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Symposium, Creditors' Rights, Security Aspects of Chattel Leases in Bankruptcy

Cover Page Footnote
Referee in Bankruptcy, Eastern District of Pennsylvania.

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DESPITE some of its risks, the leasing of chattels appears to have a growing attraction for the lessor and the prospective lessee. This trend in the direction of a broader use of the lease transaction affecting chattels is reflected in the increasing frequency of claims by alleged lessors of such property to recover its possession from trustees in bankruptcy.

Few, if any, problems are produced in bankruptcy by lease transactions involving what are termed "true," "bona-fide" or "straight" leases. These are leases calling for a rental for the "right to use" described personal property for a specific term, where the rentals over the term of the lease can be found to bear a reasonable relation to the average loss in value of the leased property due to aging, wear and tear, and obsolescence. The article involved is not usually available for outright purchase. Generally speaking, these so-called "true leases" generate little or no adversary action in insolvency proceedings.

The business of chattel leasing, however, is predominantly a financing operation. Leases have become instruments designed to finance the purchase of the leased article. For the prospective lessee, chattel leasing provides a method for capital expansion. The commitment of available funds for the outright purchase of capital equipment may not be desirable for the business at the time that the equipment is needed. In certain instances, a business may require specialized equipment only for a limited period of time or for a particular purpose. Likewise, the equipment needed by a business may have a high risk of obsolescence, not only as to the machine itself, but also as to the product that it produces. Finally, certain businesses find it advantageous to lease, rather than purchase, equipment because the rentals are chargeable as operating expense and, thus, deductible business expenses for income tax purposes.¹

From the standpoint of the lessor, the lease transaction also has certain attractive advantages over installment selling. In a lease transaction, the legal title to the leased article remains with the lessor. While the article is in the lessee's possession, it is not subject to levy by the lessee's creditors. Where several security interests are competing for the same security collateral, the lessor is able to stay out of the conflict.² Upon

*Referee in Bankruptcy, Eastern District of Pennsylvania.


2. For the rules governing the relative priority of competing security interests in the same collateral, see Uniform Commercial Code § 9-312.

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default, the lessor usually finds it easier to recover possession of the property from a lessee than to recover possession where the transaction is a conventional security interest.

Leases of chattels often provide that the lessee may become the owner of the leased article upon compliance with certain conditions. When lease agreements depart from the conventional provisions that characterize bona fide lease transactions by granting to the lessees rights or options to acquire ownership of the leased property, these agreements begin to take on "chameleon characteristics." Since chattel leasing ordinarily involves goods which the Uniform Commercial Code classifies as equipment, the filing prescribed by section 9-401 of the Code might be necessary where the option-to-purchase provisions of the lease render the transaction a security agreement. Because lessors ordinarily do not support their lease transactions with filing of any kind, these transactions are frequently attacked by bankruptcy trustees as unperfected security interests. These transactions are vulnerable because the trustee in bankruptcy is vested with the rights, remedies, and powers of a lien creditor as to all the property upon which, at the date of bankruptcy, a creditor of the bankrupt could have obtained a lien. Furthermore, section 9-301(1)(b) of the Code provides that an unperfected security interest is subordinate to the rights of persons who become lien creditors without knowledge of the security interest and before it is perfected. The problem for the courts is, therefore, to determine at precisely what point such purported lease transactions undergo the transition from a lease to a sale.

The practice of casting contracts in the form of leases with options to the lessee to purchase for a small consideration at the end of the term where all the rent has been duly paid, or with express agreements that, upon payment of all rents due under the lease, title to the leased property vests in the lessee at the end of the term, renders such transactions leases in name only. The so-called rents, in reality, are nothing other than payments of installments of the price. The Commissioners' note to Section 1 of the Uniform Conditional Sales Act declared that a lease is substantially equivalent to a conditional sale "when the buyer is bound to pay rent substantially equal to the value of the goods and has the option of becoming or is to become the owner of the goods after all the rent is paid."

