

1
2 UNITED STATES BANKRUPTCY COURT
3 EASTERN DISTRICT OF CALIFORNIA
4 FRESNO DIVISION

5 In re) Case No. 04-11065-B-11
6 Waterman Industries, Inc.,)
7 Debtor.)
8
9

10 **MEMORANDUM DECISION RE OBJECTION TO ADMINISTRATIVE CLAIM**
11 **OF CELTIC LEASING AND COUNTER-MOTION FOR PAYMENT OF**
12 **ADMINISTRATIVE CLAIM**

13 Riley C. Walter, Esq., of Walter Law Group, appeared on behalf of the debtor in
14 possession, Waterman Industries, Inc. (the "Debtor").

15 Michael T. Hertz, Esq., of Lang, Ritchert & Patch, appeared on behalf of respondent to
16 counter-movant Celtic Leasing Corp., ("Celtic").

17 Donald W. Fitzgerald, Esq., of Felderstein Fitzgerald Willoughby & Pascuzzi, LLP,
18 appeared telephonically on behalf of the Official Committee of Unsecured Creditors (the
19 "Committee").

20 Randy Rogers, Esq., of Winston & Strawn LLP, appeared on behalf of secured creditor
21 Galena National Investments LLC, ("Galena").

22 The Debtor objects to an Administrative Expense Proof of Claim filed by Celtic
23 (the "Celtic Claim"). Celtic responded to the objection with a counter-motion to allow
24 and pay the Celtic Claim as an administrative expense. The parties dispute both the
25 administrative priority and the amount of the Celtic Claim. After oral argument, the
26 court took the matter under submission to decide the administrative priority issue, *i.e.*,
27 whether the contracts between Celtic and the Debtor constitute a true lease of personal
28 property, or a non-lease financing agreement disguised as a lease. The outcome of that
issue will determine whether Celtic is entitled to have its claim paid, in whole or in part,
as an administrative expense pursuant to sections 365(d)(10) and 503(b) of the
Bankruptcy Code.¹ Celtic also asserts a claim for alleged conversion of the leased

¹Unless otherwise indicated or made clear from the context, all chapter, section
and rule references are to the Bankruptcy Code, 11 U.S.C. § 101-1330, and to the
Federal Rules of Bankruptcy Procedure, Rules 1001-9036, as enacted and promulgated
prior to the effective date of The Bankruptcy Abuse Prevention and Consumer
Protection Act of 2005, Pub. L. 109-8, Apr. 20, 2005, 119 Stat. 23.

1 equipment. For the reasons set forth below, the court finds and concludes that Celtic is
2 entitled to an administrative claim under § 365(d)(10) for the lease payments that came
3 due before the lease was rejected. Celtic is also entitled to an administrative claim for the
4 post-rejection possession and use of the leased equipment in an amount to be determined
5 pursuant to
6 § 503(b). Liquidation of the § 503(b) claim, and allowance of Celtic's conversion claim,
7 if any, will require a further evidentiary hearing.

8 This Memorandum Decision contains findings of fact and conclusions of law
9 required by Federal Rule of Bankruptcy Procedure 7052 and Federal Rule of Civil
10 Procedure 52. The bankruptcy court has jurisdiction over this matter pursuant to 28
11 U.S.C. § 1334 and 11 U.S.C. §§ 365 and 503. This is a core proceeding pursuant to 28
12 U.S.C. 157(b)(1)(B).

13 **Findings of Fact**

14 Debtor manufactures water control equipment and has been in business since
15 1912. Debtor's products are sold worldwide. They include control gates, valves, and
16 related equipment serving the irrigation and water control needs of the agriculture and
17 wastewater treatment industries. Debtor's manufacturing and business operations are
18 dependant upon computers and computer software.

19 In 1996, Debtor and Celtic entered into an agreement entitled "Master Lease
20 Celtic Leasing Corp. - Lessor" (the "Master Lease"). In November 2001, Debtor signed
21 Schedules 2 and 3 (collectively, the "Schedules"), which added computer hardware and
22 software (the "Equipment") to the Master Lease. Also in November 2001, Celtic filed
23 two UCC-1 Statements in connection with the Equipment, which stated "this filing is for
24 precautionary purposes in connection with a leasing transaction and is not to be construed
25 as indicating that the transaction is other than a true lease." On December 7, 2001, and
26 February 6, 2002, the Debtor entered into agreements to assign lease payments related to
27 Schedules 2 and 3 respectively, to Wells Fargo Equipment Finance, Inc., for the Base
28 Term of the Schedules. Those agreements were both entitled "Assignment of Lease" (the

1 “Wells Fargo Assignments”).

