UNIFORM COMMERCIAL CODE COMMENTARY

SECURED TRANSACTIONS

LEASES AS SECURITY: SOME PROBLEMS OF IDENTIFICATION

The leasing of industrial equipment has become a common commercial practice for two principal reasons: it requires substantially less capital outlay than would an outright purchase[1] and, in many cases, it presents a significant tax advantage.[2] There are, however, other—less legitimate—motives which might lead to the wider and more imaginative use of the lease form to cover what is really a security agreement.[3] For example, a buyer might seek to combine the benefits of ultimate ownership with the tax advantages of a leasing arrangement, or a conditional seller might attempt to protect his interest in the goods concerned without complying with the Code's filing requirements.[4] Similarly, the seller might try to arrange the transaction so that he could, if necessary, recover the collateral while evading the provisions of either the Code[5] or the Bankruptcy Act.[6]

Consider, for example, a buyer who is in financial difficulty, and who wants to buy machinery which depreciates very slowly. If there is a default, it is possible that a judgment sale would yield a significant cash surplus[7] which a lessor could retain but which a conditional seller would have to remit to the debtor under section 9-504(2) of the Code. Moreover, under section 9-501(3)(a),[8] there would be no way that a debtor could waive this right in a security agreement; in such a case, the seller could find a "lease" with option to purchase quite attractive. In addition, if most of the lease payments would ultimately be applied to the purchase price, it is unlikely that a buyer would object, especially if he were in financial difficulty and in urgent need of the goods. It is apparent, then, that a lease may be a true, bona-fide lease or a lease

1 Griesinger, Pros and Cons of Leasing Equipment, 33 Harv. Bus. Rev., March-April 1955, pp. 75-76.

2 Rentals under such a lease are deductible from gross income. Int. Rev. Code of 1954, § 162(a)(3). Purchase price and installment payments are not so deductible, but the equipment purchased is depreciable. Int. Rev. Code of 1954, § 167(a)(1).

3 See U.C.C. §§ 9-105(h), 1-201(37).

4 See U.C.C. §§ 9-302, -401, -402.

5 See U.C.C. §§ 9-501 to -507, which provide a scheme for reclamation and protection of security.

6 See Bankruptcy Act § 70(a), as amended, 66 Stat. 429 (1952), 11 U.S.C. § 110(a) (1964); Bankruptcy Act § 70(c), as amended, 80 Stat. 269, 11 U.S.C.A. § 110(c) (Supp. 1966). These sections give to the trustee in bankruptcy certain rights and powers which a seller may be able to circumvent by disguising the sale as a lease.

7 Although forced sales seldom cover the amount of the debt, it is possible that heavy equipment could depreciate so slowly that its value at any time would be considerably greater than the balance owed.

8 That section provides that "the rules stated [in §§ 9-502(2), -504(2)] . . . may not be waived or varied . . . insofar as they require accounting for surplus proceeds of collateral . . . ."

"intended as security."[9] It should be equally apparent that courts must be able to distinguish and identify these transactions for purposes of tax collection, bankruptcy administration, and protection of debtors and third parties in secured financing. The purpose of this comment is to examine some of the problems which must be dealt with in attempting to characterize these kinds of transactions justly and consistently.

It must be recognized at the outset that the question before the courts in these cases is a *factual* determination of whether the parties to a "lease" really intended it as a security agreement; there is seldom any dispute as to the legal consequences attendant upon the possible answers to the question. As a result, the two major difficulties which have been encountered thus far are chiefly problems of fact-finding: The infinite variety of possible fact situations has impeded the development of adequate standards for decision making, and the parol-evidence rule, coupled with "entire-agreement clauses,"[10] has raised the more basic question of what evidence should be available to the fact-finder in making this determination.

As to the development of standards, it is interesting to note that these disguised conditional sales were first attacked by the Internal Revenue Service,[11] and that, by 1955, the problem had grown to such an extent that a new Revenue Ruling was promulgated.[12] However, the problem of characterizing these transactions has not yet been entirely solved, largely because the facts of each case are so unique that it has not been possible to codify sufficiently precise standards of general applicability.[13] It is apparent that this same difficulty is present in attempting to construe and apply the standards provided by the Uniform Commercial Code.

In section 1-201(37), the Code has attempted to deal specifically with the problem of leases intended as security, and it provides certain limited guidelines to aid in resolution of these questions:

> 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.

