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S P E C I A L   I S S U E

True Leases Under Attack: Lessors Face Persistent Challenges to True Lease Transactions

By David G. Mayer

For the first time in its 23-year history, the Journal of Equipment Lease Financing is publishing a supplement to its regular issue. This article, constituting Part B of the Fall 2005 issue, addresses the growing concern about structuring lease transactions so they are clearly defensible as true leases.

For the foreseeable future, lessors will continue to face these persistent true lease challenges. Thus, despite business pressure to win deals, lessors can and should mitigate the risk of these challenges by structuring true lease transactions in a manner consistent with prevailing law and court precedent. The intent of this article is to demonstrate how lessors might accomplish that.

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By David G. Mayer

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Bankruptcy proceedings often set the stage for lessees to attack true leases as disguised security interests under Article 9 of the Uniform Commercial Code (UCC). If the lessee prevails, the lessee will likely improve its business and reorganization prospects at the lessor's expense.

In most equipment leasing transactions, the lessor weighs and balances credit, residual and liability risks against the bottom line reality that the lessor needs to win business in today's competitive markets. When structuring lease transactions, a lessor may find that it cannot clearly determine whether it has created a true lease. This uncertainty about the transaction structure has opened the door for astute lessees to challenge "lease" transactions as failing to qualify as true leases. Many, but not all, lessors have become aware of this high-stakes game, which may be played out starting as early as a dispute or troubled credit situation with a lessee.

The age has passed when leases represented novel and complex structures that few people really understood. Many lessees and their counsel know more than enough today to contest true lease status as a means to gain economic and legal advantage over the lessor. A lessor should not feel comfortable about the structure of a transaction merely because the lessee or its counsel does not question, or even agrees to, a true lease characterization before closing.[1] When the lessee's chips are down, the lessee may still attack a transaction as failing to meet the requirements of a true lease if the lessee can identify any conceivable basis to make that assertion.

With these attacks by lessees occurring with some frequency today, the basic premise of this paper is that, for the foreseeable future, lessors will continue to face these persistent true lease challenges. The corollary premise of this paper is that, despite business pressure to win deals, lessors can and should mitigate the risk of these challenges by structuring true lease transactions in a manner consistent with prevailing law and court precedent as discussed in this paper. By doing so, true leasing will remain a viable and growing method to make capital investments in equipment and other property.

OBJECTIVES AND APPROACH

The true lease question arises with respect to leases of equipment, real estate[2] and even software rights. This paper primarily addresses true leasing of equipment under state law and will help lessors structure leasing transactions, avoid confusion over leasing terminology, including accounting and tax rules, and more accurately evaluate transaction risk. The discussion will also provide ideas on how to structure transactions properly and identify some of the adverse consequences of losing a true lease challenge. To understand the true lease treatment of certain specialized leasing structures, this paper also explores the following questions:

- Can a TRAC lease[3] withstand a true lease attack?
- Is a "first amendment" lease a true lease?
- Can a "synthetic lease" qualify as a true lease?
- Can lessors structure a true lease of software?

Lessors have understandably become entangled in state law, accounting and federal tax law concepts that all seem to define true leasing, but can lead to unintended results in even the simplest lease transactions.

In the end, the reader should gain a clear view of when challenges to true leases may arise and how to defeat them or at least mitigate the risk of a true lease attack.

THRESHOLD CONTEST POINT

A true lease contest often starts with an assertion by a lessee that its transaction, however labeled, is not a lease but, instead, nothing more than a "security interest" under Section 1-201(37)[4] of the UCC, a disguised security agreement or a "lease intended as security".

Section 1-201(37) of the UCC (1-201(37)) includes a "per se" or "bright-line" test to determine whether a transaction should be treated as a true lease or disguised security agreement. This test requires an objective analysis and is supposed to disregard the documents' labels[5] and the parties' intent.[6] Current law also includes an "economic realities" test designed to evaluate the facts of each transaction to determine whether the transaction is a lease or disguised financing. The bright-line and economic realities tests together have created confusing and inconsistent law affecting the leasing industry. The court in *In re QDS Components, Inc. (QDS)* described the history of true leasing and its interpretation over roughly the last twenty years as a "body of hopelessly irreconcilable decisions construing Section 1-201(37)."[7]

THE TERMINOLOGY PUZZLE

The frustration expressed by the *QDS* court is not surprising. Courts accept true lease arguments on deceptively similar but largely irrelevant tax rules and accounting principles. As a result, lessors have understandably become entangled in state law, accounting and federal tax law concepts that all seem to define true leasing, but can lead to unintended results in even the simplest lease transactions. The leasing industry over time has created a hodgepodge of terms for leases, which further confuse the description of a transaction. For example, a lease that creates a security interest has been called a "lease intended as security," "disguised financing," a "dirty lease," a "finance lease," a "quasi-lease"[8] or a "conditional sale lease." A true lease has likewise been called a "finance lease," an "operating lease" or even a "guidelines lease." A true tax lease has been called a "tax lease" or an "operating lease." As this paper demonstrates, many of these terms cross the boundaries of usage into tax, accounting or other state law concepts that foster misunderstanding.

Despite their importance, true tax leasing guidelines under federal law and operating lease treatment under accounting pronouncements should not be used in determining the existence of a true lease for state law purposes. Lessors and lessees alike should understand that mixing terms and their related disciplines under tax or accounting principles increases the complexity, and, perhaps, the potential for true lease challenge. When structuring and discussing transactions, transaction parties should consider using the following terms to avoid confusing true lease analysis and structuring:

- An "operating lease" refers mostly to a certain type of lease under Financial Accounting Standards Board[9] (FASB) principles although various writings use the term for a true tax lease or a lease under the UCC. The term "operating lease" also correctly refers to a lease transaction where a lessor expects its lessee to return leased property after a portion of the property's useful life and enter into successive leases with the same or different lessees over the entire useful life of the property.
- A "finance lease"[10] refers to a special type of "lease" under Article 2A of the UCC (Article 2A) involving three-parties (lessor, lessee and supplier) and not a secured transaction, financing or lease intended as security under Article 9 of the UCC. It is not the same as referring to a lease transaction as a "financing," which is a lending transaction.
- A "tax lease" or "true tax lease" refers to a transaction that qualifies as a true tax lease

under applicable federal tax law (even if the tax lease does not qualify, as can happen, as a true lease under the UCC). In this type of transaction, the lessor is treated as the tax owner of the leased property.

- A "conditional sale" is the dominant term used in federal tax or guideline leases to refer to a lease that does not qualify as a true tax lease, but represents a sale of the leased property based on installment payments by a lessee to a lessor.
- The term "true lease" in this paper refers to an agreement that constitutes a lease under the UCC, even though it may not qualify as a finance lease under Article 2A.
- A "secured transaction," "security interest," "financing" or "lease intended for security" refers to a secured transaction under Article 9 of the UCC regardless of the form of, or labels on, documentation (a document called a "lease" may nonetheless constitute a secured transaction).

In short, a true lease in the context of a bankruptcy or a transaction is not the same concept as a true tax lease or an operating lease for accounting purposes regardless of the similarity of terminology to, or substantive rules under, the UCC or other state laws. It is critical to distinguish tax and accounting concepts from true leasing under state law to avoid confusion and potentially erroneous structures of true leases.

FEDERAL INCOME TAX GUIDELINES FOR TRUE TAX LEASES

Revenue Procedure 2001-28[11] (Rev. Proc. 2001-28) establishes criteria for classifying a lease as a true lease for federal income tax purposes. It is the successor to Revenue Procedure 75-21, 1975-1 C.B. 715 and other related revenue procedures. Technically, Rev. Proc. 2001-28 establishes criteria for obtaining an advance ruling from the Internal Revenue Service (IRS) that a lease is a "true lease" as contrasted with a conditional sale. Rev. Proc. 2001-28 (like its predecessor Rev. Proc. 75-21) is sometimes called the tax "Guidelines". A lease classified as a true tax lease under these rules may be called a "Guidelines Lease."

The IRS developed the Guidelines for "leveraged lease" transactions, which involve three parties: a lessor/owner, a lessee/user and a lender to the lessor. However, the leasing industry has also used the Guidelines to aid in structuring single investor leases, which involve two parties - a lessor and lessee. The Guidelines do not control or define true leasing as a matter of law, but provide criteria by which the IRS decides the character of a transaction for advance income tax ruling purposes only. The application of the Guidelines to single investor leases, while useful, has largely served as a voluntary construct on which to conservatively structure a lease involving a lessor and lessee. The theory is that if the structure works for the more complex leveraged leases, the structure will most certainly suffice for single investor transactions.[12]

A lessor is usually treated as the tax owner of property under a leveraged lease if the transaction meets all the factors in Rev. Proc. 2001-28. So, too, the lessor should be treated as the tax owner with respect to single investor leases structured consistently with the Guidelines. A few of the salient factors in the Guidelines[13] merit attention to demonstrate how they may confuse lease structuring by blurring the line between a true lease for state law and federal tax law purposes:

- The lessor must maintain a minimum unconditional "at risk" equity investment in the property being leased (at least twenty percent of the cost of the property) during the entire lease term. Within this general concept, a lessor must show that it expects the property at the end of the lease term to have a fair market value equal to at least twenty percent of its original cost. The lessor must also demonstrate that it expects that the equipment will have a useful at the end of the lease of not less than twenty percent of its original useful life (or at least one year).[14] These requirements are sometimes called the "20/20 tests."

In short, a true lease in the context of a bankruptcy or a transaction is not the same concept as a true tax lease or an operating lease for accounting purposes regardless of the similarity of terminology to, or substantive rules under, the UCC or other state laws.

In summary, both leveraged and single investor leases may deviate from the Guidelines and still qualify as true tax leases for federal income tax purposes.

- The lessee may not have a contractual right to buy the property from the lessor at less than fair market value when the right is exercised.[15]
- With exceptions, the lessee may not invest in the leased property.[16]
- The lessee may not lend any money to the lessor to buy the property or guarantee the loan portion of a leveraged lease that the lessor uses to buy the leased property.[17]
- The lessor must show that it expects to receive a profit apart from the tax benefits.[18]

In summary, both leveraged and single investor leases may deviate from the Guidelines and still qualify as true tax leases for federal income tax purposes.

It is important to remember that, even if a lease fails to meet the Guidelines' requirements for a true tax lease, the same transaction may still qualify as a lease under Article 2A. A lessor's residual interest test under the Guidelines appears to be similar to the retained interest element of true lease analysis under the UCC. Consequently, it has been tempting for lessors (or lessees) to cite the Guidelines in a true lease contest to demonstrate or refute the existence of a true lease under the UCC. As a result, lessors or lessees alike may use the Guidelines in a true lease contest to argue for or against true lease treatment under state law, and courts might be persuaded to accept such arguments, especially if a lessor fails the 20/20 test. However, because the Guidelines require a separate analysis and serve a different purpose than the UCC, lessees and lessors should differentiate tax principles when structuring or challenging a true lease under state law.

