ALABAMA LAW REVIEW

SYMPOSIUM: ARTICLE 2A OF THE UNIFORM COMMERCIAL CODE

VOLUME 39 • SPRING 1988 • NUMBER 3

OLD WINE IN NEW BOTTLES: UCC ARTICLE 2A—LEASES

*Edwin E. Huddleson, III**

* B.S. 1967, Stanford University; J.D. 1970, University of Chicago; member of the California and District of Columbia bars; engaged in private practice in Washington, D.C. I would like to thank Professor Marion W. Benfield, Jr., Douglas Brown, Professor Alison Dunham, James S. Frank, Edward A. Groobert, Raymond W. Leyden, Jr., and Roy S. Powell, Jr., for their helpful comments on an earlier draft of this article.

I. INTRODUCTION

Over the past decade, commentators and practicing lawyers have debated the desirability of a uniform state law on equipment leasing. The "statutory codification" movement was a natural reaction to the explosive growth of equipment leasing after World War II.[1] Beginning in 1980, the American Bar Association conducted comprehensive studies to define the scope and substance of a uniform state law on the leasing of goods. The impetus for these studies was strengthened by developments in international law: In response to the increasing volume of cross-border leasing, the International Institute for the Unification of Private Law (UNIDROIT) published a preliminary set of rules for international "financial leasing" in March 1981.[2] The widespread success of

1. Equipment leasing has ancient origins. *See* Nevitt & Fabozzi, *History of Equipment Leasing*, 3 J. EQUIPMENT LEASE FINANCING 48 (1985) (outlining evolution of equipment leasing from its "roots that date back thousands of years" to the earliest recorded equipment leases "in the ancient Samarian city of Ur in about 2010 B.C."). The "boom" in this industry, however, really began in the 1950s. Tax laws, Comptroller of the Currency rulings, amendments to the Bank Holding Company Act, and other regulatory changes all have contributed to the growth of modern equipment leasing. *See id.* at 51-61.

Today equipment leasing accounts for over 20% of all capital investment each year in the United States. Over $310 billion in lease receivables are estimated to be outstanding in this country. U.S. DEP'T OF COMMERCE, 1987 U.S. INDUSTRIAL OUTLOOK 53-1. Well over $90 billion worth of equipment was financed through leasing in the United States in 1986 alone. *Id.*; WORLD LEASING YEARBOOK 1987 at 289. Computers, office equipment, transportation equipment, and manufacturing and industrial equipment account for more than 60% of total equipment leased. AMERICAN ASS'N OF EQUIP. LEASING, SURVEY OF INDUSTRY ACTIVITY FOR 1985 at 6. "Items that are commonly leased range from airplanes and rolling stock through televisions and refrigerators to punch bowls and sanding machines and to more exotic items as well, as dairy cows and thoroughbred horses. Lease periods range from several hours to 20 years or more." DRAFTING COMMITTEE OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, PERSONAL PROPERTY LEASING ACT: PREFATORY NOTE (1985).

2. UNIDROIT is an organization formerly associated with the League of Nations, with member countries (including the United States) from all continents. UNIDROIT's draft rules on international "financial leasing," which apply to both true leases and installment sales, are designed to facilitate leasing and other financial transactions across international borders. *See* UNIDROIT, Preliminary Draft Uniform Rules on International Financial

equipment leasing, both at home and internationally, thus has propelled the industry towards a brave new world of "statutory codification."

The National Conference of Commissioners on Uniform State Laws, acting in 1985 after three years of restudy by a Drafting Committee of law professors and practitioners,[3] approved a proposed uniform state law on equipment leasing: the Uniform Personal Property Leasing Act (UPPLA). The sponsors of the Uniform Commercial Code ("UCC" or "Code")[4] then determined to make the UPPLA a part of the Code. Slight changes were made in redrafting the statute, resulting in the proposed UCC Article 2A-

---

Leasing Adopted by the UNIDROIT Study Group for the Preparation of Uniform Rules on the Leasing Contract as Revised by the Drafting Committee following the Committee of Governmental Experts' First Reading Thereof, Appendix to UNIDROIT, Committee of Governmental Experts for the Preparation of a Convention on International Financial Leasing, Summary Report prepared by the UNIDROIT Secretariat, Study LIX, Doc. 24 (1985), *reprinted in* 1 P. COOGAN, W. HOGAN, D. VAGTS & J. MCDONNELL, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERICAL CODE (MB) § 5C.02[3][b] (1987).

3. The Drafting Committee was comprised of two law professors, Marion W. Benfield, Jr., and William E. Hogan, and five practicing lawyers, Edward I. Cutler (Chairman), Peter F. Langrock, Morris W. Macey, Donald Osheim, and Howard J. Swibel. Two other law professors, William J. Pierce and Fred H. Miller, participated heavily in the discussions as nonvoting *ex officio* members of the Committee. Outside nonvoting advisors to the Drafting Committee represented the American Association of Equipment Lessors (AAEL), the American Automotive Leasing Association (AALA), the American Bar Association (ABA) Section on Corporation, Banking, and Business Law, the ABA Section on Real Property, Probate, and Trust Law, the ABA Section on Taxation, the American College of Real Estate Lawyers (ACREL), the National Commercial Finance Association (NCFA), the National Vehicle Leasing Association (NVLA), and the Western Association of Equipment Lessors (WAEL). The author represented the AAEL and the AALA. Initial drafting was done by the two Reporters, Ronald DeKoven and Professor James A. Martin. The Committee then accepted, revised, or rejected the suggested draft. Though the Reporters had no vote in accepting or rejecting a proposed change, they participated in discussions and were responsible for committing all Committee decisions to writing.

4. The sponsors of the UCC are the American Law Institute (ALI) and the National Conference of Commissioners on Uniform State Laws (Commissioners). The Permanent Editorial Board for the UCC is the working group for the sponsors. The original treaty between the ALI and the Commissioners was revised in 1986 to recognize the increased role of the Commissioners and the Permanent Editorial Board. Under the new regime, the Commissioners' Drafting Committees, which include outside nonvoting Advisors from industry, will be the main forum for developing new sections of the UCC and revising existing provisions. The ALI will review the Committees' UCC revisions when the revisions are in a "finished form." To help resolve interpretive problems in the absence of legislative action, the Permanent Editorial Board may promulgate supplemental annotations and comments on the UCC. *See generally* Agreement Describing the Relationship of the American Law Institute, the National Conference of Commissioners on Uniform State Laws, and the Permanent Editorial Board with Respect to the Uniform Commercial Code (July 31, 1986).

Leases (Article 2A). Article 2A then was approved by the Code's sponsors, the American Law Institute and the Commissioners. The state legislatures are now in the process of considering and enacting this new statute.[5]

II. Overview of Article 2A

Article 2A applies to all personal property lease transactions, involving billions of dollars annually. These transactions range from consumer rentals of automobiles or do-it-yourself equipment, on the one hand, to leases of items such as commercial aircraft (to the extent not preempted by federal law) and industrial machinery, on the other. As a uniform law, the statute codifies legal rules and concepts that previously were scattered partly in the common law on bailments for hire, partly in real estate law, and partly in UCC Articles 2 and 9. Generally, all of the statute's standardized provisions may be varied by agreement between the lessor and lessee.

The statute applies only to leases, not to sales or security interests disguised as leases. This expands the transactional scope of the UCC to cover leases of goods.[6] But the statute is not a comprehensive code. It leaves gaps to be filled in by other state laws, particularly consumer protection statutes and so-called "products liability" cases. To avoid conflict with state certificate of title statutes, which cover automobiles, trailers, boats, and other often-leased goods, the new leasing statute defers to those statutes. Within its own sphere, however, Article 2A preempts other state laws and addresses issues that are important for equipment leasing.

