

# MARKS & WEINBERG, P.C.

## PROTECTING THE RESIDUAL (1996)

Ask any lawyer what provisions are really "important" in a lease and he or she will probably give you a blank stare. The correct response is not an answer, but a question:

"Important for what purpose?"

Clearly, a properly worded rent provision is absolutely crucial to the lessors receiving its desired cash flow. Being clear and specific as to how rent is payable (advance or arrears), when rent is to be paid, what late fees attach, when a default for late payment occurs and the like all go to this very important aspect of any equipment lease transaction.

Most lawyers (*mea culpa*) are more comfortable when we get out of the practical aspects of leasing and into pure legal matters, such as indemnification issues, whether the lease contains UCC 2A language and the often overlooked and occasionally deadly language of a miscellaneous clause.

When leasing veterans ask this question, however, they are often really asking about the *residual value* of their equipment. Anyone with a few years experience in leasing knows that strong or weak language in the document often makes the difference in whether residual values in a true lease are realized. Some of these provisions are easy to identify, while others work in subtle ways.



Lessors looking to maximize residuals on true leases, particularly where competitive pressures require high residual estimates when booking the transaction, should go beyond the boilerplate of their documents and pay particular attention to a variety of issues, including the following:

*Return Provisions.* No big surprise here, but too many lessors take for granted that the equipment will simply produce the revenues originally estimated or contained in an appraisal. Most lessor lease forms state that the lessee will pay the cost of redelivering the equipment at the end of the term, at least within a specified geographic area. Standard forms, however, often do not take into account specific needs for highly technical or specialized equipment. Must the equipment be de-installed, re-certified by the manufacturer or another organization for maintenance or specially prepared for future shipment? Who specifies the carrier on any return? What insurance obligations apply?

Note that when we advise lessees on these issues, we tell them that they should have the right to select the carrier in the event they are paying for "freight out". Many lessee advisors go further and tell the lessee never to pay the cost of return, assuming that cost will be paid by the next lessee or purchaser (which often means it comes off the purchase price!).

*Maintenance, Use and Liens.* Everybody can recite in his or her sleep that the equipment will be maintained "in good working order and the same condition as when delivered, reasonable wear and tear accepted" or similar language. Is this enough? For computers and other technical equipment, specific maintenance requirements may be necessary in order to ensure that the equipment is not only maintained in top working order, but will be accepted by the manufacturer or whatever organization is to provide maintenance for the purchaser or new lessee.

The lessee's use of the equipment is an issue with other items. Consider the case of the lessor who leased three electric generators to a lessee only to discover at the end of the term that one of the machines had burned out and that other two were taking on an additional 33% load. The lessee



want to exercise its purchase option at appraised fair market value, which was significantly lower than expected.

This story had a happy ending due to creative reading of some lease language, but the lessor would have been in a much stronger position if the lessee had specifically agreed to limit its use of each of the three generators.

As to liens, it goes without saying that the lessor's residual will be reduced significantly if it has to remove a lien at the end of the term. Clear language that the lessee is responsible for delivering the equipment free and clear of liens, or that the lessee's obligation to keep liens off the equipment survives the end of the term is helpful. Lessors should also bear in mind that certain liens (such as motor vehicle mechanic's liens) will attach to the lessor's ownership interest in the equipment even if the lessee is not authorized to have repairs made or is required to remove the liens itself. In other words, diligence may be the order of the day.

*Subleases and Relocation.* Lessors often fail to recognize that the primary reason to resist broad lessee sublease rights involve the residual. Relocation of the equipment to out-of-the-way places, through a sublease or a broad right on the lessee's part to relocate the equipment, may result in return from overseas or a distant part of the North American continent.

In addition, if the equipment actually changes hands in a sublease, the maintenance provisions become more important. Will the new user really have the ability to properly maintain the equipment? Consider the situation with corporate jet aircraft which were initially part of a significant fleet, but are to be divided up among several users who will contract out maintenance and be generally unfamiliar with the equipment themselves.

*Landlord/Mortgagee Waiver.* If the lessee defaults to you, what is the likelihood that it has defaulted to its landlord or on its primary mortgage obligation? How eager will that



landlord/mortgagee be to let you recover your equipment and what is the likelihood that either of them will claim that the equipment is a fixture affixed to their real estate and therefore subject to their claims? These messy issues can be resolved up front (when everyone is happy) by obtaining a proper waiver.

*Purchase and Renewal Options.* We will close with what is probably the easiest example for many of us to appreciate. Logic (and the law) dictate that a lessee will be assumed to exercise any purchase option which allows it to purchase equipment for less than its fair market value. Is it clear that a fixed price (10%) purchase option is net of all applicable taxes and the cost of curing any defaults?

Often more significantly, is "fair market value" carefully defined so that an appraiser will not be confused into thinking it is appraising equipment as if purchased by a wholesale vendor? Is the appraiser to appraise the equipment "in place" (meaning that additional value to the lessee may be considered)? Who pays the cost of the appraisal (or multiple appraisals if they are necessary)? With reference to the generator example used above, does the appraiser assume that the equipment has been properly used and maintained with no more than a stated number of hours or amount of use?

As to renewals, many forms pay more attention to the purchase price of equipment under a fair market value calculation than how fair market rental is to be calculated. This is often a very difficult number to be calculated and appraisals may be unavailable. Some means of providing reference may be necessary, or at least an example that fair market rental is calculated on the basis of similarly-situated lessors and lessees, excluding unreasonably high or low special circumstances, such as leases among a single corporate group or short-term rentals.



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