Bought or Borrowed: Real-World Implications of the Lease Versus Secured Financing Distinction

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Abstract

This article addresses true leases versus secured financing and a credit manager's understanding of the early case law. It also addresses how the court's point of view will be critical in assessing this issue now, and in the future.

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As so-called "true leases" and secured financings continue to morph and meld, it has never been more difficult when drafting or reviewing these agreements to confidently predict how a court—particularly a bankruptcy court—will categorize these agreements. A true lease, in this context, is an agreement to rent land or equipment, with the expectation that at the end of the term, the land or equipment will be returned. A secured financing, by contrast, is an agreement in which equipment or land is purchased and a security interest is granted to the seller to ensure payment.

Credit managers, then, when determining whether to extend credit, must be precisely aware of what type of agreements the party seeking credit has entered into as the Bankruptcy Code provides for drastically different treatment of leases versus secured financings. Understanding this distinction is thus necessary for credit managers to correctly assess credit risk.

A. The General Distinction Between Leases and Secured Financings

The distinction between these property interests is an important one, particularly if the owner/lessee of an asset files for bankruptcy. Because the Bankruptcy Code applies different rights and obligations depending on the nature of a debtor's interest in the property, a bankruptcy court often finds itself in a position where it must determine the nature of the debtor's legal interest. But, even though current case law offers general guideposts as to how to evaluate such agreements, a unified theory allowing for credit managers to place such agreements in easy boxes labeled "true lease" and "secured financing" has not, at present, been developed.

1) Treatment of Leases in Bankruptcy

In what may come as a surprise, there is no definition of "lease" in the Bankruptcy Code. The Bankruptcy Code broadly defines "security agreement" as an "agreement that creates a security interest,"[1] and "security interest" as a "lien created by an agreement,"[2] but these definitions offer little help in distinguishing between financing transactions that involve the retention of a security interest in assets that have already been sold, versus leasing transactions where the lessor is granted a security interest in leased assets as an added layer of protection.

The Bankruptcy Code confers certain rights, and imposes various obligations, upon a debtor who is party to leases and other contracts that are "executory"[3] as of the bankruptcy filing date. A

[1] 11 U.S.C. § 101(50).

[2] 11 U.S.C. § 101(51).

[3] The most common understanding of an executory contract is "if the obligations of both the bankrupt and the other party to the contract are so unperformed that the failure of either to complete the performance would

Chapter 11 debtor in possession or bankruptcy trustee, with certain exceptions, generally has the right to assume (reaffirm) or reject (disavow, resulting in a breach of the agreement and an unsecured claim for the jilted party) such contracts or leases under section 365 of the Bankruptcy Code. Further, once a debtor has assumed such an agreement, they may assign that contract, creating value for the debtor's estates.

But, prior to the decision to assume or reject the contract or lease, the debtor is obligated to remain current on postpetition lease obligations for personal property, such as business or professional equipment,[4] failing which the leased personal property must be surrendered to the lessor or the lessor may exercise its contractual and legal remedies[5]—notwithstanding the automatic stay imposed by section 362 of the Bankruptcy Code.

One provision in the Bankruptcy Code then takes on outsized importance: section 502(b)(6), which provides that a lessor's damages are capped according to a complex formula.[6] As discussed below, how a bankruptcy court calculates the "rent" owed may be the difference between a large recovery and a much more minimal payout.

2) *Treatment of Secured Financings in Bankruptcy*

A different set of structures and rationales apply to a transaction intended (or, as discussed below, understood by a bankruptcy court *ex post facto*) to be a secured financing. In this situation, the debtor's obligations to make payments to the secured lender during the course of the bankruptcy hinge on the value of the collateral relative to the amount of the lender's claim.

If the collateral value exceeds the amount of the debt (the creditor is oversecured), the debtor may be required to make cash payments, periodic interest payments, or grant additional or

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constitute a material breach excusing the performance of another." *See* Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439 (1973).

[4] *See, e.g.*, 11 U.S.C. § 365(d)(5) (carving out "personal property leased to an individual primarily for personal, family, or household purposes").

[5] Calculating postpetition payments due under section 365(d)(5), which ostensibly provides a 60-day time limit on payments paid by a debtor to a lessor postpetition, is not always a consensual or straightforward exercise. *See, e.g.*, 11 U.S.C. § 365(d)(5); *see also In re Imperial Beverage Grp., LLC*, 457 B.R. 490 (discussing how application of section 365(d) may lead to unique calculations for each "distinct period[] of time").

