Look before you lease

Pitfalls and opportunities in leasing business equipment

By BARRY S. MARKS and JAMES M. JOHNSON

Marks is a shareholder with Berkowitz, Lefkovits, Isom & Kushner in Birmingham, Ala. Johnson is a professor of finance in the Graduate School at Northern Illinois University in Dekalb, Ill.

Did you know that eight out of 10 American companies lease some or all of their business equipment? Put another way, nearly one-third of all business investment in equipment is financed with some form of equipment lease. Despite changes in tax laws and economic conditions, equipment leasing remains one of the most popular means of financing business-equipment acquisitions in this country.

Like many types of financing, equipment leasing is form-driven. Counsel unfamiliar with key legal, tax and business considerations important to this type of financing often fail to spot problem language in some of the forms.

This article will focus on some of the more common "gotcha's" in lessor-generated form documents. Although the article will deal chiefly with financing provided by third-party lessors (as opposed to equipment vendors), most of the considerations listed below are applicable to a wide variety of equipment leases, including third-party and vendor leases, true leases and leases intended as secured transactions, short-term and "full payout" leases, leases of various types of equipment and leases of various sizes. Although advice will generally be given to lessee counsel, counsel for lessors should consider lessee priorities and options in tailoring forms to specific transactions.

Before looking at the terms of the typical lease, a few words about the role of lessee counsel are appropriate. Counsel, particularly in-house counsel representing lessees, need to be aware that equipment leasing is a specialty having a limited overlap with other types of financing. Form documents are prepared, and usually negotiated, by experienced lawyers who specialize in equipment-lease financing. It is rare that the negotiations are conducted on
Adding to the problem is the danger that the client will actually work against its own counsel. If the client has selected the leasing company prior to initiating negotiations on documentation, the leasing company has an immediate advantage and a strong disincentive where negotiating is concerned.

Finally, lessee counsel needs to assemble information about the circumstances of the negotiations before proceeding. The correct response to lessor demands often requires an understanding of the lessor’s and lessee’s respective priorities:

- **Know your lessor** — Leasing companies come in many varieties, including banks, brokers, equipment specialists, captives, independents and companies of all sizes. Each has a different level of flexibility as to various matters, such as the ability to provide future funding for upgrades or equipment additions, regulatory and practical limitations on the acceptable amount of end-of-term exposure (the “residual assumption”), and the ability to fund the transaction should a change occur in prevailing interest rates or other circumstances between execution and delivery.

- **Know your equipment** — Will the equipment require special maintenance and does the lessee want to provide this maintenance in-house? Is it likely that the equipment will require upgrades or modifications during the lease term? Is it likely that the equipment will become obsolete or otherwise undesirable during the lease term? Is it likely that the equipment will become essential to the lessee’s business so that the lessee will want the right to purchase the equipment at the end of the term for a pre-agreed purchase price?

- **Know your client** — Is the lessee likely to merge or undergo another change of circumstances during the lease term? Is the lessee particularly rate-sensitive? Does the lessee have other means of financing equipment? Is it likely to be necessary to move the equipment during the term or to make other arrangements?

Some of the most serious problems with equipment leases come at the very outset. Most leases provide that the lease term does not start until the acceptance date (or commencement date), which is the date on which the lessee signs an acceptance certificate indicating that it has inspected the leased equipment and found it to be in acceptable condition.

Once the acceptance certificate is signed, the lease become irrevocable and is an absolute obligation of the lessee. Virtually all equipment leases contain a hell or high water clause stating that the lessee must make payments in all events, even if the equipment fails to function properly. The hell or high water clause is never negotiable. Lessor counsel usually responds by comparing the lease to a loan financing, in which the borrower is not permitted to cease making payments to the bank should the collateral fail to function as desired.

With this in mind, it is crucial that the lease provides that the lessee has the absolute right to reject equipment that does not properly function. Consider the two following provisions regarding commencement of the lease term:

The lessee shall be deemed to accept the equipment upon its delivery and installation by the supplier and shall evidence such acceptance by execution of an acceptance certificate.

