Guest Counsel

The Treatment of Financing Leases in a Chapter 9 Bankruptcy Case

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The second of two parts examining bankruptcy issues. The first part appeared in the January 1996 issue of TELL.

IV. Special Provisions for Municipal Financing Leases

In the case of a municipal lease, the attributes of a true lease may appear stronger because of the need to avoid the creation of a permanent, long-term obligation under state debt limitation laws. In some states, the leases are not considered debt because of their contingent or installment nature, meaning that each periodic payment is in exchange for a corresponding right of occupancy. In other states, financing leases may escape characterization as long-term indebtedness because they bear the risks of "abatement" or "non-appropriation." As a result, the obligation to make rental payments is considered conditional. For example, the lease may contain a special provision calling for early termination in the event the municipality fails to appropriate funds with which to pay the rent due in a particular year. Alternatively, if the transaction is subject to abatement, the issuer's payment obligations may be reduced or even suspended if (as a result of damage or destruction, for example) the issuer lacks the right to use or occupy the leased property.

Thus, the contingent termination provisions of a financing lease might be suggestive of a true lease. The risk of mistreatment is exacerbated by section 365(m), which, as noted previously, specifies that "any *rental agreement to use* real property" be treated as a lease for purposes of section 365. A use agreement, thus, might be considered a traditional lease under section 365. For this reason, a special rule of construction has been added to Chapter 9 to prevent the potential mistreatment of municipal financing leases as true leases under section 365. This rule will override the rental claim limitation and thereby preserve, for lessors, the right to seek full recovery on the outstanding amount of the debt. Section 929 provides:

> A lease to a municipality shall not be treated as an executory contract or unexpired lease for the purposes of section 365 or 502(b)(6) of this title solely by reason of its being subject to termination in the event the debtor fails to appropriate rent.

The legislative history of section 929 indicates that "a lease to a municipality shall not be treated as an executory contract or unexpired lease that could be subject to assumption or rejection under section 365, or that could give rise to a claim for damages limited by section 502(b)(6), just because it is subject to termination in the event the debtor fails to appropriate rent." This implies that section 929 would not preclude lease treatment for *any* municipal lease containing a rent-appropriation provision, but would instead proscribe treatment under section 365 *solely* on the basis of such a provision. Thus, the court retains discretion to scrutinize the financing transaction on a case-by-case basis.

One ambiguity under section 929 is the extent to which it excludes municipal financing leases from the scope of section 365. Is the municipal debtor relieved of its obligation to "timely perform" its lease obligations under 365(d)(3)? Is the municipal debtor relieved of the initial 60-day deadline to assume or reject the lease? Is the municipal debtor wholly incapable of assuming or rejecting such leases? A Senate Report accompanying the amendment points out that "state law generally provides that if the municipality does not appropriate the rent, the lease may be terminated. Section 365(d)(4) [the 60-day deadline to assume or reject] may interfere with that state law decision process." This language suggests that a municipal financing lease that complies with section 929 may not qualify as an unexpired lease for any purposes under section 365.

V. Possible Effects of Characterization as Debt

If the municipal financing lease is to be treated as a debt obligation, however, some interesting possibilities might ensue. First, would a federal bankruptcy court determination that a financing lease constituted debt have any repercussions under state debt limitation laws? Might the municipal debtor seek the recharacterization of the lease as debt and then attempt to invalidate the remaining payment

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obligation as a long-term debt not previously approved by the electorate? A Chapter 9 debtor cannot confirm a plan if it is "prohibited by law from taking any action necessary to carry out the plan" or has not obtained any "regulatory or electoral approval necessary under applicable nonbankruptcy law." It is not clear whether these provisions might permit (or require) the use of state debt limitation provisions to avoid the satisfaction of otherwise valid claims. Although these issues have not yet been adjudicated, the dual identities of a municipal financing lease, which harmoniously coexist outside bankruptcy, should probably be respected in Chapter 9.

Second, under the Bankruptcy Code, a secured claim is sometimes bifurcated into two claims—a secured claim to the extent of the collateral and an unsecured claim for the deficiency. Thus, if the value of the leased property is less than the outstanding amount of the debt, a municipality could seek to bifurcate the claim into two distinct claims. These claims would then be classified and treated separately under a plan of adjustment. Given the limited use of most public facilities that are the subject of financing leases, it would not be unlikely for the debt to exceed the value of the collateral.

If so, following bifurcation of the claim, the debtor may attempt to "strip down" the lien securing the indebtedness to the underlying collateral value. Section 506(d) of the Bankruptcy Code provides that "to the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void." To the extent that lien stripping is available, it promotes the "fresh start" policy of the Bankruptcy Code by voiding that portion of the lien in excess of the collateral value. Depending on the treatment then provided to general unsecured creditors under the plan, however, the bondholder could potentially face a substantial impairment of its total claim. Generally speaking, confirmation of a municipal plan of adjustment results in the discharge of all pre-bankruptcy debt. If unsecured claims are not repaid in full under the plan, the lessor (now secured creditor), may not realize a full recovery on its original claim.

It is presently unclear whether a municipality has the authority to "strip down" liens in a Chapter 9 case. Although the lien stripping provision under section 506(d) is incorporated into Chapter 9, the Supreme Court has rejected lien stripping in cases under Chapters 7 (liquidation) and 13 (individual debt adjustment). It is unclear whether the Court's interpretation of section 506(d) under Chapter 7 and 13 cases is binding in other bankruptcy proceedings. Indeed, some lower court cases have concluded that lien stripping appropriate in a Chapter 11 case because of special provisions applicable in a corporate reorganization. Interestingly, these same provisions are incorporated into Chapter 9.

