Equipment Leasing and Finance 101

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The Equipment Leasing and Finance Industry

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• In 2014, American businesses, nonprofits and government agencies invested more than $1.4 trillion in capital goods and software (excluding real estate). Approximately 65% (or 900 billion) was financed through loans, leases and other financial instruments.
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- A historical/industry perspective is important and it is not enough to only understand the various discrete legal, documentation and other concepts applicable to equipment leasing and finance…
Specialized Area With Deep, Historic Roots

"Can't see the forest for the trees."
Not Traditional Bank Financing

• Even the most experienced equipment leasing and finance professional should remind themselves from time to time about the unique nature of this industry.

• The industry approaches issues and documentation differently because of its history and origins, viewing transactions through its own special lens…
**Not** Traditional Bank Financing
The 1800s

- The first significant recorded equipment leasing transactions related to transportation needs in the 1870s with the leasing of barges, railroad cars and locomotives using equipment trust certificates.

- Trusts continue to be used in more structured transactions like leveraged leases and in titling trusts (facilitating motor vehicle syndications).
Leveraged Lease and Titling Trust

- Equity Investor/Owner Participant
- Owner Trust/Lessor
  - Lessee
- Debt/Indenture Trustee
- Titling Trust/Lessor
  - Lessee
- Lease/Finance Co.
  - Beneficial Interest Holder
  - Beneficial Interest
  - Assignee
- Subtrust
- Lease/Finance Co.
1950s and Tax Benefits

• Truly modern equipment leasing began to hit its stride in the 1950s with the introduction of the depreciation system to the U.S. Internal Revenue Code. This system allows owners to recover the cost of purchased assets over time by way of periodic deductions or offsets to income.

• If a customer doesn’t have sufficient “tax appetite” to benefit from these deductions, a financial institution or other tax equity investor can purchase the equipment, owning it for tax purposes, and lease it to the customer, as lessee (passing on some of the benefits through pricing).
Definition and Return on Investment (ROI)

• In general, a "lease" is an arrangement where one person, the lessor, owns an asset and provides possession and use of the asset to another person, the lessee, for a fixed term. See UCC §1-203 for more complex issues of lease versus security interest.

• In return, the lessor receives compensation, known as rent. Usually, at the end of that term, the lessee either: (a) returns the asset to the lessor or (b) purchases it from the lessor. A component of the lessor’s return is therefore derived from the value of the equipment at the end of the term, whether purchased by lessee or someone else (often referred to as the “residual”). The owner also receives tax benefits such as depreciation deductions.
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Evolution to Reduce Risks

• Lessors want the contemplated return on their investment (through tax benefits, rent and the residual) but *with minimal risk*.

• Lessee is responsible for:
  - taxes
  - insurance
  - maintenance
  - risk of loss or casualty
Pushing the Envelope

- Lessors work to minimize the residual risk through special options such as:
  - First amendment option (purchase or renew – not return)
  - Dollar purchase “option”
  - Difficult return conditions
  - Evergreen lease
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Evolution of the Law

• If the lessor buys from the vendor solely to lease to the lessee, the lessee has possession from day one, and the lessee will undoubtedly end up owning the equipment, then *is it really a lease?*
  - Dollar-out leases
  - Non-tax leases
  - Capital leases
  - Dirty leases
  - Disguised security interests
  - Financing leases
  - Leases intended as security
  - ALIAS’s
Evolution of the Law

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  - Dollar-out leases
  - Non-tax leases or non-true leases
  - Capital leases *(accounting term)*
  - Dirty leases *(sounds well … dirty)*
  - Disguised security interests *(feels sneaky)*
  - Financing leases *(not Article 2A finance lease)*
  - Leases intended as security *(intent not relevant)*
  - ALIAS’s *(intent not relevant)*
Evolution of the Law

• In fact, the majority of “leases” are actually merely secured loans.

• The legal and accounting professions eventually adjusted but there are different tests for accounting, tax and commercial law (like bankruptcy).

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- Not always the same (e.g. a *synthetic lease*).
Equipment Finance Agreements Master Loan and Security Agreements

• Due to confusion caused by leases that are merely secured loans (e.g. lessor liability, state and local taxes) the dollar-out lease is slowly being replaced with loan documentation derived from its leasing roots.