However, simply observing that the sum of the rentals substantially approximates the price of the property does not of itself indicate that the transaction is a sale or intended as security. Consideration of mere arithmetic can yield only tentative and provisional conclusions. For a lessor to engage in chattel leasing, he must, even in a true lease arrangement, provide for aggregate rentals in single or successive leases that at least equal the acquisition cost of the leased article, plus his costs of doing business, a reasonable profit, less salvage at the end of the useful economic life of the article. There must be more in evidence than the substantial equivalence of the total rents and the value of the leased article, in order to transform the lease into a sale or secured transaction.

The security aspects of chattel leasing have been given rather oblique treatment under the Uniform Commercial Code. Among the contractually created security interests catalogued in section 9-102(2) are leases that are intended as security. But the substantive rules governing when or whether a lease is one intended as security are made a part of the definition of the term "security interest" in section 1-201(37). It is provided in that section that reservation of title in a lease is not a security interest unless the lease is intended as security, and whether a lease is intended as security is to be determined by the facts of each case. The presence in a lease of an option to purchase does not of itself under the Code render a lease one intended as security. Thus, the intention of the parties is made the polestar for determining whether a transaction which in form purports to be a lease is, in fact, something else. This is substantially a codification of what the judicially established law had been prior to the advent of the Code.

The Code does, however, provide a definitive rule for determining when a purported lease becomes a secured transaction. In section 1-201(37), it is provided that an agreement in a lease that "upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended as security as a matter of law." This, too, is a recodification of prior statutory law.

10. Uniform Commercial Code § 1-201(37).
11. Ibid.
12. Ibid.
13. See, e.g., Western Contracting Corp. v. Commissioner, 271 F.2d 694 (5th Cir. 1959); Breece Veneer & Panel Co. v. Commissioner, 232 F.2d 319 (7th Cir. 1956); Benton v. Commissioner, 197 F.2d 745 (5th Cir. 1952); Jefferson Gas Coal Co. v. Commissioner, 52 F.2d 120 (5th Cir. 1931).
14. Uniform Commercial Code § 1-201(37).
15. Uniform Conditional Sales Act § 1.
Options to purchase that may be exercised in other ways can also transform a lease into a security agreement. A lease agreement that contains an option to purchase that is exercisable at any time (or at stated intervals) during the term of the lease, and which gives credit towards the purchase price of a substantial percentage of the aggregate of all rentals already paid, is very likely to transform the purported lease into a secured transaction. Similarly, the presence of an option to purchase in a lease may affect its legal character in cases where the lessee is building equity in the leased property by paying rentals higher than those which would be charged as normal use charges.

However, even the presence of an option to purchase in a lease will not affect its legal character as a lease where the lessee also is given the right to terminate or extend the term of the lease, or where no part of the rentals already paid are applicable to the option purchase price. Likewise, its legal character as a lease will not be affected where the option price was intended, and is found, to be a reasonable approximation of the market value of the property leased at the end of any given period when the option may be exercised, and where the rental charges were intended, and are found, to fairly compensate the lessor for the loss in value of the property over the term of the lease, due to aging, wear and tear, and obsolescence.

The many variations of the option to purchase that are employed by the inventive minds of the legal draftsmen who prepare chattel leases render it inappropriate to attempt to catalogue them in a brief treatise. Perhaps the broadest judicial treatment of leases has occurred in a line of authoritative tax cases involving the tax consequences of chattel leases. In those cases, the Commissioner of Internal Revenue repeatedly endeavored to persuade the courts to adopt an objective "economic test" in analyzing the lease transaction to ascertain its true legal character. The economic analysis test proceeds upon the theory that, if the rental payments substantially equal the purchase price of the goods, and the lessee has the option of purchasing the property for a nominal consideration, then the agreement should be found to be a sale rather than a lease.