The statute is divided into six parts:

---

5. Article 2A has been introduced in the following state legislatures: California, Colorado, Connecticut, Delaware, Illinois, Massachusetts, Minnesota, New Hampshire, Oklahoma, Rhode Island, Utah, and Washington. To date, only Oklahoma has enacted the statute. *See* H.B. 1683, 41st Leg., 2d Reg. Sess. (1988) (to be codified at Okla. Stat. tit. 12A, §§ 2A-101 *et seq.*).

6. The statute also may be applied by analogy to leases of "personal property other than goods, taking into account the expressed intentions of the parties to the transaction and any differences between a lease of goods and a lease of other property." U.C.C. § 2A-102 comment. Article 2A thus may apply, for example, to leases of computer software. *Cf.* Note, *Computer Programs as Goods under the UCC*, 77 Mich. L. Rev. 1149 (1979).

Part 1—General Provisions. This Part includes definitions (*e.g.*, "consumer lease," statutory "finance lease"), as well as provisions governing choice of laws in consumer leases, unconscionability, options to accelerate at will, and provisions governing the statute's territorial application to goods covered by certificates of title.

Part 2—Formation and Construction of Lease Contract. Warranties, both express and implied, are governed by this Part. Other provisions in Part 2 address the statute of frauds applicable to lease transactions, when the lessee obtains an insurable interest, risk of loss, and the special status of "finance leases" in the law of warranties.

Part 3—Effect of Lease Contract. UCC filing or recording is generally not required for leased goods, but is required for leased "fixtures." Third party rights are also covered by this Part, with provisions on priority disputes (including disputes between lien creditors or secured parties and lessees) and competing claims in fixtures.

Part 4—Performance of Lease Contract: Repudiated, Substituted and Excused. One provision in this Part, section 2A-404, imposes an automatic "hell or high water" obligation on lessees to pay rent under a statutory "finance lease" that is not a consumer lease. Other provisions in Part 4 govern issues such as adequate assurance of performance, anticipatory repudiation, and substituted and excused performance.

Part 5—Default. Outlined in Part 5 are general provisions concerning default (*e.g.*, statute of limitations, procedure in event of default), as well as the statutory (as opposed to contracted for) remedies available to both the lessee and the lessor on the other party's default.

Article 1 and Article 9: Conforming Amendments. One of the amendments here, to UCC section 1-201(37), clarifies the definition of a true lease.

A. The Sales Article (Article 2) As a Model

The sales Article of the UCC, Article 2, provided a model for drafting most of Article 2A's provisions on lease formation, warranties, and remedies. Article 9 similarly provided a model for Article 2A's provisions on the rights of third parties. In order to

accommodate the unique nature of leases, the provisions borrowed from Articles 2 and 9 were adapted to reflect common-law principles governing "bailments for hire."[7] Yet in general, Article 2 provided the starting point for drafting most of the leasing Article.[8]

This raises a problem: The sales Article is the oldest part of the UCC. Since the initial publication of Article 2 in 1952, numerous minor imperfections in the Article have been revealed.[9] To its credit, Article 2A does not contain any provision corresponding to section 2-207, the sales provision that has engendered much wasteful "battle of the forms" litigation over contract formation.[10] The Article nonetheless extends to leases some of the curiously ambiguous rules that long have been applied to sales transactions.[11] To come to grips with these difficulties, the Commissioners informally have committed themselves to review both Articles in the future.[12]

---

7. "At common law a lease of personal property is a bailment for hire." U.C.C. § 2A-103(1)(j) comment.

8. The Comment to § 2A-101 states that the selection of the sales Article as a model reflects the drafters' conclusion that

> [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.

9. One illustration of these imperfections is the so-called "battle of the forms" litigation concerning sales contract formation. *See, e.g.*, Duesenberg, *Contract Creation: The Continuing Struggle with Additional and Different Terms Under Uniform Commercial Code Section 2-207*, 34 BUS. LAW. 1477 (1979); Murray, *The Chaos of the "Battle of the Forms": Solutions*, 39 VAND. L. REV. 1307 (1986). Other imperfections in Article 2 abound. *See, e.g.*, Harris, *A Radical Restatement of the Law of Seller's Damages: Sales Act and Commercial Code Results Compared*, 18 STAN. L. REV. 66 (1965); Leary & Frisch, *Is Revision Due for Article Two?*, 31 VILL. L. REV. 399 (1986); Priest, *Breach and Remedy for the Tender of Nonconforming Goods under the Uniform Commercial Code: An Economic Approach*, 91 HARV. L. REV. 960 (1978); Sebert, *Remedies under Article Two of the Uniform Commercial Code: An Agenda for Review*, 130 U. PA. L. REV. 360 (1981).

10. *See supra* note 9. With respect to lease formation, any "battle of the forms" issues will be resolved by reference to general principles of contract law.

11. For example, § 2A-405, on "excused performance," contains a broad rule of discharge for change of circumstances for *lessors*. No provision in Article 2A contains a comparable discharge for *lessees*. To find something on this subject, one must reason by analogy from the open-ended Comment 9 to § 2-615: "[W]here the buyer's contract is in reasonable commercial understanding conditioned on a definite and specific venture or assumption . . ., the reason of the present section may well apply and entitle the buyer to the exemption."

12. This committment is consistent with the Commissioners' past practice of periodically revisiting the various parts of the UCC to refine and adjust them as needed in the light

The future of the new leasing statute thus is intertwined with the future of Article 2. The old sales Article also will provide insight, by analogy, into the meaning of the new statutory law of leases.[13]

B. Freedom of Contract

Within wide limits, Article 2A allows the lessor and lessee freedom of contract in crafting their lease agreements. Section 2A-103(4) explicitly adopts the sweeping "freedom of contract" standard of section 1-102(3). The Comment to section 2A-101 explains that "the general rule" throughout the statute "is that the effect of the Act's provisions may be varied by agreement." The statute specifically confirms, for example, that its standardized provisions on warranties and remedies not affecting the rights of third parties are variable by agreement between the lessor and the lessee.[14] This is a powerful rebuttal to criticisms of the new statute: Lessors and lessees who do not like some of the statute's standardized provisions may write their lease agreement to provide otherwise.

Other statutes and case law, particularly in the area of "consumer protection," may limit the contractual freedom of the parties. The primary limitation contained in Article 2A on that freedom is section 2A-108, which enjoins the enforcement of unconscionable lease clauses. Other well established limits on "contractual freedom," including the requirement that contractual waivers of implied warranties be "conspicuous," are incorporated in section 2A-214. The statute also includes scattered provisions according protections to lessees in "consumer leases," such as section 2A-106 (limiting abusive choice-of-law and choice-of-forum clauses in consumer leases) and section 2A-109 (placing burden on

---

of experience. Early in the history of the UCC, the Commissioners tended to make repeated textual changes to improve the statute. *Cf.* Mooney, *Introduction to the Uniform Commercial Code Annual Survey: Some Observations on the Past, Present, and Future of the UCC*, 41 BUS. LAW. 1343, 1344-50 (1986). It is an enormous task to enact UCC amendments in each of the 50 states, however. Given the Commissioners' experience with this difficulty, a rigorous operating rule of thumb for amending the UCC has evolved: "Is it broken?" Have recent business or legal developments rendered the old version of the UCC unworkable? This is a practical, not a theoretical, test that contemplates making only major necessary changes, not endless minor improvements, to the UCC.

13. *See* U.C.C. § 2A-101 comment (1987).

