

Bankruptcy Risks for Personal Property Lessors

A Lexis Practice Advisor® Practice Note by Ira L. Herman, Blank Rome LLP



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This practice note discusses the risks to lessors of personal property when the lessee files a petition for relief under the Bankruptcy Code.

Equipment leases generally qualify as executory contracts under Section 365 of the Bankruptcy Code. As such, these leases of personal property may be assumed or rejected by a debtor-in-possession or trustee, unless the transaction evidenced by the documents and labeled lease is found by a court to be a disguised loan transaction. See sample clause regarding [Equipment Lease Clause\(Lessee Bankruptcy\)](#).

This practice note discusses the requirements for assuming and rejecting personal property leases, the risk that the lease will be a disguised loan transaction, and related issues as follows:

- Performance prior to Assumption and Rejection of Executory Contracts
- Assumption
- Rejection
- Equipment Lease Restructuring
- Lease Recharacterization

For related information, see [Bankruptcy Risks to Landlord when Tenant Files a Bankruptcy Case, Assumption, Assignment, and Rejection of Executory Contracts](#), and

[Special Considerations for Assumption, Assignment, and Rejection of Certain Executory Contracts](#).

Performance prior to Assumption and Rejection of Executory Contracts

A debtor-in-possession or trustee in a Chapter 11 case need not make its decision to assume or reject, until plan confirmation, unless the court orders otherwise. In a Chapter 7 case, the trustee has 60 days from the date of entry of the order for relief to assume or reject, unless the 60-day period is extended for cause. Upon the expiration of such 60-day period in a Chapter 7 case, the trustee will be deemed to have rejected the lease. For information on Chapter 7, see [Chapter 7 Liquidation](#).

Prior to assumption or rejection, a debtor-in-possession or trustee is required to timely perform all of the obligations of the debtor, except those specified in Section 365(b) (2) of the Bankruptcy Code, first arising from or after 60 days after the order for relief in a Chapter 11 case under an unexpired lease of personal property, until such lease is assumed or rejected 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. There is no analogous performance requirement in Chapter 7 cases, as in Chapter 7 cases personal property leases must be assumed or rejected within 60 days of the order for relief, unless the period is extended for cause. Any lessor faced with a motion to extend in a Chapter 7, will be well advised to demand the payment of all amounts for due for rent, especially for rent coming due during any extension of initial 60-day period

to assume. Acceptance of any such performance does not constitute waiver or relinquishment of the lessor's rights under such lease or under the Bankruptcy Code.

For more information, see [Assumption, Assignment, and Rejection of Executory Contracts](#), and [Post-Petition Performance Under Executory Contracts and Unexpired Leases](#).

Assumption

As a prerequisite to assumption, the debtor-in-possession or trustee must cure defaults, compensate the non-debtor party for any pecuniary loss resulting from those defaults, and provide the non-debtor party with adequate assurance of future performance under the lease. For information on these requirements, see [Assumption, Assignment, and Rejection of Executory Contracts – Assuming Executory Contracts and Unexpired Leases](#).

Disputes often arise between the debtor/trustee and the non-debtor concerning the existence and extent of lease defaults. Generally speaking, such disputes may be resolved by negotiations among the parties, although motion practice may be required when there are disputes regarding the extent of the cure obligations. As a practical matter, a non-debtor party must be vigilant whenever a debtor/trustee seeks to assume its leases, as a motion to assume generally is accompanied by a schedule setting forth proposed binding cure amounts with respect to the leases to be assumed. As the debtor may understate its cure obligations, this puts non-debtor parties at risk of being compelled to accept cure amounts that are less than the amount actually owed under the leases to be assumed. In this situation, a non-debtor party must file a timely objection to the proposed cure amount with the bankruptcy court to preserve its cure claim. The bankruptcy court would then adjudicate the disputed amount of the cure claim at issue, unless the parties themselves are able to resolve the dispute.

Rejection

If, based on the business judgment of the debtor or trustee, continuation of the lease is not beneficial to the estate, then the debtor/trustee may reject the lease. If the debtor/trustee rejects the lease, however, neither the estate (nor the non-debtor party) is obligated to fulfill their respective obligations under the lease. Rejection leaves the non-debtor party with a general unsecured claim against the estate for damages as a result of the rejection, subject to the specific provisions of the Bankruptcy Code that may alter the general rule in specified circumstances. To the extent

a non-debtor affiliate has guaranteed performance under a lease, the lessor may pursue any and all claims against the guarantor notwithstanding the bankruptcy, as the automatic stay generally does not extend to protect non-debtor entities. For information on the automatic stay, see [Automatic Stay](#).

Equipment Lease Restructuring

Equipment leases can be restructured just like loans. Equipment lease economics change over time. The result of changing economics may make a particular lease unfavorable to a debtor/trustee and, therefore, a likely candidate for rejection. The reasons for a decision to reject a lease tend to be very simple: either the debtor cannot afford to continue paying its current rent obligations under the lease, or the debtor can obtain a new lease for similar equipment on more favorable terms elsewhere. In these types of situations, the lessor has two choices—to allow the debtor-lessee to reject the lease and repossess (and redeploy) the equipment, or to agree to restructure the terms of the lease. In a restructuring, the lessor often determines that it is better to agree to forgive and/or defer future rent and modify other contractual lease terms rather than take back the equipment.

