Pratt's Journal of Bankruptcy Law

LEXISNEXIS® A.S. PRATT® SEPTEMBER 2017

LexisNexis

Pratt's Journal of Bankruptcy Law

VOLUME 13 NUMBER 6 SEPTEMBER 2017

LexisNexis®

QUESTIONS ABOUT THIS PUBLICATION?

For questions about the **Editorial Content** appearing in these volumes or reprint permission, please call:
Kent K. B. Hanson, J.D., at 415-908-3207
Email: ..... kent.hanson@lexisnexis.com
Outside the United States and Canada, please call . . . . . (973) 820-2000

For assistance with replacement pages, shipments, billing or other customer service matters, please call:
Customer Services Department at . . . . . (800) 833-9844
Outside the United States and Canada, please call . . . . . (518) 487-3385
Fax Number . . . . . (800) 828-8341
Customer Service Website . . . . . http://www.lexisnexis.com/custserv/

For information on other Matthew Bender publications, please call
Your account manager or . . . . . (800) 223-1940
Outside the United States and Canada, please call . . . . . (937) 247-0293

Library of Congress Card Number: 80-68780

ISBN: 978-0-7698-7846-1 (print)
ISBN: 978-0-7698-7988-8 (eBook)
ISSN: 1931-6992

Cite this publication as:

[author name], [*article title*], [vol. no.] PRATT'S JOURNAL OF BANKRUPTCY LAW [page number] ([year])

Example: Patrick E. Mears, *The Winds of Change Intensify over Europe: Recent European Union Actions Firmly Embrace the "Rescue and Recovery" Culture for Business Recovery*, 10 PRATT'S JOURNAL OF BANKRUPTCY LAW 349 (2014)

An A.S. Pratt® Publication

Editorial Office
230 Park Ave., 7th Floor, New York, NY 10169 (800) 543-6862
www.lexisnexis.com

MATTHEW BENDER

(2017-Pub.4789)

Editor-in-Chief, Editor & Board of Editors

licenses and registration for a variety of users. For subscription information and customer service, call 1-800-833-9844.

Direct any editorial inquires and send any material for publication to Steven A. Meyerowitz, Editor-in-Chief, Meyerowitz Communications Inc., 26910 Grand Central Parkway, No. 18R, Floral Park, NY 11005, smeyerowitz@meyerowitzcommunications.com, 718.224.2258. Material for publication is welcomed—articles, decisions, or other items of interest to bankers, officers of financial institutions, and their attorneys. This publication is designed to be accurate and authoritative, but neither the publisher nor the authors are rendering legal, accounting, or other professional services in this publication. If legal or other expert advice is desired, retain the services of an appropriate professional. The articles and columns reflect only the present considerations and views of the authors and do not necessarily reflect those of the firms or organizations with which they are affiliated, any of the former or present clients of the authors or their firms or organizations, or the editors or publisher. POSTMASTER: Send address changes to *Pratt's Journal of Bankruptcy Law*, LexisNexis Matthew Bender, Attn: Customer Service, 9443 Springboro Pike, Miamisburg, OH 45342-9907.

Equipment Leases in Bankruptcy: A Plan for Riding Out the Storm

By James Heiser and Aaron M. Krieger*

This article addresses some of the key considerations for lessors in formulating a plan to deal with distressed or likely-to-be-distressed lessees, both prior to and during a potential bankruptcy proceeding.

Many equipment lessors are watching yesterday's prime customers transform into tomorrow's distressed credits. This article addresses some of the key considerations for lessors in formulating a plan to deal with distressed or likely-to-be-distressed lessees, both prior to and during a potential bankruptcy proceeding. It first addresses pre-bankruptcy planning and other considerations, followed by steps that lessors can take to better navigate a bankruptcy case. With a proactive approach and a sound strategy, lessors can minimize losses and ensure that they are protected.

DEVELOPING A PLAN AND COVERING THE BASICS

The seeds of a successful equipment lease restructuring are frequently planted when the lease is first being negotiated. In preparing transaction documents, lessors should be careful to avoid forgoing fundamental protections, and, when possible, negotiate for broad covenants and other non-monetary obligations that can provide an early warning of impending stress. A payment default will quickly come to light, but by then a bankruptcy filing may be imminent or have already occurred. Leases should require regular reporting and notice of any defaults. Lessors should also consider including cross-defaults with other transactions with the lessee.

