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The Treatment of IRUs in Bankruptcy Proceedings

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I. Introduction

In the past year, the telecommunications industry has been buffeted by a significant number of bankruptcies. Many of these proceedings involve carriers or providers who either own or lease fiber optic networks. A major portion of the capacity is conveyed by a legal vehicle that is unique to the telecommunications industry, known as an indefeasible right of use agreement, or an "IRU." Because of the novelty of IRUs in the bankruptcy arena, courts are now faced with a determination whether IRUs are executory contracts under Section 365 of the U.S. Bankruptcy Code[1] or should be treated as some form of ownership.

The consequences of a determination that an IRU is or is not an executory contract will have a significant impact on the parties. Most importantly, executory contracts are subject to being rejected by the trustee of the debtor's estate under Section 365, and the grantee of an IRU that has been rejected could suddenly experience a serious loss of capacity that would adversely affect its customers. On the other hand, contracts that are not deemed to be executory would not be subject to rejection, and the owner of such an IRU might enjoy the status of a secured creditor. While no court has yet published a decision regarding the treatment of IRUs in bankruptcy, this article presents an analysis of the likely outcome of this issue that will undoubtedly arise frequently in the future.

II. Indefeasible Rights of Use

A. Overview

An indefeasible right of use is one of the most common methods of conveying assets in the telecommunications industry, and combines features of sales, leases and licenses. Most commonly, IRUs involve the conveying of conduit, dark fiber, or lit fiber including "circuitry." An IRU interest is a

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[1] 11 U.S.C. § 365.

form of acquired capital in which the holder possesses an exclusive and irrevocable right to use the facility for all, or almost all, of the facility's useful life.[2] The typical IRU agreement confers usage rights on the purchaser, but actual ownership of the facility differs from one agreement to the next. Many IRUs are structured such that the grantor retains ownership, while others provide that the grantee receives an undivided interest in the facility. IRUs that provide for the grantee to have an ownership interest often postpone the conveyance until the agreement nears its expiration. Most IRUs provide that the grantee has an option to purchase the underlying asset at the end of the IRU's term, usually for a nominal amount. Whichever party holds actual title, the IRU purchaser obtains a right to use the facility, in conjunction with others, and can treat its investment in the facility as a capital cost, instead of as an expense.[3] It is frequently said that an IRU grants most of the "indicia of ownership" while not conveying actual control of the facility.[4]

Variations of IRU agreements are available throughout the telecommunications industry, and the popularity of IRUs has had several causes. An early reference to an IRU was in the FCC's "TAT-4" decision, authorizing a transatlantic telephone cable.[5] Prior to TAT-4, competitive providers of overseas data communications were required to lease circuits from the owners of transatlantic cables, usually ATT or a foreign telephone monopoly. However, in 1964 the Commission concluded that IRUs would facilitate market entry by new competitors, thereby serving the public interest.[6] Unlike the lease arrangements that had previously subjected competitive carriers to substantial rental expense, IRUs transformed these carriers into owners.[7] IRUs assured their owners of long-term availability of facilities at predictable costs. Before long, IRUs were no longer confined to the world of undersea cables, and the FCC noted in 1993 that the IRU concept had been

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[2] Virgin Islands Telephone Corp. v. F.C.C., 198 F.3d 921, 922 n. 2 (D.C. Cir. 1999) (*quoting* IN THE MATTER OF REEVALUATION OF THE DEPRECIATED-ORIGINAL-COST STANDARD IN SETTING PRICES FOR CONVEYANCES OF CAPITAL INTERESTS IN OVERSEAS COMMUNICATIONS FACILITIES BETWEEN OR AMONG U.S. CARRIERS, 8 F.C.C.R. 4173, 8 FCC Rcd. 4173, 1993 WL 756863 (F.C.C. 1993)).

[3] In the Matter of Interconnection Arrangements Between and Among the Domestic and International Record Carriers, 89 F.C.C.2d 194, 211 n. 27, 1982 WL 190444 (F.C.C. 1982).

[4] Robert C. Fisher, Telecommunications in Transition: Private Transatlantic Cable Facilities, 19 Geo. Wash. J. Int'l L. & Econ. 493, 506 n. 103 (1985). *See also* Western Union Intern., Inc. v. F. C. C., 568 F.2d 1012, 1015 (2d Cir. 1977) (referring to IRU as an ownership interest).