2 Debtor filed this chapter 11 case on February 10, 2004. Debtor’s Chief
3 Restructuring Officer, Kenneth Leddon (“Leddon”) signed the Debtor’s bankruptcy
4 schedules as an authorized representative. Bankruptcy Schedule G states that the Debtor
5 was obligated to Celtic under a lease or executory contract in “Computer Equipment.”
6 After the Debtor filed bankruptcy, it continued to use the Equipment. On June 23, 2004,
7 more than 60 days after the commencement of the case, Debtor exercised its right to
8 extend the Master Lease and the Schedules for one year from April 1, 2005, through
9 April 1, 2006, (the “2005 Extension”). The Master Lease, the Schedules, and the 2005
10 Extension are hereinafter collectively referred to as the “Lease” or the “Celtic Lease.”

11 The Lease was apparently extended at least twice between the expiration of the
12 Base Term and the 2005 Extension. In a cover letter to the 2005 Extension, Leddon
13 confirmed the Debtor’s intent to extend the Master Lease and the Schedules for one more
14 year:

15 As you know, the original term of this agreement has been extended by
16 amendment to April 1, 2005. Therefore, the additional year term would extend
17 the agreement to April 1, 2006 at which time the equipment will either be
18 purchased by Waterman or returned.

19 The Master Lease defines the nature and scope of the agreement:

20 This is a MASTER LEASE AGREEMENT (herein called “Lease”). Lessor
21 hereby agrees to lease to Lessee, and Lessee hereby agrees to lease from Lessor,
22 the items of personal property (collectively called “Equipment” and individually
23 called an “Item”) described in any Lease Schedule(s) (“Schedule”) now or in the
24 future annexed hereto and made a part hereof, subject to the terms and conditions
25 set forth herein.

26 The Master Lease gives the Debtor the right of possession and quiet enjoyment
27 for the leased property:

28 1. QUIET ENJOYMENT: So long as Lessee is not in default hereunder, Lessor
shall not disturb Lessee’s quiet enjoyment of the Equipment subject to the terms
and conditions of this Lease.

The Master Lease provides for termination at the end of the “Base Term” as
follows:

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1 4. TERM: This Lease with respect to any Schedule may be terminated as of the
2 last day of the Base Term by either party giving the other party at least six months
3 but not more than twelve months prior written notice of such termination.

4 The Master Lease further provides that Celtic shall retain title to the leased
5 property, including the software licenses:

6 7. TITLE; PERSONAL PROPERTY: Except as otherwise provided in this Lease
7 or any Schedule hereto, title to the Equipment shall at all times remain in Lessor.
8 In the event that any of the Equipment is software governed by a software license,
9 Lessee shall keep said license current for the entire lease term and, to the extent
10 the license allows title to the software to pass to licensee, such title shall vest and
11 remain in Lessor. To the extent that such vesting requires a written conveyance
12 from Lessee, Lessee hereby conveys to Lessor any title it has or may hereafter
13 acquire in the software and foregoes any future claim to the software including
14 any right to purchase and/or use the software beyond the lease term except as
15 otherwise provided in this Lease or the related Schedule. If the software license
16 restricts any provision of this Lease without the licensor's consent, then Lessee
17 shall assist Lessor, if so requested, in obtaining such consent.

18 The Master Lease contains a "purchase or renewal" option, which may be
19 exercised at the end of the Base Term:

20 20. FAIR MARKET VALUE PURCHASE OR RENEWAL OPTION: Lessee
21 may purchase or renew this Lease for all but not less than all of the Equipment
22 subject to any Schedule as of the expiration of the Base Term or any Extension
23 Term at its then fair market value, as mutually agreed by Lessee and Lessor . . .
24 In the event Lessee and Lessor cannot agree on a fair market value, then the fair
25 market value shall be determined by the average appraisal of three appraisers . . .

26 The Schedules both modified the "purchase or renewal" option to fix a time for
27 giving notice of Debtor's election and a fair market value in the event of a purchase. The
28 Schedules each state:

Lessee has irrevocably elected to exercise its option to purchase or renew the
above referenced Lease with respect to the above referenced Schedule as of the
expiration of the Base Term of said Schedule at its then fair market value
("FMV"). At lease six months prior to the expiration of the Base Term, Lessee
shall provide Lessor with written notice of its decision to: (a) purchase the subject
Equipment; or (b) renew the Schedule. Lessee and Lessor hereby mutually agree
that: (I) if Lessee chooses (a), above, then the FMV purchase price shall be 36.8%
of the total Equipment cost, which cost includes all related disbursements made
by Lessor or its Assignee; and (ii) if Lessee chooses (b), above, then the FMV
renewal of the Schedule shall consist of a one year extension at the rental amount
in effect as of the last billing cycle of the Base Term. . . .

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1 The 2005 Extension confirms and restates the efficacy of the Master Lease:

2 8.1 Except as revised or amended or modified herein, all other terms and
3 conditions of the Lease and all other documents attached thereto or incorporated
4 therein remain fully enforceable and in effect and are incorporated herein and
shall remain fully enforceable and in effect and survive any default herein by the
Customer.

