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RECORDING OF EQUIPMENT LEASES: A PROPOSED AMENDMENT TO THE UNIFORM COMMERCIAL CODE

Introduction

In 1922, the Burroughs Adding Machine Company leased a used adding machine to the Munger Fish Company for ten months. When the lessee went bankrupt soon afterward, Burroughs sought to reclaim the machine. The referee in bankruptcy denied the application on the ground that the “lease” was really an unrecorded conditional sale and that the lessor’s reservation of title was actually an unperfected security interest in the machine. In 1965, United Airlines negotiated an unprecedented lease of commercial airliners and by 1971 airlines were leasing an estimated $2 billion worth of airplanes. In many other industries as well, the equipment lease had become an important tool of the businessman. As a result of this expansion, the burgeoning lease industry has outgrown traditional legal concepts which may have sufficed in 1925. Particularly in the field of secured transactions, the legal community has not met the needs of the business community which have arisen from widespread use of the equipment leasing device. Under present law, the equipment lease too often has the effect of a secret lien on the lessee’s assets. Limited recording requirements have permitted creditors to be misled by a double deception: a lessee is able to incur substantial liability of which there is no public record, while reaping the benefits of ostensible ownership of assets on his business premises.

As in many other areas, the most visible challenge to the lawmaker in the field of equipment leasing is factual variety. Within the genus are included transactions of all kinds—from the weekend rental of a wallpapering kit to a ten-year lease of a half-million dollars worth of linotype machines. The lessor may be a manufacturer seeking new markets for his product or a third party which neither manufactures nor handles the leased equipment. The lessee may rely on leasing only on occasion for specialized, short-term projects or he may lease the major components of his daily operation. The lessor may enter into many successive leases of the same item, as in the auto rental business, or he may seek an agreement which will extend over the entire useful life of the machine and yield a return of his investment plus a profit in a single transaction.

In business, the motives of lessees who elect against an outright purchase of their equipment are similarly heterogeneous. Uncertainty as to long-term requirements, the risk of obsolescence, and anticipated tax advantages are only

1 Burroughs Adding Mach. Co. v. Bogdon, 9 F.2d 54 (8th Cir. 1925). The lease contained an option whereby the lessee could purchase the machine at the expiration of the lease period by payment of an additional month’s rent. Id. at 55.
5 Although the tax aspects of equipment leasing are beyond the scope of this article, they are not insignificant. From the lessee’s viewpoint, leasing may be advantageous because rental payments are a fully deductible business expense. Int. Rev. Code of 1954 § 162(a). Installment payments on a conditional sales contract are generally considered non-deductible
some of the factors which may prompt a businessman to lease rather than to purchase. More often, however, the lease is useful as a method of financing. Although it is sometimes more expensive than traditional financing devices, the equipment lease requires less initial capital outlay and may be the only means of circumventing restrictive covenants under agreements with other lenders. According to a survey taken in 1968, lessees consider conservation of capital and the preservation of credit capacity the most important advantages of leasing. The survey results are borne out by the prevalence of what is called third-party leasing. Under such an arrangement, the lessor is actually a financial institution which acquires the equipment from a supplier for the specific purpose of filling the needs of the prospective lessee. The article is shipped directly to the lessee with the lessor never handling it. The lessee recoups his investment, plus interest, from the rental paid by the lessee under a long-term lease, often with an option to purchase. Under such circumstances the boundary between lease and sale often becomes rather difficult to discern. But as the law now stands, only the most flagrant of these transactions are subject to the filing rules of the Uniform Commercial Code. This is due to inadequacies in both statutory and judicial treatment of equipment leases.

The purpose of this article is to propose amendments to section 1-201(37) and several sections of article 9 of the Uniform Commercial Code which would bring leases of industrial and commercial equipment within the scope of article 9 regardless of whether or not they are intended as security. An equipment lease would then be treated in the same manner as a sale of accounts, contract rights, or chattel paper. The lessor, like the buyer of such intangibles, would be regarded as a secured party. The validity of his interest in the equipment vis-à-vis third parties would be subject to the rules of perfection under article 9. Since leasing arrangements usually contemplate possession by the lessee, it would generally be necessary for the lessor to give notice of his interest in the leased property by filing a financing statement. The proposed changes are designed to

capital expenditures, except for the interest element of such payments. Int. Rev. Code of 1954, §§ 263, 163. On the other hand, if the purchaser can take accelerated depreciation deductions on the equipment, the rental deductions available through leasing may not be as attractive. For this reason, among others, the supposed tax advantages accruing to the lessee have frequently been questioned. Marrah, To Lease or Not to Lease, Fin. Exec., Oct., 1968, at 91-104. Indeed some regard the spreading of the investment tax credit as a more significant benefit of equipment leasing. Riordan and Duffy, Lease Financing, 24 Bus. Law. 763 (1969); see Olsen and Wisniewski; Leasing: the Current Tax Picture, 29 J. Tax. 12, 15 (1968). In any event the tax considerations involved are sufficiently strong to have generated litigation over the question of whether a purported lease is actually a conditional sale. The Internal Revenue Service has formulated a test which states that the answer depends on "the intent of the parties as evidenced by the provisions of the agreement, read in the light of the facts and circumstances existing at the time the agreement was executed." Rev. Rul. 55-540, 1955-2 Cum. Bull. 39.

