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The Financing Lease as a Security Agreement: *Leasing Service Corp. v. American National Bank & Trust Co.*, 19 UCC Rep. Serv. 252 (D.N.J. 1976)

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Note

The Financing Lease As a Security Agreement

Leasing Service Corp. v. American National Bank & Trust Co., 19 UCC REP. SERV. 252 (D.N.J. 1976).

I. INTRODUCTION

Draftsmen of the Uniform Commercial Code, in an effort to standardize the legal effect of many types of credit transactions, included within the scope of Article 9 "any transaction (regardless of its form) which is intended to create a security interest in personal property or fixtures."[1] For purposes of the Code, a " 'security interest' means an interest in personal property or fixtures which secures payment or performance of an obligation."[2]

The increasing frequency with which lease agreements have been used to acquire equipment, or to finance such an acquisition, has given rise to frequent controversies over when a lease is a "true lease," and when it is a "lease intended as a security agreement." Classification of a lease as a security agreement results in the lease, and the lessor, being subject to the rules of the Code.

Although a "true lease" does not have to be filed to protect the interests of the lessor, a "security lease" makes the lessor a secured party, subject to the filing and perfection requirements of Article 9. Noncompliance with those requirements causes the "lessor" to be unprotected against properly perfected secured parties, judgment creditors and creditors in bankruptcy. Similarly, a "lessor" found to be in fact a secured party will be limited by and subjected to the remedial provisions of the Code in the event of a default by the lessee, and will, in appropriate circumstances, be subject to the seller's warranty provisions of Article 2. In addition, there are numerous other ramifications, including potential problems with usury laws.

The Code itself gives limited guidance as to the appropriate resolution of the issue in any particular situation:

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1. U.C.C. § 9-102(a) (1972 version).
2. U.C.C. § 1-201(37) (1972 version).

> Whether a lease is intended as security is to be determined by the facts of each case; however, (a) the inclusion of an option to purchase does not of itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended for security.[3]

In all situations where the conclusive presumptions of part (b) above do not establish that a particular agreement is a "lease intended as security," resolution of the issue is determined on the basis of the intent of the parties.

One such situation where the Code offers no specific instruction is where there is no purchase option of any kind contained in the provisions of the lease agreement. Although it is clear that the absence of a purchase option does not establish conclusively that a transaction is a "true lease,"[4] the general impression of courts and commentators alike has been that, under an "intent of the parties" test, the absence of an option to purchase was strong evidence that the parties intended to form a "true lease." Leases not containing an option to purchase consistently have been held not to be intended as security and therefore not subject to Article 9 of the Code.[5] In the absence of convincing evidence that the lease was intended as a security agreement, leases not containing purchase options[6] generally have been upheld as "true leases."

A recent New Jersey case poses the question of whether the foregoing analyses of the law are still valid. *Leasing Service Corp. v. American National Bank & Trust Co.*[7] involved a no-option lease which the court held to be a conditional sale-security agreement almost solely on the basis of the fact that the total rental payments over the sixty-month term exceeded the original cost of the equipment by some 37 per cent. However, several factors combine to make the precedential value of the decision questionable, including the unique advocacy positions of the parties and the atypical circumstances of the transactions involved.[8]

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3. *Id.*
4. [T]he presence of an option to purchase does not "of itself" make the lease a security lease (what "of itself" means is further explained by clause (b)). The negative implication is that the absence of an option to purchase would not necessarily, or "of itself," make the lease a true lease.
   G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY, § 11.2, at 338 (1965).
5. Del Duca, *Evolving Standards for Distinguishing a "Bona Fide Lease" from a "Lease Intended as Security"—Impact on Priorities*, 75 COM. L.J. 218 (1970) (authorities omitted).
6. Hereinafter cited in the text as no-option leases.
7. 19 UCC REP. SERV. 252 (D.N.J. 1976).
8. *See* § VI *infra.*

II. THE FACTS OF THE CASE

A. The Dispute

Leasing Service Corporation entered into a series of lease transactions with a company called "Audio." All of the transactions used form leases, specifying that Leasing Service "would secure from a specified supplier specified equipment to be leased to Audio for specified monthly rental payments to be paid according to a specified payment schedule."[9] Each of the documents contained a paragraph to the effect that the lessor reserved a "security interest in any and all property wherever located, now or hereafter belonging to lessee or in which lessee has any interest,"[10] and each was filed with the Secretary of State.