14. *See* § 2A-214 (exclusion or modification of warranties); § 2A-503(1) & comment (modification or impairment of rights and remedies); § 2A-501 comment (procedures upon default).

the lessor to justify acceleration of rentals in a consumer lease). Moreover, the new statute incorporates the general rules of section 1-102(3) that the obligations of good faith, diligence, reasonableness, and care may not be disclaimed by agreement.[15]

The impact of the new statute on standard lease forms will vary, depending on the sophistication of the particular form. Lessors will undoubtedly wish to consider how their forms deal with the issues spotlighted by Article 2A. Equipment leasing should be facilitated by uniformity in state law. Norm Chapman, President and Chief Executive Officer of San Francisco-based Security Pacific Leasing Corporation, commented: "The codification of equipment leasing under a single body of state law may well produce certain efficiencies in the documentation process. Such efficiencies are clearly to be welcomed at a time when the trend in many facets of the industry is towards higher costs and increasing complexity."[16]

III. UCC Article 2A: Its Central Provisions

The core provisions of Article 2A include the definition of a true lease, remedies and measure of damages after default, warranties, the special status of "finance leases," "consumer lease" issues, the rejection of mandatory UCC filing (or public notice) requirements for true leases, and fixtures. These provisions, which are the subject of this article, will largely determine the success or failure of the new statute. Threats of stormy opposition to Article 2A already have arisen, particularly from some vehicle lessors who are engaged in "open-end finance leasing" to consumers.[17] Overall,

---

15. Other Article 2A limits on "contractual freedom" include § 2A-504 (liquidated damages provisions must be "reasonable in light of the then anticipated harm" at outset of lease); § 2A-503(3) ("limitation of consequential damages for injury to the person in the case of consumer goods is prima facie unconscionable but limitation of damages where the loss is commercial is not"); § 2A-303(6) (right of damages "can be assigned despite agreement otherwise"); and § 2A-303(7) (ban on lease assignment must be conspicuous). *See also* U.C.C. § 2A-103(1)(u) comment (1987) ("present value should be used to determine fairly the damages payable by the lessor or the lessee on default").

16. Telecopy transmission from Norman L. Chapman, President and Chief Executive Officer of Security Pacific Leasing Corp. (Oct. 14, 1987).

17. "THREAT OF NEW UNIFORM PERSONAL PROPERTY LEASING ACT" trumpeted the front-page headline of *Car Rental/Leasing Insider Weekly Newsletter* on June 9, 1988. "Open-end" vehicle lessors have criticized the new statute's failure to validate "open-end" leases of vehicles as true leases, as well as the provisions in Article 2A covering

however, the drafters succeeded remarkably well in including in the statute the best of the earlier commercial law decisions on equipment leasing. To a great extent, Article 2A simply mirrors the common law of bailments for hire—that classic benchmark of reasonableness and gut equity in the law of equipment leasing.

A. True Leases of Goods Distinguished from "Sales" and "Security Interests"

A threshold task in drafting Article 2A was to define a lease of goods and to distinguish it from a conditional sale or disguised security interest. True leases long have been distinguished from sales for many purposes in commercial law, including determining remedies on default,[18] a lessor's rights under section 365 of the Bankruptcy Code,[19] and whether a transaction is covered by state usury laws.[20] The UCC definition of a true lease

---

"finance leases" and warranties and remedies in leases to consumers. *See* CAR RENTAL/LEASING INSIDER WEEKLY NEWSL., June 16, 1986; AUTOMOTIVE FLEET MAG., Aug. 1986, at 130; *see infra* Parts III.A, C, D & E.

18. The import of the lease/sale distinction in the law of remedies is discussed *infra* Part III.B. *See generally*, DeKoven, *Leases of Equipment:* Puritan Leasing Co. v. August, *A Dangerous Decision*, 12 U.S.F. L. REV. 257 (1978).

19. True lessors under § 365 of the Bankruptcy Code, 11 U.S.C. (1982), generally have a better chance than secured creditors of obtaining current payments, as well as repossessing the goods, when the lessee/debtor is in bankruptcy. Under that provision, the lessee (or bankruptcy trustee) must assume a true lease or reject it in its entirety, and if assumed, must give "adequate assurances" that prior defaults will be cured and that performance (payment of rentals) will take place in the future. These protections must be pursued carefully, of course, in the practical setting of a bankruptcy case. *Cf.* Terras & Pope, *Strategies for Recovery in Lessee Bankruptcy*, 3 J. EQUIP. LEASING 27 (1985). The secured creditor, in contrast, is covered by §§ 361-363 of the Bankruptcy Code. Under those provisions the buyer/debtor in bankruptcy has the right to continue to use any of the collateral property, with or without the consent of the seller/lender, so long as the secured lender is given "adequate protection" that the *value* of the property will be preserved. *Cf. In re* Pacific Express, 780 F.2d 1482 (9th Cir. 1986); *In re* American Mariner Indus., 734 F.2d 426 (9th Cir. 1984).

20. True leases, as opposed to disguised loans or "forebearances" of money, may be exempt from state usury laws. *See, e.g.*, Wright v. Agristor Leasing, 652 F. Supp. 1000, 1014 (D. Kan. 1987); Coomer v. National Cred. Corp., 282 Ark. 299, 668 S.W.2d 521 (1984); Associates Discount Corp. v. Tobb Co., 241 Cal. App. 2d 541, 50 Cal. Rptr. 738 (1966); Transportation Equip. Rentals, Inc. v. Ivie, 96 Idaho 223, 526 P.2d 828 (1974); DiLeo v. Parliament Funding & Leasing Corp., [1974-1980 Transfer Binder] Consumer Cred. Guide (CCH) ¶ 98,376 (N.Y. Sup. Ct. 1976); NBC Leasing Co. v. Stillwell, 334 N.W.2d 496 (S.D. 1983); Broker Leasing Corp. v. Standard Pipeline Coating Co., 602 S.W.2d 278 (Tex. Civ. App. 1980). Yet, the lease/sale issue may not be reached by courts in state usury law cases because transactions often may be exempt from state usury laws under the "time-price doctrine," which allows a seller of personal property to sell at one price for cash and at another

> determines not only the rights and remedies of the parties to the lease but those of third parties. If a transaction creates a lease and not a security interest, the lessee's interest in the goods is limited to its leasehold estate; the residual interest in the goods belongs to the lessor. This has significant implications to the lessee's creditors.[21]

Moreover, a secured sale, unlike a lease, is subject to Article 9, which contains rules of priority and generally requires the filing of a financing statement for secured interests.[22] True leases henceforth generally will be governed by the provisions of Article 2A, while sales and "security interests" will continue to be covered by UCC Articles 2 and 9 respectively.[23]

The original language of section 1-201(37) partially defined the distinction between a true lease and a "lease intended for security."[24] But drawing this distinction in specific cases has proved

---

for credit, without the application of usury laws. *See, e.g.*, Leasing Service Corp. v. Graham, 646 F. Supp. 1410, 1416-18 (S.D.N.Y. 1986); Credit Alliance Corp. v. David O. Crump Sand & Fill, 470 F. Supp. 489, 493 (S.D.N.Y. 1979); Boerner v. Colwell, 21 Cal. 3d 37, 145 Cal. Rptr. 380, 577 P.2d 200 (1978) (credit sale with assignment to financing institution not subject to usury laws); Burr v. Capital Res. Corp., 71 Cal. 2d 983, 80 Cal. Rptr. 345, 458 P.2d 185 (1969) (court held "sale-leaseback" subject to usury law, but transactions that were "either leases or conditional sales" held not to be a "usurious loan of money"); Johnson v. Sears Roebuck & Co., 14 Ill. App. 3d 838, 303 N.E.2d 627 (1973).

21. U.C.C. § 1-201(37) comment (1987).

22. *See* §§ 9-301, 9-302, 9-312.

