The Treatment of Financing Leases in a Chapter 9 Bankruptcy Case

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The first of two parts examining bankruptcy. The second part will appear in the March issue of TELL.

I. The Dual Nature of Financing Leases

Municipal financing leases are unique instruments. For purposes of state law limitations on the issuance of debt, such instruments are usually considered true leases, subject to periodic rental payments and the potential for surrender of the leased property in the event of non-use by the municipality. Under California law, for example, financing leases do not constitute "debt" since the issuer's liability is confined to each rental installment as it falls due — the issuer bears no long-term liability. The world of municipal finance, on the other hand, typically views such lease instruments as debt obligations, bearing traditional attributes of governmental safety and liquidity and usually enjoying favorable tax treatment. These worlds will sometimes collide upon the commencement of a bankruptcy case under Chapter 9 of the Bankruptcy Code.

Although the federal Bankruptcy Code contains many specialized provisions governing leases, the Code also contemplates that state law frequently will be used to determine the nature and extent of a party's property rights. This raises some interesting issues with respect to the proper characterization of financing leases. In Chapter 9, moreover, the potential for conflict between federal and state law becomes even more acute. Only federal law can preempt the constitutional limitation on the impairment by states of the obligation of contracts. U.S. Const., art. I, § 10, cl. 1. But federal law must, in the case of municipal debtors, yield to the reserved sovereign rights and powers of the states. U.S. Const. Amend. X. Chapter 9 was carefully crafted by Congress to accommodate both mandates. Among the provisions reflecting this tension is a prohibition on any "interference" by the bankruptcy court with any of the municipality's political or governmental powers, or the use or enjoyment of any municipal property or revenues. This provision is a formidable constraint on a municipal lessor's remedies under Chapter 9.

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This article briefly explores various concepts applicable to the treatment of financing leases in bankruptcy. First, the general bankruptcy rules respecting unexpired leases are presented. A variation on the general rules arising in Chapter 9 is then addressed. The article also discusses the potential consequences of the recharacterization of municipal financing leases as debt obligations and the impact of the "special revenue" exemptions under Chapter 9.

II. Unexpired Leases in Bankruptcy

Like individual and corporate debtors under the reorganization provisions of the Bankruptcy Code, a municipality in Chapter 9 also enjoys the potent options to reject, assume, and assign unexpired leases under section 365 of the Bankruptcy Code. Generally speaking, an unexpired lease includes any lease that has not terminated by the expiration of its stated term either prior to or during the commencement of the bankruptcy case, or that has not otherwise been previously terminated under applicable state law. A lease may not, however, be terminated based on a lease provision that is conditioned on the debtor's financial condition or the commencement of its bankruptcy case.

Section 365 is one of the most intricate provisions of the Bankruptcy Code and contains many unique rules applicable to different types of leases, including personal property leases, residential real property leases, nonresidential real property leases, shopping center leases and timeshare plans. Section 365(m), moreover, specifies that, for purposes of section 365, "leases of real property shall include any rental agreement to use real property." This provision has been construed to include operating licenses, and other verbal or nontraditional rental agreements, within the scope of section 365. Thus, notwithstanding the absence of traditional lease language, a contract to use real property will be deemed a lease for purposes of assumption or rejection under section 365.

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A. Deadlines to Assume or Reject Leases

Once the Chapter 9 case is commenced, the municipality must abide by certain deadlines for deciding how to treat the lease. In the case of a nonresidential lease of real property, for instance, the municipality has 60 days from the commencement of the case to decide whether to assume or reject the lease. If no decision is timely made, or no extension is obtained from the Bankruptcy Court, the lease is automatically deemed rejected. In the Orange County Chapter 9 case, commenced over a year ago, the county has obtained several extensions of the deadline to decide how to treat its unexpired leases. In fact, the county recently obtained an extension of the deadline until confirmation of its plan of adjustment, which is not expected to occur until June 1996.

B. Payment and Performance Pending Assumption or Rejection

1. Real Property Leases

During this period of indecision, however, lessors are not without their remedies. All municipal debtors must "timely perform" their obligations under a nonresidential lease of real property until the lease is assumed or rejected. Although, with court approval, the municipality may temporarily defer its performance for 60 days, it cannot under any circumstances delay performance past the 60-day period. The scope of the lease obligations which are subject to "timely performance" is somewhat vague and courts disagree whether *all* lease obligations must be satisfied (*e.g.*, rent, taxes, interest, late payments, attorneys' fees, maintenance charges, and other lease covenants) or only those obligations directly related to post-petition use and occupancy.

Moreover, the obligation of "timely performance" is subject to various statutory exceptions. Among the limited exceptions is an exemption from the "satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations." This exemption, which also applies when the debtor seeks to assume the lease, was added by Congress to the Bankruptcy Code last year. The new provision will likely be the subject of some uncertainty since it may be interpreted to excuse compliance with various performance covenants under the financing lease. The debtor might contend, for instance, that the replenishment of a rental reserve is a nonmonetary obligation, so long as rental payments are otherwise current. Although this result seems incorrect, the ambiguous language of the new exemption is cause for some concern.

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2. Personal Property Leases

Leases of personal property, such as equipment leases, are treated somewhat differently under section 365. The municipality generally has until confirmation of its plan to decide whether to assume or reject an equipment lease. The lessor, however, may request that the court accelerate this deadline. Although Congress amended section 365 in 1994 to also require "timely performance" of a personal property lease pending assumption or rejection, the amendment is only applicable under Chapter 11.