6 Marrah, To Lease or Not to Lease, Fin. Exec., Oct., 1968, at 96, 100.
7 Id. at 91, 96.
8 A recent estimate attributes 30% of the leasing industry to third-party transactions involving such lessors as banks and finance companies. The same source characterized this type of leasing as "the fastest growing and most hotly competitive sector of the business." Bus. Week, supra note 2; see Riordan and Duffy, Lease Financing, 24 Bus. Law. 763 (1969).
10 Uniform Commercial Code § 9-105(1)(i).
eliminate the inconsistencies of present standards for distinguishing between a true lease and a conditional sale, and to give the Code a more realistic approach to the leasing device as it is currently being used.

I. Present Code Treatment of Equipment Leases

Under the 1962 Official Text of the Uniform Commercial Code, article 9 applies only to those leases which are "intended as security." Although this provision is unelaborated in article 9, faint guidelines appear in the "General Definitions"—section 1-201. Subsection (37) defines the term "security interest," providing in part:

Unless a lease or consignment is intended as security, reservation of title thereunder is not a "security interest" . . . . Whether a lease is intended as security is to be determined by the facts of each case; however, (a) the inclusion of an option to purchase does not of itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended for security.

This language has left the courts with at least three questions not answered by the Code: (1) What facts are indicative of an intent to create a security interest by means of a lease? (2) Can facts otherwise inadmissible under the parol evidence rule be consulted on this particular issue? (3) What is a nominal consideration? As shall be seen, the answers of the courts to these problems have been harmonious with neither themselves nor the Code.

If it is determined that a lease is not intended for security, the transaction falls completely outside article 9. This will have significance most frequently in the context of a lessor’s reclamation petition which is contested by the trustee in bankruptcy for the erstwhile lessee. If it is determined that the lease was intended as security and the lessor has failed to perfect his security interest by filing a financing statement, his claim for possession will be subordinate to those of the lessee’s lien creditors. Under Code section 9-301(3), as well as section 70(c) of the Bankruptcy Act, the trustee in bankruptcy has the status of such a lien creditor. As a result, the lessee’s bankruptcy may leave the lessor with an unsecured claim for “rent” and little prospect of recovering his equipment.

II. Judicial Standards: The Option to Purchase

A. Pre-Code Standards

The Code’s distinction between a true lease and a lease intended as security was not unprecedented. The courts have long recognized that some agreements which purport to be leases are in fact conditional sales contracts in disguise.

\[\text{References}]

12 Uniform Commercial Code § 9-102(2).
13 Uniform Commercial Code § 9-301(1)(b).
15 See Annots., 175 A.L.R. 1366, 1384 (1948); 92 A.L.R. 304, 323 (1934); 43 A.L.R. 1247, 1257 (1926); 17 A.L.R. 1421, 1435 (1922) and cases discussed therein.
Prior to the enactment of the Code, various criteria were developed to aid in deciding when a lease should be regarded as a conditional sale. The most important of these was the presence and nature of an option to purchase the leased article. The option price was thought to be inversely related to the likelihood that the option would be exercised. The greater this likelihood became, the more apt were the courts to view the agreement as a conditional sale. Occasionally a court would conclude that, under the terms of a particular lease, the only sensible course for the lessee to follow would be to exercise the option. On the other hand, if it appeared probable that the demised property would be returned to the lessor, the agreement would be treated as a true lease. This approach gave the pre-Code rules a highly formalistic character, as demonstrated in the case of *In re Wright Homes, Inc.*

At issue in the case was the right of the National Acceptance Corporation to the proceeds from the sale of certain machinery which had passed into the hands of the trustee upon the bankruptcy of Wright Homes, Inc. The petitioner claimed to have leased the two machines to the bankrupt under an agreement, the terms of which are illustrated by the following chart:

<table>
<thead>
<tr>
<th>Purchase Price</th>
<th>Total Rent Over Three-Year Term</th>
<th>Price of Annual Renewal Option</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machine A</td>
<td>$12,348.59</td>
<td>$14,358.96</td>
</tr>
<tr>
<td>Machine B</td>
<td>$7,600.00</td>
<td>$8,837.28</td>
</tr>
</tbody>
</table>

The lessee was responsible for all taxes on the machines and for insurance. In the event of a default, it would be liable in liquidated damages for the unpaid rent for the entire three-year term, regardless of when the default occurred. This liability was subject to a deduction of the proceeds from the sale of the machinery should the lessor elect to sell it after repossession. The effect of the agreement was that within three years the lessor would recover his entire investment in the machines (which had a useful life of ten years) plus interest in excess of 16%, with an additional return of about 1.5% for each renewal year. These earmarks of a financing arrangement should have had special significance in light of the court's own observation that the principal business of the lessor was not the leasing of business equipment, but financing. Yet, despite the obvious purpose of the transaction, the court concluded that it must be con-

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16 *Id.* The annotations state that the principal test was whether the lessee is obligated "at all events" to pay the purchase price. If so, the agreement would be construed as a conditional sale. If, on the other hand, return of the property was "either required or permitted," the agreement would be construed as a true lease. Annots., 175 A.L.R. 1366, 1384 (1948); 92 A.L.R. 304, 323 (1934).

