The Enforceability of Leveraged Lease Income Tax Indemnities in Bankruptcy

by Ted W. Harris, Esq.

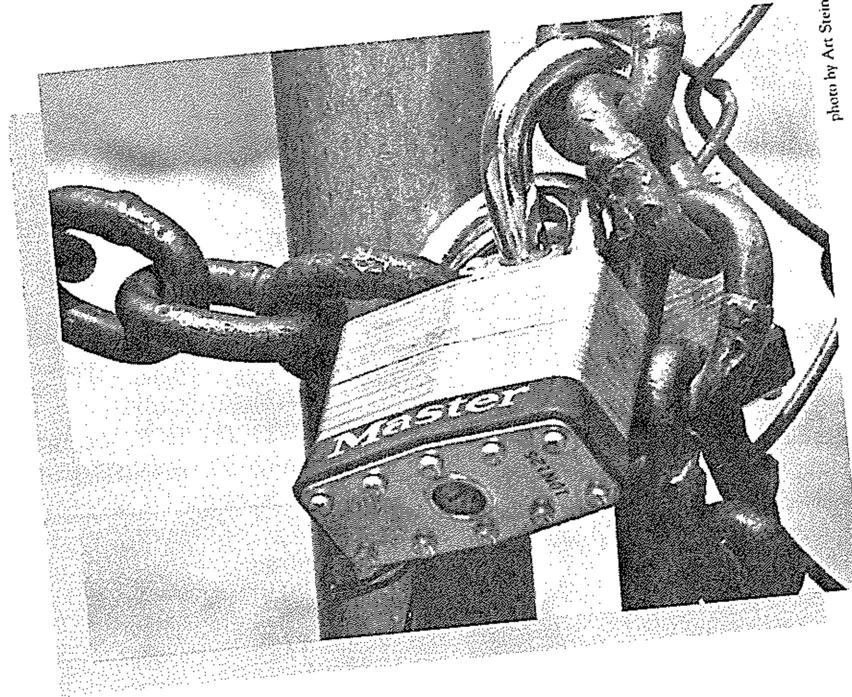

photo by Art Stein

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Introduction

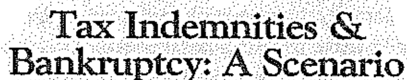
Leveraged lease transactions are arranged for a variety of reasons, including the availability of 100 percent financing for the lessee, and the lessor's ability to earn a profit on the residual value of the equipment. In addition, the transaction allows for the effective transfer of income tax benefits attributable to the equipment from the lessee, who cannot fully use such benefits, to the lessor, who can. The lessee gains from this transfer of tax benefits through a lower effective cost for the equipment.

Although the tax impact of the leveraged lease transaction is usually fully examined before the transaction is consummated, the lessor always runs the risk that its anticipated tax benefits will be lost through, for example, an act of the lessee, a structural problem in the transaction itself or a change in law. To guard against this possibility, lessors have typically required lessee indemnification against the loss of anticipated tax benefits arising from certain events, such as actions, inactions, misrepresentations or breaches by the lessee.

However, this tax indemnity obligation is usually unsecured, and is therefore only as valuable as the lessee's ability to make an indemnity payment in the event of a loss of tax benefits. In particular, if the lessee goes into bankruptcy, there is a substantial question as to whether the lessee's tax indemnity obligation will be of actual benefit to the lessor. This article will examine the enforceability of tax indemnity agreements in lessee bankruptcy proceedings under the Bankruptcy Reform Act of 1978 (referred to hereafter as the Bankruptcy Code).

The discussion will proceed in three stages. First, a typical leveraged lease transaction will be described, including a summary of the lease and the tax indemnity provisions important to the bankruptcy context. Second, an overview is presented of the provisions of the Bankruptcy Code which will most directly

affect the tax indemnity in bankruptcy. Finally, specific planning considerations for the lessor are discussed, focusing on the practical alternatives at the time of bankruptcy.



Tax Indemnities & Bankruptcy: A Scenario

Leveraged lease transactions may be structured in a number of ways. A fairly straightforward transaction is assumed for this discussion, so as to isolate the bankruptcy impact on tax indemnities.[1]

Assume that a large manufacturer needs equipment in one of its plants. However, the company is currently generating tax losses, and does not anticipate having taxable income (after the effect of net operating loss carryforwards[2]) for the next several years. As a result, it will be unable currently to use the federal investment tax credits and depreciation deductions arising from the equipment acquisition.

Instead of purchasing the equipment, the company enters into a lease with a national bank, which is currently paying substantial federal income tax and anticipates such status to continue for the next several years. The lease arrangement is evidenced by three primary documents. First, the bank enters into a typical full-payout net lease agreement with the company under which the bank, as lessor, will purchase the equipment from the respective vendors and lease it to the company, as lessee. The lease extends for seven years and provides that the lessee is responsible for all operation and maintenance of the equipment, as well as for insurance and all taxes other than those based on or measured by the lessor's net income. If the equipment is destroyed before the end of the lease term, the lessee is required to pay the lessor the "casualty loss value" of the equipment, which is an amount set out in advance in the lease. The casualty loss value is computed to reimburse the lessor for the sum of the outstanding debt, the additional taxes to be paid as a result of the casualty, the lessor's remaining investment in the equipment (plus accrued earnings to date) and the residual value of the equipment. In the event of a default under the lease, the lessor is entitled (in addition to any other available remedies) to the return of the equipment and a liquidated damages payment equal to the casualty loss value of the equipment, reduced by its current value.[3] One of the events of default defined in the lease is the voluntary or involuntary bankruptcy of the lessee, whether or not the lessee is in default in performance of any of its other obligations under the lease (the so-called *ipso facto* clause).

Assume the lessor borrows 75 percent of the equipment cost on a nonrecourse basis from an insurance company (referred to hereafter as the lender) under a finance agreement. The nonrecourse notes are secured by a security interest in the equipment and in the lease, which security interest is duly perfected against the claims of third parties under local law. The finance agreement provides, among other terms, that (1) an event of default under the lease constitutes an event of default under the finance agreement and the notes, (2) the lessor has a right to cure (correct) not more than two consecutive defaults under the lease arising solely from the lessee's failure to pay rent and (3) the lessor may, in the event of a default by the lessee under the lease, prepay the nonrecourse notes, whereupon the lender's security interest in the equipment terminates.

Finally, the lessor and the lessee enter into a tax indemnity agreement with respect to the federal income tax consequences of the transaction.[4] Although this agreement could be included in the lease, it is stated as a separate agreement primarily because of its length and special nature. The tax indemnity agreement sets forth the lessor's anticipated federal income tax benefits in the transaction. The most important benefits for purposes of the bankruptcy discussion are (1) the treatment of the lease as a true lease, resulting in the lessor being considered the owner of the equipment for federal income tax purposes,[5] (2) the availability of the investment tax credit, equal to ten percent of the cost of the equipment[6] and (3) the availability of depreciation deductions under the Accelerated Cost Recovery System (ACRS) over a five-year period.[7] The lessee makes certain representations concerning the tax consequences of the transaction, including that the equipment is and will continue to be eligible for the investment credit, and agrees that it will take no action which is inconsistent with the lessor's anticipated tax benefits.