This raises the question whether a municipal lessee may continue to use the personal property without compensation to the lessor pending its decision to assume or reject. One provision of the Bankruptcy Code, which obligates the debtor to "adequately protect" the lessor for the use of leased property, is not incorporated into Chapter 9. Thus, if it wishes to be compensated for the debtor's continued use of the equipment, the lessor to a Chapter 9 debtor has one principal remedy — to seek court approval to compel the payment of "administrative rent" during the period before assumption or rejection. This "administrative rent," however, is typically measured by the benefit to the debtor from the use of the leased property and may differ from the contractual rate. Moreover, the municipality may attempt to defer payment until confirmation, using the bankruptcy court's jurisdictional inability to "interfere" with municipal property as a shield. Notwithstanding this grim possibility, another provision of section 365 specifies that the debtor may not require the lessor "to provides services or supplies incidental" to the lease unless the lessor is "compensated under the terms of such lease for any services and supplies."

III. Effects of Assumption or Rejection

A. Cure Upon Assumption

The decision to assume a lease is subject to bankruptcy court approval, although the standard of review is the relatively deferential business judgment test. If assumption of the lease is a good business decision and rests on reasonable premises, the court should ratify the municipality's decision. It is well-established that assumption of a lease requires acceptance of both the benefits and the burdens of the contract. Accordingly, the debtor cannot sever the provisions it likes from those it dislikes but must accept the lease in its entirety. If the municipal debtor assumes the lease, it must cure past defaults (except, among others, the "nonmonetary obligations" discussed above), compensate for any losses

resulting from the defaults and provide adequate assurance of future performance under the lease. Generally speaking, the cure must restore the parties to their pre-default, pre-bankruptcy status. If the lease provides for the payment of attorneys' fees, and other costs and expenses associated with the exercise of remedies in bankruptcy, these must generally be paid upon cure as well, subject to reasonableness under the lease and possible court review. The lease should specifically provide for the reimbursement of attorneys' fees in the bankruptcy context in order to satisfy the requirements for cure upon assumption.

B. Unsecured Claim for Rejection

If the municipality rejects the lease, it typically must surrender the premises or property. Under the Bankruptcy Code, the rejection is deemed to constitute a "breach" of the lease occurring "immediately before the date of the filing of the petition." This means that the lessor is granted a pre-petition claim against the debtor even though rejection may occur many months into the bankruptcy case. The pre-petition claim will typically be calculated in accordance with applicable state law, that is, as if the breach had occurred outside of bankruptcy entitling the lessor to pursue all available contractual remedies and subject to mitigation responsibilities. In the case of a lease of real property, however, the lessor's resulting claim is subject to a bankruptcy cap. Under section 502(b)(6), the lessor's claim is generally limited to the rent reserved under the lease, without acceleration, for the greater of 1 year or 15% not to exceed three years of the remaining period of the lease. The lessor is also entitled to assert a claim for any missed rental payments and other compensation due under the lease prior to the commencement of the bankruptcy case.

C. Damages Cap Applies Only to "True Leases"

Congress specified, however, in the legislative history to section 502(b)(6) that the cap on lease damages would apply only to "true leases" and not financing leases. Thus, where the "lease" is in reality a sale of the real property, and the rental payments correspond to payments of principal and interest, rejection of the "lease" will not be subject to the cap on damages. Each financing lease will typically be scrutinized by the court to determine the underlying economic substance of the transaction. The key is whether the parties intended to create a true landlord-tenant relationship. The intent of the parties is usually discerned with reference to various factors, including: (1) whether the lease permits the lessee to acquire the premises for little or no consideration at the end of lease term; (2) whether the lessee has assumed many of the obligations normally associated with outright ownership (such as maintenance and repair, payment of taxes and insurance); (3) whether the transaction was structured solely to benefit the lessee, to gain tax advantages, for example, or circumvent state debt limitation laws, and (4) whether the rent reserved under the lease reflects actual compensation for use and possession or appears calculated to ensure a particular return on an investment. Although no single factor will be dispositive, the court retains substantial flexibility to analyze the totality of the transaction.

The second part of this article in the next issue of TELL will include Special Provisions for Municipal Financing Leases, Possible Effects of Characterization as Debt, and Special Revenue Exemption Under Chapter 9.

Letter From the President

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Association.

And, of course, many thanks to former Board Chairman, Neal Skiver, for his hard work over the past years and his ever insightful, sagacious, and cerebral viewpoint. (If any of you are looking for a 1996 bond market prediction, please call Neal! I personally don't have a prediction; Neal doesn't either, but he'll be glad to share one with you!)

The year ahead presents numerous challenges to the AGL&F. As always, the Association is carefully monitoring legal and legislative concerns, along with many other issues affecting our members. AGL&F is in the process of updating the *Fifty State Survey*; coordinating this effort is Georgeann Becker. If you have any information on legal changes affecting your state, she would appreciate a call.

The Association is conducting a membership recruitment drive, coordinated by Bob Jennings. I encourage all members to assist Bob and his committee in this endeavor. Membership growth is a critical component of our Association's continued vitality!

The Association is also interested in developing an instructional format to educate new members on the basics of municipal leasing. I am soliciting responses from members as to how to proceed with this and I encourage you to contact me directly at 913/587-4050.

I cannot stress enough the Board's commitment to meeting the needs of ALL the Association's members; we encourage ALL members to become involved in the Association. Our diverse membership, representing many different segments of the municipal finance industry, provides

us with significant challenges; these challenges also provide us with tremendous opportunities. I am confident that the profundity, professionalism, and knowledge of our members will make 1996 and beyond the best years for our Association and its members!

AGL&F President Frank Hill is executive vice president with Baystone Financial Group in Manhattan, Kansas.