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THE TREATMENT OF EQUIPMENT LEASES AS SECURITY AGREEMENTS UNDER THE UNIFORM COMMERCIAL CODE

JOHN R. PEDEN*

INTRODUCTION

Like any other form of installment credit or loan transaction providing for the debtor's acquiring possession of goods, an equipment lease enables the lessee to obtain the use of goods without providing the full capital. Similar to a conditional sale or chattel mortgage, the equipment lease also enables the financier to protect his investment by retaining title to the leased goods. However, the reasons for the increased popularity of leasing are not merely credit and security, since these benefits have been readily available in conditional sale and chattel mortgage transactions. Leases are used to achieve other functional and legal purposes. Yet, the Uniform Commercial Code classifies some types of leases in the same category as conditional sales and chattel mortgages, namely as security agreements.

In this article, the purpose and function of the equipment lease will be analyzed to determine whether, under the Uniform Commercial Code, such leases require treatment different from other security agreements. The present definition of security interest in section 1-201(37) of the Code will be examined, with particular attention given to leases in order to determine the extent to which this definition is consistent with the basic objectives of Article 9. Reference will be made to the tests applied by the courts in interpreting and applying this definition, and an attempt will be made to answer the following questions:

- (a) Is it feasible to distinguish between a lease intended as a security device and a "true" lease not so intended?
- (b) If the distinction is feasible, what test or tests are most appropriate to give effect to the policy underlying Article 9?

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- (c) What policy reasons would favor a blanket rule requiring the filing of a financing statement in respect of all leases involving a stipulated minimum term and rental in order to preserve the lessor's interest against lien creditors of, or purchasers from, the lessee?
- (d) Should these policy reasons prevail?

REASONS FOR LEASING

A number of diverse factors may influence parties to choose the lease form. These factors do not remain constant or of equal importance, but vary according to the needs of the parties and changes in different areas of the law. Sometimes a lease transaction structured to take advantage of one factor will automatically preclude the achievement of an alternative advantage. It may be argued that a review of the economic and legal reasons for the increased incidence of leasing are irrelevant to the status of a lease for purposes of Article 9. However, it is submitted that any thorough inquiry cannot ignore these reasons, since the definition of a security interest under the Code hinges upon the intention of the parties to the lease agreement.¹

Leasing of equipment is not a new device. It has been used at least since the opening of the railroads in the second half of the nineteenth century, in a form which came to be known generally as the "Philadelphia-Plan" equipment trust.² Since World War II, leasing has received a substantial stimulus from the general movement toward a credit economy and the business community's acceptance of debt financing. However, even these two occurrences do not fully explain the increasing popularity of leasing³ relative to other forms of credit financing.

1. UNIFORM COMMERCIAL CODE § 1-201 (37) [hereinafter cited as U.C.C.].

2. See generally FREEMAN, *EQUIPMENT TRUSTS* (1949); Rawle, *Car Trust Securities*, 8 A.B.A. REP. 277 (1885).

3. In 1955, it was estimated that 10 percent of all equipment then being manufactured would be leased. Griesinger, *Pros and Cons of Leasing Equipment*, 33 HARV. BUS. REV. 75 (1955).

It has been estimated that gross rentals under equipment leases quadrupled to \$400 million in the decade 1950-1960. Adkins and Bardos, *The Leasing Transaction*, 1962 U. ILL. L.F. 16.

In 1959, Charles W. Steadman stated: "[T]his leasing activity is confined almost entirely to the United States. It is a peculiarly American answer to the problem of the lack of adequate capital resources . . ." Mr. Steadman attributed this peculiarity to "rising costs and the inadequate depreciation policies of the federal government's tax program." Steadman, *Chattel Leasing—A Vehicle for Capital Expansion*, 14 BUS. LAWYER 523 (1959). Since 1959, the trend has crossed the Atlantic to Great Britain and the Pacific to Australia. See Truswell, *Equipment Leasing: A New Financial Technique*, 108 SOL. J. 867 (1964). Available statistics for financing by Australian finance com-

Until 1954, taxation was one dominant reason for leasing. Other recurrent reasons were the real and supposed advantages obtained from the omission of leased assets from the lessee's balance sheet. Each of these reasons is now of diminished importance.

In the following discussion, the term true lease is used to refer to leases not intended as security and which therefore properly fall outside the scope of Article 9. Although the distinction is close to that drawn by the financial analyst between an operating lease and a financial lease, it is the Article 9 test which is important for present purposes.

Income Tax Reasons

The income tax advantages of a sale and lease-back of real estate are well known and documented.⁴ Tax reasons predominate in the real estate situation because land itself cannot be depreciated for tax purposes,⁵ although rental paid to a third party for the use of land is fully deductible.⁶ On the other hand, the total capital cost of equipment can be deducted as depreciation. From a taxation viewpoint the choice between leasing and purchasing will depend, for the most part, upon a comparison of the rate of depreciation allowed with the rental cost. Where the minimum depreciation period is longer than the normal rental term, leasing will afford a means of obtaining greater tax deductions in early years. Of course, the tax advantages eventually expire,

panies show that the initial capital cost of equipment and plant financed by true lease during the financial year 1968-69 was double the amount for 1966-67. In the fastest developing state of Western Australia, the 1968-69 figures were three times those for 1966-67. By way of comparison, wholesale hire-purchase of inventory by the same companies rose by only 30 percent for the nation and 32.7 percent for Western Australia during the same period and other commercial loans by 57 percent and 84 percent respectively. COMMONWEALTH BUREAU OF CENSUS AND STATISTICS, FINANCE COMPANIES 1968-69.

4. Cary, *Corporate Financing through Sale and Lease-Back of Property: Business, Tax and Policy Considerations*, 62 HARV. L. REV. 1 (1948); Cary, *Current Tax Problems in Sale, or Gift, and Lease-Back Transactions*, in N.Y.U. 9TH INST. ON FED. TAX. 959 (1951). But see Lassers, *Does a Lease-Back Save You Money?*, 32 TAXES 279 (1954).

5. INT. REV. CODE of 1954, § 167 and Treas. Reg. § 1.167(a)-2 (1956). The advantages under the Australian Income Tax Law are even more marked, since depreciation is confined to plant and articles used or installed ready for use for the purpose of producing assessable income. The only exceptions are fences, dams, and other structural improvements on agricultural or pastoral land or for pearling operations, plumbing fixtures and fittings on business premises for the use of employees, and building structures to the extent to which they are essential to the support of working plant. Income Tax and Social Services Contribution Assessment Act, § 54, 1936 as amended (Austl.).

6. INT. REV. CODE of 1954, § 162(a)(3). The benefit of this tax deduction must be balanced against the fact that the lessee gains no capital appreciation of an owned asset as a hedge against inflation and is left with no asset at the expiration of the lease.

but in the meantime the lessee has had the opportunity to arrange his higher rentals to correspond with high income years and to defer payment of tax.

Where the higher rentals in earlier years exceed the interest cost of borrowing the capital to purchase the equipment (and this higher cost would not be fully recouped by tax savings), the lease method will tend to reduce rather than increase available working capital. This is one illustration of the point already mentioned that certain advantages of leasing are self-cancelling and only available in the alternative.

The tax advantage of leasing resulting from the slow depreciation methods permissible was largely removed by the 1954 amendments to the Internal Revenue Code, which permitted methods of accelerated depreciation.⁷ While some tax situations may still tip the scale in favor of leasing, most commentators agree that the previous marked advantage no longer exists. Nevertheless, it has been demonstrated that in certain situations depreciation may offer positive tax advantages when compared to rental payments.⁸ Other less important tax advantages may still be available, such as arranging for rentals to be tied to the same variables as profits (for example, the number of units produced by the leased equipment), thus performing the economic function of equity financing and resulting in a tax deduction at the same time.⁹

From the lessor's viewpoint, the 1954 amendments enhanced the advantages of leasing, since available depreciation deductions in the early years of the equipment's useful life were accelerated. However, the following practices used by lessors to increase their tax savings have now been rejected by the courts.

(a) A lessor intending to hold assets for only a part of their useful

7. *Id.* § 167(b). This section substituted for the previous straight-line method a choice available to the taxpayer of: (1) the straight-line method; (2) the declining balance method at a rate not exceeding twice the rate under (1); (3) the sum of the years digits method; and (4) any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the taxable year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed under method (2). Under method (2), two-thirds of the capital cost may be written off during the first half of the useful life of the equipment; and under method (3) approximately 70 percent may be depreciated during that period.

8. Gant, *Illusion in Lease Financing*, 37 HARV. BUS. REV. 121, 126, exh. II (1959).

9. Dean, *The Economics of Equipment Leasing*, 1962 U. ILL. L.F. 33, 39. However, field surveys indicate that this type of arrangement is generally confined to true use leases, for example, of highway construction equipment or photocopying machines for relatively short initial periods.

life would use accelerated depreciation methods based upon cost less a low salvage value, which itself was based upon the assumption that the assets would be held for their entire useful life. The court substituted for salvage value the estimated value upon contemplated resale by the lessor.¹⁰

(b) Similarly, where the taxpayer used the declining balance method, which ignores salvage value, the court prohibited depreciation to a lower level than the estimated resale value.¹¹

(c) Where the lessor holds assets for less than three years, the accelerated methods of depreciation introduced in 1954 are not available. These methods are limited to property with a useful life of three years or more, and in this context useful life means useful life in the business of the lessor.¹²

Another advantage previously available to lessors has been removed by the depreciation recapture provisions introduced in 1962. Prior to that date, where a lessee was not offered or did not exercise an option to purchase the equipment, a resale by the lessor afforded an opportunity for the additional profit to be taxed at capital-gains rate.¹³ Since 1962, under section 1245 of the Internal Revenue Code, any gain on the disposition of such property attributable to depreciation must be recaptured and treated as ordinary income of the lessor.

The theoretical possibility remains of the lessor reselling, for less than the adjusted basis, equipment upon which the lessor has already fully recouped from rentals its capital costs plus interest. If both lessor and lessee had the benefit of hindsight, this additional profit would not have been available to the lessor, since in theory it represents the higher price which the lessee must pay for the lessor's assuming the risk of obsolescence. In effect, the lessee has insured a possible loss which did not materialize; the lessee has paid in rentals the full market price for the use of equipment during a period of time which turned out to be substantially less than the economic life of the equipment. The lessor has gambled on a longer useful life, and won.

One definite tax advantage does remain for the lessor of equipment, in that it may be able to depreciate the equipment over a shorter period than an owner-user who must use the economic or useful life span. In contrast, the lessor will normally be able to treat the initial term of

10. *Massey Motors, Inc. v. United States*, 364 U.S. 92 (1960) (decided under the 1939 Code).

11. *Hertz Corp. v. United States*, 364 U.S. 122 (1960) (decided under the 1954 Code).

12. *Id.*

13. *Steadman*, *supra* note 3, at 539.

the lease as its economic life. However, the lessor's advantage will be confined to deferral, rather than reduction, of tax liability because of the recapture provisions.

In the special situation of equipment leases between associated taxpayers, total income tax liability may be reduced by splitting income. However, because of high corporate tax rates and the need to set rentals in line with current market prices and justify the leasing transaction as serving a legitimate business purpose, this possibility is likely to operate as a rather limited incentive.¹⁴

Thus, as recently as 1962, the president of a substantial leasing corporation readily admitted: "The illusion of massive tax advantages has died slowly but today few responsible lessors are basing their sales appeal for lease contracts on tax advantages."¹⁵

Financing and Accounting Reasons

Proponents of leasing allege that leasing makes possible a greater aggregate volume of financing.

This question of whether lease financing can *in fact* make it possible to have the cake and eat it too is perhaps the most significant, and certainly the most disturbing, issue raised by the growing trend toward leasing.¹⁶

Viewed objectively, the adoption of leasing as a substitute for debt financing should not enable a corporation to borrow more. Most industrial debt financing is unsecured, reliance being placed primarily upon the general credit of the borrower.

And since a lease is also a form of general credit obligation, a company should be able to obtain *at least* as much financing through a direct loan as it can through a lease commitment.¹⁷ (Emphasis supplied).

14. Comment, *Acquisition of Industrial and Commercial Equipment through Leasing Arrangements*, 66 YALE L.J. 751, 758-59 (1957).

15. Boothe, *The Practical Pros and Cons of Leasing*, 1962 U. ILL. L.F. 1, 3.

16. Gant, *supra* note 8, at 130.

17. *Id.* Emphasis has been added to the words "at least" since the evidence indicates that, depending upon the source of debt financing available to the borrower, the total cost of leasing normally runs up to one percent higher than ordinary debt financing, thereby weakening slightly the profitability and cash flow position of the borrower. Witherby, *Personal Property Lease Financing—The Lender's Point of View*, 1963 DUKE L.J. 98, 101. Cf. Boothe, *supra* note 15, at 10; Dean, *supra* note 9, at 40-42; Gant, *supra* note 8, at 126.

Despite these objective facts, corporate borrowers have been able in the past to obtain more credit by using a combination of leasing and debt financing.¹⁸ Traditional debt obligations undertaken subsequent to leasing may also be marketed at lower interest rates than would otherwise have applied. The availability of larger borrowings at lower rates has often more than compensated for the higher cost of leasing. These anomalies were made possible by prevailing conventions in the presentation of the balance sheet of corporate lessees.

