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ATTORNEYS AT LAW

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BUSINESS LEASING NEWS

"Offering leasing and financing strategies for your success"

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BLN's home page follows the theme and bold new look of the firm's web site that aptly describes Patton Boggs LLP as a "Power Base."

As you can see, BLN's e-mail has the new look too, featuring a jet engine image that relates well to BLN and its topics.

From: David G. Mayer, a business transactions partner of the law firm of Patton Boggs LLP and author of the book, Business Leasing for Dummies® (BLFD). The book is out of print, and a few copies, which may be used, can still be found. Amazon.com showed limited availability for used copies at $79.99, a 300 percent premium over the cover price. If you want to find a copy, please search the web today! Thanks for buying my book for over 45 months.

This e-newsletter offers timely, concise information and analysis backed by supporting research. Please contact Business Leasing News (BLN) to provide us with your ideas for topics and comments on BLN's articles. Our readers live in more than 23 countries and do communicate with BLN or its author, David G. Mayer. Thanks for taking your valuable time to read BLN.

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1. Tax Advisers Face Career Altering Risks Under IRS Circular 230

The Internal Revenue Service (IRS) turned up the pressure on lawyers and accountants who violate the rules in a deceptively innocent sounding publication called "Circular 230." Circular 230 governs written advice in virtually all tax-oriented transactions involving federal tax law. Under Circular 230, the IRS can deny a lawyer or accountant the privilege of practicing before the IRS, and prevent other lawyers from working with a tax practitioner who violates Circular 230. Worse yet, these draconian remedies may result from advice you request or receive from your lawyer regarding your tax leases and other tax-oriented deals. Also see: Final Tax Regulations.

Effective Date; Affected Tax Groups

Circular 230 governs tax practice before the IRS by lawyers, certified accountants, and others. The rules also apply to in-house counsel. Although Circular 230 has been in existence for many years, the IRS promulgated amendments to Circular 230 in December 2004. The rules became effective June 21, 2005.

Originally created as a tool to enable the IRS to fight tax shelters, the amendments to Circular 230 extend well beyond the tax shelter area. The rules hold the head of a firm's tax practice responsible for implementing compliance with Circular 230. To that end, Circular 230 requires firms to establish "best practices" for their tax advisory groups. In addition, the revisions institute a whole set of complex requirements and tests for written advice (including e-mail advice) on federal tax matters.

**Tip*: Because these rules fundamentally affect those tax advisers who practice before the IRS, it is important that your tax advisers remain current about changes and developments in this area. They can do so by consulting the IRS news web page at its Office of Professional Responsibility.

The new rules affect all areas of a firm's tax practice. For example, the rules would apply to tax advice on the structuring of the settlement of a lawsuit, including advice on whether someone must withhold tax from settlement proceeds. The rules would also cover an e-mail that states that a proposed change to a lease agreement should not cause the lease to be treated as a sale or a financing for tax purposes.

**Tip*: To comply with the new Circular 230 requirements, our tax practice group has implemented "Best Practices," a tax opinion policy, and a compliance checklist relating to the new requirements. The tax practice group is training our tax lawyers on the new requirements, which are both complex and controversial.

New Rules For Written Tax Advice

Under the new rules, the IRS has established **minimum standards for all written tax advice**. Specifically, a tax practitioner generally is prohibited from giving written advice (including advice by e-mail) about a federal tax issue if the practitioner:

- **bases** the written advice on unreasonable factual or legal assumptions, including assumptions as to future events;
- **relies** unreasonably upon representations, statements, findings or agreements by the client or any other person;
- **fails** to consider all the relevant facts that the practitioner knows or should know; or
- **takes** into account in evaluating the tax issue the possibility that a tax return will not be audited, or that an issue either will not be raised on audit or, raised, will be settled.

Warning*: There are even higher standards for a **"covered opinion." In general, a covered opinion is written tax advice (including e-mails) on a federal tax issue arising in connection with (1) a "listed [tax shelter] transaction" or a "substantially similar" transaction; (2) any entity, plan or arrangement *the principal purpose* of which is tax evasion or avoidance; and (3) with certain exceptions, any entity, plan or arrangement *a significant purpose* of which is tax evasion or avoidance. Covered opinions generally must describe the relevant facts, apply the law to the relevant facts, address all significant tax issues, and reach an overall conclusion. As a result, these long-form covered opinions are likely to be more time consuming and expensive for clients than the short-form opinions that frequently have been suitable for client needs in the past.