LEASE ACCOUNTING TERMS AND MORE TRUE LEASE CONFUSION

Transaction parties should not use accounting terminology or principles in true lease structuring or contests, but the terms such as a "operating lease" or "capital lease" have crept into true lease analysis. Under Financial Accounting Standards No. 13,[19] (FAS 13) first issued in 1976, the FASB created guidelines for whether a lease constitutes a capital lease or an operating lease from a lessee's and lessor's accounting perspectives.

From the lessee's perspective only, if a lease meets or satisfies any of the four criteria below, the lessee must treat the lease as a capital lease and record the equipment on its financial statements as an asset and its payment obligations as a liability. On the other hand, if the lease does not meet or satisfy any of these accounting tests, the lessee may qualify its transaction as an operating lease. Though the lessee must make certain disclosures in its financial statements about this type of lease, the lessee must record the transaction in its financials as a capitalized asset because the lease payments constitute an operating expense and, therefore, qualifies for off-balance sheet lease treatment.[20]

The basic criteria for a capital lease appear in Paragraph 7 of FAS 13.[21] A lease constitutes a capital lease if the lease:

- automatically transfers ownership of the leased property to the lessee at the end of the lease term;[22]
- contains an option that allows the lessee to purchase the leased property at a bargain price;[23]
- has a term that equals or exceeds seventy-five percent of the estimated economic life of the leased property; or[24]
- requires rental or other minimum lease payments that, on a present value basis, equal or exceed ninety percent of the fair value of the leased property.[25]

Like federal income tax law and the Guidelines, this area is ripe for confusion when parties add accounting terms to the true lease mix. For example, Section 1-201(37) defines a security interest as an arrangement that includes a purchase option for no or nominal consideration. FAS 13 provides that an "operating lease" may not have a bargain purchase option. Section 1-201(37) states that the lessee creates a security interest (not a lease) if the lessee has the option to renew the lease for the economic life of the property for little or no consideration. FAS 13 states that operating leases may not have any automatic transfer of ownership at the end of the term. Section 1-201(37) provides that a lease may not have an option to renew a lease for the remaining economic life of the property or purchase the property for little or no consideration. With such concepts sounding so much alike, it is easy for lessors or lessees to incorrectly analyze a transaction under FAS 13 instead of applying the correct rules and precedent under Section 1-201(37). Lease accounting purposes and interpretations differ from federal income tax and the UCC. Each set of principles should be applied separately when structuring transactions to minimize the potential for a true lease contest and to optimize the economic, accounting and legal benefits of true leasing.

TRUE LEASE CONCEPTS UNDER STATE LAW

Under state law, most true lease cases turn on whether the lessor retains meaningful residual value or a reversionary interest in the leased property.[26] Section 2A-103(1)(j)[27] 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."[28]

By contrast, a lease intended as security is tantamount to a security interest in the "leased" property. A "security interest" means an interest in personal property or fixtures, which secures payment or performance of any obligation.[29] A secured party, in this context, lends money to a debtor. It expects the debtor (whether called a lessee or borrower) to repay the loan with interest (whether called rent or another name), but the secured party does not own the property. Unlike a secured party, a lessor expects the lessee to return the property to the lessor or perhaps buy it or renew the lease. A lender does not. The economic and legal attributes of loans and leases differ significantly.

If a transaction does not qualify as a true lease and therefore constitutes a security interest, Article 9 of the UCC applies to the lease transaction. If a transaction qualifies as a lease, Article 2A[30] governs the rights and the remedies of the parties (to the extent the rights are not waived). The rights and remedies of the parties to the transaction under Article 9 vary significantly from those under Article 2A. State law governs the existence, nature and extent of a security interest in property in bankruptcy court.[31] Lessees use, and will continue to use, state law to attack transactions as failing to qualify as true leases. To defend and defeat these attacks, the lessor must fully understand and apply two levels of criteria that dominate a true lease analysis.

TWO TEST LEVELS UNDER SECTION UCC 1-201(37)

In determining whether a transaction is a security interest (a lease intended as security or financing) rather than a lease, Section 1-201(37) of the UCC, as suggested above, provides two test levels - the termination test and the residual value test. The first test determines whether the lessee may terminate its payment obligations during the term of the lease, and the second level test evaluates the residual interest of the lessor based on four factors listed in Section 1-201(37).

THE TERMINATION TEST UNDER SECTION UCC 1-201(37)

Transaction parties often have a misperception about the meaning of an early termination under the UCC. The UCC test is not whether the lessee can contractually terminate its lease during the term under a typical early termination option. Such a termination typically provides the lessee an opportunity to terminate the lease if it finds a buyer for the leased property and pays the lessor any shortfall from a stated or formula termination value. Instead, the termination test contemplated in Section 1-201(37) determines whether the

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lessee's obligation to make payments is subject to termination. This subtle, but important, distinction is clear in Section 1-201(37), which provides:

> "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."

A typical early termination option in a lease probably would not qualify as a termination of the obligation to payment because the consideration the lessee must pay in such an early termination provision is intended to make the lessor whole at that time. In that instance, no termination of a right of payment occurs; the lessee simply pays the lessor on a present value basis what the lessor would have received had the lessee made payments over the entire lease term. That termination right does not constitute a termination of the lessee's obligation to make payments. It is a timing difference only.[32]

Three cases support this point. In the *QDS* case[33] the court stated, in regard to a lease of lathes: "The Lease Agreement requires the Debtor to pay the Lessors upon termination the present value of precisely what they would receive if *QDS* made all required monthly installment payments for the full contract term and then exercise the purchase option." Similarly, in *Ford Motor Credit Co. v. Hoskins (In re Hoskins)*,[34] the court found that, in the lease of a Ford truck, the lessee could not terminate its lease within the meaning of Section 1-201(37), despite the existence of an early termination provision in the lease, because the lessee remained financially liable to the lessor after termination of the lease for payments that become due after the lease termination. Further, the court noted "the lessee could not simply return the vehicle and then walk away from the transaction with no further financial responsibility."[35] The lessee in *In re Sanford*, on the other hand, had the power to terminate the lease within the meaning of Section 1-201(37). The court observed: "At any time, the debtor could have terminated the lease by returning the bulldozer and paying off all of the rental payments he owed . . . with no further obligation . . . ." Thus, the right of termination occurs when the lessee has a unilateral right to terminate the lease before the end of its term.[36]

If a lessee has a right of termination within the meaning of these cases, a lease exists for purposes of the bright-line tests under the UCC. However, in many (but not all) lease transactions, lessors will generally not allow a lessee simply to walk away from a lease without liability for a termination payment or responsibility to obtain an equal sum of sales proceeds for the leased property. Most long-term commercial equipment lease transactions do not, and, in the author's opinion, likely will not, provide the lessee a right to return the leased property like a daily car without a payment obligation. Many lessors that lease equipment do so to earn the returns associated with the "spread" over their cost of funds. They usually do not take significant residual and remarketing risks associated with providing the lessee the UCC right of termination due to the limitations of their business models and lack of resources to effectively and profitability take residual risk and remarket equipment should the lessee elect to return it. Consequently, a second level residual value test under Section 1-201(37) is required for lease transactions that do not contain a right of termination as contemplated by Section 1-201(37).

RESIDUAL VALUE TEST UNDER SECTION UCC 1-201(37)

The second prong of the bright-line tests evaluates four residual value factors under Section 1-201(37). This test determines whether the lessor has a meaningful expectation of residual value in, or return of, the equipment or other property. Specifically, the test provides that a transaction is a security interest (no meaningful residual expectation by lessor) and not a lease (with meaningful residual or reversionary interest by lessor), for UCC purposes, if at least one of the following four criteria applies (and the lease payment obligation is not terminable under the UCC termination provision described above):

1. The original fixed term equals or exceeds the remaining economic life of the goods (such as a 5-year lease of a vehicle with a 5-year economic life)[37]; or

2. The lessee is bound (A) to renew the lease for the remaining economic life of such goods (for example, a vehicle lease that requires renewal through year six uses up the economic value of the five-year vehicle so the lessor has no expectation of residual value) or (B) to become the owner of such goods (for example, through a required purchase obligation of the vehicle at end of the five-year term); or

3. The lessee has an option to renew the lease for the remaining economic life of such goods for no or nominal consideration[38] (such as a $1.00 renewal option at the end of the lease term); or

4. The lessee has an option to buy such goods for no or nominal consideration (often a "dollar-out" purchase option).[39]

A rational lessee will continue to renew or buy when the lessor makes the pricing so attractive that a lessee would obviously stay in the deal and pay for the continued use, and potential ownership of, the equipment or other goods.

When structuring transactions, it is critical that lessors and lessees remember that courts will review the facts and circumstances concerning residual value at the time the parties enter into the lease (not later in the term or at the date of a dispute).[40] A lack of evidence that, at the inception of a lease, the lessor anticipates having meaningful residual value at the end of the lease can prove fatal to residual value arguments for the lessor or lessee under Section 1-201(37). This point was illustrated in the seminal case, *In re Edison Bros. Stores*[41] *(Edison)*. There the court held that the lessee-debtor failed to meet its burden of proving the lease should be recharacterized as a disguised security agreement. The record before the court provided no credible evidence that the projected fair market value of the leased property (Atrium point of service cash registers) on the date the debtor would be entitled to exercise the purchase options was nominal.

An often-raised question is whether a purchase option at certain percentage of original cost or fair market value of equipment will, with certainty, qualify a lease as a true lease under state law. In *QDS*, which extensively discussed the history of true leasing, the court considered the "Percentage Test" often used by other courts. The Percentage Test provides that a low percentage option relative to the original cost of the leased property automatically creates a security interest. The lessee in *QDS* argued that the Percentage Test as applied to the purchase option price for the lathes was nominal under Section 1-201(37). The purchase option equaled only ten percent of the original purchase price of the equipment and 8.2 percent of the total (undiscounted) stream of rents. The *QDS* court quoted several courts and authorities to disavow the Percentage Test. According to the *QDS* court, the Percentage Test is not a valid basis to determine whether a purchase price is nominal under current Section 1-201(37).

The *QDS* court may be right, but some courts still consider a percentage as a valid factor.[42] Lessors and lessees should not solely rely on a low percentage of the original cost or fair market value of property as the basis for asserting that a lease creates a security interest or true lease. A better and more persuasive approach would consider a percentage of the cost of the goods at the inception of the lease as one of the factors in considering the facts and circumstances of the whole transaction under Section 1-201(37).

For example, in *In re Sankey*[43] the court found a lease containing a suspiciously exact ten percent purchase option still constituted a true lease under the facts and circumstances that existed at the inception of the lease. The persistent ques-

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tion in the courts remains whether the purchase option is so low that a lessee will almost certainly exercise the purchase option. If so, it follows that the lessor has no meaningful expectation of residual value as an owner lessor.