In 1955, the Internal Revenue Service promulgated Revenue Ruling 55-540, which provides:

Whether an agreement, which in form is a lease, is in substance a conditional sales contract depends upon the intent of the parties as evidenced by the provisions of the agreement, read in light of the facts and circumstances existing at the time the agree-

17. Oesterreich v. Commissioner, 226 F.2d 798 (9th Cir. 1955).
18. See Breeze Veneer & Panel Co. v. Commissioner, 232 F.2d 319 (7th Cir. 1956).
20. See id. at 164.
ment was executed. In ascertaining such intent no single test, or any special combination of tests, is absolutely determinative.\(^{21}\)

However, the Government has urged and the Tax Court has repeatedly held that, if the rents equal the purchase price and there is an option to buy for a nominal amount, then it is \textit{conclusively} established that the parties intended a sale rather than a lease.\(^{22}\) The rationale for this position is apparently that the lessee is acquiring an equity in the property and, therefore, his payments would not be deductible as rental expenses under section 162(a)(3) of the Code.\(^{23}\) Since they do not qualify as rents, they, therefore, must be part of the purchase price. Thus, in \textit{Judson Mills},\(^{24}\) the court found that it matters not whether the contract was in the form of a lease or a conditional sale, or \textit{what was the intention of the parties}; if, under the terms of the contracts by which the payments were made, the [lessee] . . . acquired an equity in the machinery . . . the payments would not be deductible, due to the limitation prescribed in the Code.\(^{25}\)

Several appellate courts, while often agreeing in result, have disagreed with the means used in arriving at the result.\(^{26}\) These courts have held that this economic analysis test is only one of the factors to be used in determining the intent of the parties, and that it alone should not conclusively establish intent. What the other factors might be depends largely upon the particular circumstances of the case. Typically, some other factors which would merit consideration are the conduct of the parties, \textit{e.g.}, did the lessor report the income received as ordinary income; whether there is a right of repossession on default or bankruptcy; and the reasonableness of the rent as compared with the rentals of similar items in the same general area.\(^{27}\) Although we limit ourselves here to a consideration of the security aspects of chattel leasing, these tax cases are informative as to the method that the courts employ to learn the true character of the agreements.

One of the more carefully considered decisions involving the tax consequences of a leasing program undertaken by a manufacturer of machines is \textit{Kearney & Trecker Corp. v. United States},\(^{28}\) decided in 1961. In that case, the court considered the Government’s proposed objective

\(^{22}\) See, \textit{e.g.}, Truman Bowen, 12 T.C. 446 (1949); \textit{Judson Mills}, 11 T.C. 25 (1948).
\(^{24}\) 11 T.C. 25 (1948).
\(^{25}\) Id. at 32. (Emphasis added.)
\(^{26}\) \textit{E.g.}, Breece Veneer & Panel Co. v. Commissioner, 232 F.2d 319 (7th Cir. 1956); Oesterreich v. Commissioner, 226 F.2d 798 (9th Cir. 1955).
economic analysis and rejected it. The manufacturer, who had previously sold its machines on outright sales or under installment arrangements by use of chattel mortgage or conditional sales agreements, set up a leasing program after careful study.\textsuperscript{29} The leases it offered to prospective customer-lessees were for seven-year terms at scaled periodic rentals. A choice of three options to purchase were available to the lessee; the lessee also had the option to terminate the lease at specified intervals. In its tax returns, the lessor treated the rentals as ordinary income, while deducting depreciation on the leased machines. Finding that the rental charges spread over the first three years of the leases aggregated approximately seventy-five per cent of the list price of the machines, the Government contended that the agreements were, in reality, conditional sales since, during the first three years, the lessees were acquiring an equity through their payment of rentals. The court observed that the rentals alone did not necessarily indicate that a portion of such rentals were actually payments on an installment sale, especially where it had not been shown that such rentals, though high, were unreasonable.\textsuperscript{30} The court was able to find from the evidence that the rentals were fixed at the higher rate during the early years of the lease because the rate of depreciation was higher during those years.\textsuperscript{31} Additionally, the court found that

the option prices [under all three option plans] were intended to be and were reasonably close approximations of the market value of the machines at the end of any given number of years [and] . . . that the rental charges were intended . . . and did sufficiently compensate the [lessor] . . . for the average loss in value [of the leased article] over the term of the lease attributable to aging, wear and tear, and obsolescence.\textsuperscript{32}

