How Secured Are Secured Creditors? The Changing Landscape of Chapter 11 Plan Confirmation

Stephen D. Lerner, Moderator
Squire Patton Boggs; Cincinnati

Colin McNeil Adams
Morgan Stanley & Co., Inc.; New York

Hon. Shelley C. Chapman
U.S. Bankruptcy Court (S.D.N.Y); New York

Jeff J. Marwil
Proskauer; Chicago

John Tittle, Jr.
Tittle Advisory Group, Inc.; Irving, Texas

SQUIRE PATTON BOGGS

Unitranche Facilities: Bankruptcy Implications

2015 ABI Spring Meeting

Stephen D. Lerner
Chair, Restructuring & Insolvency Practice Group
stephen.lerner@squirepb.com

April 17, 2015

Bankruptcy Implications

SQUIRE PATTON BOGGS

- This presentation is focused on bankruptcy issues relating to unitranche financing structures.
  - Agreement Among Lenders ("AAL")
  - Credit Agreement ("CA") Structures
- There are no market-standard terms for treatment of bankruptcy issues in an AAL.
  - Most such issues, however, can be addressed and, perhaps resolved, through negotiated terms in the AAL.
- Unitranche facilities and the relationships between the lenders and debtors remain untested in the bankruptcy context – there are no reported decisions.
  - Inter-lender disputes over the terms of the AAL are not likely to be heard by the bankruptcy court because the debtor is not a party to the AAL.
  - Disputes, however, concerning the debtor-lender relationship most likely will be heard by the bankruptcy court.

squirepattonboggs.com

Basic Characteristics of Unitranche Facilities

SQUIRE PATTON BOGGS

- A single credit facility with one loan secured by a single lien on all collateral
- Two tranches of debt: first out and last out.
- From borrower's perspective it is a single loan with no portion of the debt subordinated to another portion of the debt.
- The "intercreditor relationship" between the first out lender and last out lender is governed by an Agreement Among Lenders (AAL) to which only the lenders (but not the borrower) are party (the borrower often does not see the AAL).
- AAL is highly negotiated and there is no market standard
- Lien and payment subordination in first lien – second lien deals is replaced by an AAL waterfall that regulates priority of payments and proceeds of collateral before and after specific triggering events.
- Voting rights are especially important

squirepattonboggs.com

Potential Bankruptcy Issues

SQUIRE PATTON BOGGS

- Classification of Claims
- Adequate Protection
- Post-Petition Interest and Fees
- Relief from Automatic Stay
- Asset Sales
- Credit Bidding
- DIP Financing

squirepattonboggs.com

Classification of Claims

SQUIRE PATTON BOGGS

- The Bankruptcy Code requires that only substantially similar claims may be classified together for plan purposes.
  - It does not require that they be classified together.
  - If claims are dissimilar, they may be required to be classified separately.
    - For example, the secured and unsecured portions of a credit facility would be placed in separate classes.
- AAL can account for separate classification of claims by agreement that, regardless of classification, any recovery on the claims against the debtor should be applied by the lenders in accordance with the waterfall.
- For a class of claims to approve a plan of reorganization a majority of the holders of the claims and two-thirds in the amount of the claims in the class, in each case that vote, must vote in favor of the plan.
- In a cram-down plan, an impaired (less than 100% recovery) class of claims must approve the plan.
  - This may or may not be a class of lender claims.

squirepattonboggs.com

Classification of Claims

SQUIRE PATTON BOGGS

- In the absence of another impaired accepting class, there is significant leverage in favor of the Last-Out Lenders to vote their deficiency claim in favor of a plan even if it is disfavored by the First-Out Lenders.
- To have a blocking position, the First-Out Lenders would have to have at least 34% of the amount of the claims in the class.
- The AAL may govern how lenders vote but it can be difficult to forecast potential scenarios.
  - For example: if the First-Out Lenders are fully secured and there is meaningful value remaining for the Last-Out Lenders and the value of the collateral is not quickly diminishing, the First-Out Lenders should not be able to force a quick sale that protects only their interests.
  - For example: if the First-Out Lenders are impaired or are just barely over-secured, and there is a concern that the value of the collateral is diminishing, the Last-Out Lenders do not have any interest to protect and merely have hold-up value.

squirepattonboggs.com

Adequate Protection

SQUIRE PATTON BOGGS

- Adequate protection becomes an issue when the facility as a whole is under-secured in a bankruptcy, allowing an otherwise fully-secured First-Out Lender to collect adequate protection payments.
- Typically, when a lender is under-secured, it will be entitled to adequate protection payments for the debtor's use of the collateral. If the First-Out and Last-Out loans are considered separate classes of debt, then the First-Out Lender may be considered over-secured and may not qualify for adequate protection payments.
- Adequate protection can be addressed in the AAL but treatment will be subject to bankruptcy court discretion.
- The bankruptcy court will likely not permit the debtor to treat the First-Out and Last-Out debt separately for adequate protection but together to avoid the payment of post-petition interest and fees.

squirepattonboggs.com

Post-Petition Interest and Fees

SQUIRE PATTON BOGGS

- Facility as a whole may be under-secured in a bankruptcy, leaving an otherwise fully-secured First-Out Lender with risk of non-payment of post-default interest and expenses.
  - However, AAL may contract around the problem through payment waterfall.
- While the issue of post-petition interest in the unitranche setting is untested, courts have issued rulings on post-petition interest involving different classes of debt that are analogous.
- *In re Ionosphere Clubs, Inc.*
  - Case involved three classes of equipment trust certificates, with the A certificates being first out, then the B, and finally the C certificates were last out.
  - The value of the collateral was sufficient to cover the A certificates but not the A and B certificates.
  - Court held that no post-petition interest was allowable because the debt that was secured exceeded the value of the collateral.
  - *Ionosphere* turns on whether the indenture and the subordination agreement specifically account for post-petition interest. There it did not, or was at least ambiguous and therefore did not satisfy the rule of explicitness.

squirepattonboggs.com

Post-Petition Interest and Fees

SQUIRE PATTON BOGGS

- AAL may provide that First-Out Lenders get most of the benefit of post-petition interest and fees via the waterfall provisions thereby protecting against risk of Court not awarding post-petition interest.
  - Should satisfy the Rule of Explicitness and be sure the AAL specifically discusses how to handle post-petition interest
  - Each dollar paid to the First-Out Lenders is a dollar that the Last-Out Lenders cannot ever recover.
  - Limitations are negotiated in some transactions relative to disallowed default interest.
- It is possible to address matters of post-petition interest and fees in the AAL to make First-Out Lenders whole economically, as if they collected post-petition interest and fees.
  - Note that even though First-Out Lenders may receive amounts equal to post-petition interest and fees, the debtor will not be paying such amounts; rather, they will effectively come out of Last-Out Lenders' recovery.

squirepattonboggs.com

Relief from the Automatic Stay

SQUIRE PATTON BOGGS

- In most AALs, the Last-Out Lenders agree not to object to relief from the automatic stay by the First-Out Lenders, so long as the First-Out Lenders do not seek such relief within the bankruptcy sale standstill period discussed above.
- The Last-Out Lenders also separately agree not to seek relief from the bankruptcy stay during a period of 60 to 150 days from the initial date of the bankruptcy.
- Stay relief implicates adequate protection and valuation issues.

squirepattonboggs.com

Asset Sales and Debtor-in-Possession Financing

SQUIRE PATTON BOGGS

- To date, Lenders have not typically addressed matters of asset sales and debtor-in-possession ("DIP") financing with specificity in the AAL.
  - For example, Section 5 of the shell AAL we distributed references asset sales and DIP financing but essentially just reserves the lenders' rights and requires that the First-Out Lenders and the Last-Out Lenders will "agree to agree" at a later time with regard to these and other bankruptcy/insolvency matters.
- Lenders are, however, beginning to incorporate greater specificity into the AAL—resembling the traditional first lien/second lien model.
- The following slides outline certain provisions of these more specific AALs with regard to asset sales, credit bidding and DIP financing.