Advice Not Expressly Limited Under Circular 230

Circular 230 provides certain exceptions or limitations on the scope or effect of Circular 230's requirements:

- **Short form opinion.** The most discussed exception allows lawyers to provide short-form tax advice (such as an e-mail or a short-form legal opinion) on certain types of matters where a covered opinion is otherwise required, if the advice contains a disclaimer that it may not be relied upon for purposes of avoiding penalties imposed by the IRS.

**Tip:* If a lawyer or accountant includes such a disclaimer and prepares a short form opinion, the lawyer or accountant still stands behind the tax advice. Don't treat this advice or any legal advice as a warranty or insurance. It's not either. The disclaimer prevents the taxpayer from providing the opinion to the IRS and claiming that the IRS should not impose a penalty because the "wrong" position taxpayer took was based on the advice of a tax lawyer or accountant. If, as the taxpayer, you want written tax advice to provide penalty protection, ask your lawyer about whether a disclaimer is necessary or to quantify the costs of having the lawyer prepare advice that will not require a disclaimer. Disclaimers will not protect the taxpayer from penalties for advice regarding a listed transaction or a transaction with a primary purpose of tax avoidance. Expect tax advisers to put disclaimers on most of their written tax advice (including e-mails) to avoid having to assess their tax advice on a case-by-case basis whether the tax advice may have to meet the requirements for covered opinions under Circular 230. Note that a similar disclaimer to one you may see in e-mails and written documents appears in the Disclaimer box at the end of this issue of BLN.

- **Verbal advice.** Circular 230 establishes requirements for written advice including e-mails. Verbal advice should, in any event, be consistent with applicable laws and the spirit of Circular 230, but is not subject to its rigorous and complex rules.

**Tip:* Verbal advice may not always provide what you need to close a transaction, but to the extent you can use verbal advice, your transaction costs should not be quite as high as they will be for written opinions subject to Circular 230.

- **Preliminary advice.** The new rules do not apply to preliminary advice; that is, advice that will be followed by more formal written advice.

**Tip:* Law firms will probably label e-mail responses as preliminary advice where those responses will be followed by more formal written advice on the matter, such as an opinion (either long form or short form), at the closing of a transaction. You must check whether preliminary advice exception applies if not followed by a covered opinion.

- **Negative advice.** The new rules do not apply to negative advice, such as advice that a transaction will not or is unlikely to qualify for a tax benefit.

- **No significant tax avoidance purpose.** Except in the case of advice on listed transactions (or similar transactions) and transactions the principal purpose of which is tax avoidance, the new rules do not apply to advice on a plan or transaction that has no significant tax avoidance purpose.

**Tip:* Tax practitioners are having a difficult time determining what the IRS means by a significant tax avoidance purpose. While the IRS has said that taking advantage of a tax benefit offered by the Internal Revenue Code does not create a principal purpose of tax avoidance, it is not clear whether taking advantage of a tax benefit (such as pass through treatment for partnerships) can be a significant tax avoidance purpose.

- **No significant tax issues.** The covered opinion rules do not apply to "reliance opinions" if the advice does not relate to significant tax issues, i.e., ones on which the IRS would not have a reasonable basis for a successful challenge to the taxpayer's position.

Conclusion

The IRS did not create Circular 230 because of typical, vanilla tax lease or tax-exempt transactions.

Nonetheless, tax advisers must now consider Circular 230's impact on all tax advice and transactions in leasing and other financial transactions with tax elements. Otherwise, transaction lawyers may face serious penalties that may impair their personal income and business opportunities long into the future.

I would like to thank George Schutzer, the Head of our Tax Practice Group, for editing this article.

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2. Is It Time to Lease Your Next Car?

The Federal Reserve Bank raised the key federal funds interest rate on June 30 to 3.25 percent, the ninth increase in the last year. While higher interest rates may be bad news in some sectors of the economy, higher interest rates generally favor leasing. Automobile leasing is no exception, and automobile manufacturers have been taking unprecedented steps to rebuild leasing volume for selected models of new cars. The Federal Reserve has signaled that it intends to quell any potential for inflation by continuing to raise rates. As a result, leasing your next automobile may fit the bill. See: *Fed Lifts Benchmark Interest Rate to 3.25%*, by Nell Henderson, Washington Post (July 1, 2005).