Furthermore, the Government had produced no evidence in support of its contention of the lessee's alleged equity in the machines by showing that the option prices were so low when compared to market value as to indicate that the lessees had acquired an equity when exercising their options to purchase.\textsuperscript{33} After examining all the economic factors pointed

\textsuperscript{29} “This determination [to install a lease program] was reached after noting that the average price of milling machines had risen from $10,000 to $20,000 between 1940 and 1950, that many customers wanted to try out the machines in their own plants before purchasing, that technological advances gave rise to a desire on the part of customers to avoid the risk of obsolescence, both of the machines and the product for the manufacture of which it was used, by shifting it to the manufacturer, and that many customers needed a specific machine for work of a definite duration or performance of one contract and would have no need for it thereafter.” Id. at 159.
\textsuperscript{30} Id. at 163.
\textsuperscript{31} Ibid.
\textsuperscript{32} Id. at 162.
\textsuperscript{33} Ibid.
out by the Government, the court held that the character of the trans-
action was to be determined, among other things, by the intention of
the parties as ascertained from the agreement and the surrounding cir-
cumstances existing at the time that it was made.\textsuperscript{34}

In \textit{Benton v. Commissioner},\textsuperscript{35} the court also rejected the objective
economic approach to a determination of the character of the agree-
ment. The court held that the economic relation of the value of the prop-
erty to the option price was only one factor to be considered when ascer-
taining the intent of the parties,\textsuperscript{36} and that factor was to be examined
not at the time when the option was exercised, but, rather, in the light
of the facts and circumstances that existed at the time that the parties
entered into the contract.

In a recent Fourth Circuit case,\textsuperscript{37} the respective contentions of the
taxpayer and the Government were the reverse of what they usually are.
The taxpayer had treated the series of payments which he received under
an agreement for the sale of a group of theaters as a sale of capital assets; the Government contended that the payments were rentals re-
ceived pursuant to a lease agreement. In holding that the transaction
was a sale, the court declared that the character of the transaction was to
be ascertained by looking at the \textit{substance} of the transaction and not at
the label placed upon the transaction by the parties.\textsuperscript{38} The true nature
of a transaction, said the court, was "to be determined by looking at all of
the facts and circumstances surrounding the transaction."\textsuperscript{39} In instances

\textsuperscript{34} It had been noted earlier by the court that, although certain decisions had based
determination as to the nature of each particular transaction on the intent of the parties,
"the plaintiff and defendant have agreed that the determination here be made on the basis
of the lease program as a whole and not on the basis of a consideration of each of the 87
separate transactions." \textit{Id.} at 160. The court found substantial similarity between the case
before it and Breece Veneer & Panel Co. v. Commissioner, 232 F.2d 319 (7th Cir. 1956), upon
which it relied heavily. The Breece court was impressed by the fact that, after the termination
of the "lease," the taxpayer had to pay a substantial sum before he

\textsuperscript{35} \textit{Meiselman v. Commissioner}, 300 F.2d 666 (4th Cir. 1962).

\textsuperscript{36} \textit{Id.} at 668.

\textsuperscript{37} \textit{Ibid.}
where no evidence is submitted bearing upon the intent of the parties to an agreement, their intent must be gathered from the writing itself. 40

In *Western Contracting Corp. v. Commissioner*, 41 a construction contractor requiring heavy equipment for a large project obtained 123 units, most of them new, from dealers upon leases for terms ranging from seven to twenty-eight months. None of the leases contained an option to purchase the equipment, nor were there any side agreements regarding purchase. At the end of their respective lease terms, thirty pieces were returned to the lessors; the contractor purchased the remaining ninety-three units at the end of their respective lease terms. Upon execution of the separate leases, it was the practice for the dealer-lessee to procure a loan from a bank in an amount substantially equal to the acquisition cost of the equipment by giving the bank its note and a chattel mortgage. At the same time, the dealer would also assign to the bank its lease with the contractor, who thereafter made his rental payments directly to the bank.