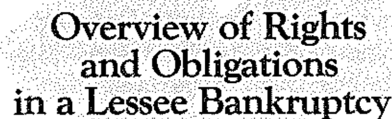
The agreement specifies that, if the lessor loses or is required to recapture any of the enumerated tax benefits because of a "trigger" event, the lessee is required to pay the lessor an amount which, after payment of all applicable taxes by the lessor on receipt of the indemnity payment, maintains the

lessor's after-tax yield on, and after-tax cash flow from, the transaction assuming availability of the tax benefits. The relevant "triggers" in the lease which give rise to an indemnity payment are (1) the incorrectness of lessee tax representations or the breach of any of its agreements relating to the anticipated tax benefits, (2) any other act or failure to act by the lessee, (3) the sale of the equipment by the lessor or lender after an event of default under the lease, and (4) a casualty occurrence, unless the lessor receives full payment of the casualty loss value.

If the Internal Revenue Service challenges any of the anticipated tax benefits, and the respective benefits could be lost because of a trigger event, the lessor is required to notify the lessee. At its own expense, the lessee may then require the lessor to contest the matter. If the lessee decides not to contest the issue, or if the "final determination" is that the lessor loses the anticipated tax benefits, the lessee is required to make an indemnity payment. The payment is specifically excluded from the security under the finance agreement.

The lessee thereafter suffers serious financial reverses and, in the third year of the lease, files a voluntary bankruptcy petition under either Chapter 7 of the Bankruptcy Code, involving liquidation, or Chapter 11, providing for reorganization. On the date the petition is filed, the lender has a perfected security interest in the equipment and the lease, which is valid as against the lessee and the trustee in bankruptcy.

Events may already have occurred which would result in an indemnity payment by the lessee, although the lessor may not yet be aware of them. For example, the equipment may not have been "new" at the time of purchase, thereby making the investment credit unavailable,[8] or may have subsequently been used predominantly outside the United States, resulting in "recapture" of the credit to the lessor.[9] In addition, if the equipment is sold during or after bankruptcy, the tax indemnity agreement will require the lessee to make an indemnity payment to the lessor to compensate for the resulting loss of tax benefits.[10] As described below, bankruptcy may well alter or eliminate lessee obligations set forth in the tax indemnity agreement.



Overview of Rights and Obligations in a Lessee Bankruptcy

There are two major provisions of the Bankruptcy Code which directly affect the enforceability of a tax indemnity agreement in a lessee bankruptcy.[11] The first is the statutory option afforded the lessee, or its trustee, to assume or reject the unexpired lease and tax indemnity agreement, even if the lease itself provides otherwise. The exercise of this option may attenuate or otherwise alter the contractual rights of the parties to the lease, and may even of itself cause the lessor tax problems if its interest in the equipment is sold by a foreclosing lender after rejection of the lease.[12] The second provision is the procedure for submission and substantiation of claims against the lessee's estate if the lease is rejected. The status of the lessor's claims (as a general, unsecured creditor) and the contingency of many of these claims may radically diminish the reimbursement for loss of tax benefits contemplated in the tax indemnity agreement.

ASSUMPTION OR REJECTION OF AN UNEXPIRED LEASE

Section 365(a) of the Bankruptcy Code provides generally that ". . . the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."[13] The prerogative of the "trustee" to assume or reject an unexpired lease is also available to a "debtor in possession" in a Chapter 11 reorganization case,[14] since a debtor in possession exercises the rights and powers of a trustee.[15] Thus, the lease and the tax indemnity can be assumed or rejected by the trustee or debtor in possession, provided bankruptcy court approval can be obtained.

It is a well-established principle of bankruptcy law that a trustee who assumes or rejects an unexpired lease must assume or reject the entire lease with all its benefits and burdens. Neither the trustee nor the nondebtor party to the lease can select individual covenants for assumption or rejection.[16] If the tax indemnity is an integral part of the equipment lease, then the obligations of the indemnity must stand or fall with the other rights and obligations of the lease itself.

Notwithstanding this principle of total assumption or rejection, the lessee might argue that the tax indemnity is a wholly separate contract from the lease itself, and that the lessee should be permitted to assume the lease and reject the indemnity contract.[17] The lessor also might argue the severability of the indemnity from the lease in an attempt to persuade a court that the indemnity should, as a matter of contract law, survive the rejected lease.[18] Although the arguments for severability of the lease

from the tax indemnity have some plausibility, and might yet be articulated in a future case, the better view is that the lease and indemnity, as parts of a single negotiated transaction, must be construed together and must be assumed or rejected as one "unexpired lease."[19]

The statutory option of the trustee to assume or reject the unexpired lease is unaffected by any provision in the lease allowing the lessor to terminate or modify the lease upon the bankruptcy or insolvency of the lessee. One of the major changes effected by section 365 is the invalidation of the so-called *ipso facto* clause which provides that lessee bankruptcy is an event of default enabling the lessor to terminate or modify the lease. Under the superseded Bankruptcy Act, such *ipso facto* clauses were enforceable by lessors, often depriving debtors of valuable rights under unexpired leases which could have aided rehabilitation.[20] Section 365(b)(2) provides generally that the trustee's right to assume the lease is not prevented by a purported default based upon: (1) the insolvency or financial condition of the debtor at any time before the closing of the bankruptcy case; (2) the commencement of a bankruptcy case; or (3) the appointment or taking possession by a trustee in a bankruptcy case or a custodian before such commencement. To similar effect is section 365(e)(1), which provides that a contractual right of termination or modification of a lease based on the insolvency or bankruptcy of a lessee or upon the appointment of a trustee is to be given no effect in bankruptcy proceedings.

The significance of this statutory invalidation of *ipso facto* default clauses resides in the trustee's absolute right to assume an unexpired lease with no preexisting defaults, other than the fact itself of bankruptcy, *without* fulfilling the requirements of cure, compensation and adequate assurance of section 365(b)(1). Whether the lessee's statutory protection against enforcement of the *ipso facto* clause also protects the lessor from a purported foreclosure by the lender of lessor interest in the lease and equipment upon bankruptcy is not entirely clear. Since lessee bankruptcy is an event of default under the finance agreement, the lender may attempt to foreclose against the lessor's interest immediately upon commencement of a lessee bankruptcy while leaving the lessee's possession of the equipment undisturbed. This problem is considered further in a following section on preventing foreclosure sale of the equipment.

