Dodd-Frank Act and Its Impact on Equipment Leasing

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It is clear and established that the Dodd-Frank Wall Street and Consumer Protection Act (P.L. 111-203, codified at 12 U.S.C. 5301) governs Equipment Leasing, which as a result triggers a scrutiny of commercial leasing transactions that may well subject lessors to the Consumer Leasing Act (CLA), Regulation M, Y, the Risk Retention Rule and many other Federal Reserve rules and regulations that are typically applicable to consumer transactions. The Act was intended to address the widespread, risky and speculative conduct of financial firms (banks and investment trading companies) and the failure of the US regulatory system to curb these abuses.

The Act, 12 U.S.C. 5301 consists of 16 titles, 37 sub-titles and hundreds of sections. Not only was the Act introduced to regulate banks, but also "nonbank financial companies". The Bank Holding Company Act, 12 U.S.C. 1843(k) and Federal Reserve Rules under Regulation Y (12 C.F.R.225) determines the term "financial" practices or issues that fall under Regulation Y's governance to include establishment of minimum capital reserves (ratio of reserves to assets) for bank holding companies, certain bank holding company transactions and the definition of nonbanking activities for bank holding companies, state member banks and foreign banks operating in the US. Falling under the Bank Holding Company Act, therefore, affects the minimum capital requirement of equipment finance companies and is responsible for the formation of the risk retention rules for ABS transactions and the Securitization markets.

A nonbank financial company is defined under Section 102 (a)(4) as a company other than a bank holding company, that is "predominantly engaged in financial activities". Further clarifying how an equipment financial company falls under the Act, for purposes of capital reserves and minimum capital reserve requirements, is the definition of "predominantly engaged in financial activities" which means a) deriving 85% or more of its consolidated annual gross revenue from activities that are "financial in nature", and b) having consolidated assets of which 85% or more are "financial in

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nature". The guidelines define activities to be financial in nature if they are:

- closely related to banking activities, such as a credit extension and debt collection, real estate appraising, asset management, credit bureau services or check cashing and check guaranty activities;
- determined to be "usual" in connection with the transaction of banking or other financial operations abroad, such as management consulting services, travel agency operations, or the organization, sponsorship, and management of a mutual fund;
- defined as financial in nature by the Gramm-Leach-Biley Act, such as insurance or annuity services provided in a principal or agency capacity, securities underwriting, or making a market in securities, or merchant banking activities used to control nonfinancial companies.

Under proposed Federal Reserves rules, this 85% test applies to either of the past two years, or it may be determined through a facts and circumstances examination. Whether or not a company's activities are "financial in nature" is determined by further reference to the Bank Holding Company Act, 12 U.S.C. 1843(k) and to proposed Federal Reserves rules under Regulation Y, 12 C.F.R. 225. Accordingly, all full-time leasing and equipment finance companies must be considered "non-bank financial companies" under the broad definition included in, and for purposes of the Dodd-Frank Act. As the name of the Act (Dodd Frank Wall Street Reform and Consumer Protection Act) belies, the Act was instituted to protect consumers from many abuses of investment trading companies and the previously unregulated US Wall Street activities and transactions.

Under Sections 113-115 of the Dodd-Frank Act, the new Financial Stability Oversight Council (FSOC) established by Section 111 of the Act may determine that a nonbank financial company (NBFC) shall be supervised by the Federal Reserve. This would make the company subject to similar prudential rules as those applied to regulated banks. For this supervision to be triggered, the FSOC shall have determined that any "material financial distress" of such a company or the "nature, scope, size, scale, concentration, interconnectedness or mix of its activities" could pose a threat to US financial stability. A leasing company or equipment finance company as a "nonbank financial company" can be supervised by the Federal Reserve by considering:

- the extent of the company's leverage;
- its off-balance-sheet exposure;
- its transactions and relationships with other significant NBFC's, or with significant bank holding companies (BHC's);
- the extent to which the company may already be regulated by any financial regulation agencies;
- the amount and nature of its financial assets, and
- the amount and type of its liabilities including, the extent of reliance on short term funding.

There are a number of US manufacturer-captives or other nonbank lessors whose main holding companies and leasing operations are not currently within the scope of banking supervision. Some of these groups have certain subsidiaries, which for various reasons do have banking charters, but do not undertake the group's leasing business. Potentially, their holding companies could be viewed as candidates for NBFC designation.

Given the underlying definition of "financial in nature", a significant nonbank financial company for purposes of the application of the new and future rules and regulations under the Act is: a) supervised by the Federal Reserve Board of Governors, or b) had $50 billion or more in total consolidated assets as of the end of the most recently completed fiscal year. These rules clearly subject many large independent and bank-owned leasing and finance companies (and their affiliates) to the broad range of rules and requirements of Dodd-Frank.

Because of the Act's consumer basis, state Attorney Generals and the Federal Trade Commission have chosen to enforce state consumer protection statutes through various fraud cases and related litigation, particularly in equipment leasing, attacking the use of customary contractual terms (many of which define "consumer" to include small businesses), and ignore the distinct and legal difference between "consumer" and "commercial" that historically uniform state statutes like the U.C.C. acknowledge. In the future, many of the "commercial" transactions of the past will now come under the increased scrutiny of Dodd-Frank as consumer transactions despite the U.C.C distinction that equipment is not, and not intended to be, for personal, family or household purposes in a commercial transaction, as differentiated from a consumer transaction. Because of the thin line developing between commercial and consumer transactions as now interpreted by Dodd-Frank, a single member LLC or a one-shareholder corporation may fall within the definition of a consumer. This is also the case for transactions where there is a guaranty by the Principal of the company or corporation.

