ALERTS

Fifth Circuit Holds Lease To Be a Secured Loan

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A purported conditional sale agreement "created a security interest rather than a lease," held the U.S. Court of Appeals for the Fifth Circuit on Aug. 7, 2018. *In re Pioneer Health Services Inc.*, 2018 WL 3747537, *3 (5th Cir. Aug. 7, 2018). Affirming the lower courts' finding "that the relevant agreements were not 'true leases,'" the court rejected a bank's "motion to compel payment under [its] contract as an unexpired lease or an administrative expense." *Id.*, at *1. The economic substance, not the form of the transaction, was decisive.

Relevance

Pioneer confirms why lessors fare better in bankruptcy cases than secured lenders. Although the lender documented the transaction in *Pioneer* as a lease to get better treatment in any later bankruptcy, the court relied on its economic substance.

Bankruptcy Code ("Code") § 365(d)(3) requires a trustee or Chapter 11 debtor-in-possession ("DIP") to perform its lease obligations pending assumption or rejection of a lease. In contrast, the DIP need not assume a security agreement within a fixed period of time to obtain the benefits of the property it covers. *Pac. Express Inc. v. Teknekron Infoswitch Corp.*, 780 F.2d 1482, 1487 (9th Cir. 1986). A borrower on a secured loan may retain the property "without paying the full agreed price," and need only "pay enough to give the lender the value of the security interest; if this is less than the balance due on the loan, the difference is an unsecured

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debt." *In re United Airlines Inc.*, 416 F. 3d 609, 610 (7th Cir. 2005) (Easterbrook J.).

When distinguishing a lease from a secured loan, "every appellate court [ruling on] the issue [holds] . . . that substance controls and that only a 'true lease' counts as a 'lease' under [Code] §365." *United Airlines Inc.*, 416 F.3d at 612, citing *In re PCH Associates*, 804 F.2d 193, 198-200 (2d Cir. 1986); *In re Pillowtex Inc.*, 349 F.3d 711, 716 (3d Cir. 2003). According to the Seventh Circuit, "[i]t is unlikely that the Code makes big economic effects turn on the parties' choice of language rather than the substance of their transaction; why bother to distinguish transactions if these distinctions can be obliterated at the drafter's will?" *United Airlines Inc.* 416 F.3d at 612.

Facts

The debtor healthcare provider in *Pioneer* entered into three agreements with the bank's predecessor ("Bank") to finance its purchase of equipment and related software to maintain its electronic health records. 2018 WL 3747537, at *1. Two agreements with the Bank were called "conditional sales agreements," providing "that upon completion of the installment payment plan, title to" the purchased equipment transferred to the debtor. Until it received full payment, the Bank would "retain title to the Equipment for legal and security purposes," and the debtor authorized the Bank to file appropriate financing statements under state law. Other provisions of these two agreements provided that the debtor was "leasing (and not financing) any software and . . . upon default," the debtor was required to delete the software, enabling the Bank to terminate any license and disable the software. A third agreement, though, acknowledged that "[the debtor] has entered into a financing agreement" with the Bank. Finally, the Bank filed an appropriate financing statement under applicable state law. *Id.*, at *1 – 2.

When the debtor sought Chapter 11 relief, the Bank moved to compel payment from the debtor under the purported leases, arguing that payments were also "actual, necessary costs of preserving the estate" and "actual, necessary costs and expenses of preserving or transferring patient records during the closing [of the debtor's] healthcare business." Id., at *2. The bankruptcy court denied the motion, reasoning that the relevant agreements were not "true leases." The district court affirmed.

The Fifth Circuit

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Security Interest, Not a Lease. First, the court applied Utah's version of the Uniform Commercial Code ("UCC") to "determine whether [the] contract is in fact a lease." *Id.* "If a lease is merely a disguised sale and security interest, Code § 365 [governing leases] will not be applicable." *Id.*, quoting *Norton Bankruptcy Law & Practice*. § 127:8 (3d ed. 2018 update). Under Utah law, when the agreement is "in the form of a lease," it will be a secured transaction if it "is not subject to cancellation by the lessee," and "the lessee . . . is bound to become the owner of the goods." *Id.*, at *3, quoting Utah Code § 70-1a-203(2)(b) and *LMV Leasing Inc. v. Conlin*, 805 P. 2d 189, 194 (Utah Ct. App. 1991).

The Bank relied on language in its "Conditional Sales Agreements"; it "is leasing (and not financing) the software" and has "the right to end its use of the software if [the debtor] fails to pay." *Id.* But the "lease" was "non-cancellable" and could not be "terminated for any reason." On "completion of the payment plan," title to the "Equipment" would pass to the debtor. Because "Utah law elevates substance over form, moreover, the parties' labels are not the key consideration," and "no further analysis is required" to find "a security interest rather than a lease." *Id.*, quoting *Bd. of Equalization of Salt Lake City v. First Sec. Leasing Co.*, 881 P.2d 877, 878 (Utah 1994). *See United Airlines*, 416 F. 3d at 617 ("Reversion without additional payment is the UCC's per se rule for identifying secured credit"). And without "further analysis," the Fifth Circuit affirmed the lower courts' finding of a security interest in *Pioneer*.

No Administrative Expense. Code § 503(b)(i)(A) gives a creditor an administrative priority claim for "the actual, necessary costs and expenses of preserving the estate." But the Fifth Circuit, like other courts "impose[s] a temporal limitation: the costs and expenses must have arisen post-[bankruptcy] through a transaction with the" DIP. *In re Jack/Wade Drilling Inc.*, 258 F.3d 385, 387 (5th Cir. 2001).

The Bank's transaction with *Pioneer* "arose years before . . . bankruptcy." *Id.*, at *4. And because the transaction was "a financing arrangement," not a lease, the Bank's claim was "an old expense to be adjusted" under a Chapter 11 reorganization plan. *Id.*, citing *United Airlines*, 416 F.3d at 613 (each payment on a true lease is a "new expense [that] pay[s] for new inputs").

Comments

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1. The Seventh Circuit explained why courts disregard form for economic substance in the lease context. ". . . [R]ent that represents the cost of funds for capital assets or past operations rather than ongoing inputs into production has the quality of debt, and to require such obligations to be assumed under [Code] § 365 to retain an asset would permit financial distress from past operations to shut down a firm that has a positive cash flow from current operations." *United Airlines*, 416 F. 3d at 163.

2. The Seventh Circuit also explained in *United Airlines* what was at stake in *Pioneer*: "The question under § 365 is whether [the DIP] must pay in full to enjoy contained [use] or whether, instead, it may reduce payments to the value of the interest secured by the leasehold and treat the residue as unsecured debt." As in *United Airlines*, the Fifth Circuit in *Pioneer* held the Bank's secured claim subject to treatment under the debtor's Chapter 11 reorganization plan.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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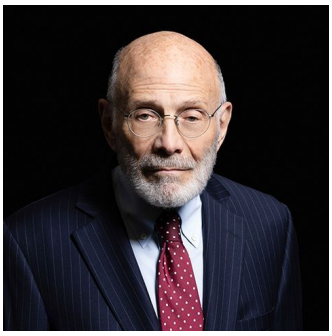

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