



BUSINESS LEASING NEWS

"Offering leasing and financing strategies for your success"

Welcome to the April 2006 edition of Business Leasing News (BLN).

About BLN: Founded in January 2002, this monthly e-newsletter primarily focuses on leasing and financing of personal property and mixed property facilities. BLN provides timely, concise information and analysis backed by supporting research. BLN's mission is to provide "leasing and financing strategies for your success."

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Founder's Note by [David G. Mayer](#)

This issue of BLN focuses on some of the challenges that the leasing industry faces. Article 1 discusses the 2006 IFC Report, which raises numerous hard questions about the future of the leasing industry and its constituent members. The IFC Report challenges the members to change and adapt and warns them of the downside of failing to do so.

Article 2 demonstrates one of the problems for sale-leaseback transactions. California used its regulatory authority to treat certain sale-leaseback transactions as loans subject to lending regulation. Such action may disadvantage the leasing market in California. Note that the entire concept of "true leasing" is under attack in my [article](#) available below.

Article 3 shows how lawyers practicing before the SEC may encounter a dilemma. On one hand, they must hold client information confidential under state ethics rules. On the other hand, the SEC can force them to "report out" that same information under certain circumstances to the SEC and others.

In Article 4, "Leasing 101" describes one of the prominent asset-based loan products called the "second lien loan." This type of loan may displace the need for sale-leasebacks and other lease transactions. In any event, these loans create greater opportunity for lenders and loan financing availability for asset-laden borrowers.

1. IFC Report Questions the Future of Leasing

The Industry Future Council (IFC) delivered a clear message to leasing companies in its 2006 [Industry Future Report](#): change or else. The era of business as usual is gone in the leasing industry and no company will prosper or even survive without taking a hard look at the numerous questions posed by IFC about its fears, hopes and vision of the future of the leasing industry.

IFC examined these issues through a process called “positive turbulence.” Positive turbulence occurs “when an individual or a business not only acknowledges outside change, but actively searches for trends and developments that can be brought inside and deployed in a manner that improves or creates a process or products.”

The Trends Affecting the Leasing Industry

IFC sampled various trends at home, at work and in education. The predominant trends show that fewer married couples live at home, an increasing amount of business is global in scope and education needs are being met more through outsourcing and technology.

The Fears, Hopes and Vision

IFC expressed fears that leasing suffers from a poor industry image. Perhaps more disconcerting, industry members have not taken enough action to correct misconceptions in the minds of lawmakers. IFC also fears that this maturing and consolidating industry faces a sea of change in deal types. In the past, lessors have structured tax leases in 70 percent of their transactions, but today, only half of the deals may be leases while about 65 percent are loans. IFC confirmed what the market has experienced over the last few years: leasing has become a commodity that has lost or is losing its ability to compete. It also suffers from lack of customer loyalty and destructive pricing – with lower yields than the deal risk merits.

But IFC has hopes too, and from these hopes spring the potential for leasing to flourish. Leasing can be viewed as part of the solution in financing and not a problem, fostering innovation and increasing products' sales. Leasing companies can adopt a global view, pursuing markets outside of the United States, where they can and should offer multiple currency, language and product types. Leasing participants can and must prepare to compete with new sources of funding such as hedge funds. They should prepare their employees for these changing markets through increased education and fostered innovation.

Finally, IFC sees the “balance of power” shifting in favor of lessees who will be able to demand more acceptable terms and conditions, especially as it relates to fair market value purchase options. Transaction specialists will rule as the days of generalist shops wane. Customers will want leasing to fit in their operations and process, in part by increasing a single point of contact with leasing organizations, integrating technology and creating a clear value proposition for the customers. Simplicity, brevity and service will attract customers. Documentation and process must be simple and as short as possible in the languages, jurisdictions and currencies of the customers' choice. Leasing products will have to rely less on accounting structures and substantial tax benefits as drivers of transaction pricing and benefit.

Where the Action Will Be

The IFC listed the product areas where growth should occur: technology, construction, power generation and transmission, transportation, healthcare and office equipment. Some of these product groups suffer from commoditization and pricing pressure, but others will garner higher returns. The outcome often depends on the leasing organization and the particular customer.

IFC urges the leasing industry to prepare for more competition and consolidation, encourage innovation and hire new and talented young people with cultural and educational diversity. The industry must work for the mutual goal of restoring a positive reputation to the leasing industry in an age when many question its prospects. Failing to consider IFC's questions may leave some companies weakened and with little future in leasing.

