right to make (and, if that right is

granted, should then make) a “protective” security filing against the lessee covering the leased equipment under the applicable state-enacted uniform commercial code to maximize the chance that, if recharacterized, the transaction will at least be classified as a secured financing rather than an unsecured loan, which could result in the lessor receiving only a fraction of what it is owed.

- *Payments Should Be Required During Attempt to Recharacterize a Lease:* Consider expressly providing in the lease that, to the extent such lease’s characterization as a lease is challenged, all lease payments will continue to be made but will be placed into an escrow account until a determination of the recharacterization issue is made. Requiring payments to be made to an escrow account will lessen leverage over the lessor to force a settlement of any recharacterization challenge. Discuss with counsel, however, whether inclusion of such a provision could influence a court’s reading of the relevant lease and encourage an interpretation of the relevant agreement as something other than a “true lease.”
- *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 a lease, and then further requirements in order for the debtor to assign such lease to a third party (often a third-party purchaser of the lessor’s business and assets). These requirements include curing any defaults that may have occurred under the lease (or providing “adequate assurance” that the default will be promptly cured)¹ and providing “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 or provide adequate assurance of such cure. Lessors should draft lease provisions broadly to include requirements for the lessee to pay any and all expenses (including default interest, attorneys’ fees and other potential costs) before any breach may be cured. The lease should also specify that all amounts are due “immediately” upon any assumption or assignment and not “promptly,” since “promptly” can mean up to 15 months or more in certain situations.²
- *Defining Adequate Assurance:* Debtors must provide “adequate assurance” of future performance 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 in connection with the lease. Such adequate assurance could take the form of

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. See 11 U.S.C. § 365(b) (“cures, or provides adequate assurance that the trustee will promptly cure ...”).

² See, e.g., *In re Williams*, No. 10-11108 BLS, 2011 WL 2533046, at *2 (Bankr. D. Del. June 24, 2011) (“Having determined that the cure claim on the Lease is \$12,000, the Court would consider confirmation of a Chapter 13 plan that provides for payment in full of that cure claim within 15 months of confirmation.”); *In re Mako, Inc.*, 102 B.R. 818, 821 (Bankr. E.D. Okla. 1988) (“Under the appropriate set of facts, a period of time in excess of a year could be prompt.”) (internal citation omitted).

up-front payments, security deposits, the provision of certain additional financial information, more frequent financial reporting requirements or other terms. While it is unclear whether a court would enforce such terms, including such provisions will make it harder for the court to ignore the parties' intent, and the court may choose to enforce some or all of such terms.

- *Anticipating the Unique Challenges Posed by Sales and Auctions:* Frequently, a debtor will enter bankruptcy in order to accomplish a sale of the debtor's assets to a third-party purchaser, which sale will generally follow a competitive auction process. Lessees may be called on to negotiate cure payments and adequate assurance payments in short time frames in advance of such auctions in order to enable the debtor to assume and assign its leases upon the conclusion of the auction and the consummation of the sale. This will often require lessors to conduct due diligence inquiries of potential bidders, who could end up being new lessee counterparties by assignment, in short time frames and with access to only limited information. Lessors who anticipate that lessees may seek to sell their businesses in bankruptcy should engage bankruptcy counsel as early as possible to guide them through this process.
- *Timing of Lease Payments:* Depending upon whether a lease is ultimately assumed or rejected by a bankrupt lessee, 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 such period is monthly or quarterly) so lessors capture payments in advance of a bankruptcy filing even for the period following such filing. Lessors might also consider structuring leases such that amounts accrue daily, to maximize the portion of such amounts that the lessor can argue accrued postpetition rather than prepetition.
- *Advance Planning Is Key:* Lessors can lay the groundwork for a successful equipment lease restructuring by considering bankruptcy issues when the transaction is documented. Ideally, bankruptcy counsel should review the transaction documents to spot potential issues, particularly in form documents that might be used many times in transactions that will span many years.

Considering these issues will not allow a lessor to avoid having to deal with a lessee's bankruptcy. It will still likely be necessary to engage experienced bankruptcy counsel to defend the lessor's rights. However, these provisions may assist in avoiding some of the pain that can result from a bankruptcy 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.

I. Rights Before a Bankruptcy Filing

Conduct a Lease Review at the First Sign of Distress: If a lessor becomes aware that a lessee is in financial distress, has defaulted or is contemplating filing for bankruptcy, a review of the lease and all associated documents and security filings should be undertaken immediately to understand the various rights afforded to the lessor and to confirm that all appropriate security filings have been made and remain effective. A complete inventory of all documents should be compiled to ensure that none are missing, and if there are any state commercial code filings associated with the transaction, the lessor should ensure that all filings are current and match any expected security.³

Prior to a bankruptcy filing, the lease's specific terms will govern the parties' various rights. A review of the lease will generally reveal the remedies that exist prior to or upon a default. Depending on the lease's terms, possible remedies may include accelerating the balance due under the lease, demanding the return of leased equipment and/or terminating the agreement. Leases may also provide lessors with a right to "step in" to the shoes of the lessee in connection with third-party agreements entered into in connection with the equipment lease either temporarily or on a permanent basis upon a default of the lease, and these rights should be analyzed and understood. Any disputes between the parties will be resolved pursuant to state law.⁴

Lessor Has Choices: After a default and prior to any bankruptcy filing, a lessor is generally able to decide, subject to the terms of the lease, 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,⁵ or (3) attempt to terminate the lease and pursue remedies. In most cases, even if the lessor has decided to ride out the bankruptcy, it is advisable to exercise any right to inspect the equipment to confirm that all of its components are properly accounted for and in the condition that the lessor expects. As debtors approach bankruptcy, it is common for maintenance and repairs to equipment to be curtailed. Many lessors have attempted to work with debtors only to later have their leases rejected and suffer large losses that might have been avoidable. Any resistance to inspection should be viewed with a high

³ It may be possible to make a corrective filing where an expected filing was forgotten or allowed to lapse. However, that filing may still be subject to attack by the bankrupt as a "preference" if the filing is made within the 90 days preceding the bankruptcy. See *In re Miller*, 428 B.R. 437, 446 (Bankr. N.D. Ohio 2010) ("[W]hen a creditor re-perfects its security interest in a debtor's property, after the original perfection has lapsed, the re-perfection of the security interest potentially constitutes a preferential transfer of property.").

⁴ If a lease agreement provides that the law of a particular jurisdiction will govern interpretation of the lease, such choice-of-law clause will generally be enforced. However, exceptions apply, and counsel should be consulted to determine whether the laws of other jurisdictions (*i.e.*, where the lessor is located, where the lessee is located or where the equipment is physically housed, to name the most common choices) might apply. If no choice-of-law clause is present in the lease agreement, the party seeking to enforce remedies may have some flexibility in selecting which jurisdiction's laws to apply.

⁵ For example, a lessor might agree to amend a lease to provide less onerous payment terms in exchange for the addition of certain other protective provisions discussed herein if such provisions were omitted for any reason from the initial documentation of the lease. If a lessor is a lessee's chief or substantial creditor, the lessor may also agree to temporarily modify lease obligations in order to help the lessee avoid bankruptcy.

degree of caution. Inspection of equipment and documentation of the results of such inspection will also help a lessor make a case for post-filing adequate protection payments if the condition of the equipment has deteriorated materially.

However, a lessor should also be aware that, to the extent certain equipment is valuable to a debtor and the lease terms remain close to market, a bankruptcy filing may not materially affect the lease. It is possible in limited circumstances for a lease to “pass through” a bankruptcy with the lessor incurring no loss. In many instances, a bankruptcy can be expected to create losses for the lessor and the bankruptcy itself can be long, drawn-out and expensive. Early and diligent action in consultation with experienced counsel is generally preferable to a “wait and hope” approach. While a lessor has some ability to act prior to or upon a default, once a bankruptcy petition is filed, the lessor’s various rights and obligations will be restricted by provisions of the Bankruptcy Code.

Termination Notice: Typically, upon a default, a lessor must provide proper notice before seeking any remedies under the lease. Failure to follow the specific notice requirements in the lease and under 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 comply with the lease and/or applicable state law. Lessors may be subject to liability for exercising remedies without first providing proper notice.

Lease Termination: One of the most important concepts in lease restructuring is that a lease properly and fully terminated prior to a bankruptcy filing is not considered property of the debtor’s bankruptcy estate. See *In re Chase Monarch Int’l Inc.*, 2018 WL 550579, at *2 (Bankr. D.P.R., Jan. 24, 2018) (“A lease contract that is validly terminated pursuant to state law may not be resurrected by the filing of a bankruptcy petition.”) (quoting *In re Santos Borrero*, 75 B.R. 141 (Bankr. D.P.R. 1987)); *In re Ass’n of Graphic Commc’ns, Inc.*, No. 10 CIV. 6413, 2011 WL 1226372, at *3 (S.D.N.Y. Mar. 31, 2011) (“A bankruptcy petition does not revive a terminated lease”) (quoting *In re Hudson Transfer Grp., Inc.*, 245 B.R. 456, 459 (Bankr. S.D.N.Y. 2000)); *In re Fitness World W., Inc.*, No. 90-3112-C H, 1991 WL 11731155, at *2 (Bankr. S.D. Iowa Mar. 4, 1991) (“A court may not revive a terminated lease simply because it is important or essential to a debtor’s reorganization efforts.”); *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). Thus, when a lessor has identified a pre-bankruptcy event of default under its lease, serious consideration should be given to terminating the lease and retaking possession of the property quickly, and in any event prior to any potential bankruptcy filing. This is particularly the case for property that may be of questionable value to the debtor. Fungible property or property with a high level of “maintenance burn” also presents the risk that the debtor will use the leased property with the intention of later rejecting the lease when the value has been extracted, leaving the lessor with an unsecured claim and property that might be of little value.

