PUBLICATION

Explaining What We Do: Finance Leases Versus Vendor Leases

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Among the challenges we face in selling leasing to business executives who are unfamiliar with sophisticated equipment financings is the task of explaining how our equipment leases differ from a vendor lease or a vendor-financed installment sale financing. This article will touch on some of the aspects of third party equipment financings and the explanations and arguments that might be presented to the uninitiated and his or her lawyers.

When we say "equipment lease" we are generally speaking of a *finance lease* as defined under Uniform Commercial Code Section 2A-103. A finance lease is a lease in which the lessor is not the manufacturer or vendor of the equipment and is only acquiring the equipment for purposes of leasing it to the lessee. Another requirement of the legal definition is that the lessee must either approve the purchase contract or receive specified warranty and supplier information before signing the lease. In other words, the lessor in a finance lease is acting in the same capacity as a lender making a loan in which the equipment is collateral. The lessee selects the equipment and determines that it is appropriate for its use and that the vendor is reliable. The lessor provides money only.

The statutory scheme of Article 2A of the Uniform Commercial Code provides the following mechanics: the lessee in a finance lease is required to make rental payments and otherwise perform under the lease whether or not the equipment works as intended; the lessor assigns all of its rights against the vendor to the lessee; the lessor is not deemed to make any "implied warranties"; and the lessee has no power to revoke acceptance after it has taken acceptance of the equipment. In order to insure there is no implication that these rights are waived, and to make clear the parties' intentions, a well-drafted commercial finance lease generally includes the foregoing concepts as a contractual matter (rather than relying on the statutory framework).

A finance lease is therefore clearly distinguishable from contracts entered into by vendors who are willing to accept payments over time either through an installment sales contract secured by the equipment or a lease transaction. In the case of these documents (referred to in this article as *vendor leases*), it is not uncommon for the vendor to agree to terms that favor the lessee, recognizing that the vendor is not only a lessor but the party who should be responsible for the performance of the equipment and any damage it may cause.[1]

In light of this distinction, and keeping in mind that the position of a finance "lessor" is essentially the same as a secured lender, the following common issues should be easily resolved with a lessee who tries to negotiate a finance lease:

1. <u>There should be no limitations on the warranty disclaimer</u>. It should be clear that, as between the lessor and the lessee, it is the lessee (the party who has selected the equipment) who is solely responsible for any failure of the equipment to operate as warranted. The lessee must look directly to the vendor, rather than the lessor, if there is a problem. The lessor assigns to the lessee any rights the lessor may have to warranties provided by the vendor or manufacturer, at least so long as the lessee is not in default under the lease and during the duration of the lease term. The lessee should not sue the lessor for damage to the lessee's business caused by the failure of the equipment, meaning that the lessee should have no rights to consequential damages and the like.

2. <u>The lessee should agree to make rental payments whether or not the equipment operates (and irrespective of any claims against the lessor)</u>. Just as the lessor is not deemed to make any warranties with regard to the equipment, the lessor has the right to expect the lessee to make all payments "come hell or high water" and irrespective of whether or not the equipment functions (this language is often referred to as the "hell or high water" clause).

A slightly related issue, is that the hell or high water clause should require lessee to make payment even if it has some claim against the lessor. As nothing but a money source, that has no obligation with respect to the quality or operation of the equipment, there shouldn't be claims against the lessor. Even the possibility of such claims obstructing the rent stream due under the lease would make it extremely difficult for the lessor to assign the lease for funding purposes (which is common and often necessary). It often requires some explanation to the lessee, but the lessor must be in a position to assign the lease to a third party and give assurances to that party that the lessee will continue to pay rent and render other performance (such as insurance and maintenance obligations) even if the lessee has a claim against the lessor and irrespective of whether the equipment works properly.

Note, lessees can take comfort in the fact they are *not* waiving all rights to sue the lessor, whether or not the lease is assigned. The lessor should remain legally liable if it has made promises to the lessee outside of the lease transaction, such as a promise to provide future financing. The lease itself, however, should not be affected by any of these claims. Just as the lessee must continue to make payments on a promissory note for a loan to finance its purchase of equipment whether or not the lessee believes it has a claim against the lender, rent payments under the lease are absolute and unconditional and not subject to deduction or set-off.