• Examples include equipment finance agreements (EFAs) and variety of “master agreements” which may or may not involve separate promissory notes.
Why Customers Use Equipment Leasing and Finance

**True Leases**

- Monetize tax benefits
  - Customers with net operating losses (NOLs)
  - Expensive equipment
  - Extra tax incentives such as bonus depreciation, investment tax credits (ITCs) and production tax credits (PTCs)

- Balance sheet effect (*landscape is changing*)

- Asset management/convenience
Why Customers Use Equipment Leasing and Finance

**Equipment Financings & Leases**

- 100 percent financing without loan to value (LTV) requirements
- Efficient, quick and inexpensive compared to traditional bank financing
  - Form driven
  - Reliance on purchase money priority
  - Understanding equipment as collateral
  - Use of “master” agreements to facilitate growth
  - Robust syndication market with well-defined law
Why Customers Use Equipment Leasing and Finance

**Equipment Financings & Leases**

- Customer’s internal approval structures
- Free up other credit lines
- Restrictions in senior credit facilities
- Less likely to impose financial covenants/restrictions
UCC, Financing Structure and Purchase Options

• Determining whether the financing is a lease or loan is critical. In general Uniform Commercial Code Article 9 will govern the collateral rights of the parties in a lending structure and UCC Article 2A will govern the rights of the parties in a “true lease” structure.

• A number of factors may be considered in determining lease v. loan. Purchase options are an important factor.
Purchase Options

• As stated earlier, if the structure is deemed a loan, then Article 9 will govern the rights of the parties vis a vis third parties that might have competing interests in the equipment. If it is a true lease, then Article 2A is the relevant UCC provision.

• The following slides address different types of purchase options and how they affect the characterization of the financing.
“True Lease Purchase Options”

• FMV Purchase Option. Here the lessee has the right to either return the equipment at the end of the lease or purchase it at its then current fair market value.

• Fixed Price Purchase Option. So long as the fixed price is a price that at the inception of the lease is a reasonable estimate of the fair market value of the equipment at the end of the lease term – when the FPO will be exercised.
“True Lease Purchase Options” (cont’d)

- FMV Purchase Option with a Floor. Here the purchase option is the greater of FMV determined at the end of the term or a fixed price determined at lease inception.
Purchase Options Resulting in Loan Treatment

• Nominal (Dollar Out) Purchase Option. In these cases, the purchase option offered to the lessee is an amount significantly below a reasonable estimate, determined at the inception of the lease, of the fair market value at the end of the lease term. A “dollar out” lease will most certainly result in the lease being characterized as a loan. Keep in mind that even if $1 is the reasonable estimate of the FMV at the end of the lease, then this will still be a loan because in almost any instance the lessee will have used up the useful economic life of the equipment involved.
Mandatory (Put) Purchase Option. Here, the lessee must purchase the equipment at the end of the term for an amount specified at the beginning of the lease.

In all the above cases, the question is who receives the financial benefit of the residual value of the equipment? If it’s the lessee, either through the ability to purchase the equipment at a bargain after the lease term or by its being able to use the equipment for its useful financial life, then it’s a loan. If the lessor retains the financial benefits of the value of the equipment at the end of the term, and the equipment still retains its relative economic useful life, then it’s a lease.
Walking on the Edge

• How about around the edges? Many financing parties have become comfortable with the notion that if the equipment is believed to contain at least 20 – 25 percent of its remaining useful life and 20 – 25 percent of its initial fair market value at the end of the lease term, then a purchase price of at least 20 – 25 percent of the initial FMV will not change the characterization from a lease to a loan. Some have decided that smaller numbers are okay depending on the type of equipment and the length of the lease. Accountants and tax advisors vary and I encourage anyone to consult with both when including fixed price purchase options in their “true” leases.
Special Purchase Options

- TRAC Lease. This type of true lease may only be done with motor vehicles and are governed by special federal and state laws. A TRAC lease contains a “Terminal Rental Adjustment Clause”. In essence, the lessee is given a FPO (the “TRAC Amount”) which must be an amount reasonably estimated to be equal to the end of term FMV. At the end of the term, the lessee either purchases the vehicle for the TRAC Amount, sells it to a third party and pays the purchase price and any deficiency to the lessor. If the purchase price exceeds the TRAC amount, the lessee keeps the excess.
Special Purchase Options