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 Lakes Region Donuts, LLC*, 2014 WL 1281507, at *5 (Bankr. D.N.H. Mar. 27, 2014) (“The common inquiry to all three sections [362(b)(10), 541(b)(2), and 365(c)(3)] is whether the commercial lease was terminated prepetition under applicable nonbankruptcy

law, *i.e.*, the state law under which the lease is to be interpreted.”); *see also 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 prior to the petition date pursuant to the provisions of the lease 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 recovered.⁶ 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 lease collateral/equipment without prior relief from the automatic stay. *See* 11 U.S.C. § 362. Such actions will be deemed violations of the stay and can subject the lessor to civil penalties and possible sanctions. *See In re Weber*, 719 F.3d 72, 82 (2d Cir. 2013) (“[A]ny deliberate act taken in violation of a stay, which the violator knows to be in existence, justifies an award of actual damages.”) (quoting *In re Crysen/Montenay Energy Co.*, 902 F.2d 1098, 1105 (2d Cir. 1990)).

Additional Prepetition Considerations: Merely terminating a lease prior to a bankruptcy filing does not necessarily mean a bankrupt lessee will be deemed to have no interest in the previously 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 be required to seek relief from the automatic stay by way of a motion to lift the automatic stay pursuant to Section 365 of the Bankruptcy Code before seeking to regain possession of the equipment. *See In re Salov*, 510 B.R. 720, 729 (Bankr. S.D.N.Y. 2014) (collecting cases and noting that “[c]ourts in all ten circuits have found that the automatic stay protects a possessory interest in property”); *see also In re Atl. Bus. & Cmty. Corp.*, 901 F.2d 325, 328 (3d Cir. 1990) (possessory interest is sufficient to trigger protection of automatic stay); *In re 48th St. Steakhouse, Inc.*, 835 F.2d 427, 430 (2d Cir. 1987) (“[A] mere possessory interest in real property, without any accompanying legal interest, is sufficient to trigger the protection of the automatic stay.”); *In re Pagoda Int’l, Inc.*, 26 B.R. 18, 20 (Bankr. D. Md. 1982) (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). The contents of such a lift stay motion are described in Section IV *infra*. In many cases, the debtor will argue that the lifting of the stay does not require it to assemble the collateral and return it to the lessor. Rather, the debtor will assert that the lifting of the stay merely allows the lessor to proceed with its state law remedies.

⁶ 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 the lessor’s efforts to recover its equipment are not delayed.

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 a bankruptcy court will find such a waiver effective.

- Second, if the lease is not a "true lease," but rather is determined by the court to be a disguised financing or conditional sale agreement, then the lessee will likely be treated as having an ownership interest in the equipment, making it property of the estate pursuant to Section 541 of the Bankruptcy Code. As discussed in greater detail in Section VIII *infra*, state law governs whether an agreement is regarded as a "true lease," a disguised financing or a conditional sale agreement, and numerous factors may be reviewed in reaching such a decision. If a debtor-lessee asserts that a 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 leased equipment is not property of the estate.

Benefits of Termination Prior to Bankruptcy: While proper termination of a lease and taking action to fully sever a lessee's possessory rights in equipment prior to a bankruptcy filing require careful diligence and occasionally significant effort, they can, under many circumstances, make a significant difference in minimizing a lessor's economic losses and avoiding the high costs associated with having property tied up in a bankruptcy case.

II. Equipment Leases Following a Bankruptcy Filing

Creation of Debtor's Estate: Once a debtor files for bankruptcy 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: Immediately upon the filing of a bankruptcy petition, Section 362 of the Bankruptcy Code provides for an automatic stay that precludes lessors (or any other parties) from taking certain actions regarding property of a debtor's estate, including actions to recover money or collateral, without first obtaining permission from the bankruptcy court. The automatic stay precludes lessors from availing themselves of any and all default remedies, including maintaining collection efforts, recovering property or terminating a lease. See 11 U.S.C. § 362(a); *In re Panek*, 402 B.R. 71, 77 (Bankr. D. Mass. 2009) (finding that "[p]unitive damages are available, under 'appropriate circumstances,' to compensate an individual for violations of the automatic stay" and awarding \$10,000 to debtor in punitive damages to be paid by creditor for violation of the automatic stay). The automatic

stay can be a trap for the unwary, as actions that are clearly permitted outside of bankruptcy can expose the lessor to harsh sanctions. Courts will, however, generally only award punitive damages for automatic stay violations in the face of flagrant and intentional violations. *See In re Achterberg*, 573 B.R. 819, 834–35 (Bankr. E.D. Cal. 2017) (“When considering an award for damages, the court considers the gravity of the offense and sets the amount of punitive damages to assure that they will both punish and deter. A creditor’s good faith or lack thereof is relevant to sanctions ... [i]n determining the appropriate amount of punitive damages, the court usually considers the following factors: (1) the nature of the defendants’ acts; (2) the amount of compensatory damages awarded; and (3) the wealth of the defendants.”). Actual or compensatory damages are awarded as a matter of statute. *See* 11 U.S.C.A. § 362(k)(1) (West) (“an individual injured by any willful violation of a stay provided by this section [362] shall recover actual damages, including costs and attorneys’ fees, and, in appropriate circumstances, may recover punitive damages.”). Lessors should consult with counsel before taking any action after receiving notice of a lessee bankruptcy.

Continued Performance Required: Lessors (and other contract counterparties) are required to continue to perform all contractual obligations to a debtor during the debtor’s bankruptcy. To the extent such performance is not given, the bankruptcy court can compel a lessor to continue to perform. Generally, the performance required of the lessor merely entails allowing the debtor-lessee to maintain possession of leased equipment, but if the applicable lease requires the lessor to provide repairs, parts or other services, then courts may require such performance as well. This will be true even if prepetition amounts are outstanding and remain unpaid. Leases should be reviewed to make sure the lessor properly understands all of its ongoing obligations. A lessor’s failure to perform may result in sanctions.

Limitations on Use and/or Sale of Debtor Property: The Bankruptcy Code permits debtors to use, sell or lease property without notice or a hearing only if such disposition would be in the ordinary course of the debtors’ business. *See* 11 U.S.C. § 363(c)(1). A debtor is specifically prohibited from using, selling or leasing any property of its estate without notice and a hearing if such disposition would be outside the ordinary course of the debtor’s business. *See* 11 U.S.C. § 363(b)(1). Payment of prepetition debts is considered outside of the ordinary course of business, and a debtor-lessee is therefore prohibited, absent court approval, from paying outstanding prepetition lease payments or other related prepetition amounts. *In re Miller Min., Inc.*, 219 B.R. 219, 223 (Bankr. N.D. Ohio 1998).

Section 365 Governs Leases in Bankruptcy: Following a bankruptcy filing, Section 365 of the Bankruptcy Code governs executory contracts and, relevant to lessors, unexpired leases. Subject to certain limited exceptions, Section 365(a) provides that “[e]xcept as [otherwise provided], the trustee [or debtor in possession], subject to the court’s approval, may assume or reject any executory contract or unexpired lease of the debtor.” 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) (citing *Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303, 1310 (5th Cir. 1985)). When a debtor determines to reject a contract or lease under Section 365, the contract or lease is deemed breached as of the date immediately prior to the

petition date. See 11 U.S.C. § 365(g)(1). Counterparties to the rejected contracts or leases are thereby permitted to file claims for breach damages (often described as “rejection damages”) in the bankruptcy case. *In re Enron Corp.*, 330 B.R. 387, 392 (Bankr. S.D.N.Y. 2005), *aff’d*, 354 B.R. 652 (S.D.N.Y. 2006). See Section VI *infra* for a fuller discussion of assumption, assignment and rejection.

Timing for Assumption or Rejection: In a case under chapter 9, 11, 12 or 13 of the Bankruptcy Code, the debtor may assume or assign, or reject, an unexpired lease at any time prior to confirmation of the plan. 11 U.S.C. § 365(d)(2).⁷ In a case under chapter 7, a lease must be assumed or rejected “within 60 days after the order for relief, or within such additional time as the court, for cause, within such 60-day period, fixes, then such contract or lease [will be] deemed rejected.” 11 U.S.C. § 365(d)(1). As discussed below in Section V *infra*, a lessor may move before the court pursuant to Section 363(d)(2) to have these time periods shortened.

III. 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)⁸

Lessor Entitled to Payment Starting upon Day 61: In a chapter 11 case, the debtor generally must commence making lease and other payments and must 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.⁹ 11 U.S.C. § 365(d)(5).¹⁰ Specifically, Section 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

⁷ Note 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).

⁸ The provisions requiring a debtor to timely perform all of its obligations under an unexpired lease of personal property were added to the Bankruptcy Code in 1994 as Section 365(d)(10). This amendment was intended to make it substantially easier for lessors to recover postpetition lease payments. See *In re Midway Airlines Corp.*, 406 F.3d 229, 234 (4th Cir. 2005). The Bankruptcy Abuse Prevention and Consumer Protection Act (“BAPCPA”) amended Section 365 by renumbering former Section 365(d)(10) as Section 365(d)(5). However, BAPCPA did not alter or amend the language of former Section 365(d)(10).

⁹ Certain amounts, however, are not required to be paid — for instance, penalty rates resulting from a nonmonetary 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(d)(5).

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.

an unexpired lease ... until such lease is assumed or rejected notwithstanding section 503(b)(1) ...

