When Is a Lease Not a Lease? Seventh Circuit Adopts "Substance Over" Form Test for True Lease Determination

January/February 2006

David A. Hatch and Mark G. Douglas

As secured financing and leasing transactions involving capital assets become more complicated to account for evolving tax, liquidity, equipment obsolescence and similar considerations, the difference between "true" leases and financing arrangements has become increasingly difficult to ascertain. The similar economic function of these transactions allows for the drafting of "leases" that work like security agreements and secured loans that work like "leases."

The distinction between these property interests is an important one, particularly if the owner/lessee of an 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 determine the exact nature of the debtor's legal interest. The Seventh Circuit Court of Appeals recently examined this issue. In *United Airlines, Inc. v. HSBC Bank USA, N.A.*, the Court of Appeals ruled that a court must consider the substance of a transaction, rather than its form, in determining whether a transaction is a “true lease” or a disguised secured financing.

Treatment of Leases in Bankruptcy

The Bankruptcy Code itself does not define the term "lease." It broadly defines "security agreement" as an "agreement that creates a security interest" and "security interest" as a "lien created by an agreement." These definitions, however, offer little guidance in distinguishing

between financing transactions that involve the retention of a security interest in sold assets, on the one hand, and leasing transactions where the lessor is granted a security interest in leased assets as an added layer of protection, on the other.

Why is the distinction important? The Bankruptcy Code confers certain rights, and imposes various obligations, upon a debtor who is party to leases and other contracts that are "executory" as of the bankruptcy filing date. A chapter 11 debtor-in-possession ("DIP") or bankruptcy trustee generally has the right to "assume" (reaffirm") or "reject" (disavow, resulting in breach) such contracts and leases under section 365 of the Bankruptcy Code. Moreover, most assumed contracts can be assigned as a means of creating value for the bankruptcy estate. Pending the decision to assume or reject, however, the DIP or trustee is obligated to remain current on post-petition lease obligations, failing which the leased property must be surrendered to the lessor or the lessor will be allowed to exercise its contractual and legal remedies notwithstanding the strictures of the automatic stay.

Different rules apply if a transaction involves secured financing rather than a lease. In this case, the DIP's or trustee's obligation to make payments to the secured lender during the course of the bankruptcy hinge on the value of the collateral relative to the amount of the lender's claim. If the collateral value exceeds the amount of the debt, the DIP or trustee may be required to make periodic interest payments to the secured creditor as a means of "adequate protection." By contrast, if a secured creditor is undersecured because its collateral value is deficient, adequate protection payments are generally not required, and the creditor will hold a secured claim only to the extent of the collateral value and an unsecured claim for the deficiency.

The ultimate fate of the collateral depends on the kind of bankruptcy case (*i.e.*, chapter 7 or chapter 11) and the DIP's or trustee's ability to deal with the secured creditor's claims in accordance with the requirements of the Bankruptcy Code. In a chapter 7, the property would either be abandoned to the secured creditor or sold to the highest bidder, with the secured creditor's liens attaching to the proceeds. By contrast, in chapter 11, the DIP could confirm a plan of reorganization under which, among other things, the secured obligation is reinstated with the same collateral, the original collateral secures a new obligation whose terms vary from the original secured debt, collateral of equivalent value is substituted for the original collateral or the collateral is sold, with the secured creditor's liens attaching to the proceeds.

Therefore, in addition to the ultimate issue of ownership of the asset in question, much depends on a transaction's characterization as a lease or a secured financing. How to make that determination given the absence of any concrete guidance under the Bankruptcy Code was the subject of the Seventh Circuit's ruling in *United Airlines*.

United Airlines

Prior to filing for chapter 11 protection in 2002, United Airlines entered into a series of transactions to fund the improvement of its facilities at four airports. One such lease arrangement involved public financing underwritten by the California Statewide Community Development Authority (the “Authority”). United has been the lessee since 1973 of a 128-acre maintenance base at San Francisco International Airport ("SFO"). The lease expires in 2013

unless the parties negotiate an extension. Rent depends on an independent party's estimate of the property's market value.

In 1997, the Authority issued $155 million in bonds to finance improvements to United's SFO facilities (other than the maintenance base). The bonds are without recourse to the Authority and are guaranteed by United. United subleases 20 acres of the 128-acre maintenance base to the Authority for 36 years — the term matches the bond repayment schedule rather than United's lease with SFO. The Authority paid $1 to sublet the premises.