17 *In re Herold Radio & Electronics Corp.*, 327 F.2d 564, 565-66 (2d Cir. 1964); Burroughs Adding Mach. Co. v. Bogdon, 9 F.2d 54, 56 (8th Cir. 1925).

18 279 F. Supp. 598 (M.D.N.C. 1968). Although the case was decided after the enactment of the Code in North Carolina, pre-Code rules apparently governed because the transaction occurred prior to the Code's effective date, June 30, 1967. N. C. GEN. STAT. § 25-10-101 (1965). The date of the referee's order reviewed in this case was August 7, 1967. 279 F. Supp. at 599.

19 279 F. Supp. at 600 n.1.

20 *Id.* at 599.
sidered a true lease. In so doing the court asserted that no case had ever held a lease to be a conditional sale in the absence of an option to purchase.21

The disconcerting result of this holding was that the lessee had undertaken a substantial obligation, secured by machinery in its possession, with no hint in the public records of either its liability to the lessor or the severe limitations on its rights in property which it ostensibly owned. The lessor had escaped the duty to give notice of his claim to the equipment because the transaction lacked the formal element of a present or contemplated transfer of title. Although the court was unable to resolve the conceptual riddle, it was painfully aware of the realities:

It is clear that the agreement here in controversy is, at least in part, an attempt to circumvent the North Carolina registration requirements for conditional sales, but the existence of questionable motives cannot detract from the validity of the agreement as a lease. . . .

It is unfortunate if the creditors of the bankrupt extended additional credit or neglected to seek satisfaction of overdue debts in the belief that the machinery named in the agreement would be subject to levy by them. But creditors fearful of their ability to collect must accept the responsibility of ascertaining the extent of the debtor's assets. The agreement could have been demanded of the bankrupt for inspection just as an ordinary lease.22

The court seems to have ignored the fact that the creditors could not demand to inspect a lease of which they were unaware. Moreover, its advice to creditors is in conflict with the policy of voluntary disclosure which the filing statutes were intended to implement. Nonetheless, the court's emphasis on the location of title conforms to a long line of decisions which have conceived the issue to be whether the lease in question fits within the mold of a conditional sale.23

B. Judicial Standards Under the Code

Some judges and commentators have concluded that the definition of "security interest" given in section 1-201(37) is merely a codification of judicially developed standards for distinguishing a true lease from a conditional sale.24 There is good reason to doubt this. The relevant sections of the Code distinguish the true lease not simply from the conditional sale but from the lease "intended as security."25 It seems clear that the drafters anticipated leasing arrangements wherein the lessor's reservation of title was intended as security although the agreement itself might bear little resemblance to the conditional sale device. The Official Comments make no reference to pre-existing case law, but the following

21 Id. at 601. At least two cases pre-dating this decision had construed similar agreements without purchase options to be intended as security under Code § 1-201(37). In re Pomona Valley Inn, 4 UCC REP. SERV. 893, 894 (C.D. Cal. 1967); In re Transcontinental Ind., Inc., 3 UCC REP. SERV. 235, 244 (N.D. Ga. 1965).
22 279 F. Supp. at 602-03.
23 Annotations and cases cited supra note 15.
25 UNIFORM COMMERCIAL CODE §§ 1-201(37), 9-102(2).
comment to section 9-102 suggests that the familiar categories of security interests are no longer adequate for dealing with current innovations in the field of equipment leasing:

When it is found that a security interest as defined in Section 1-201(37) was intended, this Article applies regardless of the form of the transaction or the name by which the parties may have christened it. The list of traditional security devices in subsection (2) is illustrative only; other old devices, as well as any new ones which the ingenuity of lawyers may invent, are included, so long as the requisite intent is found.

It should not be possible, therefore, to avoid the notice requirements of article 9 by a mere showing that the lease in question is not a “conditional sale.” Even since the enactment of the Code, however, the courts have been slow to depart from established judicial guidelines and the decisions have in many cases been unaffected by the new statutory rules. The courts have repeatedly viewed the issue in terms of alternative interpretations of the agreement in controversy as either a true lease or a conditional sale. The result has been an inordinate emphasis on form and conceptual consistency, sometimes with anomalous results. A 1966 case is illustrative.

