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True Lease or Disguised Financing

What's the Difference, and Why Should You Care?

Whether an equipment lease is ultimately characterized as a true lease or a disguised financing after the lessee seeks bankruptcy protection determines what rights and remedies the lessor has in the bankruptcy case. After discussing the test for true leases under § 1-203 of the Uniform Commercial Code (UCC), this article will identify the issues and avenues for recovery that are available to true lessors versus secured parties.

A true lessor can force the debtor to assume or reject the lease agreement and can seek administrative expense status for the debtor's use of its equipment during the bankruptcy case. In contrast, a secured creditor must seek stay relief to recover its property and adequate protection for the use of its collateral. True lessors and secured creditors may also have different rights for recovery under the debtor's plan. This article concludes with practical suggestions for counseling equipment lessors on how to structure their agreements to avoid recharacterization as a secured transaction.

but is instead a disguised financing that should be recharacterized as a security interest.⁴

Courts look to state law to determine the nature and extent of property rights relating to the estate.⁵ As such, courts look to the UCC (as adopted by the particular state) to determine whether an agreement sets forth a true lease or a disguised financing. This involves a two-step analysis.⁶

[L]essors should file precautionary UCC financing statements to ensure that their interests are properly perfected in the event that the transaction is recharacterized as a "disguised financing."

To begin, there is a bright-line test. Can the debtor/lessee terminate the agreement during its term? If the debtor/lessee does not have a right to terminate the agreement, courts look to the "residual value factors" set forth in UCC § 1-203(b) (or the relevant state's equivalent).⁷ If one or more of the residual value factors are present *and the debtor/lessee does not have the right to terminate the agreement*, then the arrangement will likely be found to be a disguised financing agreement.⁸

Parties cannot contract their way out of the disguised financing issue. Even if the agreement explicitly states that the parties intend for the trans-

What Is a True Lease?

A true lease is an arrangement in which the lessor bears both the risks and benefits of ownership of the property being leased.¹ Generally, the lessee has only the right to use the leased property during the term of the arrangement. Section 1-203 of the UCC governs whether a lease will be characterized as a "true lease" or a security interest. The determination of whether an arrangement is a true lease or a security interest (often described as a "disguised financing") is a highly fact-specific analysis made on a case-by-case basis.²

Recharacterization

Debtors/lessees often use recharacterization as a defensive move in response to a motion by the creditor/lessor seeking to enforce the terms of the parties' pre-petition agreement.³ The lessee has the burden to establish that a lease is not a true lease

3 See, e.g., Debtor's Answer and Response to Joint Motion of Med One Capital Funding LLC and First Guaranty Bank to (1) Compel Payment of Administrative Claim; and (2) Compel Performance of Unexpired Lease of Personal Property, *In re Pioneer Health Servs. Inc.*, Case No. 16-01119, Dkt. No. 1207 (Bankr. S.D. Miss. Oct. 28, 2016) (denying that parties' pre-petition arrangement constituted "true" lease).

4 See, e.g., *In re Rebel Rents Inc.*, 291 B.R. 520, 524 (Bankr. C.D. Cal. 2003).

5 See, e.g., *In re ES2 Sports & Leisure LLC*, 519 B.R. 476, 480 (Bankr. M.D.N.C. 2014) (citing *Butner v. United States*, 440 U.S. 48, 55 (1979)); *In re Ajax Integrated LLC*, 554 B.R. 568, 577 (Bankr. N.D.N.Y. 2016) ("Although the Bankruptcy Code contemplates the differences between true leases and secured transactions and the respective rights of the parties that flow from each, state law controls the classification of a contractual agreement as between the two.")