The Authority leases the 20 acres back to United for rent equal to interest on the bonds plus an administrative fee. This lease has a $155 million balloon payment in 2033 to retire the principal. United may postpone final payment until 2038; if it does, the sublease also is extended. United is entitled to prepay, in which case the sublease and leaseback terminate. If United does not pay as agreed, the Authority can evict it from the 20 acres. The leaseback includes a "hell or high water" clause requiring United to pay the rent even if its lease from the SFO ends before 2033, the property is flooded, or some other physical or legal event deprives United of the use or economic benefit of the maintenance base.

After filing for chapter 11, United took the position that none of the arrangements at the four airports in question is a "lease" for purposes of section 365 of the Bankruptcy Code. Instead, United sought a declaratory judgment that each transaction involves secured financing and that United should have the right to continue using the airport facilities while paying only a portion of the promised "rent." The bankruptcy court ruled that the arrangement at one of the airports is a

true lease, but that the other three transactions (including the SFO arrangement) are not. The district court reversed those rulings in part on appeal, holding that all four transactions involved true leases rather than secured financings. United appealed to the Seventh Circuit.

The Seventh Circuit's Ruling

The Seventh Circuit joined all the other circuit courts of appeal that have considered this issue, ruling that substance rules over form and that only a “true lease” qualifies as a “lease” under section 365 of the Bankruptcy Code. In reaching this conclusion, the Court of Appeals considered the practical meaning of the Bankruptcy Code, the Uniform Commercial Code (the “UCC”) and the historical context of the Bankruptcy Code’s enactment, including the statute's legislative history.

According to the Seventh Circuit, it “is unlikely that the [Bankruptcy] Code makes big economic effects turn on the parties’ choice of language rather than the substance of their transaction,” because to do so would allow the drafters of contracts to obliterate the distinction between the two types of transactions through creative drafting. This is consistent with the UCC, which, unlike the Bankruptcy Code, contains a detailed description of the distinction between a lease and a security interest, emphasizing that "[w]hether a transaction creates a lease or a security interest is determined by the facts of each case."

The Court of Appeals went on to explain that a lease in which "current consumption" (*i.e.*, lease payments at market rates for continued use of an asset) dominates is often called a “true lease,” while one in which the asset serves as security for an extension of credit is treated as a security agreement governed by the UCC. Finally, the Court of Appeals observed, the legal community

of the 1970s understood that the distinction between leases and security agreements was based on substance rather than form, and looked to the relevant legislative history from the adoption of the Bankruptcy Code, which explains, in relevant part:

> Whether a "lease" is [a] true or bona fide lease or, in the alternative, a financing "lease" or a lease intended as security, depends upon the circumstances of each case. The distinction between a true lease and a financing transaction is based upon the economic substance of the transaction and not, for example, upon the locus of title, the form of the transaction or the fact that the transaction is denominated as a "lease."

Thus, the Seventh Circuit concluded that substance, rather than form, should be considered in determining whether a transaction is a “true lease” or a disguised secured financing for purposes of section 365 of the Bankruptcy Code.

The Court of Appeals then examined which law should apply to divine the true nature of any given transaction. Explaining that "nothing in the Bankruptcy Code says which economic features of a transaction have what consequences," the Seventh Circuit concluded that state law is determinative on this issue — in this case California law. California, the Court of Appeals observed, has adopted a functional approach to the question in both the UCC and the common law governing real property transactions. It went on to discuss California court rulings examining various features of lease and financing transactions.

The Seventh Circuit ultimately determined that the transaction between United and the Authority was not a “true lease” under California law for the following reasons: (i) the “rent” was not measured by the market value of the property; (ii) at the conclusion of the lease, the Authority had no residual interest; (iii) the balloon payment had no counterpart in a true lease, but was a

common feature of a secured financing; and (iv) upon prepayment, the lease and sublease terminated immediately, whereas in a true lease, prepayment secures the tenant's right to use the property for the term of the tenancy. Based upon this conclusion, the Court of Appeals reversed the district court's decision and remanded the case for further proceedings.

Analysis

The Seventh Circuit's ruling in *United Airlines* does not represent a departure from the approach employed by most courts, including every circuit court of appeals to consider the issue, in determining what kind of transactions qualify as "leases" under the Bankruptcy Code. Even so, it illustrates the difficulties associated with sorting out the true nature of complicated lease and financing transactions by examining the substance of a transaction rather than the labels that have been attached to it by the parties. In almost all cases, such an inquiry demands painstaking analysis of a laundry list of factors under applicable non-bankruptcy law that have been deemed emblematic of leases, on the one hand, and financing arrangements, on the other. This analysis will only become more difficult as commercial transactions become more complex and exhibit hybrid characteristics that are not readily pigeon-holed in one category or the other.

United Airlines, Inc. v. HSBC Bank USA, N.A., 416 F.3d 609 (7th Cir. 2005).