Lessors can also enhance their leverage and reduce headaches down the road by including provisions for the payment of fees and expenses (including attorneys' fees) incurred in addressing defaults, remedies or litigation (including appeals) arising from or otherwise related to their leases. Lessors should require that these fees and expenses will remain due and owing even after all defaults are cured and after any legal proceeding is dismissed. All fees and expenses should accrue daily and be payable as they are incurred.

---

* James Heiser is a partner in Chapman and Cutler LLP's Bankruptcy and Restructuring Group, helping clients find solutions to complex bankruptcy, restructuring, and litigation disputes. Aaron M. Krieger is an associate in the firm's Bankruptcy and Restructuring Group and is a member of the Banking and Financial Services Department. The authors may be contacted at heiser@chapman.com and akrieger@chapman.com.

Lessors should have a system in place for effective default monitoring. Having early warning of a potential default can facilitate solutions that may become unavailable as a result of continued deterioration of a lessee's financial condition or a bankruptcy filing. Once a lessor becomes aware of a potential default risk, it should immediately review all relevant transaction documents. This review should confirm that all expected documents are in place, and identify any potential defaults and remedies. Lessors should also ensure that any filings permitted under the relevant transaction documents have been made (including any "protective" Uniform Commercial Code filings covering equipment under a lease that could be deemed to be a "disguising financing"). To the degree there is other collateral associated with the transaction, such as an account control agreement, lessors should ensure that all required documentation is in place.

Strategically, if a default is identified early in the process, the lessor may be able to terminate the lease and repossess or recover the equipment prior to the filing of a bankruptcy case, thereby avoiding the cost and complexity of a bankruptcy proceeding. However, lessors must be careful to ensure that declared defaults are not subject to dispute and that any required grace periods have lapsed prior to the initiation of any actions against the lessee or the equipment. Many leases also permit lessors to declare defaults based on "material adverse changes" or similar language, but these defaults can be subject to dispute and are therefore typically only declared as a last resort. Absent unusual circumstances, all known defaults should be promptly noticed and all rights should be expressly reserved in connection with these defaults. Lessors should also be careful of accepting delinquent payments or otherwise deviating from the requirements of the relevant lease documents to avoid providing lessees with any potential waiver or bad faith defenses.

Most equipment leases will provide that if a default exists and the lessee has not yet filed for bankruptcy, the lessor is permitted to terminate the lease and recover its equipment. Regaining possession following a lease termination and prior to a bankruptcy filing will serve to terminate a debtor-lessee's possessory rights in the equipment and potentially allow the lessor to avoid being caught up in the debtor-lessee's bankruptcy proceeding.

In some cases, immediate termination and repossession, if feasible, will be in the best interests of the lessor. For example, the equipment may be rapidly depreciating due to use, poor maintenance or other reasons. Pre-bankruptcy damage to the equipment will usually be treated as an unsecured claim against the debtor and may be paid out at pennies on the dollar. Thus, acting quickly may be the best means to preserve the value of the equipment. The lessor may also determine that the financial condition of the debtor is so poor that the

debtor will be unable to successfully reorganize. If the lessor opts to terminate the lease, it should attempt to regain possession of the equipment as soon as practicable.

Lessors should also note that in cases of severe distress, a debtor-lessee may view the lessor as a low-priority constituency or, worse, believe that the lessor's equipment can be used up to extract value, only to be rejected and returned in poor or unusable condition. In other cases, such as those involving mobile equipment, the equipment may be in locations where recovery may not be feasible or cost-effective. Where it is feasible, repossession before these conditions exist may minimize losses. Further, in cases where equipment is of little value to the debtor or is duplicative, moving quickly to repossess may help avoid the potentially significant cost of going through the bankruptcy process.

Where a lessor has chosen not to immediately repossess, the lessor should open the lines of communication with the lessee to set expectations and attempt to ascertain the lessee's intentions regarding the equipment. In addition to providing a path forward, this negotiation process may allow lessors to correct any documentation or perfection deficiencies that require the lessee's consent, obtain releases, and confirm that maintenance and any related obligations are being complied with. This is typically accomplished in conjunction with a forbearance agreement, which sets forth the terms through which the lessee can avoid repossession in exchange for concessions given to the lessor. Attempting to negotiate a mutually beneficial forbearance can at least open the lines of communication and better inform the lessor about the lessee and its current financial condition. Lessors must be mindful, however, that in some cases non-routine transfers from the lessee to the lessor within the 90-day period before its bankruptcy can be characterized as preferential transfers and subject to clawback.

