

Articles

"Equipment Leasing Issues in Bankruptcy"

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The Bankruptcy Reform Act of 1994 ¹ amended certain provisions of title 11 of the U.S. Bankruptcy Code relating to unexpired leases of personal property. Section 219 of the Reform Act added §§365(d)(10) and 363(e) to the Bankruptcy Code and provides personal property lessors with at least some of the same benefits that commercial real property landlords enjoy, i.e., a current rental stream during a Chapter 11 case. However, the leading cases which have followed the enactment of Section 219, *In re Edison Bros. and Elder Beerman* have demonstrated that payment is not necessarily guaranteed by the statute.²

Section 365(d)(10) only applies in Chapter 11 cases and only to true leases; leases that are determined to be conditional sales/secured transactions are not protected. Prior to the enactment of §365(d)(10), it was not uncommon for enterprising debtors to fail to make rental payments to equipment lessors and, when lessors sought to compel payment, assert the defense that the estate received no use or benefit under the lease (at least under the stated rental terms). Debtors would then ask the court to adjust the rental payment accordingly. To remedy this practice and place lessors of personal property on footing similar to that of lessors of non-residential real property, §365(d)(10) of the Bankruptcy Code requires that a debtor/lessee begin making rental payments 60 days after the filing of a Chapter 11 petition until the debtor assumes or rejects the lease.

The rental payment requirement is not absolute. For example, penalty rates resulting from a default under the lease for failure to perform nonmonetary obligations (such as maintenance) are not covered.³ In addition, in lieu of payment, the bankruptcy court may order that some amount less than the full amount due under the lease should be paid, after notice and hearing and based upon the equities of the case.⁴ To the extent that a lease is rejected during the 60 day period following the filing of the bankruptcy petition, the statute suggests that the lessor is not entitled to administrative rent for that period.⁵

By enacting §365(d)(10), Congress apparently did not intend to provide a statutory guarantee of payment to all equipment finance leases but rather, only to those leases that were true leases. Since most financing leases today skirt the line between a true lease and a secured financing transaction, the amendments appear only to have placed the burden on the debtor to prove why rental payments should not be made under a commercial lease of personal property.⁶ Enterprising debtors have asserted as a defense that the lease is a secured transaction well after the 60 day period has elapsed, in order to avoid making payments to equipment lessors. See, e.g., *In re Elder-Beerman Stores Corp.*, 201 B.R. 759 (Bankr. S.D. Ohio 1996) (lessor sought to compel payment five months after petition was filed and 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 one under Chapter 7).

Section 1110 of the Bankruptcy Code, by contrast, requires continued payment, irrespective of whether the lease is a true lease or one that is meant for finance.

Prior to the enactment of §365(d)(10), in the event a debtor refused to make rental payments, equipment lessors were required to petition the court for an order requiring the debtor to make lease payments. A court would allow such payments only to the extent that the use of the property actually benefited the estate.⁷ In return for the burden shifting under new §365(d)(10), the debtor receives a free 60 day breathing period while deciding whether to assume or reject the equipment lease. Of course, if a lease is ultimately assumed, the debtor would be required to cure any unpaid rent which accrued during the 60 day breathing spell.⁸

Articles

Section 219 of the Reform Act also amended §363(e) of the Bankruptcy Code to provide that a lessor of personal property is now entitled to adequate protection, to the exclusion of relief from the automatic stay under §362.9 Upon the lessor's motion to lift the automatic stay or for adequate protection, however, a bankruptcy court may condition the debtor's use of the property on any terms necessary to protect the lessor's interest and may even prohibit the debtor from using the property altogether.¹⁰

Relief of this nature would be appropriate if the debtor fails to make the rental payments called for under the lease or if the debtor does not have the ability to maintain or fails to maintain the property. It is unclear, however, how broad the exclusion for a lifting of the automatic stay is -- on one end of the spectrum is excluding relief from the stay only if adequate protection is granted, and at the other, is excluding such relief under any circumstances. No court has yet to directly address the issue.

Recharacterization

The amendments to §365 have given debtors greater incentive to argue that a personal property transaction is a secured transaction ¹¹ rather than a lease since (i) a lessor may have a more favorable damage claim under a lease by virtue of the provisions of Article 2A of the Uniform Commercial Code and (ii) any repossession or subsequent sale of the property will require compliance with the notice and sale provisions of Article 9 of the U.C.C.¹²

Furthermore, if the lease is determined to be a secured transaction and the secured party is undersecured (i.e., the amount of the claim is greater than the value of the collateral), the claim will be bifurcated into a secured claim -- limited to the current value of the collateral -- and an unsecured claim for the balance.¹³

From there, the debtor may seek to "cram down"¹⁴ a plan of reorganization by stripping the lien down to the current value of the collateral and paying it off over a period of years.¹⁵ Additionally, undersecured creditors are not entitled to interest on the secured component of their claims.

Whether a transaction constitutes a true lease or a secured transaction is determined by reference to state law,¹⁶ and generally will be governed by §1-201(37) of the U.C.C., as amended. Essentially U.C.C. §1-201(37) provides that the lessee will not be locked into a lease which, based upon the facts existing at the time the transaction is entered into, provides for the lessee to make rental payments equal to the economic life of the good.

In *In re Edison Bros. Stores, Inc.*, 207 B.R. 801 (Bankr. D. Del. 1997), a case with an extensive analysis of U.C.C. §1-201(37), the debtor refused to make postpetition rental payments under an equipment lease and the lessor moved to compel payment under Section 365(d)(10).

The debtor defended on the ground that the lease -- a net lease granting the debtor the option to renew for a minimum of 12 months and a maximum of 60 months, for an exercise price equal to the fair rental value of the equipment -- was really a security agreement.