When the contractor indicated a desire to purchase the equipment, the dealers arrived at the amounts that they would accept as "end payments," by taking their list prices, adding their financing costs, and deducting therefrom all rentals paid by the contractor. In this setting, the Government disallowed the rent payments as deductible business expenses. However, the court found the agreements to be lease agreements, which was what they purported to be at the time that the agreements were entered into. The transaction was not to be judged by what the parties later decided or agreed to do. 42

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40. *Jefferson Gas Coal Co. v. Commissioner*, 52 F.2d 120 (3d Cir. 1931). "[T]he real character of an instrument must be determined from the intention of the parties as gathered from a fair interpretation of the instrument as a whole." Id. at 122.

41. 271 F.2d 694 (8th Cir. 1959).

42. The Tax Court, in looking beyond the face of the leases, had considered the economic factors involved and had deduced the legal conclusion that the dealer and the contractor had intended a sale at the time of the agreements. Id. at 699. In rejecting this conclusion, which had the effect of reading an implied option or agreement into the leases, thus providing the contractor with a right to buy the equipment, the court of appeals stressed that the leases did not purport to transfer title nor did they obligate the dealers to transfer title at some time in the future. Id. at 699-700. "The absence of either an option clause or a stipulation providing that upon payment of the stipulated rent title would vest in [the contractor] . . . is likewise fatal to a contention that the instruments upon their face have the characteristics of a conditional sales contract." Id. at 700-01. While noting that "a mere mechanical application of economic factors is erroneous . . ." without consideration of other circumstances, id. at 702 n.10, the court stated: "In a proper case, the economic factors of the situation may be important in interpreting an agreement, and in arriving at the intent of the parties, but there is no legal basis here for holding . . . that such factors and circumstances can make a new agreement for the parties . . . It simply does not follow that because [the contractor] . . . ultimately acquired all 93 pieces of equipment, it therefore had the legal right to so acquire them . . ."
In *Oesterreich v. Commissioner*, the parties regarded their agreement as a lease and treated the payments as rental income and rental expense, respectively, in their tax returns. In holding the agreement to be a contract of sale, the court observed that the test was not what the parties called the transaction, nor even what they mistakenly believed to be the name of such transaction, but, instead, what the parties believed the legal effect of the transaction to be. It further held that, where the parties entered into a transaction which they honestly believed to be a lease, but which in actuality had all the elements of a contract of sale, it was a sale not a lease, no matter what they called it or how they treated it in their books.

These appellate cases cannot and should not be taken to imply that the economic analysis test cannot receive paramount consideration under any circumstances. It will be determinative of the result in cases where the amount paid for the "purchase" at the termination of the lease is disproportionately low. In all of the cases discussed above, where the courts, in finding that the agreements were leases rather than sales, refused to sanction the application of the economic analysis test as the sole criterion, the amounts paid for the property were generally substantial.

Under Section 1-201(37) of the Uniform Commercial Code, it appears that the economic analysis test would also be applicable in bankruptcy cases in those situations where the option to purchase can be exercised...
for little or no consideration.\textsuperscript{47} Thus, the few bankruptcy cases which have dealt with the security aspects of lease agreements are not in conflict with the tax cases just summarized. In \textit{In the Matter of Crown Cartridge Corp.},\textsuperscript{48} Referee Herzog of the Southern District of New York, whose decision was affirmed by the district court, had disallowed an alleged lessor’s application to recover certain machinery, on the ground that the purported lease agreement, by its terms, amounted to an unrecorded conditional sales contract. The agreement was a sixty-month lease with rentals on a sliding scale. After about two-thirds of the rentals had been paid, the lessee defaulted. Under the terms of a separate agreement executed simultaneously with the principal lease agreement, the lessee had the option to purchase the “leased” property at the end of the term at ten per cent of the list price shown in the lease. Neither the lease agreement nor the option to purchase were recorded. The referee found the list price to be 45,000 dollars and the fair market value of the leased property at the conclusion of the lease to be 24,000 dollars. He concluded that the option price of 4,500 dollars was nominal in relation to fair market value.\textsuperscript{49}

