

For Electronic Publication Only

**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE**

IN RE:)	Chapter 11
)	
E.SPIRE COMMUNICATIONS, INC.,)	Case No. 01-974 (RSB)
ET. AL.,)	
)	
Debtors.)	Jointly Administered
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)	
E.SPIRE COMMUNICATIONS, INC.,)	
ET. AL.,)	
)	
Plaintiffs,)	
)	
v.)	
)	
CIT COMMUNICATIONS FINANCE)	Adversary No. A-02-2170
CORPORATION,)	
Defendant.)	
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MEMORANDUM OPINION ON MOTION FOR SUMMARY JUDGMENT¹

Before the Court is the Motion of CIT Communications Finance Corporation a/k/a AT&T Credit Corp. (“CIT”) for Summary Judgment on the Complaint for Declaratory Judgment and other Relief filed by the Debtor, E.Spire Communications, Inc. The issue raised by the complaint is whether the agreement between the parties pursuant to which the Debtor acquired possession of certain equipment is a security interest or a lease. The issue raised by CIT’s motion is whether that determination can be made as a matter of law on the

¹ This Opinion constitutes the findings of fact and conclusions of law of the Court pursuant to Federal Rule of Bankruptcy Procedure 7052, which is made applicable to contested matters by Federal Rule of Bankruptcy Procedure 9014.

facts before the Court. The Court denies the motion for the reason that there are material facts at genuine issue and the question cannot be decided as a matter of law.²

I. BACKGROUND

On August 23, 1996, the Debtor and CIT entered into a Master Equipment Lease Agreement, No. 960823, pursuant to which the Debtor “leased” certain equipment from CIT. The Master Lease Agreement was subsequently amended by the Amendment to Master Equipment Lease dated June 5, 1997, and supplemented by the Schedules for each piece of equipment.³ The Agreement states general terms and conditions. CIT and the Debtor executed a number of Master Equipment Lease Agreement Schedules and amendments thereto, as contemplated by the Agreement. The Schedules incorporate the terms of the Agreement and identify the equipment to be leased, the length of terms of the Agreement, rental payments, and other economic factors, such as “the Termination Value” payable upon the early termination of the Agreement by the Debtor.

A. TERMS OF THE AGREEMENT

The Agreement provides for CIT to lease nine Network Systems (the “Equipment”) to the Debtor for an initial term of seven years. The Agreement is a “net” or “triple net” agreement whereby the Debtor is responsible for:

1. paying all sales, use, property and other taxes, fees, duties and governmental charges imposed with respect to the Equipment;
2. keeping the Equipment in good repair and paying for maintenance and upgrades to the Equipment;

² This Court has jurisdiction over this matter, which is a core proceeding, pursuant to 28 U.S.C. §§ 1334 and 157 (b)(2)(K), (M) and (O).

³ The Master Lease Agreement and Amendment are hereinafter referred to as the “Agreement”, unless otherwise noted.

3. obtaining, maintaining and paying for all insurance on the Equipment and indemnifying CIT against loss; and
4. assuming and bearing the risk of loss, theft, destruction, damage or governmental seizure.

According to the terms of the Agreement, title to the Equipment remains with CIT unless Debtor exercises its purchase option.

At the end of the Initial Term, the Debtor may purchase the Equipment subject to a particular Schedule for its then Fair Market Value (“FMV”) or may renew a Schedule for one year or the remainder of the “useful life” of such Equipment (whichever is shorter) at its then Fair Market Rental Value. The Agreement provides a “FMV Cap,” which represents the greatest amount the Debtor must pay for the subject Equipment at the end of the term regardless of the actual FMV at that time. In each instance the FMV Cap equals 26.5% of the original purchase price of the Equipment for that Schedule. If the Debtor does not exercise either of these options, the Debtor must de-install, remove, and surrender the Equipment to CIT at the end of the Initial Term.