The debtor's obligation to so perform continues until the lease is either assumed or rejected, unless the court orders otherwise. *See In re Lakeshore Constr. Co. of Wolfeboro, Inc.*, 390 B.R. 751, 760 (Bankr. D.N.H. 2008) (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).

Amounts Arising after 60th Day Are Administrative Claims: Amounts due under Section 365 arising after the 60th day of a case are treated as administrative expense claims in a chapter 11 case. *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, reversing lower courts that allowed reduced claim because lessor had waited to pursue its claim, and holding that lessor was entitled to full amount of its claim and such amounts were administrative expenses). Courts, however, are divided regarding the priority status of postpetition amounts due for the first 60 days.

Amount of Administrative Claim: When calculating an administrative expense claim, "there is a presumption that the contract terms and rate represent the reasonable value of the services or goods provided under the contract." *In re ID Liquidation One, LLC*, 503 B.R. 392, 399 (Bankr. D. Del. 2013). However, "[t]his presumption can be overcome if the objecting party provides 'convincing evidence to the contrary.'" *Id.* at 400; *see also In re Cook Inlet Energy, LLC*, 577 B.R. 313, 324 (Bankr. D. Alaska 2017) ("Courts have long looked to contracts as evidence of reasonable value for purposes of determining administrative expenses.").

Automatic Entitlement to Administrative Expense Claim: Under Section 365(d)(5), the entitlement to the administrative expense claim is automatic unless the debtor, the trustee or an objecting party can show that the court should order otherwise based on the equities of the case. *In re Midway Airlines Corp.*, 406 F.3d 229, 240–41 (4th Cir. 2005). As the *Midway Airlines* court explained, "[t]his [] 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." *Id.* (internal citations omitted). *See also In re Pettingill Enters., Inc.*, 486 B.R. 524, 532 (Bankr. D.N.M. 2013) ("under Section 365(d)(5), a lessor is entitled to automatically recover, as an administrative expense, any 'rent claim[s] becoming due [between] the 60th day after the filing of the bankruptcy petition and the acceptance or rejection of the lease.'" (citing *In re Lakeshore Constr. Co. of Wolfeboro, Inc.*, 390 B.R. 751, 756 (Bankr. D.N.H. 2008))).

Timing and Priority of Payments: "[A]ll administrative expense creditors must be treated with absolute equality unless a creditor agrees to subordinate its claim." *In re Food Etc., L.L.C.*, 281 B.R. 82, 88 (Bankr. S.D. Ala. 2001). Section 365(d)(5) further requires that the lessee "timely" perform its lease obligations, though courts have held that "[t]he determination of the timing of payment of administrative expenses is a matter within the discretion of the bankruptcy court." *In re HQ Glob. Holdings, Inc.*, 282 B.R. 169, 173 (Bankr. D. Del. 2002) (citing *In re Colortex Indus., Inc.*, 19 F.3d 1371, 1384 (11th Cir.1994)). The Bankruptcy Code, however, only requires 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 currently being 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 entitled to payment of its administrative expenses is case specific and will depend, among other things, on the solvency of the debtor and the competing administrative expense claims against the estate.

Practice Tip: All practitioners should calendar the 60th day after a chapter 11 filing. To the extent that payments are not commenced on or before such date, a motion should be filed to compel payment or to have the debtor decide that the lease is to be rejected. To the extent that 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 Section 365(d)(5).

When Do Obligations Arise? — “Billing Date” vs. “Proration”: After the initial 60-day period, the terms of the applicable lease control what payments must be made by the lessee-debtor. However, a question arises as to what exactly, if anything, is due on the 61st day if payments are due only on specified, scheduled dates. 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, then there is a question as to whether the lessor is entitled only to what is due under the strict terms of the lease (*i.e.*, to be paid upon the next billing date, the 15th) — 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 on the 61st day — the “proration” method. Courts have examined this question primarily with respect to Section 365(d)(3), which governs nonresidential real property leases.¹¹ Courts have been split as to the proper determination of what is due and when. Several important cases on this issue (most decided under Section 365(d)(3)) follow:

- 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*, 398 B.R. 359 (Bankr. S.D.N.Y. 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 Section 365(d)(3) required a debtor to

¹¹ The language in Section 365(d)(5) was modeled on that found in Section 365(d)(3), and accordingly courts often look to decisions construing Section 365(d)(3) in cases involving Section 365(d)(5). *See Lakeshore Constr.*, 390 B.R. at 755–56, citing *Midway Airlines*, 406 F.3d at 234.

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; *see also In re Goody’s Family Clothing Inc.*, 610 F.3d 812, 816–17 (3d Cir. 2010); *HA-LO Indus. v. CenterPoint Props. Tr.*, 342 F.3d 794, 798–800 (7th Cir. 2003) (applying “billing date” approach to month during which lease is rejected).

- In *In re MUMA Servs. 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 (including attorneys’ fees) in any proceeding relating to the lease, even if the proceeding is later dismissed. To avoid a finding that fees and expenses are post-rejection damages, all such amounts should be required to be paid as they are incurred, not following the return of equipment (and hence after a rejection). Leases can also provide that amounts accrue daily, so that in a bankruptcy it is clear that any amounts accrued on a pro-rated basis prior to the rejection date should be paid.

“Actual and Necessary Use” Not Required: Prior to the 1994 amendments to the Bankruptcy Code, Section 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. As revised, 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, Section 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)(1)(A), 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 Section 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 Constr.*, 390 B.R. at 755. As a result, court permission is not required for a debtor to commence making payments after the 61st day. As the *Lakeshore* court noted, “[t]he provisions in § 365(d)(5) were added to the Bankruptcy Code in 1994 to make it easier for lessors of personal property to recover postpetition lease payments prior to acceptance or rejection of a lease by the trustee or debtor-in-possession.” *Id.* (citing *Midway Airlines*, 406 F.3d at 234)

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. 103-835, 50 (1994), *reprinted in* 1994 U.S.C.C.A.N. 3340, 3359 (“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 P.J. Clarke’s Rest. Corp.*, 265 B.R. 392, 404 (Bankr. S.D.N.Y. 2001) (“among the cases which have discussed a landlord’s entitlement to adequate protection, none has been found in which the court held that a lessor was entitled to adequate protection payments at an amount higher than the rent reserved in the lease”). As a result, adequate protection payments are typically supplanted by claims made pursuant to Section 365(d)(5), and claims generally will not exist under both Section 365(d)(5) and Section 363(e). In other words, a claim for adequate protection will likely fail if postpetition rent payments are being made. Adequate protection payments may, however, be sought to the extent that a lease is held to be a secured financing and not a true lease.

Nonperformance by Debtor and Lease Termination: A debtor’s nonperformance following the 61st day after the petition date 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 in the 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. *In re Sturgis Iron & Metal Co., Inc.*, 420 B.R. 716, 744 (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 Section 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 administrative expense claims, with most courts finding that such amounts are *not* administrative expense claims unless they also specifically qualify for payment under Section 503(b).

- Courts generally hold 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 Section 365(d)(5)); *In re Rebel Rents, Inc.*, 291 B.R. 520, 534 (Bankr. C.D. Cal. 2003) (denying without prejudice request for administrative rent until decision on assumption or rejection was made); *In re Forman Enters., Inc.*, No. 00-20523 JKF, 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 Section 365(d)(5)).
- Some courts have, however, determined that unpaid rent incurred in the first 60-day postpetition period could be entitled to administrative status, but under only Section 503(b)

and not Section 365(d)(5). *See, e.g., In re Pettingill Enters., Inc.*, 486 B.R. 524, 533 (Bankr. D.N.M. 2013) (“In order to recover rental payments that accrue during the first 59 days after the petition date under a pre-petition lease of non-consumer personal property in Chapter 11 cases, the lessor must show that the debtor in possession gained some benefit from the property under Section 503(b).”); *In re Pan Am. Airways Corp.*, 245 B.R. 897, 900 (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 Section 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 Section 365(d)(5) expressly precludes a lessor from asserting an administrative expense claim under Section 503(b)).

- Any Section 503(b) showing would likely require an evidentiary hearing to the effect 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 that the equipment provided some other benefit to the debtor during this period. Therefore, to the extent amounts are not payable pursuant to Section 365(d)(5), such amounts may still be obtained by a claim under Section 503(b) to the extent such equipment was actually used or provided a benefit to the debtor during the bankruptcy case.

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

Because Section 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 Section 365(d)(5).

- The court in *In re Sylva Corp.*, 519 B.R. 776, 783 (B.A.P. 8th Cir. 2014), held that the issue of whether a lease was a “true” lease or a financing arrangement must be determined prior to a decision on whether an administrative expense was due.
- In *In re Circuit-Wise, Inc.*, 277 B.R. 460 (Bankr. D. Conn. 2002), the bankruptcy court held that a debtor-lessee need not make any payments until a determination is made as to whether a transaction is a true lease or a secured financing. This case appears to have had the unintended effect of encouraging debtors to make questionable challenges to 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 Section 365(d)(5) five months after the 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 the 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 Section 503(b) Applies: Section 503(b) preserves the debtor's estate during the pendency of bankruptcy proceedings by establishing a category of "allowed administrative expenses," which includes "the actual, necessary costs and expenses of preserving the estate" while in bankruptcy. 11 U.S.C. § 503(b). These expenses "receive first priority in the distribution of the assets of the debtor's estate." *In re Goody's Family Clothing, Inc.*, 401 B.R. 656, 662 (D. Del. 2009), *aff'd sub nom. In re Goody's Family Clothing Inc.*, 610 F.3d 812 (3d Cir. 2010). For a creditor to bring an administrative expense claim under Section 503(b)(1), it must demonstrate that the costs and fees for which it seeks payment provided an actual benefit to the debtor's estate and that such costs and fees were necessary to preserve the value of the estate. *Id.* (citing *In re O'Brien Envtl. Energy, Inc.*, 181 F.3d 527, 533 (3d Cir. 1999)). A lessor is generally entitled to an administrative claim under Section 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 Prods.*, 893 F.2d 624, 627 (3d Cir. 1990); *In re DVI, Inc.*, 308 B.R. 703, 707-08 (Bankr. D. Del. 2004) ("A landlord is entitled to an administrative claim in the amount of the fair market value of the premises when a debtor occupies and uses them post-petition."); *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); *see also In re Garden Ridge Corp.*, 321 B.R. 669, 676-77 (Bankr. D. Del. 2005) ("In the absence of evidence to the contrary, it is presumed that the contract rate is the fair rental value.").