Subsequent to the filing of the last of the lease agreements, Audio entered into a loan agreement with defendant American National Bank & Trust Company, through which American received a security interest in all of Audio's property. When Audio later defaulted on the payments required by the loan agreement, American took possession of all of Audio's property, including the leased property. The leased property subsequently was returned to Leasing Service, while the remainder of Audio's property was sold at a foreclosure sale. Leasing Service then sued American and the successor of the purchaser of the property, claiming a prior security interest in that property. Thus, the dispute in this case was not over the leased property, but rather was concerned with all of Audio's *other* property.

Leasing Service claimed a prior security interest, arguing that the lease documents fulfilled the requirement for a security agreement and had been filed in the appropriate place, thus fulfilling the requirement for a financing statement. American asserted that Leasing Service was not a secured party as to any of Audio's property, arguing that: (1) the documents were "true leases" and not "leases intended as security," thus failing to fulfill the requirement of a security agreement; (2) even if the "leases" were

9. 19 UCC REP. SERV. at 259. The transactions were thus what have come to be called "finance leases," in that the lessor is neither manufacturer nor dealer of the leased property. The equipment that is leased is ordered to the specifications of the lessee and in turn rented to the lessee. The lessor seldom even sees the property, and usually has no desire to own it in the sense of having the actual use of it. Such leases are to be distinguished from those where the lessor is also a dealer in the type of property leased, and the specific property is either selected from the inventory of the lessor or manufactured by the lessor to comply with the specifications of the lessee.

10. *Id.* at 261.

intended as security, they were not valid financing statements, and thus Leasing Service was not perfected;[11] and (3) even if perfected, the description of the collateral in the agreements was inadequate to perfect an interest in any property other than the leased property itself.[12]

B. The Leases

All of the agreements involved were variations of the same form lease.[13] The court interpreted only the last of the series, determining that the leases were intended as security, evidently satisfied that any variations between the individual leases were immaterial to the issue.[14]

The lease agreements encompassed a five-year term, and called for monthly rental payments. After the first 36 months, the monthly rental was to decrease by more than half.[15] The lessee agreed to provide casualty insurance on the property; to continue to pay rent even in the event of destruction or theft of the equipment; to pay all taxes occasioned by the transaction, including all property taxes; to indemnify the lessor against any and all claims and liability; and to pay a non-refundable "advance rent" deposit upon acceptance of the leases by the lessor.[16] In addition, the lease contained a provision for acceleration of rental payments and the payment of attorneys fees by the lessee in the event of a default.[17]

III. THE COURT'S DISPOSITION OF THE ISSUE

The court found that the no-option leases described above were not "true leases" but rather were "leases intended as security," and thus that Leasing Service was a secured party. Although the

11. Having found that the leases were security agreements, the court disposed of this argument summarily, finding that even though the security agreements (*i.e.*, the leases) contained no description of the types of collateral, they did give notice of the existence of a security agreement. The court held that this was sufficient under the "notice" filing concept, and thus that the leases constituted adequate financing statements. *Id.* at 263.
12. The court held that under U.C.C. § 9-110 and its rule of "reasonable identification," "[t]he description in ¶ 14—'any and all property wherever located'—was amply sufficient to put defendant American on notice that its sale of any of Audio's property would violate plaintiff's prior security interest." *Id.*
13. *Id.* at 258.
14. *Id.* at 258-59.
15. *Id.* at 259.
16. *Id.* at 260.
17. *Id.*

decision certainly is not the first to hold such no-option leases to be in fact disguised security agreements, if the court's reasoning is taken at face value, the decision does present a novel approach.

According to the court, the crucial factor in its decision was the fact that the total rental payments over the five-year term exceeded the original cost of the leased property by "approximately 37 per cent."[18]

> The cost of the equipment was listed at $42,496.00. Thus the total rent over the five-year lease term exceeded the value of the equipment by approximately 37 per cent. . . . It is therefore clear that each lease contemplates rental payments far in excess of the value of the leased equipment, and that the transaction must be viewed as a conditional sale.[19]
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> . . . [T]he degree by which the total rentals exceed the purchase value of the equipment compels the conclusion that no residual proprietary rights were contemplated by Leasing at the end of the five-year term.[20]

Although the court discussed the requirements that the lessee insure, pay taxes, and provide a deposit, and although it made note of the acceleration provision, it is clear that the court considered these factors merely to be additional support for its conclusion. It was most concerned with what it viewed as an exorbitant rate of return on the investment of the lessor.

The fact that *Leasing Service* held a no-option lease to be a "lease intended as security" is significant in and of itself because of the small number of cases reaching the same conclusion. However, if the court did consider the "excessive" rent to be the decisive factor, the case represents an even more significant departure from prior law.

