



LJN'S

# Equipment Leasing

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## True Lease or Secured Financing: Recovering Meaningful Residual Value

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Equipment lessors bargain for a very different set of legal rights than secured creditors. These bargained-for rights are often subject to attack, particularly in the Chapter 11 context where it is common for interested parties to challenge the characterization of a Chapter 11 debtor's obligations under an agreement styled as a lease. See *In re APB Online, Inc.*, 259 B.R. 812, 815 (Bankr. S.D.N.Y. 2001). As the recent decision by the Third Circuit in *Duke Energy Royal, LLC v. Pillowtex Corp. (In re Pillowtex, Inc.)*, 349 F.3d 711 (3d Cir. 2003) illustrates, when faced with the question of whether a transaction constitutes a "true" lease or a secured financing, Bankruptcy Courts will look through the cosmetics of the deal to its substance. To avoid the re-characterization of an equipment lease by a Bankruptcy Court, an equipment lessor must structure its transactions to retain an economically

meaningful "residual value" in the leased property.

### WHY IS IT IMPORTANT UNDER CHAPTER 11 OF THE BANKRUPTCY CODE?

In the Chapter 11 context, the recovery a lessor can expect to receive under a lease of personal property may be very different from the recovery it would experience as a secured creditor. This is primarily because, during the pendency of a Chapter 11 case, from and after 60 days from the petition date, lessors of personal property are entitled to receive lease payments from a Chapter 11 debtor-lessee until the debtor either assumes or rejects the lease. See 11 U.S.C. §365(d)(10). If a debtor decides to assume the lease, and the court approves the assumption, the lessor also is entitled to "cure" payments and "adequate assurance" of future performance. See 11 U.S.C. §365(b)(1). Conversely, if the debtor decides to reject the lease, then the lessor is entitled to the return of the leased property from the debtor and may assert a rejection damage claim that is treated as a pre-petition unsecured claim.

If a Bankruptcy Court re-characterizes an arrangement structured as a lease, then the party intended to be the lessor may lose the benefit of its bargain. While a secured creditor is entitled to "adequate protection" in

the form of cash payments, replacement liens, or other relief that results in the indubitable equivalent of the secured creditor's interest in the property, this may prove to be a remedy without benefit if the creditor is undersecured. Under the Bankruptcy Code, a secured creditor is only entitled to adequate protection for the value of the secured creditor's interest in the secured property. The unsecured portion of the secured creditor's claim is not entitled to adequate protection. Further, a debtor may be able to retain the secured creditor's secured property in a Chapter 11 reorganization plan by cramming-down the secured portion of the secured creditor's claim to the property's fair market value. See 11 U.S.C. §§506(a) and 1129(b)(2)(A). Thus, a self-styled lessor deemed to be a secured creditor in a Chapter 11 proceeding may find adequate protection unavailable and, in a cram-down scenario, may be deprived of the secured property that it thought it owned.

### FORM YIELDS TO SUBSTANCE IN *DUKE V. PILLOWTEX*

In *Pillowtex*, the Third Circuit Court of Appeals re-characterized as a secured financing transaction a transaction intended by both parties to be an equipment lease. The decision highlights the importance of structuring an equipment leasing transaction so that the equipment les-

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sor retains (as a matter of form) an economically meaningful "residual value" in the leased property and will be (as a matter of substance) economically motivated at the end of the lease term to take possession of the property in order to recover the residual value of such leased property.

### **THE FACTS AND STRUCTURE OF THE TRANSACTION**

Duke Energy Royal, LLC ("Duke"), an energy company, and Pillowtex Corporation ("Pillowtex"), a manufacturer of linen and bedding products, entered into a master energy services agreement ("MESA") pursuant to which Duke agreed to install certain energy savings equipment to improve the efficiency of Pillowtex's energy consumption and to reduce the operating costs incurred by Pillowtex at its manufacturing plants. 349 F.3d at 713. The parties themselves intended to structure the MESA as a true lease in large part because Pillowtex was subject to capital expenditure limitations under its senior credit facility and wanted the payments it made under the MESA to qualify as expenses, not capital expenditures.

To induce Pillowtex to enter into the MESA, the energy projects were designed to be "cost-neutral" to Pillowtex. Thus, during the term of the MESA, Pillowtex was only responsible for making payments to Duke under the MESA in an amount equal to Pillowtex's cost-savings. Duke bore the entire \$10.41 million cost of acquiring and installing the energy-savings equipment, which, to Duke's ultimate detriment, consisted of labor costs that exceeded the cost (and value) of the underlying building materials. The parties agreed that the simple payback period under the MESA would be 5 years. Once the 8-year term of the MESA expired, Pillowtex would begin to reap the

cost-savings benefits of the equipment. *Id.* at 713.

Approximately 2 1/2 years after entering into the MESA, Pillowtex and certain of its subsidiaries filed for relief under Chapter 11 of the Bankruptcy Code. When Pillowtex stopped making payments under the MESA, Duke filed a motion under section 365(d)(10) of the Bankruptcy Code to compel Pillowtex to make lease payments until such time as Pillowtex assumed or rejected the MESA. Pillowtex objected to Duke's motion on the grounds that the MESA was not a true lease but instead a secured financing, and, therefore, Duke was not entitled to receive payments pursuant to Bankruptcy Code section 365(d)(10), which requires

***The court first analyzed the terms of the MESA and held that the MESA failed to meet the bright-line test.***

that debtors keep current on their unexpired lease obligations. The District Court, sitting in bankruptcy, held in favor of Pillowtex. Duke appealed to the Third Circuit Court of Appeals.