6 See *In re Triplex Marine Maint. Inc.*, 258 B.R. 659, 669 (Bankr. E.D. Tex. 2000).

7 See, e.g., *In re Pillowtex Inc.*, 349 F.3d 711, 717 (3d Cir. 2003).

8 See, e.g., *In re Ajax Integrated LLC*, 554 B.R. 568 (holding that equipment lease was disguised financing as debtor had option of acquiring leased equipment for \$16,900); *In re Gutierrez*, 526 B.R. 449 (Bankr. D.P.R. 2015) (finding that car lease was disguised security agreement and not "true lease" as debtor could not terminate it, and because she had option to buy vehicle for no additional consideration); *In re ES2 Sports & Leisure LLC*, 519 B.R. 476 (finding that equipment lease with payments that exceeded cost of equipment, could not be cancelled and had a \$1 purchase option was secured financing); *In re Triplex Marine Maint. Inc.*, 258 B.R. 659 (finding that sales-leaseback transaction was not true lease).



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1 See ABI President Hon. Eugene R. Wedoff's (ret.) analysis in *In re UAL Corp.*, 307 B.R. 618, 631 (Bankr. N.D. Ill.), *rev'd sub nom.*, *HSBC Bank USA v. United Air Lines Inc.*, 317 B.R. 335 (N.D. Ill. 2004), *rev'd and remanded sub nom.*, *United Airlines Inc. v. HSBC Bank USA NA*, 416 F.3d 609 (7th Cir. 2005), *aff'd in part, rev'd in part sub nom.*, *U.S. Bank Nat. Ass'n v. United Air Lines Inc.*, 331 B.R. 765 (N.D. Ill. 2005), *rev'd and remanded sub nom.*, *In re United Air Lines Inc.*, 447 F.3d 504 (7th Cir. 2006).

2 U.C.C. § 1-203 ("Whether a transaction in the form of a lease creates a lease or security interest is determined by the facts of each case."); see also, e.g., *Matter of Jarrells*, 205 B.R. 994, 998 (Bankr. M.D. Ga. 1997) (holding that Georgia law required case-by-case analysis); U.C.C. § 1-203(b)-(d).

action to be a lease, if the agreement is not terminable by the debtor/lessee and any of the residual value factors are present, a court can still determine that the arrangement is a disguised financing.⁹

Recovery Options Available to True Lessors

In a true-lease arrangement, the leased property is property of the lessor — not property of the debtor's estate — and the lessor's remedies are intended to compensate it for the debtor's continued use of the lessor's property during the bankruptcy case. While a chapter 7 debtor must elect to assume a lease within the first 60 days of its case, debtors under the other Bankruptcy Code chapters need only elect to assume or reject the lease prior to confirmation of a plan.¹⁰ Prior to rejection of the lease, the debtor/lessee must continue to perform (*i.e.*, continue to make payments to the creditor/lessor). Significantly, the creditor/lessor's claims to ongoing payments during the course of the case are entitled to administrative-expense status.¹¹

However, § 365(d)(5) of the Bankruptcy Code provides a breathing period for chapter 11 debtors during the first 60 days of the case. The Code does not require the debtor to "timely perform" its obligations under the lease until "after 60 days after the order for relief."¹² Most courts have held that claims for amounts that arise during the first 60 days are not entitled to administrative-expense priority.¹³ Nevertheless, some courts have found that § 503(b) administrative expense priority claims can arise during that 60-day period.¹⁴

If the debtor ultimately rejects the lease prior to any assumption of the lease, such rejection is deemed to be a breach of the lease immediately prior to the petition date.¹⁵ The lessor is then entitled to a general unsecured claim for damages incurred as a result of the breach.

Recovery Options Available to Secured Parties

Unlike the lessor in a true lease arrangement, a secured party does not have an ownership interest in the collateral; it has a security interest, and the collateral itself is property of the debtor's estate.¹⁶ Among other things, the debtor may use, sell or lease the collateral pursuant to the

strictures of § 363. In addition, any increase in the value of the collateral inures to the benefit of the debtor, not the creditor/lessor.