5 A recital in the 2005 Extension confirms Celtic's title to the Equipment: "The
6 property that is the subject of the Lease is owned by Celtic."²

7 The Debtor made the Lease payments to Celtic until April 2005, when the
8 payments stopped. On June 16, 2005, Debtor moved to reject the Lease with a pleading
9 entitled "Motion for Authority to Reject Unexpired Leases (Celtic Leasing Corp.)" (the
10 "Rejection Motion"). In the Rejection Motion, the Debtor repeatedly referred to the
11 subject agreement as a "lease." The Rejection Motion states the "Debtor is a party to
12 several unexpired leases, many of which relate to leased equipment, no longer needed in
13 Debtor's downsized operation." It ended by noting that "[t]he Debtor believes that the
14 subject unexpired leases should be rejected because they are costly to maintain and
15 continually upgrade, and are unnecessary given Debtor's current circumstances." The
16 Debtor prayed for the following relief:

17 court order authorizing it to reject the subject unexpired leases and, if granted,
18 that the claims resulting from the rejection be filed within sixty (60) days of
19 service of a copy of the order granting this Motion upon each claimant whose
lease is rejected, and seeks such other and further relief as is just and proper.

20 Leddon signed a declaration in support of the Rejection Motion. He declared that
21 he was "familiar with the unexpired leases" and that "[t]here are three (3) equipment
22 lease contracts sought to be rejected by [the Rejection Motion]." He further stated, "[i]n
23

24 ²Notably, the 2005 Extension also contained the following language regarding
25 the advice of its counsel:

26 9. ADVICE OF COUNSEL. The Customer [Waterman] acknowledges that it
27 has reviewed this Amendment in its entirety, having consulted such legal, tax or
28 other advisors as it deems appropriate and understands and agrees to each of the
provisions of this Amendment and further acknowledges that it that it has
entered into this Amendment voluntarily.

1 my business judgment, I assert that these leases are not economically feasible, confer no
2 benefit on the estate and should be rejected.” He based this on “over 15 years experience
3 in the financial management of distressed companies” and status as a “Certified
4 Insolvency and Restructuring Advisor (CIRA) and Certified Turnaround Professional
5 (CTP).”

6 The Rejection Motion was granted. Celtic submitted the form of order entitled
7 “Order Re Motion For Authority to Reject Unexpired Leases (Celtic Leasing Corp.),”
8 which was entered on July 8, 2005. That order specifically authorized the Debtor “to
9 reject the entire lease contracts [the Master Lease, Schedules, and Wells Fargo
10 Assignments]” and set a bar date for the filing of “[a]ny claim(s) resulting from the
11 rejection of the unexpired leases shall be filed within sixty (60) days of service of this
12 Order.”

13 On August 5, 2005 Celtic made a demand upon the Debtor for return of the
14 Equipment under the rejected Lease.³ Celtic also made a demand for the post-petition
15 payments due under the Lease, which were still in default. Celtic timely filed the Celtic
16 Claim on August 17, 2005. On August 23, 2005, Debtor filed an objection to the Celtic
17 Claim, but withdrew it two days later.

18 In November 2005, Debtor filed the contested matter now before the court
19 entitled “Objection to Administrative Expense Proof of Claim Number 335 (Celtic
20 Leasing Corporation)” (the “Claim Objection”). Celtic filed a counter-motion for
21 payment of the Celtic Claim as an administrative expense of the estate.

22 **Issue Presented**

23 The issue of whether Celtic is entitled to an administrative claim turns on whether
24

25 ³At the time of the oral argument in this matter, five months after entry of the
26 order granting the Rejection Motion, none of the Equipment had been returned to
27 Celtic. There appears to be a material dispute between the parties whether the Debtor
28 refused to tender the Equipment or Celtic refused to accept it. Celtic contends that the
software has not been removed from the Debtor’s computers and is still being used.
That issue will be addressed in a subsequent proceeding when the court determines the
amount of Celtic’s § 503(b) administrative claim.

1 the agreement between the parties constitutes a true lease or whether it amounts to a non-
2 lease agreement, such as a financing or security agreement, disguised as a lease. If the
3 agreement was a true lease, then Celtic has an administrative claim under 11 U.S.C. §§
4 365(d)(10) and 503(b) based on the Debtor's pre-rejection obligation under the Lease and
5 post-rejection possession and use of the Equipment. If the agreement is a financing and
6 security agreement, Celtic has an unsecured claim for a deficiency after liquidation of its
7 collateral.

8 **Analysis and Conclusions of Law**

9 **Applicable Law**

10 The Debtor's obligation to perform an unexpired personal property lease under §
11 365(d)(10)⁴ gives rise to an administrative claim regardless of whether the lease is
12 subsequently rejected, and regardless of whether use of the leased property benefitted the
13 estate. *See In re Pacific-Atlantic Trading Co.*, 27 F.3d 401, 403-05 (9th Cir. 1994)
14 (construing identical "trustee shall timely perform" language in § 365(d)(3) regarding an
15 unexpired lease of non-residential real property). *See also In re Rebel Rents, Inc.*, 291
16 B.R. 520, 533 (Bankr. C.D. Cal. 2003) (applying the analysis in *Pacific-Atlantic Trading*
17 *Co.* to a personal property lease under § 365(d)(10)).

