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LEASING IS DISTINCTIVE!

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I. INTRODUCTION

UCC Article 2A-Leases governs over $260 billion a year in lease transactions, accounting for roughly one-third of all capital investment each year in the United States. But leasing is not well understood. The origins of Article 2A-leases in Article 2-sales, from which it borrowed heavily,[1] have masked the distinctive features of leasing law.

The obscurity of leasing law has impeded the revisions of Article 2A. Over the past decade, as the American Law Institute (ALI) and the Commissioners on Uniform State Laws have sought to revise sales and leasing law, they challenged the distinctiveness of leasing. They very explicitly put the burden on leasing to explain why sales law should not control all aspects of commercial leasing law on issues such as lease contract formation, excuse from contract, warranties, and remedies. At best, leasing was treated as a disfavored stepchild of sales law. Throughout the Terrible 2s revision process, there were persistent efforts to "dumb down" the commercial law of leasing, and to "slavishly conform" Article 2A-leases to Article 2-sales by proposing inapposite sales law rules for leasing.[2] This "slavish conformity"

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[1] The sales article of the UCC, Article 2, provided the model and starting point for drafting most of the leasing statute's provisions on lease formation, warranties and remedies. UCC Article 9 provided the model for Article 2A's provisions (in Part 3) on the rights of third parties. Taking account of the unique nature of leases, the provisions borrowed from Articles 2 and 9 were adapted to reflect common-law principles governing bailments for hire. But in general, Article 2 provided the starting point for drafting most of Article 2A-Leases.

[2] Time and again, under the slogan of "conformity," major substantive changes to leasing law were proposed in the 2A revision project—such as abolishing the Statute of Frauds for leases; loosening the parol evidence rule and undermining the binding nature of merger clauses; imposing new warranty obligations on lessors, including creating new ill-defined warranty obligations to "remote" lessees; allowing lessees to

approach—in its explicit hostility toward common commercial practice—is distinctive in the annals of the Commercial Code.[3]

What makes a lease different from a sale for purposes of contract formation, excuse from contract, warranties, remedies, and other commercial law rules? Why should the law recognize commercial leasing custom and practice? This short article briefly addresses these questions.

II. Basic Leasing Principles

True leases are distinguished from sales for many purposes in the law. Tax cases and authorities defining a lease determine whether the owner/lessor will obtain the tax benefits of ownership: depreciation deductions and investment tax credits.[4] Accounting principles allow

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escape their lease obligations under the doctrine of excuse/frustration; creating problems for lessors generally in order to account for the situation where lessees use non-conforming goods as a means of mitigating damages; changing the statute of limitations for leases; misstating the statutory measure of damages for breach of a lease agreement; and many others. These were not nonsubstantive revisions of 2A. Instead, these proposals would essentially have scrapped the existing 2A statute and started from scratch with a heavy presumption that commercial leasing law ought to be "conformed" to make it word-for-word the same as whatever sales law proposals were currently in vogue. No attempt has ever been made by proponents of this sort of "slavish conformity" to justify the systematic obliteration of leasing law, custom and practice that was entailed by their "dumbed down" proposals.

[3] The original founders of the UCC supported mainstream commercial practice. The statute reflects this in its statement of central purposes: "to simplify, clarify and modernize the law governing commercial transactions; [and] to permit the continued expansion of commercial practices through custom, usage and agreement of the parties." § 1-102. *See* Gilmore, On the Difficulties of Codifying Commercial Law, 57 Yale L.J. 1341 (1957 ("The principal objects of draftsmen of general commercial legislation—by which I mean legislation which is designed to clarify the law about business transactions rather than to change the habits of the business community—are to be accurate and not to be original."); *id.* at 1351 (in original UCC Article 2-sales, "a notable effort has been made to conform the law to current business practice"). The catchphrase "slavish conformity" was coined by the revisers of the Terrible 2s, and used repeatedly by them, to describe their very different approach toward Article 2A-Leases.

[4] Tax authorities extensively address the issue what constitutes a true lease. *See, e.g.*, Frank Lyon Co. v. U.S., 435 U.S. 561, 98 S. Ct. 1291, 55 L. Ed. 2d 550 (1978); IRS Revenue Ruling 55-540; IRS Revenue Procedure 75-21; Macan, Tax Aspects of Equipment Leasing, and Macon & Umbrecht, Cross-Border Leasing Transactions: Pickles, FSCs, and Double-Dips, Chapters 4 and 25 in *Equipment Leasing-Leveraged Leasing* (Shrank & Gough 4th ed. 2002). Tax policies limiting front-loaded depreciation, and asymmetrical tax treatment for leases (*see* IRS Revenue Ruling 55-540), reflect special concerns with preserving the federal fisc. These specialized tax policies are supplemented, in tax law, by other principles rooted in common law distinctions between leases and sales.

off-balance sheet treatment of the obligations of a lessee in a true lease.[5] In general, the standards in UCC § 1-201(37) provide a core set of rules for identifying a true lease.[6] These widely referenced UCC standards determine, for example, whether a transaction is a "true lease" outside the ambit of state usury laws,[7] and the scope of a lessor's rights under § 365 of the Bankruptcy Code when the lessee goes into bankruptcy.[8]

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[5] *See, e.g.*, FASB Statement of Financial Accounting Standards No. 13; Giroux, Potash & Ellis, Accounting for Leases, Chapter 5 in *Equipment Leasing-Leveraged Leasing* (Shrank & Gough 4th ed. 2002).

[6] To clarify the scope of 2A (*see* n.12 *infra*), the Terrible 2s revisers propose to amend the definition of "lease" in old § 2A-103(j) to exclude "the licensing of information." They would shift the position of UCC § 1-201(37), which sharpens the distinction between a lease and a security interest, to new UCC § 1-203 without change.