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A third potential anomaly facing the municipal lessor whose lease has been recharacterized as debt is the valuation of the underlying municipal asset. In order to bifurcate the claim into a secured and unsecured portion, the debtor must establish the value of the collateral. In the case of a limited use, public facility (such as jails, juvenile detention centers, libraries and public works projects), there is no comparable market for such assets and thus the value of the asset is not necessarily subject to ready appraisal. Another factor that may impact the valuation of the asset is the viability of the foreclosure remedy. Presumably, if the lessor is to be treated as a secured creditor, its rights vis-a-vis its collateral should be comparable to other secured creditors. Yet, it is generally accepted that a creditor cannot foreclose on public property or a public facility. Should the municipal debtor be able to convert the lease to secured debt, retain the use and possession of the asset, strip down the claim, and yet deprive the creditor of foreclosure rights? Does the absence of foreclosure rights affect the valuation of the property?

VI. Special Revenue Exemptions Under Chapter 9

In some cases, the rental payments due under a municipal financing lease may be payable from, or secured by, certain special revenue source, not the municipality's general property, sales, or income taxes. If so, the lease obligation may enjoy certain advantages in Chapter 9 not afforded to the municipality's general obligations. Congress amended Chapter 9 in 1988 to address the growing use of revenue bonds to finance the construction or acquisition of public improvements. In order to protect these obligations from possible adverse consequences in Chapter 9, certain unique protections were created. *See Alliance Capital Management L.P. v. County of Orange (In the County of Orange)*, 179 B.R. 185 (Bankr. C.D. Cal.1995). The protections are applicable with respect to certain defined categories of "special revenues" and do not depend on the nature of the obligation (*i.e.*, bond or lease). Although the holder of a "special revenue" obligation will continue to bear the risk that the income stream from the project will be insufficient to service the debt, or satisfy the rental payments, and will lack recourse to the issuer's general funds and taxing capabilities, the special status bestowed on such holders in Chapter 9 will generally outweigh the risks. One of the primary benefits is the opportunity to become detached from the day-to-day vicissitudes and uncertainties of the Chapter 9 process. So long as the "special revenues" are adequate and ongoing, the obligor

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need not be unduly concerned with the state of the municipality's general finances or recovery prospects.

There are five categories of "special revenues" listed in section 902(2) of the Bankruptcy Code. A House report indicates that Congress intended to "define special revenues to include the revenues derived from a project or from a specific tax levy, where such revenues are meant to serve as security tot he bondholders." Although Congress specified discrete categories of special revenues, the categories are susceptible to some flexibility. There is no applicable case law on the subject and the only guidance is contained in the legislative history which contains some general examples of various special revenues, including: (a) receipts from the operation of water, sewage, waste or electric systems, (b) highway or bridge tolls, (c) user fees, (d) special excise taxes, including hotel/motel taxes, alcoholic beverage taxes, meal taxes and license fees, and (e) proceeds from project financing, receipts received in connection with the project financing and funds held in special accounts under the terms of the indenture or bond resolution.

If the obligation is payable from "special revenues," then (a) any security interest in the payment stream will survive the commencement of the case notwithstanding section 552(a) of the Bankruptcy Code, which typically operates to cut off the effectiveness of the lien on post-petition revenues, (b) the indebtedness will continue to be serviced notwithstanding the automatic stay under section 362, and (c) any prepetition payments on account of "special revenues" will be immune from preference recovery (this provision applies generally to all bonds and notes). There are other advantages accruing to a municipal creditor whose debt is serviced or secured by special revenues and each creditor should immediately examine whether it qualifies under the special revenue exemptions under Chapter 9.

Getting the Government A Good Deal

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Tax-exempt leases are similar to an installment sale. When the lease ends, the agency owns the equipment outright. This type of lease arrangement makes sense for agencies that don't need the latest technology, or that foresee a long useful life in the equipment. However, it is important to keep in mind that since a tax-exempt lease functions much like an equipment sale, it offers little or no economic flexibility if a system reconfiguration is foreseen during the lease term.

The purchase/lease-back option helps agencies to replenish capital and minimize exposure to risk, without increasing debt load. With this option the agency sells its high-tech equipment to the lessor and leases it back; the financial risks of ownership are transferred to the lessor, while the equipment stays right where it is.

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The "Like-New" Choice

Essentially, as the result of increased computer capacity and continuous software introductions and upgrades, information technology loses its state-of-the-art status virtually days after it's installed. Therefore, depending upon the application, in many cases the acquisition of "brand new" equipment is not necessary, and for smaller agencies, may not even be an option.

High-quality "like-new" reconditioned equipment can be acquired to meet data-center, client/server, and distributed workstation computing needs at 35 to 70 percent below the cost of purchasing brand-new equipment. Reconditioned technology is generally equipment that is one generation behind and has been inspected, repaired, cleaned, painted, and restored to meet manufacturers' standard maintenance requirements. Systems are reassembled to fully operational status and pre-tested to the customer's configuration. Also, new technology can sometimes be found on the secondary market in as few as six months following its introduction, which means that just because equipment is not "new" doesn't mean that it is "old."

Meeting Demand

Greater demands and tighter budgets require creative solutions to information-technology needs. Alternatives exist that can help government agencies take advantage of changes in the market and increase equipment capabilities regardless of budget constraints. Given that state and municipal agencies are as diverse as the taxpayers they serve, exploring alternative high-tech acquisition and financing options can offer a means by which agencies can maximize productivity, flexibility, and efficiency in a manner that meets tax payers demands for services, while serving their cost-cutting consciousness.

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