squirepattonboggs.com

Bankruptcy Asset Sales

SQUIRE PATTON BOGGS

- AAL typically provides that the lenders' consent to a sale of the borrower's assets in bankruptcy must be unanimous.
- If the lenders cannot agree to a bankruptcy sale, then AAL could provide that the First-Out Lenders may act unilaterally so long as it preserves the Last-Out Lenders' rights in the collateral.
- The Last-Out Lenders typically will have the right to consent or object as a secured creditor to any sale or other disposition of the collateral during a predefined period (usually at least the length of the First-Out Lenders' standstill and in some cases up to 60 or 120 days after the commencement of the insolvency proceeding).
  - The First-Out Lenders' general remedies standstill period is distinct from this separate bankruptcy standstill/consent period.
  - If the First-Out Lenders are subject to only one standstill period, in most cases, such standstill period will have lapsed prior to the bankruptcy filing.

squirepattonboggs.com

Bankruptcy Asset Sales

SQUIRE PATTON BOGGS

- Execution risk for a potential sale under Section 363 of the Bankruptcy Code exists during the period in which (i) the Last-Out Lenders may object to a proposed sale by the First-Out Lenders or (ii) the First-Out Lenders may not pursue a sale without consent of the Last-Out Lenders.
- Note that under the Bankruptcy Code, the Court may authorize a sale under Section 363 without the consent of the lenders under a certain circumstances.

squirepattonboggs.com

Credit Bidding

SQUIRE PATTON BOGGS

- An AAL may also address the respective rights of the First-Out Lenders and the Last-Out Lenders to credit bid their claims.
  - If the First-Out Lenders credit bid, the Last-Out Lenders are entitled to receive only an offset of their obligations against the purchase price for the assets after the First-Out Lenders are paid in full.
  - The First-Out Lenders' bid is not required to satisfy all of the Last-Out Lender obligations.
  - By comparison, the Last-Out Lenders cannot credit bid their claims if the claims of the First-Out Lenders are not satisfied in full, in cash.

squirepattonboggs.com

Debtor-in-Possession Financing

SQUIRE PATTON BOGGS

- Most AALs permit First-Out Lenders to consent to use of cash collateral and to provide DIP Financing (a "Conforming DIP") satisfying each of the following criteria.*
  - the Agent retains a lien on the collateral to secure the Last-Out Lender obligations;
  - the Agent receives a replacement lien to secure Last-Out Lender obligations on post-petition assets to the same extent granted to the debtor-in-possession lender with respect to the DIP Financing;
  - the DIP Financing is commercially reasonable;
  - the DIP Financing does not (A) compel the borrower to seek confirmation of a specific plan of reorganization or (B) require the liquidation of the collateral;
  - the DIP Financing is subject to a cap on the aggregate amount thereof; and
  - the terms of the DIP Financing are otherwise consistent with the terms of the AAL.

* Subject to specific negotiation

squirepattonboggs.com

Debtor-in-Possession Financing

SQUIRE PATTON BOGGS

- Most AALs permit the First-Out Lenders to provide DIP Financing that does not satisfy the requirements of a Conforming DIP, so long as the Last-Out Lenders enjoy the right to (x) object to such "Non-Conforming DIP" and/or (y) participate in such "Non-Conforming DIP." The right of Last-Out Lenders to object raises adequate protection and other issues.
- The Last-Out Lenders may argue for the right to participate equally with the First-Out Lenders in any DIP Financing or propose and/or provide DIP Financing so long as such DIP Financing does not prime the First-Out Lenders.
- Despite use of AALs in transactions, the enforceability of AAL provisions relating to voting and other rights in a bankruptcy context is untested.
- Roll-up is likely not possible, unless First-Out Lenders and Last-Out Lenders all provide DIP financing.

squirepattonboggs.com

3/2/15

SQUIRE
PATTON BOGGS

Contact:

Stephen D. Lerner
Chair, Restructuring & Insolvency
Practice Group
Cincinnati and New York
513.361.1220
stephen.lerner@squirepb.com
www.squirepattonboggs.com

9

HOW SECURED ARE SECURED CREDITORS? THE CHANGING LANDSCAPE OF SECURED CREDITORS AND CHAPTER 11 PLAN CONFIRMATION

Lease Recharacterization in Energy Cases

33rd Annual American Bankruptcy Institute Annual Spring Meeting

John Tittle, Jr., CPA/CFF/CGMA, CTP, CIRA, CDBV
Tittle Advisory Group, Inc.
New York and Dallas

A. Introduction

With the recent plunge in the price of oil as depicted in Figure 1 below, news accounts have begun to paint somewhat of a gloomy picture for the oil and gas business.

Figure 1-End of day Commodity Futures Price Quotes for Crude Oil WTI (NYMEX)[1]

To understand the impact that this price plunge has had on the "oil patch," Figure 2 hereinbelow reflects the latest rig counts as of February 19, 2015:

[1] http://www.nasdaq.com/markets/crude-oil.aspx?timeframe=6m.

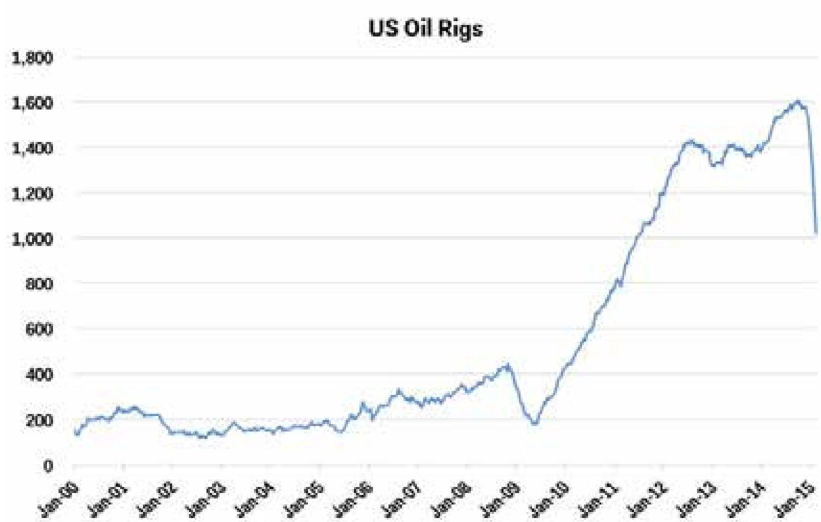

Figure 1 -US oil rig count falls to lowest since July 2011[2]

Obviously these event could signal an upcoming restructuring wave in the oil and gas business. In discussing the latest trends impacting secured creditors, including those who seek to be treated as secured creditors in Chapter 11 cases, the issue of lease recharacterization may become more prevalent in oil and gas bankruptcies and, potentially, in energy industry cases in general. To discuss the lease recharacterization issue in energy industry bankruptcies,[3] from the role of the financial advisor/expert witness, this paper presents an example based upon the author's analyses as per the legal framework as provided by counsel in the following matter: *Ecco Drilling Company, Ltd.'s Motion to Determine Characterization of Leases.*[4]

---

2 http://finance.yahoo.com/news/comes-baker-hughes-rig-count-174034270.html.

3 The author's experience in lease recharacterization matters in energy cases also includes *In re: Mirant Corporation, et al.*, Chapter 11 Case No. 03-46590 and Adversary Case No. 04-4283 (N.D. Tex., Judge Dennis Michael Lynn).

4 *In re: Ecco Drilling Company, Ltd.,* Chapter 11 Case No. 07-60987 (E.D. Tex., Judge Bill Parker) (hereinafter referred to as "*Ecco Drilling*").