Other statutory provisions also bear on the definition of a true lease. Today forty (40) States and the District of Columbia have enacted statutes—usually in their state certificate of title laws but occasionally in nonuniform versions of § 2A-110 or § 2A-103(j)—that support the "true lease" status of terminal rental adjustment clause (TRAC) leases that are widely used to cover millions of vehicles leased by the commercial motor vehicle fleet leasing industry. *See* UCC Transaction Guide § 11:07 (canvassing and discussing these TRAC/state laws). Relying on these TRAC/state laws, the courts have consistently upheld the "true lease" status of TRAC vehicle leases. *See, e.g.*, In re Charles, 278 B.R. 216, 47 U.C.C. Rep. Serv. 2d 1270 (Bankr. D. Kan. 2002) ((Kansas TRAC law); In re Beckham, 275 B.R. 598 (D. Kan. 2002), judgment aff'd, 2002 WL 31732497 (10th Cir. 2002) (same); In re Owen, 221 B.R. 56, 37 U.C.C. Rep. Serv. 2d 503 (Bankr. N.D. N.Y. 1998) (New York TRAC law); In re Architectural Millwork of Virginia, Inc., 226 B.R. 551, 39 U.C.C. Rep. Serv. 2d 36 (Bankr. W.D. Va. 1998) (Virginia TRAC law). *See generally* Leases, 54 *The Business Lawyer* 1855, 1858- 1859 (ABA 1999) (canvassing cases and authorities on TRAC vehicle leasing); New Developments: Article 2A Leases of Goods, 1993 *Commercial Law Annual* 115, 124—130 (spelling out the rationale for the TRAC/state laws). Omitted from the proposed revisions is any mention of this national uniform state law development about TRAC vehicle leasing, which should at least be noted in new Comments to the definition of "lease" in old § 2A-103(j).

[7] *See* Old Wine in New Bottles, 39 Ala.L.Rev. 615, 623 & n. 20 (1988) (collecting cases).

[8] True lessors of equipment fare better than holders of "perfected security interests" who, in turn, are better off than holders of "unperfected security interests," when the lessee/debtor is in Chapter 11 bankruptcy reorganization. *See* UCC Transaction Guide § 11:07 n.11, § 11:05 n.2 (1998 supp.) (collecting authorities). Oversimplified, true lessors are entitled to receive full current rental payments, or to repossess their equipment, under 11 U.S.C. § 365, if the "lease" transaction is a true lease. *See, e.g.*, In re Russell Cave Co., Inc., 247 B.R. 656 (Bankr. E.D. Ky. 2000); In re Furley's Transport, Inc., 263 B.R. 733 (Bankr. D. Md. 2001). By contrast, if a "lease" is viewed as a "perfected security interest" and not a true lease, then the "lessor" in this situation is entitled to receive only the smaller amount needed to provide "adequate protection" for its security interest (*i.e.*, the loss in depreciation value of the collateral, which may

Other commercial law differences between leases and sales are also important. They are the subject of this article. The Terrible 2s revisers explored whether to obliterate these differences, between leasing law and sales law, on wide-ranging commercial law issues such as contract formation, warranties, and remedies. This sweeping approach, "slavishly conforming" leasing law to sales law on commercial law issues, is intellectually bankrupt.

There are, of course, some commercial law similarities between leases and sales, though the "similarities" often rest in large part on an incomplete description of leases.[9] For example, Article 2A and Article 2 both involve transactions in goods that are delivered to the user, creating (in this respect) similar situations that call for similar *kinds* of rules covering contract formation, warranties and remedies. As the Comments to § 2A-101 point out:

> "[t]he lease is closer in spirit and form to the sale of goods than to the creation of a security interest. While parties to a lease are sometimes represented by counsel and their agreement is often reduced to a writing, the obligations of the parties are bilateral and the common law of leasing is dominated by the need to preserve freedom of contract."

There are also many significant commercial law issues, including consumer protection,[10] the rules for E commerce,[11] and the scope of the Terrible 2s,[12] where it makes sense to have similar rules for sales and leasing. Moreover, at a sufficiently high level of generality, leases and

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be only 60% to 80% of contract rentals). *See also* Associates Commercial Corp. v. Rash, 520 U.S. 953, 117 S. Ct. 1879, 138 L. Ed. 2d 148 (1997) (secured creditor entitled to adequate protection of replacement value of its collateral, not just the lower market value of collateral). And if the "lease" is viewed as an "unperfected security interest," the Trustee in Bankruptcy may be able to keep the equipment, without making current payments of any kind, and sell it. *See, e.g.*, In re Tulsa Port Warehouse Co., Inc., 690 F.2d 809, 34 U.C.C. Rep. Serv. 1357 (10th Cir. 1982).

There is no federal statutory definition of a lease, and federal bankruptcy law looks to state commercial law to define the difference between a true lease and a security interest. *See, e.g.*, H.R.Rept. 595, 95th Cong., 1st Sess. 313-314 (1977); In re PSINet, Inc., 271 B.R. 1 (Bankr. S.D. N.Y. 2001); In re Edison Bros. Stores, Inc., 207 B.R. 801, 34 U.C.C. Rep. Serv. 2d 594 (Bankr. D. Del. 1997).

[9] "Transactions in goods that are delivered to the user," for example, does not fully describe a lease, where, unlike a sale, the delivered goods remain the property of the owner-lessor.

