

Chapman Client Alert

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Current Issues Relevant to Our Clients

A Lease by Any Other Name Would *Not* Smell as Sweet: Fifth Circuit Denies “True Lease” Status to a “Sale” of Software

In a case styled *In The Matter of Pioneer Health Services, Incorporated*, ___ Fed.Appx. ___, 2018 WL 3747537 (5th Cir. Aug. 7, 2018), (“*Pioneer*”)¹ the United States Court of Appeals for the Fifth Circuit (the “*Fifth Circuit*”) recently affirmed decisions of a Bankruptcy Court and District Court recharacterizing an alleged lease to a disguised financing arrangement. Although an unreported decision, the case is interesting in that the Court determined that the transaction was “*per se*” a financing, and therefore did not need to go on to analyze the economic realities of the transaction in detail. Analyzing the transaction under the Uniform Commercial Code (the “*UCC*”) as adopted by Utah, the Fifth Circuit concluded that the transaction created a security interest and did not constitute a true lease.

Whether an arrangement constitutes a “true lease” or a secured financing arrangement is one of the more heavily litigated issues under §365 of 11 U.S.C. §101 et. seq. (the “*Bankruptcy Code*”). The distinction is critically important, as true leases and secured financings have very different treatments under both tax and bankruptcy law. In addition, merely challenging a “close call” transaction as a secured transaction as opposed to a lease may be a way for debtor-lessees to gain leverage over a lessor.

Generally speaking, a “true lease” is commonly understood to be an arrangement in which the risks and rewards of ownership are retained by the lessor of the relevant asset or property, while the lessee is entitled only to retain possession and use of such asset or property for a defined period. Courts generally look past the labels in the lease and the intent of the parties and apply two tests focused on the economic substance of the transaction: a “*per se*” (or bright line) test and an “economic realities” test. Both inquiries are fact specific. Under the *per se* test in Utah, a transaction is a secured financing if the obligation to pay rent cannot be cancelled by the lessee and the lessee is bound to become the owner of the goods. While most litigation over the “true lease” issue revolves around the “economic realities” test, the *Pioneer* case was unusual in that the court determined that the transaction was “*per se*” a financing.

In *Pioneer*, the debtor entered into several contracts for a “limited, nonexclusive, nontransferable, non-sublicensable, perpetual license” to an “electronic health record system used

for billing, scheduling, and record retention and organization.” The transaction involved three parties, a manufacturer (the “*Manufacturer*”), a funding entity (the “*Funder*”) and the debtor.

The transaction documents included three contracts, which contained certain provisions identifying the transaction as a sale, and others designating it as a lease. Two of the agreements were labelled “Conditional Sales Agreements.” Among other things, these agreements provided that the Funder was selling the described equipment to the customer, and that the sale was “non-cancelable” and “may not be terminated for any reason.” The agreements also provided that upon completion of the installment payment plan the equipment would transfer to the debtor, and that until then the Funder “shall retain title to the equipment for legal and security purposes.” A third agreement also characterized the transaction as a sale, containing an acknowledgment by the debtor that the debtor entered into a financing arrangement with the Funder, and that while bills for the equipment from the Manufacturer were to go to the Funder, the debtor retained ultimate responsibility for ensuring payment to the Manufacturer.

However, certain provisions of the Conditional Sale Agreements designated the transaction as a lease, stating that the Funder “is leasing (and not financing) the software to the Customer,” that if the debtor failed to make payments, it must delete the software, and that the Funder had the right to declare any license terminated and access the debtor’s systems to disable the software.

During the bankruptcy case, the Funder filed a motion seeking administrative expense treatment for the use of the software, seeking, *inter alia*, to have the transaction characterized as an unexpired lease under §365(d)(5) of the Bankruptcy Code, which would require that the debtor “timely perform all of the obligations of the debtor first arising from or after 60 days of the petition . . . until the lease is assumed or rejected.” The Bankruptcy Court determined that the agreements were not “true leases” and the District Court summarily affirmed the ruling.

The Fifth Circuit affirmed the decisions. Referencing case law from multiple jurisdictions, the Fifth Circuit ruled that the question of how a transaction is characterized is determined under state law. Therefore, the Fifth Circuit looked to Utah² law to make the determination.