Some states define a "consumer" for interpreting a consumer transaction by its revenue or asset size (a company with revenue under certain millions may be treated as a consumer), triggering much regulated conduct for the Lessor. Moreover, adjudication that a transaction is consumer will require compliance with the Consumer Leasing Act (CLA), 15 U.S.C. 1667-1667e amending The Truth in Lending Act (TILA), 15 U.S.C. 1601 et. seq. The purpose of the CLA is to ensure meaningful and accurate disclosure of the terms of personal property leases for personal, family, or household use. The CLA is implemented by the Federal Reserve's Board's Regulation M (12 CFR part 213). The CLA and Regulation M require lessors to provide consumers with uniform cost and other disclosures about consumer lease transactions.

As it specifically relates to the Dodd-Frank Act, the Dodd-Frank Act raises the $25,000.00 exemption threshold to $50,000.00. Accordingly, if the lessee's total contractual obligation exceeds $50,000.00, the CLA and Regulation M do not apply. Since it is not uncommon for small-ticket leasing to involve lease transactions with lessee contractual obligations for the full lease term in the range of $25,000.00 to $50,000.00 contract balances, it is undisputable that Dodd-Frank, the CLA and Regulation M are the guidelines for such lease transactions, not Article 2A or Article 9 of the Uniform Commercial Code. Therefore, leasing or equipment finance companies, whose niche is providing lease financing in the form of leases with contract balances between $25,000.00 and $50,000.00, suffer the potential scrutiny of the Act and not the U.C.C. However, since the CLA still defines a "consumer lease" as "a contract in the form of a lease or bailment for the use of personal property by a natural person for a period of time exceeding four months, and for total contractual obligation not exceeding $25,000 (now $50,000), primarily for personal, family or household purposes, whether or not the lessee has the option to purchase or otherwise become the owner of the property at the expiration of the lease 15 U.S.C. 1667 (1) (parenthetical added), commercial lease transactions are still distinguishable, provided they do not involve single member LLC members, single-shareholders of corporations or are guaranteed by the principal of the company and small businesses are not defined as consumer by state statute, by the purpose of the lease transaction. If the lease contract is being entered into and the equipment shall be used, and is entered to be, for a commercial transaction and not primarily for personal, family or household purposes, the transaction will not normally be within the reach of the CLA and Regulation M. This does not in any way mean that a leasing company or equipment finance company, as a nonbank financial company containing certain particular elements discussed above, is exempt for compliance with Dodd-Frank and not subject to the Federal Reserve's Board Supervision.

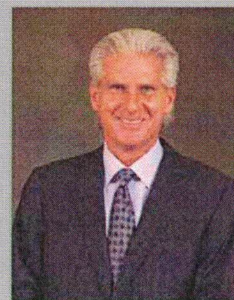
To further manage and try to avoid financial instability by abuses and fraud in banking, and specifically by abuses of investment trading companies, the Consumer Financial

Protection Bureau newly created by the Dodd-Frank Act is given authority under the Act to regulate anyone providing a "consumer financial product or service" or any service provider affiliate thereof (a "covered person" under the statute). The bureau is also given broad authority over any "covered person" whom it has reasonable cause to determine is engaging or has engaged in conduct that poses risks to consumers with regard to the offering or provision of consumer financial products or services. The bureau has the authority, and therefore the ability to require reports and conduct periodic examination of such covered persons. However, a negative by-product caused by the creation of the Bureau is a significant potential for overlap between Bureau authority and other state and federal regulatory authority. In the leasing sector, we have already seen this overlap demonstrated between the enforcement actions of the FTC and other regulatory agencies.

Under the Bureau's authority a "financial product or service" specifically includes extending or brokering leases of personal or real property that are the functional equivalent of purchase finance arrangements, if such leases are on a non-operating basis and have an initial term of at least 90 days or with leases for real property, where the transaction at the outset is intended to convey title to the lessee. If a leasing company offers products to both individuals and small businesses, it is likely to fall under the authority and regulations of the Bureau. Like the expansion of the Bureau's authority when a leasing transaction is "primarily for personal, family or household purposes", it is reasonable to anticipate that, the Bureau will be able to also claim authority for financial products or services that were once thought to be commercial.

In addition to CLA, Regulation M, Regulation Y and a litany of other Federal Reserve rules, which impose requirements on lessors in furtherance of consumer protection, the Dodd-Frank Act requires lenders of Asset Backed securities that are collateralized by pools of equipment leases to retain 5% of the loss risk for all debt obligations pooled into securities. This is called the Risk Retention Rule.

A strong argument in the case of equipment leasing CDO's can be made that the Risk Retention rule calls for an excess of what is required, because the inherent advance rate in an asset-based loan facility is 90-95%. This creates a collateralized pool of assets that is more than sufficient to protect against projected risk of losses, in addition to the value of the residual increasing the percentage of risk retention significantly above 5%.



Anthony Lamm has been voted by his peers for three consecutive years as a Pennsylvania Super Lawyer and is a frequent Speaker at National Equipment Leasing and Lending events, as well as a well-recognized author in the equipment leasing and finance field.

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