[10] UCC Article 2A-Leases in fact contains more consumer protections than Article 2 or any other part of the UCC. *See, e.g.*, § 2A-108 (unique 2A provisions on unconscionability cover "unconscionable inducement," collection of claims, and attorney's fees); § 2A-106 (limits on choice of law, choice of forum in consumer lease cases). New proposed Comments to § 2A-106 will make it clear that in a consumer lease the parties may choose the law of the State where the goods are received by the lessee (*e.g.*, the State where a vacationer picks up a rental car).

sales can be said to be alike. After all, leases and sales both involve

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The struggles over consumer protection rules in the revised Terrible 2s initially focused on proposals to expand the Comments on "unconscionability" in § 2-302 and § 2A-108. But the revisers ultimately jettisoned those proposals. They left only one new sentence in the Comments to § 2-302: "Courts have been particularly vigilant when the contract at issue is set forth in a standard form." Throughout the proposed revisions to 2/2A, instead, consumer protection interests are recognized in new special rules such as those requiring "plain English" warranty disclaimers (§ 2A-214), expanding the lessor's warranty of "marketable title" (§ 2A-211), barring consequential damages against consumers (§ 2A-504), highlighting the right of parties to seek specific performance while barring specific performance to compel rental payments by the lessee (§ 2A-521), prohibiting "cure" by the lessor after revocation in consumer deals (§ 2A-517), and creating a new statutory right for lessees to use non-conforming leased goods as "mitigation of damages" (§ 2A-517(f)). The proliferation of special consumer protections, both inside and outside the UCC, may take the pressure off § 2-302/§ 2A-108 and induce the courts to use the special consumer rules rather than the broad doctrine of unconscionability to protect consumers.

[11] Revised 2 and 2A are similar in treating the new Electronic Signatures in Global and National Commerce Act, 15 U.S.C. § 7001 *et seq.*, Pub.L. 106-229 (June 30, 2000) ("E-Sign"). New § 2-108(4) and § 2A-104(4) say that amended 2/2A sets out rules for electronic commerce in sales and leasing deals, except that "nothing in this article modifies, limits, or supersedes" E-Sign § 1001(c) or "authorizes electronic delivery of any of the notices described in" E-Sign § 103(b). The core provisions of E-Sign § 101(c) provide that, in consumer deals, electronic records satisfy old-fashioned "writing" requirements if the consumer affirmatively consents to electronic communications, is advised of various rights (including the right to withdraw consent to e communications and the right to receive an old-fashioned paper record), and consents electronically "in a manner that reasonably demonstrates" that the consumer can access the information. This may require a consumer response-in-kind using the same message medium (*e.g.* Email) in which electronic notices are to be sent to the consumer. It would facilitate better understanding of the Terrible 2s revisions if this were spelled out in the Comments.

[12] The scope issue was a particularly difficult one for the revisers of the Terrible 2s. They expended considerable energy in exploring different approaches to distinguish between "smart goods" (*i.e.* , goods with embedded software) subject to Articles 2 and 2A, and software and informational content that is outside the scope of the UCC. This issue is important to developers of software, who want to be able to embed some of their software products inside goods (*e.g.* , specially-licensed computer chips inside a camera), without losing control over the intellectual property in them under the so-called "first sale" doctrine. *See, e.g.*, Intel Corp. v. ULSI System Technology, Inc., 995 F.2d 1566 (Fed. Cir. 1993), cert denied, 510 U.S.1092 (1994) (first sale or "patent exhaustion" doctrine in patent law); United States v. Moore, 604 F.2d 1228 (9th Cir. 1979) (first sale doctrine in copyright law, 17 U.S.C. 109(a)); NEC Electronics v. CAL Circuit Abco, 810 F.2d 1506 (9th Cir.), cert denied, 484 U.S. 851 (1987) (first sale or "exhaustion" doctrine in trademark law). The scope issue is also important to supporters of UCITA, the controversial new Uniform Computer Information Transactions Act, which would be undermined if the scope of the Terrible 2s were defined too broadly.

The scope issue was resolved by the revisers defining "goods" within UCC 2/2A to exclude "information." 2A's definition of "lease" is also amended to exclude "the

transactions in goods. And very general rules of contract formation, for example, can be stated that cover both leasing and sales practice.[13]

Yet it is also true that someone overwrought with the spirit of uniformity could draft a uniform law of apples and oranges (they are both "fruit") or even a uniform law of "things" and then attempt to explain all the differences among things (including cabbages and ceil-

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licensing of information." The proposed new Comments state that "the sale of smart goods such as an automobile" would be fully covered by Article 2, even though such smart goods incorporate many computer programs. *Accord*: Revised UCC § 9-102(44),(75). The Comments also would say that: "Where a transaction includes both the sale of goods and the transfer of rights in information, it is up to the courts to determine whether the transaction is entirely within or without Article 2, or whether or to what extent Article 2 should be applied to a portion of the transaction. While Article 2 may apply to a transaction involving information, nothing in this Article alters, creates, or diminishes intellectual property rights."

Additional Comments to the definition of "goods" in the Terrible 2s might further refine the treatment of "smart goods." To be sure, the Terrible 2s "goods" rules apply to "smart goods" (*e.g.* , a camera with a specially-licensed embedded computer chip) so long as the "smart goods" remain together in one piece. But if the computer chip is taken out, and some separate sale or use of it is attempted, then intellectual property (IP) law should govern that attempted sale or use of the separated IP component. This straightforward approach provides important protections for IP. It makes sense under the Commercial Code. *See* UCC § 1-103 (UCC is supplemented by principles of law and equity—which surely encompass the reasonable protection of intellectual property). It also finds support in intellectual property law, which preempts inconsistent state law and makes a fundamental distinction between the sale of a copy and the sale of other distinguishable underlying IP rights. *See, e.g.*, United States v. Moore, 604 F.2d 1228 (9th Cir. 1979) (under copyright law, sale of a copy affects only that particular copy and leaves intact the owner's general copyright rights to publish or copy); Davidoff & CIE, S.A. v. PLD Intern. Corp., 263 F.3d 1297, 1301 (11th Cir. 2001) (trademark infringement may be found in attempted resale of "materially different" trademarked product); In re CFLC, Inc., 89 F.3d 673, 679 (9th Cir. 1996) (holding that federal patent policy gives patent holder the ability to control the identity of licensees and that nonexclusive patent licenses are not assignable without consent of the owner).