B. *Ecco Drilling*

Background[5]

In *Ecco Drilling*, the debtor (the "Lessee") filed a Motion to Determine Characterization of Leases in which it sought a determination that its agreements executed in 2006 with Bernard National Loan Investors, Ltd. ("Lessor"), a subsidiary of D.B. Zwirn Special Opportunities Fund, L.P. ("Zwirn"), were not finance leases, but were rather disguised secured transactions. These agreements involved $42.3 million of funds utilized to construct two drilling rigs and purchase three others (collectively, the "Equipment") and included an Amended and Restated Master Lease Agreement and Master Lease Agreement (collectively, the "Background Documents"). Per the instructions of counsel, the task as the expert was to review the Background Documents to determine the substance of the underlying transactions relative to the tests (the "Tests") outlined and contained in Section 1–201(37) of New York's Uniform Commercial Code ("Section 1-201(37)")[6] and Statement of Financial Accounting Standards No. 13, as amended ("FASB No. 13").[7] In addition, counsel directed that the following case law be used as the legal framework to follow in performing the Tests:

- *In re: Triplex Marine Maintenance, Inc., Debtor – Bankruptcy Case No. 99-11858, Chapter 7 (BP);*

- *In re: Worldcom, Inc., et al., Debtors, Worldcom, Inc. and MCI Worldcom Network Services, Inc., Plaintiffs, v. General Electric Global Asset Management*

[5] Taken in part from *in re Ecco Drilling Co., Ltd.*, 390 B.R. 221, 221-224 (Bankr. E.D. Tex. 2008).

[6] The Background Documents and related information were to be construed pursuant to New York Law. As to the question of state law, this was assumed by the expert and is beyond the scope of a financial expert and this paper.

[7] Certain changes to FASB No. 13 have been proposed in various authoritative literature with regard to the accounting treatment of leases. These changes are not in effect as yet, may not ever be adopted by the appropriate governing bodies, and are beyond the scope of this document.

Services, Defendant – Chapter 11, Case No. 02-13533 (AJG), (Jointly Administered), Adv. Pro. No. 03-92903, (AJG); and

- *In re: Pillowtex, Inc. et al. – Duke Royal, Appellant v. Pillowtex Corporation, Appellee Adversary Proceeding 02-2674*.

<u>*Review of Authoritative Literature*</u>

Based in part by the direction of counsel as noted hereinabove, the following sources were reviewed to provide guidance on the Transactions. These were:

- **Section 1–201(37),** which provides:
  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.

- **FASB No. 13,** which states that a lease is to be classified as a capitalized lease if it meets one or more of the following criteria (paragraph 7):
  a. The lease transfers ownership of the property to the lessee by the end of the lease term (as defined in paragraph 5(f)).

b. The lease contains a bargain purchase option (as defined in paragraph 5(d)).[8]
c. The lease term (as defined in paragraph 5(f)) is equal to 75 percent or more of the estimated economic life of the leased property (as defined in paragraph 5(g)). However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease.
d. The present value at the beginning of the lease term of the minimum lease payments (as defined in paragraph 5(j)), excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon, equals or exceeds 90 percent of the excess of the fair value of the leased property (as defined in paragraph 5(c)) to the lessor at the inception of the lease over any related investment tax credit retained by the lessor and expected to be realized by him. However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease. A lessor shall compute the present value of the minimum lease payments using the interest rate implicit in the lease (as defined in paragraph 5(k)).[9] A lessee shall compute the present value of the minimum lease payments using his incremental borrowing rate (as defined in paragraph 5(1)), unless (i) it is practicable for him to learn the implicit rate computed by the lessor and (ii) the implicit rate computed by the lessor is less than the lessee's incremental borrowing rate. If both of those conditions are met, the lessee shall use the implicit rate.

[8] FASB No. 13, paragraph 5(d), states, "A bargain purchase option is a provision allowing the lessee, at his option, to purchase the leased property for a price which is sufficiently lower than the expected fair value of the property at the date of the option becomes exercisable that exercise of the option appears, at the inception of the lease, to be reasonably assured" (the "Bargain Purchase Option").

[9] According to FASB No. 13, paragraph 5(k), the interest rate implicit in the lease is the discount rate that, when applied to (i) the minimum lease payments…and (ii) the unguaranteed residual value accruing to the benefit of the lessor, causes the aggregate present value at the beginning of the lease term to be equal to the fair value of the leased property to the lessor at the inception of the lease…" (the "Implicit Discount Rate").

Work Performed

The document review included certain Leases, referred to as "No. 60104" and No. 60104A," and the related agreements including: (i) Amended and Restated Equipment Lease Schedule No. 1 to Amended and Restated Master Equipment Lease No. 60104 Dated as of November 10, 2006 Between Bernard National Loan Investors, Ltd. and Ecco Drilling Company, Ltd. ("Schedule 1"); (ii) Equipment Lease Schedule No. 1 to Master Equipment Lease No. 60104A Dated as of November 10, 2006 Between Bernard National Loan Investors, Ltd. and Ecco Drilling Company, Ltd. ("Schedule 1A"); (iii) Warrant to Purchase Units of Ecco Drilling Company, Ltd.; and (iv) Warrant Agreement Dated as of November 10, 2006 (together with Leases 60104 and 60104A as defined hereinabove, collectively, the "Transactional Documents").

Based upon the review of the Background Documents and the Transactional Documents, provided below are the pertinent portions of the Transactional Documents relative to making the necessary calculations and applying the Tests:

- The Transactional Documents very clearly provide, "It is expressly understood that the Equipment is, and shall at all times remain, personal property of Lessor."[10]
- The Lessee shall pay the Monthly Rent and cannot terminate the leases until the end of the Initial Term. [11,12]
- Upon expiration of the leases, the Equipment is to be returned to the Lessor.[13]
- The cost of the Equipment at the Commencement Date is $25.2 and $17.1 million under Leases 60104 and 60104A, respectively (the "Equipment Cost").[14]

---

10 Leases 60104 and 60104A, paragraph 1.2

11 Leases 60104 and 60104A, paragraphs 2.1, 2.2, and 10.2

12 Schedules 1 and 1A, Section II-G provide for a prepayment purchase option. The economics appear to be very similar to paying the Monthly Rent (on a present value basis) and then exercising the Purchase Option.

13 Leases 60104 and 60104A, paragraph 13

14 Schedule 1A, Annex I. The amount used for Schedule 1 is per counsel.

- Monthly Rent is $699,758.53 and $467,858.98 under Leases 60104 and 60104A, respectively.[15]
- The Basic Term is 48 months, with a Commencement Date of February 1, 2007.[16]
- The Lessor shall have the right, upon expiration of the Initial Term, to purchase all of the Equipment for an amount equal to 15% of the greater of (i) value of such Equipment; and (ii) 100% of the going concern value of Lessee determined by a third party appraiser (the "Purchase Option").[17]

Relative to the issue as to whether the Purchase Option was nominal, the evaluation began with the deposition testimony of one of the principals in that he had testified that they had used a 7.0x to 9.0x EBITDA multiple to project the value of the Lessee in their diligence prior to the transactions. The validation of EBITDA multiples began with the review and analysis of certain industry research. The Lessor's approach to the EBITDA multiples was conservative in that the principal proposed a range of multiples of 7.0x to 9.0x EBITDA compared to the parameters reflected in the research that spanned 4.4x to 20.0x. With the research yielding such a large range, the mid-point, 8.0x EBITDA, was used to calculate enterprise value (the "Enterprise Value").