- Split-TRAC Lease. This type of true lease is similar to the TRAC lease, except, the Lessor takes some negotiated risk on the TRAC Amount. Let’s assume it’s 5 dollars and the TRAC amount is 20 dollars. Assume the lessee elects not to purchase at end of the lease and sells the vehicles. In our current example, the Lessor is taking a risk on 5 dollars of the initial costs, hence, the least amount it can receive is 15 dollars – not the 20 dollars TRAC amount. And the lessee’s maximum exposure is 15 dollars. Hence, if the vehicles are sold for 20 dollars, the lessor gets all the money. If the vehicles are sold for 13 dollars, the lessee kicks in 7 dollars. If they are sold for 17 dollars, the lessee kicks in 3 dollars. If the equipment sells for 2 dollars, then the lessee kicks in 15 and the lessor ends up with 17. More than 20 dollars and excess goes to the lessee.
Special Purchase Options

• Early Buyout Option. In the EBO situation, the lessee may purchase the equipment on a specific date during the lease term (the “EBO date”) for a specified fixed price. That price, determined at the inception of the lease, is the estimated FMV on the EBO date. An EBO purchase option should not destroy the true lease characterization of the lease.
Special Purchase Options

• Early Termination Option. Lessee has the right to terminate the lease prior to lease end on a specific date. The lessee generally has an obligation to assist the lessor in selling the equipment and insuring that some minimum agreed purchase price is achieved or paying an amount that brings the overall price to the minimum agreed price. The minimum agreed price is determined at lease inception and is the estimated FMV at the time of purchase.
Special Tools

- Companies heavily involved in the equipment leasing and finance industry are generally very familiar with a special tool that is a key building block for many deals.

- It’s a bird…

- It’s a plane…
Purchase Money Security Interest

• It a SUPER-PRIORITY purchase money security interest!
Purchase Money Security Interest

- Sometimes called a “P-M-S-I” and other times referred to as a “Pimsy,” this super-priority rule is one of the most famous exceptions to the first to file or perfect rule.

- Many companies in our industry rely on this concept to decrease the administrative expense and funding delays that would result from searching UCC filings for each transaction and obtaining subordinations from any existing lenders with conflicting security interests.

- Although the concept is straight-forward, as is often the case, the devil . . . er . . . Kryptonite is in the details.
The technical definition of a purchase money security interest is as follows:

(1) a security interest “in goods is a purchase money security interest to the extent the goods are purchase money collateral with respect to that security interest.” UCC §9-103(b)(1)

(2) the goods are “purchase money collateral” if they secure “a purchase money obligation incurred with respect to that collateral.” UCC §9-103(a)(1)

(3) a “purchase money obligation” is “an obligation of an obligor incurred as all or part of the price of the collateral or for value given to enable the debtor to acquire rights in or use of the collateral if the value is in fact so used.” UCC §9-103(a)(2)
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Goods

- Traditionally, purchase money collateral could only consist of “goods” which means all things moveable when a security interest attaches.

- “Goods” include equipment, inventory, fixtures, and software embedded in Goods (other than goods that consist solely of the medium in which the software is embedded).

- In 2001, the Uniform Commercial Code expanded this concept to allow purchase money security interests in software which is not embedded in the goods (which is a General Intangible under Article 9) if (1) the debtor acquired its interest in the software in an integrated transaction in which it acquired an interest in the goods; and (2) the debtor acquired its interest in the software for the principal purpose of using the software in the goods.
Super-Priority

• A PMSI is *not* automatically entitled to priority.

• Priority is only provided to the extent provided in §9-324 of the UCC.

• For *equipment*, the security interest to be “perfected” no later than 20 days after the Debtor receives possession of the collateral.

• Inventory is different, and discussed later.

• Fixtures can technically be either equipment or inventory.
Why Priority

• The concept of a PMSI arose to encourage borrowers, even those who have already pledged assets, to acquire new items financed by the vendor or a third party lender who makes the acquisition possible.