Section 503(b) Claim Can Recover Amounts Incurred During First 60 Days: As noted above, Section 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 Section 365(d)(5) precludes a lessor from asserting an administrative claim for the use of its equipment under Section 503(b) during this period. *In re Muma Servs. Inc.*, 279 B.R. 478, 490 (Bankr. D. Del. 2002); *In re Sylva Corp.*, 519 B.R. 776, 783 (B.A.P. 8th Cir. 2014); *see also In re Double G Trucking of the Arlatex, Inc.*, 442 B.R. 684, 689 (Bankr. W.D. Ark. 2010). Rather, Section 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 Transp., Inc.*, 263 B.R. 733, 740-41 (Bankr. D. Md. 2001); *In re D.M. Kaye & Sons Transp., Inc.*, 259 B.R. 114, 119 (Bankr. D.S.C. 2001). Courts generally award administrative expense claims at the contract rate where

equipment was useful to the debtor during this period. Therefore, 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 Section 503(b).

Burden on Claimant: The burden of proof under Section 503(b)(1) is on the claimant seeking an administrative expense claim. *Williams v. IMC Mortg. Co. (In re Williams)*, 246 B.R. 591, 595 (B.A.P. 8th Cir. 1999); *In re Philadelphia Newspapers, LLC*, 433 B.R. 164, 175 (Bankr. E.D. Pa. 2010).

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

Practice Tip: Because an administrative expense under Section 503(b) may only arise 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, if possible. To the extent a debtor uses such equipment and the use confers a benefit on the debtor's estate, an administrative claim may exist. Courts will rely on specific instances of use in making any factual determination on a § 503(b) claim. Thus, it may be necessary to conduct discovery to ascertain the specific use of the equipment and to provide sufficient evidence of that use at a hearing before the bankruptcy court. This is a further reason for prospective lessors to draft comprehensive inspection rights provisions into their lease agreements: during the first 60 days, a lessor should, if possible, have the opportunity to inspect and record the condition and use of its leased equipment for adequate protection and/or administrative expense purposes, among others.

E. Related Costs, Expenses and Attorneys' Fees

Related Costs, Expenses and Attorneys' Fees: Lessors may 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 debtor-lessee may be liable for damages for its 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 they are not covered by the lease, such amounts may not be allowed. *Lakeshore Constr.*, 390 B.R. at 758 (costs of repossession were not included in § 365(d)(5) claim, as lease did not expressly specify that such expenses would be paid by lessee-debtor). Careful drafting of lease agreements to provide for costs and expenses of enforcement of remedies under such lease agreements will help support efforts to recover such amounts.

Timing Matters: As with lease payments, courts have held that whether attorneys' fees and other expenses are required to be paid as administrative expense claims is determined based on when the costs were incurred. The lessor has the burden of showing when the amounts in question were incurred. *Lakeshore Constr.*, 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 Lemmerz*, 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 Section 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 Section 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 Section 503(b) existed for amounts arising in the first 60-day period for damage. The court also held that 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 Section 365(d)(5) or Section 503(b). *Id.* at 465. If a creditor presents no evidence of when damage to equipment occurred, the cost of such repairs will not be included in the § 365(d)(5) priority administrative claim. *In re Lakeshore Constr. Co. of Wolfeboro, Inc.*, 390 B.R. 751, 758 (Bankr. D.N.H. 2008). Regarding *Hayes Lemmerz*, the court stated that: "The circumstances in this case, however, warrant different treatment. Because knowledge concerning the precise timing of the breach (*i.e.*, damage to a particular Machine) was exclusively within the dominion and control of Hayes, it would be unfair to require GECC to shoulder this burden."
- In *In re Forman Enters., Inc.*, 2000 Bankr. LEXIS 1529 (Bankr. W.D. Pa. Dec. 14, 2000), certain fees were incurred due to litigation 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, Section 365(d)(5) did not provide for payment as an administrative claim. The court also found that attorneys' fees incurred during the first 60-day period did not benefit the estate and were therefore not payable under Section 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 Section 365(d)(5).
- In *In re Lakeshore Constr. Co. of Wolfeboro, Inc.*, 2008 Bankr. LEXIS 1868 (Bankr. D.N.H. June 18, 2008), the bankruptcy court found that 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 because they 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: Lessors should maintain a list of all expenses and the date such amounts are incurred. Document any damage that occurs and the date such damage arises, including any foregone maintenance work or “maintenance burn.” Conduct discovery if necessary. Make sure that all leases provide for payment of repairs and attorneys’ fees. These amounts may be reimbursed if they were incurred following the first 60-day period.

Attorneys’ Fees Still Must Be Reasonable: While Section 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 are required to be paid pursuant to the lease), the lessor still has the burden of proving the “reasonableness” of those fees. This may require information concerning the nature of counsel’s services, the time devoted to the matter and counsel’s hourly rate — the same type of information that will usually need to be provided 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.¹²

IV. Motions to Lift the Automatic Stay

Generally: The automatic stay generally protects debtor-lessees against actions by non-debtor lessors against estate property, but Section 362(d) allows parties to seek the court’s permission to terminate, modify or condition the automatic stay, among other things: (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 to lift the protections of the automatic stay must be made by motion to the court, with reasonable notice to the party against whom relief is sought and other parties in interest.¹³

“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 The SCO Group, Inc.*, 395 B.R. 852, 856 (Bankr. D. Del. 2007) (“Cause is a flexible

¹² 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 Assocs.*, 548 F. Supp. 748, 751 (S.D.N.Y. 1982); *see also In re Enron Corp. Sec., Derivative & ERISA Litig.*, 586 F. Supp. 2d 732, 754 (S.D. Tex. 2008) (twelve factors that may be applied in determining reasonableness of attorneys’ fee request include: “(1) the time and labor required; (2) the novelty and difficulty of the issues; (3) the skill required to perform the legal service adequately; (4) the preclusion of other employment by the attorney because he accepted this case; (5) the customary fee for similar work in the community; (6) whether the fee is fixed or contingent; (7) time limitations imposed by the client or the circumstances; (8) the amount involved and the results obtained; (9) the experience, reputation, and ability of the attorneys; (10) the undesirability of the case; (11) the nature and length of the professional relationship with the client; and (12) awards in similar cases.”) (citing *Johnson v. Ga. Highway Express*, 488 F.2d 714, 717–19 (5th Cir. 1974)).

¹³ *Ex parte* relief may be sought under certain circumstances including, among others, when there is demonstrable waste of leased property, a lack of insurance, or fraud, or if the lessor is absconding with the equipment.

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.”). Whether a court will find that “cause” exists to lift the automatic stay is thus highly dependent on the actual facts of the case.

Lack of Adequate Protection: A lessor is generally considered to be adequately protected if the lessee is continuing to make regular lease payments for the use of lessor’s property, usually understood to be the regular rent payments set forth in the lease agreement. Therefore, where a lessee is complying with its § 365(d)(5) obligations under the lease — including regular payments — cause will not likely be found to lift, condition or modify the automatic stay, at least not on the basis of a lack of adequate protection. See, e.g., *In re P.J. Clarke’s Rest. Corp.*, 265 B.R. 392, 403–08 (Bankr. S.D.N.Y. 2001) (finding that while a lessor was entitled to adequate protection, such adequate protection requirement was satisfied by lessee’s making payments as required by Section 365(d)). To the extent a debtor-lessee fails to comply with Section 365(d)(5), cause may be held to exist because of a lack of adequate protection, but all other relevant factors will be taken into account.

No Equity in the Equipment: Since “true” lessees generally have no equity in the leased equipment, this issue is usually not dispositive. Secured creditors, or lessors in connection with leases that are recharacterized as disguised financings, will have the burden of showing that the debtor-lessee has no equity in the equipment-collateral, which involves demonstrating that the value of the equipment is lower than the amount of the debt secured by the equipment.

“Necessary” to an Effective Reorganization: If a lessor carries its burden of showing that the debtor has no equity in the equipment-collateral, then the burden shifts to the debtor-lessee to prove that the equipment is necessary to an effective reorganization in order to prevent the court from lifting the automatic stay and allowing the lessor to recover its property. A lessor can rebut a showing of necessity to the reorganization by establishing that either: (1) the property is in fact not necessary to the debtor’s reorganization, or (2) there is no likelihood of an effective reorganization in any event, whether with or without the equipment (*i.e.*, courts generally will not consider property “necessary” to an effective reorganization if no effective reorganization is possible). Whether property is “necessary” to a business is fact intensive and will depend on the particular case.

Practice Tip: To the extent that a debtor-lessee is not using equipment or is not insuring equipment according to the terms of the applicable lease, or the equipment is damaged, a lift stay motion can be made immediately after a bankruptcy case is commenced. Absent an emergency, immediately after filing its case most courts will give the debtor a “breathing period” 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 Section 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. Clear inspection rights will help lessors make such a determination.

