

A true lease is better than a security interest



stitutes a security interest under Section 1-201(37) on a case-by-case basis, courts have generally interpreted this provision to mean that a contract creates a secured loan if (i) the lessee is obligated to make rental payments roughly equal to the purchase price of the equipment plus interest and (ii) the lessor has no residual value in the leased equipment at the termination of the lease.

Thus, if a lease agreement contains a purchase option that may be exercised for a nominal consideration, it will likely be construed as creating a security interest. In analyzing what constitutes a nominal consideration, some courts have held that a consideration may be sizeable, yet still be nominal (In re APB Online, 259 B.R. 816 (Bankr. S.D.N.Y. 2001), and that option prices of less than 25 percent of the original cost of the equipment are nominal (In re Triplex Marine Maintenance, Inc. 258 B.R. 659 (Bankr. E.D. Tex. 2000)).

If a lease agreement is construed as creating a secured loan, the lessor's claim will be bifurcated into a secured claim and an unsecured deficiency claim, and the debtor/lessee will have no obligation to make rental payments under the lease or to cure any existing defaults. Furthermore, contrary to some lessors' expectations, the law places serious limitations on the lessor's leverage in enforcing the lease payments. Instead of enforcing the original terms of the lease agreement, the lessor will be able to seek adequate

protection of its security interest in the equipment only to the extent that the equipment is depreciating in value. In pursuing its request for adequate protection payments, a lessor often is required to present expert testimony on the applicable depreciation rate.

Finally, the lessor's ability to repossess its equipment will be limited by the automatic stay imposed in the lessee's bankruptcy. In opposing a stay relief motion, a Chapter 11 debtor often argues that the financed equipment is necessary to its reorganization and/or that the creditor is protected by an equity cushion, thus delaying the resolution of the lessor's request for relief from the automatic stay.

In contrast, if a lease agreement is construed as a true lease under the UCC, the lease is subject to assumption or rejection under Section 365 of the Bankruptcy Code. In order to assume an unexpired lease under Section 365, the debtor/lessee must promptly cure any existing default under the lease and assure the lessor that it will continue performance under the lease.

Furthermore, some bankruptcy courts, including those within the 3rd Circuit, have held that even prior to the assumption or rejection of an unexpired lease, the lessor may be able to request adequate protection of its interest in the equipment in the form of regular lease payments under the agreement. For instance, the bankruptcy court for the Western District of Pennsylvania has held that pending the debtor's decision to assume or reject an unexpired lease, the lessor is entitled to an amount of adequate protection that would enable the lessor to

receive the benefit of its pre-petition bargain. See In re Wheeling-Pittsburgh Steel Corp., 54 B.R. 385 (Bankr. W.D. Pa. 1985).



Inez M. Markovich

In other words, in the case of a true lease, adequate protection to a lessor may be provided by the debtor-lessee's "compliance with the provisions of the lease." See id.; see also, In re Dabney, 45 B.R. 312, 313 (Bankr. E.D. Pa. 1985); In re P.J. Clarke's Restaurant Corp., 265 B.R. 392 (Bankr. S.D.N.Y. 2001) (lessors are entitled to adequate protection under § 363(e) in the form of current payments under the lease).

While an in-depth analysis of the existing law with respect to the treatment of secured lenders and equipment lessors in bankruptcy is beyond the purpose and scope of this article, equipment financiers are strongly advised to pay careful attention to the economic terms of their transactions with customers to accurately assess their ability to exercise leverage in their customers' bankruptcy cases.

Inez M. Markovich, Esquire, practices in the Philadelphia office of Frey, Petrakis, Deeb, Blum, Briggs & Mitts, P.C., where she concentrates her practice in commercial finance, workouts bankruptcy and reorganization.. She can be reached at (215) 563-0500 or imarkovich@fpdb.com.