The Agreement permits the Debtor to terminate any Schedule upon 180 days, irrevocable, prior notice, any time after three years after the commencement date of a particular Schedule, but only if the Debtor determines in good faith that the Equipment has become obsolete or surplus to its needs. If CIT requests, the Debtor must use commercially reasonable efforts to sell the items of Equipment to an unrelated third party. Upon termination, the Debtor must pay an amount equal to any deficiency between the Termination Value for such items of Equipment and the net cash proceeds of any sale, if there is such a sale. The Termination Value is set forth in the Schedules for each item of equipment.

Finally, the Agreement states that it is a true lease under applicable, non-bankruptcy law and that it is governed by New Jersey law.

II. DISCUSSION

A. Summary Judgment Standard

Federal Rule of Civil Procedure 56(c) (applicable here by reason of Federal Rule of Bankruptcy Procedure 7056) provides that summary judgment shall be granted “if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavit, if any show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law. Fed.R.Civ.P. 56(c); Fed.R.Bankr.P. 7056. In other words, summary judgment is appropriate only when (i) there is no genuine issue concerning any material fact, and (ii) the undisputed facts entitle the moving party to judgment as a matter of law. Celotex Corp. V. Catrett, 477 U.S. 317, 322, 106 S.Ct. 2548 (1986); Wetzel v. Tucker, 139 F.3d 380, 383 n.2 (3d Cir. 1998). The substantive law determines which facts are material. Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 248 (1986); Boyle v. County of Allegheny Pennsylvania, 139 F.3d 386, 393 (3d Cir. 1998).

Once the movant puts forth a properly supported motion for summary judgment, “an adverse party may not rest upon the mere allegations or denials of the adverse party’s pleading, but the adverse party’s response, by affidavits or as otherwise provided in this rule, must set forth specific facts showing that there is a genuine issue for trial.” Fed.R.Civ.P. 56 (e). A fact issue is considered “genuine” only if there is sufficient evidence on which a reasonable fact finder could base a finding in favor of the non-moving party. Anderson, 477 U.S. at 249. The Court is required to view the facts, and all permissible inferences from such facts, in a light most favorable to the nonmoving party. Matsushida Elec. Indus. Co. V. Zenith Radio Corp., 475 U.S. 574,587-88 (1986); Boyle, 139 F.3d at 393; LaSalle Nat’l Bank v. Perelman, 82 F.Supp.2d 279, 290 (D.Del. 2000).

B. Applicable State Law

The Third Circuit suggested in Continental Airlines that courts apply state law in determining whether an agreement is a true lease or a disguised security interest. In re

Continental Airlines, 932 F.2d 282, 294 (3d Cir. 1991), citing H.R.Rep. No. 595, 95th Cong., 1st Sess. 314, S.Rep. No. 95-989, 95th Cong., 2d Sess. 26, reprinted in 1978 U.S.C.C.A.N. 5787, 5812, 6271. The parties agree that the choice of law provision found in the Agreement, which provides it will be governed by the law of New Jersey, is controlling.

According to New Jersey law, the determination of whether the Agreement between CIT and the Debtor is a true lease or a security interest is governed by New Jersey's U.C.C. at N.J.S.A. 12A:1-201 (37). New Jersey's current U.C.C. 1-201 (37), effective January 10, 1995, adopts in full the revised version of U.C.C. 1-201 (37) and provides in pertinent part:

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

(a) the original term of the lease is equal to or greater than the remaining economic life of the goods,

(b) 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,

(c) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal consideration upon compliance with the lease agreement, or

(d) 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.