The time period within which the trustee must exercise the option to assume or reject differs with the relief sought by the debtor. In a Chapter 7 liquidation case, an unexpired lease is deemed rejected if not assumed within 60 days after the order for relief.[21] In a Chapter 11 reorganization, the trustee may exercise the option "at any time prior to confirmation of a plan."[22] A party in interest (i.e. the lessor or the lender) may request the court to order the trustee to make an earlier determination, but the court is usually liberal in allowing the trustee adequate time to make a reasoned decision.[23]

The lessor and the lender have the right to petition the court under section 363 for "adequate protection" of their respective interests in the leased equipment (security and reversionary interests) on a showing that these interests may be impaired during the time allowed the trustee to exercise his option.[24] The definition and forms of "adequate protection" are set out in section 361.[25] The right of the lessor and the lender to petition for protection of property interests which may deteriorate over time is a statutory balance to the inability of the lessor and the lender to reclaim the property due to the automatic stay of section 362 and the invalidation of the *ipso facto* clause.[26]

A lease under which the lessee has committed material (i.e. nonbankruptcy related) defaults can be assumed only if the trustee meets the requirements of section 365(b)(1). The trustee must:
(1) cure, or provide adequate assurance of prompt cure of, existing defaults;
(2) compensate, or provide adequate assurance of prompt compensation, for actual pecuniary loss resulting from the default; and (3) provide adequate assurance of future performance under the lease.[27]

With regard to the first two conditions, cure and compensation, if a prior default is purely monetary, either tender of the delinquent payment by the trustee or proof to the court's satisfaction that sufficient unencumbered funds are immediately available to the trustee for cure and compensation satisfies the conditions.[28] On the other hand, if it is clear that the prior monetary defaults cannot be cured in a timely fashion, the court will order rejection of the lease on the motion of an interested party.[29] If the prior default is other than purely monetary (e.g. a lapse of insurance), it must either be converted to "pecuniary loss" and cured as a monetary default or, if not convertible, must be cured according to the terms of the lease, if possible.[30] With regard to the last condition for assumption of a lease with a prior default, it is clear from the cases decided under the Bankruptcy Code that "adequate assurance of future performance" is a pragmatic term, left by Congress to the courts to define on a case by case basis.[31] This problem is further considered in a following section on planning considerations for the lessor at the time of bankruptcy.

If the trustee assumes an unexpired lease, it may also assign the lease.[32] Sec-

tion 365(f)(1) invalidates antiassignment clauses in leases, and section 365(f)(3) invalidates purported rights of termination or modification by the nondebtor upon assignment.[33] In order to assign an unexpired lease, the trustee must first assume the lease (having first fulfilled the conditions of section 365(b)(1) if the lease is in default), and provide adequate assurance of future performance by the assignee regardless of whether there has been a default.[34] The criteria for adequate assurance of performance by an assignee are the same as those for a trustee who assumes a lease previously in default.[35]

The discussion to this point has been predicated on the exercise by the trustee of his option to assume or assign the unexpired lease. Unless the lessor has economic reasons for wishing to prevent assumption, some of which are considered in a following section on influencing assumption or rejection, the lessor usually will view assumption as the best protection for its right to reimbursement under the tax indemnity, since lessee obligations thereunder survive unimpaired upon assumption. But the trustee may wish to reject the lease and tax indemnity, in which case the lessor may face undesirable economic consequences. There are severe limitations to the lessor's ability to prevent rejection.

Upon application to the court, a trustee who chooses to reject the unexpired lease will be allowed to do so unless a party in interest (i.e., the lessor or the lender) opposes the application and persuades the court that rejection should not be permitted.[36] Prior to the Supreme Court's opinion in *Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pacific R.R. Co.*,[37] the standard applied in bankruptcy to determine whether rejection should be allowed was the "burdensome test."[38] Under this test, in order to justify a rejection which was opposed by a party in interest, the trustee was required to show that continued performance under the lease would result in a net loss to the estate. This early test was consistent with the evolution of the right to disaffirm executory contracts from the principle that the trustee could abandon property profitless to the estate.[39] Although the "burdensome test" has been superseded, as noted below, it remains true that a lease which represents a drain of the assets of the debtor's estate may be rejected even over the opposition of a party in interest.

The modern test for rejection of executory contracts and unexpired leases derives from *Group of Institutional Investors* and is styled the "business judgment" test. Under this test, an unexpired lease can be rejected even though profitable if, in the business judgment of the trustee supported by a sound basis in fact, rejection is in the best interests of the estate (e.g., a more profitable lease is available to the reorganizing entity). The argument that the business judgment test should be confined to cases affected with a public interest has been rejected, and the business judgment test is firmly entrenched.[40] A nondebtor party to the lease (i.e., the lessor or the lender) who has reason to oppose rejection must therefore be prepared to demonstrate that the business judgment of the trustee is unsound; the trustee need only show that the assets of the estate previously devoted to the lease could yield a greater return if expended in another way.

There is, however, one countervailing argument potentially available to the nondebtor party even if the trustee can demonstrate the soundness of its business judgment. Some courts have articulated a criterion which can be styled the "equitable principles" standard; this standard is not a separate test, but rather is a balancing of the trustee's business judgment against the magnitude of the unfavorable consequences of rejection to the nondebtor parties to the contract or lease.[41] Although this standard has been most often applied in cases with some public interest,[42] it also has been applied in a lessor bankruptcy concerning rejection of a commercial lease.[43]

As a final note, the trustee option to assume or reject an unexpired lease may not result simply in assumption or rejection but rather in modification of the lease. Some cases have suggested that it is not only proper but desirable for a trustee to exert his bargaining power to negotiate a modified contract or lease in lieu of rejection.[44] A lessee in bankruptcy could, on the basis of this authority, force the lessor to choose between total rejection of the lease and tax indemnity and assumption with an agreed modification of the indemnity obligations less onerous to the lessee.

LESSOR CLAIMS FOR BREACH UPON LESSEE REJECTION

If the unexpired lease is rejected, the rejection operates as a statutory breach of the lease deemed to have occurred immediately prior to the filing of the bankruptcy petition, unless the lease had been previously assumed, in which case the breach is deemed to have occurred at the time of the rejection.[45]

The statutory breach occasioned by rejection gives rise to a nonpriority (unsecured) claim on the part of the nondebtor parties.[46] The lessor and the lender must file a proof of claim setting forth the amount claimed, if known, and the claim will be allowed to share in the distribution of assets to nonpriority creditors of the estate unless a party in inter-

est objects.[47] A claim need not be liquidated, fixed or matured in order to be filed, as long as the claim is characterized as a "right to payment."[48] If these claims are not filed, they will usually be forfeited, as the discharge of the debtor in a Chapter 7 liquidation or the confirmation and performance of a plan in a Chapter 11 reorganization operates in the usual case as a final release of the debtor from these claims.[49]

A lessor claim for damages for breach of the tax indemnity can present difficult problems of proof, as discussed more fully in the following section on planning considerations for the lessor at the time of bankruptcy. Generally, lessor claims will be, in descending order of certainty, for final determinations which have actually occurred, for suspected or threatened future loss of tax benefits, and for unsuspected but possible loss of tax benefits after discharge of the lessee.

