

## "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 a lease of personal property, which is 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 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 a lessor of personal property should remember is that for cases filed prior to October 22, 1994, the effective date of the Bankruptcy Reform Act, the debtor has until confirmation of the Plan to assume or reject the lease. It is up to the lessor and its counsel to apply to the Court for 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 to secured creditors filing motions to terminate the stay. For cases filed after October 22, 1994, the debtor must timely perform the obligations of an unexpired lease of personal property (but not for property used for personal, family or household purposes).

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 assurance 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 compared to the remedy of a secured creditor

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

What if the lessee wishes to reject the lease?

First, the rejection constitutes a breach of the lease under Bankruptcy 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. That means 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 are real estate leases under Code Section 502 (b) (6); however, the lessor is under a duty to reduce its balance to present value, just as it would outside bankruptcy.

What happens to the rentals that were due and unpaid from the date of petition until the date of the rejection of a lease? Generally, 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 in order for an administrative priority to lie the debtor must receive actual benefit from the leased goods prior to rejection. Actual value, or reasonable value is not necessarily the rental required under the lease contract.

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

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