[13] Where the original 2A statute borrowed language from existing Article 2, on issues such as the statute of frauds and the parol evidence rule, the statutory UCC rules for sales/leasing reflect a moderate, functioning set of principles that—because of their generality and (in a bow to leasing) formality—cover both sales practice and leasing practice. But as explained above, leasing has quite different customs, practices, and documentary requirements than sales. New sales rules proposed during the 1990s frequently would have "liberalized" sales law, undermining the significance of writings/records as the embodiment of the deal, making sales less formal, and allowing many deals to be examined after-the-fact for basic "fairness," but in the process creating commercial uncertainty and large transaction costs. This whole approach is in conflict with the more formal, structured, written traditions of leasing law.

ing wax,[14] race horses and trees, apples and oranges, and leases and sales) in footnotes or Official Comments. Oversimplification of this sort is not helpful in the context of the Commercial Code. Working rules for commerce require, not "slavish conformity" to artificially generalized uniform rules, but clarification and support for distinctive commercial transactions. Leasing is a distinctive commercial transaction. By its very nature, it is as different from sales as apples are from oranges.

III. Leasing Is Distinctive!

Overlooked by advocates of "slavish conformity" is the basic mission of UCC Article 2A to support and facilitate common leasing practice.[15] Leasing is not simply a "me too" industry that lives in the shadow of sales. The very existence of Article 2A, separate and distinct from sales law, refutes the advocates of "slavish conformity." Leasing has its own distinctive customs, practices, traditions, law, and documentary requirements.

Thousands of years old,[16] leasing has always been recognized as a distinct commercial transaction: different from sales, different from secured transactions. "A lease involves payment for the temporary possession, use and enjoyment of goods, with the expectation that the goods will be returned to the owner with some expected residual interest of value remaining at the end of the lease term. In contrast, a sale involves an unconditional transfer of absolute title to goods, while a security interest is only an inchoate interest contingent on default and limited to the remaining secured debt."[17]

Oversimplified, an intellectually elegant view of leasing is that it is

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[14] *See* Lewis Carroll, The Walrus and The Carpenter from *Through the Looking-Glass and What Alice Found There* (1872) ("The time has come," the Walrus said, "To tell of many things: Of shoes—and ships—and sealing-wax—Of Cabbages—and kings—And why the sea is boiling hot—And whether pigs have wings.").

[15] Cf. Gilmore, n.3 *supra* .

[16] Equipment leasing has ancient origins. *See* Nevitt & Fabozzi, History of Equipment Leasing, 3 J.Equipment Lease Fianancing 48 (1985) (equipment leasing has "roots that date back thousands of years," even before the Phoenicians leased vessels in the Mediterranean, to the earliest recorded equipment leases "in the ancient Samarian city of Ur in about 2010 B.C."). It is often said that: "At common law a lease of personal property is a bailment for hire," Comment to § 2A-102(1)(j). But equipment leasing is not an invention of English common law. The origins of leasing in antiquity reflect the fact that, by its very nature, leasing is a distinct commercial transaction that has always been understood as something different from a sale.

[17] White & Summers, UCC Treatise § 13-2 (Identifying a Lease).

the separation of ownership and possession in a lease that explains *why* commercial leasing law is different from sales law. The impact of the separation of ownership and possession, which defines what a lease is, makes leasing law different from sales law in many areas including: lease contract formation rules (the statute of frauds, the parol evidence rule, no-oral-modification clauses, and the custom of pre-transaction disclosure of terms in a record before delivery of the goods); lease warranties; rules about excuse or impracticality of performance in a lease; and true lease remedies. To be specific:

Lease contract formation. Leases commonly involve more complex, on-going, multi-faceted obligations than casual sales. Ownership of the residual remains with the lessor in a lease, and for that reason the lessor has a continuing economic interest in the goods that is not present in a sale.[18] Thus lease contracts commonly cover not only rent, but many other obligations, which may last twenty years or more, such as: where and when the goods (the lessor's residual) will be returned; options to renew or purchase the goods; maintenance and repairs; restrictions on use of the goods (*e.g.* , leased barges should not be used to carry oil in environmentally sensitive areas of the Caribbean); taxes; insurance; and record-keeping obligations (vitally important for aircraft leasing).

The impact of these intrinsic characteristics of leasing (as opposed to sales) is that it is more important for leases than sales to have a signed writing or "authenticated record," a parol evidence rule with strong binding effect given to merger/integration clauses,[19] and strong support

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[18] *See* Old Wine in New Bottles, 39 Alab.L.Rev. 615, 632 (1988) (marketplace significance of these lease/sale differences): "As a matter of economic self-interest, a true lessor cares about the quality, energy efficiency, durability, and long-term value of the leased goods, since there is some legitimate possibility that he may get back the goods or otherwise have to dispose of them. . . . Viewed from the perspective of the economy as a whole, lessees will have more marketplace choices and will receive more meaningful information about the goods they wish to use when the law recognizes the substantive economic differences between a true lease and a sale." 39 Alab.L.Rev. at 632.

[19] The strength of a merger clause in a lease should be addressed in new Comments to § 2A-202. To come to grips with the concern that the parol evidence rule currently excludes too much evidence, the proposed revisions to § 2-202/§ 2A-202 would distinguish between supplementation and explanation. To explain the terms of a contract, a court under new § 2-202(b)/§ 2A-202(b) may consider evidence of course of performance, course of dealing, usage of trade, without a preliminary finding of ambiguity. A new Comment will disclaim any negative inference that ambiguity must be found before evidence of intention is admissible.

for no-oral-modification clauses[20] to bring contractual certainty to the more complex terms of a typical leasing deal. To put it another way: Leasing custom and practice favors more formal structured rules of contract formation than those that might suit casual sales. Tradition, custom and practice for commercial leasing involves—not an exchange of forms—but a negotiation crystallizing in a single signed, written lease agreement. For this reason, original Article 2A deliberately omitted any provision corresponding to the old "battle of the forms" provision in sales law (§ 2-207) that engendered much wasteful litigation over contract formation. Common leasing practice for leasing involves pre-transaction disclosure of lease terms in a record, which is desirable public policy and good consumer protection. It puts the lessor and lessee on advance notice of their rights and obligations, which are very different from those of a buyer and seller.