23. Article 9, of course, contains several provisions which explicitly refer to "leases." Section 9-102, in setting forth the scope of Article 9, refers to leases and other transactions "intended as security." Section 9-206(1), which deals with contractual waivers of defenses against assignees, was amended in 1972 to apply to waivers by a "lessee" as well as a "buyer." The Comment to § 2A-303 specifically confirms that § 9-206, as amended, applies to true lease agreements. *Accord* Leasing Serv. Corp. v. Crane, 804 F.2d 828, 835 (4th Cir. 1986). Section 9-408, which was added to the Code in 1972, permits lessors and consignors of goods to file financing statements in order to assure perfected security interest status in the event it is determined that a purported lease or consignment creates a security interest. Leases are also referred to in § 9-105(1)(b) (defining "chattel paper"), § 9-106 (defining "account"), and § 9-109(4) (defining "inventory"). *See generally* U.C.C. §§ 1-201(37), 9-102(1)(a) (1987). Moreover, an assignment of a true lease may be subject to Article 9, even though the underlying lease is not. *See* § 9-106 comment 3.

24. Former § 1-201(37) ties the definition of a true lease to the definition of a "security interest," with two final sentences devoted to distinguishing true leases from a "lease intended for security":

> "Security interest" means an interest in personal property or fixtures which secures payment or performance of an obligation. The retention or reservation of title by a seller of goods notwithstanding shipment or delivery to the buyer (Section 2-401) is limited in effect to a reservation of a "security interest". The term also includes any interest of a buyer of accounts or chattel paper which is subject to Article 9. The special property interest of a buyer of goods on identification of such goods to a con-

to be a difficult and frequently litigated problem.[25] After considering a variety of suggestions, the Commissioners on Uniform State Laws decided to clarify the definition of a true lease by amending section 1-201(37) to preserve common law principles and reaffirm the importance of the residual as a source of potential gain or loss in the business of equipment leasing.

At common law, the central feature of a true lease is the reservation of an economically meaningful interest to the lessor at the end of the lease term. Ordinarily this means two things: (1) at the outset of the lease the parties expect the goods to retain some significant residual value at the end of the lease term; and (2) the lessor retains some entrepreneurial stake (either the possibility of gain or the risk of loss) in the value of the goods at the end of the lease term. Over the years, the equipment leasing industry has developed a wide variety of practices that affect the lessor's residual. These include options for the lessee to renew the lease or buy the goods, "open-end" leases with terminal rental adjustment clauses (TRAC), "puts" that provide the lessor with an option to require the lessee to purchase the goods, and lease remedy provisions that allocate the economic risks of ultimate disposal of the residual. Article 2A provides a reasonable set of rules for assessing the impact of these practices on the true lease status of a transaction.

---

tract for sale under Section 2-401 is not a "security interest", but a buyer may also acquire a "security interest" by complying with Article 9. Unless a lease or consignment is intended as security, reservation of title thereunder is not a "security interest", but a consignment is in any event subject to the provisions on consignment sales (Section 2-326). Whether a lease is intended as security is to be determined by the facts of each case; however, (a) the inclusion of an option to purchase does not of itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended for security.

U.C.C. § 1-201(37) (1977).

25. The cases and authorities are collected in Coogan, *Leases of Equipment and Some Other Unconventional Security Devices: An Analysis of UCC Section 1-201(37) and Article 9*, in 1 P. COOGAN, W. HOGAN, D. VAGTS & J. MCDONNELL, *supra* note 2, §§ 4A.01-.08; DeKoven, *Proceedings After Default by the Lessee Under a True Lease of Equipment*, in 1C P. COOGAN, W. HOGAN, D. VAGTS & J. MCDONNELL, *supra* note 2, §§ 29B.02-.05; and Mooney, *True Lease or Lease "Intended as Security"—Treatment by the Courts*, in 1C P. COOGAN, W. HOGAN, D. VAGTS & J. MCDONNELL, *supra* note 2, § 29A.05. *See generally* Ayer, *On the Vacuity of the Sale/Lease Distinction*, 68 IOWA L. REV. 667 (1983); Boss, *Leases and Sales: Ne'er or Where Shall the Twain Meet?*, 1983 ARIZ. ST. L.J. 357; Note, *Disengaging Sales Law from the Sale Construct: A Proposal to Extend the Scope of Article 2 of the UCC*, 96 HARV. L. REV. 470 (1982).

1. The statutory framework.—Given the difficulties of crafting a comprehensive definition of a true lease,[26] as well as the importance of maintaining flexibility in structuring lease transactions, the draftsmen of Article 2A decided that the definition should generally leave the issue to be "determined by the facts of each case," rather than an overly rigid definition woodenly resolving every imaginable case. The outcome is a loosely defined statutory trichotomy: transactions are either leases, sales, or security interests.

The old common law touchstone of a true lease—the lessor's meaningful residual interest—is reflected in Article 2A. Section 2A-103(1)(j) of the statute defines a "lease" as "a transfer of the right to possession and use of goods for a term in return for consideration, but a sale, including a sale on approval or a sale or return, or retention or creation of a security interest is not a lease." Thus, the term "lease" is defined by comparison to a sale (section 2-106(1)) and a "security interest" (section 1-201(37)). Yet by elaborating upon common-law principles in the amendment to section 1-201(37),[27] sharpening the distinction between a lease and a sale, the new statute provides significantly more guidance than current law as to the essence of a true lease.[28]

The Comment to section 2A-103(1)(j) contains a set of "hypotheticals [to] indicate the perimeters of the issue" and states that "[t]his section as well as Section 1-201(37) must be examined to determine whether the transaction in question creates a lease or a security interest." The structure of the amended statutory definition in section 1-201(37) is first to state the general rule: "Whether a transaction creates a lease or security interest is determined by the facts of each case." Next, several specific factors are identified that will *destroy* true lease status and create a "security interest."

---

26. The myriad legal issues that can be raised by leasing (involving tax, accounting, bankruptcy, and state law issues) make comprehensive definition of a "true lease" a most difficult and elusive task. *See, e.g.*, 1 P. Coogan, W. Hogan, D. Vagts & J. McDonnell, *supra* note 2, §§ 4.1.06, 4A.01[3].

27. The Comment to amended § 1-201(37) states that "[a]n examination of the common law will not provide an adequate answer to the question of what is a lease."

28. In practice, the courts have considered a wide variety of factors, including remedies provisions, in determining whether a transaction is a true lease. *See* 1 & 1C P. Coogan, W. Hogan, D. Vagts & J. McDonnell, *supra* note 2, chs. 4A, 29A & 29B (collecting cases and authorities defining a true lease); Harris & Mooney, *Recent Cases Relating to Equipment Leases*, in Equipment Leasing 1985 at 336-64, 375-87 (1985); Leary, *The Procrustean Bed of Finance Leasing*, 56 N.Y.U. L. Rev. 1061, 1069-76 (1981) (case law defining a true lease distilled into 14 separate factors).

Finally, other factors are listed that are *consistent* with true lease status.

Two basic factors, either of which will *destroy* true lease status and create a "security interest," where the lessee is obligated to pay rents for the lease term, are in essence: (1) where the lease is for the full economic life of the goods; or (2) where the lessee has an option to become the owner for "nominal" additional consideration.[29] Where either factor exists, the transaction is not a true lease because the lessor has no reasonable expectation of a meaningful residual. The Comment to section 1-201(37) emphasizes that "these tests focus on economics, not the intent of the parties."

Other factors are identified in amended section 1-201(37) as being *consistent* with true lease status. These include: (1) a "full payout" lease (where the present value of the lessee's payments are substantially equal to the fair market value of the goods at the outset of the lease);[30] (2) typical "net lease" provisions where the lessee assumes the risk of loss, or agrees to pay taxes, insurance, filing, recording, or registration fees, or service or maintenance

---

29. This part of the statutory definition is clearly stated in four parts:

> [A] transaction creates a security interest if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee, and
>
> (a) the original term of the lease is equal to or greater than the remaining economic life of the goods,
>
> (b) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods,
>
> (c) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement, or
>
> (d) the lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement.

U.C.C. § 1-201(37) (1987).