3. <u>The lessee should be responsible for damage caused by the equipment to third parties</u>. Some lessees argue that the lessor should not be indemnified against its own negligence and that any lessee indemnity should not include the lessor's negligence or negligent conduct. This is entirely understandable, but the lessor should generally insist that it only be responsible for its willful misconduct. Some lessors are also willing to be responsible for *gross* negligence, meaning generally that they or their employees and agents acted with a conscious and voluntary disregard of the need to use reasonable care.

One of the unfortunate results of labeling a finance lease a "lease" rather than a "loan" is that the lessor, as owner of the equipment, may be confused with a short term rental operation and may find itself the target under a line of cases holding that renters are responsible for damage caused by the equipment. This liability includes "vicarious liability" under which negligence by the lessee is imputed to the lessor as a matter of law. There are also "products liability" cases in which due to the nature of the equipment and its function or simply because the equipment is placed in the stream of commerce by the owner/renter, the lessor may be held legally liable for damage caused by the equipment whether or not the lessor has been negligent.

Even if proof of lessor negligence is required, lessors have good reason to fear that a confused and often biased jury holding that the lessor should be responsible for damage caused by "its own" equipment. Also, the lessor may actually be sued on the basis that it was negligent in trusting the lessee to operate the equipment or in not overseeing the operation closely and inspecting both the equipment and the qualifications of its operator.

The presumption must always be that any lawsuit or other third party claim is the responsibility of the lessee. This result stems from the fact that the lessee has the right to use the equipment with minimal restrictions and should be fully responsible for the equipment itself. For this reason, arguments that the lessee should only indemnify the lessor for damage caused due to the lessee's negligence are unreasonable. The lessor should know that it will not be the subject of any lawsuit or other claim and that should such a situation arise, the lessor will be indemnified and the lessee will maintain the defense litigation.

Moreover, one of the most important aspects of indemnification is that the lessee will be responsible for maintaining defense of any such action, meaning that it (or its insurance) will provide legal representation and whatever work is necessary to provide for the lessor to be dismissed as a defendant. It is obviously problematic for the lessee to be able to avoid the obligation to defend any action to the extent the claim by the injured party assert negligence on the part of the lessor.

4. The lessee's end of term obligations are an essential component of a finance lease. In order for the lessor to offer the lessee the benefits of an assumed residual value, meaning that the lessor does not have to collect 100% of its investment with interest at a high rate through the rentals alone, the lessor needs contractual protections to help it realize the assumed residual value at the end of the term from a third party if the lessee elects not to purchase the equipment. Generally speaking, these protections include knowing that the equipment will be returned in saleable condition; that the lessee will bear the costs of return; and that the equipment will be returned when required under the lease and to the location designated by the lessor.

Very often, vendors are willing to make concessions in vendor leases at the end of the lease term since they are frequently in the used equipment business and often because they are in a unique position to control end of term valuations. Finance lessors, who are most often banks and other financiers, generally are not in the same position and therefore unwilling and unable to make such concessions.

Conclusion

At the end of the day, a finance lease is not much different from a traditional bank loan in concept. Traditionally, a company borrows from a bank or other lender, signs a note and uses the money to buy equipment which it pledges to the bank as collateral. If the equipment does not work, the company may have a claim against the vendor, but it cannot withhold payment on the note or sue the lender. If the equipment injures someone, the lender should not face any risk of liability; only the borrower/user will be liable for damage caused by equipment it operates.

A finance lease lessor expects essentially the same transaction, while often offering its customers terms that are not available in a straight loan.

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[1] It is interesting that a vendor captive, which is a corporation or other entity owned by the vendor or part of the vendors corporate family may also be a lessor under a finance lease. See, e.g., *Siemens Credit Corp. v. Newlands,* 905 F. Supp. 757 (N.D. Cal. 1994).