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12 | 03

Business Law

# Energy Services Agreement Constitutes A Secured Transaction, Not True Lease

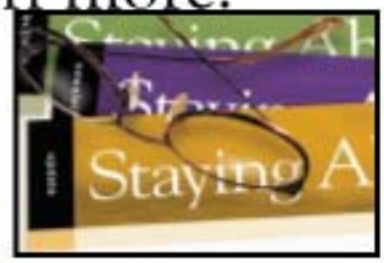
## What happened?

**In an opinion of the United States Court of Appeals for the Third Circuit filed November 14, 2003, a Master Energy Services Agreement ("Services Agreement") between Duke Energy and Pillowtex Corporation was held to be a secured financing and not a true lease.**

## What does it mean?

**The Court expressly rejected these arguments as advanced by Pillowtex, but nevertheless reached the same conclusion advanced by Pillowtex that the Services Agreement represented secured financing and not a true lease. The Court was faced with the failure of the Services Agreement through the artful drafting of end-of-lease options to meet the express terms of UCC 1-207(37)(a) which allow a *per se* determination that an agreement is a security agreement and not a lease.**

Learn more.



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In an opinion of the United States Court of Appeals for the Third Circuit filed November 14, 2003, a Master Energy Services Agreement ("Services Agreement") between Duke Energy and Pillowtex Corporation was held to be a secured financing and not a true lease.[1] Pillowtex had filed in bankruptcy and the United States District Court for the District of Delaware sitting in bankruptcy determined by application of New York law that the Services Agreement did not constitute a true lease and declined to apply Section 365(d)(10) of the Bankruptcy Code. The Court of Appeals confirmed the order of the District Court and remanded the case for a determination whether Duke Energy was entitled to adequate protection. Consistent with New York law, Pillowtex in seeking to characterize the Services Agreement as a secured financing carried the burden of proof.[2] The decision is significant in several respects:

**1.** **The Facts.** The Services Agreement was structured to include certain "surface" or cosmetic features consistent with current statutory provisions and existing case law determining agreements to be true leases:

(i) The useful life of the equipment was 20 to 25 years while the Services Agreement had a term of only 8 years;
(ii) Pillowtex as the party possessing and using the equipment agreed in the Services Agreement not to claim ownership of the equipment for income tax purposes;[3]
(iii) Pillowtex was not obligated to purchase the equipment at the end of the term of the Services Agreement and did not have an option to purchase the equipment; and
(iv) It was undisputed and confirmed by Pillowtex's counsel during argument before the District Court that Duke Energy and Pillowtex intended to structure the Services Agreement as a true lease.

**2.** **End-of-Term Options.** Although the Services Agreement provided no purchase or renewal option in favor of Pillowtex as the user of the equipment, the Services Agreement provided certain **options in favor of Duke Energy** at the conclusion of the Term of the Services Agreement including the options:

(i) to remove the equipment previously installed thereby creating the obligation for Duke Energy to replace that equipment with equipment comparable to the original equipment;
(ii) to abandon the equipment in place;
(iii) to give Pillowtex the option to extend the term of the Services Agreement for such additional period(s) and payment terms as the parties may agree upon; and
(iv) to give Pillowtex the option of purchasing all (but not less than all) of the equipment at a mutually agreed upon price.

You will note that although the putative lessee,[4] Pillowtex, did not have an end-of-lease option to renew, Duke Energy had the option to grant Pillowtex the option. When a lease contract is silent on this issue and omits any option in favor of lessee to renew the lease, lessor is always free at any time and particularly as the end of the term approaches to open discussions on renewal. Query as to what such devious drafting added.

**3.** **The Testimony.** If Duke Energy elected to exercise option (i) above, Duke Energy would be responsible under the terms of the Servicing Agreement, for all costs and expenses in removing **and replacing** the original equipment, including the costs to repair any damage to Pillowtex's facility caused by such removal. Despite the existence of the option in favor of Duke Energy to repossess the equipment, Pillowtex's Vice President for Engineering testified that in his understanding there was no chance of that option being exercised:

"It was clearly my understanding that [Duke Energy] would abandon the Lighting Fixtures and the Wastewater System at the conclusion of the [Services Agreement] and in fact statements were made to me by [Duke Energy] sales personnel to that effect. Moreover, because the energy projects were of no economic benefit to Pillowtex until the end of the term when Pillowtex would reap the energy savings going forward, I would not have signed off on the projects if the Lighting Fixtures and Wastewater System were not to be abandoned. I also believe that, based on the prohibitive cost of removing and replacing the Lighting

> Fixtures and the Wastewater System for Pillowtex, [Duke Energy] [had] no choice but to abandon the Lighting Fixtures and the Wastewater System at the end of the term of the [Services Agreement]."

**4.** **Uniform Commercial Code.** Section 1-207(37)(a) of the UCC as in effect in New York provides:

> (a) Whether a transaction creates a lease or security interest is determined by the facts of each case; however, a transaction creates a security interest if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee, ***and:***
> (i) the original term of the lease is equal to or greater than the remaining economic life of the goods,
> (ii) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods,
> (iii) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement, ***or***
> (iv) the lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement.

Section 1-207(37)(a) of the UCC ***appears*** to set up a two part *per se* test: (i) does the user of the equipment have the right to terminate the contract prior to the end of the term, and (ii) does the contract satisfy any one of the four factors. If the answer in each case is "no", then the transaction is a lease and not a disguised security agreement.