These issues were discussed in the ALI within the context of a larger debate about the importance of writing or record requirements. The outcome is not clearly explained in the Terrible 2s revisions. The sales statute of frauds is being amended, for example, in several respects that preserve small differences from the leasing statute of frauds.[21] The "small deal" exclusion in the sales statute of frauds would be raised

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[20] The opportunities for alleged oral modifications, and the value of no-oral-modification (NOM) clauses, are greater for common long-running multi-faceted leases than for casual sales. Custom, practice and policy favor giving strong binding effect to NOM clauses in leases. *See, e.g.*, 3A Hawkland & Miller, UCC Series § 2A-208:04 pp.187,192 (Art 2A-Leases) (validation of NOM clauses, "a privately created statute of frauds," "makes good sense"). There is considerable debate and uncertainty in current law about NOM clauses. *Compare* Wisconsin Knife Works v. National Metal Crafters, 781 F.2d 1280, 42 U.C.C. Rep. Serv. 830 (7th Cir. 1986) with BMC Industries, Inc. v. Barth Industries, Inc., 160 F.3d 1322, 37 U.C.C. Rep. Serv. 2d 63 (11th Cir. 1998), cert denied, 526 U.S. 1132 (1999). Yet the revisers are not proposing any clarification of current law on NOM clauses. *Compare* Hillman, Standards for Revising Article 2 of the UCC, 35 Wm & Mary L.Rev, 1509, 1524 (1994) ("section 2-209 should contain clear language delineating precisely when NOM clauses are unenforceable").

[21] The statute of frauds for both sales and leases adopts the new language of e commerce by referring to signed or authenticated "records" instead of signed writings. The statute of frauds "admissions" exception is expanded for both sales and leases to include any admission under oath, whether or not made in court. Similarly, the "specially manufactured goods" alternative appears in both § 2-201(3)(a) and § 2A-201(4)(a). The other alternatives for satisfying the sales statute of frauds are preserved, as are the slightly different rules in current 2A leasing law: The "merchant exception" in § 2-201(2) is omitted from § 2A-201 since "the number of such transactions involving leases, as opposed to sales, was thought to be modest." Comments to § 2A-201. The "part performance" alternative in the sales statute of frauds (§ 2-201(3)(c)) is omitted from § 2A-201(4) (leases) since "It was decided that, as a matter of policy,"

from $500 to $5,000, for example, while the "small deal" exclusion in the leasing statute of frauds is kept at the $1,000 figure in current § 2A-201. New Comments should be crafted for Article 2A to explain these differences in contract formation rules.[22]

Warranties. Typically lessors advertise the *quality of their services*. Unlike manufacturers or suppliers, most lessors do not engage in mass market advertising making promises or warranties about the *quality of the goods*. They are concerned with service and financing, not the making of the goods themselves. Lessors commonly lease goods supplied by a variety of different manufacturers. In finance leasing, the lessee (not the lessor) selects the goods and the manufacturer. Thus it makes little sense to talk about lessor A's advertising inducing a "remote" lessee to lease some particular kind of goods from another lessor B. *Compare* § 2-313B (mass market advertising)(proposed 2002 amendments). Nor do lessors commonly create and supply owners' manuals or instructions attached to the goods. *Compare* § 2-313A ("card in the box")(proposed 2002 amendments). Warranties made by persons who are not agents of the lessor do not create liability in the

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the act of "payment of rent for one or more months" is "not a sufficient substitute for the required memorandum." Comments to § 2A-201. The revisers envision a new 2A Comment saying that courts should address the situation case-by-case to decide whether a modification takes a deal, previously too small or otherwise outside the statute of frauds, into the coverage of the statute of frauds.

A significant proposed clarification of the sales statute of frauds involves deleting the introductory phrase "Except as otherwise provided in this section" from the statutory text of § 2-201(1). This softly encourages the view, reflected in many (but not all) court decisions, that "estoppel" may bar assertion of the statute of frauds defense. *See generally* Bellomy, Estoppel and Section 2-201 of the UCC, 100 Com.L.J. 536 (1995) (canvassing the split case law and other authorities, and describing the different standards for proving different forms of estoppel). The newly omitted statutory phrase does not appear in the corresponding statute of frauds section in Article 2A-Leases, § 2A-201.

[22] The "small deal" exclusion in the statute of frauds, for example, distinguishes between sales and leases because the $1,000 trigger of § 2A-201 (leases) is measured by the sum of the lease payments, excluding payments for options to renew or buy. This excludes consideration of the owner-lessor's residual. A lease with rental payments totaling $1,000 may well involve goods with a residual value in excess of $5,000 that would come within the scope of the sales statute of frauds if the goods were sold rather than leased. Whether the goods are leased (for rentals totaling $1,000) or sold (for amounts in excess of $5,000), the transaction is significant enough in terms of the economic value of the goods involved to warrant the formality (and safeguards) of a writing/record. Tradition, custom and practice for leasing, in any event, place more importance on a writing/record than does sales tradition, custom and practice.

lessor.[23] For these reasons, while the law of express warranty for sales is being split into three parts to cover not only ordinary express warranties in the contract (§ 2-313), but also manufacturers' warranty-like obligations to buyers in "mass advertising" (§ 2-313B) and materials accompanying the goods (§ 2-313A), the law of express warranties for leasing will remain the same (§ 2A-210).[24] Leasing is distinctive.

