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FF&E AND THE TRUE LEASE QUESTION: ARTICLE 2A AND ACCOMPANYING AMENDMENTS TO UCC SECTION 1−201(37)

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Introduction

Very often in the course of a chapter 11 case, especially in retail cases, a debtor is required to deal with the issue of whether a lease for its furniture, fixtures and/or other equipment will be considered a true lease by a court or whether it will be found to constitute a disguised financing. The outcome of this determination has important ramifications for a chapter 11 debtor. A finding that the lease is a disguised financing would favor the debtor in that the equipment would be considered property of the debtor's estate. The situation would be even more favorable for the debtor if it were determined that the underlying security interest had not been properly perfected. The lease obligation would, thus, constitute unsecured debt and be treated as such under a plan of reorganization. Similarly, even if the debt were properly perfected, if the collateral has declined in value, the undersecured portion of the debt could be treated as unsecured. Moreover, any such unsecured lease payments made during the year prior to the debtor's bankruptcy filing could be subject to attack as preferential or possibly even as fraudulent. In the event that the security interest were to have been validly perfected, the debtor would likely be required to make adequate protection payments to the lessor to avoid foreclosure. Although there is always the possibility that the debtor will lose the property to foreclosure, this situation is still better than the true lease situation in bankruptcy, in that the collateral will remain property of the debtor's estate unless it cannot make any such adequate protection payments, there is no equity in the property, and the property is not necessary for the effective reorganization of the debtor.

In contrast, in the event that a lease were determined to be a true lease, the leased property would be considered property of the lessor, and the debtor would be required to decide whether to assume or reject the lease prior to confirmation of its plan or during such shorter period of time, as ordered by the court, upon the request of a party to the lease. Although there might be no fixed deadline with respect to assumption or rejection, the debtor would be required, pending such decision, to commence making lease payments starting sixty days after the commencement of the bankruptcy case unless the court orders otherwise. Although this situation is similar to that in which the lease is considered a validly perfected secured debt, it differs in the legal ramifications of the debtor's decision to assume or reject the lease. Were the debtor to assume the lease, it would be required to cure all defaults and remain current on the lease going forward. Were the debtor to reject the lease, it would be responsible for paying rejection damages to the lessor for breach of the lease contract.

Consideration of whether a lease is a true lease or a secured transaction in bankruptcy requires a court to analyze several provisions of the Uniform Commercial Code and accompanying case law. Since 1990, courts have been looking to the newly codified Article 2A governing leases, as well as to the conforming amendment to the definition of "security interest." This codification has taken place in most jurisdictions. In conducting such analysis, courts look to the case law from which such amendments developed to fill in the gaps. This article delineates the steps to be taken by a debtor or financing lessor in conducting a true lease analysis and discusses the various approaches that a court might take in dealing with the interplay between the old and new

law.

In brief, the focus of the analysis is to determine whether the parties to the lease anticipated that any significant value would remain in the leased property for return to the lessor at the end of the lease term, and whether such value is returnable through the lessee's own free will. This will depend upon an objective examination of the substance of the transaction, with the aid of tests set forth in the Uniform Commercial Code definitions of "lease," "finance lease," and "security interest." The revised statute sets forth a two−part test which, if satisfied, has been held to mandate a finding of a secured transaction or, arguably, sets forth a rebuttable presumption of such a finding. This test has its origins in the case law developed under the prior version of the statute, the first part seeking to determine if the lease is terminable by the lessee (namely, whether it contains a so−called "hell or high water clause" (to be defined below)), and the second part seeking to establish what residual value, if any, was anticipated by the parties to remain at the end of the lease term.

Where a lease provides for a purchase or renewal option, this test will require consideration of whether the price to be paid for its exercise is so "nominal" as to render it a sham, thus serving as evidence that the parties intended to enter into a disguised financing. While the statute sets forth two tests for determining whether consideration is nominal, courts also look to several common law tests to assist them in making their decisions. Finally, if the two−part test is not satisfied, courts look to all of the facts surrounding the transaction and consider factors developed prior to the amendment of the statute, some of which are set forth in the revised version. The fact that a lease is delineated as a "finance lease" (or has its characteristics) is also taken into account.