Under the superseded Bankruptcy Act, claims too contingent or remote to be liquidated were, due to the interworkings of the concepts of allowability and provability, disallowed and not entitled to share in distribution of debtor assets.[50] Section 502(c)(1) changed this rule, providing that contingent or unliquidated claims which would unduly delay the closing of the case will be estimated. While it is clear from this section that all claims not otherwise objectionable will be allowed, because estimation is now permitted under the Bankruptcy Code, the Code nowhere articulates guidelines for estimation, and case law on the issue is sparse. One recent case invoking the estimation provisions, *In re White Motor Credit Corp.*, addressed the estimation problem by appointing a special master to supervise the disposition of 160 products liability suits pending against the reorganizing debtor.[51] Other suggestions for estimation await development in the case law under the Bankruptcy Code. The claim of the lessor under the tax indemnity, whether liquidated by estimation or by proof, is unlikely to yield a satisfactory payout to the lessor, since it will be subordinated to all secured claims and to the priority claims listed in section 507.[52] One study conducted prior to the enactment of the Bankruptcy Code calculated that the average unsecured creditor received 6.5% of his total claim from the estate of his debtor.[53]

Planning Considerations for the Lessor at the Time of Bankruptcy

INFLUENCING ASSUMPTION OR REJECTION

Upon commencement of a case by or against a lessee, the initial consideration for the lessor is the consequences of assumption or rejection of the unexpired lease (including the tax indemnity) by the trustee. If the equipment has value far in excess of the unpaid principal and interest on the loan and if the lessor is confident that there is only a remote possibility of a "trigger event" under the tax indemnity, the lessor may welcome rejection (in which case the lessor must repay the nonrecourse notes to benefit from the upside residual). At the other extreme, if the value of the equipment is much lower so that the lender will get most or all of the value of the equipment through foreclosure, or if the lessor perceives a strong possibility of a claim under the tax indemnity, the lessor may much prefer assumption. The lessor's tactics will depend on whether it wants the lease assumed or rejected.

Opposing Rejection

The lessor may well conclude that rejection by the trustee poses an unacceptable economic loss for the lessor in terms of unreimbursed tax liability. For example, the lessor may not have a "claim" as defined by the Bankruptcy Code in that the lessor is unaware of any trigger events which require an indemnity payment and the Service has not, as of the filing of the petition, threatened a challenge of previously realized tax benefits. In such a setting, rejection of the unexpired lease by the lessee would terminate the tax indemnity agreement and yet leave the lessor exposed to possible future liability with no compensation for the loss of the valuable right to indemnification which was an essential part of the deal for the lessor.

Alternatively, the lessor may have a claim under the tax indemnity which would be allowable upon rejection but which is not yet definite.[54] A threatened challenge by the Service to past tax benefits which has not yet ripened into a final determination, and may never do so, would constitute a claim subject to estimation under section 502(c)(1). Given the lack of judicial experience in the implementation of the estimation procedures, and the consequent uncertainty of full valuation, the lessor may prefer assumption by a reorganizing lessee with a prospect of rehabilitation and a possible future ability to respond to the indemnity, if and when required.

Under the circumstances, if the trustee proposes to reject the lease, the lessor must be prepared to show either

that rejection does not conform to sound "business judgment"[55] or that rejection would offend "equitable principles."[56] Usually, this showing will be extremely difficult for the lessor to make.

In a Chapter 7 liquidation case, the trustee's choice to reject could rarely, if ever, be successfully opposed. By the nature of the proceeding, there will be no surviving entity to assume the unexpired obligations of the lease. However, a showing that assumption and subsequent assignment to a willing and identified assignee would entail a net benefit to the unsecured creditors of the liquidating lessee could be sufficient to oppose rejection.[57] If a prospective assignee is willing to pay the estate a premium for the unexpired portion of the lease, and if the assignee is acceptable to both lender and lessor, the trustee would have no sound reason to reject the lease (thus multiplying the unsecured claims) rather than assume and assign, unless the cure of previous defaults under the lease would drain the assets of the estate.[58] If the cure of prior defaults is the only barrier to an assumption and assignment desired by all parties to the lease, a negotiated compromise or partial waiver of prior defaults may be considered by the lessor.[59]

In a Chapter 11 reorganization, a lessor opposing rejection could similarly attempt to demonstrate that sound business judgment required assumption of the unexpired lease as a first step to an assignment profitable to the estate. Alternatively, a lessor could claim that assumption represented a more sound economic choice for a lessee than rejection, in an attempt to controvert the trustee's stated "business judgment." In this case, the lessor would be required to show that the trustee's alternative to assumption (e.g., entering into a new lease with a third party) was an economically inferior choice for the reorganizing lessee as compared to the terms of the existing lease.

If the trustee's proposal to reject is unassailable on the ground of business judgment, as will usually be the case, then an objecting lessor must fall back on the argument that the slight economic advantage of rejection to the lessee is outweighed, in equity, by the severe economic consequences of rejection to the lessor. Under the "equitable principles" standard, a nondebtor party can oppose rejection on a showing of the disproportion between gain to the estate and loss to itself, but it should be noted that only a few reported cases have denied a trustee's exercise of the rejection option on this ground.[60]

Opposing Assumption

A lessor may have sound reasons for preferring that the unexpired lease be rejected, for instance where the lessor is confident that rejection will not lead to a tax loss due to past use of the equipment or structural problems in the lease, and where a credit-worthy third party is ready to re-lease the equipment, obviating the problem of a subsequent foreclosure sale initiated by the lender. A lessor who wishes to oppose assumption of an unexpired lease in which a prior lessee default[61] has occurred has a fair chance of success, given the statutory requirements of cure, compensation and adequate assurance of future performance which the trustee must satisfy.[62] If the lessor's economic analysis indicates that rejection (with a possible re-leasing of the equipment to a more solvent lessee) is the preferable outcome, then the lessor could take the position that adequate assurance of future performance is simply not a possibility, given the magnitude of the contractual tax indemnity obligations measured against the demonstrated inability of the lessee to manage its affairs on a sound footing.

If prior defaults under the tax indemnity itself exist, for instance a recapture of realized tax benefits for which the lessor has not been reimbursed, then the lessor can and should demand strict cure as a condition of assumption. If the lessor has suffered other pecuniary loss as a consequence of lost tax benefits, then compensation for such loss can equally well be demanded as a condition to assumption. Finally, as noted above, the lessor should demand assurances of future performance predicated on maximum liability under the tax indemnity agreement in an attempt to persuade the court that assumption should be denied.[63]

In the hard bargaining atmosphere of a lessee reorganization under Chapter 11, a lessor should be prepared to negotiate and compromise. If the lessor's own economic analysis of the consequences of assumption or rejection indicates a clear preference, and if the lessor has any bargaining leverage, compromise rather than insistence on the strict terms of the statute may yield the better result for the lessor.[64] The judicial encouragement of negotiation in lieu of rejection, noted in the previous section on rights and obligations in a lessee bankruptcy, applies as well to the nondebtor parties to an unexpired lease.

PREVENTING FORECLOSURE SALE OF THE EQUIPMENT

If the trustee rejects the lease and the lender forces the equipment to be sold, significant tax problems may arise for the lessor. Depending on the circumstances, the lessor may wish to prevent the sale and arrange to lease the equipment to a third party.

As noted earlier, the lender may attempt even prior to rejection to fore-

close its security interest in the lease and equipment against the lessor. The lender would be unable to disturb the trustee's possession of the leased equipment prior to rejection, due to the automatic stay of section 362 as well as to the statutory right to assume the lease afforded the trustee by section 365. However, the lender could argue that it should be allowed to foreclose the lessor's interest in the lease and equipment (including the reversionary interest) immediately upon commencement on the grounds that commencement of the lessee bankruptcy is a defined event of default in the security agreement and the statutory invalidation of *ipso facto* clauses is strictly a protection for the party in bankruptcy with no application to nondebtor parties (lessor and lender).