Based on the author's experience, lessors will continue to ask, as they have for years, what percentage of residual risk will suffice to assure that a court will treat their transaction as a true lease. There is no simple answer to that question, and lessors should not use set percentages alone to qualify a transaction as a true lease. Whether an option is considered a nominal or bargain purchase option depends on the option price with respect to the particular asset. To illustrate, a three-year computer lease with a fifteen percent purchase option may qualify as a true lease. In contrast, a helicopter lease with a purchase option of forty-five percent after a five-year lease may fail the true lease analysis because the helicopter may have a reasonably predictable fair market value in excess of sixty-five percent after five years. Further, in *In re Super Feeders*,[44] the bankruptcy court found that the lease constituted a disguised security agreement with a nominal purchase option even though the transaction included a purchase option price equal to twenty percent of the original purchase price. Lessors should not, therefore, use percentages that do not approximate a reasonable estimate of fair market value at the end of the lease term, and even then, not use a percentage level basis alone, to structure a transaction as a true lease.

Lessors use early buy-out options (EBO) in leases for competitive and other reasons. Although the UCC does not address such options directly, a lessor risks losing true lease treatment when it gives a lessee an early purchase option at a price that falls well below the cost of performing under the lease by paying rent for the balance of the lease term. In such a case, does the lessor have a reasonable expectation of reaching the end of the lease term and realizing residual value? It seems unlikely, and the more unlikely the lessor's residual expectation, the more likely a court will question whether the transaction constitutes a true lease.

Another common lease structure provides a fixed price purchase option (FPO). The FPO, which enables the lessee to purchase the leased property at a certain price at the end of the lease, does not alone turn a lease into a secured transaction/security interest, especially if the FPO is equal to or greater than the predictable fair market value of the equipment or other goods at the time the option is to be exercised. However, if the FPO price is nominal, then the lease will meet the requirements for a secured transaction and not a true lease. Any FPO with an exercise price that falls between fair market value and nominal sums would have to be resolved under the facts of each transaction.[45]

Finally, some courts, like in Edison (discussed below), *In re Bailey* and *In re Buehne Farms*, fail to consider three criteria described below that, if present in a lease, should not deprive the transaction of true lease treatment. Section 1-201(37) provides that a lease does not become a security interest merely because:

(1) the present value of the consideration payable by the lessee equals or exceeds the fair market value of the equipment or other goods (in the so-called "full payout lease");

(2) the lessee has the risk of loss and duty to pay insurance, maintenance and taxes like an owner of equipment; or

(3) the lessee has an option to renew the lease or purchase the equipment or other goods (assuming these options approximate fair market rental or sale value, as the case may be).

These terms commonly appear in leases, but some courts have failed to mention them in evaluating leases. In some cases, the courts even use these factors to justify the opposite result - that a lease does not exist. For example, if a lessee has the risk of loss under item (2), a court may construe the transaction as a financing.[46] In *Edison* the court used item (1) as a criteria to identify a financing (though it never reached a decision on this point). Lessors and lessees should not make the same mistake and should be ready to point out that these elements should not alone cause a lease to lose its true lease character.

Lessors should understand these three items and use them in structuring leases, disputing lessee claims that their transaction constitutes a security interest and presenting arguments to the courts in true lease contests. The failure of the courts in the past to use these items correctly may give way to more informed analysis and winning results for lessors if lessors argue strenuously and clearly that their leases should be entitled to true lease treatment even if the leases possess these characteristics. The UCC sanctions contracts as leases that contain these provisions - something the *Edison* court seemed to ignore but lessors should not.

THE "ECONOMIC REALITIES" TEST

Once a transaction overcomes the bright-line or per se tests under Section 1-201(37), indicating that a security interest may not exist (and a lease may exist), the courts have regularly applied yet another level of analysis. The second level test determines whether a true lease exists (when the per se test is not conclusive) and is frequently called the "economic realities" test or the "sensible person" test.

One court, in the case of *In re Grubbs Construction Co.*,[47] said that a security interest rather than a lease exists if "only a fool would fail to exercise the option" to purchase goods at the end of the lease, given the facts and circumstances at the inception of the lease.[48] From the court's perspective, if the lessee has "no sensible alternative" or "no choice" or is virtually "compelled" to exercise a purchase option, then the economic reality is that a lease is really just a financed sale or purchase of the equipment.[49] Economically, a lessee must exercise its purchase option to avoid giving up substantial residual value, which no sensible person would do. For example, assume a lessee has a $5,000 purchase option for a farm tractor that at the end of the lease will have a value of $18,000. What choice does a lessee really have or what sense does it make for the lessee not to buy the tractor and give up $13,000 in residual value? Such a lease transaction motivates the lessee to buy and looks like the secured loan with a $5,000 final payment. In that case, the transaction may even fail the bright-line test because a lessee could argue that the purchase option is nominal. A lessor that structures a transaction like this one should almost certainly expect challenges from a troubled lessee, even though one could argue that this structure is not obviously flawed as a true lease structure. Lessors will almost always undertake a multi-fact analysis in structuring transactions. The trends today suggest that, to satisfy true lease criteria, lessors should adhere as closely as feasible to the UCC requirements as interpreted and expanded by cases that use the economic realities test.

The trends today suggest that, to satisfy true lease criteria, lessors should adhere as closely as feasible to the UCC requirements as interpreted and expanded by cases that use the economic realities test.

The economic reality test arises from judicial precedent and Section 1-201(37)(x) or Section 1-203(d), which provides that 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." In applying this rule, courts have tried to ascertain the nature of a transaction without regard to labels or the subjective intentions of the parties.[50] In the last several years, the economic realities test has become the most important and central part of the analysis of whether the courts will characterize a lease as a true lease or a security interest under the UCC.

The preeminent true lease case that set the current trend and forms the foundation for the *Grubbs* case is *Duke Energy Royal, LLC v. Pillowtex Corp.*[51] *(Pillowtex)*. Decided under New York law, the transaction reviewed by the court did not involve a "lease" but rather, a master energy services agreement (MESA). The MESA provided for an eight-year contract under which Duke agreed to acquire, hold title to, and install $10.41 million of energy-savings equipment in nine Pillowtex facilities. The equipment included lamps, electronics ballasts, a waste heat recovery system, and various other items of energy-saving equipment constructed specifically for the Pillowtex facilities. The equipment generally had a useful life of 20-25 years. Pillowtex paid a level

The net effect for Duke was that it had little or no anticipation of residual value at the end of the term even though the leased property had about twelve years of useful life remaining at the end of the eight-year term.

amount of compensation to Duke that equaled the expected energy savings expected from the equipment. Pillowtex accounted for such compensation as utility payments rather than rent. At the end of the fifth year of the eight-year term, Duke expected to recover a "simple payback" of its investment.

Duke (and not Pillowtex) retained various end-of-term options: (1) the right to remove the equipment at its cost, (2) abandon the equipment, (3) extend the MESA term or (4) give Pillowtex the option to purchase the equipment at a mutually agreeable price. The cost to remove the equipment was prohibitive for Duke when weighed against the nominal residual value of the leased property if removed at the end of the MESA term. The net effect for Duke was that it had little or no anticipation of residual value at the end of the term even though the leased property had about twelve years of useful life remaining at the end of the eight-year term.

The Court closely evaluated whether the MESA "created an interest in personal property or fixtures which secures payment or performance of an obligation" not subject to termination within the meaning of Section 1-201(37) of the UCC and created a security agreement rather than a lease. It further reviewed the four elements of the "per se" rule in Section 1-201(37) of the UCC to determine whether the MESA transaction created a security interest as a matter of law. After extensive discussion, the court concluded that the transaction did not create a security interest under the per se test.

It then moved, with the concurrence of the parties, to the second level of analysis-the "economic realities" tests. In doing so, the Court considered, as articulated in *Edison*, whether (a) the purchase option, if any, was for nominal consideration, (b) the lessee was required to make aggregate rental payments with a present value equal or exceeding the original cost of the leased property, and (c) the lease term covered the total useful life of the equipment.[52]

In a detailed analysis of these three *Edison* factors, the Court found that when considering the "economic realities" the MESA was not a lease. Therefore, Duke was not entitled to payments under Section 365(d)(10)[53] of the federal Bankruptcy Code. The bankruptcy court ruled the MESA constituted a secured financing and specifically confirmed that that, unlike the prior versions of the UCC, the current version of the UCC does not consider the intent of the parties (which the court identified and did consider). The objective question, it noted, is whether the transaction creates a security interest or lease regardless of the name of the document purporting to be a lease.

The Court fundamentally based its conclusion on the fact that the rent exceeded the cost of the equipment as an indication, in the opinion of the court, that Duke intended to sell rather than lease the energy equipment to *Pillowtex*. The inference of the intent to sell the equipment to Pillowtex found further support in Duke's own testimony. Duke testified that it would likely abandon the equipment because it would otherwise face a prohibitively high cost to remove equipment with nominal residual value upon removal. Further, the courts found that Pillowtex had control over the purchase option because Pillowtex could refuse to negotiate a price with Duke. This refusal would force Duke to sell the equipment to Pillowtex at a nominal price or abandon the equipment, thus neutralizing the purchase option as a realistic term of the MESA.

Arguably, the court erred by ignoring two important principles of Section 1-201(37). First, it should not have considered the intent of the parties given the objective test requirement of the UCC. Second, it should have given limited, if any, weight to the fact that rent exceeded equipment cost because Section 1-201(37) states that such factor does not cause a lease to become a security interest (as stated above).

Nonetheless, the principles articulated in *Pillowtex* will likely resonate in the courts for the foreseeable future as the economic realities test increasingly dominates true lease analysis. Cases since *Pillowtex* have frequently relied on an economic realities test to decide the fate of a lease transaction. Transaction parties should focus intently on this approach as the courts appear to be sympathetic to lessee arguments that a lessors should face the economic reality that its lease structure amounted to no more than a deferred payment or conditional sale agreement, the lessee should be treated as the owner to the exclusion of the lessor, and the lessor should be relegated to a lender status.

TRUE LEASE CONCEPTS APPLIED TO SPECIALIZED TRANSACTIONS

The precedent established by *Pillowtex* has been cited in a wide range of true lease cases. This section briefly examines some of the more specialized structures on which the *Pillowtex* case (or the economic realities test) has made an impact.

CAN A TRAC LEASE WITHSTAND A TRUE LEASE ATTACK?

A "TRAC lease" is a lease that contains a special provision called a "terminal rental adjustment clause." TRAC leases apply to motor vehicles (including trailers) used more than fifty percent of the time in the trade or business of the lessee. Sometimes called an "open-end lease," a TRAC lease requires the lessee to make an unknown (open-ended) payment to the lessor at the end of the lease term. This "terminal rent" payment makes up any shortfall due to the lessor if the lessor does not receive proceeds of a sale or other disposition of the vehicle sufficient to recover its investment plus its return on the investment. The transaction looks and works like a balloon loan because the lessor transfers all residual value risk to the lessee. The lessor realizes residual value either when the lessee exercises an option to purchase the asset at the end of the lease at a stipulated amount or when the lessor sells the asset to a third-party. If the disposition of the vehicle results in excess proceeds, the lessee generally receives the excess.[54]

Despite its loan characteristics, the TRAC lease is treated as a true tax lease because of a special provision set forth in Section 7701(h) of the Internal Revenue Code of 1986, as amended. Section 7701(h) establishes the criteria for a lease to qualify as a true tax lease, and a TRAC lease agreement will include provisions that incorporate the requirements of a TRAC lease under the statute.