Discussion

I. Application of State Law

When faced with a true lease issue, bankruptcy courts look to state law. [1] Although the Bankruptcy Code [2] itself does not provide much guidance, the case law and legislative history underlying sections 101(50) and 101(51) of the Code point to state law. [3] In applying state law, courts look to the Uniform Commercial Code ("UCC"). [4] The true lease analysis has always turned on consideration of the factors set forth in the UCC definition of "security interest" and the accompanying case law. [5] With the enactment of Article 2A governing leases, new definitions of "lease" [6] and "finance lease" [7] also come into play together with a conforming revised definition of "security interest." [8] Like the UCC prior to the adoption of Article 2A, the Bankruptcy Code does not contain a definition of the term "lease." [9]

II. New Article 2A and Accompanying Amendments

Article 2A of the UCC was first codified in 1987 and underwent revisions that were completed in 1990, thus, permitting its enactment.[10] As part of such codification, UCC section 1−201(37), which sets forth the definition of "security interest," was amended to conform to the provisions set forth in new Article 2A.[11] Accordingly, the effective date of such revised provision in each state is the same as that of the newly adopted Article 2A.[12]

Although, technically, Article 2A and New UCC 1−201(37) may not be applicable to leases entered into prior to the effective dates of these provisions, the majority of courts in jurisdictions that have adopted these provisions tend to either apply the new provisions or look to them for guidance in analyzing pre−effective date leases.[13] In fact, even in situations where these amendments have yet to be adopted, or in the absence of guidance within their own jurisdiction, courts look to other jurisdictions that have adopted the new provisions.[14] Conversely, courts applying the new version of the law also look to the body of case law that developed under Old UCC 1−201(37) in the absence of case law authority or guidance as to the New UCC. [15] Accordingly, in conducting a true lease analysis, a court might apply the new version of the law, the old version or a combination of both.[16]

III. Article 2A: Lease/Finance Lease

A. Lease

The first step in the true lease analysis is to look to the UCC definition of "lease," which reads as follows:

"Lease" means a transfer of the right to possession and use of goods for a term in return for consideration, but a sale, including a sale on approval or a sale or return, or *retention or creation of a security interest is not a lease*. Unless the context clearly indicates otherwise, the term includes a sublease. [17]

The term "lease" was not defined in the UCC until the enactment of Article 2A. Although this definition is not really helpful in and of itself for purposes of the true lease analysis, it serves as a link between the UCC provisions governing leases and those governing security interests. Thus, by referencing the term "security interest," the definition of "lease" requires an analysis of such term as it is defined in UCC section 1−201(37). This provision will be discussed more fully in section IV below.

B. Finance Lease

The next step in the true lease analysis is to look to the provisions defining and characterizing a "finance lease." Section 2A−103(1)(g) defines a finance lease as follows:

"Finance lease" means *a lease* with respect to which:

i) the lessor does not select, manufacture, or supply the goods;

ii) the lessor acquires the goods or the right to possession and use of the goods in connection with the lease; and

iii) one of the following occurs:

(A) the lessee receives a copy of the contract by which the lessor acquired the goods or the right to possession and use of the goods before signing the lease contract;

(B) the lessee's approval of the contract by which the lessor acquired the goods or the right to possession and use of the goods is a condition to effectiveness of the lease contract;

(C) the lessee, before signing the lease contract, receives an accurate and complete statement designating the promises and warranties, and any disclaimers of warranties, limitations or modifications of remedies, or liquidated damages, including those of a third party, such as the manufacturer of the goods, provided to the lessor by the person supplying the goods in connection with or as part of the contract by which the lessor acquired the goods or the right to possession and use of the goods; or

(D) if the lease is not a consumer lease, the lessor, before the lessee signs the lease contract, informs the lessee in writing (a) of the identity of the person supplying the goods to the lessor, unless the lessee has selected that person and directed the lessor to acquire the goods or the right to possession and use of the goods from that person, (b) that the lessee is entitled under this Article to the promises and warranties, including those of any third party, provided to the lessor by the person supplying the goods in connection with or as part of the contract by which the lessor acquired the goods or the right to possession and use of the goods, and (c) that the lessee may communicate with the person supplying the goods to the lessor and receive an accurate and complete statement of those promises and warranties, including any disclaimers and limitations of them or of remedies.[18]

Pursuant to the italicized language in the above−cited provision, in order for a transaction to qualify as a finance lease, it must first qualify as a "lease" under Article 2A.[19] Accordingly, this provision requires that an analysis of the lease be made under UCC section 1−201(37) as a prerequisite to qualifying as a finance lease. Such analysis also requires one to take into account the fact that certain attributes of a finance lease which,

under the old law may have been considered to be attributes of a secured transaction, are no longer necessarily considered as such under the current interplay between Article 2A and New UCC 1−201(37). The following is a brief discussion of the structure, purpose and attributes of an Article 2A finance lease.