In re Atlanta Times, Inc. involved a dispute over machines in the possession of a bankrupt newspaper. After a lease had been executed by the parties, Commercial Credit Corporation (the lessor) had purchased composing room equipment designated by the Times (the lessee) at a cost of $570,116.10 and had it shipped directly to the lessee. The lease was for a term of ten years and required an initial deposit of $145,000.00 plus equal monthly rentals which totalled $712,873.20 for an overall cost to the lessee of $857,873.20. The lessee undertook all responsibility for maintenance, repair, taxes and insurance. It was found that at the end of the ten-year term the machines would still have substantial value. At the expiration of the lease, the lessee was to return the property to CCC in accordance with instructions to be given then. Apparently there was also an option to renew the lease from year to year at an annual rental of $5,701.16 (somewhat less than the monthly rental during the initial term). The agreement contained express language to the effect that it was a lease, not a conditional sale, and that the lessee had no interest in the property except the right to its use. When the lessee became bankrupt, CCC demanded possession of the machinery or the proceeds of the trustee’s auction sale. The trustee contested CCC’s claim, arguing that the lease was one intended for security within the terms of section 1-201(37) and that the lessor had only an unperfected security interest in the property. The findings and conclusions of the referee, which the district court adopted, correctly stated the issue to be whether the

27 The terms of the lease appear in 259 F. Supp. at 822, 823.
28 Sanders v. Commercial Credit Corp., 398 F.2d 988, 989 (5th Cir. 1968) (related case involving the same lease).
lease was "intended as security," but his reasoning reverted to the traditional lease-sale dichotomy:

The court has been urged to view the transaction as if the total rent were the purchase price and the monthly rental the equivalent of installments. Such approach to the transaction overlooks the prime, essential distinction between a lease and a conditional sale, to wit: in a lease the lessee never owns the property. In the absence of a right or option in the lessee to acquire ownership of the leased property, the transaction is one of lease. The judgment and reasoning of the court was affirmed by the Fifth Circuit Court of Appeals which later made the incredible comment that there was "very little if anything in the written instrument itself which subjects it to suspicion as a masquerade." 

Parol evidence. The predictable result of such mechanical reasoning has been the growth of evasive tactics by parties attempting to avoid any reference to the fatal option to purchase. The trustee is then confronted with the parol evidence rule in his attempt to show the true nature of a purported lease—especially when the instrument includes clauses which insist that the parties intend a lease only and that the writing constitutes their agreement in its entirety. One oft-cited case makes reference to the Code version of the rule in interpreting a disputed lease:

The question presented by the Petition for Review is whether the lease was intended as security and is to be determined by the facts of the case. In determining the intent of the parties, we may look only to the language of the lease itself, which provided that there are no understandings, agreements, representations or warranties, express or implied, not specified herein, respecting this lease or the equipment or service hereinabove described.

This view is supported both by pre-Code cases and by cases decided under the Code. But the applicability of the parol evidence rule in these circumstances has not been undisputed. It is arguable, for example, that the rule is superseded by the provision, in Code section 1-201(37), that the question of whether or not a lease is intended as security should be determined "by the facts of each case." This approach is suggested by the recent decision of In re Telemax Corporation. There, the trustee in bankruptcy was permitted to introduce parol.

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29 259 F. Supp. at 826.
30 Id. at 827.
31 383 F.2d 606 (5th Cir. 1967).
32 Sanders v. Commercial Credit Corp., 398 F.2d 989, 990 (5th Cir. 1968).
evidence of an option to purchase in support of his contention that the lease involved was intended as security. The referee attempted to side-step the issue by arguing that the tendered evidence would not alter the terms of the lease, but simply "amplify" them. All that would be affected would be the "legal impact" of the leases in the context of the lessee's bankruptcy. Though his reasoning might have been hazy, he clearly perceived the dilemma which he faced:

For the court to rule on the issue here that parol evidence is not admissible, would be to suggest that in order for a court ever to consider a trustee's challenge to a so-called lessor's entitlement to property, the instruments denominated as leases must invariably contain option provisions.7

To the extent that the dispute may be regarded as one among the lessee's creditors, only one of whom (the lessor) is a party to the lease, the promissory liability of the parties is not really in issue. In this sense the policy of the parol evidence rule is not violated by the Telemax ruling. But the trustee in bankruptcy is granted the status of the lessee's successor.38 Viewed in that light, his offer of parol evidence may be regarded as directly undermining the contractual obligation as defined in the instrument. It should be noted, however, that the parol evidence dilemma itself is born of the courts' own inability to deal with the financing lease other than in terms of traditional concepts of secured transactions. A few cases have surmounted the conceptual obstacle presented by the financing lease which contains no option to purchase. Most notable among them is In re Transcontinental Industries, Inc.39 The transaction involved in that case was of the familiar third-party variety. Rentals over a five-year term exceeded the purchase price by about 20%. Thereafter the lease was renewable at an annual rental of 2% of the purchase price (the equivalent of one month's rent under the original term). The lessee was responsible for repairs, alterations, insurance, taxes and indemnities and was also to bear the risk of loss or damage. Additionally, the lease provided for acceleration of the rentals in the event of default and for payment of the lessor's attorney fees. The court was not dissuaded by express reservations of title in the lessor or by the absence of an option to purchase, but recognized the lease to be essentially a financing arrangement:

Transcontinental needed equipment but had no money to purchase same without financing; USLC [United States Leasing Corporation] owned no property of such nature but had arrangements with suppliers who had prospective sales whereby suppliers could contact them relative to USLC entering into agreement with prospective buyer and invoice for property would be sent by vendor to USLC and property delivered to purchaser upon the signing of a lease agreement; then payment would be made by USLC to vendor and items of purchase put upon a leasing schedule which would then be signed by the user . . . .