It is clear that these standards are designed to be flexible enough to enable one to ascertain the true function of a transaction regardless of its form, but since

9 See U.C.C. § 1-201(37).

10 Such a clause is a written expression by the parties that the instrument is the complete integration of their agreement.

11 See, e.g., Burkett v. Commissioner, 31 F.2d 667 (8th Cir. 1929); Benton v. Commissioner, 197 F.2d 745 (5th Cir. 1952).

12 Rev. Rul. 540, 1955-2 Cum. Bull. 39.

13 For example, in Kearny & Trecker Corp. v. United States, 195 F. Supp. 158 (E.D. Wis. 1961), the agreement provided for three different purchase options and high rental payments in the early years, while in Burton v. Tatelbaum, 240 Md. 280, 213 A.2d 875 (1965), there were twenty separate writings evidencing the agreement and a claimed option to purchase based on an oral understanding.

so few cases have been decided under this section it is not yet clear whether this approach will provide an adequate means of consistently deciding this kind of case.[14] In evaluating the effectiveness of these provisions, nevertheless, it is instructive to examine the relevant decisions.

In one of the earliest Code decisions in this area, *In re Royer's Bakery Inc.*,[15] the agreement in question purported to be a lease of equipment for a term of thirty-five months, but it allowed the lessee to terminate the agreement at any time on thirty-days notice with payment of only the amount due up to that time. In addition, the lessee had an option to purchase the equipment at any time during the term of the lease, and, if he chose to do so, eighty per cent of the aggregate rentals paid up to that point would be applied toward the purchase price. The lease also contained a one-year renewal provision with all the same terms, including the option to buy. When the lessee's business failed, the lessor filed a reclamation petition seeking to recover from the lessee's trustee in bankruptcy the proceeds of the sale of the equipment. The trustee resisted the petition on the ground that the lease was really an unperfected security interest. The referee accepted the trustee's argument and denied reclamation, relying in large part upon standards articulated by the Internal Revenue Service.[16] He stated that, "whenever it can be found that a lease agreement . . . contains provisions the effect of which are to create in the lessee an equity or pecuniary interest . . . the parties are deemed as a matter of law to have intended the lease as security within the meaning of [U.C.C.] sections 9-102 and 1-201(37) . . . ."[17]

The result reached in this case is undoubtedly correct under section 1-201(37)(b), but it is not clear that the referee's reasoning was either correct or necessary to the result. On the facts of the case, it is apparent that the "equity" being created in the lessee was so substantial as to compel the inference that a security interest was intended. The rental payments for the term of the lease plus one renewal would be more than enough to cover the entire purchase price of the equipment without the payment of any additional consideration. This does not mean, however, that the referee was correct in declaring that the creation of *any* equity or pecuniary interest in the lessee is enough, as a matter of law, to preclude a finding that the transaction is truly a bona-fide lease agreement.

The better reasoning would seem to be that of *United Rental Equip. Co. v. Potts & Callahan Contracting Co.*,[18] a case remarkably similar to *Royer's Bakery*. There the contest was between the lessor and one who had purchased the equipment at a sheriff's sale resulting from a judgment and execution against the lessee. The lease called for a term of one month and then was to continue until the equipment was returned; the lessee had an option to purchase under which eighty-five per cent of his rentals would be applied to the purchase price. Relying *exclusively* upon section 1-201(37)(b), the court

14 See also U.C.C. § 9-102, Comment 1.

15 56 Berks County L.J. 48, 1 U.C.C. Rep. Serv. 342 (E.D. Pa. 1963).

16 See 1951-2 Cum. Bull. 1, acquiescing in Bowen v. Commissioner, 12 T.C. 446 (1949).

17 1 U.C.C. Rep. Serv. at 345-46.

18 231 Md. 552, 191 A.2d 570 (1963).

held that since, at some point, it would be possible for the lessee to take title without paying any additional consideration, the intention of the parties was to create a conditional sale rather than a lease. As indicated above, this reasoning could very well have been used in *Royer's Bakery*, thereby rendering irrelevant the discussion of the "creation of an equity."