18 Celtic has the burden of proving that it has an administrative claim based, *inter*
19 *alia*, on the Lease. *In re DAK Industries, Inc.*, 66 F.3d 1091, 1094 (9th Cir. 1995).
20 However, the burden is on Debtor to demonstrate by a preponderance of the evidence that
21 the Master Lease, the Schedules, and the 2005 Extension are not what they purport to be,
22 a true lease. *See In re Murray*, 191 B.R. 309, 316 (Bankr. E.D. Pa. 1996).

23
24 ⁴11 U.S.C. § 365(d)(10) sets forth the Debtor's duties under an unexpired
25 personal property lease:

26 (10) *The trustee shall timely perform all of the obligations of the debtor . . . first*
27 *arising from or after 60 days after the order for relief in a case under chapter 11 of this*
28 *title under an unexpired lease of personal property . . . until such lease is assumed or*
rejected notwithstanding section 503(b)(1) of this title, unless the court, after notice and
a hearing and based on the equities of the case, orders otherwise with respect to the
obligations or timely performance thereof. . . . (emphasis added.)

1 The issue of whether an agreement is a lease or a non-lease security agreement is
2 governed by state law. *In re Rebel Rents*, 291 B.R. at 525. Here, the Master Lease
3 contains the following choice of laws provision: “APPLICABLE LAW: This Lease shall
4 be construed in accordance with and shall be governed by the laws of the State of
5 California.” Therefore, the court will apply California law to determine the true nature of
6 the agreement. Because the applicable California statute, which defines the difference
7 between a security interest and a lease, Cal. Comm. Code § 1201(36) is based on
8 Uniform Commercial Code § 1-201(37), the court may also look to decisions from other
9 jurisdictions which interpret the U.C.C. *See In re Rebel Rents*, 291 B.R. at 526.

10 **California Commercial Code**

11 Cal. Comm. Code § 10103(a) defines a personal property lease as:

12 (10) “Lease” means a transfer of the right to possession and use of goods for a
13 term in return for consideration, but a sale, including a sale on approval or a sale
14 or return, or retention or creation of a security interest is not a lease. Unless the
context clearly indicates otherwise, the term includes a sublease.

15 Cal. Comm. Code § 1201(36)(b) delineates the distinction between a lease and a
16 security interest, in pertinent part, as follows:

17 (b) Whether a transaction creates a lease or security interest is determined by the
18 facts of each case. However, a transaction creates a security interest if the
19 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 any of the following conditions applies:

20 (i) The original term of the lease is equal to or greater than the remaining
21 economic life of the goods.

22 (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.

23 (iii) The lessee has an option to renew the lease for the remaining
24 economic life of the goods for no additional consideration or nominal
additional consideration upon compliance with the lease agreement.

25 (iv) The lessee has an option to become the owner of the goods for no
26 additional consideration or nominal additional consideration upon
compliance with the lease agreement.

27 (c) A transaction does not create a security interest merely because it provides one
28 or more of the following:

1 (i) That the present value of the consideration the lessee is obligated to
2 pay the lessor for the right to possession and use of the goods is
3 substantially equal to or greater than the fair market value of the goods at
4 the time the lease is entered into.

5 (ii) That the lessee assumes the risk of loss of the goods, or agrees to pay
6 the taxes, insurance, filing, recording, or registration fees, or service or
7 maintenance costs with respect to the goods.

8 (iii) That the lessee has an option to renew the lease or to become the
9 owner of the goods.

10 (iv) That the lessee has an option to renew the lease for a fixed rent that is
11 equal to or greater than the reasonably predictable fair market rent for the
12 use of the goods for the term of the renewal at the time the option is to be
13 performed.

14 (v) That the lessee has an option to become the owner of the goods for a
15 fixed price that is equal to or greater than the reasonably predictable fair
16 market value of the goods at the time the option is to be performed.

17 To show that Celtic's Lease is actually a security agreement, the Debtor must
18 establish that it has no right to voluntarily terminate the Lease and that one of the four
19 provisions identified in section 1201(36)(b)(i) through (iv) applies. This inquiry has been
20 referred to as the "Bright-Line Test." *In re Lerch*, 147 B.R. 455 (Bankr. C.D. Ill. 1992).

21 **The Terminability Factor**

22 The first prong of the Bright-Line Test focuses on whether the agreement is
23 subject to termination by the lessee, *i.e.*, whether the lessee is obligated to pay the entire
24 amount for the lease term without the right to terminate the lease early. If the
25 consideration the lessee must pay for the term of the lease is not subject to termination by
26 the lessee, then the transaction meets the first prong. *In re QDS Componets, Inc.*, 292
27 B.R. 313, 332 (Bankr. S.D. Ohio 2002). Here, paragraph 4 of the Master Lease
28 authorizes termination by the Debtor, but only at the end of the Base Term of the Master
Lease. The Schedules establish a new Base Term for the Schedules themselves, but they
did not modify the Master Lease to authorize an early termination. The 2005 Extension
extended the term of the Lease for an additional year without a right of early termination.
It appears that the Debtor's obligation to pay Celtic was not subject to early termination.
The court must therefore look at the Lease to see if any of the other factors under Cal.