IV. BACKGROUND AND HISTORY

Traditionally, when courts have been faced with the issue of whether a transaction which purports to be a lease is in fact a lease or is instead a disguised security device, the inquiry has focused on a determination of which party has the ownership or control of the equity interest in the leased property. This test has been stated in a number of different ways: Does the lessee acquire anything

18. *Id.* at 259. The court arrived at the 37% figure by comparing the total return under the lease ($58,124.48) to the original cost to the lessor (listed as $42,496.00). The excess ($15,628.48) amounts to approximately 37% of the original cost.
19. *Id.* at 259.
20. *Id.* at 260.

more by making the rental payments than the right to the use of the property for a term of years? Does the lessor retain any proprietary rights in the property? These variations are all reformulations of the same basic principle.

The principle was developed in pre-Code days, because many courts considered long-term "lease" transactions to be inherently suspect as disguised security devices, and therefore the courts inquired into the *functional* effect of such transactions. Factors considered in the analysis included the term of the lease in relation to the anticipated economic life and usefulness of the lease property; whether the payments specified in the lease approximated the fair rental value of the property; the effect of obsolescence and depreciation; as well as evidence of the lessor's past practices with respect to the recovery, use, or sale of leased property at expiration or termination of other leases.

The principle remains viable because of the Code's reliance upon an "intent of the parties" test in all cases other than those to which the conclusive presumptions of the Code apply.[21] Thus the courts still focus on the "functional effect of the transaction" as indicative of the parties' intent, and the same factors continue to be relevant.

V. ANALYSIS AND COMPARISON

Because of the small number of reported cases finding no-option leases to be leases intended as security, a brief summary of the facts and analysis of each, coupled with comparison to *Leasing Service*, is useful.

The only case cited by the *Leasing Service* court as direct authority for its conclusion was *In re Transcontinental Industries, Inc.*,[22] a proceeding in bankruptcy, in which certain no-option leases were found to be leases intended for security. While the situation surrounding the transaction was similar to that in *Leasing Service*, the Bankruptcy Referee did not emphasize the fact that the rent payments exceeded the purchase price, but rather considered evidence of a type conspicuously absent in *Leasing Service*: (1) an express renewal option by which the lessee could renew the lease as many times as it desired at a cost of two per cent per year,[23] (although the *Leasing Service* agreement forms contained a provision relating to renewal terms, the court noted that the provi-

21. *See* U.C.C. § 1-201(37)(b) (1972 version).
22. 3 UCC REP. SERV. 235 (N.D. Ga. 1965).
23. *Id.* at 243.

sion was not filled in);[24] (2) evidence that at the completion of the lease term lessee had a right to a first opportunity to purchase the property;[25] and (3) evidence from which the referee concluded that the lessor's customers always retained the equipment at the end of the lease term through exercise of either the renewal option or the right of first refusal.[26] Thus, although *In re Transcontinental Industries, Inc.* was authority for the conclusion reached in *Leasing Service*, it did not support the analysis used in the determination.

In re Brothers Coach Corp.[27] likewise held a no-option lease to be intended as security, but again on facts showing stronger evidence that such was the intent of the parties. Although the lease had no option to purchase, it did provide that upon the expiration or termination of the lease or if the lessor obtained possession by reason of default, the lessor would cause the property to be sold subject to the following provision:

> Upon Lessee's written request, Lessor shall promptly furnish Lessee with an accounting of such sale. If the net proceeds exceed the depreciated value of said equipment,[28] Lessor shall pay or credit the excess to Lessee as a refund of a portion of the rentals theretofore paid by Lessee; . . . .[29]

The court found that this provision was the functional equivalent of a purchase option in that it gave to the lessee the proprietary rights to any equity in the property:

> Though the agreement fails to provide for the transfer of title to the "Lessee", the Lessee has the only interest in the equity. . . . Though the ultimate determination is not based on title or the transfer of title, the agreement clearly invests the "Lessee" with the rights and obligations of ownership subject only to the lien of the "Lessor" to the extent of the payments due as depreciated value as that term is described in the agreement.[30]

This same type of reasoning was applied in *John Deere Co. v. Wonderland Realty Corp.*[31] to find that a no-option lease contained an express provision which constituted the functional equivalent of an option to purchase. The agreement had not only a *renewal*

24. 19 UCC REP. SERV. at 259.
25. 3 UCC REP. SERV. at 243.
26. *Id.* at 244.
27. 9 UCC REP. SERV. 502 (E.D.N.Y. 1971).
28. The rental payment was described as a "monthly depreciation reserve," and the "depreciated value" was defined by the agreement to be the stipulated original value minus the "depreciation reserve" payments collected up to that point in time. *Id.* at 502-03.
29. *Id.* at 503.
30. *Id.* at 504.
31. 38 Mich. App. 88, 195 N.W.2d 871 (1972).

