

**DISPATCHES FROM THE TRENCHES**

**Lease Vs. Loan Analysis Under the Uniform Commercial Code**

By: Kenneth P. Weinberg

There are several tests for determining whether a transaction that is labeled as a "lease" constitutes a true lease or a loan (loans are sometimes referred to as "leases intended as security", "financing leases" or "disguised security interests"). The proper test to apply depends upon the reason for characterizing the transaction. For example, a different test determines whether a transaction is a true lease for federal tax purposes than the test applied when determining if a lease is a true/operating lease for accounting purposes.<sup>i</sup>

Recent editions of this column have highlighted, and often criticized, the analyses that some courts have used to determine whether a transaction is a lease or a loan for state law purposes. For example: (1) in *Amba-An v. Arias-Turecious*,<sup>ii</sup> criticized in the October edition of this column, the court found a lease with a one dollar purchase option to be a "true lease" for purposes of applying Florida's dangerous instrumentality doctrine; (2) in *In re Triplex Marine Maintenance, Inc.*,<sup>iii</sup> the court determined that a lease with a purchase option equal to the greater of ten percent or the fair market value of the Equipment was a loan under the "sensible person test" solely because the lease covered all of the lessee's assets and the court felt that the lessee's only sensible choice was therefore to exercise its purchase option; and (3) in *Ace Leasing, Inc. v. Boustead*,<sup>iv</sup> criticized in the January edition of this column, the court held that the transaction was a loan solely because the lessor dispersed funds directly to the lessee and allowed the lessee to pay the vendor--- the court reasoned that, since the lessor did not pay the vendor directly, the lessor never received title to the leased equipment and therefore could not "lease" the goods to the lessee.

All of the above referenced cases involve state-law tests of whether the underlying transactions are true leases or loans. This month's column focuses on the appropriate state-law test provided under the Uniform Commercial Code ("UCC"), which is a test that state and federal courts use in

a variety of circumstances.<sup>v</sup> Article 2A 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 . . . ."<sup>vi</sup> That section further adds that the "creation of a security interest is not a lease."<sup>vii</sup> Thus, the crucial provision in distinguishing a true lease from a disguised security interest is the definition of "security interest." That definition is currently found in §1-201(37) of the UCC. Although the National Conference of Commissioners on Uniform State Laws and the American Law Institute<sup>viii</sup> have recently proposed a revised version of Article 1 of the UCC, the definition of security interest in revised Article 1 that relates to leases is substantively the same.<sup>ix</sup>

The UCC test for distinguishing a lease from a loan provides a two-part test (the "Two-Part Test") and any transaction that satisfies the Two Part Test creates a security interest and is therefore a loan as matter of law.<sup>x</sup> The elements of the Two-Part Test generally focus on whether the alleged lessor retains some interest in the goods-- often referred to as a residual interest. If there is a realistic chance that the lessee will return something of value to the lessor, the lease will likely be deemed to be a true lease.

It is important to note, however, that the Two-Part test expressed in the UCC is not the end-all-be-all when determining if a transaction is a true lease. The UCC also provides Courts with flexibility by noting that "[w]hether a transaction creates a lease or security interest is determined by the facts of each case."<sup>xi</sup> As such, even if the Two-Part Test does not result in the transaction being characterized as a loan, some courts may still find the transaction to be a loan based on an analysis of the facts and circumstances of the particular case and the underlying economics of the transaction.<sup>xii</sup> Thus, the sensible person test applied by the court in *In re Triplex Marine Maintenance* was technically consistent with that state's UCC laws.

## **Part One: Does the Lessee have the Option of Terminating the Lease Early?**

A transaction cannot be a loan *unless* 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."<sup>xiii</sup> Put another way, if the lessee has the right to terminate the lease at any time without a significant penalty, the transaction will not satisfy the Two-Part test and will not be deemed to be a loan as a matter of law. It is important to note that a termination right that requires the lessee to pay the lessor a significant sum does not result in true lease status since Courts generally view such termination payments as penalties which force reasonable lessees to continue performing under the lease.<sup>xiv</sup>

## **Part Two: Is the answer to any of the following questions yes?**

The second component of the Two-Part Test is satisfied if the answer to any of the following three questions is yes:

### **1. Is the Lessee Required to Purchase the Goods?**

If the lessee is required to purchase the goods, the lease is not a true lease.<sup>xv</sup> There is no chance that the leased equipment will be returned to the lessor.