Although the UCC and *Pillowtex* analysis apply to TRAC leases, uniform statutes have been enacted in forty-eight (48) States (all states except Kentucky and New Mexico) and the District of Columbia.[55] The statutes generally provide that the existence of a terminal rental adjustment clause does not preclude a transaction from being treated as a true lease. For example, Section 168A.17, Subd. 1a. of the Minnesota Statutes 2003,[56] states in part: "In no event shall the lease agreement be deemed to create a conditional sale or security interest merely because it permits or requests the amount of rental payments to be adjusted upward or downward by reference to the amount realized by the lessor upon sale or disposition of the vehicle." Although the statutes do not avoid the economic realities and per se tests, they lend credence to the notion that TRAC clauses alone should not alter the true lease nature of a transaction.

The trend of judicial authority runs in favor of the characterization of TRAC leases as true leases.[57] However, courts remain divided on this issue.[58] For example, the *Grubbs* case held that a TRAC lease constituted a security agreement and did not refer to a model statute. Although the Grubbs court did not mention a model statute, these statutes, while helpful, do not require the courts to characterize every TRAC lease as a true lease under state law. The statutes nonetheless create greater certainty and predictability that a TRAC lease should stand up as a true lease when challenged by a lessee as a mere secured interest.

In evaluating TRAC leases, the courts focus on evidence of whether the parties expect the lessee to recognize some equity in the vehicle subject to a TRAC lease or whether the lessee's only eco-

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Although the TRAC lease statutes help protect the transaction, they cannot alone overcome the economic realities and residual value tests under the UCC.

nomically sensible course of action is to exercise the option to purchase the vehicle.[59] For example, a TRAC lease may not qualify as a true lease when the lessor grants the lessee a nominal purchase option. One court said: "The more nominal the purchase option . . . the more likely is the conclusion that the lease was really one intended to accomplish the transfer of a title interest."[60] Further, if a lessor sets the lease term for a period that equals or even exceeds the expected economic life of the vehicle, the transaction may lose its true lease characterization.

Although the TRAC lease statutes help protect the transaction, they cannot alone overcome the economic realities and residual value tests under the UCC. As a result, the cases have presented, and, in the author's opinion, will sporadically continue to present, obstacles to true lease treatment of TRAC leases. Transaction parties should, therefore, apply the two-prong criteria and court cases discussed above when structuring TRAC leases. This effort should increase the chances that, if a lessee attacks a TRAC lease as a security interest, the TRAC lease would survive as a true lease. The judicial decisions have put lessors and lessees in the difficult position that neither may achieve the structure that makes the TRAC lease economically desirable or competitive. For lessors, the solution may lie in treating all TRAC leases as loans for pricing and security purposes to minimize the adverse impact of a true lease challenge.

IS A FIRST AMENDMENT LEASE A TRUE LEASE?

The Equipment Leasing Association (ELA) defines a first amendment lease[61] as follows:

> The first amendment lease gives the lessee a purchase option at one or more defined points with a requirement that the lessee renew or continue the lease if the purchase option is not exercised. The option price is usually either a fixed price intended to approximate fair market value or is defined as fair market value determined by lessee appraisal and subject to a floor to insure that the lessor's residual position will be covered if the purchase option is exercised.
>
> If the purchase option is not exercised, then the lease is automatically renewed for a fixed term (typically twelve or twenty-four months) at a fixed rental intended to approximate fair rental value, which will further reduce the lessor's end-of-term residual position. The lessee is not permitted to return the equipment on the option exercise date. If the lease is automatically renewed, then at the expiration of that initial renewal term, the lessee typically has the right either to return the equipment without penalty or to renew or purchase at fair market value.

In the *Grubbs* case, the court analyzed transactions that looked like the first amendment leases defined above by the ELA. The lease transaction involved a master lease agreement with multiple equipment schedules covering various types of construction equipment. Four of the leases contained options (1) for an early buyout during a seventy-two month lease, the effect of which required Grubbs to exercise the EBO or acquire the equipment at the end of month sixty-six; or (2) a required purchase option at the end of month seventy-two at the greater of fair market value or a stipulated value; or (3) if Grubbs failed to purchase under (1) or (2), it would be required to renew the lease for fourteen months. It could thereafter return the equipment without obligation, but under very onerous return conditions.

Grubbs selected this transaction because it offered the lowest "interest rate," and neither party intended that Grubbs, as the lessee, would return the equipment. Moreover, according to the court, the lessor was not even in the business of leasing, further suggesting that the agreement was a financing arrangement. In fact, the court in the *Grubbs* case listed eighteen reasons why the leases should be recharacterized and treated as security agreements under Section 1-201(37) of the UCC.[62]

A first amendment lease with attributes similar to the leases in the *Grubbs* case would likely be treated as a secured transaction instead of a true lease because the lessor has little or no residual risk or expectation that the lessee would return the equipment.

IS A SYNTHETIC LEASE A TRUE LEASE?

Despite the extreme scrutiny applied to off-balance sheet structures, non-leveraged synthetic leases have survived legislative, accounting and regulatory changes.[63] However, synthetic leases structurally will seldom, if ever, pass muster as true lease under the UCC.

A synthetic lease is a financial structure that is treated as an "operating lease" for accounting purposes under FAS 13 and as a conditional sale for federal income tax purposes. Synthetic leases exist due to inconsistencies between accounting and tax rules applicable to leases. They possess two key advantages for a lessee: (1) the lessee receives "operating lease" treatment under FAS 13 so that neither the leased property nor the corresponding liability for rent is recorded on the lessee's balance sheet; and (2) the lessee treats the transaction as a conditional sale for tax purposes. As a result, the lessee remains the tax owner of the property and can therefore deduct interest and depreciation under federal income tax rules.

In *Unocal Corp. v. Kaabipour*, a real estate synthetic lease case, the court found that "general law treats synthetic lease arrangements as an operating lease for accounting purposes, but is otherwise regarded by virtually all concerned, including the government, as a secured loan." The court construed various real estate documents as a financing instead of an operating lease in part because the nominal lessee assumed all operational, insurance, casualty and other risks of an owner. The court concluded that the lessee owned the property and the synthetic lease effectively constituted mortgage financing.[64]

In a typical synthetic lease, a lessor would give the lessee all of the upside in the property at the end of the lease and relinquish any (or at least most) of its expectation of realizing residual value from the property. By agreement, the lessor has nothing to gain other than repayment of the original purchase price on the property plus a return. The transaction is a pure credit transaction in which the parties typically state that the lease is intended to constitute a secured loan. Further, the lessor structures the transaction with a residual value that falls well short of the twenty percent residual value requirements set forth in the Guidelines and the required twenty percent continuous level of investment during the lease term. Therefore, the structuring of a synthetic lease by design violates the tax Guidelines and arguably fails the residual value tests under Section 1-201(37) of the UCC and the economic reality tests under case law interpreting Section 1-201(37).[65]

CAN LESSORS STRUCTURE A TRUE LEASE OF SOFTWARE?

A recent case, *In re CNB International, Inc.*,[66] has addressed the question of whether a lessor can enter into a true lease of software with a lessee. Although the case did not apply current UCC rules, it did imply that transaction parties might enter into a true lease of software rights. By implication the case suggested that lessors can win a true lease fight with a lessee when a lessee challenges a lease of software and/or software rights. However, a closer look at the future of software leasing may produce the opposite conclusion - software leases probably will not meet true lease criteria under the UCC.

CNB manufactured and marketed industrial presses, machine tools and related parts. It needed to acquire a new computer system that consisted of equipment and customized software developed by Symix Computer Systems, Inc. (Developer). CNB entered into a Master License

Despite the extreme scrutiny applied to off-balance sheet structures, non-leveraged synthetic leases have survived legislative, accounting and regulatory changes.

The court considered the issue of whether the transaction constituted a true lease of the software that entitled Amplicon to use the special rights under Section 365(d)(10) to recover post-petition rent.

Agreement with the Developer. To make this acquisition, CNB entered into an off-balance sheet lease with Amplicon, Inc., as the lessor. Amplicon paid for the software licenses and hardware, but it received no rights to the software. The Developer licensed the software directly to CNB, but retained the exclusive rights to "[a]ll trademarks, service marks, patents, copyrights, trade secrets and other proprietary rights in or related to the Products". . . [all of which it said] "will remain the exclusive property of Symix or its licensors."

On March 10, 1999, less than a year after the lease commenced, CNB filed a bankruptcy petition. CNB did not pay for or use the software after the date of the filing. Amplicon filed a motion to compel the assumption or rejection of the lease covering hardware and software licenses. It also asserted that Section 365(d)(10) of the federal Bankruptcy Code imposed on CNB the obligation to pay the contract rent starting sixty days after filing the petition.[67] CNB ultimately rejected the lease and Amplicon renewed its request for post-petition rent. The parties settled with respect to the equipment portion of the lease; so the court turned its attention to the claims regarding the software.

The court considered the issue of whether the transaction constituted a true lease of the software that entitled Amplicon to use the special rights under Section 365(d)(10) to recover post-petition rent. It found that the lease did not constitute a true lease with respect to the software. Rather, the lease merely represented an executory contract, which CNB could reject.[68] The transaction did not even constitute a security agreement because Amplicon, as lessor, had not acquired any property interest in the software that would enable it to foreclose on a lien against CNB. As lessor, Amplicon did not even have the essential right to transfer a right of use to CNB, as lessee, because all software rights to the software had been retained by the Developer. The court said: "With respect to the software, Amplicon simply owned nothing that it could have transferred to the debtor" (CNB). Consequently, Amplicon suffered a total loss regarding the software, including any additional payments for the post-petition period during which CNB had possession (control of the software) but did not use the software.

Under the UCC provisions applicable to the case, Amplicon's lease passed the "bright-line tests" under Section 1-201(37)[69] of the UCC and thereby avoided the per se characterization of being a security agreement. As the lessor, Amplicon lacked any reversionary or property right in the licenses or software. It had no property right to protect or recover on the expiration, cancellation or termination of the lease. It had no expectation of residual value in the software licenses or software; even less expectation than the purported lessor had in the energy-savings equipment in *Pillowtex*. Yet, the court implied that parties can enter into true leases of software, stating: "If properly structured, software leases function as an effective mechanism for access to intellectual property."[70]

When one evaluates the facts in this case under the current version of Article 2A, the CNB software transaction would not qualify as a lease under Section 2A-103(1)(j)[71] of the UCC. This conclusion arises in part because the UCC defines a "lease" as "a transfer of the right to possession and use of goods for a term in return for consideration . . .." Goods do not encompass software rights (other than rights to software embedded in goods) because goods refer to all things movable (including embedded software) at the time they are identified to the lease contract. The 2003 Amendments to Article 2A, which are not yet effective in any state, changed the definition of goods in a way that arguably precludes lessors from leasing software due to a reference to leasing items, which exclude "information." Information could encompass software rights.[72]

Arguably, a license or a lease of software or software licenses are functionally identical and even fit the quoted portion of the definition of a lease in Article 2A as follows: A software lease is "a transfer of the right to possession and use of software or software licenses for a term in return for consideration . . .. A lease of a software license or software will be treated as a sublease." However, unless software is embedded in goods, lessors can anticipate that few, if any, purported true leases of software leases will qualify as true lease under current law.