[5] In re American Tel. & Tel. Co., 37 F.C.C. 1151, 1161 (1964).

[6] *Id.*

[7] In the Matter of OVERSEAS COMMUNICATIONS SERVICES, 84 F.C.C.2d 622, 627, 1980 WL 121398 (F.C.C. 1980).

expanded to include the conveyance of ''circuitry'' from one domestic United States carrier to the other.[8]

As originally conceived, IRUs in undersea cables had the appearance of service agreements, although they conveyed to the grantee an undivided interest in the cable, itself. If the cable was laid in any private or public land, the IRU should also have conveyed an undivided interest in the right-of-way, although such land was usually a very small part of undersea facilities. The purchaser of an IRU received an allocation of a cable's total capacity, expressed in bandwidth, over which voice and data communications could be transmitted.

As the concept of IRUs spread, some IRU agreements began to look more like sales of equipment or fixtures. For example, IRUs have become one of the primary devices for conveying dark fiber, the individual optical strands over which communications can be transmitted by laser technology. In dark fiber IRU arrangements, the developer of a cable project often installs up to 864 strands of fiber, then conveys those strands, in pairs, to telecommunications carriers and other high-volume users, usually by an IRU.

In the past two or three years, there has been a new interest in domestic IRUs that again resemble capacity leases, owing to the introduction of Dense Wavelength Division Multiplexing (''DWDM''), which has significantly increased the capacity of fiber optic cable. Just two strands of fiber optic cable can now be divided into approximately thirty wavelength channels (also called ''lambdas''), each of which is capable of carrying hundreds of voice and data circuits, and may now be sold as an IRU by one carrier to another. In today's market, IRUs conveying lambdas are often called ''capacity IRUs,'' ''lit fiber IRUs,'' or ''wave IRUs.''

B. Essential Provisions of IRU Agreements.

Every IRU agreement contains a grant, although there can be differences in how each agreement expresses the measurement of what is being conveyed. The typical dark fiber IRU conveys a number of fiber strands between two points, along a specific route, with the grantee usually having the right to drop and add fibers at intermediate points along the route. Similarly, conduit IRUs contain a grant of one or more conduits or ''ducts'' along a specific route. A wave IRU is similar, except that the capacity being conveyed is usually stated in terms of gigabits, rather than fiber strands or feet of duct. A wave IRU still identifies the originating and terminating points.

The term of an IRU is often quite long, perhaps twenty years or more, and the agreement may also provide for disposition of the asset after expiration

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[8] 8 F.C.C.R. at 4173 ¶ 2 n. 6.

of its term. Whether the asset is lit fiber, dark fiber or conduit, the agreement usually provides that title to an undivided interest in the underlying cable will pass to the grantee at the end of the term, with the grantor having an option for repurchase.

Traditionally, 100 percent of the consideration for the grant of an IRU was paid upon delivery of the asset. Separate provisions in the IRU agreement (or perhaps in a separate document) often require the grantee to pay periodically for operations and maintenance services ("OM"). Perhaps reflecting recent concerns over grantors' long-term solvency, many buyers are now insisting that payment for the IRU must also be incremental, in addition to the OM payments. In such agreements, the minimum up-front payment must usually be at least 25 percent. If the grantor conveys an IRU and receives only partial payment of the consideration, the grantor ordinarily files a lien on the asset, requiring the grantee to sign a security agreement as an attachment to the IRU.

C. Is an IRU a Sale of Property, a Lease, or a Service Agreement?

There are at least three ways to characterize an IRU. First, it can be seen as comparable to the sale of an interest in property. Alternatively, it could be characterized as similar to a lease. Or, some may see an IRU simply as a service agreement.

IRUs that convey tangible assets, such as dark fiber or conduit, are fairly easy to conceptualize as sales. As previously stated, an IRU agreement sometimes requires full payment of the price of the IRU at the time of conveyance and provides also for a fixed term that approximates the expected useful life of the facility. As long as the grantor has no continuing obligation to operate or maintain the conduit or fiber, a dark fiber or conduit IRU looks very much like any other sale in which the seller conveys personal property for money. In reality, grantors often do retain operation and maintenance obligations, but under separate covenants, requiring the grantor to pay additional compensation. In most tax cases, including those involving capacity IRUs, the acquisition of an IRU has been treated as a purchase.[9] A draft Revenue Ruling, prepared in 1975 by the General Counsel's Office of the Internal Revenue Service, equated an IRU to ownership of electronic transmission channels.[10]

The second possibility is that an IRU is comparable to a lease, and several cases and commentators, particularly those concerned with accounting

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[9] *See* Revenue Rulings 69-2 and Rev. Rul. 73-77, 1973 C.B. 34.

