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Finance Leasing Under New UCC Article 2A

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Parties, from the largest multinationals to the smallest start-up firms, have used finance leasing for years as a method of obtaining the use of goods and equipment without devoting substantial upfront amounts of capital to their purchase. While leases have in many cases taken the place of the sale and purchase of goods, the laws governing leases were not embodied in an organized code as were the laws governing sales and purchases of goods in Uniform Commercial Code Article 2. Because of the absence of such embodiment, significant uncertainty existed respecting leases which fostered wasteful and expensive litigation between lessors, lessees and even customers. Thus the recent adoption by New Jersey and New York of Uniform Commercial Code Article 2A ("Article 2A") respecting lease transactions is significant.¹

The adoptions added New Jersey and New York to the growing list of states, now totalling 46, which have defined the standards by which true lease arrangements of personal property pursuant to finance, consumer or plain vanilla leases are to be governed. Prior to the enactment of Article 2A, when courts considered the respective rights and obligations of parties to leasing arrangements, they often analogized to sales and secured transactions - Articles 2 and 9 of the Uniform Commercial Code ("UCC") - which were not designed for this purpose. Article 2A endeavors to standardize the manner in which leasing arrangements are to be construed.

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Transactions which are now subject to the provisions of Article 2A range from multimillion dollar equipment leases to automobile leases, to hundred dollar appliance leases.² In effect, Article 2A now governs all arrangements whereby goods are leased.³ It should be noted, though, that the majority of provisions in Article 2A may be varied by agreement of the parties.

There are four transactions which, upon the adoption of Article 2A, may generally be referred to as leases. These are (i) the lease intended as security, (ii) the finance lease, (iii) the consumer lease, and, if none of the other labels apply, (iv) the plain vanilla lease. This article addresses how to determine whether a finance lease exists, and, if so, what are the rights, obligations and limitations of the lessor and lessee, as well as of related third parties, which result from such designation. Some practical considerations for dealing with finance leases are also discussed.

Before discussing finance leases, however, it is important to understand the distinction between the different types of leases.

1. True Lease Versus Security Interest

Certain leases are actually intended as security interests, thus, in reality not making them leases at all. Such "leases" are not governed by Article 2A, but rather by UCC Article 9. To determine whether a lease is a true lease or a lease intended as security, a party must look to UCC Section 1-201(37).

The amendment of UCC Section 1-201(37), which occurred at the same time as Article 2A was adopted, was perhaps the most important change which resulted from the adoption of Article 2A. Prior to the amendment of UCC Section 1-201(37) the subjective intent of the parties controlled whether the parties' agreement created a true lease or a security interest. This test was abandoned in favor of a more objective analysis of the economics of the transaction.⁴

Specifically, the focus should now be on: (i) whether the lessor at the expiration

of the lease has any real residual or reversionary interest in the leased goods; and (ii) whether the lessee's payment obligations are terminable.

There are four ways under UCC Section 1-201(37) in which the lessor's residual or reversionary interest can be shown to be a real and not nominal interest. It is *not* a real interest if: (i) the term of the lease is one for the remaining economic life of the goods and the lease is not subject to termination by the lessee; (ii) the term of the lease is less than the full life of the goods, but the lessee is obligated to renew the lease for the remaining economic life of the goods; (iii) the lessee has the option to buy the goods for nominal consideration; or (iv) the lessee has the option to renew the lease for nominal consideration for the remaining economic life of the goods. If a real interest does not exist, the lessor possesses only a security interest in the goods, subject to proper compliance with the provisions of UCC Article 9.

Even though UCC Section 1-201(37) has been amended in an attempt to bring greater predictability to determining whether a true lease or security interest exists, situations may still arise where the enforcement of the lease in accordance with the intent of the parties will be uncertain. Accordingly, UCC Section 9-408 permits a lessor to make a protective filing which will perfect the lessor's security interest if the lease is ultimately held to create a security interest and not a lease. Such a filing is not considered in determining whether the transaction was a lease or a sale.

Once a determination has been made that a true lease, rather than a lease intended as a security interest, exists, it is necessary to determine whether such lease is a finance lease, a consumer lease, or in the absence of any of the aforementioned, a plain vanilla lease.

2. Consumer Leases

A consumer lease is a lease between a lessor which is regularly engaged in the business of leasing or selling goods and a lessee, who is an individual who will use the goods primarily for personal, family or

household purposes.⁵ A consumer lease may also be a finance lease. A discussion of consumer leases is beyond the scope of this article.

3. Finance Leases

Finance leases, on a simplified level, are created when goods are purchased by a lessor from a manufacturer or supplier of such goods solely for the purpose of leasing the goods to a lessee. There are essentially three elements required to form a finance lease: (i) the lessor is not in the distributive chain, that is, it does not either select, manufacture or supply the goods; (ii) the lessor acquires the goods or the right to possession or use of the goods solely in connection with the lease; and (iii) the lessee is in one sense or another involved in the acquisition of the goods. Such involvement of the lessee is evidenced by any one of the following:

- A. The lessee received a copy of the supply contract before signing the lease contract;
- B. the lessee's approval of the supply contract was a condition to the effectiveness of the lease contract;
- C. the lessee received a statement describing the promises and warranties and any limitations relevant thereto contained in the supply contract before signing the lease contract; or
- D. unless the lease is a consumer lease, the lessor notified the lessee before the lease was executed of the identity of the supplier, that the lessee was entitled to the supplier's warranties and that the lessee could contact the supplier directly to receive a copy of the warranties and disclaimers.⁶

It is important to remember that intent is *not* determinative and that all of the elements of a finance lease must be satisfied.