To the extent that the amount of the creditor/lessor's claim exceeds the value of the collateral, the debtor also has the ability to bifurcate the secured claim under § 506. Using § 506(a)(1), the creditor/lessor's claim is divided into a secured claim up to the value of the collateral, and an unsecured claim for the remainder.

The debtor/lessee can also seek to avoid the creditor/lessor's security interest altogether under § 544 if the creditor/lessor did not properly perfect its security interest under applicable state law.¹⁷ Avoidance of the security interest could result in the creditor holding only a general unsecured claim for the entire amount of the claim.¹⁸

In addition, even if the creditor/lessor did properly perfect its security interest, it must compete for priority with creditors holding "all-assets" liens over the debtor's property. An equipment lessor is often relying on a purchase-money security interest to prime an existing "all-assets" filing of the debtor's senior lender, and the timing requirements involved in perfecting a purchase-money security interest must be strictly observed.

Practical Suggestions for Creditor/Lessors

To avoid the consequences of recharacterization, lessors should be mindful of the factors of UCC § 1-203. Leases should be drafted so that (1) the term of the lease is less than the economic life of the leased goods; (2) the lessee is not bound to renew the lease for the remaining economic life of the leased goods or bound to become the owner of the goods; (3) if the lessee has the option to renew the lease for the remaining life of the leased goods, it must be for sufficient additional consideration; and (4) if the lessee has the option to become the owner of the goods at the end of the lease, it must be for sufficient additional consideration.

Many equipment leases provide for a \$1 buyback at the end of the lease term, which is *per se* nominal consideration in many states. Lessors should consider eliminating this provision and replacing it with a buyback calculation that attempts to capture the value of the remaining economic life of the leased property following termination of the lease. Lessors should also take a careful look at their websites and other marketing materials to ensure that they are holding themselves out as lessors, not financing companies.

In addition, lessors should file precautionary UCC financing statements to ensure that their interests are properly perfected in the event that the transaction is recharacterized as a "disguised financing." Properly perfecting the security interest can prevent the debtor (or trustee) from avoiding the security interest under § 544. **abi**

17 11 U.S.C. § 544; see, e.g., *In re Ajax Integrated LLC*, 554 B.R. 568; *In re Triplex Marine Maint. Inc.*, 258 B.R. at 673.

18 See *In re Triplex Marine Maint. Inc.*, 258 B.R. 659, 663.

9 See *In re Gutierrez*, 526 B.R. at 461 ("[T]he parties cannot stipulate in the contract the nature of the transaction.")

10 11 U.S.C. § 365(d).

11 See *In re Midway Airlines Corp.*, 406 F.3d 229, 236 (4th Cir. 2005).

12 11 U.S.C. § 365(d)(5).

13 See, e.g., *In re Kyle Trucking Inc.*, 239 B.R. 198 (Bankr. N.D. Ind. 1999); *In re Rebel Rents Inc.*, 291 B.R. 520; *In re Forman Enters. Inc.*, 2000 WL 1849672 (Bankr. W.D. Pa. Dec. 14, 2000).

14 See, e.g., *In re Pan Am. Airways Corp.*, 245 B.R. 897 (Bankr. S.D. Fla. 2000); *In re Furley's Transport Inc.*, 263 B.R. 733 (Bankr. D. Md. 2001); *In re D.M. Kaye & Sons Transport*, 259 B.R. 114 (Bankr. D.S.C. 2001) (holding that "breathing spell" does not "require the lessor of personal property to supply its property, during the first 59 days, free and clear of any charges or protections until rejection").

15 11 U.S.C. § 365(g).

16 See U.C.C. § 9-102(a)(28) (defining "debtor" as "a person having an interest, other than a security interest or other lien, in the collateral, whether or not the person is an obligor") and U.C.C. § 1-201(b)(35) (defining "security interest" to include "an interest in personal property or fixtures which secures payment or performance of an obligation"); see also 11 U.S.C. § 541.

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