[10] General Counsel Memorandum, GCM 36334, 1975 WL 37603 (I.R.S. GCM 1975)

principles, have used the term "lease" to describe an IRU.[11] For example, in *dictum*, the United States District Court for the District of Maryland has referred to IRUs as "leases of parts of the [carrier's] fiber optic network."[12]

Finally, some may see an IRU as nothing more than a service agreement. The last alternative is plausible in the case of lit fiber IRUs, although it is at odds with the intent of the Federal Communications Commission since TAT-4, and with the small number of cases and administrative decisions that have looked at the issue so far. Recently, one Securities and Exchange Commission staff member reportedly expressed the opinion that a lit fiber IRU may not meet the accounting definition of a lease, and should perhaps be treated as a service contract.[13]

To experienced telecommunications practitioners, IRUs are clearly distinguishable from service contracts. IRUs and service agreements are marked by clear differences in the way they allocate the benefits and burdens of ownership. One such difference is in the allocation of tax burdens, which is one clear indicator that IRUs are similar to sales of assets. The most common tax allocation methodology in IRU agreements is for as many of the taxes as possible to be flowed through from the grantor to the grantee. Most importantly, ad valorem taxes, excise taxes and franchise fees are generally paid by the grantee, a practice that would not be common in service agreements. Because ad valorem taxes may be assessed on a larger asset than the one conveyed as an IRU, the IRU agreement often provides for the tax to be paid by the IRU grantor, but then allocated ratably among all the owners. Such provisions are contained in most lit fiber IRUs, and are almost universal in IRUs of conduit and dark fiber. As with any asset sale, the transaction may be subject to sales and use taxes, paid by the grantee. The allocation of tax burdens clearly points to the similarity of IRUs to sales contracts.

Conveyance obligations and warranties provide other means to compare IRUs with sales and service agreements. Typically, a dark fiber IRU contains technical specifications, setting forth standards for the performance of the fiber strands and other matters such as the quality of splices. Conduit IRUs contain comparable provisions. The IRU agreement usually requires fibers or conduit to be tested by the grantor before conveyance, with the grantee able to witness and approve the test results. Once the warranty on the fiber or conduit has expired, there is no on-going requirement for the grantor to do

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[11] *See, e.g.*, In re E.Spire Communications, Inc. Securities Litigation, 127 F. Supp. 2d 734, 738 n.6 (D. Md. 2001); Accounting by Providers of Telecommunications Network Capacity, Arthur Anderson White Paper (Sept. 30, 1999) at 4.

[12] In re e.spire Communications, Inc., 127 F. Supp. 2d at 738 n.6.

[13] *Accounting by Providers of Telecommunications Network Capacity, An Update (as of February 29, 2000)*, Arthur Andersen White Paper at 1 (*quoting* Eric W. Casey, SEC Staff, at the November 15/16 1999 Global Capacity Providers CFO Roundtable).

performance testing or maintain performance standards during the IRU's term. Here, a dark fiber or conduit IRU is almost identical to an asset sale. However, it is in the warranties and performance standards that troubling differences between lit fiber, dark fiber and conduit IRUs begin to show up. In lit fiber IRUs, performance standards are typically specified for the duration of the IRU's term. Moreover, it is common for credits to be specified if performance standards are not met. Such credits are issued against the grantee's ongoing obligations to pay for operations and maintenance, and not against the actual purchase price. However, service credits are a common element of service contracts, and their presence in wave IRU agreements makes the resemblance between a service contract and a wave IRU hard to avoid. It is noteworthy that the grantee of an IRU usually cannot terminate the agreement if the grantor fails to achieve promised performance standards, but may only sue for damages.