2. California Decides to Regulate Most Sale-Leasebacks as Loans

California's Department of Corporations cracked down on allegedly unscrupulous use of sale-leaseback transactions in its recent [Release 56-FS](#) (Release). The Release establishes broad criteria for characterizing lease and sale-leaseback transactions as loans. It creates a new definition of sale-leaseback transactions. Although California Finance Lenders Law (CFLL) does not regulate true leases, it does regulate commercial and consumer loans. In effect, the Release establishes the standards by which California can convert most sale-leasebacks into loans and thereby subjects more lessors to regulation under the CFLL in sale-leaseback transactions.

***Term to Know:** Under CFLL [Section 22009](#), a "[finance lender](#)" includes any person who is engaged in the business of making consumer loans or making commercial loans. The business of making consumer loans or commercial loans may include lending money and taking, in the name of the lender, or in any other name, in whole or in part, as security for a loan, any contract or obligation involving the forfeiture of rights in or to personal property, the use and possession of which property is retained by other than the mortgagee or lender, or any lien on, assignment of, or power of attorney relative to wages, salary, earnings, income, or commission."

The Release Description of a Sale-Leaseback

The Release describes sale-leasebacks as follows:

Under a typical sale-leaseback transaction, the borrower signs an agreement to sell his or her property to a third party, and to lease back that property from the third party for a charge. Under the terms of these agreements, the borrower agrees to pay a certain amount of money to use the property until the "lease" expires. When the "lease" expires, the borrower has the option of repurchasing the property. If the borrower fails to make the lease payments within a certain number of days of the due date, the lender may repossess the property, sell it, and retain the proceeds.

This description fails to use the basic terminology or concepts from [Article 2A](#) (Leases) of the Uniform Commercial Code. It refers to the lessee party as the "borrower" and the "lessor" in the transaction as the "third party." The Release uses the term "lease" in quotes as if to infer doubt about the validity of the sale-leaseback. It does not even mention the term "rent"- the most common term for consideration paid in leases.

***Terms to Know:** Under Article 2A, a "[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. A "sale-leaseback" is a transaction in which an owner of personal or real property sells the property to a purchaser. The purchaser becomes the owner and lessor of the property and, in that capacity, leases the property back to the seller, which thereby becomes the lessee. As the lessee, the seller pays rent or other consideration for the continued use and possession of the property he or she sold to the lessor.

The Release expresses concern for "unscrupulous operators seeking to evade the CFLL by disguising their transactions as sale-leaseback transactions." This concern led California to establish criteria that seek to protect borrowers from various "operators" with the "same level of protection required for borrowers of loans made by licensed finance lenders in compliance with the CFLL." Finance lenders and brokers, by number of [licensees](#) and dollars of loans originated, constitute the largest group of financial service providers regulated by the Department.

***Technical Point:** The CFLL is contained in Division 9 of the [California Financial Code](#), commencing with Section 22000. Effective July 1, 1995, the Personal Property Brokers Law, Consumer Finance Lenders Law, and Commercial Finance Lenders Law were consolidated without substantive change into the California Finance Lenders Law (AB 2885, Chapter 1115, Stats. 1994). The regulations under the CFLL are contained in Chapter 3, Title 10 of the California Code of Regulations, commencing with Section 1404 (10 C.C.R. §1404, et seq.).

Release Criteria

The Release states that each "lease" or "sale-leaseback" transaction will be judged on its substance and not

on its name or form. The presence of one of more of the following factors “may indicate the presence of a loan”:

The borrower receives money, followed by a "sale" of the borrower's property to the lender, with a provision for repayment in the form of rent or payments to the lender.

- The borrower is in possession of the goods or property before obtaining money from the lender.
- The borrower gives up title to goods or property as security in exchange for receiving money.
- There is no risk to the lender of losing capital, other than the insolvency of the borrower.
- The lender has the power to accelerate the principal payment of the "loan" upon default.
- The transaction includes agreements with provisions of title reversions and "repurchase" within specified periods.

The Re-Characterization Risk: Is Your Sale-Leaseback a Loan?

Very few sale-leaseback transactions will escape a re-characterization as a loan if debtors/lessees apply these standards to proposed sale-leasebacks or leases. These criteria functionally describe what occurs in most sale-leaseback deals. That is, as noted above, the property owner sells property in his possession or control, receives consideration for the sale and then leases the property from the new owner/lessor. Lessors have standard remedies, including repossessing the property as a typical way to recover their investment; yet, this standard right could by itself turn a lease into a loan. The most difficult element is deciding whether “there is no risk to the lender of losing capital.” Taken literally, lenders and lessors always face credit risk, but this element probably intends to find no right of termination within the meaning of [Article 9.201\(37\)](#).

Once a transaction is classified as a loan, then California can subject the transaction to greater scrutiny under the CFLL. That outcome may force lessors to enter into fewer leases and more loans and potentially alter the pricing due to lack of tax benefits, greater regulatory scrutiny and licensing costs as a finance lender and higher credit risk.