• It prevents a strangle-hold by existing lenders with all asset liens (although it can still happen contractually).

• The existing lender is not disadvantaged in any way by granting priority to the PMSI lender because, but for the loan made by the PMSI lender, the purchase money collateral would not be owned by the debtor in the first place.

• Filing is required within a certain period of time to prevent “secret” liens.
The Enabling Prong

- Unless the PMSI is a vendor retaining a lien (or “reserving title”) for part of the purchase price, the funds must “enable the borrower to acquire the equipment.”

- Easiest solution, *fund the vendor directly*.

- Reimbursements to the lessee/borrower can be problematic (enable to *acquire* versus enable to *retain*).
The Possession Prong

- Sometimes it is easy to determine when possession begins because the borrower signs some form of delivery receipt with a third party or the vendor has written evidence of the date of delivery.
The Possession Prong

• Sometimes it is easy to determine when possession begins because the borrower signs some form of delivery receipt with a third party or the vendor has written evidence of the date of delivery.

• You’re lucky. It’s a good day to buy a lottery ticket.
The Possession Prong

• Sometimes the situation is confusing, such as where the period between the delivery and the date of acceptance is extended due to testing, repair, additional deliveries of necessary pieces, etc.
The Possession Prong

- Sometimes the situation is confusing such as where the period between the delivery and the date of acceptance is extended due to testing, repair, additional deliveries of necessary pieces, etc.

- The 20 day period begins when “it would be apparent to a potential lender to the Debtor that the Debtor has acquired an interest in the goods taken as a whole.” UCC § 9-324, Official Comment No. 3.
The Possession Prong

- Sometimes the debtor has possession of the equipment but not as an owner able to grant a security interest (e.g. a rental conversion).
The Possession Prong

• Sometimes the debtor has possession of the equipment but not as an owner able to grant a security interest (e.g. a rental conversion).

• “Under section 2A-307(1), creditors of the lessee generally take subject to the lease contract; filing a financing statement against the lessee is unnecessary to protect the Lessor’s leasehold or residual interest. Once the lease is converted to a security interest, filing a financing statement is necessary to protect the seller's (former Lessor’s) security interest. Accordingly, the 20-day period in [this Section] does not commence until the goods become “collateral” (defined in section 9-102), i.e., until they are subject to a security interest.” U.C.C. § 9-324, Official Comment No. 3.
The Possession Prong

• For middle market transactions, you often have an invoice that’s more than 20 days old, and not much else.
The Possession Prong

• For middle market transactions, you often have an invoice that’s more than 20 days old, and not much else.

• Set up internal policies designed not only to ensure you are within the window but also whatever evidence you can provide, e.g.
  - Acceptance certificate with verification of possession date
  - Bills of lading or other third party verification
  - Verbal or email verification with the vendor (internally documented)
Cross-Collateralization

• Cross-collateralization is a common credit requirement but only the purchase money obligation is entitled to super-priority.

• When Article 9 of the Uniform Commercial Code was completely rewritten in 2001, the old “transformation rule” was killed. Article 9 now provides that “a purchase-money security interest does not lose its status as such, even if… the purchase-money collateral also secures an obligation that is not a purchase-money obligation.” UCC §9-103(f)(1).

• Secured party can have “dual status” of both (1) a purchase money lien and (2) a non-purchase money lien.
Cross-Collateralization

Consider adding language requiring payments to first be applied specifically to the non-PMSI portion of the debt. See UCC §9-103(e) ("In a transaction other than a consumer-goods transaction, if the extent to which a security interest is a purchase-money security interest depends on the application of a payment to a particular obligation, the payment must be applied: (1) In accordance with any reasonable method of application to which the parties agree; and (2) In the absence of the parties’ agreement to a reasonable method, in accordance with any intention of the obligor manifested at or before the time of payment...")
Refinancings, Restructurings or Consolidations

- “[A] purchase-money security interest does not lose its status as such, even if … the purchase-money obligation has been renewed, refinanced, consolidated or restructured.” UCC §9-103(f)(3)
- It is best to document the refinancing, consolidation or restructuring accordingly, especially if the lender/lessor changes.
§ 9-324(b). Priority of Purchase-Money Security Interests in Inventory