1. Structure and Purpose of Finance Lease Transaction

A finance lease is the product of a transaction among three parties: (i) the supplier of the equipment; (ii) the lessee, who selects the supplier and the equipment; and (iii) the lessor, who supplies the money necessary to purchase the equipment. [20] The purpose of the finance lease structure is to allow the lessor to play the limited role of being a financier/owner without the attendant responsibilities of ownership.[21] Rather, the lessee ordinarily must look to the third party supplier or manufacturer for typical owner representations and warranties, and the lessee usually bears risks such as that of the loss of the equipment. As described by one court:

In effect, the finance lessee . . . is relying upon the manufacturer . . . to provide the promised goods and stand by its promises and warranties; the [lessee] does not look to the [lessor] for these. The [lessor] is only a finance lessor, and deals largely in paper, rather than goods. In that situation, it makes no sense to treat the [lessor] as a seller to the [lessee] with warranty liability, nor does it make any sense to free the manufacturer . . . from liability for breach of promises and warranties that it would have given in an outright sale to the [lessee]. Usually, the [lessor] expects to be paid, even though the [product] might prove to be defective or totally unsuitable for the [lessee's] particular business. Thus, a finance lease is a very different animal from an ordinary lease.[22]

The Article 2A provisions governing a finance lease prescribe a set of circumstances and rules that justify placing the lessor in this limited role, while still granting the lessor the benefits of ownership. Subsection (i) of the above provision requires the lessor to remain outside the process of selection, manufacture or supply of the goods, thus, providing justification for the lessor's release from its traditional liabilities.2 [23] To ensure the lessee's reliance on the supplier, and not on the lessor, subsection (ii) requires that the goods (where the lessor is the buyer of the goods) or the right to possession and use of the goods (where the lessor is the prime lessee and the sublessor of the goods) be acquired in connection with the lease (or sublease).[24] Finally, because the lessee generally relies almost entirely upon the supplier for representations and covenants, and upon the supplier and/or manufacturer for warranties with respect to the goods,[25] subsection (iii) requires that one of the following occur: (A) the lessee receive a copy of the supply contract before signing the lease contract; (B) the lessee's approval of the supply contract be a condition to effectiveness of the lease contract; (C) the lessee receive a statement describing the promises and warranties and any limitations relevant to the lessee before signing the lease contract; or (D) before signing the lease contract and except in a consumer lease, the lessee receive a writing identifying the supplier (unless the supplier was selected and required by the lessee) and the rights of the lessee as beneficiary of the supply contract, and advising the lessee that a statement of promises and warranties is available from the supplier.[26] Further, even if the strict letter of the finance lease definition is not met, a transaction can qualify as such by agreement.[27]

2. Typical Finance Lease Provisions

Due to its financing nature, the typical finance lease contains many provisions or attributes which courts, prior to the enactment of Article 2A and New UCC 1−201(37), commonly considered "incidents of ownership" by the lessee and typical of a secured transaction.[28] The following is a list of provisions or attributes that are typical of a finance lease:

i) the lessor is in the business of financing leases;[29]

ii) the lease provides that the leased goods are acquired solely in connection with the lease;[30]

iii) the lease provides that the lessor does not select, manufacture, or supply the leased goods;[31]

iv) the lease provides that the leased goods are to be acquired or selected from a third party;[32]

v) the lease disclaims warranty and promissory liability on the part of the lessor;3 [33]

vi) the lessee bears the risk of loss;[34]

vii) the lease contains a "hell or high water" clause;[35]

viii) the lease contains a non−cancellation clause;

ix) the lease contains an accelerated payment clause;

x) the lease contains a late payment clause;

xi) the lessee is obligated to pay all taxes as to the leased goods;

xii) the lessee is obligated to procure and maintain insurance as to the leased goods;

xiii) the lessee is obligated to maintain the leased goods;

xiv) the lessee is obligated to pay all licensing and registration fees;

xv) the lease contains default provisions (*e.g.*, failure to pay rent, failure to maintain insurance, failure to pay taxes, and other similar provisions);

xvi) the lease contains provisions for the lessee's payment of attorney's fees, costs, prejudgment interest, or repossession upon the lessee's default;

xvii) the lessee is obligated to pay a non−substantial refundable security deposit;

xviii) the lessee is required to return the leased goods at the end of the lease term or is provided with the option to purchase the leased goods for consideration;

xix) the lease provides that title to the equipment is to remain in the lessor;

xx) the lessee is obligated to use markings supplied by the lessor stating that the equipment is the property of the lessor;

xxi) the lessee is prohibited from assigning the lease, subleasing the equipment, pledging or otherwise disposing of the lease or the leased property, or any interest therein;

xxii) the lessee is required to keep the leased equipment free and clear of all levies, liens, and encumbrances.[36]

While some have been found to be indicative of a transaction for security, the ultimate determination will depend on an analysis of UCC section 1−201(37).

