

"TRUE LEASES" IN CHAPTER 11: A Creditor's Primer

One of the less fortuitous legal terms in common usage among lawyers is "true lease." The term is used to distinguish leases of personal property which are truly that – a bailment or lease for hire temporarily to a third party who obtains no equity rights in the goods leased as a result of his rental payments – from the so-called "financing lease," which is simply a secured installment sale disguised as a lease.

The process of distinguishing a "true lease" from a mere "financing lease" is a topic sufficiently complex to merit its own article in a future issue. For brevity's sake here, we will over-simplify and say that a "true lease" contains no purchase option, or a purchase option for fair market value only, and the item leased has more than nominal value in the market place upon the lease's expiration. In addition, the lessor retains ownership throughout the lease and is entitled to a return of the leased goods absent lessee's exercise of its purchase option by paying the fair market value of the leased goods.

What happens if the lessee under such a lease files a Chapter 11 bankruptcy? The first thing that the lessor and its counsel should bear in mind is that a Motion to Terminate Stay is not the proper remedy to pursue. Motions to Terminate Stay are appropriate for creditors who have collateral under an Article 9 transaction,

a secured installment sale. Leases are different.

The second thing for a lessor of personal property to remember is that unlike the 60-day time limit in the Code on assumptions or rejections of non-residential real estate leases, there is no time limit in a Chapter 11 proceeding (other than the confirmation date of the plan) by which the debtor must assume or reject the lease. It is up to the lessor and its counsel to apply to the Court and ask that it set a deadline by which the debtor must assume or reject the lease. There is no charge by the Bankruptcy Court for filing such a Motion, in contrast to the fee now charged secured creditors filing Motions to Terminate the Stay.

If the lessee is in default and wishes to assume a lease, it must; (1) cure the default promptly (or provide adequate assurance of prompt cure); (2) compensate or provide adequate assurance that it will promptly compensate any party other than the debtor for any actual pecuniary loss resulting from its default (for example, repossession expenses); and (3) provide adequate insurance that it will stay current in the future. Upon assumption, the lessor may also obtain an administrative priority position under both Sections 507 and 503 for post-petition rentals which are not paid by the debtor as incurred.

When contrasted to the remedy of a secured creditor

under the Code, that is, "adequate protection," the remedies available to a lessor which moves promptly to enforce its rights seem far superior.

What if the lessee determines it wishes to reject the lease?

First of all, the rejection constitutes a breach of the lease under Code Section 365 (g). Rejection of the lease effectively terminates the automatic stay because once the debtor rejects the lease, the leased goods are no longer property of the estate. This means that the lessor is free to pick up its property.

In addition, those damages caused by the rejection of the lease, including the accelerated lease balance, become a pre-petition, general, unsecured claim. These damages are not liquidated by any formula within the Bankruptcy Code itself as they are for real estate leases under Code Section 502 (b) (6), but the lessor is under a duty to reduce its balance to present value just as it would outside bankruptcy.

What becomes of the rentals which were due and unpaid from the date of the petition until the date of the rejection of a lease? Generally speaking, the lessor may be entitled to an administrative priority for those rentals. The present minority rule among courts is that the lessor receives priority for the full contractual rentals regardless

of the actual value to the estate of the leased goods during the period prior to rejection. The majority rule, however, is that the debtor must receive actual benefit from the leased goods prior to the rejection in order for an administrative priority to lie, and the measure is the reasonable value, or the actual value, to the estate of the goods—not necessarily the rental required under the lease contract.

Any lessor under a "true lease" is best served by moving quickly to assert its right upon the filing of a Chapter 11. □

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