Costs of Motion: Certain courts have held that any costs incurred in connection with property over which the stay has been lifted, including costs of repossession and related fees as well as attorneys’

fees, are not part of the administrative expense claim under Section 365(d)(5). Rather, such amounts have been held to be only unsecured claims. See *Lakeshore Constr.*, 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 Section 503(b)), but there is an argument that such amounts may be awarded pursuant to Section 365(d)(5) following the 60th day if the underlying lease provides for their payment.

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

V. Motion to Shorten Time to Assume or Reject

Generally: Another common motion made by equipment lessors following a bankruptcy filing of a lessee is a motion to shorten the time period during which the debtor-lessee may 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, Section 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 *Rebel Rents*, 291 B.R. at 531 (ordering debtor to decide whether to assume or reject a lease within 30 days of entry of order). See also *In re Hawker Beechcraft, Inc.*, 483 B.R. 424, 429–30 (Bankr. S.D.N.Y. 2012) (setting forth factors that courts should consider in determining whether to shorten time for assumption or rejection and noting that the burden rests with the movant to demonstrate cause for shortening the time).

“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); *Hawker Beechcraft*, 483 B.R. at 429 (“the settled rule adopted from pre-Bankruptcy Code case law is that the trustee has a reasonable time to make the assumption or rejection decision.”). 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, such as: (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. In that case, 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*, 291 B.R. at 531, the bankruptcy court found that while certain equipment was important to a debtor's business and 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 the lessor had received no compensation during the postpetition period (including payment of postpetition rents accruing 60 days after the bankruptcy filing in violation of Section 365(d)(5)), the time period could be shortened. Notwithstanding the facts and the 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.
- Courts have articulated various tests or guidelines that should inform the decision whether to enlarge or reduce a debtor's time to assume or reject an executory contract. For example, in *Adelphia Commc'ns*, the court synthesized these decisions and developed a twelve-factor test consisting of the following elements: (1) the nature of the interests at stake; (2) the balance of the hurt to the litigants; (3) the good to be achieved; (4) the safeguards afforded to the litigants; (5) whether the action to be taken is so in derogation of Congress' scheme that the court may be said to be arbitrary; (6) the debtor's failure or ability to satisfy postpetition obligations; (7) the damage that the non-debtor will suffer beyond the compensation available under the Bankruptcy Code; (8) the importance of the contract to the debtor's business and reorganization; (9) whether the debtor has sufficient time to appraise its financial situation and the potential value of its assets in formulating a plan of reorganization; (10) whether there is a need for judicial determination as to whether an executory contract exists; (11) whether exclusivity has been terminated; and (12) above all, the broad purpose of chapter 11, which is to permit successful rehabilitation of debtors. *In re Adelphia Commc'ns Corp.*, 291 B.R. 283, 293 (Bankr. S.D.N.Y. 2003).

VI. Rejection, Assumption and Assignment

Generally: In connection with each of a debtor-lessee's unexpired leases, prior to confirmation, or within a shorter period of time as provided by the court, such debtor-lessee must decide whether to:

1. Reject the lease;
2. Assume and retain the lease; or
3. Assume and assign the lease to a third party.

Court Approval Required: Any decision to reject, to assume and retain or to assume and assign a lease is subject to court approval. The debtor-lessee must file a motion to reject or assume, giving lessors and other parties in interest notice of the debtor's determination and an opportunity to object. 11 U.S.C. § 365(a). In larger cases, notice is typically provided pursuant to an order establishing case-specific procedures for the rejection or assumption of leases.

Practice Tip: Lessors should carefully review any motions seeking to establish case-specific procedures for the rejection or assumption of leases to ensure that the proposed procedures are fair and reasonable, and lessors should object to the motions if appropriate. Reviewing such motions will also prepare lessors to respond within any prescribed time periods to proposed assumptions or rejections of their leases.

Applicable Standard — "Business Judgment Rule": The Bankruptcy Code does not expressly state the standard to be applied in determining whether or not courts should accept a debtor's determination to reject, assume and retain or to assume and assign an unexpired lease. Case law, however, generally provides that the proper standard to be applied is the highly deferential "business judgment rule." *In re Sabine Oil & Gas Corp.*, 547 B.R. 66, 71 (Bankr. S.D.N.Y. 2016), *aff'd*, 567 B.R. 869 (S.D.N.Y. 2017) ("the process of deciding a motion to assume [or reject] is one of the bankruptcy court placing itself in the position of ... the debtor in possession and determining whether assuming [or rejecting] the contract would be a good business decision or a bad one.' This analysis is generally referred to as a 'business judgment' test, although it varies somewhat from the traditional business judgment rule employed in state corporate law, and requires the court to look at whether the debtor's decision to assume or reject is beneficial to the estate.") (citing *Orion Pictures Corp. v. Showtime Networks (In re Orion Pictures Corp.)*, 4 F.3d 1095, 1098 (2d Cir. 1993)). When applying this standard, the court looks to the terms of the underlying agreement, as well as the circumstances facing the debtor. Factors that courts have considered in applying the business judgment rule 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, 757–58 (Bankr. S.D.N.Y. 1994), *aff'd sub nom. John Forsyth Co. v. G Licensing, Ltd.*, 187 B.R. 111 (S.D.N.Y. 1995); *see also In re Penn Traffic Co.*, 524 F.3d 373, 383 (2d Cir. 2008) (collecting cases and noting that bankruptcy courts reviewing a trustee's or debtor-in-possession's decision to assume or reject an executory contract should examine a contract and the surrounding circumstances and determine if it would be beneficial or burdensome to the estate to assume or reject it: "the process of deciding a motion to assume is one of the bankruptcy court placing itself in the position of the trustee or debtor-in-possession and determining whether assuming the contract would be a good business decision or a bad one.") (internal citations omitted).

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 Matter of Cont'l 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 damages arising from the rejection of the lease are treated as unsecured, prepetition claims. If, however, rejection occurs after the lease has been assumed, then the breach of the agreement is deemed to occur at the time of rejection. 11 U.S.C. § 365(g)(2)(A). The effect of an assumption followed by a rejection is that any rejection damages claims are typically treated as postpetition claims that must be paid in full in connection with a plan of reorganization.
- *In Chapter 7 Cases:* The lease is deemed rejected if not timely assumed or assigned, typically within 60 days from the petition date. 11 U.S.C. § 365(d)(1). If a case has been converted to chapter 7 and the assumption occurred prior to conversion, the breach is deemed to have occurred 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 Section 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(b)(1). 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, 459 (6th Cir. 2008). Damages may 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 Section 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 that may be asserted based on the rejection and breach of an equipment lease, though for real property leases there is a cap, equal to the greater of one year’s rent or 15 percent of three years’ rent. *See* 11 U.S.C. § 502(b)(6).

Status of Rejection Claim: Damages stemming from a rejection are treated as unsecured claims. *In re Am. HomePatient, Inc.*, 414 F.3d 614, 617 (6th Cir. 2005). 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 rejection of the lease, 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 is rejected, any damages from such rejection, including amounts for future rent, are entitled to administrative expense status. *In re Klein Sleep Prods., Inc.*, 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).¹⁴

Retroactive Rejection: The required notice period associated with the filing of a motion to reject and the need for a hearing before any rejection is final typically ensures that a lease is not rejected immediately upon a bankruptcy filing. Consequently, leases will not usually be rejected until 20–25 days after a rejection motion is filed, depending on the district. Some circuits, however, allow bankruptcy courts to approve rejection retroactively (“*nunc pro tunc*”) to an earlier date, often the petition date, the date of the rejection motion or a prior payment date under the applicable lease, upon equitable grounds. *In re At Home Corp.*, 392 F.3d 1064, 1065 (9th Cir. 2004) (lease rejected retroactively to the filing date of the motion); *In re Thinking Machines Corp.*, 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 or on some other earlier date. As not all districts provide for such equitable relief, a lessor may object to any attempt to reject a lease retroactively to the extent such lessor is 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, equipment subject to the lease is no longer considered part of the debtor’s estate and the automatic stay under Section 362(a) is automatically terminated with respect to such equipment. This allows the applicable lessor to recover such equipment without violating the automatic stay. 11 U.S.C. § 365(p)(1). However, the debtor may assert that this merely allows the lessor to resort to state court remedies for divesting the debtor of possession of the property.

¹⁴ *In re Merry-Go-Round Enters., Inc.*, 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 “[u]nlike the other courts which have addressed the issue, this Court is not convinced that the loss of future rents should be preferred over other general unsecured claims.”

Practice Tip: In cases involving particularly valuable equipment, or where there are numerous leases that are potentially subject to rejection, consider seeking an agreed protocol with the debtor for the rejection process. This can cover any items that are important to the lessor, such as pre-rejection maintenance, return conditions, maintenance records, and any other items deemed important by the lessor to mitigate rejection damages.

Intellectual Property: Lessors should be aware of the special rules protecting licensees of intellectual property under Bankruptcy Code Section 365(n). This section provides IP licensees with a choice, following a debtor-licensor's rejection of a contract containing an IP license, either to: (i) accept the rejection and treat the contract as terminated, or (ii) retain its rights under the contract to the subject IP, as such rights existed prepetition. Lessors should be aware that some equipment, such as computers, may contain intellectual property, such as software, to which these rules apply.

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, as applicable. 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 or to the extent a lease is rejected too close to the bar date to provide affected lessors sufficient time to prepare and file a rejection damages proof of claim prior to the established case bar date.