IV.Security Interest: New UCC 1−201(37)

New UCC 1−201(37) codifies, clarifies and/or corrects Old UCC 1−201(37), as well as the case law that developed under the provision.3 [37] Enactment of New UCC 1−201(37) can be traced back to the "lineal ancestor" of UCC Article 9, the Uniform Conditional Sales Act ("UCSA").[38] Both Old and New UCC 1−201(37) are based on the UCSA and relevant case law and, in fact, some of the New UCC provisions were taken directly from the UCSA.[39]

A. Old and New Provisions

1. New UCC 1−201(37)

New UCC 1−201(37) 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 additional 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.[40]

New UCC 1−201(37) also provides for the following definitions to be applied to the above provisions:

For purposes of this subsection (37):

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

(y) "Reasonably predictable" and "remaining economic life of the goods" are to be determined with reference to the facts and circumstances at the time the transaction is entered into; and

(z) "Present value" means the amount as of a date certain of one or more sums payable in the future, discounted to the date certain. The discount is determined by the interest rate specified by the parties if the rate is not manifestly unreasonable at the time the transaction is entered into; otherwise, the discount is determined by a commercially reasonable rate that takes into account the facts and circumstances of each case at the time the transaction was entered into.[41]

2. Old UCC 1−201(37)

Old UCC 1−201(37) provides, in pertinent part, as follows:

. . . Whether a lease is *intended* as security is to be determined by the facts of each case; however (a) the inclusion of an option to purchase does not of itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended for security.[42]

B. Objective Test

Whether a lease is intended as a security interest is to be determined on an objective basis.[43] In conducting such analysis, courts are required to disregard the form of the agreement or the stated intent of the parties that the agreement be a "lease" and, instead, must look at the agreement's economic effect on the parties.[44] Although Old UCC 1−201(37) provided objective tests for determining whether the parties to a lease "intended" a security interest, it was confusing in its use of the word "intent" which seemed to also indicate a subjective approach.4 [45]

New UCC 1−201(37) was designed to correct such confusion by eliminating reference to "intent." The current test is whether the lease itself "creates" a security interest.[46] As noted by their drafters, New UCC 1−201(37) and Article 2A seek to "draw a sharper line between leases and security interests disguised as leases to create greater certainty in commercial transactions" by focusing attention on the economics of the transaction rather than the "intent" of the parties.[47]

C. Residual Value: Two−Part Test

Courts interpreting both Old and New UCC 1−201(37) have consistently held that the principal characteristic of a lease, which distinguishes it from a secured transaction, is that it allows the lessee the right to use the leased property with an attendant opportunity to return the property to the lessor while it still has "substantial useful economic life."4 [48]

Old UCC 1−201(37) provides only two factors for making the determination as to whether the lessor has provided the lessee with the opportunity to return the leased property with a significant residual value and, accordingly, whether a transaction constitutes a security interest. These factors are contained in clause (b) of the old section, which provides that a lease constitutes a security interest where, for no additional consideration or for nominal consideration, either (i) the lessee is bound to become the owner of the property, or (ii) has the option to become the owner of the property.[49] In addition to these two factors, however, Old UCC 1−201(37) also provides that a determination under such provision must be made based on the facts of each case.[50] Accordingly, under Old UCC 1−201(37), courts used the factors provided by clause (b), but also developed various additional factor−tests as indicators of whether the lessor had provided the lessee with the opportunity to return the leased property with a remaining useful life.

New UCC 1−201(37) provides for a two−part test that incorporates both the factors provided by clause (b) of Old UCC 1−201(37) and certain of the additional factor−tests developed under the case law.