option, but also a provision whereby the lessee had an option to sell the equipment at the end of the three-year term with all proceeds of the sale which exceeded unpaid rent going to the lessee.[32] Thus, the lessee could bid at the sale as high as necessary to become the successful bidder, and never be obligated to pay more than the amount of the agreed rental.[33] The court held that although there was no "option" as such, the express provisions of the agreement allowed the lessee to become the owner of the equipment for no additional consideration. Therefore, the lease was classified as one intended for security under the Code definition.

The only other cases where a no-option lease was held to constitute a security agreement involved separate oral agreements providing the option,[34] and subsequent written modification of the lease whereby a purchase option was granted.[35]

Thus, none of the cases which could be cited as authority for the *result* in *Leasing Service* lend any credence to the court's emphasis on the amount of the rentals as establishing the requisite evidence of intent to create a security interest. All the cases reported herein were decided on the basis of a finding that although no actual option to purchase was included within the terms of the agreement, there were express provisions granting the lessee the functional equivalent of a purchase option. These provisions included renewal options, oral purchase options, or provisions granting the lessee a vested interest in the equity.

Even if it is conceded that the status of any "lease" as a security agreement must be determined from the circumstances of the particular transaction, and thus that supportive precedent for any particular set of facts nearly always will be lacking, there is authority which is directly contrary to the result reached in *Leasing Service*. *Lockwood Industrial Leasing Corp. v. Sabetta*[36] is nearly indistinguishable from *Leasing Service* on a factual basis. *Lockwood* involved a financing lease of equipment and fixtures to a retail grocery business. The lease was for a seven-year term, and did not contain a purchase option. The cost of the leased property was approximately $30,000.00, and the total rentals over the term amounted to $47,434.68.[37] A copy of the lease agreement was

32. *Id.* at 92, 195 N.W.2d at 873.
33. *Id.*
34. In re Walter W. Willis, Inc., 313 F. Supp. 1274 (N.D. Ohio 1970), *aff'd*, 440 F.2d 995 (6th Cir. 1971).
35. In re Virginia Air Conditioning Co., 11 UCC REP. SERV. 1260 (W.D. Va. 1972).
36. 16 UCC REP. SERV. 195 (D. Conn. 1974).
37. *Id.* at 197. Note that if these figures are substituted into the formula

filed by the lessor,[38] and, as in *Leasing Service*, the lease purported to give the lessor some type of an interest in "after-acquired property" of the lessee.[39] The *Lockwood* court began its analysis from the traditional basis:

> [T]he pivotal issue in determining whether or not a particular lease is one intended for security is whether the lessee's payments under it are just for the use of the property or whether they are to result in the lessee's acquisition of the ownership, the beneficial interest or equity in the leased goods. Since the lease here contained no option-to-buy provision we must analyze the facts established by the evidnce [*sic*] to resolve whether or not this lease was one intended for security.[40]

Beginning with the provisions of the lease agreement, the court found no evidence that the lessee had any right to obtain ownership of the leased goods. The fact that the total rental exceeded the purchase value of the equipment was found not to have "such probative weight as either to alter the terms of the lease or to promote the conclusion that the parties to the lease understood that the partnership was to obtain a property interest in the leased equipment."[41] Similarly, the inclusion in the description of the leased equipment of "all presently owned and hereafter acquired personal property," and the filing of a financing statement with an "after-acquired property" clause was dismissed as an awkward attempt to obtain security for the rental payments.[42]

The court found no parol evidence which implied that the intent of the parties was any different than indicated by the express terms of the lease.[43] The court summarized the situation as follows:

> In the view of this court, the right to obtain ownership of property is not to be decided by conjecture or guesswork but by the impact of evidence rationally interpreted with logical inferences drawn therefrom. And to find that there is probative persuasion to be-

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and terminology of *Leasing Service, supra* note 18, the amount by which total rentals exceeded original cost in *Industrial* was approximately 58% over a seven year term, as compared to 37% over the five year term of *Leasing Service*.