Since 15% of the Enterprise Value of $160 million, or $24 million, is greater than 15% of the value of the Equipment at the conclusion of the Initial Term, the Enterprise Value is utilized in evaluating the Purchase Option (and later, the Implicit Discount Rates). In absolute terms, $24 million is not a nominal purchase option. Given the uncertainties as to, among other things, the value of the Equipment and the ability/desire of the debtor to obtain new/different equipment had it performed as anticipated by its projections at or around the time of the execution of the Transactional Documents, it is in no way reasonably assured that the Purchase Option would be exercised as of the Commencement Date.

---

[15] Schedules 1 and 1A, Section I- A

[16] Schedules 1 and 1A, Sections I- B and I-D

[17] Schedules 1 and 1A, Section II-F. The percentage applicable to the going concern value is 60% in the case of Lease 60104 and 40% for Lease 60104A. In the aggregate, these percentages total 100%.

The present value of the future minimum lease payments for Leases 60104 and 60104A is then determined. These calculations were performed in order to determine if the present value of the minimum lease payments (Monthly Rent) equals or exceeds 90% of fair market value of the leased assets at inception of the lease for FASB No. 13 testing purposes or they equal or exceed the fair market value of the leased assets at inception as discussed above pursuant to legal framework as provided by counsel. At the instruction of counsel, the Equipment Cost is assumed to equal to the fair market value at Commencement Date for testing purposes. As to the anticipated residual value of the Equipment at the end of the Initial Term of Leases 60104 and 60104A, the $24 million Purchase Option was used as a proxy for this parameter. The calculations are incorporated into this paper as Exhibits 1 and 2.

The Monthly Rent and the Initial Term were used to calculate the present value of the future minimum lease payments. The Implicit Discount Rates were derived as the rate at which the present value of the Monthly Rent and the $24 million residual amount equals the fair market value of the Equipment at the Commencement Date, in accordance with the provisions of FASB No. 13. These Implicit Discount Rates are approximately 72.4% and 71.1% for Leases 60104 and 60104A, respectively. The $24 million amount was allocated to the two leases based upon the relative fair market value of the Equipment as of the Commencement Date. As indicated on Exhibits 1 and 2, the present value of the Monthly Rent is 43% of the fair market value of the Equipment on the Commencement Date and, accordingly, does not meet the test to be considered as a financing lease under FASB No. 13 and Case Law.

As far as the useful life of the Equipment compared to the four year-Initial Term, there has been testimony in the Case that the useful life of the Equipment is 20 to 30 years. Accordingly, the Transactions do not meet the Tests in that the Initial Term, or any extensions thereof on a month to month basis, could not be considered to be 75% or 100% of the remaining useful or economic life of the Equipment. Therefore the Transactions do not meet the test to be considered as a financing lease under FASB No. 13 and per the legal framework provided by counsel.

Expert's Findings and Conclusions

The present value of the future minimum lease payments (Monthly Rent) is less than 90% of fair market value of the Equipment at the Commencement Date. As a result, the Transactions satisfy the FASB No. 13 and tests set on the legal framework regarding the present value of aggregate future rental payments to be treated as operating leases.

The analysis of the Transactions reveals that the Initial Term is less than 75% of the economic useful life of the Equipment based upon testimony in this Case. As a result, the Transactions satisfy the FASB No. 13 and tests per the legal framework regarding useful life in order to be treated as operating leases.

The review of the Transactions suggests that title does not transfer until the end of the Initial Term and then Equipment can only be acquired for approximately $24 million. Accordingly, there is no bargain purchase option in the Transactions and the Equipment cannot be acquired by the Lessor at a nominal value. As a result, the Transactions satisfy the FASB No. 13 and test per the legal framework regarding nominal purchase option to be treated as operating leases.

The Transactions meet the Tests contained in FASB No. 13 and the legal framework to be classified as true operating leases. These Transactions fail the tests set out in 1-201(37) in order to make them secured financing arrangements.

C. The Court's Opinion[18] and Observations

The interpretation of the Court's opinion is beyond the scope of this paper and the expertise of the author, a non-lawyer. It is clear, however, that the Court found that the option price was nominal and therefore the Transactions were deemed to be secured financing

[18] *See* the Memorandum of Decision of the Court attached as Exhibit 3.

arrangements.[19] In the opinion of one prominent Dallas bankruptcy attorney, who wishes to remain anonymous, if the documents provide for a less than fair market value buyout at the end of the primary or initial term of the underlying transaction, it will be characterized as a secured financing arrangement.

[19] *in re Ecco Drilling Co., Ltd.*, 390 B.R. 221, 232-241 (Bankr. E.D. Tex. 2008).

Exhibit 1

Ecco Drilling Company, Ltd.
Lease Characterization
Monthly Rent to FMV

Implicit Discount Rate		**72.39360248%**
Lease No. 60104	**Fair Market Value at Inception**	
Present value of Monthly Rent		$ 10,902,127.66
	$ 25,200,000.00	**$ 10,902,127.66**
Present Value as a % of FMV		**43%**
FASB No. 13 Threshold		**90%**
Case Law Threshold		**100.00%**

Test:	
Present Value of Monthly Rent (above)	$ 10,902,127.66
Prorata Residual Value	14,297,872.34
Total (Per FASB No. 13)	**$ 25,200,000.00**

Exhibit 2

Ecco Drilling Company, Ltd.
Lease Characterization
Monthly Rent to FMV

Implicit Discount Rate		**71.1020107%**
Lease No. 60104A	**Fair Market Value at Inception**	
Present value of Monthly Rent		$ 7,397,872.34
	$ 17,100,000.00	**$ 7,397,872.34**
Present Value as a % of FMV		**43%**
FASB No. 13 Threshold		**90%**
Case Law Threshold		**100.00%**

Test:

Present Value of Monthly Rent (above)	$ 7,397,872.34
Prorata Residual Value	9,702,127.66
Total (Per FASB No. 13)	**$ 17,100,000.00**

Exhibit 3

The Court's Opinion in *Ecco Drilling*

EOD
06/17/2008

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF TEXAS
TYLER DIVISION

IN RE:	§	
	§	
ECCO DRILLING CO., LTD.	§	Case No. 07-60987
	§	
	§	
Debtor	§	Chapter 11

MEMORANDUM OF DECISION

This matter is before the Court upon the Motion to Determine Characterization of Leases filed by Ecco Drilling Company, Ltd., the debtor in the above-referenced chapter 11 bankruptcy case. Ecco seeks a determination that its agreements executed in 2006 with Bernard National Loan Investors, Ltd. are not finance leases as they purport to be, but are rather disguised secured transactions. Upon conclusion of the evidentiary hearing conducted on this matter, the Court took the matter under advisement. This memorandum of decision disposes of all issues pending before the Court.[1]

Factual and Procedural Background

In 2006, Ecco Drilling Co., Ltd. sought financing with which to expand its business of conducting oil and gas drilling operations. After several unsuccessful attempts to gain conventional financing for the acquisition of additional drilling rigs, Ecco signed an agreement purporting to be a finance lease on April 26, 2006 with Brin

[1] This Court has jurisdiction to consider the Motion pursuant to 28 U.S.C. §1334(b) and 28 U.S.C. §157(a). The Court has the authority to enter a final order in this contested matter since it constitutes a core proceeding as contemplated by 28 U.S.C. §157(b)(2)(A) and (O).