Accounting theory today generally provides that installment obligations for equipment purchased under conditional sale agreements must be capitalized and disclosed as a liability in the buyer's balance sheet, and that the equipment must correspondingly be recorded as an asset. In the case of equipment held under a long-term lease, however, many companies continue to omit the liability and the asset from their balance sheet and merely record rentals as recurrent expenses in the period in which they are paid. This practice has several advantages for the lessee: it enhances the ratios of its assets to debt, net worth to debt, and earnings to debt. Thus, the practice represents an inflated appearance of creditworthiness and profitability. While it appears that institutional investors,¹⁹ the Securities and Exchange Commission,²⁰ and professional accountants are aware of this situation, smaller lenders and shareholders are less likely to take into account the possibility that a company's balance sheet may not record the true picture.

More recently, action has been taken by the American Institute of Certified Public Accountants to rectify this situation. In 1949, the Institute recommended that:

18. MYERS, REPORTING OF LEASES IN FINANCING STATEMENTS 13 (AICPA Accounting Research Study No. 4, 1962).

19. Cohen, *The Future of Lease Financing Under New Depreciation Rules*, 98 J. ACCOUNTANCY 189, 192 (1954).

20. SEC Reg. S-X, 17 C.F.R. § 210.3-18 (1971) states:

(a) If material in amount the pertinent facts relative to firm commitments for the acquisition of permanent investments and fixed assets and for the purchase, repurchase, construction, or rental of assets under long-term leases shall be stated briefly in the balance sheet or in footnotes referred to therein.

(b) Where the rentals or obligations under long-term leases are material there shall be shown the amounts of annual rentals under such leases with some indication of the periods for which they are payable, together with any important obligation assumed or guarantee made in connection therewith. If the rentals are conditional, state the minimum annual amounts.

The SEC also requires the inclusion of a portion of all rentals, if material, as "fixed charges" in registration statements filed on Form S-9 where the ratio of earnings to fixed charges is shown in a summary of earnings.

where the rentals or other obligations under long-term leases are material in the circumstances, . . . disclosure should be made in financial statements or in notes thereto.²¹

The test adopted was whether "the transaction involved is in substance a purchase." A later opinion, in 1964,²² adopted a similar approach, and elaborated the criteria for identifying lease agreements in the form of installment purchases. The later opinion requires the appropriate figures to be included in the balance sheet itself, thereby eliminating the previous alternative of disclosure in notes appended to the financial statements.

Published statistics do not demonstrate whether these recommendations have been implemented fully.²³ The author's inquiries of colleagues in the accounting field leave him with the impression that a tendency remains for many corporations to exclude leasing obligations from their balance sheets or notes thereto wherever possible within the considerable area left open for interpretation under the 1964 opinion. The implication is that, despite greater awareness among lending institutions of the existence of these practices, some corporations are nonetheless able to obtain advantages in terms of finance, trade, or prestige. Therefore, these financing reasons remain an influential factor in determining whether or not to acquire equipment by leasing.

Where a company's existing loan agreements contain restrictive covenants limiting further borrowing under formulae related to balance sheet ratios, these restrictions may be avoided by leasing. However, it would appear that most draftsmen of loan agreements now close this loophole.

The taxation and accounting advantages of leasing serve no useful function other than saving the lessee money. However, the existence of other reasons for leasing, totally unrelated to security, indicate that

21. APB ACCOUNTING PRINCIPLES, ACCOUNTING RESEARCH BULL. No. 38, *Disclosure of Long-Term Leases in Financial Statements of Lessees* (1949) (re-issued in almost identical form in 1953 as Chapter 14 of Accounting Research Bulletin No. 43).

22. APB ACCOUNTING PRINCIPLES, ACCOUNTING PRINCIPLES BOARD OPINION No. 5, *Reporting of Leases in Financial Statements of Lessee* (1964).

23. A comparison of the annual surveys of accounting trends and techniques adopted by 600 survey companies shows an increase in the number of firms reporting the existence of leases which they treated as purchases or sale and lease-back transactions. The surveys also show a trend toward more adequate disclosure of detailed information regarding long-term leases. See generally AICPA, ACCOUNTING TRENDS AND TECHNIQUES, ANNUAL SURVEY (1965-70). However, these surveys do not offer any qualitative analysis of the degree of compliance with the test established by the Accounting Principles Board.

a lease can perform a useful economic function. Each reason²⁴ will be examined to ascertain whether its function could be performed equally well by a true lease, a lease with option to purchase, a conditional sale, or a chattel mortgage.

Other Reasons

1. Special Situations

Despite the slight edge in terms of net cash outlay in favor of using loan capital to finance a purchase rather than leasing,²⁵ in a number of special situations leasing offers particular advantages.

(a) In specialized industries where income is directly related to equipment, *e.g.*, trucking, and in high volume merchandising where profit is directly related to the amount of capital freed for acquisition of inventory, leasing makes good business sense. Likewise, in industries utilizing equipment with a high capital cost for only limited periods of time, leasing provides a sound solution.

In each of these instances, the true lease is the only transaction which serves the purpose indicated, namely to conserve capital. The lessee desires to pay for the use of the equipment, not for the asset itself, which, in economic terms, is merely a necessary evil. An option to purchase at market value may be built into the lease without destroying this objective, but a conditional sale or sale subject to a chattel mortgage would defeat the purpose.

(b) Where the need for equipment is only temporary, the true lease will be the most economic method, since the acquisition of an equity is contrary to the lessee's needs.

(c) Where equipment can be utilized to maximum capacity on a farm-out basis among a number of distinct users, the true lease again may prove economic. The fact that the various users are not acting jointly or in the same interest precludes any possibility of the acquisition of an equity in the equipment. It is only the use of the equipment which can be divided on a time-sharing basis.

(d) Where equipment represents a new, untried invention or its suitability for the lessee's requirements is unproven, a short-term true lease affords the lessee greater flexibility and leaves the risk of failure or obsolescence largely with the lessor. The lessee does not wish to

24. A fuller discussion of relative advantages and disadvantages may be found in Boothe, *supra* note 15; Griesinger, *supra* note 3; Myers, *supra* note 18, at 83-94; Witherby, *supra* note 17, at 99-102; Comment, *supra* note 14.

25. See note 17 *supra* and accompanying text.

invest heavily in acquiring an equity in equipment which may prove unsuitable. However, depending upon the lessee's assessment of the potential of the equipment and the possibility of its value becoming inflated should its utility be established, the lessee may wish to pay a higher current rental to obtain an option of renewal or purchase at current market price. This may be regarded more as an insurance premium than as the acquisition of a normal proprietary interest in the equipment.

(e) Where the lessee is a small business with a low credit rating, a true lease or lease with an option to purchase may be the only means available to obtain the equipment. A recent unpublished study, *Lease Financing and Small Business*, by Professor Lee Johnson of the Graduate School of Business at the University of Virginia, confirmed that small businesses may be unable to obtain straight debt financing for equipment no matter how high an interest rate they are willing to pay. This is particularly true in service industries utilizing high cost equipment but without other fixed assets.²⁶ The alternatives are leasing or equity financing.

Where leasing is chosen, the lessor, usually a specialist leasing company independent of the manufacturer or supplier, acts as a catalyst in the financing function. Often the lessor will obtain its financing from the lessee's bank, even though the bank would not have financed a purchase of the equipment by the lessee. The reason is that the bank obtains two party paper and acquires a claim against the lessor's total assets, thereby spreading its risk. While the interest rate typically charged by the lessor will be higher than the rate for prime credit debt borrowings, it will not be as high as if the lessee had adopted the only remaining alternative of equity financing.²⁷ In effect, the lessor offers a hybrid form of financing, debt coupled with a limited equity participation in the residual value of the specific equipment financed, as distinct from general equity participation in the entire operation of the lessee corporation.

(f) While the borrowing capacity of most corporations is geared to their general credit rather than the fixed assets available as security, corporations engaged in service industries with few, if any, capital assets to offer as security may be able to lease where they could not borrow. Most corporations can borrow 100 percent of the capital

26. Professor Johnson's case studies involved corporations engaged in job printing, industrial job plating, and commercial film processing.

27. Interview with Lee Johnson, Professor, University of Virginia, December, 1970.

cost of new equipment by reliance upon their other assets and general credit. However, in the limited situation mentioned above, leasing affords the only means of financing the total cost of equipment. If this particular lessee also has a liquidity problem, equipment can be leased on a smaller down payment than is necessary under a conditional sale.

In the situations outlined in paragraphs (e) and (f) the low credit rating and borrowing capacity exclude forms of financing other than leasing. However, the lessee often has a choice between a true lease and a lease with option of purchase. To the extent that the rental payments include a payment of capital toward the purchase of the equipment, both the total quantity of equipment which may be leased by the lessee and its liquidity will suffer.

(g) Certain commodities can be acquired at a lesser cost when purchased in bulk by a lessor company, and therefore can be leased to individual corporations at rates which compare favorably with normal cash prices. The typical example is the leasing of fleets of motor vehicles. In theory, it would seem that the overhead costs of the lessor's distribution functions would be just as high as any retail distributor, and hence there would be no additional savings. However, the success of lessors in this field evidences both the validity of the underlying economies attributable to the favorable borrowing terms available to the lessors themselves, and the savings in administrative cost achieved by handling, licensing, tax reporting, registration, depreciation, and maintenance on a volume basis.²⁸ These benefits are available in a true lease or lease with option to purchase. In the conditional sale or chattel mortgage situation, however, the administrative savings of the package lease are not obtained because the burden of performing these functions falls directly upon the user.

2. *Tying Agreements*

Suppliers of some equipment will make it available on no other basis than by leasing. In the past, leasing may have been regarded as a more effective vehicle for the lessor to enforce tying arrangements as to service, replacement parts, and materials to be used with the equipment. Once the equipment has become the property of the buyer, whether under a conditional sale or by exercise of an option to purchase under a lease, the seller can no longer use the power of repossession for breach as leverage for enforcing such tying arrangements. The threat of re-

28. Boothe, *supra* note 15, at 9.

fusal to supply new equipment in the future remains, but may be of less significance to the buyer. However, this analysis is materially affected by the application of the anti-trust laws in several respects.

First, if the lessor

has sufficient economic power with respect to the tying product [equipment] to restrain free competition in the market for the tied product to some degree, and a not "insubstantial" amount of interstate commerce is affected, tying contracts will almost certainly²⁹

be held illegal under either section 3 of the Clayton Act or section 1 of the Sherman Act. If the tying arrangement is used to monopolize a market, section 2 of the Sherman Act may also be infringed.³⁰ While a number of the leading cases involving tying have involved equipment leases,³¹ the language and purpose of the Clayton and Sherman provisions also extend to purchases.

Second, refusal to supply a manufacturer who has previously infringed a tying arrangement is itself subject to an action for treble damages under the antitrust laws.³² Therefore, in industries and markets where a lessor has substantial market power and/or the lessee may suffer damage through refusal of supplies, the antitrust laws will tend to eliminate any advantage which a leasing arrangement may afford a supplier in contrast to a conditional or outright sale.

3. *Human Factors*

Certain human psychological and emotional factors deserve brief mention. The pride of ownership had more meaning in times of smaller businesses and corporations which remained the personal preserve of their founders. Today, control of many public corporations is vested in managements whose criteria for measuring success are earn-

29. A. NEALE, *THE ANTITRUST LAWS OF THE U.S.A.* 215 (1970). The courts have not always applied a *per se* rule, but have upheld tying arrangements where justified by the rule of reason. *Dehydrating Process Co. v. A.O. Smith Corp.*, 292 F.2d 653 (1st Cir.), *cert. denied*, 368 U.S. 931 (1961); *United States v. Jerrold Electronics Corp.*, 187 F. Supp. 545 (E.D. Pa. 1960), *aff'd per curiam*, 365 U.S. 567 (1961).

30. *United States v. United Shoe Machinery Corp.*, 110 F. Supp. 295 (D. Mass. 1953), *aff'd per curiam*, 347 U.S. 521 (1954).

31. *International Salt Co. v. United States*, 332 U.S. 392 (1947); *International Business Machines Corp. v. United States*, 298 U.S. 131 (1936); *United Shoe Machinery Corp. v. United States*, 258 U.S. 451 (1922).

32. *Lessig v. Tidewater Oil Co.*, 327 F.2d 459 (9th Cir.), *cert. denied*, 377 U.S. 993 (1964); *Osborn v. Sinclair Refining Co.*, 286 F.2d 832 (4th Cir. 1960).

ings ratios and the standing of their corporation's securities on stock exchanges.

There are reported instances of subordinate corporate and government officials adopting leasing to avoid the need to seek approval for purchases under internal purchasing controls.³³ In the smaller company, leasing may also be simpler and less time-consuming for the business executive than negotiating a term loan to finance the purchase of equipment. Subsequent procedures for reporting to the lessor are also simpler and less costly than complying with procedures required under term loan agreements.

4. *Summary*

The following tentative conclusions are offered as the result of the foregoing analysis. There are a number of legitimate business and economic reasons for leasing transactions. However, tax reasons are unlikely to predominate in many cases, and accounting advantages are only available because of incomplete financial reporting and analysis. In most of the special situations referred to, the benefits accruing to the lessee can be achieved by a true lease, and often this is the only means of maximizing the business objectives of the lessee. In the case of tying arrangements, the lessor's objectives can best be achieved by a true lease. In those cases where the anti-trust laws will prevent the lessor from achieving those objectives, it is immaterial whether the transaction is cast in the form of lease or sale.