A Chapter 11 debtor generally implements a restructured lease or restructured lease terms by assuming the underlying lease, as amended by agreement of the parties to reflect the restructured lease terms. Chapter 11 debtors tend to delay actually assuming the amended lease until they have confirmed their reorganization plan and are ready to emerge from Chapter 11 (to avoid the unnecessary creation of administrative liabilities), but Chapter 11 debtors also may want the benefit of operating under its restructured lease during the bankruptcy case. As a result, lease amendments tend not to become effective until the Chapter 11 debtor is set to emerge from Chapter 11 and may also sometimes contain specific snapback provisions to recapture rent that was deferred or forgiven pursuant to the lease amendment. This mechanism ensures that the lessor does not waive any claims that it might have against the debtor-lessee in the event that the debtor fails to confirm its bankruptcy plan or otherwise emerge from Chapter 11.

Lease Recharacterization

As with real property leases, a personal property lease may be recharacterized as a financing agreement rather than a true lease. The legal ramifications of this distinction

are many. Leases are entitled to special protections, and lessors are afforded special rights in a bankruptcy case. If a debtor/trustee decides to assume an equipment lease, the debtor/trustee must cure any pre-petition and/or post-petition defaults under the lease. Under Section 365(d) (1) of the Bankruptcy Code, after the expiration of an initial 60-day relief period, the debtor is also required to make rent payments to equipment lessors in the amount required under the lease. By contrast, secured creditors only have a secured claim to the extent of the value of its collateral. As a result, if a document denominated as a lease is ever determined to create a security interest rather than a lessee/lessor relationship 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 value of the collateral) and an unsecured claim for the balance. From there, the debtor/trustee may seek to cram down a plan of reorganization by stripping the lien down to the value of the collateral and paying the claim off over a period of years. Additionally, undersecured creditors are not entitled to interest on the secured component of their claims. For these reasons, disputes often arise concerning the proper legal classification of an equipment finance transaction as either a true lease or disguised financing.

Whether a transaction constitutes a true lease or a disguised financing transaction will be determined not by the provisions of the Bankruptcy Code but instead by applicable state law. Thus, if a bankruptcy court were to determine that a purported lease transaction is actually a secured loan, the court can recharacterize that transaction and the lessor will lose the protections afforded to lessors under the Bankruptcy Code. Rather, the debtor's obligations under the lease will be treated as a typical finance transaction.

Courts generally focus on the intent of the parties in conducting their recharacterization analysis, but often limit their examination to the objective rather than subjective intent of the parties. Courts have applied an economic substance analysis to recharacterize a lease as a disguised financing upon finding that the economic substance of the transaction is not of the type associated with a true lease. These courts have considered several factors when determining the economic substance of an agreement. The courts generally survey all relevant factors, and no one factor is controlling. The factors to be considered are as follows:

- Whether rent payments are calculated to ensure a return on the lessor's investment or are, in fact, 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 a certain event
- Whether the lease provides the lessee with an option to purchase the assets for nominal or minimal consideration
- Whether the lessor purchased the property specifically for the lessee's use
- Whether the lessor obtained credit to purchase the leased property, with the lease term ending when the loan is due –and–
- Whether the transaction was structured as a lease instead of a loan to secure tax or other benefits

In the context of a leveraged lease, contractual equity squeeze rights or protections unquestionably improve the lessor's negotiating leverage in a bankruptcy. To the extent the lease debt holder (or its indenture trustee) must obtain the consent of the lease equity (or its owner trustee) to restructure the lease terms, the lease equity (i.e., the owner participant) can insist on a seat at the negotiating table when the lessee and the lease debt seek to restructure the terms of the lease. Participation in the process is crucial for the lease equity to protect its economic interest in the equipment, as well as for the lease equity to preserve many of the legal rights that it was promised when the lease transaction was consummated. Without squeeze rights, the lease equity may be kept in the dark when these negotiations take place and would thus have no voice on the new rent or other lease terms. In these situations, the lease equity can raise objections with the bankruptcy court, but these objections are rarely sustained unless the parties have acted in a commercially unreasonable manner or otherwise not in good faith.

Owner-participants that do have equity squeeze rights must remember that the lease debt holder ultimately will have the ability to foreclose on the equipment and may even have the right to then release it to the debtor. The owner-participant may suffer substantial adverse tax consequences if the lease debt holder elects to exercise its foreclosure rights. As such, lease equity must carefully balance this risk when negotiating the new terms of the restructured lease or lease amendment with a lessor-debtor and the lease debt holder.

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Currently he serves as Steering Committee Chair for the New York City Bankruptcy Assistance Project. He is a member of the President's Council for the Food Bank for the City of New York. He is the Editor-in-Chief of the American Bankruptcy Institute's (ABI) Section 363 Asset Sales Databank and Co-Chair of the ABI Assets Sales and Real Estate Committees. Ira is an Adjunct Professor of Law at Pace University School of Law and St. John's School of Law in the Bankruptcy LL.M. Program.

Ira received his J.D. from Boston University School of Law where he graduated cum laude with distinction and was the Editor of the Boston University International Law Journal. He has a B.A. in Political Science from Yeshiva University. Ira is a member of the New York State Bar and New York City Bar Associations.

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