Title warranties in § 2A-211 also reflect the differences between leases and sales. Unlike sales, the essential nature of a lease involves an on-going split-ownership arrangement in which both the lessor and the lessee have continuing opportunities to create claims and encumbrances against the goods throughout the lease term. On the one hand, this may warrant more on-going protections for the lessee against interference than would be appropriate for a buyer.[25] On the other hand, the distinctive nature of leasing (as opposed to sales) means that the lessee has a fiduciary responsibility to safeguard the owner-lessor's residual interest.[26] It would violate "principles of law and equity" (UCC § 1-103) and principles of good faith to allow a lessee to sue and recover damages from the lessor because the lessee's own acts or omissions allowed the creation of third-party claims or encumbrances against the leased goods (*e.g.* , a city "boots" a rented car because of the lessee's failure to pay parking tickets that the lessee incurred). This principle is not clearly explained in proposed new 2A-211.[27]

Perfecting interests in electronic chattel paper leases. Lease

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[23] *See, e.g.*, All-States Leasing Co. v. Bass, 96 Idaho 873, 538 P.2d 1177, 17 U.C.C. Rep. Serv. 933, 91 A.L.R.3d 863 (1975).

[24] To be sure, manufacturers/suppliers may advertise that customers can buy or lease from them. And a "captive" leasing company that leases only goods from a single manufacturer might advertise touting the quality of the goods. Such ads might contain promises/warranties that induce a "remote" buyer/lessee to buy/lease the goods from someone else. But those cases should be (and are) covered by sales law, in proposed new § § 2-313/2-313A/2-313B. The statute in 2A should focus on common leasing situations, the subject of 2A, not sales situations.

[25] *See* Official Comments to § 2A-211.

[26] Cf. § 2A-532 (lessee liable for injury to lessor's residual).

[27] Proposed § 2A-211 also would impose liability on a lessor for third party liens arising through no fault of either the lessor or the lessee. It is difficult to imagine that many cases would fall into this category (*e.g.* , a city mistakenly imposes a lien on an automobile through no fault of the lessor or the lessee). Once the lessee is in possession of the goods, the lessee would seem to be in the best position to prevent such "no fault" third party liens from arising. This issue involves the allocation of risk and who has the burden to obtain insurance coverage. The only rationale given for this aspect of § 2A-211 was the view stated by one early 2A Drafting Committee member that the lessor was a "deep pocket" better able to insure against the risk.

financiers and syndicators commonly take physical possession of the original signed tangible paper lease, in order to obtain a first priority perfected security interest. Revised Article 9 allows something similar for electronic chattel paper leases.[28] To perfect a security interest in electronic chattel paper, one must comply with revised § 9-105, which mandates a set of factual conditions that must be met before a secured party has ''control'' of electronic chattel paper. Thus, for example, revised § 9-105(1) requires a single authoritative copy of electronic chattel paper that is unique, identifiable, and generally unalterable; revised § 9-105(2) requires that the authoritative copy of electronic chattel paper must show on its face the secured party or its designated custodian as the assignee; and revised § 9-105(5) requires that each copy of the authoritative copy be readily identifiable as a copy. To perfect a security interest in electronic chattel paper, the holder must satisfy each and every one of the conditions in revised § 9-105. Satisfaction of these conditions has the same legal effect as possession of originally executed tangible paper leases. To facilitate understanding of commercial leasing law, these principles should be noted in new Comments to new § 2A-222.

Excused performance. The ordinary commercial understanding of the parties in a finance lease (*i.e.* , a statutory finance lease or any lease with a ''hell or high water'' clause) is that ''frustration of purpose'' will not excuse the lessee from performance. The very act of selecting a lease term (an inescapable necessity in any lease) represents a conscious choice by the lessee, allocating risk and agreeing about the scope and length of its undertakings. Typical commercial equipment leases include liquidated damages clauses or ''stipulated loss schedules''—explicit contract provisions about the damages due if there is a breach of the lease agreement at specified times in the future marked from the inception of the lease. Overriding these common lease contract provisions with a doctrine of ''excuse'' or ''frustration of purpose,'' based on a theory of the parties' implicit understandings,[29] would be the purest sophistry. Not surprisingly, no case has ever excused a lessee from performance on grounds of ''frustration of purpose'' or by analogy to

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[28] *See* revised § § 9-105, 9-314(a), 9-330, 9-102(31),(11).

[29] The implicit understanding of the parties, and the equity in vindicating it, appear to be the basis for old Comment 9 to original UCC § 2-615, which suggests that a buyer might escape its contractual obligations, under the doctrine of ''frustration of purpose,'' if there was a change in circumstances that obliterated a basic assumption of the deal, which all the parties knew about, but which was not spelled out in the sales contract.

Comment 9 of UCC 2-615 (sales).[30] In commercial leases, the lessee explicitly or implicitly accepts the risk of commercial impracticability or impossibility.[31]

This issue was fought out in the ALI. As a result of the ALI debates, the revisers rejected modifications proposed by some academics, and retained current law that properly limits the doctrine of "excuse" to lessors (not lessees) in § § 2A-405, 2A-406. This outcome should not be hidden by a failure to explain it in new 2A Comments.