30. *Id.* The Comment to amended § 1-201(37) confirms that "a full payout lease does not *per se* create a security interest. Rushton v. Shea, 419 F. Supp. 1349, 1366 (D. Del. 1976)." The court in *Rushton* held that a transaction constituted a true lease, since the lease agreement at issue did not contain a provision allowing the lessee "to ever obtain ownership or the practical equivalent thereof." Moreover, as the Tenth Circuit explained in *In re* Fashion Optical, 653 F.2d 1385 (10th Cir. 1981):

> [T]he fact total "rentals" may exceed the price does not automatically eliminate the possibility of a true lease because if the parties reasonably anticipated the equipment's market value to depreciate only slightly . . . [over the lease term], or indeed appreciate, the lease might well be found to require greater than nominal consideration for full ownership.

Id. at 1390.

costs;[31] (3) the mere existence of a option to renew the lease or buy the goods;[32] and (4) options to renew or buy at a fixed price equal to or greater than reasonably predictable fair market value (as predicted at the time the transaction is entered into).[33] Moreover, the amended statutory definition deletes all reference to "the parties' intent." The Comment to the section explains that most of the criteria that courts have relied upon to show intent, including "typical net lease provisions, a purported lessor's lack of storage facilities or its character as a financing party rather than a dealer in goods," are "as relevant to true leases as to security interests." Objective criteria, not a search for subjective intention, is the order of the day.

These are significant clarifications of the law. Yet no attempt was made to answer all questions, since the variety of transactions that parties to a "lease" can produce is almost unlimited. Rather, the general standard is that whether a particular transaction creates a lease or a "security interest" will be determined on the basis of all the facts and circumstances.

2. Options to renew or buy.—One linchpin in the definition of a true lease that goes to the heart of the lease-sale distinction is the subject of options. This is a sensitive area for both lessors and lessees, since the price of an option to renew or buy directly affects the lessor's monetary return. In general, amended section 1-201(37) contains a sensible treatment of options in a true lease. The statute retains some ambiguity in treating the subject of "bargain options," which may be inevitable or even desirable.

(a) Development.—Originally, the Drafting Committee considered tying the definition of a true lease to artificial percentages and formulas for determining what constitues "nominal consideration" for options to renew or buy. These formulas were of two types. One required the option price to have some minimum absolute value, measured as a percentage of the original value of the goods. The other type of formula required the option price to be some substantial fixed percentage of the "reasonably predictable fair market value" of the goods at the time the option was to be

31. U.C.C. § 1-201(37) (1987).
32. *Id.*
33. *Id.*

exercised, with the "reasonable prediction" determined at the time the transaction was entered into.

Ten percent of the original value of the goods was considered and rejected as a possible benchmark for defining "nominal consideration." One such proposal, for example, would have accorded true lease status to "leases" with fixed price purchase options whenever the option was "equal to or greater than ten percent of the fair market value of the goods at the time the lease was entered into." This sweeping proposal was quickly rejected, as being at odds with settled law, since it would have accorded true lease status to transactions with ten percent fixed-price options where the reasonably predictable fair market value of the goods was eighty percent, not ten percent, at the time the option was to be exercised.

The Committee draftsmen also considered and rejected a similar "ten percent" rule that would have stamped some transactions as "security interests" by amending section 1-201(37) to provide with respect to options that "[a]dditional consideration is nominal if it is less than . . . 10 percent of the fair market value of the goods at the time the lease agreement was entered into."[34] This proposal overlooked the fact that a nine percent fixed-price purchase option would *not* be nominal where nine percent was a reasonable estimate of the fair market value of the goods at the time the option was to be exercised. True lease status may be present in such cases.[35]

---

34. DRAFTING COMMITTEE, UNIFORM PERSONAL PROPERTY LEASING ACT, Draft No. 5, Exh. A.

35. Throughout the motor vehicle leasing industry, seriatim *renewal options* commonly appear in lease agreements, which are written so that if all the options were exercised, the later ones would be for a fair market value price that would be less than "10 percent of the fair market value of the goods at the time the lease agreement was entered into." *Id.* para. (x). Often rent schedules set out in a motor vehicle lease agreement will cover option renewal time periods well beyond the time that the vehicle normally would be used under the lease. Where that is so, the scheduled rent for that time period typically will be quite low, though it still will be at a fair market value price covering the lessor's administrative expenses of maintaining the lease relationship. Only in a small percentage of cases, usually involving utility lessees or railroad lessees, will the lessee actually exercise his renewal options so as to continue leasing a motor vehicle for this extended length of time. Yet many motor vehicle lease agreements contain this sort of extended renewal option provision, with an accompanying schedule of fair market value rents.

Transactions with seriatim option renewals of this kind seem to be true leases, the AALA argued, since this form of lease is imbued with economic substance, encouraged by business realities, and consistent with longstanding industry practice. *Cf.* Frank Lyon Co. v.

Equally without merit was an early proposal that would have accorded true lease status to "leases" having fixed-price purchase options whenever the option was "equal to or greater than 75% of the reasonably predictable fair market value of the goods or renewal option at the time the option is to be performed if exercised, as predicted or predictable at the time the lease was entered into." This proposal would have accorded true lease status to leases containing "bargain" options to renew or buy. When the lessor and the lessee agree at the outset to give the lessee a twenty-five percent discount on the anticipated fair market option price, they have written a "bargain" option agreement that "tilts the scales" to encourage exercise of the option. Well-settled principles of law indicate that this sort of bargain option agreement may not constitute a true lease.[36]

The Drafting Committee also rejected a proposed amendment to section 1-201(37) that would have provided, with respect to options, that "[a]dditional consideration is nominal if it is less than . . . _____ percent of the reasonably predictable fair market value of the goods or renewal option at the time the option is to be performed if exercised."[37] The proposal overlooked the fact that any percentage number less than 100 percent, might be interpreted implicitly to sanction "bargain" options as clearly consistent with "true lease" status.

United States, 435 U.S. 561, 583-84 (1978). In such transactions, the lessee is not obligated either to renew the lease for the remaining economic life of the goods or to become the owner of the goods. Functionally, one can view this sort of motor vehicle lease as a *series* of separate leases. The Comment to § 2A-103 is pertinent here:

> [W]ith each renewal of the lease the facts and circumstances at the time of each renewal must be examined to determine if that conclusion [that a transaction is a lease, not a security interest] remains accurate, as it is possible that a transaction that first creates a lease, later creates a security interest.

36. One theme that often runs through the cases and authorities is that the owner/lessor in a true lease at the outset must have some legitimate possibility for return or other disposition of the leased property before the end of the economic life of the property. *See, e.g., In re* Marhoefer Packing Co., 674 F.2d 1139, 1143, 1145 (7th Cir. 1982). With respect to options to renew or buy, under state law, the essence of a true lease may be that the *original agreement* should leave the lessor with a significant economic stake in the residual and should not "tilt the scales" to require or encourage the lessee to exercise the option for the remaining economic life of the property. *Cf. id.* at 1144-45; U.C.C. § 1-201(37) (1987) (options for "nominal" consideration inconsistent with true lease status); *see also* Mooney, *supra* note 25, § 29A.05[2][b].

37. Drafting Committee, Uniform Personal Property Leasing Act, Draft No. 5, Exh. A.

After considering these and other proposed formulas, the Commissioners abandoned the notion of using artificial formulas and percentages to define an option in a true lease. Instead, they adopted the functional approach that had developed at common law.