Further, where lessors structure "software leases" as installment payment agreements (IPAs) to pay software license fees over time, as is commonly the structure in software financing transactions, a lessee could allege that the arrangement does not even qualify as a lease because the software not only does not constitute goods but the lessor also has no right to grant possession and use of the software to the lessee. Those rights remain with the software owner and/or licensor and, like in the *CNB* case, typically bypass the lessor. Accordingly, a closer examination of software leasing suggests that, even though a lessor may be able to lease software, as implied by the court in *CNB*, the lessor may face an uphill battle to win treatment of the lease of software as a true lease.

If a lessor becomes the licensee with sub-licensing rights, the lessor may have a stronger argument that it does have the rights to transfer possession and use of the software rights to the lessee, which should entitle the lessor to true lease treatment. The lessor could also show that it has a reversionary interest in the software rights and residual value in leasing the software in the future to gain its full value over time as the owner of the software rights. With attention to the bright-line tests, lessors may be able to structure leases that pass the bright-line tests for the existence of a security interest and overcome the scrutiny that may arise under economic realities test in a bankruptcy of a lessee. A lessor could argue, in support of a true lease, that the lessor is entitled to true lease treatment because the lessor can realize residual value from its continued rights to license (lease) the software after the prevailing lease expires.

SEVEN CONSEQUENCES OF FAILING THE TRUE LEASE TESTS

As a consequence of the *Pillowtex* case and similar cases, it has now become an inevitable event in most lessee bankruptcy proceedings that lessees will challenge the lessor's true lease characterization and rights under a purported lease. For the lessor, it is equally clear that it can receive far superior treatment than a secured lender and should therefore remain cognizant of the structures that will withstand these lessee challenges. More specifically, consequences of losing a true lease challenge, include:

1. **Loss of Section 365(d)(10) payments**. A lessor has meaningful rights to payment under Section 365(d)(10) of the federal Bankruptcy Code.[73] Section 365(d)(10) requires debtors-in-possession to "timely perform all of the obligations of the debtor . . . first arising from or after 60 days after the order for relief in a . . . Chapter 11 . . . under an unexpired lease of personal property . . . until such lease is assumed or rejected." When Pillowtex successfully challenged the characterization of the MESA as a lease, it escaped the obligation to make payments to Duke and thereby preserved valuable cash for its bankruptcy estate-a powerful incentive to mount a challenge against "lease" transaction.[74]

2. **No required cure of defaults under Section 365(b)**. Under Section 365(b), as modified by the *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, a debtor-lessee must cure all monetary and non-monetary defaults before the debtor-lessee can assume the lease. A lessor does not enjoy this right if the court characterizes the transaction as financing instead of a true lease.

3. **Potential loss of lien and/or priority**. If for any reason a lessor fails to make a timely and correct filing of financing statements under the UCC[75] or other priority creating statute, the lessor may not achieve expected priority with respect to the leased property. In that instance,

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The remedies available under a true lease thus provide several advantages to a lessor over those of a secured party with respect to the same property.

another secured party may take priority and leave the lessor with little or no recovery in a bankruptcy.[76] Even if a valid, secured claim exists[77] due to a proper grant of a security interest, the security interest may still be subject to:

- the "cram down" provisions under Section 1129 of the federal Bankruptcy Code (producing lower payments to the lessor than contractual rent);
- a reduction of the value of the collateral (leased property) under Section 506 of the federal Bankruptcy Code; or
- the "strong-arm" powers of the trustee in bankruptcy to avoid a lien of the lessor against the leased property Section 544(a) of the federal Bankruptcy Code.[78]

4. **Opportunity lost to receive residual value**. If the lessor made residual value assumptions, and/or depended on residual value to achieve its economic return, the characterization of the lease as a security interest would wash out any residual recovery and potentially leave the lessor with a substantial economic downside loss that would have been avoided by structuring the transaction correctly as a true lease. In a true lease, the lessor would retain title to the leased property and the upside or downside of the property's value.

5. **Usury laws may apply to the transaction**. In most states, laws exist that set maximum lawful rates of interest on loans or forbearance in the collection of money. If a lease is construed to be a loan for usury purposes, the lessee may press the case that the lessor violated applicable usury law and should suffer the penalties of overcharging the lessee for the interest on the loan relating to the so-called leased property. The consequences vary by state but can result in the loss of interest and principal of the loan (on top of the loss of rights as a lease). Lessors should watch out for this argument, and pay special attention to structuring true leases where the lease rates may violate usury laws if the transaction is recharacterized as a loan subject to the usury laws.[79]

6. **"Finance lease" treatment unavailable**. If a lease does not exist under Article 2A, then a lessor cannot obtain the benefits of a "finance lease." The statutory "hell and high water" treatment under Article 2A goes up in smoke with the loss of finance lease treatment. Although most leases provide a contractual provision, the statutory support may have significant benefits for the lessor and would be lost if a lease does not exist.[80]

7. **Loss of favorable lessor remedies under Article 2A.** When a lessor properly structures a "lease" under the Article 2A of the UCC (a true lease in this paper), the lessor obtains remedies of an owner of goods, such as equipment, instead of remedies of a secured party under Article 9 of the UCC. For example, Part 6 of Article 9 requires a secured party (even if called a "lessor") to give reasonable notice of a disposition of foreclosure of collateral, and to sell the collateral in a commercially reasonable manner, paying the excess proceeds to the debtor (even if called the "lessee"). The true lessor is not shackled by these rules. Instead, the lessor is entitled under Section 2A-503 to put itself "in as good a position as if the lessee had fully performed the lease." Lessors can cancel a lease, recover the goods (equipment), collect discounted rents and even require the payment of liquidated damages (a genuine pre-estimate of damages, including lost residual value, that can not be easily or accurately calculated).[81] The loss of rights for a lessor (when treated as a secured party) is substantial, and worthy of economic, credit and legal analysis when structuring a lease. The remedies available under a true lease thus provide several advantages to a lessor over those of a secured party with respect to the same property.

CONCLUSION: THE ROAD TO SUCCESS IN TRUE LEASING

True leasing has been around in its modern forms for several decades. In the last several years, lessees have shown an increasing propensity to challenge a lease transaction as a lease intended for security. As a result, lessors now encounter a persistent risk of challenges to true lease transactions. Although the risk exists, it should be manageable if lessors consider the following points when structuring true leases under the UCC:

1. **Remember the two-prong test**. Structure transactions using both the bright-line/per se test under UCC Section 1-201(37) and the economic realities test as seen in *Edison, Pillowtex, QDS* and *Grubbs*.

2. **Expect regular challenges**. The willingness of the courts to look pragmatically and technically at leases to determine if they will pass the economic realities test will motivate lessees to attack lease transactions. Lessees may do so even if they concurred at the time of signing the lease that the transaction then met all applicable true lease criteria, as occurred in *Pillowtex*.

3. **Establish residual value evidence at lease inception**. Appraisals or other written evaluations that the lessor and lessee considered as to remaining residual value may provide important evidence to retain true lease treatment. Lessors and lessees should create and preserve this information to prove, in a court challenge, that the transaction included the required residual assumptions to meet the UCC and economic realities tests. A failure to have adequate evidence can impact a case as it did in *Edison*.

4. **Structure each transaction based on current law**. To structure leases effectively, lessors and lessees, and their counsel, must understand and maintain knowledge of current court decisions regarding true leasing. By doing so, they will have the tools to fully evaluate the risk of a true lease challenge under the state law that governs their transaction and to structure transactions properly to meet their goals.

5. **Keep accounting and tax lease concepts separate from UCC rules**. FAS 13 and other accounting guidance should not influence the UCC lease issues. A true tax lease may exist even though a lease is intended as security under the UCC. That situation occurred in *Pillowtex*. Keep tax, accounting and UCC concepts separate and avoid using them interchangeably in a lease contest. This approach does not preclude the use of the same facts of the case for a separate analysis of whether FAS 13 or federal income tax law rules have been met.

With careful adherence to the evolving requirements of law, lessors should, in most transactions, be able to structure, use and defend[82] true leases as a viable method of making capital investments in equipment, software and real estate. Competition for business and risk management may understandably impede these efforts in the face of persistent lessee challenges and market conditions. However, the ultimate choice about structuring true leases will be made by lessors - one deal at a time. When making this choice, all lessors share responsibility for the future of this important financial product.

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Endnotes

[1]See *Pillowtex* at note 51, *infra*. Despite the agreement of the parties that their transaction constituted a true lease for income tax purposes, Pillowtex still successfully challenged the transaction as failing to qualify as a true lease for state law purposes.

[2]Although an analysis of true leases involving real or

mixed property (personal and real property combined) is beyond the scope of this paper, a series of cases arising out of the United Air Lines bankruptcy illustrate the complexity and inconsistency of the true lease decisions. *Compare United Air Lines, Inc .v. HSBC Bank USA*, 322 B.R. 347 (N.D. Ill. 2005) (applying the "economic realities" test to a Colorado airport facilities lease, and finding a true lease primarily because the lessee obtained no equity in the leased property) *with Bank of New York v. United Air Lines, Inc.*, 2005 WL 670528 (N.D. Ill., 2005) (applying the "economic realities" test to a New York airport facilities lease and finding no true lease), *citing In re Hotel Syracuse, Inc.*, 155 B.R. 824, 838 (N.D.N.Y. 1993). In *United Airlines, Inc. v. HSBC Bank USA, N.A.*, Case Nos. 04-4209, 04-4315 & 04-4321 (7th Cir. 2005) *available at* http://www.ca7.uscourts.gov/tmp/MN0Y76RN.pdf, the appellate court, on July 26, 2005, reversed the lower court finding that a "true lease" existed because, in substance, the transaction created a secured transaction. United leased a maintenance base from an airport. United used the base as collateral to obtain a secured loan. United did not enter a lease regardless of labels on the documents. United did not acquire a right of use of the base because it already had the rights under a lease from the airport. The characteristics of the transaction fit the mold of a secured loan rather than a lease, including the factors (on page 14) that (1) the creditors determined "rent" based on a money advance by the creditors; (2) the property reverted to United at the end of the lease in 2013 without additional consideration; (3) the structure included a balloon payment obligation like loan deal (unlike a lease); and (4) United had a prepayment right by which it could immediately terminate the sublease transaction.

[3]See *infra* notes 54-60 and accompanying text regarding TRAC leases as true leases under state law.

[4]Some states have restructured § 1-201(37) of the UCC either by creating a new § 1-203, which lists the distinguishing factors between a lease and security interest, renumbering the section as § 1-201(35) and defining a security interest more narrowly than the old Section 1-201(37). Section 1-203 is *available at* http://www.law.cornell.edu/ucc/1/paper1.htm#s1. For ease of reference, this paper refers only to Section 1-201(37). Section 1-201(37) is available at http://www.law.cornell.edu/ucc/1/article1.htm#s1-201.