Therefore, one is virtually forced to the conclusion that in many leases (other than true leases) one objective, probably the primary one, is to enable the lessee to acquire an equity in the equipment while reserving to the lessor the protections of ownership as security. Since this is precisely the purpose of the conditional sale and chattel mortgage which are treated as security agreements under Article 9, there is at least a *prima facie* case for arguing that in any lease under which the lessee is acquiring an equity, the intention that it should operate by way of security should be implied.

SIGNIFICANCE OF THE CODE DISTINCTION BETWEEN TRUE LEASES AND LEASES INTENDED AS SECURITY

The Code definition of security interest includes title reserved under a lease "intended as security," thus equating such a lease with other

33. Comment, *supra* note 14, at 763 n.57.

personal property security agreements.³⁴ The definition distinguishes true leases, which are not intended as security, and excludes them from the operation of the Code. Before examining the details of the definition, the importance of the distinction may be illustrated by noting the consequences of a determination that a particular lease is a security agreement.³⁵ The analysis will be confined to the lease transaction itself. Of course, the lessor very often uses either the lease or the equipment itself as collateral in obtaining its own financing. Irrespective of whether the lease agreement is a true lease or a security agreement, it constitutes chattel paper.³⁶ Therefore, any dealing with the lease by the lessor, whether as collateral for a pledge or by outright sale, will create a security interest under Article 9.³⁷ If the lessor uses the equipment as collateral a security interest is created, but this is not so in the case of a sale.

Perfection and Priority

The obvious but most important consequence of this classification is that a lease held to be a security agreement will be subject to the perfection and priority provisions of Article 9. If a financing statement is not filed under section 9-402, the lessor's title to the equipment will be subordinated to persons who become lien creditors or receive delivery of the equipment for value as transferees in bulk, if such persons were without knowledge of the lessor's interest.³⁸ If the lease qualifies as a purchase money security interest,³⁹ as it normally would, and if the lessor files within 10 days after the collateral comes into the lessee's possession, he will still prevail over an intervening lien creditor.⁴⁰ A lessor of either farm equipment having a purchase price not exceeding \$2500 or of consumer goods is excused from filing in relation to his purchase money security interest in the goods.⁴¹ There is no such

34. U.C.C. § 1-201(37).

35. Security agreement is defined in U.C.C. § 9-105(1)(h) as "an agreement which creates or provides for a security interest."

36. U.C.C. § 9-105.

37. The interest can be perfected by filing a financing statement or taking possession of the lease agreement. U.C.C. § 9-305. To prevent a subsequent purchaser of the lease agreement from obtaining priority under section 9-308, the assignee should take possession of the lease agreement.

38. U.C.C. § 9-301(1)(b), (c); § 9-301(3); and Art. 6.

39. Defined in U.C.C. § 9-107.

40. U.C.C. § 9-301(2).

41. U.C.C. § 9-302(1)(c), (d). Filing is required where the farm equipment or consumer goods are fixtures or are motor vehicles required to be licensed.

exception in the case of equipment used or bought for use primarily in a business or profession.⁴²

Encumbrance of Equipment by Lessee

If an equipment lessee purports to pledge or otherwise encumber the equipment, the result may be markedly different according to whether the common law or the Code applies. The lessee's position under a common law lease is governed by the *nemo dat qui non habet* rule. If the lease effectively reserves to the lessor the property in the equipment, the lessee has no property right in the goods which he can encumber. The lessee's interest in the lease agreement is a chose in action, a general intangible under section 9-106, which he may offer as security but in which the secured party can acquire no stronger position than the lessee; it may be weaker where, for example, the lease purports to prohibit, or condition default upon, the attempted encumbrance.

In this case, the encumbrancer could still file a financing statement in order to protect his position against creditors who might acquire subsequent claims over the lessee's interest. Since Article 9 also permits a party to file a financing statement prior to the attachment of a security interest,⁴³ a party wishing to take a security interest in the lessee's equipment could obtain a security agreement and file a financing statement in the expectation that the lessee might exercise an option to purchase the equipment. However, the security interest could not attach until the lessee obtained rights to the equipment, and in the ordinary course this would only take place when the lessee acquired title to the equipment by fulfilling his obligations to the lessor.⁴⁴

Where the lease is governed by Article 9, the reservation of title by a lessor who omits to file will be ineffective against a creditor of the lessee who takes security over the lessee's interest in the same equipment, provided this creditor has perfected either by filing or taking possession.⁴⁵ The appropriate priority rule, section 9-312(5)(b), applies regardless of the respective times of attachment. If the creditor

42. Where goods are used for several purposes, the test to be applied is which use is the primary one. The classifications in section 9-109 are mutually exclusive and the same goods cannot *at the same time* fall into more than one class. U.C.C. § 9-109, comment 2.

43. U.C.C. § 9-402(1).

44. A similar result is obtained under the English common law doctrine of "feeding the title" or "feeding the estoppel." See *Patten v. Thomas Motors Pty. Ltd.* 83 W.N. (Pt.2) (N.S.W.) 378 (1965); *Butterworth v. Kingsway Motors* [1954] 1 W.L.R. 1286.

45. U.C.C. § 9-312(5)(b).

fails to file, priority is governed by the time of attachment,⁴⁶ and hence the lessor retains his priority. Furthermore, section 9-307 will have no application, since the terms "buyer in the ordinary course of business" and "buying" are defined in such a way as to exclude other dispositions of a security nature.⁴⁷

Whether a bailment by a lessee under a true lease to an artisan for the purpose of repair or improvement will give rise to a lien which will be preferred to the lessor's interest depends upon the statutory and common law rules of each state. In the absence of statute, it has been generally held that the artisan's lien is not effective against the owner who has not authorized the work.⁴⁸ However, some state statutes provide that a lien will arise when the work is performed at the request of the owner, his authorized agent, or a lawful possessor⁴⁹ of the goods. In the latter case the artisan's lien will prevail over the lessor's interest.

When the lease creates a security interest, section 9-310 will apply. This section provides that an artisan's lien upon goods in his possession given by statute or rule of law takes priority over a perfected security interest, unless the lien is statutory and the statute expressly provides otherwise. A lien may be created over equipment leased under an Article 9 lease in two situations:

(a) by virtue of a state statute. Unless the statute provides otherwise, section 9-310 will prefer the artisan's lien to the lessor's perfected security interest,⁵⁰ and, a fortiori, it is submitted, to a lessee's unperfected security interest. In the latter case, the same result would flow from the common law principles.⁵¹

(b) by virtue of the lessor's express or implied authority, under the general principles of agency. In the absence of any contrary agree-

46. U.C.C. § 9-312(5)(c). In this case it may be that the creditor's security never attaches to the equipment since the debtor has no rights in the collateral unless he exercises an option to purchase. U.C.C. § 9-204(1).

47. U.C.C. § 1-201(9). Contrast the definition of "purchase" and "purchaser" in section 1-201(32), (33).

48. *In re Midwest Livestock Commission Co.*, 292 F. Supp. 955, 960 (D. Nev. 1967) and other cases cited in 8 C.J.S. *Bailments* § 35(a) n.60 (1962).

49. E.g., CAL. CIV. CODE § 3051 (West 1954); N.C. GEN. STAT. § 44-2 (1950); Lee, *Liens on Personal Property Not Governed by the Uniform Commercial Code*, 44 N.C.L. REV. 322, 337 (1966).

50. However, if the lessor has perfected by taking possession, his security interest will prevail since the artisan's lien is terminated by loss of possession, assuming of course that the artisan voluntarily surrendered possession.

51. See note 48 *supra* and accompanying text.

ment, section 9-310 will again prefer the artisan's lien.⁵² However, in appropriate situations, the lessor should require, as a pre-condition to his authorization, a subordination agreement from the artisan, as contemplated by section 9-316.

Therefore, on the lien issue, no materially different result arises by virtue of a determination that a lease does or does not create a security interest.

Sale of Equipment by Lessee

The Code provisions have no effect upon the inability of an equipment lessee to convey title to a third party. Outside of the Code, the *nemo dat qui non habet* rule precludes a lessee from passing title to a third party, no matter how bona fide the purchaser may be. In the absence of special circumstances creating an estoppel, or unless the lessee is a merchant,⁵³ mere possession is not evidence of ownership so as to enable the purchaser to prevail against the owner.⁵⁴ If the lease is subject to Article 9, a buyer of goods from a lessee could take free of the lessor's title in two limited situations.

(a) The first instance is where a buyer in the ordinary course of business buys goods "in good faith and without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party" from a lessee who was "in the business of selling

52. For a comparison with English and Australian statutory and common law rules, see Peden, *The Creation of Common Law Liens*, 18 INT'L. & COMP. L.Q. 129 (1969).

53. U.C.C. § 2-403(2).

54. It is no doubt true that possession of personal property is some evidence of ownership, and may be sufficient in a given case to protect one dealing with the property as that of possessor. But mere possession, unaccompanied by other circumstances giving it a specific character or creating an estoppel, is not such evidence of ownership as to prevail against the true owner, except in cases of negotiable instruments, mortgaged chattel property, or that sold under conditional sales agreements.

The rule that one cannot be divested of his property without his consent, and the principle that one cannot possess or convey a greater title than he himself has, controls all questions arising as to personal property attempted to be transferred or as to lien created thereon. The effect of possession as evidence of ownership is subordinate to these principles, save in the exceptions noted. The mere fact of one putting property into the charge or custody of another does not divest the possession of the true owner; the legal possession still remains in the owner, for the agent, bailee or lessee thereof can have no greater title than his grant provides.

Cooperider v. Myre, 37 Ohio App. 502, 505, 175 N.E. 235, 236 (1930).

goods of that kind.”⁵⁵ The result is the same whether or not the security interest is perfected. However, such a situation is unlikely to arise, since a merchant does not usually take on lease equipment of the kind which he also holds as inventory for sale in the course of his business.

In this context, the term equipment has been used in its ordinary non-Code meaning. However, an interesting point arises out of the distinction between the definitions of equipment and inventory under the Code.⁵⁶ Where a leasing company has given a security interest over the inventory which it holds available for sale or lease, the financing statement should refer to the collateral as inventory. However, once an item is leased, it may be argued that it falls outside the definition of inventory and therefore becomes equipment since it is no longer goods *held for sale or lease*.⁵⁷ This argument has been advanced by Fairfax Leary, tentatively at first,⁵⁸ but later more forcefully.⁵⁹

It is submitted, and I think Mr. Leary would probably agree, that inventory remains inventory if it has been leased under a true lease, since the title to the goods remains with the lessor who therefore arguably continues to “hold them for sale or lease.” This may also be the position where the lease is intended as security so long as the lessor retains title, because the lessee has not exercised his option to purchase. Once this option is exercised, of course, the security interest in the inventory is converted to a security interest in the proceeds. To avoid any possible doubt, the financier of a dealer who holds stock for sale and lease should file a financing statement covering the goods “whether as equipment or as inventory and proceeds thereof.”

It is also submitted that the courts should have regard for the fact

55. U.C.C. § 9-307(1), § 1-201(9). The same result could be reached under section 2-403(2).

56. These classifications are defined in U.C.C. § 9-109.

57. A similar ambiguity arises in the definition of inventory in the Personal Property Security Act of 1967, § 1(n) (Ont.).

58. PROCEEDINGS OF THE FIRST ANNUAL UNIFORM COMMERCIAL CODE INSTITUTE, *Lease Financing and Other Techniques of Financing Equipment Under the U.C.C.*, 113, 117-18 (1967).

59. Leary, *Leasing and Other Techniques of Financing Equipment Under the U.C.C.*, 42 TEMPLE L.Q. 217, 228 (1969). The question is of limited practical significance, and would only be likely to arise where a lessee makes a sale which purports to be in the ordinary course of business. Mr. Leary suggests that where goods have been leased and therefore arguably become equipment, the financier of the lessor would retain priority for its purchase money security interest without the need to notify prior financiers, as is necessary in the case of inventory under section 9-312(3). The author would suggest that if the goods are inventory when received by the lessor, this classification governs and section 9-312(3), rather than section 9-312(2), applies, irrespective of whether the goods later become equipment.

that in most instances new equipment is delivered directly by the manufacturer to the lessee, although property in the goods is passed to the lessor company. Since the *possession* of this equipment has never been physically held by the lessor, more weight accrues to the argument that the definition of inventory turns upon whether the lessor holds and retains title. Any other conclusion would exclude all leased goods from the "inventory" of lessor companies.