Finally, virtually every IRU agreement provides for operation and maintenance, sometimes in a separate and attached OM Agreement. In a dark fiber or conduit IRU, the principal OM obligations are surveillance, locating and scheduled maintenance of the assets, for which the grantee may pay a fixed annual fee. In addition, emergency repairs, grantee-requested maintenance and relocation of the assets are generally provided by the OM contractor on a cost-plus basis, shared among all the IRU grantees who benefit from the service. Dark fiber and conduit IRUs structured in this manner are easily conceptualized as sales, because the OM obligations are separate and distinct from the conveyance of the asset, and purchased on a pay-as-you-go basis. The fact that the OM contractor may also be the grantor of the IRU should not be allowed to confuse the issue, because the grantee could easily find a substitute provider of the OM services. In wave IRUs, the grantor's obligation to operate the opto-electronic equipment continues to exist throughout the lengthy term of the IRU, and is a clearly distinguishable obligation from the OM duties that the grantor performs in dark fiber and conduit IRUs.

III. Section 365 of the Bankruptcy Code

Section 365(a) of the Bankruptcy Code provides that "the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor." 11 U.S.C. § 365(a).[14] Under bankruptcy law, a contract is deemed executory if performance is due to some extent on both sides.[15] An executory contract has also been defined as "one in which a party binds himself to do or not do a particular thing, whereas an executed contract

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[14] Conversely, a trustee may not assume or reject a contract that is not executory. In re Giesing, 96 B.R. 229, 230, 1989 WL 11521 (Bankr. W.D. Mo. 1989).

[15] *See* N.L.R.B. v. Bildisco and Bildisco, 465 U.S. 513, 104 S. Ct. 1188, 79 L. Ed. 2d 482, 11 Bankr. Ct. Dec. (CRR) 564, 9 Collier Bankr. Cas. 2d (MB) 1219, 5 Employee Benefits

is one in which the object of the agreement is already performed."[16] In fact, the Bankruptcy Code does not define executory contract, because Congress decided when it revised the code that the meaning was already well understood.[17] It appears that in the courts where the issue has been decided, if the debtor's performance has not been completed, the contract is executory. The Sixth Circuit, for example, has stated that "[e]xecutory contracts involve obligations which continue into the future. . . . Generally, they are agreements which include an obligation for the debtor to do something in the future."[18]

If a contract or lease is rejected under Section 365 of the Bankruptcy Code, the creditor who loses the benefit of the agreement is entitled to file a damages claim, which may be paid depending on the distribution to unsecured creditors. However, such creditor of a rejected contract or lease has no way to compel the debtor to perform. Accordingly, a party that entered into an IRU with the expectation of receiving long term capacity could suffer dire consequences. On the other hand, a trustee (or debtor-in-possession) does not have the option to reject a contract that is not executory in the Bankruptcy Code sense.[19]

IV. IRUs in Bankruptcy

To date, no U.S. bankruptcy court has squarely addressed the executory character of an IRU in a reported case. In fact, although there is intense interest in this issue today, the status of IRUs is untested by bankruptcy case

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Cas. (BNA) 1015, 115 L.R.R.M. (BNA) 2805, Bankr. L. Rep. (CCH) ¶ 69580, 100 Lab. Cas. (CCH) ¶ 10771 (1984). *See also* In re Giesing, 96 B.R. at 231 (contract is executory if obligations of both parties are so unperformed that the failure of either to complete performance would be a material breach) (citation omitted); In re Waldron, 36 B.R. 633, 637 (Bankr. S.D. Fla. 1984), *appeal decided*, 785 F.2d 936, 14 Bankr. Ct. Dec. (CRR) 488, Bankr. L. Rep. (CCH) ¶ 71069 (11th Cir. 1986), *cert. dismissed*, 478 U.S. 1028, 106 S. Ct. 3343, 92 L. Ed. 2d 763 (1986) (legislative history of Section 365 suggests that contract where some performance remains due by all contracting parties is executory); H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 347 (1977), U.S., Code Cong. and Ad. News 5787, 6303.

[16] In re Rovine Corp., 5 B.R. 402, 404, 2 Collier Bankr. Cas. 2d (MB) 944 (Bankr. W.D. Tenn. 1980), *amendment denied*, 6 B.R. 661, 6 Bankr. Ct. Dec. (CRR) 1285, 3 Collier Bankr. Cas. 2d (MB) 114 (Bankr. W.D. Tenn. 1980) (referring to Farrington v. State of Tennessee, 95 U.S. 679, 683, 24 L. Ed. 558 (1877)). *See also* Matter of Tak Broadcasting Corp., 137 B.R. 728, 734, Bankr. L. Rep. (CCH) ¶ 74503 (W.D. Wis. 1992) (true unexpired lease involves unperformed mutual obligations and benefits).