Once a finance lease is created, various provisions of Article 2A set forth certain rights and obligations of the lessors and lessees, as well as the rights and obligations of third parties such as the manufacturer or supplier of the goods. Most important of these provisions are UCC Sections 2A-407 and 2A-219.

UCC Section 2A-407 provides that once a lessee accepts the goods under a finance lease, its obligations become irrevocable and independent. This situation is essentially identical to what used to be, and still is, referred to as the "hell or high water lease". In other words, once the lessee has accepted the goods, notwithstanding any defects in the goods or breaches of warranties (except one dis-

cussed below), the lessee's obligations, including, most importantly, the obligation to continue to make the lease payments, will continue. This result is warranted because the finance lessors are generally financial institutions and have no part in the manufacture or selection of the goods. The one exception to the lessor's right to minimize the lessee's recourse against it is the warranty contained in UCC Section 2A-211 which warranty provides that no other person holds a claim to, or interest in, the goods which will interfere with the lessee's enjoyment of its leasehold interest.

In consideration for the lessee essentially giving up all of its rights against the lessor⁷, UCC Section 2A-209 expressly makes the lessee a third-party beneficiary of the supply contract between the manufacturer or supplier of the goods and the lessor. Accordingly, to the extent that the supply contract contains express, or even implied, warranties, the lessee is entitled to the benefit of those rights. The protection of UCC Section 2A-209 may not be excluded, modified or limited. However, an exclusion, modification or limitation of any term of the supply contract or warranty, including any with respect to rights and remedies, and any defenses or claims (e.g. the statute of limitations), effective against the lessor as the acquiring party under the supply contract, is also effective against the lessee as the beneficiary designated under UCC Section 2A-209.⁸

Since qualification as a finance lease requires the satisfaction of all elements, situations may arise where finance lease status may not be respected. Accordingly, finance lessors, as well as lessors in sale leaseback transactions which generally will fall within the definition of a finance lease, should continue to include typical "hell or high water" language in their lease agreements.

When one is entering into a lease which clearly is, or has the potential of being defined as, a finance lease, the following actions should be considered:

If a lessee:

- (i) make certain to review and understand the terms and conditions of the supply contract, particularly to determine what representations and warranties, express or implied, are contained in that agreement;
- (ii) attach the supply contract to the lease, or obtain a representation from the lessor that it has delivered to the lessee a true and complete copy of the supply contract;

- (iii) enter into direct negotiations with the supplier of the goods; and
- (iv) carefully inspect and test any goods before accepting them. Acceptance results in lessee's promises under the lease becoming irrevocable and independent.

If a lessor:

- (i) make certain that all elements required for the lease to be characterized as a finance lease are present;
- (ii) have the lessee sign-off on the purchase order, confirming lessee's approval;
- (iii) include express language that the lessee reviewed and approved the form of the supply agreement;
- (iv) include specific "hell or high water" language and/or language confirming that the lease is intended as a finance lease pursuant to Article 2A of the UCC;
- (v) specifically disclaim all warranties; and
- (vi) file a UCC-1 Financing Statement pursuant to Section 9-408 of the UCC.

4. Plain Vanilla Leases

Lease agreements which do not fall within the security interest, consumer lease or finance lease categories are still leases accorded full recognition. The provisions of Article 2A do not affect the parties' rights to create such leasing arrangements and in fact may be instructive as to certain provisions. As with consumer leases, a discussion of plain vanilla leases is beyond the scope of this article.

The adoption of Article 2A has modified certain rights and obligations which generally apply to lease participants. It has also defined the types of leases which exist. Certain benefits as well as disadvantages may exist by using one form of lease over another, depending on the circumstances of the transaction. Before executing your next lease agreement, it is thus important to review the effect of Article 2A on your transaction.

¹ As of the writing of this article, Connecticut had not adopted Article 2A.

² The rapid expansion in leasing should be noted. As of 1986, approximately "one-third of all the new equipment ordered in the United States was delivered under leases." Barnes, Distinguishing Sales and Leases: A Primer on the Scope and Purpose of UCC Article 2A, 25 U. Mem. L. Rev. 873 (Spring 1995).

³ See 2A-103(j) respecting the definition of "Lease" and 2A-103(h) respecting the definition of "Goods".

⁴ See UCC 1-201(37) for the definition of "Security Interest".

⁵ See 2A-103(e) for the definition of "Consumer Lease".

⁶ See 2A-103(g) for the definition of "Finance Lease".

⁷ See 2A-407.

⁸ See Official comments to 2A-209.