Upon delivery, the lessee shall inspect the equipment and, if the lessee determines in its sole discretion that the equipment functions properly, the lessee shall execute an acceptance certificate.

A second, related issue is whether the term of the lease begins prior to the date the lessor makes payment to the vendor. Should the lessor be entitled to a 30-, 60- or 90-day “float” while the lessee is paying lease rentals? Is there a danger (given the size and nature of the leasing company) that the lessor will go out of business and be unable to make the required payment to the vendor after the lessee has signed an irrevocable lease?

A third issue that often escapes attention at the outset of a lease is the matter of interim rent. Most leasing companies, and many lessees, prefer to pay rent on the first or fifteenth day of the month. Because the lease term starts on execution of the acceptance certificate, it is unlikely that the actual lease commencement date will fall on the first or fifteenth day.

Most leases provide that the lessee pays interim rent during the period from actual acceptance to the pre-agreed first rental payment date. On its face, it seems perfectly logical to calculate this rental as 1/30th of a monthly rent payment (or 1/90th of a quarterly payment).

Consider, however, that the lessee generally calculates the amount of rent it will be paying over the agreed term of the lease: 36, 48, 60 months, etc. Paying a full interim rent can increase the lease term by as much as 29 days (89 days in a quarterly rent lease).

In some circumstances, this does not present a problem for the lessee. Often, however, the lease is a full payout lease, in which the lessee is aware that it is repaying the full initial purchase price of the equipment with implicit interest over the lease term. If so, by paying interim rent, the lessee is paying more than the entire purchase price of the equipment. Even in a shorter-term lease, the additional payment is something for which the lessee...
A third, often overlooked, alternative is the early buy-out option (EBO). An EBO gives the lessee the right to purchase the equipment from the lessor for a pre-agreed amount. Again, this purchase price covers the lessor's anticipated return.

The difference between the two is fairly obvious: Under an ETO, the lessee parts with the equipment for an agreed-upon cost to cancel. Under an EBO, the lessee purchases the equipment during the lease term. As such, the EBO really protects only the lessee's initial cost-of-funds assumption; if interest rates fall or lessee acquires additional funding ability, an EBO may be preferable. On the other hand, the cost of exercising an EBO will normally be significantly higher than an ETO. This is because the lessor's hoped-for residual upside must be recovered, as well as the conservative residual estimate the lessor originally assumed. Further, the lessee will in all likelihood be required to pay sales tax on exercising the EBO, since title will pass to the lessee — a cost not relevant to the ETO case.

A third, often overlooked, alternative is the sublease right. Subleasing is often available where the lessor is not in
the position to offer an ETO or an EBO, or the lessee cannot negotiate either of those two options on acceptable terms. In order to avail itself of the sublease option, however, the lessee must be in a position to market equipment to similarly situated lessees who may be better able to use the leased equipment. In a large organization, prospective lessees could be sister companies, which might make the search for a potential user less daunting.

Common to virtually all leases is a requirement that the lessee insure the leased equipment and be responsible in the event the equipment is damaged or destroyed. Among the key issues to be considered in this portion of the lease are whether the lessee desires the right to apply insurance proceeds to replace leased equipment (preserving the financing and expediting acquisition of replacement equipment) and how the lessee's obligation with respect to loss or destruction is calculated.

Most leases provide that the lessee must pay (through insurance proceeds or otherwise) the stipulated loss value (SLV) or casualty value of the equipment. In theory, the SLV simply compensates the lessor for its anticipated return on the lease at the end of the term.

SLV and EBO values are very much the same, since the lessor is disposing of its interests in the leased equipment under either scenario. An SLV value for any month during the lease should equal the present value of remaining lease payments and originally booked residual value (as in the ETO case), adjusted for tax effects. The lessor often increases the residual value component to cover its potential upside on disposition of leased equipment. In fact, SLVs typically are significantly higher than their theoretical value because of aggressive residual value components (and lack of lessee understanding). Significant improvement (reduction) in the cost of SLVs can be achieved by vigorous negotiation.