Practice Tip: Always calendar any bar dates established in the case. Failure to observe such dates may result in a claim being forfeited. It is also generally good practice for lessors to file a proof of claim prior to the bar date even if there are no amounts that are known to have become due and owing prepetition. Such proofs of claim should reserve the lessor's rights to file an amended proof of claim for damages that arose prepetition and that were not yet known (such as undiscovered damage to equipment) or liquidated as of the date of filing.

B. Assumption

Assumption Generally: Once a debtor assumes an unexpired lease, the debtor receives all the benefits, but must also assume all the burdens, of the lease; *i.e.*, assumption binds the debtor to perform all of its obligations under the lease. *In re White*, 370 B.R. 713, 717–18 (Bankr. E.D. Mich. 2007) (“By assuming the Lease in their Plan under §§ 1322(b)(7) and 365(a), Debtors became obligated under the Plan to perform all of their contractual obligations under the Lease.”) (chapter 13 case, citing chapter 11 case *City of Covington v. Covington Landing Ltd. P’ship*, 71 F.3d 1221, 1226 (6th Cir. 1995) (“When the debtor assumes the lease or the contract under § 365, it must assume both the benefits and the burdens of the contract. Neither the debtor nor the bankruptcy court may excise material obligations owing to the non-debtor contracting party.”)). Once a lease is assumed, payment and other obligations arising under the lease during the postpetition period are administrative expense obligations and will be treated as administrative expenses, even if the lease is later rejected. *In re Klein Sleep Prods., Inc.*, 78 F.3d 18, 26 (2d Cir. 1996).

Statutory Predicate: As with rejection of an unexpired lease, a debtor's assumption of a lease also requires court approval.¹⁵ Further, Section 365 contains additional requirements that serve as protections for a lessor that must be met by the lessee prior to any assumption. Specifically, Section 365(b)(1)(A) requires that:

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: Bankruptcy Code Section 365(b)(1)(A) therefore requires that before assuming a lease, a debtor must:

- (1) cure, or provide adequate assurance of "prompt" cure, of prepetition defaults under the lease;
- (2) provide "adequate assurance" of future performance of the lease by either the debtor or any assignee; and
- (3) compensate the lessor, or provide adequate assurance of prompt compensation, for any actual losses resulting from any breach of the lease.

Cure Payments:

Monetary Defaults: Debtor-lessees must pay lessors all amounts that are outstanding under the lease. These amounts necessarily include any prepetition defaults and 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 Section 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*, 542 U.S. 919 (2004). To answer such question, in 2005 Congress revised Section 365(b)(2)(D), leaving most nonmonetary defaults subject to the otherwise operative core requirements of Section 365(b).

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

¹⁵ 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.

Practice Tip: Courts routinely hold that debtor-lessees must cure all defaults in order to assume an agreement. Certain defaults, such as failure to insure the equipment for an earlier period, however, may never be cured. To the extent that a debtor fails to comply with any condition and is unable to cure such default, grounds may exist to challenge the assumption depending on the nature of the default. 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 does not necessarily need to be effected immediately; Section 365(b) 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 three years have been found to be "prompt." Compare *In re Coors of N. Miss., Inc.*, 27 B.R. 918, 922 (Bankr. N.D. Miss. 1983) (cure amount paid over 36-month period was found to be "prompt"), with *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." *Embers 86th St.*, 184 B.R. at 901, citing *In re R.H. Neil, Inc.*, 58 B.R. 969, 971 (Bankr. S.D.N.Y. 1986); accord *Matter of World Skating Ctr., 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) ("What 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) ("the 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 be provided in many ways but is usually 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 that 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." *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 debtor-lessee or a third-party assignee provides sufficient “adequate assurance” is to include specific requirements in the underlying lease in the event the lessee 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 them, such provisions will surely be reviewed by the court and would provide evidence of the parties’ intent at the time they entered into the lease. If a lessor knows that its lease may be assumed and assigned to one of several third parties (as in an auction scenario), the lessor should determine whether it has any concern about the creditworthiness or suitability in general of any such prospective assignees and should raise any concerns as quickly as possible.

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. A lease may be assumed and 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. *See In re Fleming Cos., Inc.*, 499 F.3d 300, 305 (3d Cir. 2007). 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 order to accomplish an assumption and assignment, the Bankruptcy Code requires that a debtor do more than is required for an assumption alone. In addition to meeting the requirements found in Section 365(b) to cure all defaults prior to assuming an executory contract or unexpired lease, a debtor must also provide adequate assurance of future performance by a proposed assignee of an assumed lease in order to be permitted to assume and assign such lease. *U.L. Radio Corp.*, 19 B.R. at 541. Adequate assurance of future performance by the assignee is fact intensive and is determined by the circumstances of each case. *Fleming Cos.*, 499 F.3d at 307 (“Adequate assurance of future performance are not words of art; the legislative history of the [Bankruptcy] Code shows that they were intended to be given a practical, pragmatic construction.... What constitutes adequate assurance of future performance must be determined by consideration of the facts of the proposed assumption.”) (internal quotations omitted).

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. Clauses that condition assignment of the lease on the lessor’s receiving a portion of the debtor’s profit from the assignment are also 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, since such clauses operate to indirectly bar assignments. *See* § 365(f)(3).

Only Certain Types of Leases 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. *See* § 365(c).

VII. Other Important 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. *See In re AbitibiBowater Inc.*, 418 B.R. 815, 822 (Bankr. D. Del. 2009) (“An executory contract must be assumed or rejected in toto.”) (quoting *Sharon Steel Corp. v. Nat’l Fuel Gas Distribution Corp.*, 872 F.2d 36, 41 (3d Cir. 1989)). 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 that lease in its entirety, or *cum onere* — that is, subject to existing encumbrances. *But see, e.g., In re Royster Co.*, 137 B.R. 530, 533 (Bankr. M.D. Fla. 1992) (permitting assumption and rejection of equipment lease riders separately).

Section 365 Governs: Section 365 of the Bankruptcy Code requires that a debtor assuming an unexpired lease 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. *See AbitibiBowater Inc.*, 418 B.R. at 822. Importantly, interdependent provisions of a lease agreement may not be restructured into a series of separate agreements. *In re ATP Oil & Gas Corp.*, 517 B.R. 756, 759–60 (Bankr. S.D. Tex. 2014) (“An executory contract ... must be assumed in its entirety. A debtor may not pick and choose those portions that it wishes to enforce and reject those that it does not deem desirable. That is black letter law engraved in stone.”) (internal citations omitted).

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) (affirming lower court and holding that 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 Pac. Exp., Inc.*, 780 F.2d 1482, 1488 (9th Cir. 1986) (disguised financing agreement was a separate agreement from maintenance and software agreements); *In re LG Philips Displays USA, Inc.*, No. 06-10245 (BLS),

2006 WL 1748671, at *4 (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, Inc.*, 50 B.R. 491, 492 (Bankr. M.D. Fla. 1985), *subsequently aff'd*, 831 F.2d 974 (11th Cir. 1987) (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 Dowdy*, No. 11-03329-KMS, 2015 WL 393412, at *3 (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 more burdensome equipment. To the extent that a drafter wishes an agreement to be non-severable, it should include explicit provisions to that effect. While the court will also review other considerations, inclusion of language stating that the various parts of the agreement constitute one indivisible agreement will likely prove important to the court.

Practice Tip: To avoid a debtor-lessee’s attempts to “cherry-pick” only certain parts of an agreement, use a master lease agreement and include language making clear that several pieces of equipment or different obligations are part of a single, integrated agreement.

Parties Can Consensually Agree to Assumption of Agreements with Amendments: Lessors and lessees may agree to an assumption of a lease, as amended. *See, e.g., In re Sportsman’s Warehouse, Inc.*, 457 B.R. 372, 382 (Bankr. D. Del. 2011).

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 these 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 the insolvency of a debtor. Following a bankruptcy filing, however, these clauses, commonly referred to as “*ipso facto*” provisions, are made invalid pursuant to Section 365(e)(1). See *In re Chateaugay Corp.*, No. 92 CIV. 7054 (PKL), 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.”); *In re Lehman Bros. Holdings Inc.*, 452 B.R. 31, 39 (Bankr. S.D.N.Y. 2011) (“It is now axiomatic that *ipso facto* clauses are unenforceable in bankruptcy.”). 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. It is important for lessors not to attempt to enforce an *ipso facto* default, as the sanctions for violating the automatic stay can be severe.

C. Asset Sale Motions Pursuant to Section 363

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 Section 363 of the Bankruptcy Code rather than attempt a plan of 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 and other critical executory contracts 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. The failure to timely object to the cure amount will likely prevent the lessor from later asserting that additional amounts are owed.
 - *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 — may make assumption impossible without first obtaining the lessor’s consent, depending on the nature of the default.
- 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. It is common for debtors to strategically assert that no amounts are due, with the hope that no one would object. 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. Lessors must also be aware that debtors may seek and be granted the right to assume and assign certain executory contracts and unexpired leases that, for a variety of reasons, ultimately may not be assumed and assigned in connection with the sale.

D. Non-Debtor Guarantees

To the extent that a non-debtor affiliate of the debtor-lessor has guaranteed a lease, the lessor may generally pursue any and all claims against the guarantor notwithstanding the bankruptcy, since the automatic stay and other bankruptcy protections generally do not extend to non-debtor third parties. 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 generally apply to them. *See, e.g., In re Tricord Sys., Inc.*, No. ADV.03-4174, 2004 WL 2066817, at *7 (D. Minn. Aug. 27, 2004). In *Tricord Sys.*, the lessor drew on a letter of credit while its lessee was in bankruptcy. The District Court affirmed the bankruptcy court's ruling 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 typically prevent actions against non-debtor guarantors or prohibit draws on letter of credit.