NAVIGATING THE BANKRUPTCY CASE

In most cases, a lessor will need to resolve its dispute with the lessee in a bankruptcy proceeding, either with a negotiated solution or by taking advantage of the protections afforded lessors under the Bankruptcy Code, described below. This may be an attractive option if the lessor has market or above-market rate leases with a distressed company that is likely to both successfully reorganize and assume the relevant leases. In determining how to proceed, lessors should always consider the tax implications of terminating their leases.

If a lessee files for bankruptcy, the automatic stay will prevent the lessor from exercising remedies and will stop any acts to obtain possession of the equipment

that are already underway.[1] However, the lessor should calendar the 60th day after a Chapter 11 filing. To the extent that payments are not commenced on or before this date, a motion should then be filed to compel payment or to press the debtor to decide whether to assume or reject the lease.

Importantly, the automatic stay does not typically prevent actions against non-debtor guarantors. Thus, in situations where a guarantor is solvent, as early as the first day of a lessee's bankruptcy case, the lessor can typically proceed against guarantors for recovery. Further, the automatic stay generally does not prohibit draws on third-party letters of credit or other liquidity facilities, if available.

There are also special protections in the Bankruptcy Code for equipment lessors. Section 365(d)(5) requires a debtor in a Chapter 11 case to timely perform all of the obligations of the debtor (including making lease payments) starting 60 days after the debtor-lessee's bankruptcy filing.[2] These payments must continue until the lease is assumed or rejected unless the court, based upon the equities of the case, orders otherwise.[3] This section essentially requires that rental and other lease payments accruing after 60 days from the commencement of a case be treated as "administrative expenses."[4] The debtor must pay administrative expenses in full in order to confirm a plan of reorganization.[5] Further, Section 365(d)(5) expressly provides that it overrides Section 503(b)(1), which otherwise requires, in order for payments to be deemed an administrative expense, that the equipment at issue be actually used by and provide benefit to the estate. Thus, for amounts payable after day 60, lessors can avoid litigating the sometimes fact-intensive inquiry of whether or not the equipment conferred a benefit on the debtor-lessee.

Lessors can still seek administrative claims for amounts due during the first 60 days of the case under Section 503(b).[6] However, administrative expenses may only exist pursuant to Section 503(b) during the first 60 days following a bankruptcy case to the extent of the benefit that the equipment actually conferred on the debtor.[7] Therefore, lessors should closely monitor the use of

---

[1] 11 U.S.C. § 362.

[2] 11 U.S.C. § 365(d)(5).

[3] *Id.*

[4] *In re Garden Ridge Corp.*, 321 B.R. 669, 676–77 (Bankr. D. Del. 2005) ("In the absence of evidence to the contrary, it is presumed that the contract rate is the fair rental value.").

[5] 11 U.S.C. § 1129(a)(9)(A).

[6] *In re Muma Servs. Inc.*, 279 B.R. 478, 490 (Bankr. D. Del. 2002).

[7] *See, e.g., In re Furley's Transp., Inc.*, 263 B.R. 733, 740–41 (Bankr. D. Md. 2001).

equipment during this period. Lessors should also pay careful attention to whether their equipment is being used, not only for purposes of making a Section 503(b) claim, but also to establish whether the equipment is necessary to the lessee's reorganization.

Courts will rely on specific instances of use in making any factual determination on a Section 503(b) claim.[8] It may be necessary to conduct discovery to ascertain the specific use of the equipment and to provide sufficient evidence of that use at a hearing before the bankruptcy court. To the degree possible, Lessors should maintain a list of all expenses and the date that they are incurred, and document any damage that occurs.

To the extent that a debtor-lessee is not insuring the equipment or is materially violating the terms of the lease, a lift stay motion should be made as soon as practicable. In addition to the inherent temptation to "burn through" the equipment, bankruptcy often imposes new stresses and manpower limitations on debtor-lessees, making close monitoring essential. However, absent an emergency, most courts will give the debtor a "breathing period" immediately after filing its case before the court will determine that the equipment is not necessary for a reorganization. This period usually coincides with the 60-day period under Section 365(d)(5).

THE ENDGAME

The Bankruptcy Code allows the debtor to assume or reject leases in its business judgment.[9] If a debtor determines to reject a lease, the rejection is deemed effective as of the petition date and rejection damages will be treated as unsecured claims against the debtor's estate which may be paid out at pennies on the dollar.[10] However, to the degree that any payments have been made under Section 365(d)(5), or if any administrative claims have arisen under this section, they are not typically subject to disgorgement by the lessor. While a debtor's decision to assume or reject leases must be made within 60 days in a Chapter 7 case, debtors under other chapters of the Bankruptcy Code can delay until plan confirmation unless the court orders otherwise.[11] Thus, if the lessor believes that equipment is at risk, it should not delay in seeking automatic stay relief.