### **THE THIRD CIRCUIT APPLIES NEW YORK LAW**

As a preliminary matter, the Third Circuit observed that whether an agreement is a true lease or a secured financing arrangement under the Bankruptcy Code is a matter of state law. *Id.* at 716. After deciding that New York law applied to the MESA, the court turned to the New York Uniform Commercial Code and the definition of "security interest" under 1-207(37)(a) of the UCC. The court interpreted this section as establishing a two-part test for determining

whether a transaction creates a lease or a security interest. The first part of the analysis is a bright-line test, sometimes referred to as a "*per se*" rule. The second part, which is performed by a court only if the bright-line test does not support the re-characterization of a purported lease, compels a court to look to the particular facts of the case to see whether the economics of the transaction suggest that the transaction is more fairly characterized as a lease or a secured financing arrangement.

***The First Level of Analysis: The Bright-Line Test Under §1-201(37)(a) of the New York UCC.*** Under the bright-line test, a transaction creates a security interest if (i) the lessee does not have the right to terminate the lease prior to the end of its term and (ii) any one of the following four is present: 1) the original term of the lease is equal to or greater than the remaining economic life of the goods; 2) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods; 3) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration; or 4) the lessee has an option to become the owner of the goods for no additional consideration or nominal consideration. These factors are termed as "residual value factors" because they determine whether any meaningful residual value remains for lessors at the end of the term of the lease.

***The Second Level of Analysis: The Economic Realities.*** The second part of the test under Section 1-201(37) of the New York UCC requires a court to analyze the specific facts of the case and determine the economic reality of the transaction. The court enumerated various factors,

taken from relevant case law, including: 1) whether the purchase option is nominal; 2) whether the lessee is required to make aggregate rental payments having a present value equaling or exceeding the original cost of the leased property; and 3) whether the lease term covers the total useful life of the equipment. See *In re Edison Bros. Stores, Inc.*, 207 B.R. 801 (Bankr. D. Del. 1997).

**The Third Circuit's Decision.** The court first analyzed the terms of the MESA and held that the MESA failed to meet the bright-line test. While the court observed that Pillowtex could not terminate the MESA during the MESA's term, which satisfied the first part of the test, the court held that none of the residual value factors were present because Pillowtex was not contractually bound at the expiration of the term of the MESA to become the owner of the energy fixtures and did not possess the option to become the owner for nominal additional consideration. It was not enough that Duke expressly reserved the right under the MESA to grant Pillowtex the option to become the owner at the end of the term of the MESA or that Duke could extend the term of the MESA or give Pillowtex the option of purchasing the underlying equipment on terms later agreed to by the parties. Similarly, the fact that Duke would have little or no bargaining power at the end of the term of the MESA (due to the high cost of removing and replacing the equipment) was not sufficient for the court to find any of the factors met in a *de facto* sense.

Upon determining that the MESA did not create a security interest as a matter of law under the bright-line test, the court proceeded to analyze the economic realities of the transaction. The court gave great significance to the fact that the present value of the aggregate rental payments made to

Duke under the MESA equaled or exceeded the cost of the energy fixtures. See *Pillowtex*, 349 F.3d at 719. As a result, Duke effectively received payment in full for the transferal of the lighting fixtures to Pillowtex, which constituted evidence that the transaction was a sale. The court also noted that Pillowtex did not account for its payments under the MESA as a true lease. Instead, Pillowtex treated its payments to Duke as utility expenses, which was different from the way Pillowtex treated other manufacturing and production equipment obtained from Duke concurrently with the MESA.

Distinguishing relevant case law, the court dismissed the fact that the useful life of the energy savings equipment greatly exceeded the 8-year term of the MESA. While the court acknowledged that this factor may be a relevant fact under certain circumstances, "[s]uch an inference would only be proper ... where the evidence showed a plausible intent by the transferor to repossess the goods." *Id.* at 720. Here, the economic realities of the MESA transaction belied the existence of such intent because Duke had no economic motivation to repossess the fixtures and to realize upon the equipment's residual value at the end of the MESA's term; not only was the cost of removal prohibitively expensive, but virtually no resale market existed for the used equipment.

After analyzing each of the relevant factors, the court held that the MESA was "substantively better characterized as a security agreement than a true lease." *Id.* at 719. This was true even though the MESA possessed characteristics typical of a true lease: Title to the equipment remained with Duke throughout the term of the MESA, and Pillowtex agreed not to claim ownership of the equipment for income tax purposes.

**The Intent of the Parties Does Not Control the Issue Under the New York UCC.** The court rejected Duke's argument that the District Court erred by failing to analyze the intent of the parties. Under the revised UCC, courts no longer consider this factor in determining whether a transaction is a lease or a security agreement. Instead, the "court must subordinate the parties' intent to the economic reality that Duke would not have plausibly reclaimed the fixtures at the end of the MESA's term." *Id.* at 723. Similarly, the court dismissed Duke's admonition that the "[e]quipment leasing between sophisticated commercial entities dealing at arms length for their mutual benefit is an important commercial activity and one that should not be lightly re-characterized." *Id.* at 722. The Third Circuit observed that it was "particularly appropriate" to refuse to defer to the intent of the contracting parties in a bankruptcy proceeding because the cost of doing so would be imposed on third-party creditors. *Id.*

## CONCLUSION

In structuring transactions, equipment lessors need to be mindful of the nature of the asset leased and the recovery cost associated with repossessing the asset. Also, prudent equipment lessors must be cognizant of the substance-over-form approach bankruptcy courts will take in analyzing these transactions. An equipment lessor that fails to account for the impact of recovery cost on the residual value of the leased property is at risk of having the transaction re-characterized as a secured financing arrangement.



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