The Leasing and Lending Solutions

The impact of the Release will be determined over time. However, any lessor on one hand, or any lessee on the other hand, must consider structuring transactions carefully to avoid the potential regulatory trap set by the Release. One way to manage this issue is to make and receive only commercial loans.

Under [Section 22502](#) of the CFLL, a "commercial loan" refers to (1) a loan of a principal amount of five thousand dollars (\$5,000) or more, or (2) any loan under an open-end credit program, whether secured by either real or personal property, or both, or unsecured, the proceeds of which are intended by the borrower for use primarily for other than personal, family, or household purposes.

**Tip:* As a lessor, consider taking these steps:

- **Structure** your transactions as true leases. (See [True Leases Under Attack](#) article below.)
- **Avoid** transactions under \$5,000 (that is, do “commercial loans”).
- **Apply** for a finance lender’s license under Section 22100, et seq. of the CFLL. Applicants must have and maintain a minimum net worth of at least \$25,000 and must obtain and maintain a \$25,000 surety bond.
- **Comply** with the lender’s license rules with the bonus that you may become entitled to an exemption from the [usury provision](#) in Section Article XV(1) of the California Constitution.
- **Obtain** a written and signed statement from the borrower/lessee, in a loan application or other loan or lease documents, that the borrower/lessee intends to use the funds for business reasons and not for personal, family, or household purposes. This statement expresses the intention that, regardless of the size of the loan or lease investment, the proceeds will be used for a commercial transaction and not a consumer deal.

Conclusion

California's Corporations Commission apparently intends to stop lending deals allegedly disguised as leases in the small ticket market, which is an understandable and laudable goal. However, by treating many leases as loans, and not clearly defining which deal size exempts the parties, California may also force financing and leasing organizations to become licensed finance lenders subject to lending rules creating a larger measure of uncertainty and further dampening of the small ticket leasing market in California. Since most of the large lessors and lenders obtain lender licenses, they may even like this result.

Thanks to [Michael Green](#) of Dakota Financial, LLC, for spotting this regulatory change in California and sending it to BLN.

3. Lawyers May Report Out Under Sarbanes-Oxley Despite Contrary State Ethics Rules

Though lawyers in 42 states can breathe easy, lawyers in eight states, including California, as well as those in the District of Columbia, face a dilemma. What will they do when the Security and Exchange Commission (SEC) requires them to "report out" violations of the Sarbanes-Oxley Act, but state ethics rules may prohibit such disclosure? This dilemma arose in [2005 Formal Ethics Opinion 9](#) in January 2006 in North Carolina.

ISSUE: Will lawyers in North Carolina be authorized to report a material violation of the securities laws or breach of fiduciary duty of certain officers as required by securities regulations if the same reporting may violate state ethics rules on non-disclosure?

OUTCOME/DECISION: Yes. Lawyers appearing and practicing before the SEC may disclose such violations without violating North Carolina Rules of Professional Conduct. Federal law preempts contrary state ethics rules.

LAW OF CASE: The Opinion described the Rule 205, Standards for Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, which became effective on August 5, 2003, 17 C.F.R. Part 205 ("Rule 205"), as follows:

Section 205.3 of Rule 205 sets forth the duty of an attorney appearing and practicing before the Commission to report evidence of a material violation of securities law or breach of fiduciary duty to the chief legal officer and chief executive officer of the client company and, if an appropriate response is not forthcoming, to the audit committee of the board of directors or to the board itself (commonly referred to as "reporting up"). Paragraph (d)(2) of section 205.3 contains a provision permitting, but not requiring, what is commonly referred to as "reporting out" as follows:

(2) An attorney appearing and practicing before the Commission in the representation of an issuer may reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary:

(i) To prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors;

(ii) To prevent the issuer, in a Commission investigation or administrative proceeding from committing perjury, proscribed in 18 U.S.C. 1621; suborning perjury, proscribed in 18 U.S.C. 1622; or committing any act proscribed in 18 U.S.C. 1001 that is likely to perpetrate a fraud upon the Commission; or

(iii) To rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.

Section 205.6 of Rule 205 addresses sanctions and discipline. Paragraph (c) provides:

(c) An attorney who complies in good faith with the provisions of this part shall not be subject to discipline or otherwise liable under inconsistent standards imposed by any state or other United States jurisdiction where the attorney is admitted or practices. (Emphasis added.)

These regulations as interpreted in the Opinion essentially mean that attorneys who represent or are employed by publicly reporting companies and who appear and practice before the SEC must, in a conflict with relevant state ethics rules, pay deference to federal law and report out SEC violations. See [Fidelity Federal v. de la Cuesta](#), 458 U.S. 141 (1982) holding that federal regulations preempt any conflicting state ethics rules.