A lessor should oppose an immediate lender foreclosure by arguing that the same considerations which require treatment of the lease as an integrated whole for assumption purposes require evenhanded application of the automatic stay and invalidation of *ipso facto* default clauses.[65] A lessor could further claim that the *ipso facto* clause in the security agreement is dependent on the validity of the same clause in the lease itself, and thus is necessarily invalidated by section 365(b)(2). Finally, the lessor should argue that recognition by the court of lessee bankruptcy as an incurable default is inequitable and would work a forfeiture.[66]

Whether or not the act of lessee bankruptcy alone is sufficient, a rejection under section 365 clearly constitutes a default under the lease which permits the lender to declare a default under the finance agreement and the promissory notes. Such a declaration causes payment of the outstanding principal balance of the notes to be accelerated, thereby enabling the lender to cause the equipment to be sold to pay off the notes.

A foreclosure sale of the equipment may give rise to immediate investment tax credit recapture and taxable gain to the lessor. If property on which the investment credit has been claimed has been disposed of, the taxpayer must "recapture" or pay additional taxes based on the credit taken in the year of the disposition.[67] The amount recaptured starts at the full ten percent credit if the sale occurs in the first year of the lease, decreasing two percentage points each year so that after five years, no amount is recaptured if a sale takes place.[68] The additional tax liability can be quite significant. For example, if the foreclosure sale takes place in the fourth year of the lease, and the original equipment cost was $10 million, the lessor would be required to pay an additional $400,000 in income taxes (four percent of the $10 million cost).

In addition to this investment credit recapture, the lessor will be required to recognize as a gain an amount equal to the outstanding principal balance of the debt at the time of sale (plus any proceeds the lessor receives from the sale), reduced by lessor's tax basis in the equipment.[69] All of this gain will be taxed as ordinary income because of the depreciation recapture rules,[70] again potentially resulting in a large tax burden to the lessor. As a result, the lessor may, depending on the surrounding economics, wish to prevent a foreclosure sale of the equipment following rejection of the lease.

In theory, a lessor is automatically protected from the adverse tax consequences of a foreclosure sale by either the tax indemnity agreement or the remedies section of the lease. In particular, the remedies section contains a liquidated damages clause under which, in the event of a default, the lessor is entitled to the return of the equipment and a payment equal to the casualty loss value of the equipment reduced by its fair value. The casualty loss values are computed so as to maintain the lessor's net yield in the transaction despite the early termination, including reimbursement for the recaptured investment credit and earlier recognition of income.

There is substantial doubt that the liquidated damage clause in the lease or the comparable damage provision in the tax indemnity will, as a legal and practical matter, fully protect a lessor following a foreclosure sale of its interest in the equipment. Rejection of the lease gives rise to an unsecured claim by the lessor under the remedies provision which may be subject to challenge by unsecured creditors of the lessee as not fully allowable.[71] Even if allowed, such a claim will entitle the lessor only to share *pro rata* with other unsecured creditors.[72] As a result, a lessor may suffer significant and unreimbursed tax liability upon a foreclosure sale of the equipment following rejection of the lease.

It may therefore be in the lessor's best interests to try to prevent the foreclosure sale and arrange for leasing the equipment to another party. The finance agreement contains a provision which would allow the lessor to stop the sale. In the event of a default, the lessor is permitted to repurchase the notes for their outstanding principal balance (plus accrued interest and costs), thereby paying the lender in full and terminating its security interest. If interest rates have fallen below the rate set forth in the notes, or the equipment has a sale or rental value in excess of the debt, the lessor may wish to elect this procedure even if tax considerations are not paramount. However, if another favorable lease can be arranged, repurchase of the notes will be even more attractive, since the lessor can avoid any investment credit recapture and immediate recognition of gain caused by a sale of the equipment. If the lessor is unwilling or unable to repurchase the notes in full, it may try to reach an accommodation

with the lender under which the sale is postponed and the equipment is leased to a third party.

In summary, a lessor may suffer significant additional tax expense if equipment is sold following rejection of the lease. Although the lease and tax indemnity purportedly require a lessee to compensate the lessor for this expense, the lessor will probably not receive more than a small fraction of the reimbursement from the estate. Depending on a number of other variables at the time of rejection (including the current level of interest rates, the value of the equipment and the presence of other potential lessees), the lessor may find it advisable to prevent the foreclosure sale of the equipment and arrange for re-leasing it to a third party.

FILING PROOF OF LESSOR CLAIMS

At the time a lessee bankruptcy is either imminent or an accomplished fact, the lessor should protect its interests under the tax indemnity by gathering as much information as possible. All claims, either for prior defaults or for unmatured lessee obligations under the unexpired lease, must usually be asserted by the lessor in the bankruptcy proceeding or be forfeited. A lessor's sole protection against involuntary waiver of a claim is accurate information both as to prior acts of the lessee which may trigger loss of tax benefits and as to other factors (e.g. changes in interpretation of the tax laws) which may similarly entail loss or recapture of tax benefits.

Assumption of the Unexpired Lease

When the trustee proposes to assume an unexpired lease with prior defaults, there is strictly speaking no occasion for a lessor to file a "proof of claim."[73] Until the unexpired lease is rejected, the lessor is neither a creditor nor a claimant, but rather is the holder of a right to demand cure, compensation and adequate assurance of future performance as a precondition to assumption.[74]

Whether a lessor intends to support or oppose the trustee's proposed assumption of the lease, full protection of the lessor's interests requires knowledge of all past defaults under the tax indemnity and prior acts of the lessee which may give rise in the future to tax liability for the lessor. If the tax indemnity agreement provides that the lessee's obligation to reimburse the lessor matures only after a "final determination" of tax liability has occurred, only the lessee's failure to respond to such a prebankruptcy final determination would constitute a default requiring cure under section 365(b)(1)(A).

A lessor can demand, however, that the lessee provide "adequate assurance" of its ability to reimburse the lessor for future "final determinations" which are certain, likely or only possible due to past acts of the lessee or another trigger giving rise to an indemnity payment.[75] The more information a lessor can bring to bear on its own tax exposure after assumption of the lease, the more assurance will the lessor be able to demand from a reorganized lessee.

A court would surely require adequate assurance of lessee ability to discharge an obligation which was certain to arise during the term of the tax indemnity,[76] and would likely require assurance of some sort of lessee ability to discharge an obligation which would probably arise in the future. Whether the court would compound the lessee's burden by demanding assurance of performance of obligations which may never arise is unclear, but counsel for the lessor is not foreclosed by any provision of the Bankruptcy Code from requesting such assurance.[77]

Rejection of the Unexpired Lease

If a legitimate demand for adequate assurance prior to assumption has been involuntarily waived by a lessor due to inadvertence, the lessor will have another opportunity to make itself whole in the future by demanding its contractual reimbursement from the reorganized lessee when and if the contingency occurs. The case is otherwise with a rejected lease—claims which are not filed do not share in the distribution of assets and are usually discharged upon liquidation or confirmation.[78] A lessor should protect itself in the event of the rejection of the unexpired lease, including the tax indemnity agreement, by assembling all its claims for filing under section 502(g) so that its distribution will be as large as possible.