(b) Guiding principles.—The important principle recognized in amended section 1-201(37) is that lessors under a true lease are economic investors possessing a real economic stake in the residual value of the leased goods. Well-settled legal principles, reflected in the amendment to section 1-201(37), confirm that the option price in a true lease must be related to "reasonably predictable fair market value"[38] and not simply to a bargain or "nominal" option that is so low that, as a matter of economics and so far as the parties can foresee, it effectively "cashes in" the lessor's residual interest. The original agreement in a true lease cannot contain an economically irresistible option, which the parties expect from the outset will be exercised by the lessee to purchase the goods or renew the lease for the remaining economic life of the goods. To have a true lease, the original agreement must leave the lessor with some meaningful economic interest in the residual.[39]

The statute rejects the view, expressed during the Drafting Committee sessions, that "[i]t doesn't make any difference whether you have a lease or a sale, as long as you know which is which." Traditional common-law principles recognize that it makes a difference whether the lessor has a meaningful residual interest in the goods. A meaningful residual interest has a significant effect on

---

38. *See supra* note 36. The statute and the Comment to amended U.C.C. § 1-201(37) make it clear that "reasonably predictable" means predictable as of the time the transaction is entered into.

39. Where the lessee is obligated to pay rents for the lease term, the "lessor" has no meaningful residual if the lease extends for the full economic life of the goods or if the lessee has an option to become the owner for "nominal" additional consideration at the expiration of the lease term. *See* U.C.C. § 1-201(37) (1987). Moreover, the requirement for a meaningful residual explains the caveat about the lessee's obligation to pay rents for the lease term. Consider the unusual situation, for example, of a true lease wherein the lessee has *both* an option to terminate the lease at any time without penalty and an option to become the owner for "nominal" additional consideration. This sort of transaction may be a true lease, notwithstanding the existence of a "nominal" purchase option that deprives the lessor of an *entitlement* to a meaningful residual, since the lessee can walk away from the lease at any time without penalty. *Cf. id.*; *Marhoefer*, 674 F.2d 1139. The lessee's right to terminate the lease at any time without penalty creates the possibility that the goods may be returned to the lessor; in that sense, the right gives the lessor a meaningful economic interest in the residual.

lease pricing as well as on practical assessments of the risks, rewards, and expertise involved in being a successful lessor. A lease is not simply an installment sale with a balloon payment at the end. And the lessee's acquisition of the goods for their full economic life is not a foregone conclusion. In a true lease, the lessor has a real entrepreneurial stake in the residual.

The implications of this principle are far-reaching: 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. The residual is not just a "throw-in" in a true lease. It is a significant source of potential gain or loss for the lessor. Ordinarily, all other things being equal,[40] one might expect rental payments under a true lease to be lower than periodic payments under a disguised sale where the seller, at the outset of the transaction, plans never to deal with the residual. 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.[41] One essential difference between the two is that the lessor in a true lease retains a real, economically meaningful interest in the residual.

(c) Treatment of options by the new statute.—The amendments to section 1-201(37) reflect the central importance of the lessor's meaningful residual. True lease status is not destroyed by the mere existence of an option to renew the lease or buy the goods. Where the option price in a lease is "*stated to be the fair market value of the goods,*"[42] amended section 1-201(37) creates a safe harbor validating such options as consistent with true lease

40. The statement in the text contemplates a hypothetical comparison between a lease and a sale where, among other things, both the sale and the lease involve the same property and the same number of payments over the same period of time. The same idea can be expressed by saying that in a true lease, the lessor retains a meaningful, valuable residual.

41. Yes, Matilda, as a matter of economic reality there is a difference between a true lease and an installment sale. *Compare* Kripke, Book Review, 37 BUS. LAW. 723, 726-27 (1982) (reviewing EQUIPMENT LEASING—LEVERAGED LEASING (B. Fritch & A. Reisman eds. 2d ed. 1980)) ("there is no true distinction between leases and a purchase of property in installment payments") *with* Coogan, *Is There A Difference Between a Long-Term Lease and An Installment Sale of Personal Property?*, 56 N.Y.U. L. REV. 1036 (1981) (commenting at length that true leases differ from installment sales).

42. U.C.C. § 1-201(37) (1987) (emphasis added).

status. This safe harbor defines the classic case where the lessor retains a real, economically meaningful interest in the residual.

Another part of amended section 1-201(37) validates certain fixed-price options as clearly consistent with true lease status by stating:

> A transaction does not create a security interest merely because it provides that
>
> . . . .
>
> (e) the lessee has an option to become the owner of the goods for a fixed price that is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed.[43]

This safe harbor for true leases with fixed-price purchase options at "reasonably predictable fair market value" also requires the lessor to retain a meaningful residual. Given the widespread use of fixed-price purchase options, this part of amended section 1-201(37) should be helpful to equipment lessors, particularly in bankruptcy and usury cases.

Options can transform a lease agreement into one for security if the lessee cannot terminate its obligations under the lease (simply "walk away" from it) and "the lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement."[44] This portion of amended section 1-201(37) shows how the concept of a "nominal" purchase option is related to the concept of the lessor's meaningful residual. Transactions are *not* true leases where the parties anticipate, at the outset of the transaction, that the option will be irresistible in the sense that the option price is extremely low in comparison to the fair market value of the property.[45]

---

43. *Id.*

44. *Id.*

45. In a "Prefatory note" to the materials presented at the Commissioners' 1985 Annual Meeting, the Committee that drafted Article 2A explained:

> For example, a "lease" may contain an option for the lessee to buy the goods at the end of the lease period at a price that is extremely low in comparison to the value of the goods at that point. Thus, the option will almost certainly be exercised and the overall effect of the transaction is to transfer ownership from the "lessor" to the "lessee," with the retention of title acting as security for the lessor. In those cases where the parties anticipated when they entered the transaction that the option would be "irresistible" in this sense, courts have found little difficulty under Section

One criticism leveled at amended section 1-201(37) is that it fails to validate, as clearly consistent with true lease status, agreements with a fixed-price option that "approximates reasonably predictable fair market value." This criticism is unsound. The only purpose of substituting "approximates" for "equal to or greater than" would be to validate, as clearly consistent with true lease status, agreements with fixed-price options at *less* than predictable fair market value. This seems unwarranted. When the lessor and lessee agree at the outset to give the lessee a *discount* on the option price so that the option is less than the reasonably predictable fair market value, the parties have entered a "bargain" option agreement that "tilts the scales" to encourage exercise of the option. That sort of agreement, which may or may not constitute a true lease,[46] undercuts the importance of a lessor's entrepreneurial stake in the residual. Neither reason nor authority supports a sweepingly overbroad provision granting safe harbor true lease status to such agreements.

Moreover, as a matter of drafting statutes, it does not make sense to use a vague word like "approximates" in what is supposed to be a safe harbor test for valid fixed-price options in a true lease. It would be difficult for a lessor to determine whether the lease agreement falls within a safe harbor that is defined by the word "approximates." Extensive litigation would arise over the meaning of this one vague word. Courts might well search for a percentage formula to give meaning to the word. Viewed in this light, the word "approximates" appears to be a stalking horse for a mathematical or percentage formula of the kind that was considered and rejected. The Commissioners properly rejected the proposal to insert the vague word "approximates" in the safe harbor for fixed-price options.

True leases are defined sensibly in Article 2A. Amended section 1-201(37) provides that some transactions are clearly true leases, that other transactions are clearly secured transactions, and that everything else is to be determined by reference to "the facts of each case." This clarifies current law to some extent, while accommodating the whole spectrum of existing leasing practices. The

---

1-201(37) of the Uniform Commercial Code in finding that the transaction is a secured sale and not a true lease.

46. *See supra* note 36.

safe harbor for true leases with fixed-price purchase options "equal to or greater than" reasonably predictable fair market value parallels the wording of IRS Revenue Procedure 75-21, a basic set of tax law guidelines that has been familiar to the leasing industry for over a decade.[47] No business justification exists for switching to "approximates": The safe harbor phrased in terms of "equal to or greater than" covers a *wide range* of predicted option values.[48] The overall standard for judging true lease status, under amended section 1-201(37), is by reference to "the facts of each case." These standards should give businessmen all the flexibility that they

---

47. Revenue Procedure 75-21 sets out guidelines that the Internal Revenue Service uses for advance ruling purposes in determining whether leveraged lease transactions are valid leases. Two of the four conditions in Rev. Proc. 75-21 are as follows:

(1) *Minimum Unconditional "At Risk" Investment*

. . . .