1 Comm. Code § 1201(36)(b) apply.

2 **Residual Value Factors**

3 Subsections (i) through (iv) of § 1201(36)(b) are referred to as the Residual Value
4 Factors. *In re QDS Componets, Inc.*, 292 B.R. 313, 332 (Bankr. S.D. Ohio 2002). If the
5 lease is not subject to early termination, and one of these Residual Value Factors is
6 present, then the court’s inquiry ends and the transaction is deemed to have created a
7 security interest. *Id.* at 333.

8 With regard to subsection 1201(36)(b)(i), the original term of both Schedules 2
9 and 3 appears to be less than the remaining economic life of the Equipment. Both
10 Schedules state an original “Base Term” of 24 months, which would have expired in
11 November 2003. At the end of the Base Term, the Equipment had remaining economic
12 life as evidenced by the fact that the Debtor elected to extend the Lease and continued to
13 use the Equipment after the Base Term expired. The Debtor failed to establish that the
14 Base Term of the Lease is equal to or greater than the remaining economic life of the
15 Equipment. Therefore, the “economic life” factor embodied in Cal. Comm. Code
16 § 1201(36)(b)(i) is not present.

17 With regard to subsection 1201(36)(b)(ii), that factor is met when the lessee is
18 “bound,” meaning contractually obligated, to renew the Lease “for the remaining
19 economic life of the goods,” or is bound to become the owner of the goods. Stated
20 differently, the Lease must require the Debtor to either renew the Lease for the remaining
21 economic life of the Equipment, or to purchase the Equipment for the fair market value
22 agreed to in the Schedules, 36.8% of its original cost. The specific language in the Lease
23 is recited above.

24 The Debtor was not contractually obligated to renew the Lease for the remaining
25 economic life of the Equipment, or for any other term. The Debtor had an *option* to
26 purchase the Equipment or to renew the Lease for one year. There is no evidence to
27 suggest that a one-year extension amounts to “the remaining economic life of the goods.”
28 Similarly, the Debtor was not contractually obligated to become the owner of the

1 Equipment; again, that was an available option. Indeed, Leddon's Cover Letter to the
2 2005 Extension kept open the option to surrender the Equipment all together. It states
3 that at the end of the 2005 Extension, Debtor will "buyout the equipment . . . at fair
4 market value, or return it to the Lessor." Accordingly, the "bound to renew or become
5 the owner" factor embodied in § 1201(36)(b)(ii) is not present.

6 With regard to subsections 1201(36)(b)(iii) and (iv), the issue is whether the
7 "renew or own" options were valued at "nominal or no additional consideration." Under
8 the Master Lease, the "renewal option" was based upon the then "fair market value of the
9 Equipment" and "subject to the then prevailing interest rates, Lessee's credit standing,
10 and such other terms and conditions to be mutually agreed upon by Lessee and Lessor."
11 Under the Schedules, the "renewal option" was tied to "the rental amount in effect as of
12 the last billing cycle of the Base Term." Under the 2005 Extension, the Debtor did not
13 reserve the option to renew at all. Turning now to the "purchase option," under the
14 Master Lease, the "purchase option" was fixed at the Equipment's "fair market value" at
15 the expiration of the lease term. The Schedules both fix the purchase price at 36.8% of
16 the Equipment's total cost. Again, at no time were the "renew or own" options available
17 to the Debtor for "no additional consideration."

18 Therefore, the remaining issue is whether the "renew or own" options were
19 available to the Debtor for "nominal" consideration. Subsection 1201(36)(d)(i) of the
20 Cal. Comm. Code defines when consideration is and is not "nominal" within the meaning
21 of subsection 1201(36)(b):

22 Additional consideration is not nominal if (A) when the option to renew the lease
23 is granted to the lessee, the rent is stated to be the fair market rent for the use of
24 the goods for the term of the renewal determined at the time the option is to be
25 performed, or (B) when the option to become the owner of the goods is granted to
26 the lessee, the price is stated to be the fair market value of the goods determined
at the time the option is to be performed. Additional consideration is nominal if it
is less than the lessee's reasonably predictable cost of performing under the lease
agreement if the option is not exercised.

27 Here, under the Master Lease, the Debtor had the option to renew the lease at the
28 end of the Base Term, or any extended term, for "its then fair market value" to be

1 determined by agreement of the parties or by independent appraisers. This is in line with
2 what Cal. Comm. Code § 1201(36)(d)(i) defines as “*not nominal*” consideration. Under
3 the Schedules, the consideration required to renew was “the rental amount in effect as of
4 the last billing cycle of the Base Term.” Again, this is not “nominal.” The fact that the
5 “renewal” rental was fixed in the Schedules as the prior rental amount suggests that the
6 renewal option was for at least fair market value. The Debtor offered no evidence that
7 the consideration required to renew was “nominal.” Therefore, § 1201(36)(iii) is not met.