A transaction does not create a security interest merely because it provides that

(a) the present value of the consideration the lessee is obligated to pay the lessor for the right to possession and use of the goods is substantially equal to or is greater than the fair market value of the goods at the time the lease is entered into,

(b) the lessee assumes risk of loss of the goods, or agrees to pay taxes, insurance, filing, recording, or registration fees, or service or maintenance costs with respect to the goods,

(c) the lessee has an option to renew the lease or to become the owner of the goods,

(d) the lessee has an option to renew the lease for a fixed rent that is equal to or greater than the reasonably predictable fair market rent for the use of the goods for the term of the renewal at the time the option is to be performed, or

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

N.J.S.A. 12A:1-201 (37) (West 2002)(effective January 10, 1995).

i. Termination

Under 1-201(37), the threshold question is whether the agreement between the parties provides for a right of termination by the lessee. N.J.S.A. 12A:1-201 (37)(providing that a transaction creates a security interest when the agreement is *not subject to termination by the lessee*); In re Yarbrough, 211 B.R. 654, 658 (Bankr. W.D.Tenn. 1997)(“the grammatical interpretation of . . . [1-201 (37)] requires that a lease not be subject to termination by the lessee *and* one or more of the circumstances found in sub parts [(a)] through [(d)]”). CIT has asserted that this requirement has been met by the right to terminate provided by the Termination Option at ¶18 (a)(3) in the Agreement (DOC No. 10, Ex. A). The Termination Option provides:

Provided that no Event of Default or Potential Default has then occurred and is continuing, Lessee will have the right, upon provision of 180 days irrevocable written notice, to terminate a Schedule with respect to all, but not less than all, of the items of Equipment constituting an individual 5ESS switch on any Rental Payment Date *occurring on or after the third anniversary of the Commencement Date for such items of Equipment if Lessee determines in good faith (and, upon request, provides an officer’s certificate to such effect), without discriminating among items of Equipment or other similar equipment owned or leased by Lessee, that such items of Equipment have become obsolete or surplus to its needs. If request by Lessor, Lessee will use commercially reasonable efforts to sell the applicable items of Equipment to an unrelated third party but the failure to consummate such a sale shall not relieve Lessee of any payment obligations set forth in the next sentence. Upon such a termination, Lessee will pay to Lessor an amount equal to any deficiency between the Termination Value for such items of equipment, determined as set forth on the applicable Schedule, and the net cash proceeds of any sale of such items of Equipment received by Lessor from Lessee and shall surrender the affected items of Equipment to Lessor in accordance with the provisions of Section 18(b) [regarding surrender].*

(DOC No. 10, Ex. A ¶18 (a)(3))(emphasis added).

Thus, although the agreement contains a “Termination Option,” the Debtor’s right to terminate is subject to important limitations. First, the Termination Option can only be exercised after three years. Second, the Equipment in the Schedule it wishes to terminate must be determined to be obsolete or surplus. Third, and most important, the Debtor must pay an amount, the Termination Value, calculated according to a formula.

The Termination Value that the Debtor would have to pay for each piece of Equipment is set forth in the applicable schedule. The Termination Value is determined according to a sliding scale of percentages of equipment cost. (DOC No. 10, App. B). For example, the Schedule for the Columbus - Switch 1 provides a chart as follows:

Termination Report

Date	Full TV + Pro Rata Rent
Aug 22, 1996	100.960942
Nov. 22, 1996	103.101152
Feb. 22, 1997	101.814964
May 22, 1997	102.321601
Aug. 22, 1997	102.711197
Nov. 22, 1997	100.780103
Feb. 22, 1998	97.418859
May 22, 1998	96.341985
Aug. 22, 1998	92.171694
Nov. 22, 1998	90.442703
Feb. 22, 1999	89.463893
May 22, 1999	85.627404
Aug. 22, 1999	81.681349
Nov. 22, 1999	80.402091
Feb. 22, 2000	78.965012
May 22, 2000	74.581598
Aug. 22, 2000	70.078004
Nov. 22, 2000	68.310367
Feb. 22, 2001	66.674113
May 22, 2001	62.263208
Aug. 22, 2001	57.730281
Nov. 22, 2001	55.785182
Feb. 22, 2002	54.295220

May 22, 2002	50.490820
Aug. 22, 2002	46.624444
Nov. 22, 2002	44.948420
Feb. 22, 2003	43.126196
May 22, 2003	38.882244
Nov. 22, 2003	32.530831
Feb. 22, 2004	30.696142
May 22, 2004	26.648638
Aug. 22, 2004	22.375581

*As a Percent of Equipment Cost

(DOC No. 10).