1. "Hell or High Water" Factor: First Part of Test

The first part of the two−part test set forth in New UCC 1−201(37) requires that the obligation of the lessee to make rental payments not be terminable by the lessee during the term of the lease.[51] This factor encompasses the concept of the "hell or high water clause," which requires the lessee to make rental payments to the lessor "come hell or high water."[52]

Although Old UCC 1−201(37) was silent as to the hell or high water factor, its use to determine whether a transaction constitutes a security interest can be traced back to the UCSA. The drafters of New UCC 1−201(37) removed the factor from section 1(2) of the UCSA and modified it to reflect current leasing practice.[53] Under the UCSA, if the lessee had the right to terminate the lease without paying the full price of the goods, there could be no conditional sale.[54]

The policy behind the adoption of the hell or high water factor as the first part of the two−part test of New UCC 1−201(37) was to correct the results of decisions made by some courts under Old UCC 1−201(37).5 [55] The gloss accorded to Old UCC 1−201(37) by these courts was to deem the two factors listed in clause (b) (option to purchase or required purchase for no or nominal consideration) as *per se* evidence of a security interest without looking to any other determinative factors. Accordingly, if the lease provided for the lessee's purchase or option to purchase the leased property for no or nominal consideration, these courts found the lease to constitute a security interest even if the lease could be terminated by the lessee.5 [56] Conversely, some courts deciding cases under Old UCC 1−201(37) have placed so much emphasis on the hell or high water factor that they have held, by negative implication, that if the obligation to make the rental payments is terminable at will by the lessee, the lease is a true lease.[57]

In contrast, New UCC 1−201(37) rejects the use of any of the above factors as stand−alone or *per se* indications of a security interest.[58] Instead, New UCC 1−201(37) sets forth a two−part test, placing equal significance on the hell or high water factor and the two factors listed in clause (b) of Old UCC 1−201(37) and, in addition, provides an alternative list to the latter second part of the test, of other factors developed under the old case law.[59]

2. Residual Value Factors: Second Part of Test

The Residual Value Factors that comprise the second part of the two−part test are set forth in the first paragraph (¶1) of the above−cited New UCC 1−201(37) provision. Each of these factors, when combined with the hell or high water factor, indicate that the lessor is not retaining a substantial residual interest in the leased property and, accordingly, that the lease is essentially a secured transaction. The Residual Value Factors are set forth in the following order.

a.Four Statutory Factors

First: The original term of the lease is equal to or greater than the remaining economic life of the leased property.[60] As explained by the oft−cited *Marhoefer* case which was decided under the Old UCC: "Where the term of the lease is substantially equal to the life of the leased property such that there will be nothing of value to return at the end of the lease, the transaction is in essence a sale."6 [61]

Second: The lessee is bound either (i) to purchase the goods, or (ii) to renew the lease for the remaining economic life of the goods.[62] As discussed with respect to the prior factor, where a lessee is contractually bound to either purchase or renew at the end of the lease term, courts have inferred from such provisions the parties' intent that no value would remain for the lessee at such time.6 [63]

Third: The lessee is provided with an option to renew the lease for the remaining economic life of the goods for no or nominal additional consideration.6 [64] As with the forced purchase or renewal factor, a low option price has been found to indicate the parties' assumption that at the end of the lease term, the lessee will have become the owner of the leased property because the lessee has already consumed all or most of its useful life.[65]

Fourth: The lessee is provided with an option to become the owner of the goods for no or nominal additional consideration.[66] As discussed in connection with the renewal option, a low option price may indicate the anticipated absence of any substantial useful life for the leased property by the end of the lease term.6 [67]

b.Remaining Economic Life and Nominal Consideration

Application of the Residual Value Factors requires an analysis of the "remaining economic life" of the leased property and/or whether the consideration to be paid under a purchase or renewal option is "nominal."[68] Old UCC 1−201(37) does not set forth any guidelines for determining these issues. [69] Accordingly, development of these guidelines was left to the courts, and the tests for both issues often overlapped.[70] In fact, in some cases decided under Old UCC 1−201(37) where the option price was $1.00, the courts construed such an option as "nominal" without any analysis or comment on the remaining economic life of the property.[71]

In contrast, New UCC 1−201(37) sets forth guidelines for determining both of these issues.7 [72] More is said about "nominal" consideration than is said regarding "remaining economic life."[73] With respect to the latter, it is to be determined based on the "facts and circumstances at the time the transaction [was] entered into."[74]

With respect to "nominal" consideration, parameters are set at two ends of the spectrum: consideration is nominal if it is for less than the lessee's reasonably predictable cost of performing were the option not to be exercised; consideration is not nominal when the option to renew or purchase is stated in the agreement to be the fair market value of the property.[75] Although the New UCC provision appears to be helpful in setting forth these parameters, they are ambiguous and, accordingly, as under Old UCC 1−201(37), these issues have been left to case law development.7 [76]