8 As for the “purchase option,” under the Master Lease and the 2005 Extension, the
9 Debtor was required to pay “fair market value” in order to purchase the Equipment. This
10 is not “nominal consideration.” Under the Schedules, the consideration for the purchase
11 option was fixed at “36.8% of the total Equipment cost, which cost includes all related
12 disbursements made by Lessor or its Assignee.” Again, this “fixed” price is not nominal
13 under § 1201(36)(d)(i).

14 In 1990, the Cal. Comm. Code § 1201 was amended to conform to revisions made
15 by the drafters of the Uniform Commercial Code to § 1-201. *In re QDS Components,*
16 *Inc.*, 292 B.R. 313, 330 (Bankr. S.D. Ohio 2002) (applying California law). The 1990
17 amendment eliminated any reference to a percentage test for nominality. *See In re*
18 *Charles*, 278 B.R. 216, 224 (Bankr. D. Kan. 2002) (holding that the enactment of new
19 U.C.C. § 1-201(37), which disavows percentage tests, supersedes the authorities applying
20 the percentage tests (quoting White & Summers, U.C.C. § 30-3, 4 ed. 1995 &
21 Supp.2001)); *In re Beckham*, 275 B.R. 598, 604 (D. Kan. 2002) (concluding that Tenth
22 Circuit authority endorsing a bright-line rule that option prices of less than 25% of the
23 original equipment cost are per se nominal “has been superceded by the amendments to
24 [§ 1-201(37)]”).

25 Moreover, even if the percentage test had survived the enactment of U.C.C. §
26 1-201(37), courts and commentators have pointed out that such tests are not a reliable
27 indicator of nominality. *See In re APB Online, Inc.*, 259 B.R. 812, 819-20 (Bankr.
28 S.D.N.Y. 2001) (rejecting percentage tests because they are “the crudest proxies for the

1 correct calculation”(quoting 4 White & Summers, U.C.C. § 30-3 at 20)).

2 In this case, the court is persuaded that 36.8% of the Equipment cost is “not
3 nominal.” The Debtor presented no evidence on this point. Therefore, § 1201(36)(iv) is
4 not met. As a result, the Bright Line Test has not been satisfied. The Celtic Lease
5 appears from its terms to be a true lease.

6 **The Economic Realities of the Transaction**

7 Finally, after determining that the “Bright Line Test” has not been satisfied, the
8 court must examine the “economic realities” of the transaction. *In re QDS Components*,
9 292 B.R. at 333 (citing *In re Triplex Marine Maintenance, Inc.*, 258 B.R. 659, 669
10 (Bankr. E.D. Tex. 2000)). The key issue in this inquiry is whether the lessor retains a
11 meaningful residual interest at the end of the lease term. *Id.* If there is a meaningful
12 reversionary interest for the lessor--either an up-side right or a down-side risk--the parties
13 have entered into a lease, not a security agreement. If there is no reversionary interest, the
14 parties have entered into a security agreement. *In re QDS Components*, 292 B.R. at 333
15 (quoting White & Summers, § 30-3 at 30).

16 Under California law, in determining whether the lessor retained a meaningful
17 reversionary interest, the court considers two factors: (1) whether the purchase option
18 price is nominal; and (2) whether the agreement contains any provision for the lessee’s
19 acquisition of equity in the subject property. *Addison v. Burnett*, 41 Cal. App. 4th 1288,
20 1296 (1996). The *Addison* court looked to the bankruptcy court’s decision in *In re*
21 *Zaleha*, 159 B.R. 581, 585 (Bankr. D.C. Idaho 1993) for an explanation of the “economic
22 realities” test:

23 If a lease contains an option to purchase for no or nominal consideration . . . it
24 suggests that the lessor does not care, in an economic sense, whether or not the
25 option is exercised. If the lessee develops equity in the leased property such that
the only sensible decision economically for the lessee is to exercise the option . . .
it suggests the lessor did not expect the return of leased goods.

26 Here, Application of the *Addison* factors leads to a determination that Celtic
27 retained a meaningful reversionary interest in the Equipment. As elucidated above, the
28 purchase option price was not “nominal.” Nothing in the Master Lease, the Schedules, or

1 the 2005 Extension created an equity interest for the Debtor in the Equipment. Indeed,
2 the Debtor expressly reserved the right to purchase the Equipment or surrender it at the
3 end of the 2005 Extension, which suggests that the Debtor had no expectation of
4 acquiring an equity interest, or owning the Equipment, without paying for it at fair
5 market value. Therefore, the *Addison* factors are absent: Celtic did retain a meaningful
6 residual, or reversionary interest in the Equipment.

7 The Debtor argues that the Master Lease is a finance/security agreement because
8 the Equipment was obtained from a third-party supplier; stated differently, because Celtic
9 did not manufacture the Equipment. This fact is not conclusive of the issue because
10 Celtic retained a “meaningful reversionary interest” in the Equipment. *See, e.g., In re*
11 *Edison Bros. Stores, Inc.*, 207 B.R. 801, 821 (Bankr. D.Del. 1997). (“[T]he fact that the
12 role of the lessor is that of a financier is inconclusive to show that a disguised secured
13 transaction was intended because this kind of three party transaction is typical in true
14 lease[s] as well as in installment sales.”).