Investment Corporation, acting through its principal, Joe Gasparini (the "April Lease"), whereby Brin would provide funding for the completion of two partially-completed drilling rigs, known as the Brewster and the U36, and funds for acquiring three new rigs referenced as the F&H rigs. The document was denominated as a "Master Lease Agreement" under which components for individual units were to be acquired at periodic intervals and each would be listed on a separate lease schedule, which stood as a separate agreement and which would supersede the master document in the event of any conflict of terms.[2]

Unknown at the time to the principals of Ecco, Brin was actually incapable of funding any of the amounts contemplated by the agreement. In fact, Brin was not a financing entity at all. It was instead an entity with a joint venture relationship with an $8 billion hedge fund known as D.B. Zwirn Special Opportunities Fund, L.P. (hereinafter "Zwirn") to whom Gasparini forwarded potential investment opportunities. After this particular Gasparini pitch,[3] Zwirn funded the original $25.2 million which eventually was forwarded to vendors as progress payments as components were acquired and equipment was delivered. Brin assigned its interest in the April Lease to Zwirn as of May 1, 2006.[4]

However, cost overruns began to plague the completion of the rigs contemplated

---

[2] Ecco Ex. 9, ¶1.1.

[3] Ecco Ex. 19.

[4] Ecco Ex. 22.

by the April Lease, and Ecco was struggling to maintain financial viability while desperately seeking the additional sums needed to complete the partially-constructed rigs. It made at least one payment to Brin during the initial six-month period under the April Lease but, unfortunately, no payments were forwarded to Zwirn as the true holder of the contractual rights. While maintaining the secrecy of his company's assignment of the April Lease to Zwirn and though it again apparently had no capital with which to fund such a commitment, Brin agreed to advance additional sums to Ecco for the completion of the unfinished rigs and for new acquisitions. Ecco thereafter proceeded with plans to acquire more rigs and/or rig components, as well as associated trucks and drill pipe.

Meanwhile, Zwirn began to be concerned about whether it was receiving accurate information from Gasparini and the financial viability of the Ecco deal in general. Two rigs were completed in the summer of 2006, but several more were in various stages of completion. Upset that the initial funding had been scattered among various projects instead of focused upon a few, thereby delaying the installation date of the rigs under the lease, Zwirn demurred from any commitment for the additional funding that Brin had promised to Ecco for completion of the various projects.[5]

Because of the delay in getting the rigs on line and its growing skepticism about the quality of information it was receiving through Gasparini, Zwirn subsequently revealed itself to Ecco as the true party in interest under the April Lease and began to

[5] Ecco Ex.13.

threaten the exercise of its foreclosure rights against Ecco property due to nonpayment in the fall of 2006. Now recognizing that the promise of obtaining the needed funds from Brin was illusory, Ecco then engaged in a series of tense discussions with Zwirn about additional financing in an effort to salvage the rig procurement program. Those talks resulted in the advancement of an additional $17.3 million by Zwirn, raising the total to approximately $42.3 million, and the tendering of additional consideration from Ecco in the form of warrants and a revised residual purchase option. The agreement of the parties was memorialized in two documents executed in November 2006 listing Zwirn's subsidiary, Bernard National Loan Investors, Ltd., as lessor,[6] and Ecco as lessee.

The "Amended and Restated Master Lease Agreement" superseded the April agreement and its stated purpose was "to assure that their form and substance fully reflects their intent and to address certain matters which arose subsequent to the April 06 Master Lease."[7] The agreement was structured as a master document with one attached and superseding schedule which incorporated the schedules from the April 2006 document. The equipment was identified as the "personal property of Lessor."[8] Each schedule specified a four-year initial term and then provided for a month-to-month

---

[6] Though Bernard is ostensibly listed as the lessor in the documents, it was merely the vehicle through which Zwirn participated in the transaction with Ecco. All relevant decisions were made by Zwirn and, with exception of references to actual lease provisions, it will be identified as the purported lessor throughout this memorandum for ease of reference.

[7] Ecco Ex. 8, 7th recital. Brin and/or Gasparini were hereby eliminated from the transaction.

[8] *Id*. at ¶ 1.2.

continuance of the terms until Ecco gave 120 days' written notice of any intent to terminate.[9] Each schedule was to constitute a net lease[10] wherein Ecco was solely responsible for the payment of taxes,[11] insurance,[12] delivery charges,[13] and other ongoing responsibilities, and the risk of loss rested solely upon Ecco.[14] Because Ecco had dealt with a third-party supplier, Bernard disclaimed the issuance of any warranty regarding the equipment to be procured.[15] The document states an intention that "each such Schedule shall qualify as and be a 'finance lease' under UCC 2A."[16] Bernard was given the right to accelerate all payments due "for the full term of any and all Schedules" in the event of Ecco's default.[17] Bernard was granted a first lien on all of Ecco's assets and Ecco's principals were required to execute guaranty agreements to secure Ecco's performance under the agreement.[18] Of greatest significance was that the attached schedule provided Ecco, with certain stipulations, an option "to purchase all of the Equipment leased

---

9 *Id*. at ¶ 2.1.

10 *Id*. at ¶ 3.

11 *Id*. at ¶ 6.2.

12 *Id*. at ¶ 12.

13 *Id*. at ¶ 8.2.

14 *Id*. at ¶ 11.1.

15 *Id*. at ¶ 5.

16 *Id*. at ¶ 5.2.

17 *Id*. at ¶ 10(b).

18 *Id*. at ¶ 20.1.

hereunder . . . on an "AS IS WHERE IS" basis for an amount equal to 15% of the greater of (i) the value of such Equipment . . . or (ii) 60 % of the going concern value of Lessee determined by a third party appraiser."[19]

For the new rigs to be financed, the parties also executed a document entitled the "Master Lease Agreement."[20] This agreement was also structured as a master document and it was virtually identical to the Restated Agreement but contained a schedule of new projects.[21] The document again claimed to be a finance lease.[22] The purchase option was again established as 15% of the greater of the value of the equipment, but in this document the alternative was 40% (not 60%) of the going concern value of Ecco as determined by a third party appraiser.[23]

Collectively under the agreements, Ecco was obligated to tender to Zwirn forty-eight (48) monthly payments of \$1,167,617.51[24], for a total of \$56,045,640.48 –

---

[19] *Id*. at ¶ F of the executed schedule attached thereto.

[20] Ecco Ex. 7.

[21] It is undisputed that sections 1 through 33 of the two November leases are identical and they contain identical Exhibits A through J. The only differences in the Leases are with respect to the first seven paragraphs of the "Amended and Restated Master Lease Agreement," the Schedules, which set the "monthly rent" under each Lease and the Purchase Option under each Lease, and the Annexes, which list the equipment acquired under each Lease and the purchase orders relating to each vendor.

[22] *Id*. at ¶ 5.2.

[23] *Id*. at ¶ F of the executed schedule attached thereto. Thus, combined with the option price formula contained in the Restated Lease, Ecco's purchase option was 15% of the fair market value of the equipment or 100% of Ecco's going concern value.

[24] A monthly payment of \$699,758.53 was required under Schedule No. 1 to the Amended and Restated Master Lease (Ex. B-7), and a monthly payment of \$467,858.98 was required under the

constituting an approximate 14% return component added to the $42.3 million advanced by Zwirn. However, other than the initial payment in November 2006, Ecco made no payments on the leases to Zwirn. Under the threat of foreclosure by Zwirn, Ecco voluntarily filed for bankruptcy relief under chapter 11 of the Bankruptcy Code on November 23, 2007.

Discussion

Once again this Court is called upon to interpret whether a document which purports to be a lease actually constitutes a true lease[25] or whether it is instead a disguised security agreement which creates a security interest under §1-201(37) of the Uniform Commercial Code.[26] In *In re Triplex Marine Maint., Inc.*, 258 B.R. 659 (Bankr. E.D. Tex. 2000), this Court engaged in a rather extensive discussion of the methodologies which have been employed to distinguish true leases from disguised security interests and the efforts to bring some degree of clarity to this troublesome area. Differentiating between the two has become increasingly problematic in recent years by the advent of the financing lease, now recognized under Article 2A of the U.C.C., which shares many

Equipment Lease Schedule 1 to the Master Lease (Ex. B-9).