[5]*See B & S Marketing Enterprises, LLC v. Consumer Protection Division*, 835 A.2d 215 (Md. Ct. Spec. App. 2003) (finding a loan transaction existed despite the agreement being labeled a sale-leaseback). *But see NationsBank of North Carolina, N.A. v. Capital Associates International, Inc.*, 916 F. Supp. 549 (W.D.N.C. 1996) (finding that the form of the contract was an important consideration in determining whether an agreement was a true lease).

[6]*See, e.g., In re HomePlace Stores, Inc.*, 228 B.R. 88 (Bankr. D. Del. 1998) (holding that under Ohio law the intent of the parties should not control whether an agreement is a true lease, no matter how clearly that intention is expressed).

[7]*In re QDS Components, Inc.*, 292 B.R. 313, 323 (Bankr. S.D. Ohio 2002). However, a more uniform, objective approach seems to be developing as illustrated in *In re Lerch*, 147 B.R. 455, 458 (Bankr. C.D. Ill. 1992).

[8]*General Electric Capital Corporation v. EPlus, Inc.*, 2005 WL 700954, *1 (S.D.N.Y. 2005).

[9]For general information on FASB principles visit the FASB's website at http://www.fasb.org/.

[10]A "finance lease" is a special form of three-party lease transaction. Once a transaction qualifies as a "lease" under Article 2A, certain characteristics of the transaction allow the lessor to become a "finance lessor" and receive the benefits of a "finance lease" under § 2A-102(1)(1) or §2A-103(i)(g)/2A-103(1)(g) of the UCC."

The core concept of a finance lease is to protect a lessor from liability relating to defective equipment when the lessor only provides money and not equipment in the lease transaction. Equipment is one category of goods under Article 9 of the UCC. UCC § 9-102(33). A finance lease separates the sales portion from the lease portion of the transaction, and makes the lessee the beneficiary of the contract by which a supplier sells the leased property. *Id.* § 2A-209. A finance lease requires that, in a distinct transaction, a third party, such as a manufacturer, 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." *Id.* § 2A-102(1)(1)(i), § 2A-103(1)(g)(i). Additionally, the lessor may only acquire rights in the goods "in connection with the lease" or another lease and may not own any of the goods before entering into the lease. *Id.* § 2A 102(1)(1)(ii), § 2A-103(1)(g)(ii). Finally, the lessee must either approve the purchase contract or receive supplier information before signing its lease agreement by meeting one of four detailed requirements. *Id.* § 2A-102(1)(1)(iii), §2A-103(1)(g)(iii).

When a lessor and lessee enter into a finance lease, the lessor acquires certain additional protections or rights. The most important protection stems from the "hell or high water" clause, which, upon the lessee's acceptance of the goods, requires the lessee, in a nonconsumer lease, to make its payment obligations to the lessor independent of any breach of obligations by the lessor or the supplier. *See Id.* § 2A-407; David G. Mayer, *Leasing 101: The "Hell-or-High Water" Clause: A Critical Provision in Leasing*, BUSINESS LEASING NEWS (July 2002), at http://www.pattonboggs.com/Newsletters/Bln/Release/bln_2002_07.htm.

Other benefits for a lessor include: (1) shielding the lessor from liability under implied warranties of infringement found in § 2A-211, merchantability found in § 2A-212(1) or fitness for a particular purpose. *Id.* § 2A-213, (2) freeing the lessor from the risk of loss under § 2A-219(1) and (3) depriving the lessee of the power to revoke its acceptance of goods that do not conform to the contract under § 2A-516(2). See also Official Comment (g) to § 2A-103(g). It is important to note that these rights can and should be drafted into a lease contract so as not to rely solely on qualifying a transaction as a finance lease under Article 2A.

Hell or high water provisions generally work as intended by Article 2A, but recent cases have undercut its protections. *See Jaz, Inc. v. Foley & First Hawaiian Leasing*, 85 P.3d 1099 (Haw. Ct. App. 2004) (acceptance of equipment required to trigger §2A-407); Amelia H. Boss and Stephen T. Whelan, *The ABCs of the UCC, Amended Article 2A: Leases*, 53-56, published by American Bar Association (2005); David G. Mayer, *BLN Case & Comment: Fraud Washes Out Hell or High Water Clause in Eureka Broadband Case*, by, BUSINESS LEASING NEWS (May 2005) available at http://www.pattonboggs.com/newsletters/bln/Release/bln_2005_05.htm#5 (noting that fraud by lessor defeats hell or high water right).

[11]The federal leasing guidelines for true leases are *available* at http://www.irs.gov/pub/irs-irbs/irb01-19.pdf. See also: Rev. Rul. 55-540, 1955-2 C.B. 39 *available* at http://taxlinks.com/rulings/1955/revrul55-540.htm to which Rev. Rul. 2001-28 refers at page 1157. Section 4.01 of Rev. Ruling 55-540 presents several judicially accepted factors for determining whether a transaction is a sale or a lease. The factors most indicative of a sale include: (1) the lessee makes periodic that build an equity interest in the property to be acquired by the lessee; (2) the lessee acquires title upon payment of a stated amount of "rentals" which, under the contract, the lessee is required to make; (3) the total amount the lessee is required to pay for a relatively short period of use (or possession) constitutes an inordinately large proportion of the total sum required to be paid to secure the transfer of the title; (4) the agreed "rental" payments materially exceed the current fair rental value (this may be indicative that the payments include an element other than compensation for the use of the property); (5) the property may be acquired under a purchase option at a price that is nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or that is a relatively small amount when compared with the total payments that are required to be made; and (6) some portion of the periodic payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest. See IRS Letter Ruling, Release 2001-0072 (March 30, 2001), *available* at http://www.irs.gov/pub/irs-wd/01-0072.pdf.

[12]The IRS will consider the lessor in a leveraged lease transaction to be the owner of the property and the transaction a valid lease if all the Guidelines are met. If all Guidelines are not met, the IRS nevertheless will consider ruling in appropriate cases on the basis of all the facts and circumstances. A discussion of the application of the Guidelines to single investor leases is beyond the scope of this paper. *Id*. at Rev. Rul. 2001-28 at § 3. However, in general, any single investor lease that meets applicable Guidelines criteria is virtually assured to qualify as a true lease for federal income tax purposes.

[13]The Guidelines contain several other considerations. For example, Guideline leases with uneven rents may be subject to I.R.C. § 467, which can affect the timing of rental income and deductions. Rev. Proc. 2001-28, § 5.01. The IRS will not issue advanced rulings on "limited use property" (property that, in general, has no other potential user at the end of the lease term). Rev. Proc. 2001-28, § 5.02. An IRS overview of the Guidelines is available at http://www.irs.gov/formspubs/page/0,,id=11999,00.html.

[14]Rev. Proc. 2001-28, § 4.01(3).

[15]Rev. Proc. 2001-28, § 4.03.

[16]Rev. Proc. 2001-28, § 4.04.

[17]Rev. Proc. 2001-28, § 4.05.

[18]Rev. Proc. 2001-28, § 4.06.

[19]*Available at* http://www.fasb.org/pdf/fas13.pdf.

[20]Off-balance sheet transactions have been subject to intense pressure and evaluation by the FASB and the Securities and Exchange Commission (SEC). Although a discussion of this topic extends beyond the scope of this paper, it is important to structure transactions with appropriate attention on the accounting implications. See David G. Mayer, *FIN 46R Clarifies Off-Balance Sheet Issues*, BUSINESS LEASING NEWS (Feb. 2004) available at http://www.pattonboggs.com/Newsletters/Bln/Release/bln_2004_02.htm#3 (regarding consolidation of variable interest entities - an updated form of special purpose entities invented by FASB). See also

Tim Reason, *Hidden in Plain Sight*, CFO.com (Aug. 1, 2005) available at http://www.cfo.com/archives/directory.cfm/2984411?f=shortcut.

Starting with the fiscal years ending after June 15, 2003, public companies have had to comply with the off-balance sheet disclosure requirements in registration statements, annual reports and proxy or information statements. The rules arise out of Section 401(a) of the Sarbanes-Oxley Act of 2002 *available* at http://thomas.loc.gov/cgi-bin/query/z?c107:H.R.3763.ENR: Effective April 7, 2003, these disclosure rules included a separately captioned section in Management's Discussion and Analysis (MD&A) highlighting the disclosures for readers. For the SEC discussion, click on: Final SEC Rules *available* at http://www.sec.gov/rules/final/33-8182.htm.

The SEC has recently released a detailed report on off-balance sheet transactions. The report recommends more transparency and accounting consistency regarding off-balance sheet leases. The SEC report is available at http://www.sec.gov/news/studies/soxoffbalancerpt.pdf. *See also Rethink Off-Balance-Sheet Reporting: SEC*, CFO.com (June 20, 2005), available at http://www.cfo.com/paper.cfm/ 4098167?f=search (describing key aspects of the SEC report).

[21]FAS 13 remain subject to wide interpretation despite FASB's goal to make FAS 13 a "cookbook" approach to achieving consistent treatment and reporting of leases by lessors and lessees. FAS 13 is likely to undergo substantial revision or change in the future in a joint project of FASB and the International Standard Accounting Board (IASB). FAS 13 have been amended and interpreted extensively.

[22]Paragraph 7a of FAS 13.

[23]Paragraph 7b of FAS 13.

[24]Paragraph 7c of FAS 13.

[25]Paragraph 7d of FAS 13.

[26]*See QDS infra*, at note 7, and *Pillowtex infra*, at note 52.

[27]Section 2A-103(1)(j) is *available* at http://www2.law.cornell.edu/ucc/2A/article2A.htm#s2A-103 The 2003 amendments provide a different definition that this paper generally does not consider, except with respect to software, because no state has adopted the amendments yet.

[28]Goods refer to all things that are moveable at the time they are identified to the lease contract. *See* note 71 *infra*. "States often have their own definitions of a lease, a tax lease or financing lease for such tax and other reasons. These terms that may appear to be similar to UCC terms but ultimately may have a different meaning. *See e.g.*, Rule 3.294 of Texas Administrative Code, Tax Administration (Definitions) *available* at http://info.sos.state.tx.us/pls/pub/readtac$ext.TacPage?sl=R&app=9&p_dir=&p_rloc=&p_tloc=&p_ploc=&pg=1&p_tac=&ti=34&pt=1&ch=3&rl=294

[29]Section 1-201(b)(35) of UCC. A "security interest" means an interest in personal property or fixtures which secures payment or performance of an obligation. The right of a seller or lessor of goods under Article 2 or 2A to retain or acquire possession of the goods is not a "security interest," but a seller or lessor may also acquire a "security interest" by complying with Article 9. Whether a transaction in the form of a lease creates a "security interest" is determined pursuant to Section 1-203 (also Section 1-201(37) in many states).

[30]Article 2A "applies to any transaction, regardless of form, that creates a lease." Section 2A-102.