Before leaving this area, counsel should be careful as to the wording of any replacement "option." Many lease forms currently require the lessee to replace equipment that has been destroyed. The option to replace should always rest in the lessee because that company should be fully compensated through payment of SLV. Also, care must be taken as to the precise wording of what is permissible as replacement equipment. Standard language often requires identical replacement equipment, or equipment from the same manufacturer. Greater flexibility in substitutable equipment is desirable in most cases.

At the end of the lease term, most leases state that the lessee must return the equipment to: "a location designated by the lessor within the continental United States." Return is to be at the lessee's own cost and exposure, but often by a common carrier or other means selected by the lessor.

Many consultants urge that the lessee not agree to pay the cost of return of the equipment as the purchase price usually includes the cost of freight-in. The lessee should be aware, however, that refusing to pay for return delivery usually results in higher lease rates because it affects the lessor's assumed end-of-term residual-value recovery.

A better negotiating position is often to limit the areas to which the equipment must be returned, such as return within a 100-mile radius of the lessee's place of business, or to negotiate a cap as to the financial obligation to be incurred by the lessee.

Another common pitfall is language reading as follows:

At the end of the term, the lessee shall deliver the equipment to a location within the continental United States specified by the lessor, fully de-installed and crated and recertified by the manufacturer for future use.

This language would require the lessee to cease using the equipment, de-install it and have it checked by the manufacturer for recertification during the lease term. Better language requires the lessee to begin these procedures at the end of the term, assuring the lessee full use of the equipment during the entire lease term.

As to purchase and renewal options, the best advice is for the lessee's counsel to read carefully the printed form. Many draftsman insert in "standard" language terms such as the following:

So long as the lessee is not in default hereunder, the lessee shall have the option to purchase the equipment at its fair market value (as determined by the lessor); or "at the greater of fair market value or 10 percent of the original equipment costs ..."; or "... at the fair market value as determined by mutual agreement or, if the parties cannot agree, by an appraiser selected by lessor ....

Many of the problems with these types of language are readily apparent. What is not so apparent is the use of the term "in default." Unless otherwise defined, this would deny the lessee the right to exercise its purchase option (or, if used elsewhere, its early termination, early buy-out, replacement or renewal option) if the lessee is one day late in providing annual financial statements, paying a property tax or taking any other action. Better language reads "so long as no event of default has occurred and is continuing hereunder," giving the lessee the benefit of any grace period.

In the case where options to renew the lease or purchase the equipment at lease end are important, it is important to have a more objectively determined fair market value process than the standard provisions
summarized above. Many leases are silent altogether regarding such options.

Also, the stated language requires the lessee to purchase the "equipment," which is likely to be read as "all but not less than all equipment." If the lessee desires the right to purchase only selected portions of the equipment, the language should so state. The language is particularly onerous if the lease covers many types of equipment, such as a computer, telephone system and fleet of delivery vans.

Because of its popularity, equipment leasing has emerged as a distinct form of financing. Counsel faced with lessor-generated documents should be aware that it is not merely negotiating another loan-type arrangement, but attempting to work in a field dominated by full-time specialists. Careful reading and education will go far in leveling the playing field.

Key limitations on equipment use

• Ability to move equipment to new location
• Ability to secure financing for equipment upgrades
• Right to modify or improve equipment
• Right to remove modifications free of lessor claims

Provisions adding flexibility

• Early termination option — Lease terminated. Equipment returned to lessor. Lessee guarantees lessor return when equipment sold to a third party.

• Early buyout option — Lease terminated. Lessee purchases equipment for pre-agreed price.

• Sublease right — Lease term continues, with lessee obligations remaining in place. Equipment possession transferred to a third party, who pays rental to lessee (or to lessor by assignment).

• Assignment right — New lessee assumes original lessee duties under lease. Original lessee is released.

Return and purchase option

• Who must pay cost of return (shipping, insurance, de-installation)?

• To what location must the equipment be re-delivered?

• When must de-installation, crating and shipping be completed (when must it start)?

• How is fair market value calculated?

• May lessee purchase less than all equipment?