(b) The second situation is where a buyer buys farm equipment having an original purchase price not in excess of \$2,500 (other than fixtures) or consumer goods, without knowledge of the lessor's interest, for value and for his own farming operations or his own personal, family, or household purposes.⁶⁰ If the lessor had filed a financing statement before the purchase took place, his interest would prevail.⁶¹ These circumstances would not extend to a sale of equipment used as such by the lessee, since the lessee's use, rather than the use intended by the buyer from the lessee, determines the classification. In other words, section 9-307(2) only applies to a purchase by a consumer or farmer from a consumer or farmer.⁶²

Dealing with the Lessee's Interest

Prior to the introduction of the Code, some jurisdictions precluded creditors of the mortgagor or conditional vendee from proceeding against the mortgagor's or vendee's interest by levy or other judicial process.⁶³ Other jurisdictions specifically sanctioned such levy, notwithstanding any prohibition in the security agreement.⁶⁴ Most jurisdictions permitted the debtor voluntarily to transfer his equity in goods, but required him to notify the creditor of such transfer.⁶⁵ A lease, under which the lessee has acquired an equity, would probably have been

60. U.C.C. § 9-307(2).

61. The buyer would still be entitled to the interest or equity of the lessee in the equipment. The lessee's power to transfer his rights to the collateral, voluntarily or involuntarily, cannot be excluded by a lease subject to Article 9. See U.C.C. § 9-311. A similar provision exists in the Australian statutes regulating hire-purchase agreements. Uniform Hire Purchase Act, § 9. The English Court of Appeal has reached a similar result without the aid of a statutory provision. *Wickham Holdings Ltd. v. Brooke House Motors Ltd.* [1967] 1 W.L.R. 295. For a general discussion of this question under English and Australian law see Peden, *Measure of Damages in Conversion and Detinue*, 44 *AUSTL. L.J.* 65 (1970).

62. *Everett National Bank v. Deschuiteneer*, 109 N.H. 112, 244 A.2d 196 (1968).

63. U.C.C. § 9-311, comment 2.

64. *E.g.*, *Farrow v. Ocean County Trust Co.*, 121 N.J.L. 344, 2 A.2d 352 (Sup. Ct. 1938; CAL. CODE CIV. PRO. § 689a (West 1967)).

65. *E.g.*, COLO. SESS. LAWS, 1961, ch. 87, § 7.

treated as analogous to a conditional sale, but under a true lease the lessee would have had no equity to transfer. Since the lease invariably provided that any attempted disposition or parting with possession constituted default, an assignee of the lessee's interest acquired no rights against a non-consenting lessor.

Since the introduction of section 9-311 of the Code, a lessee's interest under a lease which is subject to Article 9 can be voluntarily or involuntarily transferred, notwithstanding a provision in the security agreement prohibiting such transfer. In those jurisdictions in which such a prohibition was effective under the pre-Code law, it will be relevant to determine whether or not a lease is subject to Article 9.

Lessor's Remedies

The remedies of a lessor upon the lessee's default and the corresponding rights of the lessee to redeem such default will vary according to whether the lease is regarded as a security agreement under Article 9 or a true lease.⁶⁶ Where the agreement is outside Article 9, the lessor's remedies are found in the law of bailments. Where Article 9 applies, Part V dealing with remedies is theoretically applicable but appears inappropriate in certain fact situations.

The lessor's remedies may be briefly summarized as follows:

1. *Repossession of the Equipment Upon Default*

This remedy is the same whether or not the Code applies, and default is left to be defined by the agreement. Under the Code, the secured party can only proceed to repossess without judicial process if the repossession can be accomplished without breach of the peace.⁶⁷ Since the Code does not define breach of the peace, the common law principles will apply.⁶⁸ In the case of a true lease, the common law of the various states has not always been in harmony:

[S]ome courts [hold] that the owner of property is only liable for excessive force in retaking his property; that he may use such

66. See Hogan, *The Secured Party and Default Proceedings Under the U.C.C.*, 47 MINN. L. REV. 205 (1962); Comment *Leases: Security Interests: Uniform Commercial Code: Matter of Royer's Bakery, Inc. (No. 2)*, 4 CCH *Installment Credit Guide* ¶ 99274, at 89631 (E.D. Pa. 1963); *United Rental Equip. Co. v. Potts & Callahan Contracting Co.* 251 Md. 552, 191 A.2d 570 (1963), 49 CORNELL L.Q., 672, 677-79 (1964).

67. U.C.C. § 9-503.

68. See *Cherno v. Bank of Babylon*, 282 N.Y.S.2d 114, 54 Misc. 2d 277, *aff'd*, 288 N.Y.S.2d 862 (1968).

force as is reasonably necessary to overcome the resistance wrongfully interposed. Others hold that where opposition is offered to the retaking of the property the owner must resort to the remedies offered by proceedings at law.⁶⁹

However, the view which appears to have prevailed is expressed in the following terms:

We think that the correct view is that where possession of property has been lawfully acquired as by a conditional sale or bailment and the agreement between the parties allows the owner to retake when certain conditions arise he may retake if he can do so without force, but when the taking is resisted he may not use force, he must have his remedy by proceedings at law.⁷⁰

On this point, the common law draws no distinction between a pure lease, a lease intended as security, or a conditional sale. In addition, the Uniform Conditional Sales Act section 16, some chattel mortgage statutes, and some other personal property security legislation⁷¹ adopted a rule similar to that prevailing at common law and now adopted uniformly in Article 9. Similar issues arise in relation to the right of the lessor to enter another person's land or premises in order to repossess his goods. These are resolved solely by reference to the common law.⁷²

2. *Claim for damages for unpaid rentals*

The lessor must give credit to the lessee in appropriate cases for the value of the goods upon repossession.⁷³ If the lease provides for payment on default of the total rent for the unexpired period of the lease, the courts are likely to strike the provision down as a penalty,⁷⁴ unless it bears a reasonable relationship to the damages suffered.⁷⁵ There is

69. *Abel v. M.H. Pickering Co.*, 58 Pa. Super. 439, 446 (1914).

70. *Id.* at 446-47. This statement was approved in *Stewart v. F.A. North Co.*, 65 Pa. Super. 195 (1916). See also *Girard v. Anderson*, 219 Iowa 142, 257 N.W. 400 (1934) and cases cited therein.

71. *E.g.*, Pennsylvania Motor Vehicle Sales Finance Act, 69 P.S. § 615g (1965).

72. See Hogan, *supra* note 66, at 244.

73. *E.g.*, *Electrical Prods. Consol. v. Sweet*, 83 F.2d 6 (10th Cir. 1936); *Rentways, Inc. v. O'Neill Milk & Cream Co.*, 282 App. Div. 924, 125 N.Y.S.2d 282 (1st Dep't. 1953), *aff'd*, 308 N.Y. 342, 126 N.E.2d 271 (1955).

74. *Kothe v. R.C. Taylor Trust*, 280 U.S. 224 (1930); *Witherby*, *supra* note 17, at 136-39.

75. *Irving Trust Co. v. Perry*, 293 U.S. 307 (1934).

nothing in section 9-504 to alter this position, which is, if anything, strengthened by the good faith provisions of the Code.⁷⁶

This position may also be reinforced by section 9-506 and the comment thereto. Section 9-506 provides that: "[T]he debtor may . . . redeem the collateral by tendering fulfillment of all obligations secured by the collateral" The comment suggests that "tendering fulfillment" is confined to the "payment in full of all monetary obligations *then due* and performance in full of all other obligations *then matured*." (Emphasis supplied). Unmatured obligations are to remain secured, thereby implying that they are only to mature with the effluxion of time in accordance with the normal (not the default) provisions of the security agreement.⁷⁷

The Code specifically makes all the secured party's remedies cumulative,⁷⁸ thus avoiding the danger of compelling a lessor to elect between these first two remedies of repossession or action for the rental obligation as has sometimes been the case in conditional sales contracts.⁷⁹

The proposed Uniform Consumer Credit Code limits provisions for additional payments on default in certain lease transactions. However, these limitations apply only to consumer credit sales⁸⁰ and consumer credit loans, and not to consumer leases.⁸¹ The Credit Code does not prescribe rate ceilings for leases. The distinction drawn between a sale and lease under the Credit Code is similar to that under the Uniform Commercial Code in that a sale includes:

[A]ny agreement in the form of a bailment or lease if the bailee or lessee agrees to pay as compensation for use a sum substantially equivalent to or in excess of the aggregate value of the goods involved and it is agreed that the bailee or lessee will become, or for no other or a nominal consideration has the option to become, the owner of the goods upon full compliance with his obligations under the agreement.⁸²

76. U.C.C. §§1-201(19), 1-208.

77. Professor Hogan appears to have overlooked the italicized portion of the Comment quoted above, and also the subsequent sentence in the Comment dealing with unmatured obligations. Hogan, *supra* note 66, at 239 n.159.

78. U.C.C. § 9-501(1).

79. Warren, *Statutory Damages and the Conditional Sale*, 20 OHIO ST. L.J. 289, 291 (1951).

80. UNIFORM CONSUMER CREDIT CODE §§ 2-210, 2-414 (hereinafter cited as U.C.C.C.).

81. U.C.C.C. §§ 3-210, 3-405.

82. U.C.C.C. § 2-105(4).

Similarly, the federal Truth in Lending Act does not require disclosure of finance charges or rates in the case of true leases because of the difficulty of evolving a practical method of regulating disclosure.⁸³

3. *Retention or Sale of the Equipment Following Repossession*

In the case of a true lease not subject to Article 9, repossession upon default terminates the lease and restores to the lessor full possessory rights in addition to the proprietary rights, which are retained throughout. The lessor has absolute discretion to retain the equipment, and there is no obligation to resell or re-lease the equipment. The only qualification upon this statement is that in computing any damages against the lessee, the courts through the common law principle of mitigation will assume that after repossession the lessor obtained market value for the equipment, either as rental or purchase price.

4. *Rights of Secured Parties*

Under a lease subject to Article 9, the secured party's rights are qualified in several respects.

First, if the collateral is consumer goods, and the debtor has paid 60 percent of the purchase price, the secured party is obliged to resell within 90 days.⁸⁴ Since the definitions of consumer goods and equipment are mutually exclusive,⁸⁵ this provision cannot apply in the case of an equipment lease, even though such lease is intended as security. Nonetheless, the debtor or any secured third party whose security interest is recorded by a financing statement can force the secured party to resell.⁸⁶

Second, the debtor or any secured third party is given a statutory right of redemption by tendering fulfillment of all obligations secured by the collateral together with the secured party's expenses.⁸⁷ Such a right does not exist in the case of a true lease which can be terminated absolutely by the non-defaulting party upon the other's breach.

Third, where the secured party is obliged to resell or voluntarily re-

83. Except for inconsequential contextual differences, the same definition has been adopted in the federal Truth in Lending Act for the term "credit sale" as has been applied to consumer credit sales in the U.C.C.C. Truth in Lending Act, Act of May 29, 1968, Pub. L. No. 90-321, § 103(g), 82 Stat. 146; 12 C.F.R. § 226.2(n) (1971).

84. U.C.C. § 9-505. The Uniform Consumer Credit Code does not impose any additional obligations as to the resale of consumer goods following repossession.

85. U.C.C. § 9-109.

86. U.C.C. § 9-505(2).

87. U.C.C. § 9-506.

sells the equipment, the manner in which he resells is regulated by the procedures laid down in section 9-504, which embodies the standard of commercial reasonableness contained in section 9-507. The purpose of these provisions is to substitute for the previous rigid requirements a standard which is sufficiently flexible to enable the economic interests of the debtor to be best served. The lack of specificity in the term "commercially reasonable" should not prevent effective and intelligent application of the standard by the courts.⁸⁸

Fourth, in addition to providing that the proceeds from the sale of collateral shall be applied to the secured party's realization expenses, satisfaction of the indebtedness secured by the security interest and of indebtedness secured by subordinate security interests, section 9-504 requires that the secured party must account for any surplus to the debtor. In the case of a security interest in goods, including equipment, this right cannot be waived. This situation is unlikely to arise very often because of the planned obsolescence of most equipment.⁸⁹ Where the lessee's equity exceeds the realization value, the economic realities of the situation make it unlikely that the lessee will allow the lessor to proceed to resell, since a default sale, together with selling and legal expenses, is unlikely in these circumstances to yield the maximum amount, despite the requirements of commercial reasonableness. In spite of the anticipated rarity of these situations, the distinction between a true lease and a lease intended as security retains theoretical significance under section 9-504, since a lessor in a true lease is not obliged to account to the lessee.

It has been suggested by Goode and Ziegel⁹⁰ that the Article 9 remedies are not appropriately drafted for some leases which fall within its scope as leases intended as security. They maintain that difficulties arise because these remedy provisions are based upon the assumption that the debtor is ultimately obligated to pay the whole price or debt, and point specifically to sections 9-504 and 9-506 in these terms:

Section 9-504 entitles the secured party, after repossession and sale, to recover any deficiency. How is this rule to be applied in a case such as the *Royer's Bakery* case, where the lessee was never obligated to pay the price and could terminate the lease at any time without further liability? Again, Section 9-506 entitles the debtor to redeem on tendering fulfillment of "all obligations secured by the collateral." What can redemption denote in this con-

88. Hogan, *supra* note 66, at 220 *et seq.*

89. Comment, *supra* note 66, at 679.

90. R. GOODE & J. ZIEGEL, *HIRE-PURCHASE AND CONDITIONAL SALE* (1966).

text? Surely it cannot mean that the debtor is entitled to have the property vested in him if he has paid simply the rentals up to the date of termination of the lease. Yet in the above case that was the extent of his obligation.⁹¹

It would seem that section 9-504 raises no problem, since it only imposes a liability upon the debtor if the security interest secures an indebtedness. It does no more than entitle the secured party to enforce its rights under the agreement. In a case such as *Royer's Bakery*, this would be confined to unpaid rentals up to the time of repossession.