38. *Id.* at 198. The financing statement contained the legend: "This filing is a memo of the lease transaction."
39. *Id.* at 200.
40. *Id.* at 199.
41. *Id.* at 202. Earlier, the court had typified this transaction as a now "common" situation where one party obtains the use of equipment in return for making payments which "in the end will pay for the equipment and leave the financier a respectable profit on the arrangement." *Id.* at 198.
42. *Id.* at 200.
43. *Id.*

> lieve that a lease is one intended for security because the transaction is one in which the lessee seeks financing to obtain the use of equipment he is unable to pay for by turning to a financing house whose business is to furnish such monetary assistance is to say that there can be no true lease ever entered into by such parties but all, as a matter of law, must be characterized as leases intended as security.[44]

VI. THE EFFECT OF THE DECISION

Leasing Service marks a significant departure from traditional analysis of no-option leases, not only in the emphasis placed on the "lessor's" rate of return on its investment, but also because the court dealt with the "intent of the parties" issue directly in terms of an intent to create a security interest, rather than in the traditional focus on an intent that the lessee will obtain a proprietary interest in the leased property.

When predicting the possible impact of *Leasing Service*, it is important to consider some facts which may cause the *Leasing Service* analysis to be of limited application to other situations. First, the "lessor" asserted that the transaction was *not* a lease, while a defendant, not a party to the "lease" transaction, asserted that the document was in fact what it purported to be. All of the conflicts in the other cases cited herein saw the roles reversed, with the lessors arguing "true lease," and third parties presenting evidence of a contrary intent of the parties to the "lease." Because these cases look to the true intent of the parties to the "lease," the assertions of such a party that the intent was not as it appears carries more probative force than assertions by a nonparty, who is not likely to have first-hand knowledge. While the lessor's rate of return may be relevant in all such conflicts, when it is relied upon by one who was not a party to the transaction it may not be enough in and of itself to overcome both the written provisions of the agreement and the assertions of a party.

Second, the court's discussion of whether or not these "leases" were in fact security agreements must be classified as dictum, because a finding that the leases were "true leases" would not have been fatal to Leasing Service's asserted security interest. It must be reiterated that the conflict was not over the leased property, but over other property of the lessee. Thus, all that was needed to sustain the claim of the lessor as to a prior security interest in that other property was a finding that the after-acquired property clause contained in the leases was itself a "security agreement." There is

44. *Id.* at 202-03.

no procedural prohibition against a single document serving as a "true lease" with respect to some property, while at the same time serving to create a security interest in other property not the subject of the lease transaction.[45] It is submitted that, because the property at issue was not the property which was the subject of the lease, the court's inquiry into whether that property was in fact "leased" or instead the subject of a conditional sale was superfluous to the resolution of the conflict.

Third, although the court made several assertions that the parties could not have contemplated that the lessor would have any residual proprietary rights in the equipment at the end of the term,[46] the court specified that it received no evidence regarding the anticipated useful life of the equipment or its projected value at the end of the lease term.[47] Positive evidence of anticipated value at the end of the term might have overcome what the court seems to have treated as a presumption arising from the rate of return.

Finally, even assuming that the foregoing facts do not seriously undercut the precedential value of the case, the line of inquiry adopted by the court does not lend itself to predictable results. The agreements at issue contained express recitations that "[t]he equipment is, and shall remain, the property of lessor," and that "[l]essee shall have no right, title or interest in or to the equipment except as expressly set forth in this lease."[48] The financing statements which were filed contained the legend that the filings were for "informational purposes only," the transaction being a lease and not a conditional sale. It is thus difficult to discern exactly what more a "true lessor" could do to insure that a lease transaction would be upheld as what it purported to be. If a rate of return which a court deems to be excessive were allowed to overcome the express provisions of an agreement in the context of a lessor asserting the agreement as a "true lease," the only recourse

45. Under U.C.C. § 1-201(37), "security interest" means an interest in personal property or fixtures which secures payment or performance of an obligation. Under U.C.C. § 9-105(h), "security agreement" means an agreement which creates or provides for a security interest. U.C.C. § 9-201 provides that: "Except as otherwise provided by this Act a security agreement is effective according to its terms between the parties, against purchasers of the collateral and against creditors." Despite all of the "terms of art" of the Code, a security agreement remains essentially a contract, and the parties thereto retain the freedom to grant or retain precisely the interest that they want in precisely the property that they want.

46. *See* notes 19 and 20 and accompanying text *supra*.

47. 19 UCC REP. SERV. at 260.

48. *Id.* at 261.

a "true lessor" would have would be to reduce that rate of return. What constitutes an "unreasonable rate of return" is a very ambiguous standard upon which to hinge the classification of what often are "high stakes" financing transactions. Although financing leases are subject to much abuse, such leases do perform a legitimate function in this age of high overhead. Legal standards which require a lessor to sacrifice a reasonable margin of profit in order to insure protection only serve to compound the problem and have no place in modern commercial law.

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