[31]*See Butner v. United States*, 440 U.S. 48, 55(1979); *In re Bailey*, 2005 WL 1120308 (Bankr. W.D. Ark. 2005); *In re Architectural Millworks, Inc.*, 226 B.R. 551, 553 (Bankr. W.D.Va. 1998) (*citing In re Yarbrough*, 211 B.R. 654, 656 (Bankr. W.D. Tenn. 1997)).

[32]*In re Bailey*, 2005 WL 629002 (Bankr. M.D. Louisiana 2005). These payments may not be discounted and even if they are, may contain a "pad" in the termination that improve lessor's anticipated economic returns of the scheduled lease term.

[33]*See infra* note 7.

[34]*In re Hoskins*, 266 B.R. 154 (Bank. W.D. Mo. 2001).

[35]Month to month leases of equipment often allow a lessee to return the equipment and walk away without further payment obligations. In the case of *In re Sanford*, 2005 WL 629022 (Bankr. M.D. La., Jan. 31, 2005), the lessee could walk away any time, and the contract therefore constituted a terminable lease and a true lease even though a portion of the rental payments would apply to the payment of the price payable on exercising a purchase option). Rent-to-own leases arguably qualify as true leases, and rent-to-own statutes may have an impact on the true lease analysis. For example, *Perez v. Rent-A-Center, Inc.*, 866 A.2d 1000 (N.J. Super. App. Div. 2005) and *In re Lepri*, 2004 WL 1242556 (Bankr. D. Vt. 2004) each discusses rent-to-own agreements and statutes that are instructive in not finding that a security interest exists. *See also In re Chance Industries, Inc.*, 2002 WL 32653678 (Bankr. D. Kan. 2002) (termination rights did not exist for UCC purposes because of economic burden on lessee arising on a termination).

[36]*See supra* note 35. If the lessee has a unilateral right to terminate before the end of the lease term, the transaction cannot as a matter of law be deemed a security interest. *In re Murray*, 191 B.R. 309, 315 (Bankr. E.D.

Pa. 1996) (*citing In re Lerch*, 147 B.R. 455, 460 (Bankr. C.D. Ill. 1992)); In re Eagle Enters., Inc., 223 B.R. 290, 298 (Bankr. E.D. Pa. 1998), *aff'd*, 237 B.R. 269 (E.D. Pa. 1999).

[37]A recent decision, *In re Fleming Companies, Inc.*, 308 B.R. 693 (Bank. D. Del. 2004), found the term of the grocery store equipment lease used up the economic life of the equipment, rendering the lease a disguised security agreement under UCC Section 1-201(37)(a).

[38]*In Chance Industries, Inc. v. TFC Leasing, Inc. (In re Chance Industries, Inc.)*, 2002 WL 32653678 (Bankr. D. Kan. 2002) the court finds that a lessee pays nominal additional consideration when, as stated in Section 1-201(37), the additional consideration payable by the lessee is less than "the lessee's reasonably predictable cost of performing under the lease agreement".

[39]A dollar purchase option does not always mean a lease is one intended for security. For example, if the lessee retains a right to terminate the lease, the purchase option may not prevent the lease from gaining true lease status. *See In re Copeland*, 238 B.R. 801, 805-806 (Bankr. E. D. Ark. 1999); *In re Shores*, 2005 WL 1212591 (Bankr. M.D.FL., April 18, 2005) ($1.00 purchase option after 36 months for warehouse portable agreement).

[40]*In re Buehne Farms, Inc.*, 321 B.R. 239, 245, (Bankr. S.D. Ill. 2005). Similarly, the UCC examines the "reasonably predictable" economic life of goods at the inception of a lease. Section 1-201(b)(35) and Section 1-201(37). Consequently, diagnostic equipment that, as closing, has a reasonably predictable life of ten years and a lease term of seven years, does not lose its true lease character because the equipment becomes obsolete technologically at six years into the lease term. The lessor entered the lease expecting meaningful residual value.

[41]*In re Edison Bros. Stores*, 207 B.R. 801, 811-12 (Bankr. D. Del. 1997). The *Edison* case is one of the most important decisions in the last decade to use the economic realities test. In reaching its decision, the court in *Edison* evaluated three factors under New York law: Whether the purchase option price at the end of the lease term is nominal; whether the lessee is required to make aggregate payments having a present value equaling or exceeding the original cost of the leased property; and whether the lease term covers the total useful life of the equipment. If the *Edison* court had found that the answer to any of these questions was "yes," the outcome would probably have been different - a security interest would have existed in the transaction instead of a true lease. More recently, the court in *In re Rebel Rents*, 291 B. R. 520 (Bankr. C.D. Cal. 2003), found that the lessee failed to meet its burden of proof to show the transaction included a nominal purchase option that gave the lessor little expectation of residual value. As stated by the court in *In re Buehne Farms, Inc.*, 321 B.R. 239, 243 (Bankr. S.D. Ill, 2005): "The burden of proving whether the agreements are disguised security agreements or true leases rests with the party who would lose if no evidence were presented (citation omitted). Notwithstanding a presumption placing the burden on the party who claims that what purports to be a lease is actually not, if that presumption is overcome, then the burden shifts to the opposing side to refute the evidence that the transaction is a disguised sale." (citation omitted).

In characterizing a lease agreement as other than what it purported to be, the QDS court confirmed that the lessee bears the burden of proof. However, in *In re Circuit-Wise*, 277 B.R. 460 (Bankr. D. Conn. 2002), the court questioned this fundamental premise by barring lessor from using the special protections of 11 U.S.C. Section 365 until the court determined whether the transaction constituted a true lease. In effect, the court switched the burden of proof to the lessor rather than giving it the presumptive benefit of treating its transaction as a true lease until otherwise proven by the lessee. Fortunately for lessors, other courts as of June 15, 2005 have not followed the *Circuit-Wise* decision.

[42]Other courts continue to use the percentage test as a rule of thumb. For example, in *CIT Technology Financing Services, Inc. v. Tryicyle Enterprises, Inc.*, 13 A.3d 783, 787 (App. Div. 3rd Dept. 2004), the court found that a purchase option price in excess of twenty-five percent of market value of machinery was more than nominal and gave a successor lessor a significant reversionary interest in leased machinery. Consequently, the court held for that reason and others that a true lease existed. Below that level, however, the opposite should not be true. Virtually every technology equipment lease will be subject to a true lease test in that residual values often fall well below twenty-five percent. This approach has existed for 20 years as evidenced by a case where the court found a true lease of heavy equipment with caps on purchase options from twenty-one percent to twenty-five percent in the case *In re North American Rental*, 54 B.R. 574 (Bankr. D. N.H. 1985); *In re Access Equipment*, Inc., 62 B.R. 642, (Bankr. D. Mass. 1986) (twenty-five percent minimum purchase option price lease of machinery constituted a true lease); *In re Buehne Farms, Inc.*, 321 B.R. 239, 245 (Bankr. S.D. Ill., Jan. 26, 2005)(leases of cattle were not true leases).

[43]*In re Sankey*, 307 B.R. 674 (D. Alaska 2004).

[44]*In re Super Feeder*, 236 B. R. 267 (Bankr. D. Neb.

1999).

[45]See the last three paragraphs of Comment 3 to Section 1-203 (the successor statute to parts of Section 1-201(37) in some states) for a discussion of the determination of nominal consideration for purposes of deciding whether a purchase option converts a lease into a secured transaction.

[46]*In re Bailey*, 2005 WL 1120308 (Bankr. W.D. Ark. 2005)

[47]*In re Grubbs Const. Co.*, 319 B.R. 698, 717 (Bankr. M.D. Florida 2005).

[48]If lessee builds up equity in leased property, the lessee, if sensible, would buy that property (i.e., where the cost to return the property to the lessor approximates the cost to exercise a purchase option to buy the property). *See In re Buehne Farms, Inc.*, 321 B.R. 239, 245 (Bankr. S.D. Ill 2005). *See In re Beckham* 275 B.R. 598, 602-05 (D. Kan. 2002); *In re Zaleha*, 159 B.R. 581, 585; *In re Zerkle Trucking Co.*, 132 B.R. at 316, 320 (Bankr. S.D. W. Va. 1991).

[49]*In re Grubbs Const. Co.*, 319 B.R. 698, 716 (Bankr. M.D. Florida 2005).

[50]*In re Bailey*, 2005 WL 1120308 (Bankr. W.D. Ark. 2005).

[51]*Duke Energy Royal, LLC v. Pillowtex Corp.*, 349 F.3d 711 (3d Cir. 2003).

[52]*In re Edison Bros. Stores*, 207 B.R. 801, 813.

[53]See federal Bankruptcy Code Section 365(d)(10) *available* at http://www4.law.cornell.edu/uscode/11/365.html. Section 365(d)(10) of the Code requires the debtor to perform all obligations under a lease after 60 days from the date the lessee files its petition in a Chapter 11 case. By failing to achieve true lease treatment, Duke could not avail itself of this special lease protection. Under the new *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005* (Public Law No. 109-8), Section 365(d)(10) has been renumbered to Section 365(d)(5) of the federal Bankruptcy Code.

[54]This paper describes the basic TRAC lease. Another variation of a TRAC lease is called a split-TRAC lease. A split-TRAC requires the lessor to share (or split) the residual value exposure with the lessee. In other words, in a typical TRAC lease, the lessee pays the sum necessary ("open-ended" amount) to make the lessor whole. For example, assume a lessor needs a residual value of thirty percent of original equipment cost (OEC) to make its yield in a transaction. Assume the equipment sells for ten percent, which establishes the shortfall of twenty percent (30% minus 10% proceeds). The lessee must pay the lessor the twenty percent shortfall so the lessor receives its thirty percent of OEC. In contrast, a split-TRAC limits the lessee's payments to the lessor to a guaranteed residual amount. The lessor must absorb any shortfall in excess of the lessee's guaranteed residual value amount. Assume the same transaction but this time in a split - TRAC structure in which the lessee limits its payment obligation to the lessor to fifteen percent of OEC. Assume, again, that the equipment sells for ten percent of OEC. In a split-TRAC, the lessee pays the lessor fifteen percent (10% sale proceeds + 15% lessee guaranteed residual amount payment = equals 25%). The lessor absorbs five percent of the downside to equal the thirty percent.

[55]The statutes are *available* at http://www.elaonline.com/GovtRelations/State/TRAC-2004.pdf.

[56]Minnesota TRAC statute *available* at http://www.revisor.leg.state.mn.us/stats/168A/17.html.

[57]*In re Owen*, 221 B.R. 56, 63-64 (Bankr. N.D.N.Y. 1998) (upholding the "true lease" character of TRAC vehicle leases in lessee's Chapter 11 bankruptcy proceedings); *In re Architectural Millwork*, 226 B.R. 551, (Bankr. W.D. Va. 1998) (sanctioning a true lease where the TRAC payment by a lessee approximates fair market value and the parties do not expect a build up of equity for a lessee).