[6] 11 U.S.C. § 502(b)(6) (providing that claims "of a lessor for damages resulting from the termination of a lease of real property [are capped if] such exceeds—(A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of—(i) the date of the filing of the petition; and (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus (B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates[.]").

replacements liens to the secured creditor as a means of "adequate protection."[7] But, if a secured creditor's collateral value sits below the total debt (the creditor is undersecured), a debtor will typically not have to make adequate protection payments, and the secured creditor's claim will extend only to the value of the collateral, with the remaining deficiency claim categorized as unsecured.

B. Strategic Implications Relating to Differential Treatment

Given the distinctions in the Bankruptcy Code, a lessor typically receives greater overall protections in bankruptcy than a party that has a pure executory contract, given that a debtor must make postpetition payments to the lessor and may assume and then assign the lease, providing defined value to the lessor over the following period of time. Similarly, the Bankruptcy Code provides that in a Chapter 7, a debtor must act on its decision to assume or reject executory contracts or leases within 60 days;[8] in a Chapter 11, a lessor may move the bankruptcy court to "determine within a specified period of time whether to assume or reject such contract or lease."[9] These provisions provide a semblance of certainty to the lessor that the debtor will make a decision within an appropriate timeframe.

A secured creditor, by contrast to a lessor, typically enjoys even greater rights and protections, and may even receive a higher recovery than if that same creditor were to be considered a lessor, so long as the secured creditor's collateral retains its value. Whereas the damages a lessor may receive if the lease is assumed are capped under section 502(b)(6), a counterparty to a secured financing has the potential upside of the value of collateral, which may or may not be worth more than the obligation and may exceed the damages capped under section 502(b)(6).

The ultimate fate of the collateral, however, depends on the type of bankruptcy case in question (*e.g.*, a Chapter 7 liquidation versus Chapter 11 reorganization), and in a Chapter 7, the property would either be abandoned to the secured creditor or sold to the highest bidder, with the secured creditor's liens attaching to the proceeds. In a Chapter 11, however, a debtor may confirm a plan of reorganization by which (i) the secured obligation is reinstated with identical collateral; (ii) the original collateral secures a new obligation whose terms vary from the original secured debt; (iii) collateral of equivalent value is substituted for the original collateral; or (iv) the collateral is sold, with the secured creditor's liens attaching to the proceeds. Any one of these options may

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[7] See 11 U.S.C. § 361(1)-(2).

[8] *See* 11 U.S.C. § 365(d)(1).

[9] *See* 11 U.S.C. § 365(d)(2).

give a secured creditor a higher recovery or greater security than a landlord, but not without heavy downside risk.

C. The Current State of the Law

Although this area of law is in its infancy, cases addressing this issue have attempted to offer guidance on how to determine an agreement is a true lease or a secured financing.

1) United Airlines, Inc. v. HSBC Bank USA, N.A.

First, in *United Airlines, Inc. v. HSBC Bank USA, N.A.*,[10] United entered into complex transactions to obtain money to build or improve premises at four airports. For each airport, a public body issued bonds (which bore tax-free interest) and then turned this money over to United against United's promise to retire the bonds and reimburse administrative costs. At each airport, United entered into an agreement (marked in the form of a "lease") giving the public body that had issued the bonds the right to evict United from the facilities if United failed to make the required payments. When United entered bankruptcy, however, it took the position that the "leases" were in fact secured loans, thus preventing United from having to pay high rent fees.

The Seventh Circuit provided the first analytical framework by which to distinguish leases from secured financings: analyzing the *substance* of the transaction, rather than its form. The court noted that "rent" that represents the cost of funds for capital assets or past operations, rather than ongoing inputs into production "has the quality of debt, and to require such obligations to be assumed under § 365 to retain an asset would permit financial distress from past operations to shut down a firm that has a positive cash flow from current operations."[11]

2) In re Pioneer Health Services, Inc.

Second, in *In re Pioneer Health Services, Inc.*,[12] Pioneer, a healthcare provider, bought access to software to maintain its electronic health records and financed the purchase through First Guaranty Bank.[13] First Guaranty Bank argued that the software agreements were in fact leases,

[10] 416 F.3d 609 (7th Cir. 2005).

[11] *Id.* at 613.

[12] 739 Fed. Appx. 240 (5th Cir. 2018).