However, the schedules to the lease provided that rent for the first 12 months of any additional term would be \$1. Alternatively, the debtor had an option to purchase the equipment at the end of the initial term for an exercise price equal to the equipment's fair market value. The bankruptcy court determined that the relevant time to determine whether the option price was "nominal" under U.C.C. §1-201(37) (and, therefore, whether the lease was "true" or created a security interest) was at the inception of the transaction, by examining what the anticipated fair market value of the equipment was.

The burden of proof on this issue was placed squarely on the debtor. The debtor tried to show that on an accounting basis, the equipment would be fully depreciated at the end of the lease term. The court believed, however, that book value had little to do with fair market value and determined that the debtor could not prove that the fair market value of the goods at the expiration of the lease was nominal at the time the transaction was entered into.

The court further held that (i) the present value of the rental stream was less than the fair market value of the goods at the end of the lease term, and (ii) the term of the lease did not approximate the useful life of the property.

Articles

Conclusion

Although §219 of the Reform Act has shifted the burden to debtors to establish why payments under equipment leases should not be made, it has left enterprising debtors with wiggle room.

A Debtor may choose to not pay an equipment lessor following the 60 day breathing spell and may interpose an objection to a motion to compel payment, alleging that the lease is not a true lease. Months may go by before this issue is fully adjudicated and in the meantime, the debtor may decide to reject the lease and object to any administrative claim for nonpayment of rent during the postpetition-prerejection period, arguing that the equipment conferred no use or benefit upon the estate.

Alternatively, the case may be converted during the same period, or may become administratively insolvent. Accordingly, it may make better sense for a lessor, at a minimum, immediately at or prior to expiration of the 60 day period, to determine whether the debtor intends to make rental payments -- if he is not currently doing so. If not, the lessor should seek to enforce its rights under §§365(d)(10) and 363(e).

NOTES

1) Pub. L. No. 103-394, 108 Stat. 4107.

2) *In re Edison Bros. Stores, Inc.*, 207 B.R. 801 (Bankr. D. Del. 1997); *In re Elder-Beerman Stores Corp.*, 201 B.R. 759 (Bankr. S.D. Ohio 1996).

3) See 11 U.S.C. § 365(b)(2)(D) (added by Section 219 of the Reform Act), which provides that the "cure" provisions of Section 365(b)(1) do not apply to "the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the...unexpired lease." See also *In re Claremont Acq. Corp.*, 186 B.R. 977 (C.D. Cal. 1995), *aff'd*, 113 F.3d 1029 (9th Cir. 1997). However, some would contend that such an interpretation of Section 365(b)(2)(D) is squarely at odds with Section 365(d)(10).

On April 30, 1997, the Vice President of the Equipment Leasing Association testified before the House Committee on the Judiciary in support of H.R. 764 and H.R. 120, which would amend Section 365 of the Bankruptcy Code to clarify that, before assuming a lease of personal property, a debtor *must* cure a default of a nonmonetary obligation. The proposed amendment to Section 365 has since been incorporated into the *Consumer Bankruptcy Reform Act of 1997* (S. 1301), which is currently pending before the Senate Judiciary Committee. Hearings are scheduled for this Spring.

4) "The trustee shall timely perform all of the obligations of the debtor...unless the court, after notice and a hearing and based on the equities of the case, orders otherwise with respect to the obligations or timely performance thereof." 11 U.S.C. § 365(d)(10). See also, *e.g.*, *In re Elder-Beerman Stores*, 201 B.R. at 763.

5) "The trustee shall timely perform all of the obligations of the debtor...first arising from or after 60 days after the order for relief...*notwithstanding Section 503(b)(1) of this title....*" 11 U.S.C. § 365(d)(10) (emphasis added).

6) "This will 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 [whether to assume or reject]." 140 Cong. Rec. H 10,764 (daily ed. October 4, 1994).

7) See *In re Ernst Home Center, Inc.*, 209 B.R. 955, 965 at n.9 (Bankr. W.D. Wash. 1997).

8) See 11 U.S.C. § 365(b)(1). There would not have to be a cure of penalty rates due to a default by failing to perform nonmonetary obligations. 11 U.S.C. § 365(b)(2)(D).

Articles

- 9) See 140 Cong. Rec. H 10,769 (daily ed. October 4, 1994); 11 U.S.C. § 363(e) ("This subsection [prohibiting or conditioning use, sale or lease of property as necessary to provide adequate protection of an interest therein] also applies to property that is subject to any unexpired lease of personal property (to the exclusion of such property being subject to an order to grant relief from the stay under Section 362.")).
- 10) 11 U.S.C. §§ 362(d), 363(e).
- 11) If a transaction is deemed to be a secured transaction, Section 365 of the Bankruptcy Code will not apply.
- 12) See, e.g., *General Elec. Capital Corp. v. Danneman Assocs., Inc.*, No. 93C-08-165, 1995 WL 163561 (Del. Super. Ct. March 14, 1995); *Basic Leasing, Inc. v. Paccar, Inc.*, No. 89-4963 (CFS), 1991 WL 117412 (D.N.J. June 24, 1991).
- 13) 11 U.S.C. § 506(a).
- 14) See 11 U.S.C. § 1129(b).
- 15) Liens securing only real property that is the debtor's primary residence cannot be stripped. 11 U.S.C. § 1123(b)(5).
- 16) See *In re Continental Airlines, Inc.*, 932 F.2d 282, 294 (3d Cir. 1991) (citing H.R. Rep. No. 595, 95th Cong. 1st Sess. 314, reprinted in 1978 U.S.C.C.A.N. 5787, 5812).