(1) New UCC 1−201(37) Test #1: Option to Purchase or Renew For Less Than Reasonably Predictable Cost of Performance is Nominal

New UCC 1−201(37) provides that consideration *is nominal* if it is for less than the lessee's reasonably predictable cost of performing were the option not to be exercised ("New UCC Test #1").[77] This test has been described as a codification of a common law test alternatively known as the "economic realities" test, the "no sensible alternative" test, or the "no lessee in its right mind" test.[78] Because the case law discussing this New UCC test is sparse, its application should take into account this common law test which will be discussed more fully in section IV.C.2(4) below.

(2) New UCC 1−201(37) Test #2: Fair Market Value; Presumptively Not Nominal

The New UCC 1−201(37) definition of "nominal" further provides that consideration is *not nominal* when the option to renew or purchase is stated in the agreement to be the fair market value of the property ("New UCC Test #2").[79] This test compares the option price to the fair market value of the property. As in the case of the first parameter for nominal consideration, the New UCC case law interpreting this second parameter is sparse. Although a minority of courts have taken the approach that a fair market value option is not nominal *per se*,[80] other post−amendment decisions −− consistent with the approach taken under the Old UCC −− have found that a fair market value option in a lease constitutes only a presumption that the option was not for nominal consideration, which can be rebutted by facts and circumstances particular to the transaction.[81] Accordingly, pursuant to the large body of case law from which the New UCC "fair market value" parameter developed, an option for fair market value can be nominal.[82]

One instance where a fair market option has been found to be nominal is where the value of the property is shown to be negligible.[83] As noted by one commentator: "If the 'fair market value' is so small as to be 'nominal' under any common sense understanding of the term, then the lease is intended for security."8 [84]

A second such instance occurs when the fair market option is shown to be illusory because no market for the property exists. This generally occurs when the property is custom−made or modified for the express use of the lessee, or when the property is of the type that will become obsolete and useless due to anticipated

technological advances.8 [85] The test in this situation is the "useful life" of the equipment, not its functional life; accordingly, the usefulness of the equipment is evaluated "as is," and not as refurbished.[86] Furthermore, courts have found that the absence of a market for the equipment may also indicate that the term of the lease is either equal to or greater than the "useful life" of the equipment, which also brings into play the first of the Residual Value Factors.8 [87]

A third instance where even substantial fair market value options may be found to be nominal arises when options are shown to be illusory because the lessee's cost of removal and redelivery, in the absence of the option's exercise, is so high that it approaches or exceeds the anticipated fair market value. Under such circumstances, the so−called fair market value option price is effectively nominal in that the lessee's only reasonable economic choice is to exercise the option.[88] Thus, in determining whether the option price is nominal, the anticipated cost of removal and return should be deducted from the purchase option price when comparing that price to the anticipated fair market value, because the lessee would be saved that expense were it to exercise the option.[89]

(3) Common Law Test: Measure Purchase Option Price v. Original Purchase Price or Total Rentals; Tax and Accounting Purpose of Transaction

Because of the gray area left by New UCC 1−201(37) with respect to the meaning of "nominal," courts continue to use common law tests to determine whether an option is nominal. One test used under both the New and Old UCC is a comparison of the option price to the original purchase or list price of the property. Pursuant to this test, option prices of less than 25% of the original cost have been found to be nominal.[90] Similarly, courts have compared the option price to the total rentals to be paid under the agreement. Generally, option prices of 25% or less of total rentals have likewise been found to be nominal. [91]

These guidelines are also similar to those that have been set forth by the Internal Revenue Service ("IRS") or the Financial Accounting Standard Board ("FASB") for purposes of a lessor's tax and accounting treatment of the leased property. The IRS has considered 20% of the original cost of the equipment as representing a valid residual useful life, while FASB has required that the leased item have an estimated residual life of more than 25%.[92] Although the UCC, tax, and accounting standards for determining residual life are all intended to distinguish between a true lease and a secured transaction, they are not necessarily controlling in the UCC context.[93] Nevertheless, these standards serve as evidence of what is deemed to be remaining residual life of equipment.