* * * *

37 Id.
From all of these attending facts and circumstances it would appear that the lessee had no design other than to obtain the equipment and have someone finance its costs. USLC had no property to lease and had its concern only on supplying and financing at a profitable rate of earning and to be surely secure in its doing.40

The referee concluded that the lease was intended as security and that, since it had not been filed as required by article 9, the lessor's reservation of title was an unperfected security interest subordinate to the trustee's claim.41 Unfortunately, this pragmatic approach is the exception, not the rule.

Nominal consideration. Even where the presence of an option to purchase is undisputed, the courts have foundered on the further question of whether the consideration to be paid for the exercise of that option is nominal. Code section 1-201(37)(b) states that a lease is intended as security if it contains an option whereby the lessee may become the owner of the property for a nominal consideration. The precise meaning of the word "nominal" has often been the subject of litigation. The clause has occasionally been interpreted to refer only to amounts which are absolutely nominal, such as the sum of one dollar.42 More frequently, however, it has been interpreted to include an option price which is nominal under the circumstances, though perhaps substantial in itself.43 Under this latter rule, standards have varied. Option prices have been compared to the purchase price of the leased item,44 the rentals to be paid under the lease,45 and the anticipated market value at the time the option may be exercised.46 When the latter standard is used, the option price must be substantially equivalent to the fair market value if it is to escape the "nominal" classification.47 On the other hand, the option price may be as low as 25% of the purchase price without causing suspicion that the lease is intended as security.48 One court has even

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40 Id. at 243, 244.
41 Id. at 244.
43 See cases cited notes 44, 45 and 46 infra.
44 Burroughs Adding Mach. Co. v. Bogdon, 9 F.2d 54 (8th Cir. 1925) (option price $47.22, purchase price $547.19; conditional sale); In re Alpha Creamery Co., Inc., 4 UCC REP. SERV. 794 (W.D. Mich. 1967) (option price $1,481.90, list price $4,690.00; true lease); In re Wheatland Elec. Prod. Co., 237 F. Supp. 820 (W.D. Pa. 1964) (option price $2,006.25, list price $8,025.00; true lease); Crest Inv. Trust, Inc. v. Atlantic Mobile Corp., 252 Md. 286, 250 A.2d 246 (1969) (option price $1,960.00, purchase price $3,400.00; true lease); Xerox Corp. v. Smith, 9 UCC REP. SERV. 1132 (N.Y. Civ. Ct., Oct. 15, 1971) (option price $15,000.00, purchase price $29,500.00; true lease).
45 In re Washington Processing Co., Inc., 3 UCC REP. SERV. 475 (S.D. Cal. 1966) (option price $1,350.00, three-year rental $13,972.50; conditional sale); Gibreal Auto Sales, Inc., v. Missouri Valley Mach. Co., 186 Neb. 763, 186 N.W.2d 719 (1971) (option price $8,580.00, three-year rental $36,000.00; true lease).
46 Burroughs Corp. v. Barry, 380 F.2d 427, 430 (8th Cir. 1967) (option price $3,094.00, market value $3,000-$4,000.00; true lease); In re Oak Mfg., Inc., 6 UCC REP. SERV. 1273 (S.D.N.Y. 1969) (option price $119.50, market value $920.00; conditional sale); In re Crown Cartridge Corp., 220 F. Supp. 914 (S.D.N.Y. 1962) (option price $4,505.47, market value $24,000.00; conditional sale).
47 Burroughs Corp. v. Barry, 380 F.2d 427, 430 (8th Cir. 1967); In re Oak Mfg., Inc., 6 UCC REP. SERV. 1273, 1276 (S.D.N.Y. 1969).
held that, if the option price exceeds 50% of the total price of the leased property, the lease must be regarded as bona fide as a matter of law.\textsuperscript{49}

Often the option price is variable, being subject to a deduction for all or part of the rentals already paid at the time it is exercised. Judicial reaction to such schemes has been diverse. An early Code case takes a strict view of this kind of agreement:

A provision such as this in a lease readily provides a device for financing the purchase of equipment. By crediting earlier payments of rent to the purchase price, the lessee is accorded an equity or pecuniary interest in the subject matter of the lease which he may recover at his option.

It would seem therefore, that whenever it can be found that a lease agreement concerning personal property contains provisions the effect of which are to create in the lessee an equity or pecuniary interest in the leased property the parties are deemed as a matter of law to have intended the lease as security within the meaning of Sections 9-102 and 1-201(37) of the Uniform Commercial Code.\textsuperscript{50}

A more recent case goes to the opposite extreme, holding that where the "equity" accrued will not exceed 50% of the total price the instrument is a true lease as a matter of law.\textsuperscript{51}