According to The Wall Street Journal, Detroit has been "trying to reignite sluggish sales" and, to help do so, the manufacturers have "aggressively returned to a strategy that has burned it in the past: pushing people to lease instead of buy." See: *Car Makers Push Leases Again,* by Jennifer Saranow, The Wall Street Journal, Page D:1, Col. 4 (S.W. Ed., May 19, 2005). Even with record car sales in May using the novel sales promotion where consumers can buy at manufacturer employee pricing, leasing cars may still prove to be very attractive in the rising interest rate environment.

**Tip:* For easy steps to evaluate your lease - buy decision, start by considering factors that favor of buying a car. For example, you should probably buy if you drive your car more than 15,000 miles per year or tend to keep your car more than five years. In these usage patterns, you may find buying is cheaper than leasing because of excess mileage charges or forced purchase when the lease expires. Then, consider the factors that favor leasing. For example, if you want a new car every two to three years and diligently maintain your car, leasing may work for you because your usage pattern fits a typical lease term and required maintenance. Whether you lease or buy, prepare to bargain for the cheapest purchase price of a car and then ask for lease pricing. Get competing bids for a lease or purchase. Be sure to select the right mileage for your personal use (buying miles at inception is cheaper than paying $.015 to $.025 per mile for exceeding your contractual limits on miles). Select a car with the highest residual value to drive down your lease rate. Dealers have become savvier about residual values because they over estimated these values in the past and lost their shirts on resale at lower pricing than the predicted residual value. Higher residual values still translate into lower lease payments. For more on the steps to in making lease - buy decision, see: *Your Next Car: To Buy or Lease?,* by Jane Bryant Quinn, Good House Keeping (2005).

In trying to build leasing volume, manufacturers went so far in May as to allow consumers to break leases within the first twelve months. In the past, an early exit from a lease in a typical three-year transaction would require the consumer to buy the car or pay significant fees. Manufacturers have taken a cautious approach to these programs by offering them on select models and market locations. For example, General Motors offered a "Freedom Lease" in May that allowed consumers to break a lease within the first 12,000 miles. However, the program only applied to Buick LaCrosse, Chevrolet Cobalt and Pontiac G6 models.

**Tip:* Visit Edmunds.com for lease and loan calculators to determine which transaction works for you. When manufacturers offer heavy cash incentives, buying a car may trump a lease for the most favorable pricing.

Check with your car dealers for the current leasing programs and other special incentive offers. You may find that your driving preferences and desired model fit within a leasing program that is more cost-effective for you than buying your next car. In any event, it appears that car leasing is moving onward and upward again.

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3. SEC Criticizes Off-Balance Sheet Leasing in New Sarbanes-Oxley Report

The Securities and Exchange Commission (SEC) finally met its Congressional mandate under the Sarbanes-Oxley Act of 2002 (Act) to publish a study (Study) of off-balance sheet (OBS) arrangements. Not surprisingly, the Study generally criticized OBS lease transactions, in part by describing $1.25 trillion of fixed (and undiscounted) OBS lease accounting obligations outstanding in the US.

In late June, the SEC issued its Study under the robust title of "Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers." About 100 SEC staff (Staff) participated in the study. The Staff broadly examines business arrangements involving off-balance sheet implications including:

- investments in the equity of other entities,
- transfers of financial assets (where there is continuing involvement),
- certain retirement arrangements,
- leases,
- contingent obligations, and

- guarantees, derivatives, and other contractual obligations—with an emphasis on the use of special purpose entities where relevant.

The Staff generally concluded that (1) significant progress has been made in several areas since the passage of the Act (with room for improvement in the OBS financial reporting) and (2) financial reporting requirements should be simplified to increase transparency and understanding of financial statements. Study at p. 1.