15 Galena argues that it has a security interest in the Equipment that is senior to that
16 of Celtic. It points to the fact that Galena has a financing statement which was filed
17 earlier in time than Celtic’s financing statement. However, Galena’s argument begs the
18 question of whether the Master Lease constituted a true lease. The filing of a financing
19 statement by a lessor is not determinative of true lease status. *See, e.g., In re Owen*, 221
20 B.R. 56, 62 (Bankr. N.D.N.Y. 1998). (“The fact that [the lessor] filed financing
21 statements . . . [does not establish a disguised security agreement]. Rather, . . . the filing
22 of the financing statement was the result of an abundance of caution to assure that [the
23 lessor's] rights were protected.”)

24 Debtor contends that Celtic simply financed the Debtor’s purchase of the
25 Equipment. Debtor argues that Celtic never owned the Equipment and was not the
26 licensee of the software. However, a financing agreement can be in the form of a true
27 lease, the two concepts are not mutually exclusive. Under Cal. Comm. Code § 10103(7),
28 a “finance lease” is a true lease if certain elements are met; namely, (1) the lessor does

1 not manufacture or supply the goods, (2) the lessor acquires the goods or the right to
2 possession and use of the goods in connection with the lease, and (3) the right to
3 possession and use of the goods is a condition to the effectiveness of the lease contract.
4 All of these elements exist with regard to the Lease. Celtic did not manufacture or
5 supply the Equipment. The Debtor had the right to “quiet enjoyment” possession and use
6 of the Equipment only during the term of the Lease. By the terms of the Lease, Celtic
7 owned the Equipment at all times, which gave it the right to possession and use of the
8 goods upon expiration of the Lease if the Debtor did not exercise the purchase option.
9 Add to this the “economic realities” analysis based on the absence of the two *Addison*
10 factors above, and the Debtor’s argument fails.

11 The Debtor further argues that Celtic never owned the Equipment. However, the
12 Debtor’s argument is inconsistent with the express language in the Master Lease and the
13 2005 Extension, both of which the Debtor signed. The Master Lease states, “Except as
14 otherwise provided in this Lease or any Schedule hereto, title to the Equipment shall at
15 all times remain in Lessor.” The 2005 Extension states, “The property that is the subject
16 of the Lease is owned by Celtic.” In the 2005 Extension, the Debtor also reserved the
17 right to surrender the Equipment back to Celtic. Based on the plain language in these
18 documents, the Debtor is not in a position to argue now that Celtic was not the owner of
19 the Equipment, or that the Debtor ever intended to own the Equipment. The Debtor
20 offers no evidence that it ever treated the Equipment as its own. For example, there is no
21 evidence as to how the Debtor treated the Equipment for tax reporting purposes, *i.e.*, did
22 it deduct the Lease payments as a business expense or depreciate the Equipment
23 according to an approved depreciation schedule?

24 In Leddon’s declaration, he states that he “believed” that Celtic never owned the
25 Equipment. Leddon’s declaration is disingenuous and unworthy of any weight. There is
26 no evidence that Leddon, as the Debtor’s “Chief Restructuring Officer,” was even around
27 in 1996 and 2001 when the Debtor signed the Master Lease and the Schedules
28 respectively, so he had no personal knowledge of what the Debtor intended the

1 documents to mean. Further, Leddon's self-serving and opportunistic statement starkly
2 contradicts all of the documents which he actually signed and filed with the court during
3 the course of this case. Finally, his declaration of "belief" is largely irrelevant under §
4 1201(36), as the Official Comment to the U.C.C. states:

5 Reference to the intent of the parties to create a lease or security interest has led
6 to unfortunate results. In discovering intent, courts have relied upon factors that
7 were thought to be more consistent with sales or loans than leases. Most of these
8 criteria, however, are as applicable to true leases as to security interests.
9 Examples include the typical net lease provisions, a purported lessor's lack of
10 storage facilities or its character as a financing party rather than a dealer in goods.
11 *Accordingly, amended [U.C.C.] Section 1-201(37) deletes all reference to the*
12 *parties' intent.* (emphasis added.)

13 Cal. Comm. Code § 1201(36) cmt. Uniform Commercial Code.

14 Galena and the Committee both argue that the Lease may be a "sham"
15 transaction. Galena and the Committee disregard the fact that the Debtor bears the burden
16 of proof on that allegation. The Debtor certainly did not treat the Lease as a "sham"
17 before its chapter 11 plan got confirmed and before Celtic started pushing for payment of
18 an administrative claim. The court cannot even consider this argument without
19 admissible evidence. The Master Lease, the Schedules, and the 2005 Extension are clear
20 and unambiguous, and all the parties to these agreements were sophisticated. This court
21 will honor the plain language of the contract in the absence of a reason to do otherwise.
22 *See Sharon Steel Corporation v. Chase Manhattan Bank, N.A.*, 691 F.2d. 1039, 1048
23 (2nd Cir. 1982).