(C) *Residual Investment.* The lessor must represent and demonstrate that an amount equal to *at least* 20 percent of the original cost of the property is a reasonable estimate of what the fair market value of the property will be at the end of the lease term. . . . In addition, the lessor must represent and demonstrate that a remaining useful life of the longer of one year or 20 percent of the originally estimated useful life of the property is a reasonable estimate of what the remaining useful life of the property will be at the end of the lease term.

. . . .

(3) *Purchase and Sale Rights.*

No member of the Lessee Group may have a contractual right to purchase the property from the lessor at a price *less than* its fair market value at the time the right is exercised.

Rev. Proc. 75-21, 1975-1 C.B. 715-16 (emphasis added).

48. There are many uncertainties, such as technological obsolescence and changes in the rate of inflation, that may affect the "reasonably predictable fair market value" of the residual. One recent article, for example, listed the following "macroeconomic conditions and forces [that] affect residual values in different asset categories": (1) *The U.S. economy and level of activity of foreign trade.* "For example, a year ago an average 10- to 15-year-old bulkcarrier was selling at a rock-bottom price of $1 million to $1.6 million, reflecting a depressed, over-supplied market. Today, because of increased movement of grain to the U.S.S.R., these same ships cannot be bought for under $2.2 million." (2) *Tax and other legislation.* "The FAR 36 Stage II noise abatement requirement has rendered many older aircraft that had a commercial value either useless or in need of extensive retrofitting." (3) *Changes in technology.* "These include changes in computers, medical equipment, trailers, trains and airplanes." (4) *Regulation and deregulation.* "The Jones Act protects rates, and consequently ship prices, to the extent that U.S. flagships are often quadruple the value of other world vessels." (5) *Foreign exchange rates.* "As the dollar weakens, it is tougher for foreign companies to sell in the U.S.; as it strengthens, it is easier to sell in the U.S. The converse is true for U.S. companies abroad." Chrappa & Mulvihill, *Estimating and Guarding Equipment's Residual Value is Now Crucial to Successful Leasing*, LEADER'S EQUIP. LEASING NEWSL., Aug. 1987. The impact of these kinds of economic uncertainties is such that a wide range of values should qualify as "reasonably predictable" option prices in any given transaction.

need. As equipment lessors requested, moreover, the statute preserves, rather than undercuts, the importance of the residual as a source of potential gain or loss in the business of equipment leasing. In commenting on the new leasing statute, Ned Mundell, President and Chief Executive Officer of California-based U.S. Leasing International, stated: "The long-term interests of the equipment leasing industry, and the public interest, are best served by recognizing the importance of a lessor's entrepreneurial stake in the residual. We are satisfied that the new UCC provisions on leasing do that."[49]

(d) Bargain options.—Transactions with fixed-price "bargain options" that are exerciseable for less than "reasonably predictable fair market value" will be assessed on the basis of "the facts of each case" under amended section 1-201(37), as under current law. The Comments to new section 1-201(37) are ambiguous on the proper treatment of such bargain options. We are told that:

> A fixed price purchase option in a lease does not of itself create a security interest. This is particularly true if the fixed price is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed. A security interest is created only if option price is nominal and the conditions stated in the introduction to the second paragraph of this subsection are met [*i.e.*, if the lessee cannot simply "walk away" from the lease by terminating its obligations]. There is a set of purchase options whose fixed price is less than fair market value but greater than nominal that must be determined on the facts of each case to ascertain whether the transaction in which the option is included creates a lease or a security interest.[50]

The courts are left to interpret, as best they can, this Delphic pronouncement on fixed-price purchase options for "less than fair market value."

Two possible interpretations are immediately apparent. One is that some bargain options—at less than *reasonably predictable* fair market value—are consistent with true lease status, as long as the option price is not so low as to become "nominal." This interpretation, of course, invites courts to search for some percentage formula (fifty-one percent? seventy-five percent? or ninety per-

---

49. Telephone interview with D.E. (Ned) Mundell, President and Chief Executive Officer of U.S. Leasing International (Oct. 7, 1987).

50. *See* U.C.C. § 1-201(37) comment (1987).

cent?) to try to pin down the metaphysical difference between a permissible "bargain" option and an impermissible "nominal" option in a lease. Such a view of the Comment lends a schizophrenic quality to amended section 1-201(37), in light of the statutory text's rejection of formulas and percentages as an approach to defining a true lease. This sort of schizophrenia has ample precedent in the law.[51] But the search for a mathematically precise definition of a lease seems a vain quest for illusory benefits. Economic uncertainties of life (such as technological obsolescence and changes in the rate of inflation) are such that a *wide range of values* should qualify as "reasonably predictable fair market value" option prices in any given transaction. Given this reality, it seems unrealistic and artificial to seek mathematically precise percentages or formulas to define an impermissibly low option price that will destroy true lease status. It should take an extreme case to show a "bargain" fixed-price option totally outside the ballpark of "reasonably predictable fair market value" option prices.

The other interpretation of the Comment would be that its reference to "a set of purchase options whose fixed price is less than fair market value" means "less than [what] fair market value" *turns out to be* at the time the option is exercised. This view of the Comment would fit well within the decided cases: True leases may include fixed-price options that are not nominal in light of the "reasonably predictable fair market value" of the goods, as predicted at the outset of the transaction, even if later unexpected events make the option price a bargain (or even "nominal") at the time the option is actually exercised. When a fixed-price purchase option *turns out to be* "less than fair market value," a question may arise as to whether the transaction is a true lease. But the

---

51. Professor Gilmore has written about the "pervading schizophrenia" of the *Restatement of Contracts* (both First and Second), while praising those works. G. GILMORE, THE DEATH OF CONTRACT 75-76 (1974) (Lecture III). A principal illustration of this schizophrenia is the tension between the formalistic definition of contract "consideration" in § 75 of the *Restatement*, on the one hand, and the notion in § 90 that contracts could be created by a "promise reasonably inducing definite and substantial action," on the other hand. Eventually, the approach in § 90 swallowed the approach in § 75. *See* RESTATEMENT (SECOND) OF CONTRACTS §§ 75, 90 (1979); *see also* Farber & Matheson, *Beyond Promissory Estoppel: Contract Law and the "Invisible Handshake"*, 52 U. CHI. L. REV. 903 (1985) (survey of every case in the past ten years citing § 90 of the Restatement, concluding that "promissory estoppel is being transformed into a new theory of distinctly *contractual* obligation"). It is, of course, the fate of any statutory restatement of the common law—whether the *Restatement of Contracts* or Article 2A—to be poised uneasily between past and future.

statutory text and Comment on amended section 1-201(37) make it clear that it is "the facts and circumstances *at the time the transaction is entered into*" that are controlling. Where a fixed-price purchase option is not "nominal," when viewed in light of the circumstances known at the outset of a transaction, the option is consistent with true lease status. Overall the test remains whether, as a practical matter, at the outset of a transaction, the lessor had an economically meaningful interest in the residual.

The outcome of court cases on "bargain options" (as opposed to their logic chopping) should turn out to be approximately the same, no matter which interpretation of the statute gains judicial favor. Moreover, some ambiguity about the status of "bargain options" may be inevitable (or even desirable) in light of the courts' still-evolving commercial law definition of a lease.

3. TRAC leases.—"Open-end" leases, with terminal rental adjustment clauses (TRAC), have been widely used in the motor vehicle leasing industry for over thirty years. Essentially, this type of lease sets out a schedule of rental payments, together with a corresponding *estimate* for the value of the residual at the end of the lease term. TRAC provisions in the agreement then provide that the *actual* value of the residual will be determined at the end of the lease term by appraisal, sale to a third party, or otherwise, and that a payment then will be made by the lessee or a credit given by the lessor to reflect the difference between the actual and estimated residual values. Widely different variations on this basic format may appear in specific "open-end" leases.