Primary Goals of SEC Staff

The SEC listed its primary goals as follows:

1. **Discourage** transactions and transaction structures primarily motivated by accounting and reporting concerns, rather than economics;

2. **Expand** the use of objectives-oriented standards, which would have the desirable effect of reducing complexity in accounting standards;

3. **Improve** the consistency and relevance of disclosures that supplement the basic financial statements, making financial disclosures more informative and clear; and

4. **Improve** communication focus in financial reporting. Abandon a strict compliance mindset in favor of clear disclosure and understandable information to help investors and regulators evaluate financial statements.

Recommendations on Lease Accounting

The Staff summarized its recommendation regarding leasing in one key paragraph:

> The Staff recommends that the accounting guidance for leases be reconsidered. The current accounting for leases takes an "all or nothing" approach to recognizing leases on the balance sheet. This results in a clustering of lease arrangements such that their terms approach, but do not cross, the "bright lines" in the accounting guidance that would require the lease to be recognized on the balance sheet. An extrapolation of the findings from the sample of issuers in the Study to the approximate population of active U.S. issuers suggests that there may be approximately $1.25 trillion in non-cancelable future cash obligations committed under operating leases that are not recognized on issuer balance sheets, but are instead disclosed in the notes to the financial statements.

Criticism of 90 Percent "Bright-Line" Test

The Staff also criticized the leasing industry as structuring transactions, using Financial Accounting Statement No. 13 (FAS 13), with the goal of keeping fixed financial obligation off of the balance sheet. It said in part that, when the Financial Accounting Standards Board (FASB) issued FAS 13 in 1976 "…many lessees immediately began to restructure their leases to avoid recognizing liabilities. Their efforts were aided by parties [lessors and lease accountants] who sought to profit from offering their expertise in structuring leases in ways that provided 'preferable' accounting. Such structuring tends to reduce transparency. Indeed, oftentimes that is its point." Study at p. 22.

Placing even greater focus on how the "bright-line" test under FAS 13 distorts financial reporting, the Staff also said:

> The "all-or-nothing" nature of the guidance means that economically similar arrangements may receive different accounting—if they are just to one side or the other of the bright line test. For example, most would agree that there is little economic difference between a lease that commits an issuer to payments equaling 89% of an asset's fair value vs. 90% of an asset's fair value. Nonetheless, because of the bright-line nature of the lease classification tests, this small difference in economics can completely change the accounting. Study at p. 62.

***Warning:** The SEC apparently intends to eliminate accounting-motivated structures and allegedly deliberate attempts to work around the intent of disclosure standards. It may seek to end rules-based, bright-line tests on which the financial accounting for a transaction often depends. You should be aware of any structure in which the form of the transaction may arguably have little or no consistency with its economic substance. Such a transaction may be suspect as the SEC continues to push its point on aligning financial reporting with economic substance of lease transactions. Study at p. 99.

Accomplishments Since Passage of SOX

Despite these criticisms, the Study did acknowledge that much has been accomplished since the passage of the Act, including the issuance of additional guidance from the FASB in its:

- Interpretation No. 46(R), Consolidation of Variable Interest Entities (revised December 2003) —an interpretation of ARB No. 51 (FIN 46(R)) (recording and disclosing liabilities on the balance sheet of entity with the greatest risk and reward elements of an asset in an entity or structured part of a transaction); and

- Interpretation No. 45. Guarantor's Accounting and Disclosure Requirements for Guarantees Including Indirect Accounting for Guarantees of Others, an Interpretation of FASB Statements No. 5, 57 and 107 and rescission of FASB Interpretation No. 34 (Nov. 2002) (relating to recording on-balance sheet liabilities for indemnities and guarantees including residual value obligations).

**Comment:* The SEC Study presents a policy view and recommendations for off-balance sheet accounting. The SEC's posture appears to be more aggressive that that of FASB which wrote FAS 13. Their interaction should be interesting to watch, but note that the FASB has not placed FAS 13 on its immediate agenda of projects.

In discussing the Study, *CFO Magazine* reported recently that: "One hundred companies moved nearly $8 billion in assets with outstanding liabilities off their balance sheets, according to the commission's report. By contrast, retained interests actually reported on balance sheets equaled about $1.6 billion." See: *Rethink Off-Balance-Sheet Reporting: SEC*, by Lisa Yoon, CFO.com (June 20, 2005). Clearly, the leasing industry is not alone in using accounting guidance to structure OBS arrangements. Although the SEC Study articulates understandable policy issues and goals, off-balance sheet transaction rules under FAS 13 remain available, valid and useful for a wide array of leasing transactions.