---

[8] *Id.*

[9] *In re Chateaugay Corp.*, 10 F.3d 944, 954–55 (2d Cir. 1993) (citing *Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303, 1310 (5th Cir. 1985)).

[10] 11 U.S.C. § 365(g)(1).

[11] 11 U.S.C. § 365(d)(2).

Under most circumstances, a lessor will prefer to have its leases assumed. Before a debtor assumes a lease it generally must cure all extant defaults that are capable of being cured and provide adequate assurance (but not a guarantee) of future performance under the lease.[12] An assumption essentially restores the parties to their pre-bankruptcy state. To the extent that a debtor lessee fails to cure any defaults, the lessor can challenge the lessee's assumption of the lease. However, if the lessor does not raise an objection to the debtor's failure to cure, it may be forever barred from doing so. As a result, lessors must ensure that any and all defaults will be cured or intentionally waived prior to any objection deadline to a debtor's motion to assume the lease.

If the prerequisites to assumption of a lease are satisfied, the debtor may also assign the lease to a third party. Importantly, a debtor-lessee can assign the lease to a suitable third party notwithstanding a non-assignment clause in the lease. Lessors should do their due diligence on any proposed assignee as soon as it is known, and ensure that adequate assurance is given that the assignee can perform all of the material obligations under the lease. If the lessor has any concerns, it should bring them to the court's attention as soon as practicable.

Often, in order to force a negotiated solution in its favor, a debtor-lessee will threaten to reject the lease. However, it is important to note that, unlike a secured loan where the debtor can sometimes pay the secured creditor only the value of its collateral, a lease must be assumed or rejected in its entirety.[13] Thus, where the equipment is essential to the operation of the debtor-lessee, lessors may retain leverage even if the market lease rate for the equipment has dropped or if the equipment is in less than perfect condition. The decision of whether to negotiate with the debtor-lessee or force an assumption or rejection should be made based on the debtor-lessee's financial circumstances existing at the time, the prospects for a successful reorganization, and the value of the equipment, among other factors. However, if the lessor has been carefully monitoring the case and is executing on its plan, it will be well positioned to make an informed decision.

Lessors should also be mindful that bankrupt lessees will sometimes attempt to use the bankruptcy process to force a form of "Dutch auction" on their lessors. For example, lessees may have many leases of similar equipment from multiple lessors in varying states of repair. If the debtor-lessee does not need all of its existing equipment, rather than immediately instituting rejections, the

---

[12] 11 U.S.C. § 365(b)(1)(A); *see also In re M. Fine Lumber Co., Inc.*, 383 B.R. 565, 570 (Bankr. E.D.N.Y. 2008).

[13] *See, e.g., In re Holland Enterprises, Inc.*, 25 B.R. 301, 303 (E.D.N.C. 1982) (debtor must assume or reject *in toto*; it cannot assume one part of an agreement and reject another part).

lessee may offer to all of its lessors a restructured lease rate that is very low, threatening that once a certain number of the proposed restructured leases are accepted, future offers will be lower until all needs are filled, after which the rest will be rejected and potentially receive only pennies on the dollar. Whether or not this is a successful strategy typically depends on a combination of factors, but lessors can sometimes band together to negotiate as a group to counteract this process and potentially improve the outcome for all lessors.

Many of today's bankruptcy cases end in asset sales pursuant to Section 363 of the Bankruptcy Code, rather than traditional reorganizations. It is critically important that lessors pay close attention to the contents of any Section 363 sale and sale procedures motions, as they may provide for the applicable leases to be assigned to a third-party purchaser and may provide a cure amount to be paid. It is common for debtors to strategically assert that no amounts are due, with the hope that counterparties will fail to notice and therefore fail to object. If the lessor fails to object, it will likely be left with no recourse against the debtor-lessee.

CONCLUSION

Lessors can draft lease agreements with protections that will provide early warning of distress and help insulate them from some of the dangers associated with a lessee's default. Lessors can also negotiate mutually beneficial solutions with lessees in the event that they do become distressed. Even where a solution cannot be negotiated, a diligent lessor, paired with experienced counsel, has many tools available to preserve the value of its equipment and its leases during and through a bankruptcy case.