[25] Generally, in a lease, the lessor relinquishes its right to possession and use of goods for a specified term while retaining title and the right to any residual value that remains in the goods after the lease terminates. In a secured financing transaction, a seller relinquishes not only right to possession and the use of goods, but also transfers title and any residual value which might exist in the goods at the conclusion of the financing term.

[26] A security interest is "an interest in personal property or fixtures which secures payment or performance of an obligation." N.Y. U.C.C. §1-201(37) (McKinney 2001).

characteristics with a secured transaction and has generally rendered obsolete any methodology formerly used by courts based upon identifying attributes of ownership.[27] Thus, changing business practices have led to changes in the statutory guidance provided to courts charged with detecting secured transactions disguised as leases.

As an initial matter, "[w]hether a consignment or a lease constitutes a security interest under the Bankruptcy Code will depend upon whether it constitutes a security interest under applicable State or local law." *In re Lamar*, 249 B.R. 822, 825 (Bankr. S.D. Ga. 2000). Pursuant to the agreement of the parties as expressed in a choice of law provision contained in the leases,[28] and as confirmed by the parties in open court, New York law governs the construction of the leases. The Court will therefore apply New York law to determine the true nature of the agreement.[29] The burden of proof is upon

---

[27] This is true because leases now constitute a legitimate form of financing the acquisition of needed assets. As one commentator has observed:

> Leases are a form of financing . . . because they provide somebody with control and beneficial use of goods without having paid the full purchase price. They achieve that "financing" not by extending credit. . . . But leases achieve financing by dealing with rights of possession. So the key here is that when we are talking about lease transactions that go into Article 2A, we are talking about transactions in which, at least nominally, the purpose of the deal is to put somebody, that is, the lessee, in physical possession of the goods with the right to use them.

Raymond T. Nimmer, *U.C.C. Article 2A: The New Face of Leasing*, 3 DEPAUL BUS. & COMM. L.J. 559, 562-63 (2005).

[28] See ¶ 30 of Ecco Ex. 7 & 8.

[29] Though there is no significant difference in the statutory approaches to this problem adopted in New York and Texas, the provisions of §1-201(37) have now been re-codified in the most recent amendment to the Uniform Commercial Code and Texas has incorporated those changes. The definition of "security interest" is now provided in §1-201(35) and the guidelines for distinguishing a lease from a security interest have been moved to §1-203. However, New York has yet to adopt these recent stylistic revisions.

Ecco to demonstrate by a preponderance of the evidence that Zwirn's interests arising from the referenced leases should be recharacterized as a disguised security interest. *Worldcom, Inc. v. Gen. Elec. Global Asset Mgmt. Serv. (In re Worldcom, Inc.),* 339 B.R. 56, 62 (Bankr. S.D.N.Y. 2006); *Triplex Marine*, 258 B.R. at 664.

Zwirn contends that the difficulty in distinguishing true leases from disguised security interests should be properly resolved by giving credence to the parties' freedom to contract, their expressed intentions, and the resulting self-characterization of these documents as financing leases. However, under revised §1-201(37) applicable to this dispute, the intention of the parties has been abandoned as a proper tool by which to distinguish a true lease from a disguised security interest and replaced by an evaluation of the economic structure of the particular transaction.[30] As recognized in *Duke Energy Royal, L.L.C. v. Pillowtex Corp. (In re Pillowtex Corp.)*, 349 F.3d 711 (3d Cir. 2003):

> . . . the New York U.C.C. no longer looks to the intent of the drafting parties to determine whether a transfer is a lease or a security agreement. Specifically, the 1992 version of §1-201(37) directed courts to determine "[w]hether a lease is *intended* as security"; this language was amended in 1995 to read "whether a transaction *creates* a lease or security interest." In this way, the reference to the parties' intent was explicitly omitted.

---

[30] Zwirn's reliance upon *In re Edison Bros. Stores, Inc.*, 207 B.R. 801, 809 (Bankr. D. Del. 1997) as authority for its position is misplaced in that *Edison Bros*. was decided under the prior version of §1-201(37), which attempted to decipher the intent of the parties rather than the economic structure of the transaction. Under the current regimen, even Article 2A governing finance leases defers to the analysis outlined in §1-201(37). If the transaction meets the definition of security interest under §1-201(37), then it does not qualify as a lease under §2A-103(1)(j).

Id. at 721 (emphasis in original).[31]

In examining the economic structure of a purported leasing transaction, particularly with the growing use of financing leases, we are essentially searching for economic realities. In theory, those realities would seem easy to identify:

> In a true lease, the economics are that the lessor has a realistic expectation of having the goods returned to it and having a residual value that it can then realize in those goods. So the key is whether or not the transaction in and of itself contemplates almost inevitably giving ultimate control and ownership for the life of the product to the lessee or giving an economically viable product back to the lessor at the end of the lease.

Raymond T. Nimmer, *U.C.C. Article 2A: The New Face of Leasing*, 3 DEPAUL BUS. & COMM. L.J. 559, 565 (2005). In other words, is the transaction structured in such a way that the lessor has an objectively reasonable economic expectation that the goods will come back to it at the end of the lease term? *Id*.

Revised §1-201(37) seeks to guide that economic evaluation. A lease purported to

---

[31] The Third Circuit also referenced the Official Comment to the amended version of the statute which states in part:

> Reference to the intent of the parties to create a lease or security agreement [under the former statute] 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.

Pillowtex, 349 F.3d at 721-22. *See also, In re Owen*, 221 B.R. 56, 62 (Bankr. N.D.N.Y. 1998)[finding that "...the labeling of the Agreement as a "lease" and referring to the parties as "lessor" and "lessee" in and of themselves are not controlling."]; *In re Homeplace Stores, Inc*., 228 B.R. 88, 93 (Bankr. D. Del. 1998)[noting that "...[w]hether a document is a security agreement as opposed to a lease...is dependent on certain factors extrinsic to the document and not capable of control by words in the document"].

be a disguised security interest is first analyzed under §1-201(37)(a), which establishes a two-part *per se* rule, also known as the bright-line test, under which a purported lease shall be recharacterized as a transaction creating a security interest if the lessee cannot terminate the payment obligation during the term of the lease and if one of four residual value factors is found to exist which establishes that the purported lessor has not retained any meaningful residual interest in the leased goods.[32] For transactions that satisfy the foregoing bright-line test, the inquiry comes to an end — such purported leases constitute security agreements as a matter of law. *Pillowtex*, 349 F.3d at 717; *In re Owen*, 221 B.R. 56, 60 (Bankr. N.D.N.Y. 1998) [finding that "[w]hile NYUCC § 1-201(37) clearly indicates that the Court is to examine the facts of each case in characterizing a transaction, . . . the first paragraph of the amended statute qualifies this by setting out a bright line test whereby, as a matter of law, a transaction creates a security interest"]; *In re*

---

[32] The four residual value factors guiding this objective determination are:

> (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.

N.Y. U.C.C. §1-201(37)(a) (McKinney 2001)(emphasis added).

Kim, 232 B.R. 324, 330 (Bankr. E.D. Pa. 1999).

In this particular dispute, the parties agree that the referenced documents do not permit Ecco to terminate its payment obligations under the lease prior to the expiration of the lease term.[33] Thus, the first prong of the bright-line test is satisfied. There is also no dispute that the remaining economic life of the rigs (20 to 30 years) extends much further than the four-year lease term provided in the agreements. The parties further agree that Ecco is not bound under the agreements to renew the lease or to exercise any purchase option. In fact, Ecco possesses no option to renew the lease agreement at all. Thus, the only circumstance available to trigger a *per se* finding of a security interest under §1-201(37)(a) is whether the consideration to be paid under the purchase option granted to Ecco under the agreements was a nominal amount.

