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August 2002

Are The Courts Eroding The Ability of Lessors To Receive Lease Payments In Bankruptcy?

Recent case law appears to be eroding the lessor's right to receive rental payments commencing on the sixtieth (60th) day after a Chapter 11 filing. Where debtors contest the "true lease" nature of the transaction, courts have stayed the obligation of the debtor to make rental payments until a determination is made as to whether the transaction is a lease or a loan. First, however, a refresher on the statute.

Prior to the 1994 amendments to the Bankruptcy Code, if a lessee filed for protection under Chapter 11, in order for a lessor to ensure post-petition payments for personal property (i.e., equipment) were made in a timely fashion, the lessor had to satisfy an amorphous standard. That standard required that a lessor prove that the debtor had used and benefitted from its possession of the equipment and the payments the lessor would receive would not necessarily equal the contract rentals.

Fortunately, Congress was convinced that such a standard was not workable, was not given uniform application in bankruptcy courts and did not provide adequate protection for creditors. Accordingly, in 1994, Congress revised the Bankruptcy Code to provide lessors a level of protection that was warranted and equitable. Congress enacted Section 365(d)(10) of the Bankruptcy Code.

This statute requires that a lessee who has filed Chapter 11 must make post-petition lease payments until the lease is assumed or rejected. The lessee, after the expiration of sixty (60) days from the Chapter 11 filing, must make payments *at the contract rental amount*. Ultimately, if the lessee assumes the lease, the lessee must cure pre-petition arrears, or if it rejects the lease, the lessee must give up possession of the equipment. The intent of Section 365(d)(10) is clear; to prevent a lessee that has filed a Chapter 11 case from enjoying a free ride to utilize equipment without paying for it. However, part of that "free ride" may have been given back to the lessee.

Recently, in the Circuit Wise bankruptcy pending in Connecticut, a bankruptcy court held that a lessor was not and would not "be entitled to protections of Section 365(d)(10) until and unless [the] court determines that the lease was, in fact, a 'true' or 'bona fide' lease". In prior updates, we advised as to the recurring dilemma facing Courts when the "true lease" issue is being challenged. We believe that the statute requires and several cases have held that payments must be made while the lessee is challenging the "true lease" nature of the transaction. However, the Circuit Wise court stated further that "[it] is indeed necessary, as prerequisite to determining whether an equipment lessor has rights under section 365 ... to periodic payments under Section 365(d)(10) ... to determine *first* whether the agreement denominated as a lease is indeed a true lease".

In Circuit Wise, the Debtor filed a voluntary Chapter 11 petition. The Debtor did not make any post-petition payments to the lessor under the terms of a "lease" after the date of filing. Ten months after the initial filing, the lessor filed a motion with the bankruptcy court for an order directing an assumption or rejection by the Debtor of the "lease". The Debtor argued that "the lease is not a 'true' or 'bona fide' lease but rather is a disguised 'security agreement' within the purview of Bankruptcy Code §101(50)". Accordingly, the Debtor claimed that the lease is not entitled to the protections of Section 365(d)(10). The Court's decision on the issue surprised even the most seasoned bankruptcy practitioners and ran contrary to other reported decisions.

The Court held that the lessor is not and will not be entitled to the protections of Section 365(d)(10) until and unless the Court determines that the lease is a 'true' or 'bona fide' lease. The Court elaborated by stating "[o]n its face, Section 365(d)(10) requires that for a person or entity to obtain the protection of Section 365(d)(10), that person or entity must be a lessor and not the holder of a security interest."

The Court based its decision on the "plain meaning" of Section 365(d)(10) because the Bankruptcy Code provides different rights and remedies for lessors and holders of security interests. In fact, the Court took the analysis a step further and stated that even if the plain meaning rule of construction was not applicable the court's determination on the issue would not change. According to the Court, it is well-settled under other sections of Section 365 that the term lease (which is not specifically defined in the Code) refers only to "true" or "bona fide" lease and does not refer to agreements which, although labeled "leases", are actually disguised security agreements within the purview of Bankruptcy Code §101(50).

According to the Court, the lessor's argument that the term "lease" as used in Section 365(d)(10) means that a lease is "presumed" to be a lease until a court rules otherwise, flies in the face of the well-established rules of statutory construction. In essence, the Court held that in order to be afforded the protections of Section 365(d)(10), a person or entity must be a lessor and if there is litigation surrounding whether the transaction is or is not a lease agreement, or in fact, is a security agreement, a person or entity is not presumed to be a lessor but instead must wait for the court to adjudicate the matter before being afforded protections under 365(d)(10).

While the Court, in its decision, claims not to be insensitive to delay tactics by debtors to put-off their obligations under Section 365(d)(10), the Court stated that there are appropriate protections that can be structured for the lessors who claim "true lease" status while the "true" or "bona fide" lease issue is being adjudicated. For instance, the Court went on to state that an equipment lessor should request an expedited trial schedule and a prompt decision on the "true" or "bona fide" lease issue and that Courts should liberally grant such requests; or a debtor's request for a more extended adjudication schedule, should be conditioned on posting appropriate security to protect the equipment lessor's accruing claim for administrative rent in the event that the "lessor" ultimately prevails on the "true" or "bona fide" lease issue. The Court even suggested that if the debtor's pleading raised the "true" or "bona fide" lease issue for an "improper purpose", sanctions could be awarded.

CONCLUSION

As one can easily discern from the Circuit Wise decision, a lessor may not be afforded the protections under Section 365(d)(10) if a question is raised regarding whether a transaction is a "true" or "bona fide" lease until there is an adjudication of that issue. Vigilance in pursuing remedies, seeking court directives, and insisting on lessee compliance is as important now, just as it was prior to 1994.

Moritt Hock Hamroff & Horowitz LLP is a broad based corporate law firm with more than 25 lawyers and a staff of paralegals. The firm has extensive experience in litigation; creditors' rights and bankruptcy; real estate law; tax & trusts and estates; direct marketing, advertising & new media; intellectual property & unfair competition; general corporate, financial services, secured lending & leasing.

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