To the same effect is \textit{First Nat’l Bank v. Phillips},\textsuperscript{50} which affirmed the holding of the referee in bankruptcy who had denied a petition to reclaim property allegedly leased to the bankrupt under the terms of an “equipment rental agreement.” The referee decided that the agreement, by its terms, constituted a conditional sale which, being unrecorded, was void as to the trustee.

In \textit{In the Matter of Royer’s Bakery, Inc.},\textsuperscript{51} certain machinery was delivered to the bankrupt company under the terms of an unfiled written lease agreement. The term of the lease was thirty-five months, and the lessee was given the privilege of returning the equipment, upon thirty days’ prior notice, without further obligation except the payment of all amounts due at the date of return. The lease was renewable. However, the lessee also had the option to purchase the leased equipment at any time during the term of the lease or renewal thereof upon payment of the list price, “less 80\% of the aggregate rental payments previously made, up to but not exceeding, the list price of the equipment so pur-

\textsuperscript{47} See text accompanying notes 14 & 15 supra.
\textsuperscript{49} The court observed that the purchase price was “patently out of proportion to the market value of the goods,” and that the sale, therefore, tended “to create an inference that the ‘lease’ [was] . . . a device for camouflaging what is in all essential respects a conditional sales contract under New York law.” Id. at 917.
\textsuperscript{50} 261 F.2d 588 (5th Cir. 1958).
\textsuperscript{51} 56 Berks County L.J. (Pa.) 48 (1963).
The referee found the option to purchase in the lease a device for financing the purchase and held the lease to be an unperfected security interest for lack of filing.

In *Matter of Larr Optics & Electronics Co.*, the lease of equipment contained an option to purchase whereby, upon payment of all rentals for the entire term of the lease, the lessee became entitled to a bill of sale upon its payment of a sum amounting to slightly more than two months' rent. The lease was for sixty months. The referee found that the rentals were unrelated to the use of the property, that the total rentals for sixty months were a fixed obligation of the lessee-bankrupt, and that the reservation of title in the purported lessor was nothing more than a device to secure that fixed obligation.

In *Matter of Transcontinental Indus., Inc.*, the trustee challenged the validity of the purported equipment leases, wherein the bankrupt was the lessee, as being unperfected security financing agreements. After examining the circumstances under which the leases were entered into, the referee found that it was the intention of the parties and the purpose of the agreements to accomplish a purchase of the equipment under security financing arrangements which the parties fashioned in terms of a lease.

Most of the reported cases dealing with equipment leases have been concerned with situations growing out of proceedings involving the debtor-lessee. But there is opportunity for situations involving the lessor as well. It is not uncommon for lessors to finance the purchase of machinery and equipment which becomes the subject matter in lease agreements with their customers. When they do, the lease agreements may become part of the lenders' collateral.

In the leasing industry, lending institutions play an important role. This is so because lessors require substantial amounts of capital funds to finance their acquisitions. In states where the Uniform Commercial Code is in effect, this financing may be accomplished by using the lease as collateral. When combined with the note obligations of the lessor, the assigned lease constitutes chattel paper in the hands of the lending institution within the meaning of section 9-105(1)(b) of the Code. Its status as chattel paper is not affected by the problem of whether the lease is a true lease or one intended by the lessor and lessee as security. Where, however, the lease is one intended for security, some complex questions

52. Ibid.
in priorities among conflicting security interests can evolve between creditors of both the lessor and the lessee.\textsuperscript{55}

It will be some time before the law relating to the security aspects of chattel leasing is developed sufficiently to provide the relative certainty that is so badly needed in this small corner of personal property law.

\textsuperscript{55} See note 2 supra.