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# Equipment Leasing Newsletter®

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## Best Practices and the Leasing Industry

**By Cameron Krueger and Steve Byrnes**

"Best practices" seem to be on the tips of everyone's tongues these days. At the recent ELA Executive Roundtable Conference, the concept of applying best practices to leasing companies was a key focus of discussion. This trend is a clear endorsement of continually benchmarking performance and learning from others what works and what doesn't.

In the past decade, we have seen radical consolidation followed by the re-entry of the independent lessor. At the same time, leasing has migrated from being a sales and marketing driven industry, to one where systems and operations are now integral components of the go-to-market strategies of industry leaders. Regardless of the size or marketing thrust of the entity, lessors need to concentrate on how to keep costs under control while simultaneously building competitive advantage through the ongoing commitment of building, implementation and re-evaluation.

### What are Best Practices?

Best practices are business practices and processes enabling superior performance. Not all best practices are widely implemented within the industry, as some practices are limited by company type or market niche, or are simply not known to the

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## On-Site Sales: What Lessor's Counsel Should Know

**By Anthony L. Lamm**

When equipment lessors evaluate the risks of underwriting lease transactions for manufacturing equipment, one of the primary considerations in the credit decision is the resale value of the equipment in the event of default. In preparing for this risk, a key component of an underwriter's evaluation must be how to access and market the equipment in the event of a default. Therefore, it is critical to look at every transaction from the perspective of how much money a piece of equipment will bring in a sale, if there is an established market for the particular equipment, and also, how and where the equipment can best be marketed and sold if a liquidation is necessary. An often-overlooked and significant factor in this analysis is whether the lessor will have unfettered access to remove the equipment to sell, refurbish, and/or prepare for liquidation at the location where it has been used.

If the lessee is cooperative and agrees to surrender possession of the equipment, there is said to be a "voluntary surrender" or a "friendly foreclosure." In this amicable setting, the equipment lessor's counsel can focus on presale notices and negotiating terms for release and indemnity, insurance, an auctioneer's contract or the contract with a purchaser, and repayment of the deficiency by the lessee.

Sometimes, however, there will be an interim period after the lessee's default and prior to the sale by contract or auction where the lessee may be given an opportunity to cure the default and enter into a Forbearance Agreement with the lessor. Under these circumstances, it is wise to secure the lessee's consent to a Judgment for Possession in a form that is suitable for filing with the Clerk of Courts and delivery to the sheriff. The most common form of Judgment for Possession traces its foundation to 9-609 (a)(1), which provides in pertinent part that: "After default, a secured party may take possession of the collateral." [If the governing contract is a true Lease, the statutory basis for a lessor to retake possession of its collateral is Article 2A-525 (6).]

In the majority of cases, the equipment lessor will want the sheriff to secure access to the lessor's equipment at the location where the equipment is found so the lessor's repossession and/or remarketing agent can remove the equipment from

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## *On-Site Sales*

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the lessee's location to a convenient site for the remarketing agency to prepare, store and/or show the equipment for sale. This is not always possible or practical, however. Certain equipment, like manufacturing equipment or equipment that constitutes a fixture, may be too expensive to remove and store, especially if the equipment is not so easily remarketed. If it is anticipated that the removal and storage of this type of equipment is impractical, it is reasonable that the lessor might decide that selling the equipment at the lessee's location itself is in the best interests of all concerned. Although a lessee is likely to resist an on-site sale, the best argument for forcing one can be found in Article 9.

The basis of disposing of collateral on a debtor/lessee's premises is 9-609 (a)(2) and 9-610 (b). 9-609 (a)(2) provides in pertinent part that: "After default, a secured party: (2) without removal, may render equipment unusable and dispose of collateral on a debtor's premises under Section 9-610." Section 9-610 (b) Commercially Reasonable Disposition provides that "[e]very aspect of a disposition of collateral including the method, manner, time, place and other terms must be commercially reasonable. If commercially reasonable, a secured party may dispose of collateral by public or private proceedings, by one or more contracts, as a unit or in parcels and *at any time and place* and on any terms" (emphasis supplied).

In situations where the collateral involves manufacturing equipment, or equipment that is integral to the lessee's trade or business, selling the equipment at the lessee's place of business is not only commercially reasonable, but it is practical as well because it transfers the cost of removal to the buyer. Official Comment 6 to 9-609, "Secured Party's Right to Disable and Dispose of Equipment on Debtor's premises," explains that: "In the case of some collateral, such as heavy equipment, the physical removal from the debtor's plant and the storage of the collateral pending disposition may be impractical or unduly expensive. This section follows former Section 9-503 by providing that "in lieu of removal, the secured party may render equipment unusable or may dispose of collateral on the debtor's premises."

In addition, if the leased equipment is only one part of a manufacturing process (but not necessarily unique), a higher sales price can be obtained if the buyer witnesses the equipment in operation, or together with the complete set of equipment that constitutes the manufacturing process. It should also be pointed out that from a standpoint of determining whether a commercially reasonable manner of sale was conducted, it is difficult to attack the price paid at a sale that demonstrated the equipment in operation, on-site, and for its intended use. Moreover, one can argue that the lessee's location is the truly ideal setting for inspection and sale because some of a buyer's questions and concerns can be answered only through an on-site inspection where there also may be an opportunity to ask the lessee or employees questions.

