

MARKS & WEINBERG, P.C.

DISPATCHES FROM THE TRENCHES

A LITTLE SOMETHING ABOUT EFA'S: WHAT IS AN EQUIPMENT FINANCE AGREEMENT?

An industry with a myriad of finance structures and even more colorful names (such as split TRACs, first amendment, leveraged, synthetic, dirty, finance, put and security leases) has added another – the Equipment Finance Agreement or “EFA”.

An EFA is, simply put, a single document used to document a loan transaction which includes the note, security agreement and loan agreement all in one. Carefully drafted, it will be very similar in form to a lease (master or one-off) but cover all legal requirements for a complete loan package.

According to recent statistics, only one-quarter of “leases” in this country are “true leases.” The other seventy-five percent of leases are dollar-out leases, dirty leases, financing leases, leased intended as security, disguised security interests, non-tax leases, ALIAS or whatever other term you use to refer to a lease which is essentially a secured loan. Nevertheless, our industry has relied on lease language in financing documents for over half a century.

Problems Caused by Confusion

Unfortunately, there are numerous situations where judges, governmental agencies and other are confused by these “leases” which are not leases.

For example, there are “vicarious liability” laws which can make owners of personal property liable for injuries which that property causes to third parties even if the owner did not behave improperly and was not negligent in any way. The fact that an equipment lessor, which is merely a financing source, is the owner of the property for tax or other purposes is sometimes sufficient for a lessor to be liable under these laws.

In most cases, judges have “followed the light” in holding that the “lessor” under a dollar-out or other non-tax lease is merely a secured lender and not an owner. However, there are exceptions to the rule. In *Amba-An v. Arias-Turecious*, 704 So. 2d 1093 (Fla. Ct. App. 1997), a lessor under a dollar-out lease of a motor vehicle was held to be liable under Florida’s dangerous instrumentality doctrine for damages caused by the negligent

operation of the leased equipment by the lessee. The doctrine is supposed to apply only to owners of equipment and not secured lenders with merely a lien on it.

The District Court of Appeals held, as a matter of law and despite the fact that the lease contained a dollar purchase option, that the lease was a true-lease and that the lessor could be held liable under Florida's dangerous instrumentality doctrine. In support of its findings, the court noted that the agreement was entitled "Commercial Vehicle Lease Agreement" and that the document stated that the lessor retained title to the truck. Additional facts leading to the court's conclusion included the fact that: (1) interest was not specifically mentioned in connection with monthly payments; (2) the lessee could not assign its interest in the lease without the lessor's written permission, but the lessor could assign its interest at will; (3) the lease required the lessee to carry liability insurance; (4) the lessee was required to display signs, if asked, indicating that the lessor owned the truck; and (5) the lessee was required to return the truck in good operating condition if not purchased in accordance with the terms of the lease.

Although a fairly recent Federal Statute, the Graves Act, codified at 49 U.S.C. §30106, attempts to protect lessors with respect to motor vehicle vicarious liability statutes like the one addressed in the *Amba-An* case, there is some debate as to the effectiveness of that law. In addition, there are other theories of lessor liability not addressed by this Act.

The non-true lease also creates frequent problems with state and local taxing authorities. People running these offices routinely tax \$1.00-out leases as true leases. Of course, in the process of doing so, they tax the "finance charge" or money earned at the "implicit rate" of the lease as well.

The EFA

For these and other reasons, the Equipment Finance Agreement is becoming increasingly popular and may eventually replace the familiar non-true lease as the finance vehicle of the future. In short, EFAs are used to finance motor vehicles and other potentially dangerous equipment, to be clear that lessees/borrowers have title to the equipment when necessary for tax exemptions available only to the lessee/borrower and in other situations where non-true leases might create problematic ambiguities.

An EFA is simply a loan and security agreement by another name. Unlike a non-true lease, the transaction is stated to be in the nature of a loan or financing rather than a lease of personal property and an EFA is much clearer on its face as to the parties' intention.

For example, a good EFA will be clear with respect to the following issues:

- An EFA uses terms like "lender" and "borrower" instead of "lessor" and "lessee".
- An EFA clearly states that the borrower owns the equipment and that the lender has a security interest in it. In addition, an EFA will contain a very clear grant of a security interest. Although all lease forms should contain at least a precautionary grant in case a bankruptcy court determines the transaction to be a loan, in both true and non-true leases, this issue is frequently handled less thoroughly than in standard loan

documents. In focusing everyone's attention more accurately on real nature of the transaction, the use of an EFA often results in stronger protection in this regard.

- The potential confusion between finance lessors and short term rental companies (*à la* Hertz-Rent-A-Car) should be all but eliminated and conventional leasing language such as the disclaimer of warranties is not as necessary in an EFA.
- Return and Purchase Option Provisions are completely removed from an EFA and any balloon payment due at the end of the financing can be expressed as what it truly is, a balloon payment and not a purchase option.
- Tax language can be simplified considerably in an EFA. For example any federal or state income tax indemnity for loss of tax benefits should be removed. In addition, the clearer loan status of this document should make it easier on finance company personnel to manage the company's tax obligations with respect to the payment of sales and property taxes.
- Language in the Defaults and Remedies Section of the EFA more accurately reflects the lender's rights and obligations under Article 9 of the Uniform Commercial Code instead of blurring the lines between Article 9 and Article 2A. The end result is that the finance company should be the same position under an EFA as it is under a non-true lease. However, with clearer loan language, there is less possibility of committing an error during the process of foreclosing and collecting deficiencies and language is more accurate across the board.
- Similarly to above, EFAs are more likely to have a stronger usury savings clause. Although usury considerations should (theoretically) apply to non-true leases, they generally do not apply to true leases and lease forms frequently contain a fairly short usury savings clause, under which the interest rate is reduced to the maximum rate permitted by law. Again, in focusing everyone's attention more accurately on real nature of the transaction, the use of an EFA often results in stronger protection in this regard and a more detailed usury savings clause is often used.

As a result of the foregoing clarifications, an EFA can provide significant protections over a non-true lease, particularly with respect to lessor liability and certain state tax issues. In addition, since it uses standard loan language, it is easier to work traditional lending structure such as a floating rate loan into the documents.

At the same time, because the EFA does not include documents specifically labeled as "promissory notes" or "security agreements", many lessors that are under internal restrictions prohibiting the making of traditional loans can close an EFA transaction. It is further distinguishable from traditional loan documents by being much more "equipment focused" like its equipment lease ancestor. The absence of a promissory note eliminates extra paper and, to a large degree, the EFA can be modeled on an existing lease agreement package so as to preserve familiar late fee policies, document modeling, and other details.

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 worth over a billion dollars and are recognized throughout the industry. Ken has published *Dispatches from the Trenches* since 2002, routinely publishes articles in a variety of equipment leasing and financing journals and has participated in numerous seminars on equipment leasing and finance 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.lease lawyer.com or contact Ken at 205.251.8307.

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.lease lawyer.com or contact Weinberg at 205-251-8307.



Article appeared in the July, 2007 issue of the *Monitor*.
For more articles/news regarding the equipment leasing and finance industry, visit
<http://www.monitordaily.com/>