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DISPATCHES FROM THE TRENCHES

The "Ins + Outs" of UCC Finance Leases & Co-Lessee Issues

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This edition of Dispatches from the Trenches provides background information with respect to what the term õfinance leaseö means when used under the Uniform Commercial Code (UCC) ô which is significantly different from how that term is commonly used by some in the leasing industry ô and discusses some of the risks related to co-lessees and potential solutions.

What is a UCC Finance Lease?

Lease financing has been described by one commentator as possibly õthe most important single source of funds to support business expenditures for capital equipmentö (Amelia H. Boss, The History of Article 2A: A Lesson for Practitioner and Scholar Alike, 39 Ala. L.Rev. 575, 577 [1988]). Lease financings involve three or more parties: the lessee, the lessor and the equipment supplier(s). The lessee selects the equipment and negotiates particularized modifications with the equipment supplier. The lessor then purchases the selected equipment and leases it to the lessee. Traditionally, lessors involved in lease financings have been thought of as passive lessors whose transactions remain functionally the equivalent of an extension of credit. (See e.g., *Nath vs. Nat. Equipment Leasing Corp.*, 439 A.2d 633 [Pa. 1981], noting that this type of lessor õis not in the business of selling or marketing merchandise [but rather, it is in] the business of circulating funds.ö) Given the limited function of the lessor, the lessee relies entirely on the supplier for representations, covenants and warranties. (Edwin E. Huddleston III, Old Wine in New Bottles: UCC Article 2A ó Leases, 39. Ala. L. Rev. 615, 616 Notes 1 [1998].)

Lease financings can take various forms, one of which is a finance lease as defined under Article 2A of the UCC. Unfortunately, the term finance lease is sometimes a source of confusion. Many people in the leasing industry use that term to refer to a transaction which, although called a lease, is actually a loan from the lessor to the lessee with the õleased propertyö serving as collateral for the loan ô such as a lease with a $1 purchase option. Those people distinguish the finance leases from õtrue leases,ö which are also called õtax leasesö or õoperating leases.ö To avoid any confusion, we will use the term õlease intended as securityö to refer to leases that are actual loans and the term õtrue leaseö to refer to leases that are not simply disguises security interests.

Under Article 2A of the UCC, the term finance lease is defined to be a true lease that õconsists of an overall three-party transaction in which: (1) the lessor does not select, manufacture, or supply the goods, (2) the lessor did not own the goods before the lease was arranged, and (3) the lessee either approves the purchase contract or receives specified warranty and supplier information before signing the lease agreement.ö (Ian Shrank and Arnold G. Gough, Equipment Leasing-Leveraged Leasing [PLI 4th ed., 1999], Vol. 1, Section 3:1.5[C].)

Due to the limited role that a lessor plays in a finance lease and the important role that such transactions play in our economy, Article 2A offers special statutory protection to lessors who lease goods in this manner. As noted in the comments to the UCC, the various sections of Article 2A operate to õsubstitute the supplier of the goods for the lessor as the party responsible for warranties and the like.ö (UCC Section 2A-101, comments [emphasis added]). For example, Section 2A-209 automatically extends the sellerøs warranties (and their exclusions) to the lessee and automatically excludes any implied warranties of fitness or merchantability by the lessor. (Shrank, supra at Section 3:1.5[B].) In addition, Sections 2A-516, 517 state that once the lessee has accepted the property, it has no right to revoke that acceptance. Most importantly, Sections 2A-407 and 508 create a statutory õhell or high waterö clause by making the lesseeøs obligations (including payment obligations) irrevocable and independent of the lessorøs or supplierøs obligations. (Id. at Section 3:1.10[A].) In other words, once the lessee accepts property under a finance lease, that lessee is obligated by statute to perform under that lease õcome hell or high water.ö As Shrank explains, the interplay of these UCC provisions õallows a computer lessor to promise vital services to the lessee, then to breach this promise entirely, yet requires the lessee to continue paying rent without set-off, all without any express clause in the lease agreement.ö (Id.)

All the aforementioned protections afforded lessors under finance leases can be obtained through contractual provisions. The Official Comments to the UCC state that õ[i]f a transaction does not qualify as a finance lease, the parties may achieve the same result by agreement.ö (UCC Section 7-2A-103, comment [g].) Indeed, the UCC õprovisions are merely codifications of standard commercial leasing practices that previously were achieved by contract rather than by statute.ö (Shrank, supra at Section 3:1.10[A].) Well-respected authorities therefore encourage lessors to õinclude express ÷hell or high waterø clauses if for no other reason than to avoid arguments about whether a ÷finance leaseø is involved.ö (Id. at §3:1.[D].)

Co-Lessees

Many people in the industry have heard that co-lessees do not provide the same protection as a guarantied lease but do not necessarily know why. Usually, the co-lessee issue is raised when the better credit does not want to (or can't) sign a guaranty. In such cases, a proposal is made for "joint and several obligations." However, this co-lessee resolution should be considered carefully as it raises a variety of risks, most of them resulting from the judicial system's lack of familiarity with this issue.

Courts know what to do with guaranties. However, this author knows of no litigated cases involving co-lessees in which the lessor sought to compel one lessee to cover another's obligations or joint obligations. As such, it is much more difficult to determine how a court would rule if one lessee defaults or goes into bankruptcy. Similarly, there is little (if any) precedent for how a court might rule if the lessees (in a true lease) or actual owner/borrowers (in a lease purchase) squabble over the use and possession of the equipment or their respective obligations to pay taxes, remove liens, maintain, pay for return or pay rent.

Co-borrowers are not uncommon, but a lease is a significantly different situation since a lease includes the right to use and possess equipment as well as the obligation to pay for it, while a loan document only covers repayment of a debt. Quite simply, co-borrowers cannot generally involve the lender in a dispute regarding the collateral in the same way that co-lessee's may be able to do so. Clearly, a lease purchase is less of a problem than a true lease, but judges have a penchant for ignoring the substance of a lease-purchase transaction when it suits them.

If a guaranty cannot be used, a lease-sublease structure may provide an appropriate work-a-round. In that case, the original lessee will become the "sublessor" and the documents should

make clear that the original lessee/sublessor remains legally obligated for performance but has no rights to use the equipment, all of which rights are passed to the sublessee. The sublease can then be assigned as collateral to the original lessor. Of course, there are intricacies here and such documents must be drafted carefully to ensure that the sublessee's rights are fully subject and subordinate to the original lessor's rights. In addition, this structure implicates a variety of UCC and other documentation issues.

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 or contact Weinberg at 205-251-8307.

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