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4. Leasing 101: What is a "Finance Lease"?

A "finance lease" is a special form of three-party "lease" transaction. Once a transaction qualifies as a "lease" under Article 2A of the Uniform Commercial Code (UCC), certain characteristics of the transaction allow the lessor to receive the benefits of a "finance lease" under Section 2A-102(1)(1) or Section 2A-103(1)(g) of the UCC and become a "finance lessor." Section 2A-103(1)(j) of the UCC defines a "lease" as "a transfer of the right to possession and use of goods for a term in return for consideration, but a sale… or retention or creation of a security interest is not a lease."

The finance lease fundamentally protects a lessor from liability relating to defective equipment or other goods when it only provides money, as a passive investor, and not equipment or other goods in the lease transaction. A finance lease separates the sales portion of the transaction from the lease, and makes the lessee the beneficiary of the contract by which a supplier sells the leased property. Section 2A-209. A finance lease requires that, in a distinct transaction, a third party, such as a manufacturer, and not the lessor, as owner, supplies the goods (equipment) to the lessee based on the lessee's specifications. The focus of the definition of a finance lease is on the transaction, not the parties. Accordingly, the lessor must "not select, manufacture, or supply the goods." Section 2A-102(1)(1)(i) or Section 2A-103(1)(g)(i). The lessor must only acquire rights in the goods "in connection with the lease" or another lease and not own the goods before it enters into the lease with the lessee. Section 2A-102(1)(1)(ii) or Section 2A-103(1)(g)(ii). Finally, by meeting one of four detailed requirements, the lessee must either approve the purchase contract or receive supplier information before signing its lease agreement. Section 2A-102(1)(1)(iii) or Section 2A-103(1)(g)(iii).

When a lessor and lessee enter into a finance lease, the lessor acquires certain additional protections. The most important protection stems from the "hell or high water" UCC provision, which, upon the lessee's acceptance of the goods, requires the lessee, in a non-consumer lease, to make its payment obligations to the lessor independent of any breach of obligations by the lessor or the supplier. Section 2A-407. Other benefits for a lessor include: (1) shielding the lessor from liability under implied warranties of infringement (Section 2A-211), merchantability (Section 2A-212(1)) or fitness for a particular purpose (Section 2A-213), (2) freeing the lessor from the risk of loss (Section 2A-219(1)) and (3) depriving the lessee of the power to revoke its acceptance of goods that don't conform to the contract (Section 2A-516(2)).

Tip: The hell or high water rights and lessor recourse waivers can and should be drafted into your lease contracts because you should not rely solely on your lease qualifying as a finance lease under Article 2A. Comment (g) to Section 2A-103(1) (i)(g) even suggests that you can achieve the same effect as finance lease treatment by drafting your contracts properly. Even if, for example, you include contractual hell or high water provisions that generally work as intended by Article 2A, recent cases have undercut lessor protections. For affiliates of a supplier, such as a technology company finance subsidiary, Article 2A creates no special rules whether a transaction constitutes a finance lease. That determination depends on the facts of each deal.

For more discussion of finance leases and the hell or high water rights, see: The ABCs of the UCC, Amended Article 2A: Leases, by Amelia H. Boss and Stephen T. Whelan, at pages 53-56, published by American Bar Association (2005); *Jaz, Inc. v. Foley & First Hawaiian Leasing*, 104 Haw. 148, 85 P.3d 1099 (Haw. Intermed. Ct. App. 2004) (acceptance of equipment required to trigger Section 2A-407 hell or high water protections for lessor); *BLN Case & Comment: Fraud Washes Out Hell or High Water Clause in Eureka Broadband Case*, by David G. Mayer, Business Leasing News (May 2005) (fraud by lessor defeats hell or high water right).