In a similar situation, section 9-506 would be interpreted as entitling the debtor to redeem its interest in the collateral upon payment of all obligations then due. Admittedly, the section refers to redeeming "the collateral," but it hardly seems too difficult an exercise in statutory interpretation to imply the qualification suggested above.

The above analysis of true leases and leases intended as security has shown that the only consequences of this distinction which are crucial are the first two, namely invalidation, as against the lessee's lien creditors or other secured creditors, of unperfected leases creating security interests. These results, coupled with the incentive thereby created to file and hence to give notice to other creditors of the lessee of its limited interest in equipment in its possession and apparent ownership, appear as the consistent policy of Article 9. Since the primary purpose of inclusion of equipment leases within the scope of Article 9 is the notification and protection of the lessee's other creditors, one may inquire why these creditors are not equally entitled to protection in the case of a true lease. Whether the line should be drawn at this point is a question which can be more adequately considered after an examination of the present definition of security interest in the Code and the manner in which this definition has been interpreted by the courts.

ANALYSIS OF THE CODE DEFINITION OF SECURITY INTEREST

The term security interest is defined in section 1-201(37) as "an interest in personal property or fixtures which secures payment or performance of an obligation." Section 9-102 takes up this definition in delimiting the scope of Article 9 as applying "to any transaction (regardless of its form) which is intended to create a security interest in

91. *Id.* at 145 n.41.

personal property or fixtures." Security agreement is defined to mean an agreement which creates or provides for a security interest.⁹²

Goode and Ziegel point out that not every lease intended as security will create a security interest, and that some leases, though not creating a security interest nor constituting security agreements, nonetheless fall within section 9-102 and hence are governed by Article 9 as a whole.⁹³ The author believes that these learned scholars have not done justice to the Code draftsmen. The primary scope section in Article 9 is 9-102. The definitions in 1-201(37) and 9-105 are merely interpretive and subsidiary. It is conceded that a lease intended as security may not create a security interest as defined in 1-201(37) because payment of performance of an obligation is not secured by an interest in personal property. Conversely, reservation of title under a lease will not be regarded as a security interest unless the lease is intended as security. Both elements, the actual securing of payment or performance of an obligation upon an interest in personal property and the intention that the lease shall operate as security, are necessary for a lease to create a security interest under the 1-201(37) definition.

However, the criterion for the applicability of Article 9 set forth in 9-102 is not whether a transaction is intended as a security but whether it is intended to create a *security interest* in personal property or fixtures. Similarly, a security agreement is not an agreement intended as security but one which creates or provides for a security interest.⁹⁴ Goode and Ziegel rely on the alleged distinction between the language "intended to create a security interest" in 9-102(1) and "an interest which [actually] secures payment of performance of an obligation" in 1-201(37). The distinction turns upon the meaning of "a transaction

92. U.C.C. § 9-105(1) (h).

93. The truth of the matter is that the Code draftsmen have in their definitions made an unhappy marriage of two inconsistent concepts. By section 9-105, a security agreement is defined as "an agreement which creates or provides for a security interest." Section 1-201(37) defines a security interest as "an interest in personal property or fixtures which secures payment of performance of an obligation." But by section 9-102, Article 9 is made applicable to "any transaction (regardless of its form) which is intended to create a security interest in personal property or fixtures." Hence a lease which, though not in fact securing a debt or obligation, is "intended as security" (applying the canons of intention laid down in section 1-201(37)) falls within section 9-102 so as to be governed by Article 9 as a whole but does not create a security interest for the purpose of section 1-201(37); nor, apparently, does it constitute a security agreement within section 9-105!

R. GOODE & J. ZIEGEL, *supra* note 90, at 145 n.41.

94. U.C.C. § 9-105(1) (h).

which is intended to create a security interest" in 9-102(1). Where such a transaction actually creates a security interest, it comes within the 1-201(37) definition and Article 9. Where it intends but fails to create a security interest, it will be outside 1-201(37) but may still come within 9-102(1) because of the intent. Goode and Ziegel assume that it will.

An alternative approach is to interpret the relevant part of section 9-102(1) as applicable only to any transaction (regardless of its form) which is intended to (*and does in fact*) create a security interest. This latter approach appears more consistent with the overall scheme and purpose of the Code.

The Test of Intention

Most discussion and litigation concerning leases as security has revolved around that part of the definition of security interest which adopts an intention test for leases and consignments. The first part of this definition excludes a reservation of title in a lease which is not intended as security.⁹⁵ The definition then proceeds to set out three rules for determining whether a lease is intended as security:

- (a) whether a lease is intended as security is to be determined by the facts of each case;
- (b) the inclusion of an option to purchase does not of itself make the lease one intended for security;
- (c) 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 not make the lease one intended for security.

A lease will therefore create a security interest if:

- (a) it secures payment or performance of an obligation upon personal property reserved by the lease; and
- (b) the lease is intended as security. Such intention is to be determined objectively on the basis of the facts of the case, so that the parties' declarations of intention are not conclusive;
- (c) where the lease includes an option to purchase:
 - (i) this is not of itself determinative as to the existence of a security interest;

95. "Unless a lease or consignment is intended as security, reservation of title thereunder is not a 'security interest . . .'" U.C.C. § 1-201 (37).

- (ii) if the lessee can exercise this option for a nominal or no additional consideration, the lease per se reserves a security interest.⁹⁶

What is the relationship of the various divisions of this definition? The intention of the parties is the primary test, but the definition implies that the courts should look to the substance of the transaction rather than to its form or the parties' verbal declarations of intention. An objective test is indicated.

Where the parties expressly declare that their lease is intended as security, a court would accept this declaration, since it cannot adversely affect any third party. In the converse situation where such an intention is expressly disclaimed,⁹⁷ a court should still have regard to the other terms of the transaction and surrounding circumstances to determine its true purpose and effect. By adopting objective criteria, the courts have actually moved toward a functional economic approach, rather than adopting a distinction between sale and lease which is confined to the legal issue of an obligation to purchase or the passage of title. This is in accord with the policy of Article 9.

Facts relevant to an objective determination of the parties' intention include length of the lease in relation to the economic life of the equipment, relation of the lease rentals to market rental values, relation of the option price to list price, relation of option price to anticipated or actual depreciated value at the time the option is exercised, provision for deduction of rentals from purchase price, requirement of a security deposit, and the right of a lessor to accelerate payments upon default. Other factors include whether the lessor has acquired the equipment especially for the specific lessee customer, whether it is intended that the equipment will be permanently affixed to the lessee's premises, and whether there are reasons other than retention of security, such as those

96. The definition is based upon the Uniform Conditional Sales Act § 1 and the case law developed thereunder. The definition under that act included *inter alia* "any contract for the bailment or leasing of goods by which the bailee or lessee contracts to pay as compensation a sum substantially equivalent to the value of the goods, and by which it is agreed that the bailee or lessee is bound to become, or has the option of becoming the owner of such goods upon full compliance with the terms of the contract."

97. *E.g., In re Atlanta Times Inc.*, 259 F. Supp. 820 (N.D. Ga. 1966), *aff'd per curiam sub nom. Sanders v. National Acceptance Co. of America*, 383 F.2d 606 (5th Cir. 1967). The lease contained this provision: "[I]t is and is intended to be a lease, and Lessee does not hereby acquire any right, title or interest in and to the chattels, except the right to use the same under the terms hereof."

discussed at the beginning of this article, which stand up under analysis as legitimate justifications for casting the transaction in the form of a lease rather than as a conditional sale or chattel mortgage.

Some of these factors will be analyzed in discussing the case law, but several initial points are obvious. The form of, and factual background and circumstances pertaining to, lease transactions vary greatly from case to case. Few of the effects and consequences of a lease agreement can be predicted accurately when the agreement is made. This raises the question whether a court with the benefit of hindsight is entitled to judge the parties' intentions by the actual consequences of their agreement, rather than by the consequences which could have been foreseen at the time their bargain was made.

Where it is not unforeseen developments but the parties' own actions which have resulted in alterations in the normal effect of the lease agreement, the parties' actions, rather than their declared intentions, should be regarded as dispositive in determining the nature of the lease. An example is where a lessee under a written lease bearing all the indicia of a true lease subsequently purchases the equipment for a nominal consideration although the lease contained no option.

A further problem may arise if a lease of the type in the last example is challenged before the alleged unwritten option is exercised. In such a case, if the lease contains an entire agreement clause, its effect, when coupled with the application of the parol evidence rule, could enable the lessor to refute allegations of an option which conceivably might be made by a lien creditor or trustee in bankruptcy of the lessee.

The parol evidence rule alone will not necessarily preclude the admission of evidence of an option, since an option itself is not inconsistent with a lease. However, where the court concludes that the written lease is intended as a complete and exclusive statement of the terms of the agreement,⁹⁸ extrinsic evidence of further terms is not admissible. One means which has been used to exclude evidence of a verbal option is an entire agreement clause. In the *Atlanta Times* case⁹⁹ the result of such a clause was a holding that the written lease was conclusively presumed to contain the entire agreement.

The merit of the conclusive exclusion of other evidence in this type of case is open to some question, and one wonders whether the court would have taken the same approach if there had been stronger factual

98. This common law principle is made statutory, so far as sales are concerned, by U.C.C. § 2-202. See *In re Atlanta Times, Inc.*, 259 F. Supp. 820, 825 (N.D. Ga. 1966).

99. 259 F. Supp. 820 (N.D. Ga. 1966).

evidence of a collateral option agreement.¹⁰⁰ At no point did the court refer to the line of authority holding that the parol evidence rule does not apply to persons other than parties to the document. Admittedly, "the precedents are often arbitrary and confused,"¹⁰¹ but they do contain many clear statements epitomized by the following:

The Parol Evidence rule does not apply in litigation between one or more parties to the written instrument and a stranger to the written instrument, but only applies to litigation between the parties and their privies.¹⁰²

The significance of the issue becomes apparent from a review of the cases. To date, only one lease, which did not include an option to purchase, has been held to create a security interest.¹⁰³ In fact, the absence of an option has been regarded as strong evidence that the lease is not intended as security.¹⁰⁴ This suggests the obvious possibility that parties desirous of evading Article 9 will adopt an entire agreement clause in the lease but reach an extrinsic verbal gentlemen's agreement embodying the option to purchase. Admittedly, as the court pointed out in *Atlanta Times*, the parties, especially the lessee, will not often be willing to rely on a verbal understanding in transactions of substantial proportions.

The strongest argument for upholding the parol evidence rule in cases such as *Atlanta Times* is that the primary test for determining

100. "Even if admissible, the testimony regarding the existence of an option to acquire the leased property fails of its mark. Taken in the light most favorable to the trustee, it would show no more than an expectancy, not legally enforceable." *Id.* at 825. This evidence was disputed by other unequivocal testimony to the effect that there was no agreement to give an option. See also *Burton v. Tatelbaum*, 240 Md. 280, 213 A.2d 875 (1965), in which testimony of an option agreement was also excluded, but again the court considered that even if admitted, the evidence would not have altered the result.

101. J. WIGMORE, EVIDENCE § 2446 & n.5 (1940).

102. *Swift v. Beaty*, 39 Tenn. App. 292, 282 S.W.2d 655, 658 (1955); accord, *Bowman v. Tax Comm.*, 135 Ohio St. 295, 20 N.E.2d 916, 919 (1939). "While parol evidence may not be received to contradict or vary the terms of a written instrument as between the parties thereto and their privies, such evidence is admissible when otherwise competent in controversies between strangers to the instrument, or between a stranger and a party thereto."

103. *In re Transcontinental Industries, Inc.*, 3 UCC REP. SERV. 235 (N.D. Ga. 1965). This was a special case in which a number of other factors outweighed the absence of a purchase option. Cf. *In re Atlanta Times, Inc.*, 259 F. Supp. 820 (N.D. Ga. 1966); *In re Overbrook & Barson's, Inc.*, E.D. Pa., Bankruptcy No. 29210, 5 UCC REP. SERV. 546 (1968). Likewise under the Uniform Conditional Sales Act, § 1, the courts refused to find a conditional sale unless the lease contained an option to purchase. E.g., *Western Machinery Co. v. Graetz*, 42 Cal. App. 2d 296, 108 P.2d 711 (App. Div. 1940).

104. *In re Wheatland Electric Products Co.*, 237 F. Supp. 820 (W.D. Pa. 1964).

whether a lease creates a security interest is the parties' intention. If an entire agreement clause would be binding upon the parties so that a lessee could not enforce an oral option agreement against a recalcitrant lessor, it would follow that in law no option existed. Nonetheless, if the parties' orally expressed intention at the time the lease was made was that the lessee should have an option, this would be an objective fact which the court should be entitled to take into account in determining whether the lease created a security interest.