One additional problem in connection with the Code's clause on nominal option terms is presented by the decision of \textit{In re Wheatland Electric Products Co.}\textsuperscript{52} In concluding that an equipment lease was not intended as security, the court relied on the non-sequitur that if a nominal option term makes the lease one intended for security, a non-nominal option term indicates that it is not. The agreement in question provided that the lessee might purchase the machinery at any time by paying the agreed price of $8,025.00. The lessee was to be allowed a credit, however, of from 70% to 75% of all rentals already paid to the extent of 75% of the purchase price, so that the actual cost of exercising the option might be as low as one-fourth of the total price. The court apparently considered its finding that such consideration was not nominal to be conclusive, since it did not go on to consider the broader issue of whether the facts of the agreement might indicate that the lease was intended as security.\textsuperscript{53} Other courts have taken the same approach, concluding that if the option price is not nominal, the lease is not intended as security.\textsuperscript{54} The clear intent of section 1-201(37)(b), however, is simply to set a minimum standard—a rule of exclusion whereby leases of a certain kind cannot be regarded as true leases. It does not follow that the absence of such an option term makes the lease ipso facto a true lease.

Decisions to date on the status of equipment leases upon the lessee's bankruptcy indicate that judicial standards are too uncertain to serve as a reliable

\textsuperscript{50} In re Royer's Bakery, Inc., 1 UCC REP. SERV. 342, 345-46 (E.D. Pa. 1963).
\textsuperscript{53} \textit{Id.} at 822.
guide to prospective lessors and lessees. The basic weakness of these standards is that they are founded on the imponderable statutory criterion of "intent." The question of whether a lease was intended as security is a highly factual one which has led the courts to engage in speculative assessments of the import of particular terms of the disputed agreements. Even with consistent, well-defined standards the scope of the filing rules would be too narrow. The old judicial habit of looking for a conditional sale beneath the guise of a lease has severely limited the reach of the "intended as security" clause. Even courts which have found such an intent in the absence of an option to purchase have relied heavily on the conclusion that the leased property would probably not be returned to the lessor.\textsuperscript{55} Leases which bear little or no resemblance to a conditional sale remain well outside the boundaries of article 9. It is submitted, however, that creditors need to know of these leases, too. Though they may fall short of an undertaking to purchase, they represent substantial, undisclosed obligations which are pertinent to the creditor's evaluation of the lessee's financial position. In addition, the presence of leased equipment on the lessee's business premises may give the false impression that they are the unencumbered assets of the lessee. The proposed amendments would extend the reach of article 9 to include such "true" leases and eliminate, or substantially reduce, the need for arduous factual inquiry as to the intent of the parties.

\section*{III. Accounting For Equipment Leases}

The inadequacy of the filing provisions with respect to equipment leases is further aggravated by methods of reporting leases in financial statements whereby the lessee's obligations under an equipment lease are not fully disclosed. The lease-or-sale question has been a recognized problem in the accounting profession for some time and remains a subject of considerable controversy. In 1964 the Accounting Principles Board of the American Institute of Certified Public Accountants issued Opinion No. 5, "Reporting of Leases in Financial Statements of Lessee" which set standards for determining when a lease should be treated as a sale. The broad policy of the Opinion is that leases which are "essentially equivalent to installment purchases of property" should be treated according to their substance rather than their legal form.\textsuperscript{56} This means that the property and the related obligation will be included in the balance sheet as an asset and a liability respectively. The standard for distinguishing between lease and sale is the presence of terms which create, in the lessee, a "material equity" in the property. The inclusion in the lease of either of the following features will usually establish this factor:

\begin{itemize}
  \item [a.] The initial term is materially less than the useful life of the property, and the lessee has the option to renew the lease for the remaining useful life of the property at substantially less than the fair rental value; or
\end{itemize}

\textsuperscript{55} In re Pomona Valley Inn, 4 UCC REP. SERV. 893, 894 (C.D. Cal. 1967); In re Transcontinental Ind., Inc., 3 UCC REP. SERV. 235, 244 (N.D. Ga. 1965).

\textsuperscript{56} AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, OPINIONS OF THE ACCOUNTING PRINCIPLES BOARD, Opinion No. 5, Reporting of Leases in Financial Statements of Lessee, Sept. 1964, ¶ 9 [hereafter cited as A.P.B. Op. No. 5].
b. The lessee has the right, during or at the expiration of the lease, to acquire the property at a price which at the inception of the lease appears to be substantially less than the probable fair value of the property at the time or times of permitted acquisition by the lessee.\footnote{57}

In addition, any of the following terms will "tend to indicate" that an equity is being built up and that the lease should be treated as a sale:

a. The property was acquired by the lessor to meet the special needs of the lessee and will probably be usable only for that purpose and only by the lessee.

b. The term of the lease corresponds substantially to the estimated useful life of the property, and the lessee is obligated to pay costs such as taxes, insurance, and maintenance, which are usually considered incidental to ownership.

c. The lessee has guaranteed the obligations of the lessor with respect to the property leased.

d. The lessee has treated the lease as a purchase for tax purposes.\footnote{58}

Somewhat stricter standards are set for leases in which the parties are related.\footnote{59}

For purposes of maximum disclosure to the lessee's creditors, these APB standards are much too vague and cumbersome. Moreover, the Board has sharply restricted the applicability of Opinion No. 5 to leases which are (1) non-cancelable, or cancelable only upon the occurrence of a remote contingency; and (2) "material," individually or as a group, in relation to the lessee's net assets or the lessee's future operations.\footnote{60}