Accessions. The law of accessions also recognizes the distinctive nature of leasing. Lease interests in an accession (*e.g.* , an automobile engine being inserted into a car, or an airplane engine being attached to an airplane, or a computer software program being installed in a computer) are more hardy and enduring than the contingent interest of a simple secured creditor in the same accession.[32] One reason why this is so is that a secured party with a simple non-purchase-money perfected security interest in an accession (*e.g.* , the auto engine, the airplane engine, or the computer software) is on notice of—and subject to being trumped by—a prior perfected security interest in the whole (the car, the airplane, or the computer with its installed software).[33] By contrast,

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[30] *Compare* Hawkland & Miller, UCC Series § 2A-405:5 (Art 2A) *with* White & Summers, UCC Treatise § 14-4. The impact of washing out the deal with the doctrine of "excuse" is very different in the case of a lease of new equipment as opposed to the case of a real estate rental. *Contrast* the English Coronation Case, Krell v. Henry, 2 KB 740 (1903) and other real estate cases cited by Hawkland & Miller, UCC Series § 2A-405:01, § 2A-405:05 (Art 2A). Real estate (which generally appreciates in value over time) represents "sunk costs," whereas new equipment (which *depreciates* in value over time) is commonly created/manufactured and bought by a lessor (and third-party financiers) in reliance on there being a market demand for it, that is, in reliance on the lessee being bound by the deal. Nor is an equipment lease comparable to hypothetical "excuse" cases involving a long-term supply contract for coal. When the coal supply contract is terminated early, under doctrines of excuse or frustration of purpose, the seller faces essentially the same market in remarketing the coal. There is no such thing as "used coal." But the market for new equipment is very different—in terms of warranties, price, and availability—from the market for *used* equipment. Moreover, long-term equipment leases are priced and marketed very differently from short-term leases. It would wreak havoc in the multi-billion dollar a year equipment lease finance industry, and raise prices to consumers, if lessees could escape their obligations by invoking the doctrine of "excuse"/frustration of purpose.

[31] *See, e.g.*, Bank One, Marion v. Marion, Ohio, Internal Medicine Inc., 1997 WL 176140 (Ohio Ct. App. 3d Dist. Marion County 1997).

[32] *See* UCC § 2A-310 & its Official Comments. *Compare* new UCC § 9-336 Comment 6 (Example 3).

[33] *See* new UCC § 9-336 Comment 6 (Example 3).

lease interests need not be filed in the UCC filing system to be valid,[34] and it makes no sense to decide priority disputes involving such non-filed lease interests by reference to UCC filing rules.

True lease remedies. True lease remedies and measure of damages are different from sales law, essentially because of the lessor's residual interest.[35] In a lease, the lessor owns the goods, while the lessee has only an interest in using the goods for a limited time. The impact on measure of damages is that, in general, a lessor's damages for the lessee's breach are equal to lost rentals plus any damage to the residual; while the lessee's damages for breach are the extra rental expense of renting substitute goods.[36]

Years ago, courts sometimes confused lease remedies with sales remedies. When the lessee defaulted, some courts mistakenly credited the lessee with the entire sales proceeds in calculating the lessee's deficiency.[37] This improperly credited the lessee with the value of the lessor's residual. Lease remedies are different from sales remedies.[38]

Other lease remedies rules in 2A also illustrate the distinctive nature of leasing. ***(A) Liquidated damages.*** One of the great innovations of original Article 2A was the liberalized standard in § 2A-504 for assessing the validity of liquidated damages clauses. The complexity of leasing transactions (as opposed to sales)—including tax issues that have no counterpart in sales law—requires liberalized rules encouraging the

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[34] *See* Mooney, The Mystery and Myth of "Ostensible Ownership" and Article 9 Filing: A Critique of Proposals to Extend Filing requirements to Leases39 Ala.L.Rev. 683 (1988).

[35] The value and importance of the lessor's residual interest in a true lease is also an important factor that explains why a lessor in a true lease is not required to make UCC filings to protect its residual interest against third-party creditors. *See* Mooney, *supra* n. 34.

[36] This is oversimplified, of course, since tax losses and other damages often may exist. For example, a lessee may seek damages if the lessor breaches duties in addition to supplying the goods, such as repairing and maintaining the goods. *See* original UCC § 2A-103(1)(g) Comment. Often the lessor's greatest concern upon breach by the lessee is recovering possession of the goods. And a lessor often incurs incidental damages in the form of costs incurred to sell or relet the goods after repossession.

[37] *See* DeKoven, Leases of Equipment; Puritan Leasing Company v. August, A Dangerous Decision, 12 U.San Fran.L.Rev. 257 (1978).

[38] Where a purported "lease" is found to be a disguised security interest, the "lessor" (secured party) may be barred from obtaining a deficiency judgment against a defaulting "lessee" (debtor) if it failed to give notice to the debtor as required by Article 9 when disposing of the collateral. *See, e.g.*, Fleming v. Carroll Pub. Co., 581 A.2d 1219, 13 U.C.C. Rep. Serv. 2d 610 (D.C. 1990); Old Wine in New Bottles39 Ala.L.Rev. 615, 641- 657 (1988).

liquidation of damages in commercial equipment leases to help facilitate commerce.[39] ***(B) Statute of limitations.*** The statute of limitations in § 2A-506(2) contains a "discovery" rule in harmony with modern theories of statutes of limitations. It also reflects considerations of fairness rooted, in part, in the fact that it may be some time before damage to the residual is discovered by a lessor who is not in possession of the goods (such as a leased vessel on distant seas). Moreover, starting the statute of limitations running when the injured party learned, or should have learned, of the breach is a fairer rule. It works even-handedly between lessors and lessees. ***(C) Use of non-conforming goods as "mitigation of damages."***; In the marketplace, by agreement, both buyers and lessees may reject non-conforming goods and then use them as a method of mitigating damages. The Terrible 2s revisions propose to statutorily codify a right to such "mitigation use" for both buyers and lessees. But for leases (as opposed to sales) it is much more difficult to distinguish between legitimate "mitigation of damages" by the lessee (on the one hand) and an unscrupulous lessee's attempt to knock down the stated lease rental rate by falsely claiming non-conformity (on the other hand). This is because temporary use of the goods—characteristic of "mitigation of damages"—is a central feature of leasing, but not sales. Temporary use of the goods, followed by return to the seller/lessor, is the norm for leasing; it is not the norm for sales. This is why, if there is a new statutory right to "mitigation use," a new Comment should be added to § 2A-517(f) stating that courts must be vigilant to ensure that the right of "mitigation use" is not abused by lessees falsely claiming non-conformity to knock down the lease rental rate.