[17] Cloyd v. GRP Records, 238 B.R. 328, 333, 42 Collier Bankr. Cas. 2d (MB) 1731 (Bankr. E.D. Mich. 1999).

[18] In re Becknell Crace Coal Co., Inc., 761 F.2d 319 (6th Cir. 1985) *cert. denied*, 474 U.S. 1006, 106 S. Ct. 528, 88 L. Ed. 2d 460 (1985) *reh'g denied*, 474 U.S. 1111, 106 S. Ct. 901, 88 L. Ed. 2d 934 (1986); *accord* Matter of Cloyd, 238 B.R. at 333 (generally executory contract includes obligation for debtor to something in the future).

[19] *See* In re Giesing, 96 B.R. at 230.

law. Accordingly, whether an IRU would be considered an executory contract subject to rejection or be considered a secured transaction is likely to rest upon a court's assessment of the specific terms and conditions of the IRU in question.

It appears that IRUs are similar in nature to leases which are sometimes deemed "true" leases and other times are characterized as secured transactions. The authors believe that the characterization as a sale or lease will depend upon the nature of the IRU. Generally a dark fiber IRU resembles a sale more than a lit fiber IRU which resembles a true lease. Unlike IRUs, however, there is case law on the issue of whether leases are true leases or secured transactions.

According to the legislative history of § 365 of the Bankruptcy Code, the determination of whether a transaction constitutes a true lease or a disguised secured transaction should be governed by state law.[20] Capitalized leases are governed by the respective state commercial codes and the Uniform Commercial Code which has been adopted by all 50 states.[21]

Section 1-201(37) of the UCC 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.[22]

Courts have held that whether a lease is intended as a security agreement

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[20] *See* In re Continental Airlines, Inc., 932 F.2d 282, 294, 21 Bankr. Ct. Dec. (CRR) 1111, 24 Collier Bankr. Cas. 2d (MB) 1878, Bankr. L. Rep. (CCH) ¶ 74018 (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). *See also* In re Zaleha, 159 B.R. 581, 582, 23 U.C.C. Rep. Serv. 2d 1035 (Bankr. D. Idaho 1993) (whether transaction is true lease or disguised security interest is determined by state law); In re Shelby, 127 B.R. 682, 686, 15 U.C.C. Rep. Serv. 2d 584 (Bankr. N.D. Ala. 1991).

[21] In re Murray, 191 B.R. 309, 314, 28 U.C.C. Rep. Serv. 2d 1087 (Bankr. E.D. Pa. 1996), *aff'd*, 201 B.R. 381, 32 U.C.C. Rep. Serv. 2d 34 (E.D. Pa. 1996) (interpreting the amended version of UCC § 1-201(37)) (noting that since state statute is based on the UCC, decisions from other jurisdictions which interpret the same uniform statute are instructive).

[22] U.C.C. § 1-201(37) (West 1999).

is to be determined based upon the facts of each case.[23] Courts are required to examine the intent of the parties and the facts and circumstances which existed at the time the transaction was entered into.[24]

In determining whether an agreement that purports to be a lease is instead a disguised security agreement, the majority of courts have focused on certain of the UCC factors, including: (1) whether the lessee's payment obligation is not subject to termination by the lessee during the term of the obligation; (2) whether 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, and (3) whether the purchase option price at the end of the lease term is nominal.[25]

IRUs as true leases

In *In re Murray*,[26] a bankruptcy court in Pennsylvania concluded that a motor vehicle lease was a true lease, thereby falling within the ambit of 11 U.S.C. § 365. The debtor contended that the lease was a disguised security agreement so that he could retain possession of the vehicle by bifurcating the claim into secured and unsecured components.[27] In support of his claims, the debtor argued that the lease contained the normal incidents of ownership and because, in his view, the purchase option constituted nominal consideration.[28] The court disagreed, concluding that the lease was a true lease because the evidence indicated that the purchase price was equal to the lessor's estimate

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[23] *See* International Trade Admin. v. Rensselaer Polytechnic Institute, 936 F.2d 744, 751, 24 Collier Bankr. Cas. 2d (MB) 2123, 68 Ed. Law Rep. 294, Bankr. L. Rep. (CCH) ¶ 74072 (2d Cir. 1991); In re Pan Am Corp., 130 B.R. 409, 413, Bankr. L. Rep. (CCH) ¶ 74227 (S.D. N.Y. 1991); All Good Leasing Corp. v. Bimco Industries, Inc., 143 A.D.2d 788, 533 N.Y.S.2d 336, 337 (2d Dep't 1988).