The Rules of Bankruptcy Procedure provide a statutory tool for a lessor to obtain information concerning past acts of a lessee which may trigger loss of tax benefits.[79] Rule 205 provides that a "party in interest"[80] may obtain a court order to examine "any person" (including the debtor) on "any matter which may affect the administration of the bankrupt's estate."[81] As a supplement to the lessor's independent efforts to determine its maximum allowable claims under the breached tax indemnity, the Rule 205 examination, conducted under oath, may prove useful.

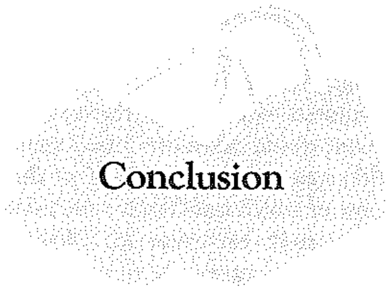
Rejection of the unexpired lease constitutes a statutory breach, deemed to have occurred prior to the petition and on a par with other nonpriority, unsecured claims.[82] Upon approval of rejec-

tion by the court, a lessor should file proof of all claims pursuant to section 501(a) and (d).[83] A claim filed under section 501 is "deemed allowed" unless a "party in interest" objects.[84] If an objection is made to the lessor's claims, the court, after a hearing on the issue, will determine the amount of claim and allow such amount for *pro rata* distribution.[85]

A lessor can anticipate objections to its more speculative claims both from the trustee and from the other unsecured creditors. Since distribution to the unsecured creditors is made *pro rata* after payment of priority claims,[86] all unsecured creditors have a direct economic interest in disputing large claims which will diminish their own participation in the limited assets available for distribution.

Lessor claims after rejection will likely fall into one of the following categories: (1) Claims for final determinations which have occurred prior to the filing of the proof of claim. Since these claims, if they exist, are liquidated and noncontingent, they should be allowed. (2) Claims for suspected or threatened loss of tax benefits. Examples of this class would be a preliminary assertion by the Service that the lessor was not the first user or that the lease was not a true lease. A threatened foreclosure sale of the equipment also falls within this class. Since these claims are both contingent and unliquidated, the estimation procedure of section 502(c)(1) will be invoked to assign a value. A lessor can and should submit its own valuation to counter the low valuations or absolute objections likely to be submitted by objecting creditors. (3) Claims for liabilities which are neither threatened nor suspected but which may, nonetheless, attach after discharge due to predischarge acts of the lessee. This class of claims, which the lessor cannot support with proof, might well be disallowed as simple speculation. A lessor should, however, submit a claim for loss of indemnity against the unknown and should attempt to persuade the court that absolute disallowance of this claim would work an inequity.

The uncertainty of allowance of lessor claims which are unsupported in the factual record suggests that only thorough and complete investigation of the lessee's prior activities under the lease and use of the leased equipment will ensure the allowance of all lessor claims under the tax indemnity agreement breached by rejection of the unexpired lease.



Conclusion

Tax indemnity agreements are generally enforceable in lessee bankruptcy proceedings, but they will not always be effective to protect lessor's tax benefits. This effectiveness depends in large part on whether the trustee assumes or rejects the lease, of which the tax indemnity should be considered an inseparable part. A lessor will usually be entitled to the full benefit of the tax indemnity if the lease is assumed, in which event past defaults must be cured and adequate assurance of future performance must be given. If, on the other hand, the lease is rejected, the lessor may face additional tax liabilities through foreclosure sale of the equipment, may remain totally uncompensated for losses of tax benefits not yet liquidated by the time the case is closed and, in any event, will only be entitled to recovery of a small fraction of its allowable claims as an unsecured creditor of the lessee. Each of these potential consequences should be considered by a lessor in addressing the broader questions of whether to support or oppose assumption or rejection of the lease, how to deal with the lender and the manner of identifying and pressing claims for loss of tax benefits in lessee bankruptcy proceedings.

FOOTNOTES

1. The example used includes only a single lessor, lessee and lender. In many transactions, the equity participant (or participants) forms a grantor trust to act as lessor. If there are multiple lenders, an indenture trustee may also be used to administer their role in the transaction. *See generally* B. Fritch & A. Reisman, Equipment Leasing-Leveraged Leasing 235 (1980). In addition, performance of lessee obligations under the lease and/or tax indemnity agreement could be secured through the grant of other collateral to the lessor, a guarantee of lessee obligations by its corporate parent, if any, or the issuance of a standby letter of credit by a bank.
2. The Internal Revenue Code of 1954, as amended, generally permits a taxpayer to carry net operating losses in a particular year back to earlier years, and forward to later years, to offset taxable income in those years. I.R.C. § 172 (C.C.H. 1983).
3. A number of measures are commonly used in ascertaining current value, including "fair market value" or "discounted fair market rental value," determined in either case by agreement or by appraisal, or the sales price if the equipment is in fact sold.
4. The lessee may or may not indemnify the lessor against state and local

income or franchise taxes incurred by the lessor in connection with the lease. The lessee typically also indemnifies the lessor (and the lender) against other liabilities, including all other tax liabilities arising from the purchase or use of the equipment (except for taxes based on or measured by the lessor's net income) and all other liabilities of any kind arising out of the use or operation of the equipment.

5. The lessor generally will be considered the owner of the equipment for federal income tax purposes if it bears significant and genuine attributes of ownership. *Frank Lyon Co. v. United States*, 435 U.S. 561, 584, (1978); *cf. Oesterreich v. Comm'r.* 226 F.2d 798, 802 (9th Cir. 1955); Rev. Rul. 55-540, 1955-2 C.B. 39 (each setting forth a number of factors to consider). Solely for purposes of deciding whether it will issue an advance ruling with respect to a leveraged lease transaction, the Service has issued a set of guidelines containing much stricter rules than set forth in the cases and published rulings. Rev. Proc. 75-21, 1975-1 C.B. 715; Rev. Proc. 75-28, 1975-1 C.B. 752; Rev. Proc. 76-30, 1976-2 C.B. 647; Rev. Proc. 79-48, 1979-2 C.B. 529.

6. Code section 38 permits a lessor an investment tax credit equal to ten percent of the tax basis of most kinds of new personal property placed in service during the year. I.R.C. §§ 46(a)(2)(B), 46(c)(1), 46(c)(7) & 48(b) (C.C.H. 1983). Code section 48(q) requires the depreciable basis of property with respect to which the ten percent investment credit has been claimed to be reduced by one-half of the credit, or five percent. However, the lessor is not required to reduce its basis in this manner if it claims only an eight percent, rather than ten percent, credit. The Code also allows an additional "energy credit" in the case of certain kinds of "energy property." *Id.* § 46(a)(2)(A)(ii). Although the extra energy credit will not be discussed further, its availability in a particular transaction will increase the lessor's tax benefits, as well as the potential risk if the benefit is required to be recaptured.

7. Code section 168 prescribes allowable depreciation deductions for most kinds of tangible property acquired after December 31, 1980. I.R.C. § 168 (C.C.H. 1983). Eligible property is classified into five "recovery classes," with each class having its own specified schedule of depreciation deductions. *Id.* § 168(c). It is assumed here that the property under lease is "5-year property," the class into which most leased personal property will fall.