The flaw in *Royer's Bakery* is obviously the breadth of its language, for certainly there could be many cases in which the bona-fide lessee would be establishing some substantial equity or pecuniary interest. One such case is *In the Matter of Wheatland Elec. Prods. Co.*,[19] in which the court was again concerned with the application of section 1-201(37). Here the bankrupt had leased equipment under a written agreement which was to run for one year[20] and which gave the lessee an option to purchase for a stated sum. If the option was exercised, seventy-five per cent of the rentals would be applied to seventy-five per cent of the purchase price, so that here, unlike the previous cases, the lessee would always have to pay at least twenty-five per cent of the price regardless of how he timed his purchase. The lease was later modified and extended, but retained the same option clause; ultimately it was extended a second time, and at that point the option to buy was deleted from the agreement. The court held that the agreement was a true lease and not one intended as security. This decision was based on the fact that the exercise of the purchase option required the payment of more than a nominal consideration, and, in addition, on the fact that the option to purchase had expired before it was exercised.[21] This result seems clearly correct, since the option to purchase could never be exercised by the lessee without the payment of substantial consideration. Even if he waited until the termination of the lease, he would still be required to pay an additional twenty-five per cent of the list price. On the question of consideration, then, it seems that the Code guidelines, as they were applied in *Wheatland* and *United Rental*, are useful in the determination of the true intention of the parties to an agreement.[22]

The *Wheatland* court, however, did not rely solely on this issue, but relied also on the absence of a purchase option. It is not at all clear whether this fact standing alone would necessarily be conclusive on the issue of intent, especially when, as here, the lease is not looked at as of the date of execution but as of a point later in time.[23] Certainly the absence of such a clause is strong evidence that the lease is not intended for security, but it would seem that, as in *Royer's Bakery*, the significance of any one particular factor has been

[19] 237 F. Supp. 820 (W.D. Pa. 1964).

[20] The length of a lease and the termination conditions may often be illuminating as to the parties' true intention. For example, in *Wheatland* the lease could not be terminated for at least one year, and the option to purchase could not be exercised before this time; in *United Rental* and *Royer's Bakery*, on the other hand, the lease could be terminated and the option to purchase could be exercised at any time.

[21] 237 F. Supp. at 822.

[22] It is submitted that if the *Wheatland* court had applied the rationale of *Royer's Bakery*—that the creation of an equity establishes a lease to be security as a matter of law—it is probable that a different result would have been reached.

[23] Tax decisions require that the determination of the issue of intent be made as of the date the parties entered into the agreement, See, e.g., Beckwith Mach. Co. v. Matthews, 190 Md. 182, 192, 57 A.2d 796, 801 (1948).

articulated far to strongly. In this respect, it seems that these two decisions share a common deficiency: they both seem unaware that they are making a factual determination which over time may be unique and that, consequently, the breadth of their language does a disservice. It is clear that in developing rules to deal with these cases, the courts must recognize that such a potentially great variety of factual variations requires a more general and flexible approach, and that present solutions must anticipate the problems which are likely to occur. Section 1-201(37) of the Uniform Commercial Code was designed to provide for such a flexible approach, and the courts should be conscious of this in rendering their decisions.

The second major problem which arises in such cases is determining what evidence the court may consider in attempting to ascertain whether the parties intended the "lease" as security. Obviously, sections 1-201(37) and 9-102(1)(a) and (2) look to an identification of actual intent regardless of form, and any exclusionary rules which would tend to inhibit the success of this inquiry must be regarded suspiciously. The parol-evidence rule[24] is one such rule which is particularly important here, especially when the instrument contains an entire-agreement clause.[25] This problem is illustrated by *In the Matter of Atlanta Times, Inc.*,[26] in which the court refused to admit evidence of an oral purchase option. In that case, the bankrupt had leased certain equipment for a ten-year term, and the "lease" contained no purchase option. The agreement recited that it was a lease, and that it constituted the entire agreement between the parties, but the trustee in bankruptcy contended that the transaction constituted a conditional sale, and that the rentals were really the installment payments. At the trial, the trustee offered the testimony of the lessee to the effect that the parties had also agreed to a purchase option which could be exercised for a nominal consideration. The lessor objected to the introduction of this evidence, and in the alternative denied the allegation. The court excluded the testimony on two grounds: first, because it sought to vary the terms of the written agreement in violation of the parol-evidence rule; and, second, because under Georgia case law, "where the written agreement also contains an 'entire agreement' provision, it is conclusively presumed that the writing contains the entire agreement in regard to the subject matter."[27]

The second reason given by the court is particularly significant, because the parol-evidence rule standing alone will not necessarily exclude evidence of a purchase option.[28] The rule operates in two stages. The first stage allows the introduction of evidence in order to rebut the presumption that the writing under consideration is a complete expression or integration of the agreement of the parties. If any evidence, including parol evidence, can show that the writing is only a partial integration, then the second stage can operate to allow the admission of evidence to prove the content of the missing terms. At both stages, of course, evidence is still excluded if it tends to prove terms which are inconsistent with the principal writing.

