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Important Provisions that should be in Every Lease

Recent editions of Dispatches from the Trenches have discussed a variety of boilerplate and other provisions which, although important, are not always given much attention. On the other side of the coin are provision that everyone knows are real important. This edition of Dispatches from the Trenches focuses on the more important provisions. Although a thorough review of all the provisions that should be found in leases is beyond the scope of this edition, the following overview should be helpful. It begins by outlining a few categories that generally describe the reasons for the various provisions that should be found in leases. It follows with a description of certain provisions which any good lease should contain.

Underlying Reasons for Certain Provisions

In general, equipment lease documents are designed to accomplish the broad goals outlined below.

A. Protection of the Rent Stream

Some provisions are designed to give the lessor the benefit of its bargain from the lease itself, chiefly the rent stream. Language in the lease providing rental terms fall in this category and so does the "Hell-or High Water" clause which requires the lessee to pay the lessor rent no matter what-- i.e. "come hell or high water." Language regarding the lessee's continued ability to pay rent, such as cross default and certain other default provisions, also fall into this category. Guaranties and security deposit arrangements may also be considered as revenue-protection.



B. Protection of the Leased Equipment

Other provisions are designed to protect the value of the equipment that is being leased. These provisions are especially important in situations where there is value attributed to the leased equipment at the end of the lease. Provisions that fall into this category include the return provisions as well as purchase and renewal options.

Some provisions in this category overlap with the first category since many of the provisions which protect the equipment help protect the lessor's ability to receive the rent stream to the extent the lessor may need to look to the value of the equipment to make itself whole in the event the lessee defaults in its obligations to pay rent. Provisions that protect the equipment, or substitute a desired cash settlement, fall into this category. For example, provisions regarding the use and maintenance of the equipment during the term and property damage insurance fall into this category.

C. Protect the Lessor from Liability

As we all know too well, the "deep pockets" of financial institutions sometimes result in their being the target of law suits in the event the equipment injures someone. Well-drafted equipment leases help protect lessors from such risks by including provisions which: (1) require the lessee to maintain liability insurance that protects the lessor, (2) limit the lessee's use of the equipment and (3) require the lessee to indemnify the lessor against a variety of potential lawsuits and other claims.

D. Protect Enforceability

With the increase in lessee bankruptcy and fraudulent transactions, lessors are more-and-more concerned with protection against claims that the lessee did not actually approve the lease as required by corporate law or that the deal is a sham. Most of this protection is found in officer's certificates, opinions of counsel, corporate resolutions and other documentation outside the lease,



including good invoice documentation and sometimes inspection reports. This category also includes lease provisions that protect against legal technicalities such as usury "savings clauses" and severability provisions.

Specific Provisions

A. Term of Lease; Rent; Late Fees; Acceptance

Generally, the term of an equipment lease will begin on acceptance of the equipment and will continue for a specified period of time, which may be subject to renewal or early termination through various options. The term of the lease should be clearly stated as should the amount of rent and the designation of when it is due. Most leases clearly state whether the rent is intended to be paid in advance or in arrears. Late fees charged to the lessee in the event the rent payments aren't made timely should also be clearly outlined in the lease.

One of the most common problems with this aspect of lease documents is failure to have a clearly defined beginning point for the lease. As noted above, leases usually begin when the lessee accepts the equipment. This helps to avoid any issues which may arise if the equipment later malfunctions. The lessor, who is merely a source of funds, should be paid regardless of any such problems. As a general rule, virtually all of the lessee's obligations to the lessor, including the obligation to pay rent and to indemnify the lessor, arise only when the equipment has been accepted. Likewise, the lessor's obligation to make payment to the vendor of the equipment arises on the lessee's acceptance. Fumbling this opening kick-off can result in the lessor finding itself between vendor and lessee with no protection.



From a paperwork standpoint, the lessor will rely on the delivery and acceptance certificate, which should properly refer to the lease and should require the lessee to acknowledge that the equipment is fully operational. As discussed in previous editions of Dispatches from the Trenches, lessors who have an acceptance certificate signed before the equipment is inspected do so at their peril.

B. Net Lease; Hell or High Water Clause; Warranty Disclaimer

There is a great deal of overlap in these concepts, which are actually intended to be separate and to deal with distinct, although similar, issues. The net lease provision states that the lessee is responsible for paying operating costs, taxes and insurance. This effectively means that the rent payment is "net" to the lessor (except for the lessor's income taxes and overhead).

The hell or high water clause is important to establish that the lessee must pay the full amount of rent whether or not the equipment functions and that the lessee has no right of offset. If this clause is explained to the lessee, it should be pointed out that the lessee does not, in this clause alone, give up its right to sue the lessor if it feels that the lessor has breached any terms of the lease, including representations regarding the equipment. Such assurances, however, should never be put in writing unless the writing is reviewed by counsel.

The warranty disclaimer language is fairly standard because it is based on statutory requirements. Under statutory law, lessors make an implied warranty that the equipment is "merchantable" and "fit" for the lessee's intended use UNLESS THE WARRANTY DISCLAIMER LANGUAGE IS PRESENT IN THEIR LEASE.

C. Return Provisions

Some of the provisions that address directly the lessor's anticipated residual value realization are the return provisions of the lease. These provisions address the condition in which the equipment



must be on the date of return, the allocation of the costs of redelivery, where delivery will occur and what additional charges the lessee may be required to pay.

If there is any doubt as to the lessee's obligation, the lessor should notify it in advance as to what the obligations are assumed to be. In many cases, a given type of equipment will require a special return provision, such as a requirement that the equipment is in adequate condition to receive government certification or to be maintained by a proper service organization in the future.

D. Additional Provisions

Of course strong leases will also have a variety of other important provisions, such as: an equipment description; the right of lessor to assign without the lessee's consent; adequate maintenance and return provisions; language regarding the payment of sales, use and other taxes; an income tax indemnity (if applicable); UCC-2A finance lease language; a grant of a security interest (which may be precautionary) and written authorization to file financing statement; restriction on the lessee's change of name, structure or state of formation; a statement that each Schedule is a separate lease that incorporates the Master Lease (very important for purposes of syndication) and that the language in the Schedule controls over conflicting language in the Master Lease; a statement that the lessee grants the lessor a power of attorney to negotiate settlement and endorse checks for insurance payments; lessor inspection rights; language clearly designating any security deposits and stating that any such deposits can be commingled with other funds and will not bear interest; and choice of law, jurisdiction and venue provisions (discussed in recent editions of Dispatches from the Trenches)



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