IV. Conclusion

Leasing is distinctive. The important differences between leases and sales were not clearly explained, however, in the original 2A statute. The statutory language of 2A is important.[40] But new explanatory Com-

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[39] As stated in the Comments to § 2A-504: "Many leasing transactions are predicated on the parties' ability to agree to an appropriate amount of damages or formula for damages in the event of default or other act or omission. The rule with respect to sales of goods (Section 2-718) may not be sufficiently flexible to accommodate this practice. Thus, consistent with the common law emphasis upon freedom to contract with respect to bailments for hire, this section has created a revised rule that allows greater flexibility with respect to leases of goods."

[40] Traditional tools of statutory construction include examination of the statute's text, structure, and legislative history, as well as consideration of the statute's object and policy and the need to construe the statute to avoid absurd or bizarre results. *See,*

ments need to be added to the 2A statute.[41] The strong questioning of leasing's distinctiveness during the Article 2A revision process, the recurring tendency to distort and "dumb down" the law of leasing, and the persistence of ill-advised efforts to obliterate commercial leasing law by forcibly importing inapposite sales rules into Article 2A (which governs over $250 billion of commerce in the United States each year)—all this provides, in and of itself, compelling reason to add more "user friendly" Comments to 2A, to explain why commercial leasing law is what it is.

Accordingly, at its 76th Annual Meeting in San Francisco in 1999, the American Law Institute (ALI) approved the following principle: "Throughout their course, the Official Comments to revised UCC Article 2A-Leases should be revised to spell out more explicitly how and why commercial leasing law differs from sales law, to help courts and practitioners reach sound results in applying 2A." The vote of the 2/2A Drafting Committee, at its last meeting, similarly reaffirmed that new Comments should be included in the 2A statute on the distinctiveness of leasing. The outcome of the ALI's Annual Meeting in May

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e.g., Pilot Life Ins. Co. v. Dedeaux, 481 U.S. 41, 107 S. Ct. 1549, 95 L. Ed. 2d 39 (1987); Wisconsin Public Intervenor v. Mortier, 501 U.S. 597, 610 n. 4, 111 S. Ct. 2476, 115 L. Ed. 2d 532, 33 Env't. Rep. Cas. (BNA) 1265, 21 Envtl. L. Rep. 21127 (1991); Train v. Colorado Public Interest Research Group, Inc., 426 U.S. 1, 96 S. Ct. 1938, 48 L. Ed. 2d 434 (1976); Mova Pharmaceutical Corp. v. Shalala, 140 F.3d 1060, 1067-1068, 40 Fed. R. Serv. 2d 624 (D.C. Cir. 1998) (Wald, J.); Gunther, Learned Hand pp.470-473 (Knopf 1994); Henry J. Friendly, Mr. Justice Frankfurter and the Reading of Statutes, in BENCHMARKS 206 (1967); Randolph, Dictionaries, Plain Meaning, and Context in Statutory Interpretation, 17 Harv.J.L. & Pub.Pol. 71 (1994). *See generally*, The Case of the Speluncean Explorers: A Fiftieth Anniversary Symposium, 112 Harv.L.Rev. 1851- 1923 (1999).

[41] The courts always have paid close attention to the Comments on issues such as the law of unconscionability (*see* UCC § 2-302) and the "quantity term" in the statute of frauds (*see, e.g.*, PMC Corp. v. Houston Wire & Cable Co., 797 A.2d 125, 128, 47 U.C.C. Rep. Serv. 2d 1327 (N.H. 2002); White & Summers, UCC Treatise § 2-4). Throughout the Terrible 2s revision process, the revisers expended considerable time and energy in crafting new Comments on significant issues. These include new Comment 5 to § 2-207 taking no position on the so-called "*Gateway* issue" involving "rolling contracts" or late-delivered terms appearing on or inside the container in which the goods are delivered (*see* Hill v. Gateway 2000, Inc., 105 F.3d 1147, 31 U.C.C. Rep. Serv. 2d 303 (7th Cir.), cert denied, 522 U.S. 808 (1997); Specht v. Netscape Communications Corp., 306 F.3d 17, 32-34 (2d Cir. 2002); the Comment reconciling tort products liability concepts of "defect" with the implied warranty of merchantability in § 2-314; the one new sentence surviving from the many very extensive new Comments that were suggested for the law of unconscionability (§ 2-302); and the Comments explaining the split of old express warranty law for sales (§ 2-313) into three new parts: § 2-313 (express warranties); § 2-313A ("card in the box"), and § 2-313B ("mass market advertising").

2001, on UCC Article 2A-Leases, was similarly that "the Reporter and Chair of the Drafting Committee agreed to work" on drafting new Comments for 2A that will explain more clearly how and why commercial leasing law differs from sales law.

There is significant work remaining to be done in the Comments of UCC 2/2A on topics such as the scope of the Terrible 2s and refined rules for dealing with "smart goods." The significance of federal E-Sign rules for consumers is insufficiently spelled out, as is the meaning of several other proposed new provisions. New Comments to 2A need to come to grips with, and better articulate, the distinctiveness of leasing on a host of commercial law points. As presently proposed, the Terrible 2s revisions leave much to the courts. They deserve more and better guidance than has been forthcoming so far.

Triggering controversy, the proposed amendments to the Terrible 2s seem likely to be debated further, ensuring continuing discussion within our society about what are the best rules for American commerce in the Twenty-First Century.