



So You Thought You Had a Lease?

By: Jeffrey Posta

Whether a transaction creates a “true” lease or a security interest (also referred to as a “lease intended for security,” “financing lease,” “disguised security interest” or “dirty lease”) is an important one, particularly if the owner/lessee of the asset files for bankruptcy. This is so because different rights and obligations apply under the Bankruptcy Code depending on the nature of the debtor’s interest in the property. Bankruptcy courts are frequently called upon to decide this issue, and generally consider the economic substance of a transaction, rather than its form, in determining whether a transaction is a “true lease” or disguised secured financing.

If the transaction at issue is a “true lease”, the provisions of Section 365 of the Bankruptcy Code dealing with assumption, rejection, and post-petition performance of leases apply. Otherwise, the transaction will be treated as a financing arrangement. This is a very important distinction, since the recovery a lessor may expect to receive in a bankruptcy case can be very different from the recovery it may receive as a secured creditor. This “secured” reference presumes that a security interest in the collateral was properly perfected under state law, which is not always the case when the expectation was that the transaction was a lease.

If a lease is found to be a sale, the party intending to be a lessor may lose the benefit of its bargain. The property may be sold to the highest bidder, with the secured creditor’s lien attaching to the proceeds. In a Chapter 11 case, while a secured creditor is entitled to “adequate protection” of its interest, including cash payments, this remedy will be affected if the value of the collateral is less than the amount due and the creditor is undersecured. Then, the creditor is only entitled to adequate protection of the secured portion, not the unsecured portion. Further, a debtor may be able to retain the property by cramming-down the secured portion of the creditor’s claim to the property’s fair market value. Therefore, the lessor held to be a secured creditor may not receive either adequate protection and/or the property it thought it owned. See, 11 U.S.C. §§ 506(a) and 1129(b)(2)(A).

In a bankruptcy case, the existence, nature and extent of a security interest is governed by state law. Butner v. United States, 440 U.S. 48, 54-55 (1979). State courts generally use the Uniform Commercial Code (“UCC”) to determine whether a transaction

is a sale, and the “lessor” must comply with UCC Article 9 when disposing of the “leased” assets after default. Bankruptcy courts use the UCC to determine: 1) whether the “lessor” has rights under Section 365 (applicable only to true leases); and 2) whether the “lessor” must perfect a security interest in the “leased” equipment to avoid becoming an unsecured creditor.

The UCC states that “[w]hether a transaction creates a lease or a security interest is determined by the facts of each case.” There is a laundry list of factors that are considered. See N.J.S.A. 12A:1-201 (37). Key elements of a security interest include that the supposed lessee has an unavoidable obligation to pay the lessor for the possession and use of the asset, and this duty to pay extends over the life of the agreement and cannot be terminated by the lessee. Also, if the asset has little or no remaining value at the end of the lease, the transaction is more likely to be deemed a sale, not a lease.

There is much uncertainty in the law about whether a transaction is a sale or a true lease. Lessors desiring true lease treatment need to carefully document their transactions to protect their interests.

Jeffrey S. Posta, Shareholder, is a member of the Bankruptcy & Creditors’ Rights Group of Stark & Stark, P.C., LEAN members in New Jersey and Delaware. Mr. Posta concentrates his practice in the areas of bankruptcy, debtor-creditor matters, business law and commercial civil litigation in state and federal courts. His practice includes debtor, creditor and fiduciary representations in bankruptcy proceedings, pre-bankruptcy workout and insolvency counseling, and state court litigation involving business disputes, receiverships, attachments, replevins and foreclosure actions. Representative clients include banks, insurance companies, institutional lenders, equipment lessors, landlords, and a variety of individual and corporate creditors.

Mr. Posta is the Chair of the Dispute Resolution Section of the New Jersey State Bar Association, a past President of the Mercer County Bar Association, and a past Chair of both the Ethics and Fee Arbitration Committees of the New Jersey Supreme Court in Mercer County.