[24] *See* Pan Am Corp., 130 B.R. at 413 (*citing* In re Air Vermont, Inc., 44 B.R. 440, 443, 39 U.C.C. Rep. Serv. 1443 (Bankr. D. Vt. 1984)). *See also* In re The Answer—The Elegant Large Size Discounter, Inc., 115 B.R. 465, 469, 13 U.C.C. Rep. Serv. 2d 1247 (Bankr. S.D. N.Y. 1990) (interpreting Arizona law); In re Chateaugay Corp., 102 B.R. 335, 343, 19 Bankr. Ct. Dec. (CRR) 1102, 21 Collier Bankr. Cas. 2d (MB) 135 (Bankr. S.D. N.Y. 1989). Pactel Finance v. D.C. Marine Service Corp., 136 Misc. 2d 194, 518 N.Y.S.2d 317, 318, 4 U.C.C. Rep. Serv. 2d 665 (Dist. Ct. 1987) ("Courts should look to the economic reality of the transaction, rather than to its form, in determining whether there has been a sale or true lease.").

[25] *See* In re Edison Bros. Stores, Inc., 207 B.R. 801, 807-810, 34 U.C.C. Rep. Serv. 2d 594 (Bankr. D. Del. 1997) (*citing* various cases). *See also* In re Zaleha, 159 B.R. at 582) (reviewing factors courts consider to determine whether transaction is true lease or disguised sale).

[26] In re Murray, 191 B.R. 309, 317, 28 U.C.C. Rep. Serv. 2d 1087 (Bankr. E.D. Pa. 1996), *aff'd*, 201 B.R. 381, 32 U.C.C. Rep. Serv. 2d 34 (E.D. Pa. 1996).

[27] *Id.* at 311.

[28] *Id.* at 313.

of the residual value and was not nominal.[29] Also, at all times the lessor owned the vehicle.[30]

In *In re Frady*,[31] the debtors had entered into two leases for the rental of a VCR and for the rental of a washing machine. The debtors argued that the leases were really "disguised sales."[32] Because the purchase price at the end of the leases was not nominal, the court concluded that in fact the leases were true leases, subject to acceptance or rejection under Section 365 of the Bankruptcy Code.[33] In *In re Huffman*,[34] the debtor had entered into a lease for an electric range. In concluding that the lease was a true lease, the court relied on the fact that the debtor had the right to terminate the lease.[35] Because the debtor could have terminated the lease after one week, the court did not agree that the transaction resembled a sale.[36]

A lit fiber IRU often exhibits the characteristics of a true lease. This type of IRU entails the grantor providing the conduit, fiber, electronics and (significantly) the service required to operate it all. Accordingly, the grantor has ongoing performance obligations which, if not performed, render the IRU useless. Added to this is the fact that some lit fiber IRUs are structured so that the grantee may also have ongoing payment obligations. The accumulated effect of such facts make it likely that a court would conclude that such an IRU for lit fiber resembles a true lease and falls within the ambit of Section 365 of the Bankruptcy Code. The implication of such a finding is that the debtor/grantor could reject the IRU to avoid continued performance.[37]

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[29] *Id.* at 316.

[30] *Id. See also* In re Lerch, 147 B.R. 455, 20 U.C.C. Rep. Serv. 2d 260 (Bankr. C.D. Ill. 1992) (holding that automobile lease was true lease); In re Zaleha, 159 B.R. at 583 (concluding that truck lease was true lease because evidence indicated that lessor intended to retain residual value of vehicle).

[31] In re Frady, 141 B.R. 600, 601, 18 U.C.C. Rep. Serv. 2d 914 (Bankr. W.D. N.C. 1991).

[32] *Id.* at 602.

[33] *Id.*

[34] In re Huffman, 63 B.R. 737, 14 Bankr. Ct. Dec. (CRR) 990, 15 Collier Bankr. Cas. 2d (MB) 1078, 2 U.C.C. Rep. Serv. 2d 1685 (Bankr. N.D. Ga. 1986),

[35] *Id.* at 739.