**Comment:* The Opinion seems clear that attorneys should adhere to SEC regulations, but the debate continues about their responsibilities and the potential clash between state and federal law. The concepts of reporting out SEC violations may have merit as do state ethics rules on confidentiality, but attorneys should not be put in the middle of a conflict between state and federal law with no clear path to discharge their duties. See [Conduct Still Far From Settled in Some States](#) by Steve Seidenberg, the [ABA Journal Report](#) (March 31, 2006).

4. Leasing 101: What Is “Second Lien Loan”?

If any loan product can boast of exploding growth in the last few years, it is second lien loans. Significant financial institutions have been promoting and writing about these loans since they became a hot product in 2003. See [The Evolution of Second Lien Loans](#), [CapitalEyes](#), Bank of America Business Capital (Nov. 2004).

A “second lien loan” is a secured transaction in which certain lenders hold a second priority security interest on the assets of the debtor. In other words, the holder of the second lien is only entitled to foreclose on the secured collateral after the lenders holding the first priority; perfected security interests are paid in full from the proceeds applied from sale or other enforcement actions with respect to the collateral. As a result, these loans, which are also called “last-out tranche” loans, present the second lien lender with higher risk and should provide higher yields than the first priority security interest. See [Second Lien Loans](#), Gladstone Capital (2006).

**Tip:* You can use the second lien loan in a good economy and in a slow economy. According to Bank of America:

During bull market periods like 2005, these loans will be used to finance LBOs and recapitalizations, particularly those for middle-market issuers that do not have easy access to the high-yield market. During the bear market periods, they will revert to rescue finance vehicles funded primarily by distressed players and hedge funds.

Expect to enter into separate documents from the first priority secured transaction for second lien transactions. See [Why Investors and Borrowers Continue to Tap Second Lien Loans](#), [CapitalEyes](#), Bank of America Business Capital (April 2006).

5. About Patton Boggs LLP; Recent Publications; Upcoming Speech

[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, healthcare, pharmaceuticals, and technology law. We regularly work in teams to meet our clients' 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 healthcare equipment. We have specific teams for aviation, infrastructure/power, healthcare, federal leasing/finance/marketing, municipal leasing/finance, and more.

We work from the "front-end" to the "back-end" of a transaction's life. For example, we 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.

Recent Publications

The following is representative of recent works by [David G. Mayer](#):

- [Aviation finance will take flight under Cape Town Treaty](#) by David G. Mayer, Ft. Worth Business Press (Feb. 13, 2006).
- Federal Leasing: A Lifeline in a Sea of Red Ink? – The Feds need us, by David G. Mayer, ELT Magazine, the leasing publication of the Equipment Leasing Association (Jan.- Feb. 2006). Thanks to Jack Helmly of [GTSI Financial Services](#) and [Michael Guiffre](#) of Patton Boggs LLP for their editing and input on this article.
- [Legal Opinions and Title Insurance Mitigate Risk Under The Cape Town Convention](#), by David G. Mayer and Frank Polk, aviation partner at McAfee & Taft, LNJ's Equipment Leasing Newsletter (Nov. 2005).
- [True Leases Under Attack: Lessors Face Persistent Challenges to True Lease Transactions](#), by David G. Mayer, Journal of Equipment Lease Financing (Special Issue, Fall 2005), a 17,000 word article. Special thanks go to the many editors, including Patton Boggs bankruptcy partner, [Jeff LeForce](#); Patton Boggs tax partner, [George Schutzer](#); Patton Boggs Associate, [Joel A. Bannister](#); three members of the ELA's Legal Committee; and two Foundation reviewers. [2005 JELF ARTICLE OF THE YEAR!](#)
- [The Cape Town Convention: New Complexities and Opportunities](#), by David G. Mayer and Frank Polk, aviation partner at McAfee & Taft, LNJ's Equipment Leasing Newsletter (Oct. 2005).

Upcoming Speech

- Cape Town Convention and Aircraft Protocol Training Seminar, sponsored by the Strategic Research Institute, April 27 – 28, 2006 • The Renaissance Mayflower Hotel - Washington, DC. (David Mayer will be speaking on transaction practice and prospective international interests under the Treaty.) For more, click on: [Full Program](#).

Thanks to BLN's Team

I would like to thank BLN's team at Patton Boggs LLP. The team includes [J. Atwood Jeter](#), a senior associate in the firm's real estate and wind energy groups, Patton Boggs staff editors, Paul Dumansky, Adrian Nicole McCoy and Michelle Steckel, as well as our lead designer, Winston Jackson, and Project Manager, Sarah Sweeney. Claire Campbell, our Chief Librarian in Dallas, keeps BLN going with much appreciated research assistance. Thanks also to [Douglas C. Boggs](#), a Business Transactions/Securities partner and website reviewer for BLN, and our Marketing Chief, Mary Kimber, for assisting BLN through our firm's editing, design, and posting process.

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