F. Consensual Lease Restructuring

Rather than having the debtor-lessee reject a 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 with respect to the amount of the cure payments. Any amendment may be evaluated by the court and any appointed 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 seek approval from 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. Lessors should ensure that any order makes clear that the obligations under the restructured lease are postpetition administrative claims, and they should attempt to negotiate other appropriate "comfort" terms.

VIII. Lease Recharacterization: True Lease or Disguised Financing?

One of the most litigated issues under Section 365 is whether a transaction is a "true" lease, and is therefore subject to Section 365, or if it is instead a secured financing 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.¹⁶ 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” is commonly understood as an arrangement in which the risks and rewards of ownership are retained by the lessor of the relevant asset or property, while the lessee is entitled only to retain possession and use of such asset or property for a defined lease period. Called “true” because they pass the accounting requirements for the lessor to claim depreciation tax benefits, such leases typically offer comparatively lower lease payments or rent. Operating leases are typically true leases, whereas capital leases may not be. A true lease may also be called a tax lease or tax-oriented lease.

B. Consequences of Recharacterization

Whether a lease transaction is characterized as a true lease or as a disguised financing can have tremendous consequences in bankruptcy. If the lease is recharacterized as a loan, the debtor-lessee loses the right to assume or reject the lease (since following recharacterization there is no lease); rather, the leased asset or property will be treated as if it were the property of the debtor, serving as collateral for a secured loan extended by the lessor to the lessee, with the purported lease payments being treated as payments on the loan.

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 Section 365(b)(5).
- The debtor-lessee does not need to assume the lease to retain possession of the property.
- The debtor-lessee 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 recharacterized secured party is undersecured (*i.e.*, if the amount of the lessor’s claim against the debtor is greater than the value of the purportedly leased asset or property), the debtor may use Section 506 to bifurcate the lessor’s claim into a secured claim — to the extent of the value of the collateral asset or property — 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 over the objection of the lessor by reducing the value of the lessor’s secured claim to the value of its collateral and paying such claim off over a period of years, effectively allowing the debtor

¹⁶ To this point, the discussion herein has assumed that all so-called lease transactions are “true” leases.

to continue to use and possess (and in fact own) the purportedly leased asset or property while changing fundamental payment terms of the purported lease.

- 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 potential residual recovery for the lessor and shift the burdens and benefits of ownership to the lessee.
- The lessor/recharacterized lender may also be liable to the extent that the recharacterized 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 recharacterized loan (on top of the loss of rights as a lease).
- In a worst-case scenario, if the recharacterized lender has failed to perfect its security interest (perhaps because it believed it was a true lessor/owner), its security interest may be avoided in bankruptcy so that it is left with nothing more than a general unsecured claim for the entire balance owed. *See* 11 U.S.C. § 544.

Practice Tip: Even where the risk of recharacterization is perceived as remote, lessors should consider negotiating for a grant of a lien on the equipment and making a filing pursuant to the applicable state's commercial code, asserting an interest in the equipment or otherwise asserting a "protective" security interest in the collateral should the lease ever be recharacterized as a loan. When filing proofs of claim for amounts owed, lessors should also reserve all rights to revise such proofs of claim in the event of recharacterization to ensure treatment as secured creditors (assuming proper security filings have been made).

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 by a bankruptcy court under applicable state law. *See United Airlines, Inc. v. HSBC Bank USA, N.A.*, 416 F.3d 609, 614–15 (7th Cir. 2005) ("Whether a 'lease' is [a] true or bona fide lease or, in the alternative, a financing 'lease' or a lease intended as security, depends upon the circumstances of each case. The distinction between a true lease and a financing transaction is based upon the economic substance of the transaction ... Because nothing in the Bankruptcy Code says which economic features of a transaction have what consequences, we turn to state law."); *In re Pillowtex, Inc.*, 349 F.3d 711, 716 (3d Cir. 2003); *In re Cont'l 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 heavily rely on Section 1-203 of the UCC (and court interpretations thereof), which contains standards for characterizing a lease as a true lease or as a disguised financing. Should a transaction pass the "per se" test in UCC Section 1-203, courts

may still examine whether such transaction passes an “economic realities” test. Only upon passing both tests will a transaction be deemed a true lease. See *In re Lasting Impressions Landscape Contractors, Inc.*, 2017 WL 4127833, at *7 (Bankr. D. Md. Sept. 15, 2017) (“[W]hile [§ 1-203] sends a court on a search for the lessor’s residual interest, it provides no path markers to guide the way ... Rather, § 1-203 lists six conditions that, alone, are not sufficient to distinguish between a lease and security agreement.”); *In re HP Distribution, LLP*, 436 B.R. 679, 689 (Bankr. D. Kan. 2010) (holding that under Texas law, the mere fact that a chapter 11 debtor’s truck leases did not satisfy the bright-line test for being deemed disguised security agreements per se did not mean that they were true leases; the bankruptcy court still had to consider the economic realities of the agreements to determine whether they created mere security interests).

I. “Per Se” Test under UCC § 1-203

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 1-203 of the UCC includes a “per se” or “bright-line” test to determine whether a transaction should be treated as a true lease or a 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 Section 1-201(37), which provides that:

(b) ... 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**:

(1) the original term of the lease is equal to or greater than the remaining economic life of the goods,

(2) 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,

(3) 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

(4) 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.

Section 1-203 of the UCC, however, also notes that “[w]hether a transaction in the form of a lease creates a lease or security interest is determined by the facts of each case.”

2. “Economic Realities” Test

In addition, current law also includes a second level of analysis, an “economic realities” test that is designed to evaluate the facts of each transaction to determine whether the transaction is a lease or a 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 Section 1-201(37) were met, the court held that the transaction was a secured financing under the “economic realities” test).

In evaluating the “economic reality” of the transaction, courts will look at a number of factors, including whether the purchase option is nominal; whether the lessee is required to make aggregate rental payments having a present value equaling or exceeding the original cost of the leased property; and whether the lease term covers the total useful life of the equipment. *In re Edison Bros. Stores, Inc.*, 207 B.R. 801, 809–10 and n. 8, 9, 10 (Bankr. D. Del. 1997); *In re Fleming Cos., Inc.*, 308 B.R. 693, 697 (Bankr. D. Del. 2004) (bankruptcy judge held that the equipment lease was a disguised security agreement, not subject to Section 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 — that normally are possessed by the lessor;
- whether the lessor purchased the property specifically for the lessee’s use or the property was designed for installation in the debtor’s facility;
- whether the transaction was structured as a lease instead of a loan to secure tax or other benefits;
- the ability of the lessor to market the equipment at the end of the lease term;
- the amount of the lease payments over the term of the contract in relation to the initial value of the equipment;

- whether at the time of the agreement the long-term operation of the debtor’s facility required its continued possession of the equipment;
- the economic benefit to the debtor in having the transaction structured as a lease rather than a sale;
- whether the lease is terminable at will by the lessee;
- whether the lessor has the duty to repair;
- whether the lessee is compelled to purchase the goods at the termination of the lease;
- whether mandatory payments due under the lease are equal to or greater than the value of the leased goods; and
- whether the useful life of the leased property exceeds the term of the lease.

While none of these factors alone is determinative, courts will look to these and various other 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.

Relevant Case Law

- In *In re Lasting Impressions Landscape Contractors, Inc.*, No. 15-24433-TJC, 2017 WL 4127833, at *5 (Bankr. D. Md. Sept. 15, 2017), the court determined that purported leases of a number of vehicles were in the nature of secured financing arrangements, not true leases, since under the terms of the relevant leases, the lessor retained no meaningful upside right nor downside risk and thus, the court found, had no reversionary interest in the vehicles.
- In *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 percent of the purchase price at the end of the lease terms. Inquiring under UCC Section 1-201(37) (the predecessor to Section 1-203), the court concluded that the arrangements were not security interests because the leases were not subject to early cancellation and the lessor held a meaningful reversionary interest therein (despite the purchase option for 10 percent of the original lease value).
- In *In re ES2 Sports & Leisure, LLC*, 519 B.R. 476 (Bankr. M.D.N.C. 2014), an equipment lease in which the payments exceeded the cost of equipment was non-cancelable and had a \$1 nominal purchase option at its end was “per se” a secured financing.

- In *CIT Tech. Fin. Servs., Inc. v. Tricycle Enters., Inc.*, 787 N.Y.S.2d 133 (N.Y. 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 percent 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 on a “rule of thumb” employed by Massachusetts courts to the effect that a purchase option price greater than 25 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 Section 1-201(37).
- In *In re Sanford*, No. 04-13648, 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 *In re Chance Indus., Inc.*, No. 01-11698, 2002 WL 32653678 (Bankr. D. Kan. Mar. 29, 2002), four lease agreements were held to be secured transactions under Section 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 recharacterize a lease as a secured financing, a court 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 percent of the lease value and 25 percent of the market value of the equipment at lease term are not “nominal.”

D. *Pillowtex* Decision¹⁷

The *Pillowtex* decision remains one of the most preeminent recharacterization cases and serves to set forth the current standard regarding recharacterization. Decided under New York law, the case 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 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 Section 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 Section 365(d)(5).¹⁸

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?

¹⁷ *Duke Energy Royal, LLC v. Pillowtex Corp. (In re Pillowtex, Inc.)*, 349 F.3d 711 (3d Cir. 2003).

¹⁸ In deciding that the agreement was not a true lease but instead created a security interest, the court emphasized 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 Section 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 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 two tests described above.