Like all other states, Utah has adopted the Uniform Commercial Code (the “UCC”), and looks behind the form of the agreement in determining whether an arrangement is in fact a true lease or whether it is a disguised financing arrangement. The Fifth Circuit noted that the UCC (§1-203) identifies specific instances in which a security interest (as opposed to a lease) is always created (i.e., the “*per se*” test). These include where the transaction is “in the form of a lease,” the agreement “is not subject to cancellation by the lessee,” and “the lessee . . . is bound to become the owner of the goods.”

Here, the Funder’s arguments focused on the special provisions in the agreements designating a software lease as a “lease,” noting that the debtor (i) agreed that the arrangement is a lease and (ii) granted the Funder the right to terminate the use of the software in the event the debtor failed to pay. The Fifth Circuit, however, rejected those arguments, reasoning that the substance of the agreement is more important than the form. It noted that the purported lease was non-cancellable and could not be terminated for any reason and that at the completion of payments thereunder the debtor became the owner of the equipment. In short, the arrangement triggered the “*per se*” test of the UCC in that the agreements are “in the form of a lease,” “are not subject to cancellation by” the debtor, and the debtor “is bound to become the owner of the goods,” and therefore the Fifth Circuit affirmed the rulings of the Bankruptcy Court and the District Court.³

The characterization of an agreement as a loan and security agreement as opposed to a “true lease” has a number of important ramifications that can determine whether the

purported lessor potentially receives a full recovery or pennies on the dollar on its claim.⁴ These include, but are not limited to (a) whether the debtor may retain the property without having to comply with the ongoing post-petition rent requirements of 365(b)(5); (b) whether the debtor needs to assume the lease to retain the property; (c) whether the debtor needs to cure pre-petition arrearages or provide adequate assurance of future performance, (d) whether the debtor may use §506 of the Bankruptcy Code to bifurcate the secured claim into a claim that is secured to the extent of the value of the property and an unsecured claim for the remaining deficiency, (e) whether the lessor may lose any residual value, and (f) if the recharacterized secured party failed to perfect its security interest in the property (e.g., by making a “protective” UCC filing), whether the claim may be deemed to be entirely unsecured.

Essentially, if the lease is recharacterized as a disguised financing, the purported lessor may be forced to accept the value of the leased equipment on the day of the bankruptcy filing, which may be in a depreciated state. A recharacterization may also require expensive litigation and expert testimony in the Bankruptcy Court to ascertain the equipment’s value. Worse, if no protective UCC filing was made, the purported lessor may only have a general unsecured claim. In other words, recharacterization allows a debtor to retain the full value of “leased” equipment while potentially paying little or nothing for the privilege, which creates an incentive for a debtor to attack transactions where there is any reasonable chance of prevailing.

While not surprising, the *Pioneer* case reminds drafters to be mindful of the requirements to establish the status of a transaction as a lease. In short, lessors wishing to receive the special protections provided to lessors under the Bankruptcy Code should be mindful to make sure that the *per se* test of 1-203 of the UCC isn’t implicated by the transaction, and importantly, that the economic realities of the transaction support a characterization as a lease. This includes ensuring that the lessor retains residual risk in the equipment and avoiding common pitfalls such as bargain purchase options. Before entering into any lease, lessors should ask: Do the economic benefits and burdens of the property rest with the lessor or the lessee? Does the lessor retain a meaningful residual value on the property or a meaningful reversionary interest in the property? If the answers to these questions are unclear, lessors should consult with experienced counsel to ensure that the transaction is priced properly for the level of

risk and that all possible steps to achieve “true lease” status have been taken. If a lessor learns that a lessee is in financial distress, it should move quickly to engage counsel and take appropriate protective measures, including to ensure that “protective” UCC filings have been made with respect to each piece of equipment.

For More Information

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- 1 On Appeal from the United States District Court for the Southern District of Mississippi, Case No. 3:17-CV-561.
 - 2 While there was a dispute as to whether the Law of the state of Utah (by virtue of a choice of law provision) or Mississippi, the parties conceded that both versions of the UCC are almost identical, as a result the appellate court adopted the same approach as the Bankruptcy Court.
 - 3 Although the Fifth Circuit relied upon the UCC “*per se*” test in connection with its decision, even if the transaction passes muster under the “*per se*” test, many courts employ an economic realities test that looks at the details of the transaction to determine who has the benefits and burdens of ownership of the property.
 - 4 For a more fulsome discussion of the differences between a true lease versus a financing, see Chapman and Cutler’s handbook entitled “[Bankruptcy Desk Reference for Equipment Lessors](#)” (most recently updated in June 2017).

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