The test prescribed under section 1-201(37) contemplates that the parties' intention shall be judged objectively by reference to their total conduct, and not merely by overt expressions of their intention. The purpose of Article 9 would be frustrated if evidentiary rules could be used to shield sham transactions. If evidence of an oral option is admitted and is convincing, the very fact that it was not embodied in the written agreement is a factor tending to prove an intention to create a secret security interest under the guise of a true lease. The policy reasons for the parol evidence rule, designed to govern the rights of parties to the contract *inter se*, are not persuasive in the context of conflicting claims by third party creditors. If accepted, these criticisms would not preclude the lessor from denying the verbal option agreement, but such denial would be weighed with other evidence relating to the existence of such an option.¹⁰⁵

Economic Analysis Tests for Purchase Option

There is considerable scope for using economic and mathematical models to evolve subsidiary tests under the final part of the section 1-201(37) definition, which is based upon a finding that the lessee shall become or has an option to become the owner "for no additional or for a nominal consideration." This test is both the most positive and specific, and the only conclusive part of the whole definition. Accordingly, it has received most attention from the courts.

It has been suggested that this test requires a determination whether the lease enables the lessee to acquire an equity in the chattels prior to actually exercising the option to acquire title.¹⁰⁶ In this context, the term equity is used in the business or commercial sense of a financial interest which really amounts to a credit against the payment which the

105. Comment, *Leases as Security: Some Problems of Identification*, 8 B.C. IND. & COMM. L. REV. 764 (1967).

106. Welsh, *Judicial Interpretations of the Filing Requirements Under Article 9 of the Code*, 37 TENN. L. REV. 273, 282 (1970).

lessee must ultimately make in order to acquire title. This formulation has been criticized on the grounds that the fact that the lessee might acquire some equity is no guarantee that he will do so.¹⁰⁷ The answer to this criticism is twofold.

(a) The section 1-201(37) test is one of intent, although the circumstances and terms of the lease must be viewed objectively to determine that intent. These factors must be considered as of the date of commencement of the lease agreement. The court is placed in a position at least as advantageous as that of the parties for determining the outcome of the financial aspects of the lease as they would have appeared to them when the bargain was made.

(b) Once the lessee has acquired a substantial equity in the equipment which enables it to acquire title at less than current market value, common sense indicates that the option will be exercised.¹⁰⁸ This fact of business life overcomes any continued reliance upon the distinction between a buyer under a conditional sale who is "obliged to purchase" and a lessee who merely has an "option to purchase."¹⁰⁹

The "equity" formulation is a reasonable one, provided it is regarded functionally in an economic or business sense, and is not confused with legal concepts such as equitable interest or the passing of title. As an economic formulation it naturally presupposes further subrules for its implementation in actual cases. The courts have now embarked upon economic analysis which has made possible the articulation of certain tentative subrules.

1. *Ratio of Option Price to Original List Price*

If no consideration or a nominal consideration (in the sense in which courts "frequently use it interchangeably with the sum of \$1.00 or some other small amount") is required, the definition per se requires a finding of a security interest.

107. Comment, *Equipment Leasing Under the UCC*, 13 U.C.L.A. L. REV. 125, 135 & n.62 (1965).

108. Comment, *supra* note 66, at 695.

109. This distinction first received judicial approval in England in the landmark case of *Helby v. Matthews* [1895] A.C. 471, where the House of Lords upheld the ingenuity of the draftsman in devising the hire-purchase agreement. The importance of the distinction in English and Australian law is that a hirer under a hire-purchase agreement, who has an option, but not an obligation, to purchase cannot pass title to a bona fide purchaser, as can a conditional purchaser under the Factors Act 1899, § 9. Similarly, the goods are not available to the hirer's other creditors or trustee in bankruptcy, nor need the hire-purchase agreement be filed or registered. The distinction is entirely legalistic and serves no legitimate function or social purpose.

In other cases, a comparison of the option price with the original list price may be meaningful. In a number of cases, comparisons of option prices yielding percentages of 25 percent,¹¹⁰ 32 percent,¹¹¹ and 58 percent¹¹² of list price were persuasive in a finding of a true lease.¹¹³

However, this direct comparison is usually inadequate, since a lessee may still be obtaining title for less than full consideration if the option price is substantially less than actual market value at the time of its exercise. If this is so, it follows that unless the lessor has made a very bad bargain, it will already have received the difference between market value and the option price by way of rentals which represented more than payment for mere use. Hence, the analysis should also take into account rentals already paid and the market value of the equipment at the date of exercise of the option.

2. *Ratio of Option Price to Market Value*

The relationship which the option price bears to the actual market value of the equipment when the option to purchase may be exercised comes much closer to reflecting the terms of the definition. However, it is important not to regard any discrepancy between the two figures as conclusive. The lessor and lessee at the time of entering the lease do not know the precise effect which obsolescence and market fluctuations will have upon the value of the equipment. The test should require the court to disregard the benefit of hindsight, and to determine whether the option price provided in the agreement bore a reasonable relationship to what the parties might reasonably have anticipated the market value to be at the time contemplated for exercise of the option.

In every case, the courts have made this comparison, although regard is often paid to the actual market value at the time for exercise of the option, rather than a hypothetical estimate of that value made as at the commencement of the lease.¹¹⁴ Admittedly, the distance between the option price and actual market value was so great in some of these

110. *In re Wheatland Electric Products Co.*, 237 F. Supp. 820 (W.D. Pa. 1964).

111. *In re Alpha Creamery Co.*, 4 UCC REP. SERV. 794 (W. D. Mich. 1967).

112. *Crest Investment Trust, Inc. v. Atlantic Mobile Corp.*, 252 Md. 286, 250 A.2d 246 (1969).

113. On the other hand, a ratio of less than 25 percent is to be considered as showing an intent to make a lease a security. *In re Alpha Creamery Co.*, 4 UCC REP. SERV. 794, 797-98 (W.D. Mich. 1967).

114. "[T]he determining factor to be considered is the intention of the parties at the time the contract was entered into as construed in the light of facts and circumstances at that time" *In re Transcontinental Industries, Inc.*, 3 UCC REP. SERV. 235, 242 (N.D. Ga. 1965).

cases that no reasonable estimate could possibly have been anywhere near as low as the option price.¹¹⁵ However, it is important that the principle of law should be clearly stated so that a correct result will be obtained in cases closer to the borderline.

In determining the anticipated market value at the option exercise date, evidence of the depreciation methods adopted by the lessor for accounting purposes, and especially those allowed by the Internal Revenue Service for taxation purposes, will be relevant.

3. *Meaning of Nominal Consideration*

Once the margin between the anticipated market value and a lower option price is calculated, a determination must be made whether this discount margin is so substantial as to render the option price nominal consideration within the meaning of the definition. This raises a major unresolved issue as to whether nominal is intended to cover any consideration which is not fair, adequate, and related to actual value although it may be substantial, or whether the term is confined to a non-substantial amount.

Louis Del Duca has suggested that the "Code test would appear to weight the scales in favor of a ruling that a transaction qualifies as a bona fide lease where a substantial consideration not clearly constituting a 'fair' or 'adequate' consideration is paid."¹¹⁶ However, he qualifies this prima facie view by stating that "[i]t would appear, however, that to find the 'lease' to be qualified as a bona fide lease, a term in the lease requiring payment of some amount approaching a 'fair' or 'adequate' consideration for the chattel at the time the option to purchase is exercised would be necessary."

Although he offers no authority for this interpretation, and there appears to be none in point,¹¹⁷ this view finds support in the general

115. For example, equipment whose current market value had depreciated to between \$7,500 and \$10,000 could be acquired for an option price of \$1,350. *In re Washington Processing Co.*, 3 UCC REP. SERV. 475 (S.D. Cal. 1966). In another case, the lessee could have exercised its option for about 40 percent of the depreciated value. *In re Transcontinental Industries, Inc.*, 3 UCC REP. SERV. 235 (N.D. Ga. 1965). In neither case did the referee consider specifically the appropriate rate of depreciation.

116. Del Duca, *Evolving Standards for Distinguishing a "Bona Fide Lease" from a "Lease Intended as Security"*—Impact on Priorities, 75 COM. L.J. 218, 219 (1970).

117. Judge Miller has pointed out that the courts have used the term "nominal" interchangeably with the sum of \$1.00 or some other small amount. *In re Wheatland Electric Products Co.*, 237 F. Supp. 820, 822 (W.D. Pa. 1964). However, although each of the cases he cites as examples involved bailment leases with option prices of \$1.00, no issue turned upon the quantum or the characterization of this sum as nominal, nor was there

purpose of Article 9. While the core meanings of the terms certainly indicate that substantial is more nearly the contrary of nominal than are any of the terms fair, adequate, or sufficient, it seems obvious that an option price which is substantial in absolute amount, such as \$1 million, will be inadequate, and therefore an indication of a security interest, if it is only 50 percent of the anticipated market value of the equipment at the contemplated option exercise date.¹¹⁸

It is submitted that substantial or nominal should not be considered as criteria for measuring dollar amounts of option prices in absolute terms. Rather, these option prices should be measured as percentages of anticipated market value. If this percentage is substantial, for example, above 80 percent, there is a good case for treating the agreement as a bona fide lease. Such a benchmark allows some leeway for differences of opinion as to depreciation rates and the charging of higher rentals in early years to offset the lessor's risk of early obsolescence. However, any percentage falling below some such benchmark should be regarded as nominal within the meaning of the definition.

The author acknowledges a natural inclination to recoil from the proposition that anything below 80 percent is a nominal figure. On closer examination, this may be seen as merely succumbing to the temptation to apply the well established contract law principle that adequacy of consideration is immaterial. In the contract field, the distinction is truly between:

(a) a purely nominal consideration of one dollar, which may be insufficient to support a contract because it is wholly illusory; and

(b) a substantial, though totally inadequate and unfair, consideration which will support a contract because the courts will not inquire into the fairness of the bargain, except where, for example, fraud is alleged or specific performance sought.

The purposes of required filing under Article 9, the protection of other creditors and bona fide purchasers and prevention of secret liens, suggest a very different interpretation of nominal. The author submits that for these purposes any payment which fails to bear a reasonable relation, for example 80 percent, to anticipated market value should be regarded as nominal. If the above reasoning is a correct analysis of the

any indication that the court would confine the term "nominal consideration" to an amount of this order.

118. Conversely, an option price of \$1.00 could be adequate and fair (although not substantial in absolute terms) if this genuinely was the anticipated market value.

legislative purpose in Article 9, consideration might be given to the desirability of amending the final part of the definition of security interest to read "for no consideration or for a substantially smaller consideration than the actual market value of the property." This would avoid any unnecessary confusion arising from use of the term nominal.

The device used in many leases of allowing the lessee to credit all or a percentage of rentals paid against the option price is only a method of calculation or bookkeeping. The quantum of the option price is clearly the amount of fresh consideration which must be furnished in order to acquire title. The credit for rentals paid may be achieved in several different ways.

(a) An option may be granted which is exercisable at any time during the currency of the lease. The option price is stated as list price, but credit is allowed for a certain percent of rentals already paid. Several cases using this method have come before the courts, and leases providing for a credit of 100 percent,¹¹⁹ 85 percent,¹²⁰ 80 percent,¹²¹ and 75 percent¹²² have all been held to create security interests.

However, another case, in which a lease providing for a credit of up to 75 percent of rentals paid was held to be a true lease, illustrates that the crucial figure is not the percentage of rentals credited, but rather the relationship of the new consideration furnished to the anticipated market value at the date the option is exercised. The case, *In re Alpha Creamery Co., Inc.*,¹²³ involved a three year lease of a typewriter accounting machine at a monthly rental of \$118. The lease contained a purchase option rider under which the lessee could purchase the equipment at any time during the lease at the list price of \$4,690. Credit would be allowed for a deposit of \$234 plus 75 percent of rentals paid in if the option were exercised during the first year, or 70 percent if exercised thereafter. However, since the anticipated depreciation of the equipment in the first two years of the lease was nearly equal to the rentals, the allowance of credit for 75 percent of the rentals resulted in a faster rate of depreciation than the accrual of credit. The result was that until very near the end of the term the option price exceeded slightly the antici-

119. *General Electric Credit Corp. v. Bankers Commercial Corp.*, 244 Ark. 984, 429 S.W.2d 60 (1968).

120. *United Rental Equipment Co. v. Potts and Callahan Contracting Co.*, 231 Md. 552, 191 A.2d 570 (1963). The report does not state explicitly that the option could be exercised at any time during the lease, but the absence of any stated restriction appears to imply that this was the case.

121. *In re Royer's Bakery, Inc.*, 1 UCC REP. SERV. 342 (E.D. Pa. 1963).

122. *Stanley v. Fabricators, Inc.*, 459 P.2d 467 (Alaska 1969).

123. 4 UCC REP. SERV. 794 (W.D. Mich. 1967).

pated market value of the equipment. Influenced to some extent by this factor,¹²⁴ the court held that the consideration was not nominal and that the lease was a true lease.

*Crest Investment Trust, Inc. v. Atlantic Mobile Corp.*¹²⁵ is a similar case where 75 percent of the rental payments could be deducted from an option price of \$3,400 for an office trailer. Since the option was only exercisable within one year of commencement of the lease,¹²⁶ the maximum possible credit was 75 percent of the annual rent of \$1,920 (equaling \$1,440), leaving a minimum option price of \$1,960, which was considered not to be nominal when compared with the total price of \$3,400. The categorization of this relationship, expressed as a percentage at 58 percent, can not be criticized. However, the court apparently assumed that the figure of \$3,400 represented the actual value of the trailer at the end of one year, although nowhere in the opinion is there any reference to evidence having been given on this point.