By Inez M. Markovich, Esquire

As the economy begins its recovery after settling a recession for the last couple of years equipment financiers continue to find themselves involved in bankruptcy cases filed by their customers. The treatment of an equipment financier and the extent of its bargaining power, in its customer's bankruptcy depends largely on whether the underlying lease is ultimately characterized as a "true lease" or a secured loan. As this article demonstrates, a true lease provides a lessor with far more protection of its interest in the equipment than does a secured loan classification.

Whether a lease should be classified as a true lease or as a secured financing agreement disguised as a lease is based on state law, or the Uniform Commercial Code (UCC), which has been adopted in all 50 states. The UCC does not define a true lease. Instead, it explains what constitutes a "security interest" in Section 1-201(37).

Although courts determine what con-

value continued from page 20

companies determined that the best strategy to accomplish its goal of control was to acquire the senior secured debt – at a slight discount. H.I.G. Capital's creativity and flexibility allowed them to take control without the risks associated with a bankruptcy sale process.

The second example of the acquisition of senior secured debt was not for purpose of control but, rather, for the return that could be made. Fetco Home Décor, Inc. is a leading designer and wholesaler of upscale picture frames, wall décor and home accent pieces headquartered in Randolph, Massachusetts.

Fetco had spent the last year focusing on operational improvements and re-vamping its product line. Nevertheless its senior lender demanded immediate liquidity. We were engaged in early 2004 to simultaneously market the company for sale and to seek a private placement to refinance existing debt, provide working capital while leaving equity unimpaired. Patriarch Partners, LLC, a hedge fund, was able to be quick, creative and

flexible and provided a \$20,000,000 recapitalization and restructuring facility that closed in early April 2004 that accomplished the goal sought by all of the stakeholders. While expensive, such hedge fund recapitalizations are a creative way and powerful tool to leave shareholder's equity unimpaired.

The financially challenged middle market companies of today and tomorrow present a lucrative opportunity for acquisitions by private equity firms, strategic buyers and hedge funds of both the business and the debt and provide the opportunity to create value from distress for all stakeholders.

J. Scott Victor is a founding partner and Managing Director of SSG Capital Advisors, L.P., a boutique investment banking firm, with offices in West Conshohocken, Pennsylvania, New York, New York and Cleveland, Ohio, specializing in financially challenged middle market companies throughout the United States and Europe.



solvent continued from page 18

or absence of contract provisions which might attempt to confer such interest." In *re A&L Properties*, the U.S. District Court for the Central District of California concluded that "where the debtor's estate proves solvent, a contract creditor is entitled to post-petition interest at the rate set forth in the contract. This rate is the 'legal rate' for purposes of 11 U.S.C.S. § 726(a)(5)."

While courts have developed several theories for determining what the legal rate means, synthesizing all the pertinent case law suggests that only when there is no contract rate of interest should the federal judgment rate be imposed upon a solvent debtor. The well-publicized decision in *Cardelucci*, which advocates for uniform application of the federal judgment rate, is consistent with this conclusion. The debt owed in *Cardelucci* did not arise out of a pre-petition contract providing for interest, but rather from pre-petition tort claims.

Employing contract rates, not the fed-

eral judgment rate, is logical because no provision of the Bankruptcy Code permits solvent estates to avoid fulfilling their contractual obligations to creditors. Blanket adoption of the federal judgment rate for all debt makes no sense when a valid, enforceable contract interest rate binds the debtor. Therefore, the notion that a solvent debtor must comply with all of its contractual obligations, including the obligation to pay post-petition contract rates of interest, is not heretical.

Mr. Shenfeld can be contacted at Reed Smith LLP, 355 South Grand Avenue, Los Angeles, California 90071, rshenfeld@reedsmith.com. Scott Esterbrook, an associate in Reed Smith's Corporate Restructuring & Bankruptcy Group, assisted with the preparation of, and contributed to, this article. Mr. Esterbrook can be reached at Reed Smith LLP, 2500 One Liberty Place, 1650 Market Street, Philadelphia, Pennsylvania 19103, sesterbrook@reedsmith.com.