As to leases which are not essentially sales under the Board's guidelines, only this broad requirement is made:

[F]inancial statements should disclose sufficient information regarding material, non-cancelable leases which are not recorded as assets and liabilities (see paragraphs 13 and 14) to enable the reader to assess the effect of lease commitments upon the financial position and results of operations, both present and prospective, of the lessee. Consequently, the financial statements or the accompanying notes should disclose the minimum annual rentals under such leases and the period over which the outlays will be made.\footnote{61}

It should be noted that, once again, the rule is applicable only to "material," non-cancelable leases. In addition, the Board approves the practice of relegating the lease obligation to a footnote in the financial statement. It has been argued that such minimal footnote disclosure is inadequate to reveal the impact of the lease on the lessee's credit capacity,\footnote{62} but many consider the "off balance sheet"
advantages of the financing lease to be illusory. In any case, the fact remains that for a great many leases which do not fall within the "material, non-cancelable" classification, no particular balance sheet disclosure procedure is required.

The Board is now considering revisions of the standards embodied in Opinion No. 5 which would require capitalization of more leases. Considerable opposition to broadening the standards has been voiced, however, on the theory that an equipment lease is an executory contract and not a fixed liability. Critics have argued that disclosure of the lessee's obligations under the lease is desirable, but that the general capitalization of leases is unrealistic and would have a distorting, even misleading effect on the balance sheet of the lessee. Whatever the eventual decision of the APB, it is clear that its present rules do not give sufficient notice of the lease obligation to creditors, although it is also arguable that such is not the function of the financial statement. As a result, creditors cannot rely on the debtor's balance sheet for all the information they might wish to have about leasing obligations. Without effective disclosure either in the balance sheet or through filing under article 9, there exists a hiatus in the lessee's discernible financial position, a gap which the following proposals are intended to fill.

IV. Proposed Amendments

The principal change would be in the Code's definition of the term "security interest." It is proposed that section 1-201(37) be amended in the following manner:

(37) "Security interest" means an interest in personal property or fixtures which secures payment or performance of an obligation. The retention or reservation of title by a seller of goods notwithstanding shipment or delivery to the buyer (Section 2-401) is limited in effect to a reservation of a "security interest." The term also includes any interest of a buyer of accounts, chattel paper, or contract rights which is subject to Article 9 and the interest of a lessor in personal property or fixtures leased under an "equipment lease" as defined in Section 9-105(1)(j). The special property interest of a buyer of goods on identification of such goods to a contract for sale under Section 2-401 is not a "security interest," but a buyer may also acquire a "security interest" by complying with Article 9. Unless a [lease or] consignment is intended as security, reservation of title thereunder is not a "security interest" but a consignment is in any event subject to the provisions on consignment sales (Section 2-326). [Whether a lease is intended as security is to be determined by the facts of each case; however, (a) the inclusion of an option to purchase does not of itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended for security.]

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63 Whitman, Accounting Issues in the Capitalization of Leases, PUB. UTIL. FORT., Sept. 30, 1971, at 27; BUS. WEEK, supra note 2, at 46.
64 Whitman, supra note 63; see also A.P.B. Op. No. 5, ¶ 7.
66 New language is in italics. Deletions are indicated by brackets.
A definition of "equipment lease" should be incorporated into article 9 by the addition to section 9-105(1) of the following sub-section (j):

(j) "Equipment lease" means any lease of goods except:

(i) one in which the term, including all renewal periods, is less than four months with no option to purchase;

(ii) leases of farm equipment having a purchase price of not in excess of $2500, other than fixtures under Section 9-313 and motor vehicles required to be licensed;

(iii) leases of consumer goods other than fixtures under Section 9-313 or motor vehicles required to be licensed.

Section 9-102, which defines the policy and scope of article 9, should also be changed by amendments to sub-sections (1) and (2):

(1) Except as otherwise provided in Section 9-103 on multiple state transactions and in Section 9-104 on excluded transactions, this Article applies so far as concerns any personal property and fixtures within the jurisdiction of this state

(a) to any transaction (regardless of its form) which is intended to create a security interest in personal property or fixtures including goods, documents, instruments, general intangibles, chattel paper, accounts or contract rights; [and also]

(b) to any sale of accounts, contract rights or chattel paper;

(c) to any equipment lease.

(2) This Article applies to security interests created by contract including pledge, assignment, chattel mortgage, chattel trust, trust deed, factor's lien, equipment trust, conditional sale, trust receipt, other lien or title retention contract and [lease or] consignment intended as security. This Article does not apply to statutory liens except as provided in Section 9-310.

The object of these amendments is to make the filing rules of article 9 applicable to all long-term leases of commercial or industrial equipment. The new provisions would relieve the courts of the problem of evaluating the intent of the parties to the lease. They would also benefit creditors by increased disclosure of a debtor's financial obligations since article 9 would extend to equipment leases which were exempt in the past due to a narrow judicial construction of the phrase "intended as security." This broader rule is also preferable because it better reflects the general definition of "security interest" in section 1-201(37) as "an interest in personal property or fixtures which secures payment or performance of an obligation."