[24] See U.C.C. § 2-202.
[25] See note 10 supra.
[26] 259 F. Supp. 820 (N.D. Ga. 1966).
[27] Id. at 825.
[28] Obviously a purchase option is not necessarily inconsistent with a true lease.

Returning to the *Atlanta* case, then, it can be seen that an entire-agreement clause rigidifies the parol-evidence rule by barring evidence of a partial integration. When this clause is given the benefit of a "conclusive presumption," the court may not consider any evidence tending to show even terms which are entirely consistent. As was shown above, moreover, the principal standards which have been successful to date have dealt with inferences to be drawn from the agreement itself. If *Atlanta* and *Wheatland* are read together, the result is a good example of the possible misuse of one of these clauses. In *Wheatland*, the absence of an option to purchase was considered very significant in determining the intent of the parties, but under *Atlanta*, evidence of such an option would be inadmissible if the lease contained an entire-agreement clause. It is certainly arguable that less respect ought to be given to attempts of the parties to shield the true nature of their transaction when the effect is to facilitate an evasion of legal duties.

The Code provides that the intention of the parties is determinative of the creation of a security interest, regardless of the form of the transaction.[29] By giving effect to an entire-agreement clause, the court limits the evidence which can be considered in determining the true intention of the participants in a transaction, and at the same time places the emphasis on its form. The Code has premised its treatment of these transactions on the actual intention of the parties, but *Wheatland* and *Atlanta* limit the extent of the examination which can be made in determining that intent. Whether any compensating purpose is served by allowing the use of entire-agreement clauses in this kind of case is highly questionable. They open the door to collusion between the lessor and lessee to insulate the equipment from claims of the lessee's creditors. For example, the parties may simply draw a lease without a purchase option, while making separate arrangements to pass title. If the instrument contains an entire-agreement clause, evidence of the separate arrangements will be inadmissible, and if, as in *Wheatland*, the court considers the absence of a purchase option highly controlling on the issue of intent, it will be impossible to treat the sham lease as a conditional sales contract. As a result, the purpose of section 1-201(37) will be greatly frustrated, and its effectiveness severely inhibited. It should be obvious that entire-agreement clauses may serve a useful purpose in other legitimate transactions, but that in the area of leases intended as security they are retarding the development and use of badly needed standards. It is suggested, therefore, that it would not be inappropriate to deny effect to entire-agreement clauses in this area on the ground that they frustrate an important and clearly expressed policy. This would then permit the introduction of evidence of many other relevant factors, and would allow the courts to make a far more intelligent determination of the true intention of the parties. Such procedure would be in accord with the trend in evidence today, that is, to allow the introduction of more evidence and have any objections go to the weight the court should give it.[30]

As stated above, the development of effective standards and the admis-

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[29] U.C.C. § 1-201(37). See also U.C.C. § 9-102, Comment 1.

[30] See, e.g., 2 Davis, Administrative Law § 14.01, at 251 (1st ed. 1958).

sibility of certain evidence are the two major problems in this area. Codification of standards has not yet presented a complete solution, partly because of judicial acceptance of entire-agreement clauses. As has been suggested, the nullification of these terms may facilitate the development of the ultimate solution. If the courts cannot reach a solution, the law will be faced with the clearly undesirable task of mitigating the harshness of its own inadequacy. Instead of distinguishing these transactions, it will be necessary to penalize the honest businessman by *removing* some of the differences simply because they are effectively undiscoverable. In the same way, it will be necessary to resort to requirements that will provide only partial solutions, such as having all equipment leases filed in a centralized office. Apart from its inefficiency, this kind of response is weak because it reveals a preference for ignoring the functional differences between transactions instead of giving legal effect to them. It is thus clear that standards must be developed and used so that courts may accurately characterize these transactions. It can be hoped that in deciding future cases under section 1-201(37), the courts will recognize that they are involved in fact-finding among many varied cases. If they do recognize this, they will be able to use the tools of section 1-201(37) without seeking the security of overly broad generalizations which only serve to cloud the area.

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