

Defending the Equipment Financier — Avoidance Actions, Preference Payments and Lease Repurchase Agreements

Since equipment leasing and finance companies provide a critical source of capital, they often become the target of an avoidance action in a bankruptcy case filed by a lessee or manufacturer of leased equipment. Obtaining a good understanding of the defenses available to finance companies will enable them to minimize exposure in preference actions of this type.

By Inez M. Markovich and Steven B. Freedman

It goes without saying that defending preference actions is a hardship endured by creditors in just about every industry. Because equipment leasing and finance provide a critical source of capital to businesses of all sizes in the U.S. economy, it should come as no surprise that equipment leasing and finance companies often become the target of an avoidance action in a bankruptcy case filed by a lessee or manufacturer of leased equipment. Defending a preference action can be particularly taxing when the underlying transfers occur in the context of lease repurchases made pursuant to program agreements between an equipment finance company and the seller of leased equipment. Nevertheless, obtaining a good understanding of the defenses available to the finance company will enable it to minimize its exposure in preference actions of this type.

Repurchase provisions are utilized in a variety of financial agreements, including mortgage warehouse and equipment leasing transactions. In the case of equipment leasing, lease repurchase provisions are often found in program agreements between equipment sellers who originate the lease and third-party purchasers who provide capital to the seller by acquiring its lease portfolios. These provisions typically provide for the originator's mandatory repurchase of any assigned leases in the event of certain defined conditions, such as payment defaults under the lease. Thus, if an originator's equipment is defective and the customer refuses to pay, a typical program agreement requires the originator of the lease to remove the assignee from the dispute by repurchasing the lease.

Over the course of a relationship, the original lessor and the assignee may make a number of repurchases pursuant to their program agreements. Furthermore, where the leased equipment is of poor quality or the originator does not provide lessees with adequate service of the leased equipment, the number of repurchases will be greater, with the original seller sending money to the assignee in return for the re-assignment of the leases. In the event the equipment seller seeks bankruptcy protection, the Chapter 7 trustee or in a Chapter 11 case, the debtor-in-possession, will challenge the payments as avoidable preference payments.

Defined within §547 of the Bankruptcy Code, an avoidable preference payment is a debtor's transfer of a property interest, within 90 days of its bankruptcy filing, to another party as repayment for an antecedent,

unsecured debt. See 11 U.S.C. §547. The purpose of §547 is to prevent debtors from favoring certain unsecured creditors over others (transfers to secured creditors are generally not subject to avoidance under §547), thus preventing a "race to the courthouse" to be first in line to the debtor's assets. For example, if a debtor who owes a creditor \$5 million pays \$1 million dollars to the creditor ten days before it files for bankruptcy relief, this payment may qualify as an avoidable preference payment. If the trustee or debtor-in-possession succeeds in avoiding the transfer as a preference payment, the creditor will be forced to return the \$1 million payment to the bankruptcy estate. The creditor will then be left with an unsecured claim against the estate in the amount of the entire obligation, with a typically disappointing pro rata distribution of mere pennies on the dollar.

The initial step in assessing whether a lease repurchase payment constitutes an avoidable preference transfer is to determine whether the payment was on account of an antecedent debt — one of the §547 elements in establishing a preference transfer. 11 U.S.C.A. §547(b)(2). For the purposes of §547, an antecedent debt is an obligation incurred prior to a debtor's alleged preferential transfer. *In re Bridge Information Systems, Inc.*, 299 B.R. 567, 571 (E.D. Mo. 2003). Applying this broad definition, the trustee or the debtor will argue that the debtor's obligation to re-purchase the lease constitutes an antecedent debt and the payment made to the creditor constitutes an avoidable preference transfer. Most courts will probably agree with this position.

Fortunately for creditors, §547 provides a number of defenses to a preference action, some of which serve to protect purchasers of equipment lease portfolios who receive repurchase payments from failing equipment vendors pursuant to their program agreements. In defending a preference action, the equipment financier should first look to §547's contemporaneous exchange exception, which permits creditors to keep transfers on account of an antecedent debt if the payment occurs contemporaneously with an exchange of new value. 11 U.S.C.A. §547(c)(1).

A simple example of a contemporaneous exchange would be a debtor's purchase of office supplies in the days preceding bankruptcy. Of course, a lease repurchase is a more complicated transaction than a purchase of

pens and pencils, but courts apply the same principles in examining the transaction. See e.g., *Freehling v. Aabbey Galleries, Inc.*, (In re Hytha), 39 B.R. 196 (Bankr. S.D. Fla. 1984) (holding payments made pursuant to “buy-back” agreement constituted contemporaneous exchange for new value); see e.g., *Jonas v. Farmer Bros. Co.* (In re Comark), 145 B.R. 47 (B.A.P. 9th Cir. 1992) (repurchases of securities made pursuant to repurchase agreement constituted contemporaneous exchange for new value). Thus, the leasing company’s first argument should be that the debtor’s lease repurchase was a contemporaneous exchange of money for the value of the repurchased lease. In raising this defense, the creditor will need to persuade the court that the repurchased lease had an economic value approximately equivalent to the repurchase payments. See e.g., *Lowrey v. U.P.G., Inc.* (In re Robinson Bros. Drilling, Inc.), 877 F.2d 32 (10th Cir. 1989).