The exception of short-term leases under four months in duration is intended

67 Other amendments to this section have been proposed by the Permanent Editorial Board, supra note 9.
to relieve lessors from the filing requirements in situations where there is little likelihood that the lessee's creditors will be misled by an appearance of ownership. The four-month limit is, admittedly, arbitrary but is suggested by the use of a four-month grace period in section 9-103(3). The exception of leases of certain farm equipment is intended to make the definition conform to the present Code policy which permits perfection of purchase money security interests in such equipment without filing.\textsuperscript{68} The exception of certain consumer leases is intended to make the definition conform to a similar policy with respect to consumer goods.\textsuperscript{69} It is important to note that "equipment lease" is a defined term with a meaning independent of the article 9 definition of "equipment." This minor ambiguity should not create any problems since most equipment leases will involve goods which come within the definition of "equipment." It might be preferable, however, to replace the term "equipment lease" as it has been used in this article with some other term, such as "business lease," in order to avoid even the slightest confusion. Undoubtedly, other problems and potential inconsistencies would be caused by the adoption of the proposed amendments. The following suggestions are intended to deal with them but make no pretense of being exhaustive.

The definitions of "collateral," "debtor," and "secured party" under section 9-105 should be amended to reflect the treatment of an equipment lease as creating a security interest:

\begin{enumerate}
\item \textit{Collateral} means the property subject to a security interest, and includes accounts, contract rights, and chattel paper which have been sold and goods leased under an equipment lease;
\item \textit{Debtor} means the person who owes payment or other performance of the obligation secured, whether or not he owns or has rights in the collateral, and includes the seller of accounts, contract rights or chattel paper and the lessee under an equipment lease. Where the debtor and the owner of the collateral are not the same person, the term "debtor" means the owner of the collateral in any provision of the Article dealing with the collateral, the obligor in any provision dealing with the obligation, and may include both where the context so requires;
\item \textit{Secured party} means a lender, seller or other person in whose favor there is a security interest, including a person to whom accounts, contract rights or chattel paper have been sold and the lessor under an equipment lease. When the holders of obligations issued under an indenture of trust, equipment trust agreement or the like are represented by a trustee or other person, the representative is the secured party.
\end{enumerate}

Section 9-311 on the alienability of a debtor's rights in the collateral would, in its present form, impose an undue burden on the contractual freedom of the parties to a lease. It is suggested that the equipment lease be excepted from that section:

The debtor's rights in collateral may be voluntarily or involuntarily

\footnotesize{
\begin{tabular}{l}
68 Uniform Commercial Code § 9-302(1)(c).  \\
69 Uniform Commercial Code § 9-302(1)(d).  \\
70 Uniform Commercial Code § 9-109(2).
\end{tabular}
}
transferred (by way of sale, creation of a security interest, attachment, levy, garnishment or other judicial process) notwithstanding a provision in the security agreement prohibiting any transfer or making the transfer constitute a default, except where such a provision appears in an equipment lease.

Without this amendment the effect of section 9-311 on equipment leases would be to give lessees a general right of alienation which they do not now have. The lessor of equipment could not provide himself with the reasonable protection of a conventional default clause. In the case of a "true" lessor who, under the present rules, is not required to file a financing statement, this would add insult to injury. The proposed amendments would not only impose upon him the burden of perfecting his interest in leased property, but they would nullify an important default clause in his agreement with the lessee. The best solution is a broad exception of all equipment leases from section 9-311. This may result in a diminution of the assets available for levy by the lessee's creditors (especially where the terms of the lease give him an equity interest in the property). That disadvantage is outweighed, however, by the benefit of broader notice requirements under the proposed amendments.

The interest of the lessor in the leased property should also be protected from the holder of a security interest in the lessee's "after-acquired property" by the addition of the following subsection (7) to section 9-312 on priorities among conflicting security interests:

(7) The security interest of the lessor under an equipment lease has priority over a conflicting security interest in the same collateral if the lessor's interest is perfected at the time the lessee receives possession of the collateral or within ten days thereafter.

This provision gives the lessor the same protection as that afforded by subsection (4) to holders of purchase money security interests in collateral other than inventory.

V. Conclusion

The approach of current statutory and judicial rules to the security aspects of equipment leasing is inadequate. The emphasis of sections 1-201(37) and 9-102(2) on the intent of the parties has left enforcement of article 9 in a factual quagmire. Judicial interpretation of the term "lease intended as security" has so limited the applicability of article 9 with respect to leases that it reaches only the grossest attempts to disguise what are essentially financing transactions. At present a debtor may undertake substantial lease obligations which the lessor is not required to perfect by any form of notice to the lessee's creditors. The failure of the courts to recognize the security factor inherent in any equipment lease and the need of creditors to be aware of such leases is compounded by incomplete disclosure, under current accounting principles, of lease information in the financial reports of the lessee. The foregoing proposals are submitted as a possible remedy of this situation.

Michael J. Cunningham