Subject to subsection (c) and except as otherwise provided in subsection (g), a perfected purchase-money security interest in inventory has priority over a conflicting security interest in the same inventory, has priority over a conflicting security interest in chattel paper or an instrument constituting proceeds of the inventory and in proceeds of the chattel paper, if so provided in Section 9-330, and, except as otherwise provided in Section 9-327, also has priority in identifiable cash proceeds of the inventory to the extent the identifiable cash proceeds are received on or before the delivery of the inventory to a buyer, if:

1. the purchase-money security interest is perfected when the debtor receives possession of the inventory;
2. the purchase-money secured party sends an authenticated notification to the holder of the conflicting security interest;
3. the holder of the conflicting security interest receives the notification within five years before the debtor receives possession of the inventory; and
4. the notification states that the person sending the notification has or expects to acquire a purchase-money security interest in inventory of the debtor and describes the inventory.
Specialized Equipment

- Protection of secured parties’/lessor’s interest in most equipment will be governed by Articles 2A and 9 of the UCC. However, under UCC Sections 9-303(c) and 9-311(a), protection of the lender’s interest in certain certificated types of equipment will be governed by the title statutes of the applicable jurisdiction under which the goods are certificated. In the case of vehicles, that would be the state. With respect to other goods, such as aircraft or vessels, it would be the federal statutes.
Specialized Equipment

- There are other unique aspects surrounding equipment types.
- Using motor vehicles again as an example…
Specialized Equipment

- There are other unique aspects surrounding equipment types.
- Using motor vehicles again as an example…
  - Leasing or subleasing is common (quiet enjoyment issues)
  - Non-uniform 9-311(d) in Idaho, Illinois, Louisiana and Rhode Island (UCC, rather than COTA, applies even if lessee/borrower are in the business of leasing, rather than selling
  - Special Accession Rule (title trumps even PMSI in accession)
  - Lessor liability (Graves Amendment)
Protecting the Value of the Equipment Collateral

- It is very important to the lessor in a true lease situation and the lender in a loan transaction that the Equipment maintain its value throughout the term of the financing. It is particularly important in the true lease situation where the lessor expects that the equipment will be returned.

- Lenders and lessors protect the value of the collateral by including provisions on maintenance, return conditions, lien lifting and insurance, among other things.
Return Conditions

Return Conditions. Leases generally provide that leased equipment will be returned to the lessor in the same condition as when originally leased with ordinary wear and tear excepted.

Depending on the specific type of equipment, more detailed return conditions may be required. Other return conditions include:

- Deinstallation, disassembly, crating and shipping.
- Removal of markings, removal of waste and fluids.
- Compliance with any current rules and regulations applicable to the equipment.
- Maximum usage provisions and similar items.
- Inclusion of service manuals, blue prints, operational manuals and service records.
- Rights to inspect prior to return.
- Continuation of lease payments until the equipment complies with return conditions.
Maintenance

• Financing documentation will require that the equipment be maintained in good operating condition, order and repair, normal wear and tear excepted.

• Equipment will also be maintained in accordance with some objective standard (i.e., manufacturer’s recommended, industry standard…)

• Lessee will be required to make all modifications required to comply with applicable law.

• Tagging to show lessor/lender’s interest.
Casualty Value

- In the event that the equipment is destroyed during the term of the lease or loan financing, the lessee will be required to pay the casualty or stipulated loss value.

- The Casualty Value is an amount (usually shown in a schedule where the amount adjusts on a periodic basis often coinciding with the payment schedule). In essence, the CV is an amount which will include the amount (often present valued) of all the future rent/loan payments to be paid through the stated term of the lease, plus, in the case of a lease, the estimated FMV of the equipment at the end of the lease, plus, in a lease situation, an amount equal to the loss of economic benefits due to the early termination of the lease.

- In a lending transaction the CV will include the future payments under the loan (sometimes present valued), including any balloon payment. There may also be some prepayment premium or breakage costs to be paid as well.
Casualty Value (cont’d)

• The casualty value is generally insured in the event of a casualty occurrence. That is, the insurance casualty amount will be at least equal to the casualty value of the equipment at the time of the casualty occurrence as calculated under the lease.
Questions

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