There is very little well-settled law interpreting 9-609 (a)(2) and 9-610 (b). However, *Spickler v. Lombardo*, 11 Pa. D&C 3d 627 (Pa. D&C 1978) and *Sierra Financial Corporation v. Brooks-Farrer Company, et al.*, 15 Cal. App. 3d 698, 93 Cal. Rptr. 422 (Cal, App. 1971) do suggest that non-repossession in a judicial disposition does not render invalid the transfer of title nor a sale commercially unreasonable. On direct point, footnote 12 in *Spickler* emphasizes the Comment in the Uniform Commercial Code (9-609 (a)(2)) by clarifying the position on commercial reasonableness, as follows: "There are some factors in the instant case which might make the sale to plaintiff commercially reasonable despite

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nonpossession: the purchaser had opportunity to inspect the goods, the goods were heavy equipment and it was impractical or at least difficult to move them to a protected place, neither the debtor nor any other person had actual possession and there was no obstacle to plaintiff's taking actual possession promptly or within a reasonable time."

Of course, having a strong Article 9 argument is always a nice weapon in a lessor's arsenal, but as often is the case, being right and prevailing are not often the same. With this in mind, and with clear benefits to selling certain heavy equipment on site, lessors may also want to strongly consider the benefits of negotiating an out-of-court, on-site sale with a lessee.

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## True Lease

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*In re Spears*, 20 UCC. Rep. Serv.2d 260 (BC CD Ill, 1992) (option price over 25% resulted in a true lease).

On the other end of the spectrum, there are ample cases holding that a 10% purchase option is nominal. *See e.g., Equilease Corp. v. AAA Mach. Co.*, 30 B.R. 323, 325 (Bankr. S.D. Fla. 1983); and *In re Haddox*, No. 2-82-02133, 1983 Bankr. LEXIS 5667 (Bankr. S.D. Ohio August 5, 1983).

Although cases with specific holdings regarding security interests between 10% and 25% are much less common, some do hold that purchase options of 15% and 20% are not nominal. *See e.g., Keeling v. Ford Motor Credit Corp.*, 9 UCC. Rep. Serv.2d 227 (Maryland 1988) (residual value of at least 15% of original selling price results in a true lease); and *Western Enterprises, Inc. v. Arctic Office Machines, Inc.*, 36 UCC. Rep. Serv. 1331 (Alaska 1983) (purchase option price of 20% of original costs found not to be nominal).

Unfortunately, these cases do not allow for any clear rule. For example, the line of cases holding that a purchase price greater than 25% is a true lease have resulted in a line of cases holding that purchase options less than 25% are loans. *See e.g., In re Royal Food Mkts., Inc.*, 121 B.R. 913, 915 (Bankr. S.D. Fla. 1990) (finding consideration to be nominal where option price is less than 25% of original purchase or list price).

### Factors That Do Not Prevent the Transaction From Being a Lease

Under the old definition of security interest, courts developed myriad additional factors that they have found to constitute "incidents of ownership" by the lessee and, thus, evidence of a disguised security interest. Some of the factors that have been *erroneously* applied include whether the lessor is granted a security interest and whether a Financing Statement is filed by lessor and whether the lessor has any facilities to store or retake the leased property. Of course, many factors erroneously applied are characteristic of the type of leasing engaged in by banks, captive financing companies and other financial institutions and would result in many true leases constituting disguised security interests. The drafters of the current definition of security interest sought to rectify the erroneous use of such factors by setting forth certain factors that cannot be viewed as solely determinative of whether a transaction is a true lease or a disguised security interest. The current definition of security interest therefore explicitly 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. In addition, in the Official Comments to the current definition, the drafters specify several additional factors and further provide that, in fact, most of the "incidents of ownership" factors developed by the case law (but not specified in the statute or official comment) should similarly be considered as not determinative of a transaction for security.

### Conclusion

Although the current definition of a security interest provides substantially more guidance, there is no "definitive formula" to guarantee true lease treatment. Nonetheless it is helpful to bear in mind the following: 1) it is safer if the lease term, including any renewal periods required pursuant to the terms of the lease, does not exceed 80% of the equipment's useful life; 2) if the lessee doesn't have a reasonable business decision with respect to whether or not to return the equipment at the end of the lease term, some courts will treat that transaction as a loan no matter how carefully the numbers are structured — for example, very expensive return requirements may prevent a transaction from being a "true lease"; 3) the Uniform Commercial Code clearly provides that it is not fatal to true lease treatment for a lease to obligate the lessee to pay an amount that equals or exceeds the cost of the goods, but some courts may be confused by this issue and could incorrectly find full payout leases to be loans; and 4) although there is a wide variation of case law on this point, as a rule of thumb: (a) a fair market value purchase option of greater than 25% is very safe; and (b) a fair market value purchase option of 10% or less is quite risky.

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