It is not clear how this formula works and what relationship the Termination Value has to the value of the Equipment at the time of termination. Under one possible interpretation, were the Debtor to terminate the Columbus Switch Schedule in August 2002, the Debtor would have to pay almost 47% of the original cost of the switch. According to the spreadsheet attached to the Affidavit of Donald Bush, Treasurer of the Debtor, the original cost of the Columbus Switch was \$1,611,591.68 (DOC No. 17, Ex. C, Bush Aff.). If the Debtor did terminate the Columbus Schedule in August 2002, the Debtor would have to pay \$745,271.55, according to the Court's math. That amount would be in addition to the total rent already paid under the terms of the Agreement. Under that interpretation, it appears that upon termination the Debtor must pay the full amount, as if the Agreement went to the full term. If that is so, the so-called right of termination may be of little economic significance.

Of course other interpretations are possible. But this is CIT's motion for summary judgment, and it bears the burden of showing that there are no genuine issues of material fact and that it is entitled to judgment. The Debtor, on the other hand, is entitled to all reasonable inferences in its favor. CIT's position is that the right of termination makes the agreement a true lease under the U.C.C. But the applicable section implies that agreement is a lease if

the obligation to pay for the use of the goods is subject to termination. If the Agreement requires the payment of either the total balance or the remaining economic value of the equipment, it may not fall within that provision. CIT has not sufficiently established that there is a right to terminate the obligation to pay within the meaning of the statute. It has not demonstrated the economic significance of the Termination Option.

An agreement without a right of termination may still be a lease under N.J.S.A. 12A:1-201(37). CIT, however, has not provided sufficient facts as to the remaining economic life of the goods to enable the Court to apply the factors enumerated in the statute.⁴ Three of those four factors require a showing of what the remaining economic life of the goods is at the end of the lease term. Without that evidence, and without a clear showing that the agreement provides a meaningful right to terminate, it is impossible to conclude that CIT is entitled to judgment.

III. CONCLUSION

For the foregoing reasons, the Motion of CIT Communications Finance Corporation for Summary Judgment is denied.

Order accordingly.

Dated: June 20, 2002

The Honorable Ronald Barliant
United States Bankruptcy Judge

The Clerk will furnish copies to:

Linda Richenderfer

⁴ The Debtor submitted CIT's responses to Request for Admission whereby CIT stated that "the Equipment's 'remaining economic life' . . . was reasonably predicted to be in excess of the initial term of the Agreement . . ." (DOC No. 17, Ex. B). The Debtor also submitted CIT's Interrogatory responses in which CIT states that "at the time the agreement was entered into, the Equipment had a reasonably predictable remaining economic life of at least 98-120 months." (DOC No. 17, Ex. B). CIT did not offer any underlying evidence to support these assertions.

Maria April Sawczuk
Saul Ewing LLP
222 Delaware Avenue
Suite 1200
Wilmington, DE 19899
(302) 421-6804
Counsel for the Debtor

Jan A.T. van Amerongen, Jr.
Reed Smith
1201 Market Street
15th Floor
Wilmington, DE 19801
(302) 778-7575
Counsel for CIT Communications Finance Corporation

Mark S. Kenney
Office of the United States Trustee
844 King Street, Room 2313
Wilmington, DE 19801

Francis A. Monaco, Jr.
Walsh, Monzak & Monaco, P.A.
1201 Orange Street, Suite 400
Wilmington, DE 19801
(302) 656-8162
Counsel to the Official Committee of Unsecured Creditors