But what is "nominal" consideration? Zwirn contends that an option price measured in terms of millions of dollars could never be characterized as nominal. However, it is widely recognized that the term "is used in its relative, rather than absolute sense" and that "courts have had to devise tests to determine whether consideration of a significant amount can be relatively nominal under the circumstances and thus evidence of a disguised security interest." *Worldcom,* 339 B.R. at 66, n.6. "Consideration may be sizeable yet still be nominal." *In re APB Online*, 259 B.R. 812, 818 (Bankr. S.D.N.Y. 2001). However, the earlier jurisprudence outlined in *Triplex Marine* reveals the

---

[33] ¶ 2.1 of Ecco Ex. 7 and 8. See also, Ecco Ex. 30 at p. 4 wherein Zwirn recognizes that the "contracts have hell-or-highwater provisions."

evolution in judicial determinations of whether consideration is nominal in the relative sense and, though additional help was anticipated, the revisions to §1-201(37) offer little additional guidance to courts seeking to assess whether the designated consideration in a particular circumstance should be considered nominal enough to have precluded the retention of a meaningful residual interest by the purported lessor.[34] Instead, revised §1-201(37) offers merely the parameters of the spectrum of nominality.[35] On one end, consideration is nominal if it is for less than the lessee's reasonably predictable cost of performing if the option is not exercised.[36] On the other end, consideration is *not* nominal if the purchase option price is based on the fair market value of the property.[37] However, parties rarely litigate those extremes and the statute offers little assistance for evaluating the nominality issue under more median circumstances. Thus, courts must necessarily revert to earlier common law tests in evaluating whether an option is nominal under the

---

[34] "The central feature of a true lease is the reservation of an economically meaningful interest to the lessor at the end of the lease term. Ordinarily this means two things: (1) at the outset of the lease the parties expect the goods to retain some significant residual value at the end of the lease term; and (2) the lessor retains some entrepreneurial stake (either the possibility of gain or the risk of loss) in the value of the goods at the end of the lease term." Edward E. Huddleson, *Old Wine in New Bottles: UCC Article 2A-Leases*, 39 ALA. L. REV. 615, 625 (1988).

[35] E. Carolyn Hochstadter Dicker and John P. Campo, *FF&E and the True Lease Question: Article 2A and Accompanying Amendments to UCC Section 1-201(37)*, 7 AM. BANKR. INST. L. REV. 517, 539 (1999) [hereinafter Dicker and Campo].

[36] The revised statute does seek to prevent improper consideration of certain isolated attributes usually present in a finance lease that formerly might have been considered persuasive, if not definitive, evidence of a secured transaction. See N.Y. U.C.C. §1-201(37)(c)(i) (McKinney 2001)(emphasis added).

[37] *Id.*

economic realities presented by each particular case.[38]

As outlined in *Triplex Marine*, courts have utilized various comparisons in attempting to discern the relative nominality of a purchase option amount. Comparisons of the option price are made to the original purchase price,[39] to the total lease payments,[40] and, ultimately, courts simply try to make sense out of the economic circumstances. "No matter how the option amount is expressed, if the only sensible course of action is to exercise the option, then it is one intended for security." Richard L. Barnes, *Distinguishing Sales and Leases: A Primer on the Scope and Purpose of UCC Article 2A*, 25 U. MEM . L. REV. 873, 885 (1995) and cases cited therein [summarizing that "the option price is nominal if the sensible lessee would in effect have no choice and, in

---

[38] If a court determines that the consideration of this exception does not compel a conclusion that a security interest was created *per se*, it proceeds to an examination of all of the facts to determine whether the economic realities of a particular transaction create a security interest. *In re Taylor*, 209 B.R. 482, 484-85 (Bankr. S.D. Ill. 1997). Since nominality of the purchase option is a major factor in that determination as well, it is really a distinction without a difference as to whether this decision is reached as a result of the bright-line test or a consideration of other economic realities.

[39] *In re Bevis Co., Inc.*, 201 B.R. 923, 926 (Bankr. S.D. Ohio 1996)[finding option price of 10% of cost of equipment to be nominal]; *In re Phoenix Pipe & Tube*, 154 B.R. 197, 200 (Bankr. E.D. Pa. 1993)[same]; *see also In re Super Feeders, Inc.*, 236 B.R. 267, 270 (Bankr. D. Neb. 1999)[finding a fixed option price of 5% of the original purchase price to be nominal while recognizing that a purchase option price of less than 25% of the original purchase price constitutes evidence of a security interest, *citing Kimco Leasing, Inc. v. State Board of Tax Commissioners*, 656 N.E. 2d 1208, 1215 (Ind. Tax. 1995)] and Dicker and Campo, 7 AM. BANKR. INST. L. REV. at 543, notes 90 and cases cited therein ["...option prices of less than 25% of the original cost have been found to be nominal."]

[40] "When the option price is a relatively low percentage of the total lease payments, this indicates nominal consideration." *In re Super Feeders, Inc.*, 236 at 270; *see also, Orix Credit Alliance, Inc. v. Pappas*, 946 F.2d 1258, 1261 (7th Cir. 1991) (finding an option price of 12% of total rental payments to be significant in determining an agreement was a sale rather than a lease); and *In re Wakefield*, 217 B.R. 967, 971 (Bankr. M.D. Ga. 1998) (finding 10% option price "to be significant in concluding that the option price is nominal").

making the only sensible choice, would cut off the lessor's reversionary interest."].

In tacit recognition of the fact that a 15% option price could likely be deemed nominal in a relative sense under these circumstances if measured by the fair market value of the goods, or by the total purchase price, or by the total lease payments, much of the debate at the hearing centered upon the going concern value of Ecco. Both sides actually exerted great efforts to quantify the actual option price by the use of experts who, based upon recently prepared EBITDA projections, opined about what projections could have been made in 2006 regarding the going concern value of Ecco and whether that amount would have exceeded 15% of the fair market value of the equipment. However, those recently-developed insights are not really germane to this determination.

Execution of a document in this type of dispute creates either a lease or a security interest. "Nominality, therefore, must be determined by considering the parties' *prediction* of concluding value at signing, not by considering the actual value at the conclusion of the term." 4 JAMES J. WHITE AND ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE §30-3 at p. 32 (5th ed. 2002). "Transactions are not true leases where the parties anticipate, *at the outset of the transaction*, that the option will be irresistible in the sense that the option price is extremely low in comparison to the fair market value of the property." Edwin E. Huddleson, *Old Wine in New Bottles: UCC Article 2A-Leases*, 39 Ala. L. Rev. 615, 633 (1988)(emphasis added). Thus, it is the value anticipated by the parties at the time the agreements were executed that determines whether the option price is nominal.

Ecco's representative, Bill Roberts, testified that he thought that the value of the equipment at the end of the contract term would be approximately the acquisition cost (less interest) – $42.5 million – and he estimated at that time that Ecco's EBITDA could be approximately $22 million. Though he believed that the eventual purchase option would be based upon 15% of the fair market value of the equipment (thereby resulting in an anticipated $6.375 million option price), there was never any doubt in his mind that the purchase option would be exercised and that, if the transaction resulted in Ecco's acquisition of six operating drilling rigs, the option price would be "a bargain" no matter which formula was used or what set of projected numbers was applied. In his words, "we would have never paid the principal and the interest and then walked away."