### **2. Is the Lessee required to Lease the Goods for their Full Economic Life?**

If the lessee is required to lease the goods for their full economic life, nothing of value will be returned to the lessor and the lease is not a true lease.<sup>xvi</sup> The result is the same even if the initial lease term is for less than the economic life of the goods *if* the lessee is *required* to renew the lease for the remaining economic life of the goods.<sup>xvii</sup>

### **3. Does the Lease contain a Nominal Renewal or Nominal Purchase Option?**

Any reasonable lessee would be certain to exercise an option: (1) that allows it to renew the lease for the remaining economic life of the goods for no additional consideration or for nominal consideration; or (2) that allows it to become the owner of the goods for no additional consideration or for nominal consideration. As a result, no lessor under any lease that contains either of these options can expect to receive something of value from the lessee at the end of the lease term and such leases are deemed to be loans rather than true leases.<sup>xviii</sup>

The UCC definition of security interest also notes that a transaction designated as a "lease" does not create a security interest *merely* because: (1) the lease is a "full payout lease" (where the lessee is obligated to pay an amount equal to or greater than the cost of the goods); (2) the lease is a "net lease" (where the lessee assumes the risk of loss, and the costs of taxes, insurance, filing, service and maintenance); (3) the lease contains an option to purchase or renew (unless the option is binding or for no additional or only nominal consideration); or (4) there is an option to renew or buy at a fixed price equal to or greater than the reasonably predictable fair market value.<sup>xix</sup>

In summary, the tests used to determine if a transaction is a true lease or a loan varies and depends upon the reason the characterization is needed. For many state law purposes, the definitions of "lease" and "security interest" under the UCC provide the appropriate test. That test contains a bright line rule which states that a transaction which satisfies both elements of the Two-Part Test is a loan as a matter of law. Lessors desiring true lease treatment under state law should be careful that their transactions do not satisfy both prongs of this Two-Part Test. Lessors should also be aware that, notwithstanding the Two-Part Test, the UCC provides courts with broad discretion by noting that whether a transaction is a lease or a loan depends on the facts of each case. Due to the lack of certainty in this area of the law, prudent lessors should take precautions to protect their interests transactions that they consider to be true leases.

Kenneth P. Weinberg is a founding partner of Marks & Weinberg, PC. He and co-founder, Barry Marks, have significant experience in dealing with virtually every type of equipment and facility lease financing, have participated in leasing financings for more than a billion dollars of equipment and are recognized throughout the industry. Weinberg has written *Dispatches from the Trenches* since 2002, routinely writes articles in a variety of equipment leasing and financing journals, and has participated in numerous seminars on equipment leasing issues. If you would like more cases or articles on leasing, or have any questions or comments about this column or other leasing issues, please visit [www.leaselawyer.com](http://www.leaselawyer.com) or contact Weinberg at 205-251-8307.



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<sup>i</sup> Hence the birth of "synthetic leasing."

<sup>ii</sup> 704 So. 2d 1093 (Fla. Ct. App. 1997).

<sup>iii</sup> 45 UCC Rep. Serv.2d 977 (Bankruptcy Ct., Texas, 2000).

<sup>iv</sup> 55 P.3d 371 (Mt., 2002).

<sup>v</sup> For example, the UCC test is used by state courts to determine whether a transaction is a loan and the lessor must comply with Article 9 of the UCC when disposing of leased assets after a lessee default. It is also used by bankruptcy courts to determine: (a) whether the lessor has rights under 365(d)(10) of the bankruptcy code (applicable only to true leases); and (b) whether the lessor must "perfect" a security interest in the leased equipment in order to avoid becoming an unsecured creditor. See *Butner v. United States*, 440 U.S. 48, 54-55 (1979)(the existence, nature and extent of a security interest in property is governed by state law); See also 11 U.S.C. §101, Historical and Statutory Notes ("Whether a . . . lease constitutes a security interest under the bankruptcy code will depend on whether it constitutes a security interest under applicable State or local law.") Courts also use the UCC test to determine whether state usury laws that apply to loans are applicable to transactions labeled as leases. See *Bell v. Itek Leasing Co.*, 555 S.W.2d 1 (Ark. 1977).

<sup>vi</sup> UCC §2A-103(j).

<sup>vii</sup> *Id.*

<sup>viii</sup> These are the legal bodies responsible for drafting and promulgating the UCC.

<sup>ix</sup> Under Revised Article 1, the definition of security interest has been shortened substantially and the provisions used to determine whether a given transaction is a lease or a loan have been moved into Revised Section 1-203. Comments to that section note that the definition is "substantively identical" to UCC §1-201(37). As of June 20th, Revised Article 1 has only been adopted in Virginia. It is currently circulating in Connecticut, Massachusetts and Texas. It has been withdrawn from North Dakota and is being held for 2004 in Hawaii.

<sup>x</sup> See UCC §1-201(37)(a) through (d); See also *e.g.* In re Taylor, 209 B.R. 482, 484 (S.D Ill. 1997).

<sup>xi</sup> See UCC §1-201(37) and Revised UCC §1-203.

<sup>xii</sup> *Id.* at 487.

<sup>xiii</sup> UCC §1-201(37).

<sup>xiv</sup> See *e.g.* In re Taylor, 209 B.R. at 485.

<sup>xv</sup> UCC §1-201(37)(b)(2).

<sup>xvi</sup> UCC §1-201(37)(b)(1).

<sup>xvii</sup> UCC §1-201(37)(b)(2).

<sup>xviii</sup> UCC §§1-201(37)(b)(3) and (4).

<sup>xix</sup> UCC §§1-201(37)(c).