A case with somewhat similar initial facts is *In re Wheatland Electric Products Co.*,¹²⁷ but the finding of a true lease was based upon the fact that the original lease had been superseded and the option had been allowed to expire at the relevant time.

(b) A similar result may be obtained where the lease stipulates a fixed option price and precludes the allowance of any credit for rentals paid, but requires that the purchase option can only be exercised after all or a stated number of the rental installments have been paid on their due dates. It is more difficult to compare the cases within this category in terms of percentages because of the differing formulas prescribed in the lease agreements and the absence of full valuation figures in the reports.

For example, in *Washington Processing Co.*,¹²⁸ the three year lease provided for total rental payments of nearly \$14,000 and an option to purchase, exercisable only at the end of the lease, for \$1,350. The court's decision that this option price was nominal in relation to the current value of the equipment estimated at between \$7,500 and \$10,500

124. In fact Referee Bension appeared to attach greater weight to the ratio of option price to list price, and held that 32 percent represented an amount that was not nominal. The author has explained above his objections to this approach.

125. 252 Md. 286, 250 A.2d 246 (1969).

126. The written lease appeared to confine precisely the exercise of purchase option to the first anniversary of the lease. However, the lessor's practice was to allow the option to be exercised at any time after delivery, and the court's opinion is based upon this practice, rather than the strict terms of the purchase option.

127. 237 F. Supp. 820 (W.D. Pa. 1964).

128. 3 UCC REP. SERV. 475 (S.D. Cal. 1966).

is clearly correct. The decision also supports the previous comment that consideration by no means equivalent to one dollar or nominal in absolute terms may still be nominal in relation to actual value for the purposes of the section 1-201(37) definition. The only criticism of the decision is the referee's failure to inquire as to the estimated value which the parties at the commencement of the lease¹²⁹ would have anticipated the equipment would have had at the time contemplated for exercise of the purchase option, three years later. Theoretically, this might well have approximated \$1,350, although the court's oversight is probably excused by the common assumption, in the absence of specific contrary evidence, that the actual value of \$7,500 to \$10,500 was indeed the anticipated value.

However, *In re Merkel Inc.*¹³⁰ is not explained or justified so easily. A five year lease stipulated gross rentals of \$9,120 and an option exercisable at the end of the lease for \$800. The court measured the \$800, which was less than nine percent, against the total rentals, and held the consideration to be nominal. No attempt was made to relate the option price to the anticipated or actual value of the machinery at the end of the lease.

Other Indicia of Intention

While the ratio of option price to anticipated market value, and often, though less correctly, the ratio of option price to total rentals, per se can lead to a finding of a security interest, a finding of an adequate option price does not conclude the issue in the opposite direction. Moving one step further, the absence of an option, although a very important factor, does not preclude a finding of a security agreement. A brief examination will therefore be made of other indicia, which, taken alone or cumulatively and with or without a purchase option, may demonstrate an intention to create a security interest.

1. Relationship of Total Rentals to Market Purchase Price

If the structure of the lease, comprising its minimum term multiplied by the periodic rental for that term, will enable the lessor to recover the present cash market value in full plus interest at an appropriate rate, the lessor may not need or intend ever to recover possession of the

129. See note 114 *supra*.

130. 45 Misc. 2d 753, 258 N.Y.S.2d 118 (Sup. Ct. 1965), *rev'd on other grounds*, 25 App. Div. 764, 269 N.Y.S.2d 190 (1966). On the appeal, two judges found the lease to be a true lease, although their reasoning is not reported in the opinions.

leased equipment once all rentals have been paid in full.¹³¹ However, absent a purchase option at a nominal figure, an intention to abandon its proprietary interest in leased equipment can not easily be imputed to the lessor. On the other hand, if there is added to the above facts a finding that the minimum term closely approximates the anticipated economic life of the equipment, the intention becomes fairly obvious.

2. *Relationship of Periodic Rental to Market Rental*

A similar intention of security may be indicated where the periodic rental is substantially higher than prevailing market rentals for similar equipment. Since the lessor will obtain his return more quickly, an argument can be made that it will release the equipment to the lessee for a nominal consideration even though there is no express option. The argument is really only a makeweight, since most commercial lessors will seek to obtain the highest possible return, including any residual value in equipment at the end of a lease. The higher than market rental may reflect the lessor's conservative judgment on the risk of obsolescence.

3. *Other Conditions of the Lease Agreement and Surrounding Circumstances*

While a number of cases have involved consideration of other factors, the most important is probably *In re Transcontinental Industries*,¹³² since it is the only reported case of a lease without an option being held to create a security interest. The referee did not rely on any one condition in the lease, but rather upon the aggregation of the following conditions together with other surrounding circumstances.

(a) The lessee was required to pay all taxes and insurance premiums, and make repairs and alterations.

(b) The lessee was required to pay a stipulated loss value to the lessor in the event of destruction of the equipment, and to indemnify the lessor against all damages and claims arising out of the delivery, use, or return of the equipment.

(c) The lessee was required to pay a substantial deposit and obtain waivers from landlords.

131. In other words, the rentals duly discounted equal or exceed present market value. Of course, the problem remains of determining the appropriate discount rate, and this determination will have a substantial influence upon the apparent relationship of total rentals to market values. Examples of these capitalization techniques are given by Gant, *supra* note 8, at 139-40, exh. VI and VII.

132. 3 UCC REP. SERV. 235 (N.D. Ga. 1965).

(d) The lease provided for acceleration and the payment of attorney's fees in the event of default.¹³³

(e) Although there was no option to purchase, the lessee was given a right of first refusal at the end of the lease period.

The conditions referred to in (a) and (b) taken alone appear to be equivocal on the issue of creation of a security interest. Clauses similar to those in (a) have been present in other agreements held to be true leases,¹³⁴ and clause (b) only appears to protect the lessor from the risk of inadequate insurance coverage. The other conditions are substantial indications of a security interest, although the requirement of a deposit is somewhat equivocal.¹³⁵

Other surrounding circumstances which influenced the findings of the referee in *Transcontinental* included the following.

(a) The lessor never supplied equipment itself, but purchased equipment specifically for the purpose of leasing to the individual lessee requesting it.¹³⁶ The lessor's staff was not capable of physically handling the volume of equipment leased by it, nor was there any evidence of storage facilities or handling procedures for such equipment. From these circumstances, the referee concluded that "at the termination of the leases the property for the most part was retained by the lessees either through purchase or exercise of rent renewal option."¹³⁷

There are other circumstances which imply an intention to grant a "one-time lease" of equipment which the lessor does not anticipate reclaiming. The most striking example is where the utilization of the equipment approved by the lessor involves its attachment to realty or other chattels by means which render its removal impossible without substantial impairment.¹³⁸ A less usual illustration is where the lease period exceeds the expected life of the equipment.¹³⁹

133. *Accord, In re Pomona Valley Inn*, 4 UCC REP. SERV. 893 (C.D. Cal. 1967).

134. *E.g., Burton v. Tatelbaum*, 240 Md. 280, 213 A.2d 875 (1965); *In re Atlanta Times, Inc.*, 259 F. Supp. 820 (N.D. Ga. 1966).

135. "The absence of a security deposit tends to indicate that a true lease was intended, although its presence may be shown to serve a legitimate purpose rather than to serve as a disguised down payment." Welsh, *supra* note 106, at 283, citing *Sanders v. National Acceptance Corp. of America*, 383 F.2d 606 (5th Cir. 1967) and *Sanders v. Commercial Credit Corp.*, 398 F.2d 988 (5th Cir. 1968).

136. *Accord, In re Pomona Valley Inn*, 4 UCC REP. SERV. 893 (C.D. Cal. 1967).

137. 3 UCC REP. SERV. 235, 244 (N.D. Ga. 1965).

138. If the equipment becomes a fixture and the lease is held to create a security interest therein, priorities will be regulated by section 9-313. *See Leary, supra* note 59, at 232-35. For an illustration of a holding that equipment attached to realty was the subject of a true lease, *see Burton v. Tatelbaum*, 240 Md. 280, 213 A.2d 875 (1965).

139. *In re Pomona Valley Inn*, 4 UCC REP. SERV. 893 (C.D. Cal. 1967).

(b) Although the lessor had purchased the equipment direct from the supplier, a bill of sale was required from the lessee as an additional precaution to ensure that the lessor obtained title without reservation. Since the lessee never had title to pass to the lessor, this was really a paper device for further assurance, and not in fact a sale and lease back. In itself, it would not have supported a finding of a security interest.

Where the lease does arise out of a sale from lessee to lessor, "the facts seem to point clearly to the conclusions (a) that the sale and lease are not independent transactions, (b) that the price of the one is integrally related to the price of the other, and (c) that the transaction is a secured borrowing."¹⁴⁰ The author adopts these conclusions reached by Professor Myers after a comprehensive empirical study. It should be pointed out that while conclusions (a) and (b) are inferences of fact, conclusion (c) is equivalent to a statement of a legal result that Article 9 is applicable.

Identical conclusions have been reached by English¹⁴¹ and Australian¹⁴² courts where interdependence of the sale and hire-purchase agreement or lease-back to the seller could be shown. Earlier American decisions in lease-back situations were based upon an estoppel arising from the lack of change of possession,¹⁴³ and such an estoppel could be avoided, in theory at least, by providing for a notorious change of possession or by clear labelling to indicate the change of ownership. However, the test in section 1-201(37) makes no specific reference to outward appearances, but calls for an examination of the parties' actual intentions.

While the initial discussion of the reasons for leasing showed that accounting, and to a lesser extent tax, reasons may justify a sale and lease-back, the intention that the lessor shall retain a security in the equipment can not be ignored.

(c) The agreement required the lessee to sign such financing state-

140. See Myers, *supra* note 18, at 6. These conclusions were adopted by the Accounting Principles Board, *supra* note 21, ¶¶ 19-22.

141. *In re Watson*, [1890] 25 Q.B.D. 27; *Soneleigh Finance Ltd. v. Phillips*, [1965] 2 Q.B. 537.

142. *Price v. Parsons*, 54 C.L.R. 332 (1936); *Boydell v. James*, 36 S.R. (N.S.W.) 620 (1936).

143. *Davis v. Bigler*, 62 Pa. 242, 1 Am. Rep. 393 (1869). Another problem arises where there has been no change of possession because of the rule in many states that retention of possession of personal property by a seller is fraudulent. See, e.g., 1 G. GLENN, *FRAUDULENT CONVEYANCES AND PREFERENCES* §§ 346-63 (1940) and cases cited therein; Leary, *supra* note 59, at 231.

ments as were required to perfect the lessor's interest under the Code. The lessor did prepare and file, although apparently deficiently, such a statement. As pointed out earlier, such a requirement and the actual filing may be only precautionary and do not necessarily indicate an intention that the lease should operate as a security. An express denial of any such intention should be sufficient to negate any such implication.

4. *Treatment for Tax and Accounting Purposes*

If the parties prepare their tax returns or financial statements on the basis that the lessee has purchased the equipment, this is a clear indication of their intentions. However, for taxation and accounting reasons explained earlier, the lessee is unlikely to capitalize lease transactions except where they are clearly conditional sales under Article 9. The lessor's balance sheet treatment of equipment leases has caused far less difficulty than the lessee's, but the inclusion of equipment leases in the lessor's balance sheet as either "receivables under contracts for equipment rentals" or "equipment held for lease" respectively is also relevant to the determination of the parties' intentions.¹⁴⁴

Apart from the way in which the parties' own treatment of their transactions may reflect upon their intentions, the ruling principles laid down by taxation and accounting authorities are not particularly helpful to the resolution of the lease question under Article 9.¹⁴⁵ The *Guide for Tax Treatment of Leases of Equipment*¹⁴⁶ issued by the Internal Revenue Service under section 162(a)(3) of the Internal Revenue Code of 1954 has been referred to by the courts in Article 9 cases.¹⁴⁷ However, it offers no further analysis than that outlined in this article on such questions as when the lessee has acquired an equity or the meaning of nominal consideration for a purchase option.

Accounting authorities have suggested that the test for determining whether the leased equipment should be capitalized on the lessee's balance sheet is whether "the terms of the lease result in the creation of a material equity in the property."¹⁴⁸ The following quotation from

144. *Burton v. Tatelbaum*, 240 Md. 280, 312 A.2d 875 (1965).

145. For a general discussion of the taxation guidelines see Leary, *supra* note 59, at 238-40.

146. Rev. Rul. 540, 1955-2 CUM. BULL. 39.

147. *E.g., In re Royer's Bakery, Inc.*, 1 UCC REP. SERV. 342 (E.D. Pa. 1963).

148. Note 22 *supra*, at ¶ 10. The criterion previously recommended was whether "the transaction involved in substance a purchase." APB ACCOUNTING PRINCIPLES, ACCOUNTING RESEARCH BULL. No. 43, ch. 14, ¶ 7 (1953). The Board rejected the criteria suggested by Professor Myers of "the extent . . . that leases give rise to property rights." Myers, *supra* note 18, at 4.

the latest opinion of the Accounting Principles Board shows how closely its recommended principles approximate the tests suggested above for implementing the definition of security interest in section 9-201(37):

The presence, in a noncancelable lease or in a lease cancelable only upon the occurrence of some remote contingency, of either of the two following conditions will usually establish that a lease should be considered to be in substance a purchase:

- a. The initial term is materially less than the useful life of the property, and the lessee has the option to renew the lease for the remaining useful life of the property at substantially less than the fair rental value; or
- b. The lessee has the right, during or at the expiration of the lease, to acquire the property at a price which at the inception of the lease appears to be substantially less than the probable fair value of the property at the time or times of permitted acquisition by the lessee.