[36] *Id. See also* In re Rigg, 198 B.R. 681, 685, 31 U.C.C. Rep. Serv. 2d 310 (Bankr. N.D. Tex. 1996) (holding that rent-to-own appliance contracts were leases under Section 365); In re Blevins, 119 B.R. 814, 20 Bankr. Ct. Dec. (CRR) 1706 (Bankr. N.D. Okla. 1990) (rental purchase agreements for television, cd player, speakers, bedroom set and microwave were true leases subject to assumption or rejection).

[37] While a lit fiber IRU is strongly suggestive of an executory contract, arguments to the contrary do exist, particularly if: (a) the purchaser of the IRU has paid in full for the useful life of the lit fiber capacity; and (b) the debtor is not required to liquidate the underlying assets (right-of-way, conduit, electronics and fiber) for the benefit of creditors. For a debtor in that circumstance to reject the lit fiber IRU could result in the IRU's purchaser being paid

The grantee would be left with a damages claim but not capacity to serve its customers.

IRUs as capitalized leases

In other cases, courts have concluded that agreements styled as leases are actually not subject to assumption or rejection under Section 365 of the Bankruptcy Code. For example, in *In re Pacific Express, Inc.*,[38] the court concluded that the "lease" was actually a disguised security agreement. The court noted that "[c]ourts have declined to apply section 365 to security agreements, even where those agreements have taken on the surface formalities of contracts or unexpired leases that might otherwise come within the apparent reach of that section."[39] Therefore, Section 365 of the Bankruptcy Code did not govern.[40]

Likewise, in *In re Shelby*,[41] the debtors had executed an agreement to acquire possession of a color television. The court noted previous decisions under Alabama law, which had held that where a consumer could acquire personal property under a lease agreement by fulfilling the terms without paying more than a nominal purchase price, the transaction would be deemed a secured transaction.[42] The court concluded that because the lease at issue provided that the debtors would own the television at no additional or nominal consideration, it was a secured transaction.[43]

The foregoing analysis of leases that bore the characteristics of secured

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negligible damages for the rejected contract while the debtor enjoys the practical result of having the asset returned to be resold after reorganization. This would create an unconscionable windfall to the debtor at the IRU owner's expense.

[38] In re Pacific Exp., Inc., 780 F.2d 1482, 1486, 14 Bankr. Ct. Dec. (CRR) 69, Bankr. L. Rep. (CCH) ¶ 70954, 42 U.C.C. Rep. Serv. 1414 (9th Cir. 1986).

[39] *Id.* at 1487.

[40] *Id. See also* In re Giesing, 96 B.R. at 232 (option contract where debtors had fully performed by paying option fee was not executory). *But see* In re Waldron, 36 B.R. 633, 636 (Bankr. S.D. Fla. 1984), *appeal decided*, 785 F.2d 936, 14 Bankr. Ct. Dec. (CRR) 488, Bankr. L. Rep. (CCH) ¶ 71069 (11th Cir. 1986), *cert. dismissed*, 478 U.S. 1028, 106 S. Ct. 3343, 92 L. Ed. 2d 763 (1986) (option to purchase real estate was deemed to be executory contract).

[41] In re Shelby, 127 B.R. 682, 683, 15 U.C.C. Rep. Serv. 2d 584 (Bankr. N.D. Ala. 1991).

[42] *Id.* at 686.

[43] *Id.* at 694. *See also* In re Lopez, 163 B.R. 189, 191 (Bankr. D. Colo. 1994) (court concluded that pawnbroker transaction was a secured transaction, not an executory contract); International Trade Admin. v. Rensselaer Polytechnic Institute, 936 F.2d 744, 750, 24 Collier Bankr. Cas. 2d (MB) 2123, 68 Ed. Law Rep. 294, Bankr. L. Rep. (CCH) ¶ 74072 (2d Cir. 1991) (lease with 99 year term and pre-paid rent over first three years was not true lease); In re Puckett, 60 B.R. 223, 235, 3 U.C.C. Rep. Serv. 2d 734 (Bankr. M.D. Tenn. 1986), subsequently *aff'd*, 838 F.2d 471 (6th Cir. 1988) and subsequently *aff'd*, 838 F.2d 470 (6th Cir. 1988) (lease of household appliances were disguised sales of goods with financing rather than true leases), *aff'd*, Consumer Lease Network, Inc. v. Puckett, 838 F.2d 470 (6th Cir. 1988).