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5. Case & Comment: Affiliate to Vendor Gets Finance Lease Protection in Sony Financial Case

As vendor and captive finance companies flourish, lessees continue to claim that they don't have to pay rent to a lessor when equipment sold by an affiliated vendor company fails to perform correctly. In a typical transaction, a lessee selects the equipment, services and software, if any, to be provided by a vendor. The lessee then obtains financing from the vendor's affiliated leasing/finance company. The lessee examines and accepts the equipment and software, if any, from the vendor. Then, the lessor buys the equipment from the vendor with which it is affiliated and pays for software licensing fees where appropriate. The lessor usually obtains an acceptance certificate from the lessee that causes the lease to commence, including the obligation to pay rent. At this juncture, the lessee typically receives warranties from the vendor and undertakes a hell or high water obligation to pay rent to the lessor. See: *Leasing 101: The "Hell-or-High Water" Clause: A Critical Provision in Leasing*, by David G. Mayer, Business Leasing News (July 2002).

BACKGROUND: In *Sony Financial Services, LLC v. Multi Video Group, Ltd*., 2005 WL 91310 (S.D. N.Y.), the court dealt with a similar fact pattern. In an extensive review of the contractual and lease provisions, the court described the transaction in which Sony Financial Services, LLC (Sony Financial) purchased equipment from its affiliate, Sony Electronics, Inc. (Sony Electronics), and leased it to Multi Video (Video). The case primarily covered the question of whether the Sony entities were entitled to a summary judgment against Video. The court found that no question of material fact existed on which Video could defeat the motions for summary judgment for a breach of contract, in the case of Sony Electronics, or breach of the lease, in the case of Sony Financial. The court also addressed issues regarding forum selection, choice of law and contractual interpretation, including whether the relationship between Sony Electronics and Sony Financial provided valid defenses that the lessee could assert as the basis of refusing to pay rent under the lease with Sony Financial covering unique products of Sony Electronics.

ISSUE: Does the alleged failure of video equipment of Sony Electronics to perform correctly entitle Video, as lessee, to refuse to pay rent to Sony Financial, the owner/lessor affiliated with Sony Electronics?

OUTCOME: No. Video asserted that Sony Electronics breached a "Beta Test Site Agreement" (also referred to herein as a "BTSA") by failing to appropriately service certain video editing equipment, which Video alleges never functioned correctly. The court found the argument without merit because the BTSA neither controlled Sony Electronics' arrangement nor had any relevance to the lease with Sony Financial. It stated:

> The Lease entered into between Sony Financial and Multi Video expressly and unambiguously indicated that Sony Financial was an entity separate from Sony Electronics. The Lease states:
>
> IMPORTANT: NO SUPPLIER OR ANY SALESPERSON [i.e., Sony Electronics] IS AN AGENT OF LESSOR [Sony Financial] NOR ARE THEY AUTHORIZED TO WAIVE OR ALTER THE LEASE. THEIR REPRESENTATIONS OR ASSURANCES OF CURE SHALL IN NO WAY AFFECT THE RIGHTS OR OBLIGATIONS OF LESSOR.
>
> … The Equipment Schedule contained a similar provision…. In addition, the Lease made clear that Multi Video's obligation to Sony Financial under the Lease was distinct from Multi Video's relationship with Sony Electronics. The Lease stated as follows:
>
> LESSEE [Multi Video] AGREES THAT TIME IS OF THE ESSENCE; AND TO MAKE PAYMENTS REGARDLESS OF ANY PROBLEMS LESSEE MIGHT HAVE WITH THE EQUIPMENT INCLUDING ITS OPERATION, CAPABILITY, INSTALLATION, OR REPAIR REGARDLESS OF ANY CLAIM ... OR DEFENSE LESSEE MIGHT HAVE AGAINST THE VENDOR [i.e., Sony Electronics], DISTRIBUTOR OR MANUFACTURER ... AND ANY SALESPERSON OR OTHER THIRD PARTY….
>
> Moreover, as noted, the Certificate [of Acceptance] provided as follows:
>
>> ... in the event that [the][e]quipment fails to perform as expected or represented, Lessee [Multi Video] will continue to honor the Lease by continuing to make monthly payments in the normal course of business and will look solely to the seller or manufacturer [Sony Electronics] for the performance of all covenants and warranties, whether express or implied….

> In sum, the Lease and related documents unambiguously stated that a failure on the part of Sony Electronics with respect to any obligation it might have to provide working equipment would have no effect on Multi Video's obligation to continue making lease payments to Sony Financial. Therefore, Multi Video's failure to continue making lease payments constitutes a breach of the Lease agreement.