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 strengthened another §547 defense, the “ordinary course of business” defense. Pursuant to this defense, a transfer made during the preference period is not an avoidable transfer if (1) the transfer was made as part of the ordinary course of business or financial affairs of the debtor and the transferee; or (2) if the transfer was made according to ordinary business terms. 11 U.S.C.A. §547(c)(2). Prior to the Bankruptcy Reform Act’s enactment, a creditor had to prove that the transfer satisfied both the subjective “ordinary course of business” test, and the objective “ordinary business terms” test to qualify for the exception.

Applying the new “either/or” test to a loan repurchase agreement, the creditor now has the burden of establishing only one of these elements. To determine if the transfer was made within in the ordinary course of business, courts look to the timing of payment, the historic course of dealings between the debtor and the transferee, and the circumstances under which the transfer was made. See *Stratton v. Equitable Bank*, 104 B.R. 713, 734 (D.Md. 1989) (holding repurchase payments made by the corporate debtor to the lender bank with respect to mortgage loans assigned to the bank pursuant to a mortgage sale, service and assignment agreement were made in the ordinary course of the parties’ business and were not avoidable as preferential transfers); *Willson v. MLA, Inc.* (In re Ascot Mortgage, Inc.), 153 B.R. 1002 (Bankr. N.D. Ga. 1993) (holding debtor seller’s loan repurchase payments to the defendant buyer under a loan purchase agreement were in the ordinary course of business between the debtor and defendant). Thus, a transfer should not be avoidable if the transferee can document that the transfers were part of a history of loan repurchases predating the ninety-day preference period, and that the manner of the payments conformed to the parties’ prior practices.

Although the above subjective test is generally easier to establish, the creditor may need to turn to the second, objective industry standard test, especially if the parties do not have an established history of lease repurchases. *U.S. Interactive Corp. v. Sampson Travel Agency, Inc.* (In re U.S. Interactive, Inc.), 321 B.R. 388 (Bankr. D. Del. 2005). In this instance, the creditor will need to present testimony that the transfer corresponded to industry standards. As payment practices and lease purchase agreement terms may vary widely between different companies in the same industry, courts will only avoid a transfer if it is so beyond industry norms as to be idiosyncratic or extraordinary. *In re Tolona Pizza Prods. Corp.*, 3 F.3d 1029, 1033 (7th Cir. 1993).

The last §547 defense available to an equipment financier is the “new value” defense, which protects a transfer from avoidance if the creditor advanced “new value” to the debtor after the challenged transfer. 11 U.S.C.A. §547(c)(4). In the context of assignment of loans or leases, courts have held that the assignee or purchaser of such obligations advances “new value” to the debtor for the purpose of §547(c)(4) if, subsequent to the repurchases at issue, the purchaser purchased other

loans from the debtor. See *In re Ascot Mortgage, Inc.*, 153 B.R. at 1020 (holding debtor received new value where defendant’s purchase of leases after receipt of alleged preference transfer provided debtor with greater value than that provided to defendant). Notably, the “new value” defense protects the preferential repurchase payment only to the extent of the subsequent purchase of new loans or leases. 11 U.S.C.A. §547(c)(4).

Finally, as payments made to secured creditors are not preference transfers, courts will not avoid potential preferential repurchase payments if courts determine that the underlying program agreement was in fact a secured loan, and not a “true sale” of the lease portfolio to the leasing company. See *In re Pineview Care Center, Inc.*, 152 B.R. 703 (D.N.J. 1993)(pre-petition transfers to a secured creditor are not avoidable preference payments). In determining whether an assignment of assets constitutes a true sale or a secured loan, courts will consider the legal and economic substance of the transaction. *Major’s Furniture Mart, Inc. v. Castle Credit Corp., Inc.*, 602 F.2d 538 (3d Cir. 1979).

Courts will often construe agreements providing for full recourse to the transferor in the event of a default as secured loan agreements because they do not transfer a significant enough risk of loss to the assignee in order to qualify as a sale. *Fireman’s Fund Ins. Cos. v. Grover* (In re Woodson Co.), 813 F.2d 266 (9th Cir. 1987). In the context of a sale of financial obligations, courts will conclude that a transaction creates a sale if the assignee looks to the underlying obligors for repayment of its investment and views the seller of the obligations as a mere servicer of such assets. *Bear v. Coben* (In re Golden Plan of California, Inc.), 829 F.2d 705 (9th Cir. 1986). While terms of equipment leasing program agreements vary, they often contain repurchase and remarketing provisions where the risk of loss stays with the assignor. Thus, in the context of a preference lawsuit, creditors typically have strong grounds to argue that they are secured creditors and, as such, do not have to return the repurchase payments to the trustee.

In sum, although trustees and debtors-in-possession may look to lease repurchases as fruitful grounds for preference actions, §547 provides equipment leasing and finance companies with a number of defenses that should help them significantly reduce and, in many cases, completely eliminate their potential liability in such actions. **m**



Inez M. Markovich, Esquire, and Steven B. Freedman, Esquire, practice in the Philadelphia office of

Frey, Petrakis, Deeb, Blum & Briggs, P.C., where Markovich concentrates her practice in the areas of commercial finance transactions and bankruptcy and reorganiza-

tion, with an emphasis on representing creditors in corporate Chapter 11 and Chapter 7 cases, and Freedman specializes in commercial litigation and bankruptcy. They can be reached at 215.563.0500 or via email at imarkovich@fpdb.com or sfreedman@fpdb.com.