G. Burden Is on Party Challenging the Characterization

The burden is on the lessee to demonstrate by a preponderance of the evidence that the lease is not what it purports to be. See *Lasting Impressions*, 2017 WL 4127833, at *6 ("The party attempting to reclassify a lease as a security interest bears the burden of proof."); *In re Rebel Rents, Inc.*, 291 B.R. 520, 524 (Bankr. C.D. Cal. 2003), citing *In re Murray*, 191 B.R. 309, 316 (Bankr. E.D. Pa. 1996).

H. Post-Recharacterization Treatment

To the extent the lessor has been granted and properly perfected a security interest in the equipment by means of prepetition protective security filings:

- If the recharacterized lender is oversecured (*i.e.*, if the value of the leased equipment exceeds the value of the lessor's claim against the debtor), 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 recharacterized 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 does not have a properly perfected lien, the entire claim will be an unsecured claim, likely without recourse either to meaningful payment or to the collateral itself.

Practice Tip: To avoid having the lease recharacterized and becoming entirely unsecured, lessors should always get a lien and make a "protective" filing to perfect in the leased equipment.

IX. Unique Lease Issues

A. Rolling Stock, Railcars and Aircraft Pursuant to Sections 1110 and 1168¹⁹

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

I. Section 1110

Overview of Section 1110: Section 1110 of the Bankruptcy Code provides important protections for secured parties with a security interest in, and for 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 Section 1110, to continue to receive the protections of the automatic stay (which prevents remedies from being exercised 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 (known as making an "*1110(a) Election*"). Such agreement requires that the debtor, subject to court approval: (a) perform all obligations under the security agreement, lease or conditional sale contract; and (b) cure any existing 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

¹⁹ It is important to note that BAPCPA (Pub. L. 109-8, 119 Stat. 23, enacted Apr. 20, 2005) amended and clarified both Section 1110 and Section 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. BAPCPA removes the purchase-money security interest requirement and, as a result, the distinctions between leases and loans are no longer relevant in determining whether Section 1110 or Section 1168 protection applies.

right to repossess. All 1110(a) Elections must be approved by the court. *Matter of Florida Airlines, Inc.*, 73 BR 64, 66 (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 Section 1110 giving rise to an administrative expense inasmuch as court approval is required).

Who May Utilize Section 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 Section 1110, including repossession of aircraft collateral, even if its security interest was not properly perfected by recording with the FAA registry or by filing a UCC financing statement. *In re Air Vermont, Inc.*, 761 F.2d 130, 130–31 (2d Cir. 1985); but see *In re Ozark Air Lines, Inc.*, 2007 WL 43742, at *7 (Bankr. N.D. Okla. Jan. 4, 2007) (citing *Air Vermont* and noting that that holding applies only in chapter 11 cases).

Section 1110 Stipulation: During the initial 60-day Section 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 Section 1110(b) agreement (a “Section 1110 Stipulation”). This allows a debtor to retain the equipment while the debtor decides whether to enter into (and perhaps negotiates with the lessor regarding the terms of) an 1110(a) Election.

Debtor Must Perform under the Financing Documents: Section 1110 is consistent with the requirement of Section 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 Section 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. 1985) (under Section 1110, the debtor agrees to perform the obligations as they become due); see also *In re Trans World Airlines, Inc.*, 145 F.3d 124 (3d Cir. 1998); *In re AMR Corp.*, 485 B.R. 279, 305 (Bankr. S.D.N.Y.), *aff’d*, 730 F.3d 88 (2d Cir. 2013) (“within the first 60 days of the case, the debtor must agree to perform its contractual obligations as they become due and that the debtor must also cure certain — but not all — contractual defaults.”). In addition to performing 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. 11 U.S.C. § 1110(a)(2)(B)(i).

Defaults under Section 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 Section 1110 Stipulation, giving rise to an administrative claim in bankruptcy. *Trans World Airlines*, 145 F.3d at 142; see also *Airlift Int’l*, 761 F.2d at 1509. 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 equipment prior to repossession, a lessor is entitled to administrative expense claims for breaches of other terms of the

Section 1110 Stipulation. For example, in *Trans World Airlines*, 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 prepetition unsecured claim, since the debtor's failure to meet maintenance conditions was a breach of the 1110(a) Election that permitted it to maintain the aircraft without assuming the lease. *Trans World Airlines*, 145 F.3d at 142.

An 1110(a) Election Differs from an Assumption under Section 365: It is important to note that while an 1110(a) Election keeps the automatic stay in place, the making of an 1110(a) Election is clearly distinct from the assumption of a lease under Section 365. 1110(a) Elections and Section 1110 Stipulations are not the same as an assumption of the financing. When a debtor fulfills the requirements of Section 1110, it is still free to assume or reject an unexpired lease, even though by meeting the requirements of Section 1110 it is now liable for obligations under the lease as they come due. In contrast to Section 365 where, upon assuming a lease, a debtor is liable for all future obligations under the lease, under Section 1110 the debtor agrees only to perform the obligations *as they become due*. Thus, in the event of a postpetition breach under Section 1110, only the amounts that are due are afforded administrative expense priority status, whereas the entire amount due under the lease would be an administrative expense upon breach of a contract or lease that has been assumed under Section 365. *Airlift Int'l*, 761 F.2d at 1509. For this reason, debtors sometimes make an election under Section 1110(a) in order to continue to use the aircraft until the next payment is due for "free," with the intention of never making any future payments under the lease.

Payments under the Agreement Serve as Adequate Protection: Section 1110 (in contrast to Sections 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 Int'l*, 761 F.2d at 1503, 1508.

2. Section 1168

Section 1168 operates with respect to rolling stock much in the same way that Section 1110 operates with regard to aircraft. However, unlike Section 1110, Section 1168 is only applicable in a bankruptcy of a "railroad," as defined in the Bankruptcy Code. Under Section 1168, 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 to cure all defaults thereunder. The performance of the 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 Section 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 that 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 predetermined residual amount when selling the equipment, the lessee would receive the difference. If the lessor does not get the full predetermined residual amount when selling the equipment, the lessee is responsible for making 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. CODE 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. D. Kan. 2002) (finding a TRAC lease 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 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 nonterminable and the lessee had no significant equity in the vehicles. In another Kansas case, *In re HP Distribution, LLP*, 436 B.R. 679 (Bankr. D. Kan. 2010), the court held that a TRAC lease was a "true" lease where it passed both the UCC bright-line test and the economic realities test, as the lessor retained a meaningful reversionary interest in the leased equipment.

Sample Restructuring Timeline and Milestones

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

Before a Default:

If time permits, pre-bankruptcy planning can potentially prevent significant losses and save significant time and expense during the bankruptcy. At the first sign of stress, inventory the transactions and ensure that any state uniform commercial code filings or continuation statements associated with the transaction are in place. While any curative filings may still be voidable as preferences if they are made in the 90-day period prior to the bankruptcy filing, if the bankruptcy filing does not occur until after that preference period runs, the lessor can potentially avoid substantial losses. Adequate pre-bankruptcy planning can also provide opportunities to engage with the lessee, ensure that any equipment is properly maintained and insured, and provide other opportunities to minimize losses.

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 the lease requires a notice of default, send it immediately. No notice should be sent following a bankruptcy filing. Be sure also to check any guarantees associated with the transaction for any cross-default provisions. Actions against non-debtors are typically not subject to the automatic stay. If the default entitles the lessor to terminate the lease and recover its equipment, the lessor should consider whether to take such action prior to a lessee's bankruptcy filing.

Following a Bankruptcy Filing:

Immediately Contact the Lessee about Its Intentions: In certain instances, a lessee may abandon the equipment — be prepared to retake it. Depending on the number of leases at issue, consider engaging a specialist to monitor and protect the equipment.

Closely Monitor and Document the Use of Equipment: An administrative expense claim may only arise pursuant to Section 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 Section 503(b) claim. Such information will also establish whether the equipment

is necessary to the lessee's reorganization for lift stay motion purposes. It may be necessary to pursue litigation in the bankruptcy court to obtain discovery into the debtor's use of the equipment, and otherwise to assert the lessor's claims. Early, proactive engagement with the debtor, along with active enforcement of any claims in the bankruptcy court, is frequently less costly and time consuming in the long run than a "wait and hope" approach.

Document All Costs and Expenses: If the lease provides for payment of repairs and attorneys' fees, maintain a list of all expenses, all costs and any damage that occurs and the date such amounts are incurred and/or damages arise. Such amounts may be reimbursed to the 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 prior amounts may not be reimbursable.

Check the Insurance Clause: Determine whether the 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 the 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 either to force the debtor to properly maintain the equipment or to repossess the equipment.

Inspection: If it is available under the lease documents, consider undertaking a routine inspection of the leased equipment for adequate protection and inventory purposes. However, lessors should be careful to obtain appropriate lessee consent before entering onto the premises of the lessee, and should consider consulting restructuring counsel to ensure that the proposed inspection does not risk violating the automatic stay violation.

60 Days after a Bankruptcy Filing:

Payment Should Commence: Section 365(d)(5) requires equipment lessees to 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 Section 365(d)(5).

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

Assumption/Assumption and Assignment: If a lessee seeks to assume or to assume and assign a lease, (i) calculate everything that is owed under the lease, (ii) inspect the equipment and make sure that the equipment is in good condition — if there is any damage that is the lessor's responsibility under the lease, require that this damage is cured prior to lease assumption, and (iii) make sure the entire lease is being assumed.

Other Considerations:

Guarantors: If the obligations under the lease are guaranteed by non-bankrupt individuals or companies, actions can usually 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 a letter of credit despite the bankruptcy filing.

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