LAW OF CASE: The court observed that leases of this type have been routinely upheld, citing the hell or high water concepts arising in cases under Article 2A of the Uniform Commercial Code (Article 2A). In *Siemens Credit Corp. v. Am. Transit Ins. Co*., 2001 WL 40775, at * 1 (S.D.N.Y. 2001), the court stated that the lease at issue is a "finance lease under Article 2-A of the New York Uniform Commercial Code and obligates [the lessee] to make all payments due under it regardless of the condition or performance of the leased equipment." See: *Leasing 101: What is a "Finance Lease"* by David G. Mayer, Business Leasing News (July 2005), Article 4 above.

The *Sony* court also relied on *Telecom Int'l Am., Ltd. v. AT&T Corp*., 187 F.R.D. 492, 493, 497 (S.D. N.Y.1999) to drive its point home. In that case the plaintiff agreed to purchase equipment from AT&T Corp. and to obtain financing by signing leases with AT&T Credit Corp. After encountering technical problems with the equipment, the lessee ceased making lease payments to AT&T Credit Corp. See p. 494. The *Sony* court further stated that "AT&T Credit Corp. subsequently accelerated the unpaid balance on the lease prompting the plaintiff to bring suit against AT&T Corp. alleging that the lessee had breached the lease." AT&T Credit Corp. subsequently intervened and the court granted its motion for summary judgment, stating as follows:

> AT&T Credit [Corp.] is entitled to judgment because [the plaintiff] had accepted the equipment, executed commencement certificates unequivocally stating its unconditional obligation to AT&T Credit [Corp.] in accordance with the terms of the [leases], and had agreed under the [leases] that its obligations of repayment of the financing extended by AT&T Credit [Corp.] were independent of any defenses or breaches under [the plaintiff's] contracts with AT&T [Corp.]." Pages 494-95.

The *Sony* court noted that in the AT&T Corp. case the relationship between the AT&T entities [lessor and vendor] to be "irrelevant."

**Comment:* Sony Financial won this case because it had both the law and good drafting on its side. The case illustrates the value of vendors like Sony and AT&T having a separate, though affiliated, entity to provide financing (as contrasted with the manufacturer providing financing directly). That structure enables the lessor to argue that it is entitled to hell or high water protection under Article 2A and/or under contractual hell or high water language of the lease and sales documents. Neither entity acted as the agent of the other or made any representation or promise for the other. As a vendor with affiliated finance or captive leasing company, you should read the *Sony Financial* case carefully and recheck your documents to assure that they:

- **Provide** clear provisions that state that neither the vendor nor the lessor acts as the agent of the other and that neither of them can bind the other or make representations for the other;

- **Include** hell or high water language in your leasing contracts (the lease, schedules and acceptance certificates) that states that no problem with the equipment, including its design, operations, capability, installation or services/maintenance, will constitute or create a defense to paying rent and performing all other lease obligations;

- **Maintain** corporate and operational separation between the vendor and financing companies to the extent feasible and consider creating a separate financial services company to facilitate the assertion of rights to payment come hell or high water; and

- **Obtain** a waiver of all Article 2A defenses from your lessee in the lease contracts and provide specific installation provisions, including the exclusive remedies that a lessee has if the equipment fails to work as expected. In all events, you should protect the lessor so it receives unabated cash flow and a clear right to assign all or part of the lease cash flows, the asset and/or residual value of the equipment.

The Sony case provides some useful language for lessors and some instructions on how to beat lessee challenges to paying rent when equipment doesn't work. For affiliated finance and leasing companies, the question often revolves around satisfying the vendor's customer at any cost, even accepting non-payment of rent or other compromise. The right choice for a company, therefore, is often more a function of economics and corporate policy on customer satisfaction than strict enforcement of rights the law gives vendors and their affiliate-lessors by contract or under Article 2A.

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6. About Patton Boggs LLP and My Law Practice; Recent Publications; Upcoming Speeches

Patton Boggs LLP is a law firm of more than 400 lawyers located in five offices in the United States and internationally in Doha, Qatar. The firm has extensive capabilities in four major practice areas: Business Transactions, Intellectual Property, Public Policy and Litigation. I am a member of the Business Transactions Group. This group includes over 100 lawyers with a broad array of skills in equipment leasing and finance, corporate finance, secured transactions, syndications, wind power and other project finance, oil and gas transactions, mezzanine financing, hedge fund work and related creditors rights/bankruptcy, real estate and technology law. We regularly work in cost-effective teams to meet our client's needs.