Conversely, the evidence establishes that Zwirn expected the purchase option to be exercised as well. It did no independent valuation regarding the anticipated fair market value of the equipment or the projected going concern value of Ecco at the end of the contract term. To the extent it was concerned at all about those issues, it simply relied upon Ecco's projections.[41] The evidence establishes that Zwirn's focus instead was upon evaluating its exposure during the contract term and maximizing its anticipated return at the conclusion of the contract term. Zwirn operatives consistently evaluated this

[41] Ecco Ex. 30 at p. 6.

transaction in these terms.[42] Those attenuated from the negotiations were surprised to learn that the stream of lease payments would fully amortize the debt at 14% and expressed disbelief that Ecco had agreed to pay a 15% purchase option in addition to the fully amortized debt.[43] The purchase option was essentially viewed by Zwirn as a premium,[44] which at one point was expected to raise its return on investment to the range of 19%.[45] The evidence reflects that Zwirn was constantly evaluating its "exit point" and those evaluations never contemplated or evaluated the reacquisition of the equipment as a component.

And that focus never changed. Its December 2006 internal memorandum, which summarized the restructuring transactions which had occurred in the prior month, stated that "we *received* effectively 60% of the equity in [Ecco], split between a 45% warrant position and a 15% residual, based on the greater of the going concern value of the Company or cost of the equipment."[46] That report concluded as follows:

---

[42] It is also true that everyone in the transaction treated this as a capital lease for accounting purposes. It was treated in the financial statements of both Ecco and Zwirn as a loan. It was treated as a loan for tax purposes by both entities. Indeed, Zwirn's accountants characterized them as disguised loans, notwithstanding their structure as leases, and insisted upon written confirmation that the lessee was treating the transactions like loans, just like Zwirn. Ecco Ex. 18. While accounting and tax treatments do not necessarily dictate legal characterizations, the evidence establishes that these treatments are imposed in recognition of the economic realities of the transaction.

[43] Ecco Ex. 17.

[44] Ecco Ex. 18.

[45] This was Gasparini's projection in the spring, Ecco Ex. 17, and was still Zwirn's expectation in December 2006. Ecco Ex. 30.

[46] Ecco Ex. 30 at p. 2 (emphasis added).

> *Expected Returns*
>
> Based on expected total fundings of $42.1 million, progress payments of 0.01235 for the first two months and then 48 monthly lease payments thereafter, and factoring in the 15% purchase option (ascribing no value to the warrants) based on cost, our expected return is 37%. If we factor in the value of our warrants (45% of the Company), at the end of the 48-month term, using cost as a conservative estimate of enterprise value, our expected return is 52.8%.[47]

No projection or contingency is ever made regarding the return of the equipment. No mention is ever made of any expectant value of returned equipment at the end of the contract term. Though Zwirn's representative, Todd Dittman, testified at the hearing that he "had no idea" at the time as to whether Ecco would exercise the purchase option and sought to highlight reasons which might have precluded the actual exercise of the purchase option by Ecco,[48] he had honestly conceded at a deposition three weeks earlier that, "It looked to us as if it could have been a very attractive economic option for them."[49] Despite its contemporary pleas to the contrary, Zwirn's actions at the time of the transaction fail to reveal any effort to plan, provide or protect any entrepreneurial stake or other residual interest which it supposedly held in the goods.

---

[47] Ecco Ex. 30.

[48] Again considerations raised in 2008 really are not germane, nor are the actual events in the way they unfolded. There is no evidence that these considerations were raised and evaluated at the time of the transaction. "Foresight not hindsight controls." 4 JAMES J. WHITE AND ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE §30-3 at p. 29 (5th ed. 2002).

[49] Ecco Ex. 37.

Zwirn made no attempt to ascertain what the residual value of the equipment would be at the end of the lease term because it understood that the circumstances of the transaction dictated that Ecco would exercise the purchase option no matter how the final figure was quantified. A fair appraisal of the circumstances reveals that the most compelling economic reality existing at the time of the transaction was that the agreement encompassed the primary assets that allowed Ecco to conduct its business enterprise. In agreeing to the parameters of the purchase option, Ecco was not planning on its own demise, nor was Zwirn expecting it. If Ecco did not exercise the purchase option at the end of the term, it would be left without those rigs and without any guarantee that those rigs could be replaced in any reasonable or timely manner. The transaction was not structured in anticipation that Ecco would simply walk away from these rigs four years into a 30-year useful life after having gone to considerable efforts to plan and direct the construction of those rigs, after having crafted them and implemented them for their specific drilling needs, and after having paid $56 million for Zwirn's funding of the $42.5 million construction price.[50] Certainly the payment of a 15% purchase option, whether calculated upon the basis of the rigs' fair market value or upon the possibility of a debtor's enhanced EBITDA, would have not inhibited Ecco's retention of the rigs,

[50] The fact that Ecco was required to pay an amount greater than the entire purchase price of the assets further buttresses the conclusion that these agreements created a security interest rather than a lease. Courts applying New York law have noted that "if the alleged lessee is 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 alleged lease agreement, a sale is likely to have been intended since what the lessor will receive is more than a payment for the use of the leased goods and loss of their value; the lessor will receive a consideration that would amount to a return on its investment." *Owen*, 221 B.R. at 61-62.

regardless of how high the calculated number became. Indeed, by including the EBITDA alternate calculation, the agreements reflected the economic reality that the transfer of six fully operational drilling rigs for only 15% of the rigs' market value would likely occur and that such a transfer would place Ecco into an economically advantageous position in the marketplace — a position likely to bring financial vitality to its balance sheet — and it was an anticipated vitality in which Zwirn was eager to participate. The concept that Ecco, after having invested so much into the procurement and adaptation of these rigs, would simply forego all of that investment of time and energy and start its operations from scratch to acquire similar but unfamiliar assets from another source, instead of exercising a 15% option (and thereby giving Zwirn a *meaningful* residual interest under the realities of the situation), is simply not credible. Conversely, Mr. Roberts' testimony that Ecco always intended to exercise the purchase option under these agreements is both credible and compelling.

White and Summers suggest that the issue of nominality under §1-201(37) "is merely a proxy for the questions: Is the option price so low that the lessee will certainly exercise it and will, in all probable circumstances, leave no meaningful reversion for the lessor?"[51] Under the circumstances presented in this case, the Court finds that the answer lies in the affirmative.[52]

---

[51] 4 White and Summers, *supra* note 48, at p. 33.

[52] This conclusion does nothing to preclude the recognition of legitimate finance leases. It recognizes, however, that, when such a finance lease involves the primary operating assets of a company, the lessee's right to terminate the leasing relationship during the contract term becomes of heightened

Conclusion

This Court therefore concludes that the two agreements between Ecco and Zwirn's subsidiary, Bernard National Loan Investors, Ltd., identified as the "Amended and Restated Master Lease Agreement" [Ecco Ex. 8] and the "Master Lease Agreement" [Ecco Ex. 7], must each be characterized under the provisions of §1-201(37)(a) of the New York Uniform Commercial Code as documents creating security interests in favor of Bernard National Loan Investors, Ltd. in the assets of Ecco Drilling Co., Ltd. This conclusion is mandated under the *per se* rule of §1-201(37)(a)(iv), as well as under a general examination of all of the facts and circumstances in this case. Therefore, the Motion to Determine Characterization of Leases filed by Ecco Drilling Company, Ltd. shall be granted.

This memorandum of decision constitutes the Court's findings of fact and conclusions of law[53] pursuant to Fed. R. Civ. P. 52, as incorporated into contested matters in bankruptcy cases by Fed. R. Bankr. P. 7052 and 9014. A separate order will be entered which is consistent with this opinion.

Signed on 06/17/2008

THE HONORABLE BILL PARKER
CHIEF UNITED STATES BANKRUPTCY JUDGE

importance, there should be a rational relationship between the contract term and the amount paid by the lessee, and any option to purchase the assets must be substantial enough to clearly demonstrate that the lessor expects to enjoy a reversionary interest at the end of the contract term.

[53] To the extent that any finding of fact is construed to be a conclusion of law, it is hereby adopted as such. To the extent any conclusion of law is construed to be a finding of fact, it is hereby adopted as such. The Court reserves the right to make additional findings and conclusions as may be necessary.