24 Finally, the court notes that the Debtor has repeatedly referred to the Lease as a
25 "lease" in all of its pleadings throughout the course of this bankruptcy case. For
26 example, in the Rejection Motion, the Debtor referred to and treated the Lease as a
27 "lease." In addition, the Wells Fargo Assignments were replete with references to the
28 term "lease." The Debtor's sudden and opportunistic change of position now, after the
chapter 11 plan has been confirmed, and the time has come to actually pay the
administrative claims, does not pass the proverbial "smell test."

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1 **Calculation of the Administrative Expense Claim**

2 The full amount of Celtic’s administrative claim remains unliquidated, but some
3 of it can be allowed and paid immediately. There are three distinct components to
4 Celtic’s Claim. First, Celtic argues that it is entitled to receive the post-petition lease
5 payments that came due during the pre-rejection period from April 2005 through July
6 2005 pursuant to § 365(d)(10) (“Pre-Rejection Payments”). The court agrees with Celtic
7 on the first point. Celtic is entitled to receive the Pre-Rejection Payments at the amount
8 stated in the Lease. The plain language of § 365(d)(10) required the Debtor to timely pay
9 the rent due until the Lease “from or after 60 days after the order for relief” until the
10 Lease was rejected. The Debtor stopped making the Lease payments after expiration of
11 60 days and Celtic is not claiming any payments during that period. Construing virtually
12 identical language in § 365(d)(3), the Ninth Circuit stated in *In re Pacific-Atlantic*
13 *Trading Co.*, 27 F.3d at 404:

14 By providing for timely performance of *all* lease obligations, “notwithstanding
15 section 503(b)(1),” the statute has already granted priority payment status to the
16 full amount of rent due The fact that a trustee does not comply with this
17 directive before the lease is rejected cannot justify denying a lessor the priority
18 treatment for the full amount which Congress has already bestowed upon it.
19 (emphasis original.)

20 Second, Celtic argues that the 2005 Extension created an independent
21 administrative liability for the full term of the extension and that Celtic is therefore
22 entitled to receive post-rejection lease payments for the remainder of the 2005 Extension;
23 for the period from August 2005 through to April 2006 (“Post-Rejection Claim”). Here,
24 the court disagrees in part with Celtic. The “extended” Lease was never formally
25 assumed pursuant to § 365(a), so the full “extended” term of the Lease did not become an
26 administrative liability. The 2005 Extension extended the term of the Lease, but it did
27 not cut off the Debtor’s right to reject the Lease during that term. Celtic is entitled to an
28 administrative claim under § 503(b) measured by the “actual and necessary” value to the
29 estate of the Debtor’s hold-over possession and use of the Equipment. This amount is
30 presumed to be the amount stated on the face of the Lease, but this presumption is

1 rebuttable upon a showing that the actual use value of the Equipment was demonstrably
2 less. *In re Trak Auto Corp.*, 277 B.R. 655, 667 (Bankr. E.D. Va. 2002)). Accordingly,
3 the value of the Post-Rejection Claim is a question of fact and will require discovery and
4 additional evidence.

5 Third, Celtic argues that it is entitled to recover the value of the Equipment on the
6 theory that the Equipment was converted post-rejection (“Conversion Claim”). The court
7 does not have enough evidence to determine whether a conversion of the Equipment has
8 actually occurred, when it occurred, or what the damages should be. The Conversion
9 Claim, if any, may or may not be entitled to administrative priority depending, *inter alia*,
10 on if and when the alleged conversion actually occurred. *See In re National Refractories*
11 *& Minerals Corp.*, 297 B.R. 614, 619 (Bankr. N.D. Cal. 2003) (landlord’s administrative
12 claim for real property damage depends on when the damage occurred). Again, that issue
13 will require discovery and an evidentiary hearing.

14 **Conclusion**

15 Based on the foregoing, the Court finds and concludes that the Master Lease
16 Agreement and related documents constitute a true lease. Accordingly, the Motion by
17 Celtic Leasing for Payment of Administrative Claim will be granted to the extent Celtic
18 seeks allowance and payment of the Pre-Rejection Payments. Celtic’s Post-Rejection
19 Claim is entitled to administrative priority under § 503(b) in an amount to be determined
20 in a future evidentiary hearing. Likewise, Celtic’s alleged Conversion Claim will require
21 an evidentiary hearing. The Debtor’s Objection to Administrative Expense Proof of
22 Claim No. 335 will be denied to the extent the Debtor wants all of Celtic’s Claim
23 disallowed, or classified as an unsecured non-priority claim. By separate order, this
24 matter will be set for further briefing and hearing with regard to liquidation of Celtic’s
25 Post-Rejection Claim and allowance of the Conversion Claim.

26 DATED: May 17, 2006

27 /s/ W. Richard Lee
28 W. Richard Lee
United States Bankruptcy Judge