Chapter 4A: Leases

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Chapter 4A: Leases

- Compare a purchase money security interest in an item of equipment with a lease of the same equipment.
- In each case, the party acquiring the equipment makes periodic payments to the party providing the equipment.
- In each case the party providing the equipment retains a property interest in the equipment.
- Contrast a security interest with retention of title in a true-lease transaction.

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- Remember: An attempt to retain title in a sale of goods transaction until full payment of the purchase price simply amounts to retention of a security interest. See UCC §2-401.
- Article 2A applies to leases. Article 9 applies to security interests.
- At the end of a true lease, the lessor gets the property subject to the lease back. In a purchase money financing, when the debt is paid, the debtor keeps the property.
- Creditors, trustees in bankruptcy and buyers are all subject to the lessor's interest.

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- Unlike a security interest, the lessor need not give any public notice of its interest in order to defeat third party claimants.
- Thus, the key question becomes whether a transaction is a "true" lease transaction or instead a disguised sale of goods with a reservation of a security interest.
- We begin this analysis with UCC §1-201(37). Notice that certain factors require a finding that a lease is actually a disguised security interest.

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- If the lease is not subject to cancellation by the lessee during the lease term, then the lease may be a disguised security interest.
- Think of the obligation to pay rent. If the lessee must make each rental payment for the life of the lease, it looks like a repayment of debt in installments secured by the leased property because you can not return the property to the lessor to eliminate the obligation to make future rental payments.
- Inability to terminate the lease payments coupled with one other factor is the key.

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- Original term of lease is equal to or greater than remaining economic life of goods.
- 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.
- Lessee has option to renew lease for remaining economic life of goods for no consideration or nominal consideration.
- Lessee has option to become owner of goods for no consideration or nominal consideration.
- Any one of these four features, coupled with "no termination," creates a security interest.

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- The general idea of the test: will the lessor receive anything of value back at the end of the lease term?
- The lessor will not receive anything of value back if the lease may not be cancelled and the term of the lease equals or exceeds the useful life of the goods subject to lease.
- The lessor will not receive anything of value back if the lessee is compelled economically or contractually to purchase the goods or renew the lease beyond economic life.
- Key: retention of meaningful residual interest.

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- The lessor can retain a meaningful residual interest in the leased goods even if the lessee assumes certain risks of loss and other responsibilities typically associated with ownership.
- The lessor can retain a meaningful residual interest in the leased goods even if the lessee pays a high price in lease payments to use the goods.
- The lessor can retain a meaningful residual interest in the leased goods even if the lessee has an option to renew or buy the goods.

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- In each situation, we look at the facts of the case unless the lease contains a term that requires the conclusion that the lease is really a security interest.
- Residual value is an economic rationale for making a distinction between leases and security interests.
- Key timing question: is test performed at the time the lease is signed or at the time any option or renewal might be exercised?

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- The test of residual value is performed at the time the lease is entered into and not at the time of decision for the exercise of an option to purchase the goods or renew the lease.
- This timing rule is found in the In re Zahela case, Text at 350, 354.
- This timing rule makes sense because it prevents a transaction that was a lease transaction at its inception from mutating into a secured transaction at a later date based on extraneous factors. Remember: financing statements need not be filed for leases!

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- If another timing rule were used, then the only way a lessor might protect itself would be to make a precautionary UCC filing.
- The UCC permits the use of precautionary filings without prejudice in characterization.
- Note §9-505(a) and (b). A lessor may file a financing statement using the terms “lessor” and “lessee” rather than “secured party” and “debtor”! The mere fact of filing a financing statement is not to be considered in the analysis of whether a transaction is a true lease or a secured financing.

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- If you have a significant transaction and the lease versus security interest characterization is in doubt you have only one choice.
- Pay the $15 and file the financing statement. Do not waste lawyer time on the question.
- However, in some states the filing fee may be more expensive or other taxes and fees may apply. In that case, you will have to make a judgment.
- Some businesses, however, do not want the cost and paperwork of secured financing. They want to use true leases for this reason. A rule that changes the outcome mid transaction does not work for these folks.

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- Note that the drafting committee could not come up with a formula to define what percentage of value should constitute nominal value. See Text at 357.
- The In re Powers case, Text at 357, is a simple test of your understanding of the requirements of UCC §1-201(37).
- There was an option to purchase the leased goods for a nominal price.
- However, the lessee could terminate the lease and stop making payments at any time. The definition for a mandatory secured financing is not met. Thus, the court had to analyze facts and circumstances.

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- How does a true lease differ from a security interest in a bankruptcy of the lessee/debtor?
- In a true lease transaction, the bankrupt lessee must either reject the lease and lose the asset or accept the lease and, thus, perform in accordance with the terms of the lease.
- In a credit transaction, the creditor has a secured claim for the value of the collateral and an unsecured deficiency claim for the balance.
- The difference can be particularly telling in a Chapter 11 or Chapter 13 case. Text at 361.

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- How does a true lease differ from a security interest in a bankruptcy of the lessee/debtor?
- And, of course, if the creditor/lessor did not file a financing statement to perfect its interest, the difference is enormous.
- In an unsecured credit transaction, the creditor has an unsecured claim for unpaid amounts and can not get the asset back
- In a lease transaction, the lessor will either get the property back or receive its lease payments in full.
- Think about the incentive for a debtor, particularly a consumer, to continue making payments.