Our leasing and equipment finance work entails a full range of transactions. We help our clients buy, sell, finance and lease real and personal property, including business and commercial aircraft, energy assets, facilities, vehicles, production equipment, technology hardware and software and health care equipment. We have specific teams specifically for aviation, infrastructure/power, health care, federal leasing/finance/marketing, municipal leasing/finance and more.

We work with our clients from the "front-end" to the "back-end" of a variety of transactions. For example, we can assist in the development, construction and financing of infrastructure and power projects, structure and close securitizations, syndications and asset sales, and complete large asset-based company financings. We also restructure troubled credits, appear in court on complex bankruptcies, and act for our clients in such routine matters as repossessions, lift stay actions, true lease contests, workouts and forbearance arrangements. We provide extensive litigation resources with a record of proven success.

You are welcome to call me at 214.758.1545 or e-mail me at dmayer@pattonboggs.com. We value your contact with us on any topic, including questions arising from BLN articles or about our law practice.

Publications

Look for several new publications by David G. Mayer during the balance of 2005 covering such topics as true leasing (for the Journal of Equipment Leasing), the Cape Town Convention (for LNJ's Equipment Leasing Newsletter), wind energy (Canada) and the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (for Equipment Leasing Today, the magazine of the Equipment Leasing Association).

Recent Publication:

- *Norvergence Strikes Again – Problems With Forum Selection Clauses,* by David G. Mayer, The Monitor at page 26-27 (May 2005).

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7. A Message from the Founder, David G. Mayer

"Customer Care"

Customers, particularly good ones, should be highly valued and treated by companies as critical elements of their businesses. For without customers or clients, there is no business, no way to pay the bills or feed the proverbial machine of commerce.

In this vein, I was struck by an article in the "Next" section of Fast Company Magazine (July 2005) with an article entitled *Customers Don't Grow on Trees.* Page 25-26. It was written by Don Peppers and Martha Rodgers, authors of a new book entitled: *Return on Customer: Creating Maximum Value From Your Scarcest Resource*, Currency Books (2005). The authors begin their article as follows:

> The only value your company will ever create is the value that comes from customers -- the ones you have now and the ones you will have in the future. Businesses succeed by getting, keeping, and growing customers. Customers are the only reason you build factories, hire employees, schedule meetings…or engage in any business

activity. Without customers, you don't have a business.

The authors observe that companies don't behave this way because they pursue contradictory business goals - generally focusing on hitting this quarter's numbers and disregarding the long-term implications of how they treat or service customers. The authors say in this regard: "The problem is that treating customers as a scarce resource is an incredibly subversive idea, undermining one of the most tried and true business premises - that capital is the scarce resource."

To measure the value of customers, the authors propose a new metric: "Return on Customer"/SM that reflects the cost of compromising customer focus and acknowledges that capital may not be the scarcest resource of a company. Rather, customers, particularly good ones, may be the scarcest and most important resource. Thus, Return on Customer/SM, which is a twist on return on investment, takes into account the current and future value of customers to a business, which translates ultimately into cash flow. The authors conclude: "…The only value you can ever create must come from customers, your scarcest resource. It's time for companies and their managers to behave accordingly." In short, they promote a "customer-centric" business model of understanding your customer's needs. See*: Best Buy counts customers*, PCWelt.com, an excerpt from the book (July 2005).

Early in my career as a corporate lawyer, there were times when people focused so much on closing the next transaction that they disregarded the rough treatment directed at the customer (lessees). It seemed clear that such behavior would lead to a one-time customer - that is, no repeat business and no other cash flow from future deals from the customer. That behavior made no sense to me then and still makes no sense to me today. Customers and clients are the key to many businesses, including my own. They must be treated with respect, individuality, personal care and focused attention. It is wise to apply the Return on Customer/SM metric to every one of our customers or clients - to measure with some rigor to the financial value of a customer relationship. But it seems to me, in any event, we should realize that quality customer care is critical because, as the authors correctly say, customers "don't grow on trees."

Have a great month of July and thanks for reading Business Leasing News.

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All the best,

David

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