[13] Pioneer financed the purchase through a third party, which then assigned its interest to another party, which was itself the predecessor in interest to the appellant First Guaranty Bank, which ultimately filed a motion to compel payment under the contract as an unexpired lease or an administrative expense. *Id.* at 241.

as opposed to secured financings. The Fifth Circuit reiterated that the substance approach as discussed in *United Airlines* applied in full force, but expanded that decision's reasoning to provide the second analytical framework by which to distinguish leases from secured financings: whether the payments due to the lessor or secured lender are "old expenses to be adjusted to deal with financial distress."[14] This distinction brings into focus the motivation behind how a bankruptcy court analyzes these types of agreements: lease expenses should be paid because they allow a debtor to earn income and obtain value; secured financings should not be paid because they represent onerous debt that must be restructured.

3) *In re Anchorage Sportsplex, Inc.*

Third, in *In re Anchorage Sportsplex, Inc.*,[15] debtor Anchorage Sportsplex, an Alaskan non-profit corporation, built a large indoor soccer dome in Anchorage, but soon encountered financial difficulties and filed for Chapter 11 protection. Anchorage Community Development, which had purchased the land upon which Anchorage Sportsplex intended to build the soccer dome, entered into a 50-year lease with Anchorage Sportsplex for upfront prepaid rent of $1.2 million. After Anchorage Sportsplex's bankruptcy filing, Anchorage Community Development filed a motion to compel payment of real property taxes. U.S. Bank, a party in interest, argued that Anchorage Sportsplex did not have to pay the taxes because the "lease" with Anchorage Community Development was, in fact, a secured financing. The court disagreed, and, after applying a substance analysis, provided the third analytical framework by which to distinguish leases from secured financings: determining whether the agreement contains typical hallmarks of true leases is critical. In *Anchorage Sportsplex*, the court found that the agreement with Anchorage Community Development was in fact a true lease, because (i) Anchorage Sportsplex had the right to occupy the dome exclusive of Anchorage Community Development; (ii) the lease form contained a description of the property; and (iii) the rent was to be paid at particular times (as opposed to a situation where a secured debtor may prepay all the debt owed on a secured financing).

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[14] *Id.* at 245.

[15] 462 B.R. 722 (Bankr. D. Alaska 2010).

D. Application of Distinction to Credit Managers' Analyses

In conclusion, there are three key takeaways that credit managers must understand in order to properly distinguish leases from secured financings:

- Substance of the Transaction: As all three cases illustrate, a court will not be swayed by any argument that a lease or financing is what it purports to be. Instead, courts will always look to the underlying substance of the deal. Credit managers should do the same, and not rely on how the document is labeled or what the other side claims a document to be. This can be a jarring exercise, as a credit manager seeking to extend credit must be familiarized with client documents—particularly when that client may not be able to accurately predict how a court will view any given agreement. Obviously, in performing the analysis, a credit manager may wish to involve their legal department or engage the services of outside counsel if the magnitude of the credit and the lease versus secured financing is large enough or impactful enough to warrant doing so.

- Value Provided to Debtor: What appears to be animating bankruptcy courts in how they evaluate these agreements by way of an instinctual or gut-check analysis of whether the agreement is a net positive one that will bring in additional funds to the debtor's estate, or whether the agreement is at least partially responsible for the debtor's entrance into bankruptcy and thus may best be described as an onerous agreement requiring modification. Credit managers should perform that same gut-check analysis when evaluating such agreements, by asking "is this a net positive or negative for the debtor?" Said another way, if the contract appears to increase value, it is more likely to be considered a lease, but if payment on the contract only serves to pay down prior debt, it is more likely to be considered a secured financing and, therefore, not add value to the company. In performing this gut-check analysis, a credit manager may be able to determine that there is more value against which to extend credit rather than less value if the agreement is a secured financing. Further, if a credit manager believes the agreement is more likely to be construed as a secured financing, then besides there being less value against which to extend credit, the credit manager may also have to assess whether the secured financing will come ahead of the extension of unsecured credit or make less assets available for the creditor to look to if it has to collect on its receivable.

- Recognize Hallmarks of Leases: Although the cases are quick to suggest that even agreements which bear many of the hallmarks of being a true lease may nonetheless still be ruled secured financings based on the substance. But understanding the traditional hallmarks of lease, such as (i) whether the property reverts back to the

lessor after the termination of the lease period; (ii) whether no option exists for the lessee to purchase the property for a nominal price at the end of the lease term; and (iii) whether the lease does not require the payment of taxes, insurance, or other costs commonly thought of as a landlord's responsibility.

As the case law regarding this issue is still in its very early stages, these takeaways will likely evolve over time. Nevertheless, these takeaways will serve as the original building blocks for the true lease versus secured financing analysis and a credit manager's understanding of the early case law and guidance from the court's will be critical in assessing this issue now, and in the future.

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