In addition, it is arguable that, where a lease transaction is essentially tax driven and structured merely to provide the lessor with the tax benefits of ownership, this serves as evidence that the transaction is not a "true" lease but, instead, a secured financing. Such a factor has been found to evidence a secured transaction in cases involving leases of real property.[94]

Another provision which arguably might evidence the estimated useful life of equipment over time is a stipulated loss value ("SLV") table which sets forth values to be paid for the equipment in the event that it is lost or damaged. SLVs are essentially forced purchase options. Accordingly, where SLVs range below 25% of the purchase price or total rentals, it is arguable that they provide further evidence that the remaining useful life of the property will be used up by the end of the lease term.

(4) Common Law Test: Economic Realities/ No Sensible Alternative/ No Lessee in its Right Mind

Yet another common law test used by courts deciding cases under both the New and Old UCC is the so−called "economic realities" test which, as discussed, has also been dubbed the "no lessee in its right mind" or "no sensible alternative" test. This test provides that if at the end of the lease term, the only economically sensible course for the lessee to take is to exercise the option to purchase the property, then the lease is a security agreement.[95] The "economic realities" test has been applied to demonstrate evidence of "nominal" consideration with respect to certain of the tests discussed above, including those where the option price is less than the reasonably predictable cost of performance (*see* New UCC Test #1),[96] as well as those where the

application of return or removal provisions would offset the value of an option to purchase or renew (*see* New UCC Test #2).[97]

D. Two Part Test: Presumptively Mandatory?

It is unclear from the language of New UCC 1−201(37) and the official comment whether satisfaction of the two−part test mandates a finding that the transaction is one for security without an accompanying analysis of the remaining facts of a particular case.[98] Commentators have stated that, in doing away with the objective "intent" standard, the new version focuses on the facts of each case.[99] This view is consistent with those cases decided under Old UCC 1−201(37) that held that an option to purchase the property for no additional consideration or nominal consideration was not conclusive evidence of a security interest but, instead, simply one factor to be used in determining such objective "intent."[100]

Despite the ambiguity of New UCC 1−201(37), courts interpreting the statute have found it to mandate a finding of a security interest if the two−part test is satisfied.[101] On the other hand, the converse does not mandate a finding of a true lease. Failure to satisfy the two−part test requires an examination of the remaining facts of a case prior to making any final determination.[102] The language of the statute similarly appears to require examination of all the facts of a case in the first instance, regardless of the results of the two−part test. Thus, in attempting to reconcile this language with the New UCC case law, it is arguable that the two−part test is presumptively mandatory, namely, that if the facts of the case rebut the presumption created by the two−part test, the transaction would not be considered to be one for security.[103]

E. Facts of Each Case Test: UCC and Other Case Law Factors Not Determinative of Security Interest

In addition to the factors discussed above, courts have developed many additional factors which they have found to constitute "incidents of ownership" by the lessee and, thus, evidence of a financing arrangement. This is especially so in the case of an Article 2A finance lease, in that many of these factors are characteristic of such type of lease. Some courts have accorded more weight to these factors than others and, at times, have erroneously considered them to be determinative of a transaction for security.[104]

The drafters of New UCC 1−201(37) sought to rectify this situation by setting forth certain of these factors in the second paragraph of the above−cited New UCC 1−201(37) provision and by providing that while they might be indicative of a transaction for security, they cannot be viewed as solely determinative of such question. In addition, in the Official Comment to New UCC 1−201(37), the drafters specify several additional factors and further provide that, in fact, most of the "incidents of ownership" factors developed by the case law (but not specified in the statute or official comment) should similarly be considered as not determinative of a transaction for security.

1. Case Law Factors

The following is a list of the "incidents of ownership" factors developed by courts under Old UCC 1−201(37):

(i) the lessor is a financier;

(ii) the lessee is granted an equity interest in the leased property;

(iii) rental payments exceed the purchase price of the leased property;

(iv) the lessee is required to pay a substantial security deposit which looks like a down payment;

(v) the lessee is required to join the lessor in the execution of, or permit the lessor to execute, a UCC financing statement and/or retention of a security interest by the lessor;[105]

(vi) the lease is to be discounted with a bank;

(vii) the leased property is to be acquired or selected from a third party by the lessee (as opposed to the lessor);

(viii) the leased property is to be purchased by the lessor specifically for lease to the lessee;

(ix) the lessor does not inspect the leased property;

(x) the lessor lacks facilities to store or retake the leased property;

(xi) the lessor does not carry the leased property as assets on its books, but rather as accounts receivable;

(xii) the lessor does not take any depreciation deductions with respect to the leased property;

(xiii) the lessee pays sales tax incident to the acquisition of the leased property;