[58]*See Leases*, 58 BUSINESS LAWYER 1567, 1569 & nn.26-28 (2003) and *Leases*, 54 BUSINESS LAWYER 1855, 1858 & nn.21-28 (1999) (surveying cases and authorities on TRAC vehicle leasing).

[59]*In re Dunn Bros., Inc.*, 16 B.R. 42, 45 (Bankr. W.D.Va.1981) (describing the economic realities test for determining if TRAC payment is nominal by questioning whether the option to purchase is set at such an attractive price that the only sensible course for the lessee is to take it). Although this case arose before the model statutes became effective, the courts can be expected to consider the economic realities test in determining true lease treatment of a TRAC lease.

[60]*In re Aspen Impressions, Inc.*, 94 B.R. 861, 865 (Bankr. E.D. Pa.1989). Note again that this decision pre-existed the effective date of the model statutes. Arguably, the court may have reached a different decision today consistent with the legislative intent to support TRAC leases.

[61]The term "first amendment lease" is defined at http://www.chooseleasing.org/Glossary.htm#F.

[62]*In re Grubbs Const. Co.*, 319 B.R. 698, 720-21 (Bankr. M.D. Florida, 2005). The court stated 18 factual basis for its decision to find a financing, and not a true lease, including the following numbered reasons from the case: (5) Grubbs had the risk of loss; (6) Grubbs was obligated to insure the Equipment; (7)

Grubbs was responsible for the payment of all taxes associated with the leased property; (8) the lease specifically excluded any warranties; (9). Grubbs was responsible for all repairs and maintenance to the Equipment; (13) the key factor considered by Grubbs' chief financial officer in his decision to finance the Equipment with Banc One (as opposed to the numerous other finance companies considered), was the effective interest rate charged by Banc One for its financing under the Early Buyout Option Addendum; (14) the cost of performing under the Early Buyout Option (Alternative #1) was less than performing under the other available alternatives; (15) There was no evidence that Banc One retained any expectation of retaining the Equipment at the end of the Lease term for purposes of leasing it again to third parties; (17) the only economically sensible course for Grubbs, absent default, was to exercise the Early Buyout Option; (18) the default and remedy provisions of the Lease are similar to those found in a typical financing arrangement -- that is, in the event of default or casualty loss, Grubbs also remained liable for the entire indebtedness after crediting the value of the Equipment or its insurance proceeds.

[63]David G. Mayer, *Synthetic Leases Revisited: Are They Dead or Alive?*, BUSINESS LEASING NEWS (Feb. 2003), *available* at http://www.pattonboggs.com/Newsletters/Bln/Release/bln_2003_10.htm#3; David G. Mayer, *Synthetic Leases Are Down, But Not Out, Under New FASB Guidelines*, BUSINESS LEASING NEWS (Oct. 2003), *available* at http://www.pattonboggs.com/Newsletters/Bln/Release/bln_2003_02.htm#5.

[64]*See Unocal Corp. v. Kaabipour*, 177 F.3d 755, 765-766 (9th Cir. 1999), cert. denied, 528 U.S. 1061. The structure, not the terminology of a "lease," convinced the court to construe the synthetic lease as a financing. For a helpful analysis of synthetic leases, including contrasting rights and remedies between secured transactions and leases, see W. Kirk Grimm, Michael G. Robinson and Arnold G. Gough, Jr., *Chapter 23: Synthetic Leasing, §23:5 Commercial Law Aspects of Synthetic Leasing Equipment Leasing - Leveraged Leasing*, PRACTISING LAW INSTITUTE (March 2004).

[65]For a detailed discussion of the current state of synthetic leases and their structures, *see* Mindy Berman, *Synthetic Leases: Changed But Still Viable*, JOURNAL OF EQUIPMENT LEASE FINANCING, Vol. 22/ No. 2, Fall 2004 available at http://www.leasefoundation.org/Reports/JELF/Fall04/SynthLeases.pdf.

[66]*In re CNB International, Inc.*, 307 B.R. 363 (W.D.N. Y. 2004) *available* at http://www.nywb.uscourts.gov/clbdecisions/9911240.pdf.

[67]*See* David G. Mayer, *Lessees in Bankruptcy Declare Open Season on True Leasing*, BUSINESS LEASING NEWS (May 2004). See footnote 53, *supra*, for more explanation of Section 365(d)(10).

[68]In the bankruptcy context, an "executory contract" is a contract where there remains substantial performance yet to be completed by the debtor and the non-debtor party for the other party at the time the bankruptcy is filed. *See* http://www.lawdog.com/bkrcy/lib2a6.htm#Executory%20Contract. In *In re Summit Ventures*, 1991 WL 133412 (Bankr. D. Vt.)), *available* at http://www.vtb.uscourts.gov/opinions/published/1991wl133412.html, where the court stated: "The Bankruptcy Code does not expressly define the term "executory contract." [FN 2] The legislative history of 11 USC § 365 reveals, "there is no precise definition of what contracts are executory, it generally includes contracts on which performance remains due to some extent on both sides." H.R. Rep. No. 595, 95th Cong., 1st Sess. 347 (1977); S.Rep. No.989, 95th Cong., 2d Sess. 58, reprinted in 1978 U.S.Code Cong. & Admin.News 5787, 5844, 6303. Many Courts have embraced Professor Countryman's definition of executory contract that states "(A) contract under which the obligation of both the bankrupt and the other party to the contract is so far clearly unperformed that failure of either to complete performance would constitute a material breach excusing the performance of the other." Countryman, Executory Contracts in Bankruptcy: Part I., 57 Minn.L.Rev. 439, 469 (1973), *See, e.g., Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F2d 1043, 1045 (4th Cir.1985), cert. denied, *Lubrizol Enterprises Inc. v. Canfield*, 475 U.S. 1057, 106 S.Ct. 1285 (1986); *In re Knutson*, 563 F.2d 916 (8th Cir.1977)."

[69]The New York version of Section 1-201(37) of the New York Consolidated Laws is *available* at http://assembly.state.ny.us/leg/?cl=122&a=4.

[70]The court continued: "Counsel for both parties have cited the same treatise for its description of this methodology: Software leases are common in three-party and four-party transactions . . . . In the relevant model in which the lessor plays a role primarily defined in terms of financial, rather than operational, support, the transaction delivers a copy of the software in a transaction in which the lessor makes the acquisition payment and the lessee-licensee uses the software. 99-11240B 11. *When the transaction is fully documented among all three parties, the respective rights of the parties are relatively clear. The licensor transfers a possessory right and a conditional use right to the lessor with the understanding that the lessor will convey the possessory right to*

the lessee. 1 Raymond T. Nimmer, THE LAW OF COMPUTER TECHNOLOGY, § 8:15 (3rd ed. 1997) (emphasis added)."

[71]The definition of a "lease" is *available* at http://www2.law.cornell.edu/ucc/2A/article2A.htm#Lease.

[72]The term "goods" is defined as "all things that are movable at the time of identification to the lease contract." Section 2A-103(1)(n) or Section 2A-103(1)(h). Because the 2003 amendments to the UCC excluded "information" from the definition of a good, it is unclear the extent to which Article 2A may be applied to leases including related software or software licenses, which may be construed to be "information," an undefined term in Article 2A. It is clear that software embedded in goods constitute a part of the goods. Consequently, hard-wired software in a printing press control panel, which constitutes equipment (a category of goods under Section 9-102(33)), would be part of the printing press (equipment) under Article 2A.

[73]Under the new *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005* (Public Law No. 109-8), Section 365(d)(10) has been renumbered to Section 365(d)(5) of the federal Bankruptcy Code *available* at http://thomas.loc.gov/cgi-bin/bdquery/z?d109:SN00256:|TOM:/bss/d109query.html|. *See* David G. Mayer, *Bankruptcy Reform Favors Leasing, But Poses New Challenges for Lessors*, by David G. Mayer, BUSINESS LEASING NEWS (May 2005), *available* at http://www.pattonboggs.com/newsletters/bln/Release/bln_2005_05.htm.

[74]The same result does not apply to Section 1110 of the federal Bankruptcy Code. Section 1110 does not differentiate the relief for secured creditors and lessors, rendering the true lease analysis irrelevant. Section 1110 provides that after filing a bankruptcy case, a debtor with airline equipment subject to Code Section 1110 must (A) within 60 days agree to perform all obligations of the lease or security agreement going forward, (B) cure all current pre-and post-bankruptcy defaults before the 60 days expire, and (C) only as permitted in the agreement, cure any defaults that occur after the 60 day period. A debtor can also reach an agreement with the lessor or financier to extend this 60-day time frame. If the debtor fails to reach an agreement or cure all defaults within the 60 days, the debtor must immediately surrender the equipment and all accompanying records and documents. Section 1110 also states that these rights are not limited by any other power of the bankruptcy court.

Section 1110 provides some of the strongest creditor protections in the entire Code. Section 1110 protects a lessor or financier of aircraft, aircraft engines, propellers, appliances, or spare parts if placed in service after October 22, 1994, with a lessee or borrower who at the time was an air carrier with an operating certificate to carry ten or more passengers or 6000 pounds of cargo. If a lease fails to qualify for state law purposes as a true lease, this protection evaporates. If the equipment was placed in service before October 22, 1994, Section 1110 only protects financiers with purchase money security interests (under 1994 definition) or lessors with leases structured as true leases for federal income tax purposes. The definition of purchase money security interests and other Article 9 definitions are *available* at http://www.law.cornell.edu/ucc/9/article9.htm.

[75]*In re Sho-Me Nutriceuticals*, 319 B.R. 273 (Bankr. M.D. FL, Jan. 3, 2005) (questionable finding of no security interest created in equipment because the lessor failed to file an amended financing statement. It is not clear whether a valid grant and attachment of a security interest also did not occur).

[76]To avoid a total loss of rights in the collateral, lessors typically file precautionary security interest financing statements under Section 9-505 of the UCC.

[77]Although some lessors do not always include a protective grant of a security interest in a lease, it is extremely important to do so to perfect the lessor's security interest in the property in case the lease is construed as a disguised financing. The failure to perfect a valid security interest does not render the security interest invalid. The grant, if properly done, represents a separate right and interest in property. *See In re Thompson*, 315 B.R. 94 (Bankr. W.D. Mo. 2004), *amended in part*, 316 B.R. 326 (W.D. Mo. 2004).

[78]*In re Grubbs Constr. Co.,* 319 B.R. 698, 710 (Bankr. M.D. Florida, 2005).

[79]*Leasing 101: What is Usury?*, David G. Mayer, BUSINESS LEASING NEWS (June 2004), at http://www.pattonboggs.com/Newsletters/Bln/Release/bln_2004_06.htm#5.

[80]*See supra*, note 10.

[81]*See* UCC §§ 2A-501-505, 2A-523 and 2A-525. Enforceability of liquidated damages is determined on a case-by-case basis under state law according the Official UCC Comment to UCC § 2A-504.

[82]Beating True Lease Challenges: A Lessor's Guide to Structuring and Defending True Leases, LNJ'S EQUIPMENT LEASING NEWSLETTER, Vol. 23, Number 7 at 1 (Aug. 2004).

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