. . . .

The determination that lease payments result in the creation of an equity in the property obviously requires a careful evaluation of the facts and probabilities surrounding a given case. Unless it is clear that no material equity in the property will result from the lease, the existence, in connection with a noncancelable lease or a lease cancelable only upon the occurrence of some remote contingency, of one or more circumstances such as those shown below tend to indicate that the lease arrangement is in substance a purchase and should be accounted for as such.

- a. The property was acquired by the lessor to meet the special needs of the lessee and will probably be usable only for that purpose and only by the lessee.
- b. The term of the lease corresponds substantially to the estimated useful life of the property, and the lessee is obligated to pay costs such as taxes, insurance, and maintenance, which are usually considered incidental to ownership.
- c. The lessee has guaranteed the obligations of the lessor with respect to the property leased.
- d. The lessee has treated the lease as a purchase for tax purposes.¹⁴⁹

However, in a subsequent opinion on *Accounting for Leases in*

149. APB ACCOUNTING PRINCIPLES, ACCOUNTING PRINCIPLES BOARD, OPINION No.5 ¶¶ 10, 11.

Financial Statements of Lessors,¹⁵⁰ the Board did not adopt specific criteria, but listed a number of pertinent factors including but not limited to those adopted in *Opinion No. 5* for lessee's financial statements. Thus, the Board recognized the possibility that leases would continue to be treated as receivables in the balance sheets of lessors while being excluded as assets or obligations in the balance sheets of lessees—that is, neither party would disclose the ownership of the equipment as an asset. The Board justified this apparent inconsistency by emphasizing “the principal accounting problem of lessors to be the allocation of revenue and expense to accounting periods covered by the lease in a manner that meets the objective of fairly stating the lessor's net income.”¹⁵¹ The Board acknowledged that there “continues to be a question as to whether assets and the related obligations should be reflected in the balance sheet for lessees other than those that are in substance installment purchases. The Board will continue to give consideration to this question.”¹⁵²

It would appear that the tests adopted by the taxation and accounting authorities, though basically consistent with the policy of the Code definition of security interest, shed no further light on the analysis suggested in this article. However, the parties' own treatment of their transactions as sales or purchases in tax returns and financial statements could be weighty evidence of their intention to create Article 9 security interests. Conversely, treatment as true leases is only self-serving testimony, and would not of itself rebut an intention to create a security interest inferred by virtue of the other criteria discussed above.

The above analysis suggests the following conclusions regarding the Code definition of security interest.

(a) The primary test of the existence of a security interest is the parties' intention, objectively determined.

(b) The Code positively requires a finding of such an intention only where an option to purchase may be exercised for no consideration or a nominal consideration.

(c) The test of nominal consideration requires a comparison of the option price with what the parties at the commencement of the lease might reasonably have anticipated would be the market value at the time for exercise of the option. By expressing this comparison as a

150. APB ACCOUNTING PRINCIPLES, ACCOUNTING PRINCIPLES BOARD, OPINION NO.7 (May, 1966).

151. *Id.* at ¶ 18.

152. *Id.*

percentage, the term nominal should be applied as a measure of relative, rather than absolute, value.

(d) A figure of 80 percent of market value is suggested as the benchmark below which the option price may be considered nominal. This, or any alternative percentage, should not be applied as an absolute rule, however. Such a figure could be used as a presumption casting the burden of disproving intent to create a security interest upon the lessor. In any event, the opportunity should remain for the lessor to introduce evidence of a contrary intention.

(e) Where there is no option to purchase or where the consideration approximates actual market value, no presumption is indicated under the Code definition, nor is any justified in either direction. The presence of any of the factors discussed above or any other relevant circumstances should be weighed by the court to determine objectively the parties' intention. Too strict an application of the parol evidence rule to a lease containing an entire agreement clause appears unjustified and could work injustice to the lessee's other creditors.

CONCLUSION: POLICY ISSUES

Some brief concluding remarks seem necessary in relation to three policy issues arising out of this analysis and foreshadowed at the beginning of this article.

Is it sound policy for Article 9 to apply to leases intended as security?

The stated policy of Article 9 is that "the traditional distinctions among security devices, based largely on form are not retained The scheme of the Article is to make distinctions, where distinctions are necessary, along functional rather than formal lines."¹⁵³

One important expression of this policy is the rejection of any reliance upon written instruments or the concept of title as criteria for the existence of a security interest.¹⁵⁴ This position is in marked contrast to Commonwealth Bills of Sale legislation, which only strikes at transfers or assurances of proprietary interests in goods created by documents.¹⁵⁵

153. U.C.C. § 9-101, Comment.

154. *Id.* and U.C.C. § 9-202.

155. For similar reasons the Accounting Principles Board rejected Professor Myer's criterion of the creation of property rights. OPINION No.5, *supra* note 149, at ¶ 5, ¶ 9 where the following statement appears: "[S]ome lease agreements are essentially

The Code's policy is justified because it is functional and attempts to reflect the realities of the transactions it regulates. The inclusion of "leases intended as security" within the ambit of Article 9 is entirely justified because this type of lease achieves the same functional result as other forms of chattel security. Some inconsistencies as to the lessor's remedies arise from the application of Part V of Article 9 to leases intended as security but not to true leases.¹⁵⁶ Consideration could be given to extending similar provisions to true leases. Such action may be justified and achieved without raising the further question of whether the perfection and priority provisions of Article 9 should be extended to true leases. That question is discussed below.

Are the existing Code definition and the author's suggestions for implementation consistent with the general policy of Article 9?

The functional policy of Article 9 dictates that all transactions intended to create security interests in personal property should be regulated by the perfection and priority provisions. Although these provisions contain many variations and exceptions, they are based upon the function of the transaction or the type of collateral involved. It is submitted that, subject to one possible qualification raised below, the method of implementing the definition of "leases intended as security" outlined in this article only equates with other security interests those leases which are intended to achieve essentially similar results, and is therefore consistent with the policy of Article 9.

Should the ambit of the definition be expanded so that Article 9 applies to true leases?

This is a broader issue, and requires some analysis of the ultimate purpose of Article 9 and what classes of persons the perfection and priority provisions are intended to protect. The qualification foreshadowed in the previous paragraph relates not to the adequacy of the means suggested for implementing the present definition, but rather to the question of whether the definition itself should be broadened to cover leases other than those intended as security.

The perfection and priority provisions of Article 9 are designed to

equivalent to installment purchases of property. In such cases, the substance of the arrangement, rather than its legal form, should determine the accounting treatment."

156. See text accompanying notes 64-91 *supra*.

protect unsecured creditors of the lessee,¹⁵⁷ transferees in bulk from the lessee,¹⁵⁸ creditors of the lessee who perfect a security interest in leased equipment prior to perfection by the lessor,¹⁵⁹ and lienors who obtain liens upon the leased equipment for services or materials furnished with respect thereto.¹⁶⁰ The question then becomes whether these parties are entitled to similar protection when the equipment is held by the lessee under a true lease.

As demonstrated earlier,¹⁶¹ a bona fide purchaser of leased equipment is unlikely to obtain protection except where the lessee is a merchant, and the situation is similar whether or not the Code applies. However, where the goods are farm equipment having an original purchase price not exceeding \$2,500 or consumer goods, filing under Article 9 becomes material.

The protection offered to these parties by the Code is twofold:

(a) if the lease creates a security interest which has not been perfected, it is subordinated to these parties' claims; and

(b) if the security interest created by the lease is perfected, these parties will have the means of ascertaining the lessee's true position because the lessor has either repossessed the equipment or filed a financing statement.

Since most lessors who have legal advice already file for any lease likely to fall within the scope of Article 9, the protection of these third parties will normally be that described in (b). This is the only way to evaluate the purpose of Article 9, since it encourages filing by imposing the abovementioned sanctions for failure to file.

The primary policy of Article 9 then appears as the requirement of notice filing for the protection of the abovementioned parties.¹⁶² The major argument for requiring such notice in the case of a true lease is that in its absence others may rely upon the lessee's apparent ownership in extending credit or in purchasing the leased equipment from the lessee. Support for the argument may be found in the recording

157. U.C.C. § 9-301(1)(a), (3) (lien creditors).

158. U.C.C. § 9-301(1)(b).

159. U.C.C. §§ 9-301(1)(a), 9-312 and other priority sections referred to in section 9-312(1).

160. U.C.C. § 9-310.

161. See text accompanying notes 53-56 *supra*.

162. "The prime purpose of the Uniform Commercial Code is to require that all persons holding security interests in any property to publicly reveal such interest by the filing of a short and simple, but concise statement." *In re Transcontinental Industries, Inc.*, 3 UCC REP. SERV. 235 (N.D. Ga. 1965).

statutes of a few states which require all long-term bailments¹⁶³ to be recorded.

Another argument is that although a purchaser of equipment from a lessee who has no power to sell can obtain no title, if the lessor has in fact filed a financing statement to obtain protection from lien creditors, the purchaser will be able to ascertain the true state of the title by a search.¹⁶⁴ However, a lessee wishing to unlawfully dispose of equipment could use a fence or false name with the result that a search would not reveal the financing statement.

One proponent has argued that "there should be a presumption in favor of the application of Division Nine to most business leases,"¹⁶⁵ supporting his contention by the secret lien argument and the facts that filing is simple, involving little time or cost, and that most lessors informed by counsel file anyway. He suggests exclusion of leases for a term of less than six months and short periodic leases.¹⁶⁶

Rules of thumb or statutory provisions based upon the distinction between a business lease of equipment and a consumer lease, and/or upon the period of the lease, are sound in theory. However, the merits must be weighed against the opposing claim that creditors extending credit to debtors today no longer assume that goods in a debtor's possession are the debtor's property.¹⁶⁷ The validity of this argument depends upon

163. Generally for terms in excess of three years. The relevant references to these state statutes and to the recording requirements regarding security interest in aircraft, buses, and trucks under federal statutes are collected in Comment, *supra* note 66, at 673 n.7 and Comment, *supra* note 14, at 770 n. 93.

164. This argument should not be confused with the doctrine of constructive notice. The Code does not impose any penalty for failure to search nor is the author advocating such a doctrine. U.C.C. § 1-201(25), (26), (27).

165. Comment, *supra* note 107, at 136.

166. A similar distinction requiring disclosure in accounts of long-term non-repetitive leases but ignoring short-term or periodically renewable leases is recommended by the AMERICAN ACCOUNTING ASSOCIATION, A STATEMENT OF BASIC ACCOUNTING THEORY 32-33 (1966).

167. This assertion is made by the Bankruptcy Law Amendment Committee of The Board of Trade in England as a ground for recommending the repeal of the Bankruptcy Act provision that property in the possession, order, or disposition (reputed ownership) of a bankrupt, though not in fact owned by him, forms part of his estate and vests in his trustee. Cmnd. 222 ¶ 10 (1957) cited by R. GOODE & J. ZIEGEL, *supra* note 93, at 154. Although the provision is still in force in England, a corresponding provision was deleted from the Australian Bankruptcy Act in 1966. A similar assumption apparently underlies the unique category of "customary hire purchase agreements" created by the New Zealand Chattels Transfer Act 1924, namely that purchasers or encumbrancers ought to know that possession of goods within those classifications regarded by law as customarily sold under hire-purchase may not be owned by the possessor. Hence, these agreements are exempted from registration; all other hire-purchase agreements must be

one's "judgment as to strength of the policy that a public record should show all claims against the assets used in a business."¹⁶⁸

Creditors normally do not rely exclusively upon the asset value of the equipment of the lessee as the source from which they will be paid. If one of the lessee's reasons for choosing the lease form of financing is to avoid recording the equipment as an asset and the corresponding obligation as a liability on his balance sheet, creditors will have even less cause to complain that they relied upon the equipment as an asset of the lessee.

On balance, there would seem to be some justification for adoption of an amendment to the definition of security interest to include all leases, whether or not intended as security, which stipulate a non-cancelable term in excess of a prescribed minimum, for example five years. This addition should apply only to leases of equipment as defined in section 9-109(2).

Such an amendment would require filing in relation to some leases which are not within the present scope of Article 9. However, the burden of filing is not a heavy one, and may well be offset by the greater certainty and consequent reduced need for legal advice which would follow from adoption of a quantitative test such as that suggested. This result is in harmony with the aim of the Code draftsmen "to provide a simple and unified structure within which the immense variety of present-day secured financing transactions can go forward with less cost and with greater certainty."¹⁶⁹

registered to preserve the seller's title. Chattels Transfer Act, 1924, 15 Geo. 5, No. 49, § 57. In the United States, "credit extension moved from apparent ownership to an 'enterprise' theory of credit" based upon submitted balance sheets, financial reports, and credit ratings. Leary, *Secured Transactions-Revolution or Evolution*, 22 U. MIAMI L. REV. 54, 59-60 (1967).

168. Leary, *supra* note 59, at 249.

169. U.C.C. § 9-101, Comment.