(xiv) the lessee is responsible for insuring the leased property;

(xv) the lessee bears the risk of loss as to the leased property;

(xvi) the lessee is responsible for paying all taxes as to the leased property;

(xvii) the lessee is required to pay all license or registration or other similar fees as to the leased property;

(xviii) the lessee is responsible for maintaining or repairing the leased property;

(xix) the lease contains a provision disclaiming warranties of fitness and/or merchantability on the part of the lessor;

(xx) the lease requires an indemnity or guaranty issued by a third party;

(xxi) the lessee is required to indemnify the lessor or assume risk;

(xxii) the lease contains default provisions such as acceleration of rent, or other mortgage remedies;

(xxiii) the lease contains default provisions inordinately favorable to the lessor;

(xxiv) the lease contains a provision for liquidated damages; and

(xxv) the lease contains default provisions which provide that, upon sale of the leased property, the lessee is liable for any deficiency in total rent in excess of the sale proceeds, or which entitle the lessee to receive any surplus proceeds over the rental value.[106]

Courts deciding cases under the New UCC follow the approach taken by its drafters, namely, that most of these case law factors are found in true leases.10 [107] This approach is based on those decisions rendered under Old UCC 1−201(37) which held that the above−cited factors are not determinative of transactions for security.[108]

2. Statutory New UCC Factors

Among these case law factors, the following are set forth in the second paragraph (¶2) of the above−cited New UCC 1−201(37) provision and described as being indicative, but not determinative, of a secured transaction.

The first of these factors describes the situation where the rental payments to be made by the lessee are, in total, substantially equal to or greater than the fair market value of the leased property at the time the lease is executed.[109] This scenario has been considered indicative of a transaction for security on grounds that the "rental" payments are related not to the rental value of the property, but to the amount of money invested by the lessor to purchase the property plus interest. [110] Accordingly, some cases decided under Old UCC 1−201(37) found this to be determinative of a transaction for security. [111] This finding can be further explained on grounds that the lessee is effectively paying for the remaining residual life of the property. [112] When determining this issue, pursuant to the language of the New UCC, courts are required to employ a "present value" analysis. [113]

Two conceptually similar situations are encompassed by the fourth and fifth factors in terms of purchase or renewal options. These involve situations where the lessee has an option to renew the lease or purchase the leased property for a fixed rent or purchase price that is equal to or greater than the reasonably predictable fair market rent of the property for the term of the renewal, or its value at the time the option is to be performed.[114] Furthermore, courts have held that the fact that the option price might be fixed does not of itself create a security interest. [115]

The third factor encompasses the option scenario, namely, the situation where the lessee is given the option either to renew the lease or purchase the leased property. [116] This factor does not touch on any related consideration but, instead, simply restates subfactor (a) of Old UCC 1−201(37) with the addition of the renewal option.[117]

Finally, the following factors are set forth relating to the costs which the lessee may be required to bear under a lease: (i) risk of loss, (ii) payment of taxes, (iii) obtaining and maintaining insurance, (iv) payment of filing, recording, or registration fees, and (v) payment of service or maintenance costs.[118] The lessee's acceptance of the responsibility for such costs has been found by courts under both the Old and New UCC to be typical of "net leases," and to reflect the relative bargaining power among the parties rather than the character of the transaction.11 [119]

Conclusion

The true lease analysis will, thus, require application of the two−part test, but will ultimately depend upon a finding, based on the facts of each case, as to whether residual value will remain for the lessor at the end of the lease. From a financing lessor's perspective, in order to avoid a finding that a lease constitutes a disguised security interest, the lessor must endeavor to draft the lease and structure the transaction to demonstrate objective evidence of a true lease. Although the lessor could include language in the lease that states that the lease is intended to be a "true lease" or a "finance lease," such language, although an indication of intent, has not been found to be determinative. Similarly, although the lessor could seek to structure the transaction as a "finance lease," the ultimate focus of a court will be on the two−part test and the facts of the case. Accordingly, it is with these latter factors in mind that the lessor should tailor its transaction.

On the other hand, to be safe, the financing lessor should seek to protect its interest in the leased property in the event that it is found by a court to be a security interest. Toward that end, the lease should provide for the perfection of a security interest in the leased property and should further state that the grant of the security interest is merely a precautionary measure in the event that the lease were found to be one for security. Also, the lessor should endeavor to establish a pattern of timely payment of rent in order to avoid a situation where it would be required to return such payments as preferential transfers.

Footnotes