While the District Court ran right through the four factors and went directly to the economic realities of the transaction contained in the Servicing Agreement,[5] the Court of Appeals in following the District Court strictly interpreted the language of the *per se* rule of Section 1-207(37)(a) and expressly rejected its application before turning to the economic realities.

**Economic Reality.** The Services Agreement provided that the cost of acquiring and installing the energy fixtures would be paid by Duke Energy, which incurred total costs of approximately $10.41 million. Of this amount, approximately $1.66 million was for material and labor costs for the wastewater system. Approximately $4.46 million was for labor to install the lighting fixtures and $4.29 million was for material costs for the lighting fixtures, with the result that the cost of labor to install the fixtures was higher than the cost of the actual materials themselves. In addition, the payments were structured to ensure that Duke Energy would recover its costs three (3) years prior to the end of the term of the Services Agreement.

The District Court found these economics clearly weighed in favor of characterizing the Services Agreement as a sale and security agreement.[6] The District Court was persuaded that if the "lessee" was obligated to pay the "lessor" a sum equal to or greater than the full purchase price of the leased goods plus an interest charge over the term of the agreement, a sale was likely to have been intended since what the "lessor" would receive would be more than a payment for the use of the leased equipment; the lessor would receive the full return on its investment.

It is interesting that the Court made no mention of the companion provision of the New York UCC in Section 1-207(37)(b) to the effect: "A transaction does not create a security interest merely because it provides that: (i) the present value of the consideration the lessee is obligated to pay the lessor for the right to possession and use of the goods is substantially equal to or is greater than the fair market value of the goods at the time the lease is entered into."

**5.** **Intent.** Duke Energy argued on appeal that the District Court erred by failing to analyze the intent of the parties. Duke Energy asserted that the record demonstrated that the parties structured the Services Agreement so that it would qualify as a lease under relevant accounting standards so that Pillowtex would not reduce the amount of credit available to it under its senior credit

facility. Duke Energy also quoted counsel for Pillowtex to the District Court: "I don't disagree that … the parties were trying to create a lease, I would admit that."

In response, the Court clarified that the New York UCC no longer looks to the intent of the parties to determine whether a transfer is a lease or a security agreement. The Court pointed out that the 1992 version of § 1-201(37) directed courts to determine "[w]hether a lease *is intended* as security" (emphasis added); but that this language was amended in 1995 to read "[w]hether a transaction *creates* a lease of security interest" (emphasis added). The Court underlined that with this revision the reference to the parties' intent was explicitly omitted. The Court quoted at length from the Official Comment to the amended version confirming the importance of the changed language:

> "Prior to this amendment, [s]ection 1-201(37) provided that whether a lease was intended as security (i.e., a security interest disguised as a lease) was to be determined from the facts of each case … Reference to the intent of the parties to create a lease or security agreement has led to unfortunate results. In discovering intent, courts have relied upon factors that were thought to be more consistent with sales or loans than leases. Most of these criteria, however, are as applicable to true leases as to security interests … Accordingly, amended section 1-201(37) deletes all references to the parties' intent."

The Court citing earlier cases confirmed that "judicial opinions and the Official Uniform Commercial Code Comments … clearly place the focus of the inquiry under the revised statute on the economics of the transaction rather than on the intent of the parties as had been the emphasis previously".

**6.** **<u>The Bottom Line</u>.** The Court seemingly rejected the arguments of Pillowtex based upon the express contractual terms of the Services Agreement that the only way the fixtures could be removed at the end the term would be if Duke Energy was willing to pay millions of dollars to acquire and install replacements. Furthermore, the Court recites and seemingly rejected the argument of Pillowtex, again based on the contractual terms of the Services Agreement, that Pillowtex **effectively,** but not expressly, had the option to acquire the equipment for no or nominal consideration because Pillowtex could compel Duke Energy to abandon the equipment by refusing to negotiate an extension of the Services Agreement.

The Court expressly rejected these arguments as advanced by Pillowtex, but nevertheless reached the same conclusion advanced by Pillowtex that the Services Agreement represented secured financing and not a true lease. The Court was faced with the failure of the Services Agreement through the artful drafting of end-of-lease options to meet the express terms of UCC 1-207(37)(a) which allow a *per se* determination that an agreement is a security agreement and not a lease. Nevertheless, these end-of-lease contractual provisions including the economic compulsion they would work on Duke Energy to abandon the equipment and the too-cute "option to grant an option" provide a compelling background and incentive for the Court's conclusion.

(Footnotes)

[1] *In re: Pillowtex, Inc.* 2003 WL 22683081 (3rd Cir. (Del.)).

[2] *In re: Owen,* 221 B.R. 56, 60 (Bankr. N.D.N.Y. 1998).

[3] Pillowtex never accounted for the energy equipment as true leases.

[4] The Services Agreement was not labeled a lease, nor the parties "lessee" and "lessor".

[5] The District Court found that the economic realities of the Services Agreement would compel Duke Energy to purchase the Lighting Fixtures at their minimal market value rather than incur the substantial cost to remove the Lighting Fixtures and acquire and install replacement fixtures.

[6] *In re: Edison Bros. Stores, Inc.*, 207 B.R. 801, 809-810 (Bankr. D. Del. 1997).

*This Update has been prepared by Anthony F. Walsh, Partner and member of Saul Ewing's Business Practice Group. This Update is intended for informational purposes only, and its contents should not be considered legal advice. For more information, please contact Mr. Walsh at awalsh@saul.com or (215) 972-7738.*