8. The full ten percent investment credit is available to the lessor only if the equipment is "new section 38 property," or property owned by the taxpayer at the time it is first used, or ready or available for use. *Id.* § 48(b). If the equipment had been used by the lessee (or had been ready for use) before having been acquired by the lessor, the equipment would constitute "used section 38 property," only $125,000 of the cost of which qualifies for the investment credit each year. *Id.* § 48(c). Given the cost of the equipment under lease, the lessor would obviously lose a significant portion of the investment credits if the equipment were deemed "used" at the time the lease was entered into.

9. With certain exceptions, property used predominantly (more than 50 percent of the time) outside the United States does not qualify for the investment credit. *Id.* § 48(a)(2)(A). If property initially eligible for the investment credit is used in a manner which would have made it ineligible (such as by using the property predominantly outside the United States in a subsequent year), or if the property is sold or transferred, all or a portion of the investment credit claimed is recaptured, i.e., required to be paid as additional tax in the year of such use or sale. *Id.* § 47. See section on preventing foreclosure sale of the equipment, *infra.*

10. See section on preventing foreclosure sale of the equipment, *infra.*

11. Bankruptcy Reform Act of 1978, Pub.L.No. 95-598, 92 Stat. 2549 (codified at 11 U.S.C §§ 101-151326).

12. See section on preventing foreclosure sale of the equipment, *infra.*

13. 11 U.S.C. § 365(a). All future references to sections are to 11 U.S.C. §§ 101 *et seq.* unless otherwise indicated. The language of section 365(a), quoted in the text, overrules cases decided under the superseded Bankruptcy Act by establishing that any unexpired lease, whether or not it meets the criteria developed for executory contracts, may be assumed or rejected by the trustee. Leases of personal property, as well as of real property, are controlled by this section. *See, e.g., In re OPM Leasing Services, Inc.*, 21 B.R. 993 (S.D.N.Y. 1982).

14. 11 U.S.C § 1107(a). Chapter 7, governing liquidation, does not provide for a debtor in possession.

15. Except for the right to compensation for its services. *Id.*

16. *In re LHD Realty Corporation*, 9 B.C.D. 361 (S.D. Ind. 1982); *In re Italian Cook Oil Corp.*, 190 F.2d 994 (3d Cir. 1951).

17. If the tax indemnity is not incorporated into the lease instrument but is a separate document with its own recitals and covenants, the lessee could argue that the indemnity is in fact a related but separate undertaking which the lessee should be allowed to reject, thus relegating the lessor to its allowable claims for damages, while assuming the unexpired term of the lease itself. This argument should fail in light of the principle that the trustee assumes a lease *cum onere* [with all of its obligations] (see cases cited in note 16, *supra*) and in light of the fact that the indemnity clearly forms an integral part of the consideration passing to the lessor for executing the lease. Careful draftsmanship by the lessor could preclude even the possibility of the lessee's

attempted severance of the lease and the indemnity. The indemnity could be integrated into the lease document itself or, if a separate document, could clearly cross-reference the lease and recite that the consideration for lessee indemnity obligations is the execution of the lease.

18. The lessor could argue that the indemnity necessarily survives lessee rejection of the lease on the ground that it is analogous to a guaranty executed by the lessee in return for an obligation of the lessor (execution of the lease) which has been fully performed. On this theory, the lessor would attempt to sever the executory obligations of the lease (payment of rents by the lessee in consideration of quiet enjoyment of the leased equipment) from the fully performed obligation (execution of the lease) for which the indemnity was the agreed consideration. A version of this argument was unsuccessfully attempted by a franchisor in *In re Rovine Corp.*, 6 B.R. 661 (W.D. Tenn. 1980), who claimed that a noncompetition covenant necessarily survived rejection of a franchise agreement by the trustee of the bankrupt franchisee. The court in *Rovine* simply reiterated that a lease must be rejected or assumed in its entirety, and included the noncompetition covenant with the rejected franchise.

19. The case authority supports this result. *See* cases cited in notes 16 and 18, *supra.* A concise statement of the judicial insistence on totality of rejection or assumption is contained in *In re A.R. Dameron & Associates, Inc.*, 1 C.B.C.2d 1110, 1113 (N.D. Ga. 1980): ". . . the lease contract must be construed as a whole by the court and not torn apart and construed in pieces" [citations omitted].

20. *See, e.g., Finn v. Meighan*, 325 U.S. 300 (1945).

21. 11 U.S.C § 365(d)(1). In a voluntary case, the filing of the petition constitutes the order for relief. *Id.* § 301. In an involuntary case, an order for relief must be entered by the court either upon default of the debtor or upon proof of the prerequisites for involuntary relief. *Id.* § 303(h).

22. *Id.* § 365(d)(2).

23. *Id. See, e.g., In re New England Carpet Co.*, 8 B.C.D. 1121 (D. Vt. 1982); *Theatre Holding Co. v. Mauro*, 9 B.C.D. 263 (2d Cir. 1982); *In the Matter of Russell Johns*, 1 C.B.C. 2d 174 (D. Nev. 1979).

24. 11 U.S.C. § 363(e) provides that an "entity" with an interest in property used by the estate may request "adequate protection" of its interest.

25. *Id.* § 361. The details and interworkings of sections 361 and 363 are beyond the scope of this article.

26. *Id.* § 362 provides, in brief, that acts, whether judicial or private, against property in which the debtor has an interest (including a leasehold interest), which acts would be otherwise proper, are stayed by the filing of a petition in bankruptcy. A party may petition for relief from the stay (section 362(d)), but such relief would be denied pending trustee exercise of the option to assume or reject.

27. *Id.* § 365(b)(1).

28. *In re Lafayette Radio Electronics Corp.*, 4 C.B.C. 2d 220 (E.D.N.Y. 1981); *In re A.R. Dameron & Associates, Inc.*, 1 C.B.C.2d 1110 (N.D. Ga. 1980).

29. *In re Greco*, 1 C.B.C.2d. 619 (D. Hawaii 1980); *In re Luce Industries, Inc.*, 4 C.B.C.2d 355 (S.D.N.Y. 1981).

30. 2 Collier on Bankruptcy, ¶ 65.04[1] (15th ed. 1979). If the lease contains no cure provision for a nonmonetary default, or if the default is literally incurable, the court is free to approve a cure which gives the nondebtor party the benefit of its bargain. *Id.*

31. *See, e.g., In re Belize Airways, Ltd.*, 5 B.R. 152 (S.D. Fla. 1980); *In re Taylor Manufacturing, Inc.*, 6 B.C.D. 1161 (N.D. Ga. 1980).

32. 11 U.S.C. § 365(f).

33. The trustee may neither assume nor assign a contract in the nature of a personal services contract or a financial accommodation. 11 U.S.C. § 365(c), 365(e)(2). Since the usual equipment lease falls outside both of these categories, this limitation will not be further considered.

34. *Id.* §§ 365(f)(2)(A), 365(f)(2)(B).

35. *In re Sapolin Paints, Inc.*, 5 B.R. 412 (E.D.N.Y. 1980). One peculiarity of an assignment of a lease with a tax indemnity is the uncertain status of the lessor's future claims for loss of tax benefits triggered by pre-assignment acts of the lessee. Since it is doubtful that any assignee would consent to indemnify the lessor against tax liability which may attach after assignment but be triggered by pre-assignment activity of the lessee, the lessor may attempt to require a continuing indemnification from the lessee, in the nature of a bond, against such liability as an element of "adequate assurance."

36. 11 U.S.C. § 365(a).

37. 318 U.S. 523 (1943).

38. *E.g., American Brake Shoe & Foundry Co. v. New York Rwys.*, 278 F. 842 (S.D.N.Y. 1922).

39. *Dushane v. Beall*, 161 U.S. 513 (1896).

40. *Group of Institutional Investors*, note 37, *supra*, was a railroad reorganization case. The argument that only cases similarly affected with the public interest should apply the business judgment test was rejected in *In re Minges*, 602 F.2d 38 (2d Cir. 1979). The following cases all have applied the business judgment test. *In re J.H. Land & Cattle Co.*, 3 C.B.C.2d. 695 (W.D. Okla. 1981); *In re Marina Enterprises, Inc.*, 8 B.C.D. 59 (S.D. Fla. 1981); *In re High Fliers, Ltd.*, 7 B.C.D. 747 (S.D. Cal. 1981).

41. *In re Minges*, 602 F.2d 38 (2d. Cir. 1979); *In re Penn Central Transportation Co.*, 458 F.Supp. 1346 (E.D. Pa. 1978); *Matter of U.L. Radio Corp.*, 6 C.B.C.2d 430 (S.D.N.Y. 1982).

42. *In re Penn Central*, note 41, *supra*, [rejection by lessor of leases in railroad reorganization]; *Brotherhood of Railway, etc. v. REA Express, Inc.*, 523 F.2d 164 (2d. Cir. 1975) *cert. den.*,

423 U.S. 1017 (1975); *Shopman's Local 455 v. Kevin Steel Products, Inc.*, 519 F.2d 698 (2d. Cir. 1975) [rejection of collective bargaining agreements].

43. *In re Minges*, note 40, *supra*.
44. *Group of Institutional Investors v. Chicago Milwaukee, St. Paul & Pacific R.R. Co.*, 318 U.S. 523 (1943); *Brotherhood of Railway etc. v. REA Express, Inc.*, 523 F.2d 164 (2d Cir. 1975).
45. 11 U.S.C. §§ 365(g)(1), 365(g)(2)(A).
46. *Id.* § 502(g).
47. *Id.* §§ 501, 502(a).
48. *Id.* § 101(4)(A).
49. *Id.* §§ 726, 727, 1141(d)(1)(A). The plan will ordinarily include provision for *pro rata* payment of allowed claims.
50. See discussion in 3 Collier on Bankruptcy, ¶ 502.03 (15th ed. 1979).
51. 11 B.R. 294 (N.D. Ohio 1981). The pending Johns-Manville bankruptcy could require similar estimation. *In re Johns-Manville Corp.* (Bk. Ct. S.D.N.Y. Aug. 26, 1982).
52. 11 U.S.C. § 507.
53. *See* D. Epstein & J. Landers, Debtors and Creditors 629 (1978).
54. 11 U.S.C. §§ 101(4), 502(g).
55. This is the usual test for rejection. *See* note 40, and authorities there cited.
56. This is the standard applied by some courts in cases involving extraordinary hardship for nondebtor parties.
57. 11 U.S.C. § 365(f).
58. Cure of previous defaults, other than *ipso facto* defaults, is a precondition for assumption and assignment. *Id.* §§ 365(b)(1), 365(f).
59. Since prior defaults would usually be in the nature of delinquent rentals, any compromise may of necessity involve satisfaction of the lender, the assignee of the rents.
60. *See* notes 41-43, *supra*, and accompanying text.
61. If there has been no prior lessee default, or if the only default has been the bankruptcy itself, then the lessor is powerless to prevent assumption.
62. 11 U.S.C. § 365(b)(1).
63. The lessor will be handicapped in this attempt by the lack of any "experience rate" developed by the industry which could serve as support for a lessor claim that loss of tax benefits will occur in the future.
64. Section 365(b)(1), the conditions for assuming an unexpired lease in default, may be partially waived to effectuate such a compromise.
65. If the lender attempts to foreclose the lessor's interest in the lease and equipment, it will probably file an action in the proper state court. The lessor could either defend in the state court or, more likely, seek injunctive relief from the bankruptcy court where the lessee's case is pending.
66. *See, e.g.*, *Brown v. Avemco Inv. Corp.*, 603 F.2d 1367 (9th Cir. 1979).
67. I.R.C. § 47 (C.C.H. 1983).
68. *Id.* § 47(a)(5)(B).
69. *Id.* § 1001; Treas. Reg. § 1.1001-2(a).
70. Code section 1245 requires that any gain recognized on sale of an asset will be treated as ordinary income to the extent of past allowable depreciation deductions. I.R.C. § 1245 (C.C.H. 1983).
71. If the lessor attempts to submit a claim for a threatened sale of the equipment by a foreclosing lender after rejection, such a claim could be opposed by the trustee and the unsecured creditors of the lessee on two grounds: First, the damage on which this claim would be grounded (loss of tax benefits) is avoidable by the lessor, in that the lessor has the contractual option to repurchase the notes from the lender and thus avoid the sale. The unsecured creditors could claim that the future damages will be, if they occur at all, self-inflicted, and that the lessee's estate should not be diminished by inclusion of such a claim. Second, those opposing the claim could characterize the threatened sale in foreclosure as essentially a workout between the lessor and the lender which should not be allowed to impact on the distribution of the lessee's assets to creditors who have no similar options.
72. See discussion on allowance of claims in the section on filing proof of lessor claims, *infra*.
73. "Proof of claim" is a term of art in the Bankruptcy Code, a description of the means by which creditors and equity security holders present their claims or interests to the bankruptcy court so that such claims may be allowed for purposes of distribution of the debtor's assets. *See* 11 U.S.C. §§ 501, 101(4).
74. *Id.* § 365(b)(1).
75. *Id.* § 365(b)(1)(C).
76. The usual tax indemnity agreement will, by its terms, survive the expiration of the lease itself.
77. The problems of estimating the quantum of assurance required for obligations which are probable or possible is not treated in the Bankruptcy Code. The procedure for estimating contingent and unliquidated claims, 11 U.S.C. § 502(c)(1), might be relevant for this purpose.
78. *Id.* §§ 727, 1141(d)(1)(A).
79. The Bankruptcy Reform Act of 1978 provides, in section 405(d), that the Bankruptcy Rules, to the extent not inconsistent with the Reform Act, remain in effect until superseded or repealed.
80. "Party in interest" is undefined in the Bankruptcy Code, but is in practice given a broad scope.
81. Rule 205(a), (d).
82. 11 U.S.C. §§ 365(g), 502(g).
83. Prior defaults are transformed into claims by rejection, and all remaining unperformed obligations of the lessee under the lease are also "claims." See 11 U.S.C. § 104(4).
84. 11 U.S.C. § 502(a).
85. A claim otherwise allowable may fail if it falls into one of the enumerated categories of section 502(b).
86. *Id.* §§ 726, 1123, 507.