Theoretically, "open-end" TRAC leases reward lessees who take good care of the leased goods, while compensating the lessor for any unusual wear and tear. TRAC lessees pay fair value for their use of the goods, according to supporters of the "open-end" lease, while the TRAC lessor retains the residual value. One view of TRAC clauses is that they simply allow the parties to determine the amount of actual depreciation on the leased goods. Others point out, however, that typical TRAC provisions give the lessee (not the lessor) the potential gain or loss from disposition of the residual. This point arguably undercuts any meaningful residual interest of the lessor and suggests that TRAC transactions are not true leases.

TRAC motor vehicle leases to commercial lessees are specifically recognized as true leases by the federal tax laws.[52] But the case law is divided on whether TRAC leases are true leases under state law.[53] The Commissioners decided that amended section 1-201(37) would be *silent* on the thorny question of whether TRAC leases are true leases.

"Open-end" leases also raise the issue of whether TRAC provisions or some variations of them are validated by the liberal provisions of new section 2A-504 on "liquidation of damages."[54] TRAC provisions that essentially deprive the lessor of any meaningful interest in the goods at the end of the lease term may or may not pass muster as true leases. Viewed as liquidated damage formulas, however, some more narrowly drawn TRAC provisions seem "reasonable." One common lease provision, according to the Comment in section 2A-504, leaves the lessor with potential profits from a sale of the residual, while essentially making the lessee a guarantor of the estimated residual value set out in the lease. This "one-sided" TRAC provision leaves the lessor with a meaningful interest in the residual. Where reasonable, the courts should find that it qualifies as an enforceable provision in a true lease. Other kinds of narrowly drafted TRAC-like provisions, which charge the lessee for excessive use or poor maintenance as opposed to changes in value due to market trends, also seem consistent with true lease status.

Whether true lease status should be accorded to more broadly drafted TRAC vehicle leases currently in widespread use is less clear. Three additional major arguments might be advanced for recognizing these transactions as true leases under state law. *First*, TRAC vehicle leases, in order to qualify as "operating leases"

---

52. Tax law treatment of "open-end" leases by the courts, before the 1983 amendment of 26 U.S.C. § 168(f)(13), and the 1986 redesignation of that Code section as 26 U.S.C. § 7701(h), is illustrated by Swift Dodge v. Commissioner, 692 F.2d 651 (9th Cir. 1982), and Leslie Leasing Co. v. Commissioner, 80 T.C. 411 (1983). *See generally* Henze & Simpkins, *Open End Leases: Are They True Leases or Conditional Sales?*, 7 Rev. Tax. Indiv. 369 (1983).

53. The opinion in Budget Rent-A-Car v. Bergman, 121 Cal. App. 3d 256, 175 Cal. Rptr. 286 (1981), suggests that the "open-end" car lease in that case was a true lease. Typically, however, "open-end" vehicle leases are held to be leases "intended as security," and not true leases. *See, e.g., In re* Tulsa Port Warehouse Co., 690 F.2d 809 (10th Cir. 1982); Bill Swad Leasing Co. v. Stikes, 571 F.2d 1361 (5th Cir. 1978); *see also* Mooney, *supra* note 25, § 29A.05[2][d].

54. *See infra* Part III.B.

under accounting rules, often leave the lessor with some minimum "at risk" investment in the vehicle (*e.g.*, twenty percent of original cost) that cannot be recouped from the lessee under the TRAC clause.[55] The vehicle lessor's minimum "at risk" investment arguably leaves the TRAC vehicle lessor with a meaningful economic stake in the residual and thereby establishes true lease status.[56] *Second*, TRAC vehicle leases commonly provide the lessee with an option to return the vehicle at any time. This sort of TRAC transaction is not a sale, since it involves no "passing of title,"[57] and the lessor remains liable as title holder of the vehicle. Moreover, the transaction would not appear to be a security interest, since if the lessee can return the goods at any time, there may not be a sufficient "obligation" to secure.[58] Viewed in light of the UCC trichotomy under which transactions are either leases, sales, or security interests, this sort of TRAC transaction in the end may be characterized as a lease. *Third*, vehicles are a unique kind of asset, in that the marketplace for used vehicles in America establishes the reasonably predictable market value of used vehicles to a very high degree of certainty. As a practical matter, it is the market for used vehicles and not the lessor or lessee that guarantees the residual value of used vehicles. Even broadly phrased TRAC vehicle leases operate, under this view, to charge the lessee only for excessive use or poor maintenance, as opposed to changes in value due to market trends. Under this "legal realist" argument, TRAC vehicle leases are true leases because in the special case of vehicles they are functionally the same as true leases with more narrowly drawn provisions that simply charge the vehicle lessee for excessive use. Courts have not yet had occasion to come to grips with these and other considerations about TRAC leases. Thus, the question of whether TRAC vehicle leases are true leases under state law remains unsettled.

---

55. *See* FEDERAL ACCOUNTING STANDARDS BOARD (FASB) STATEMENT No. 13 ¶ 7d. "Operating lease" status is often sought, under FASB Statement No. 13, because, among other reasons, "operating leases" are not listed as debt on the lessee's books. *See id.* at ¶ 16b.

56. TRAC vehicle lessors also may have an "at risk" stake in the vehicle in the form of ownership liabilities, such as state taxes and potential liabilities under product liability and anti-tampering odometer rules.

57. *See* U.C.C. § 2-106(1) (1987).

58. *See* U.C.C. § 1-201(37) (1987). A question exists, of course, as to whether the imposition of the TRAC condition on the lessee, when the vehicle is returned, is a penalty that makes the transaction a security interest.

Outspoken critics of Article 2A include some motor vehicle lessors who fault the new statute for failing specifically to validate "open-end" TRAC leases as true leases. The statute mirrors the common law, however. To this date, the weight of the case law has not recognized broadly phrased "open-end" TRAC leases as true leases under state law. Moreover, equipment lessors in the past have opposed according true lease status to "open-end" TRAC leases outside the specific context of motor vehicle leasing.[59] The Commissioners acted reasonably in leaving the status of "open-end" TRAC leases to be determined by the courts under the general "facts of each case" test of amended section 1-201(37) and the evolving common law. This approach simply preserves the *status quo* under state law regarding "open-end" TRAC leases.

B. Remedies

One major impetus for the new statute was dissatisfaction among equipment lessors, and their lawyers, with inconsistent and unpredictable court decisions on the remedies available under a true lease. Article 2A clarifies the law on lease remedies. Ordinarily, the remedies available for breach of a true lease will be those specified in the lease agreement. Yet Article 2A provides a minimum safety net set of remedies, including a measure of damages for the lessee's breach, which will apply if the lease agreement is silent (or held invalid) on remedies issues.

The Comments to Article 2A were expanded to clarify its complex statutory remedies provisions. The California Bar has criticized the remedies sections of Article 2A and has expressed doubts about the efficacy of "legislation by comment."[60] The statute and its Official Comments, however, set out a sound remedies scheme.

---

59. One major reason for this is that TRAC clauses undercut the importance of residual values as a source of potential gain or loss for the lessor, removing this aspect from the business of equipment leasing where TRAC clauses are used. Vehicle lessors argue that the market value of used vehicles is highly predictable and certain, so that this unique market, not the TRAC form of leasing, essentially has eliminated from the business of vehicle leasing the importance of market fluctuations in the residual value of vehicles.

60. REPORT OF THE UNIFORM COMMERCIAL CODE COMMITTEE OF THE BUSINESS LAW SECTION OF THE STATE BAR OF CALIFORNIA ON PROPOSED CALIFORNIA COMMERCIAL CODE DIVISION 10 (ARTICLE 2A) 64 (Dec. 1, 1987).

1. In general.—The starting point for ascertaining the available remedies is the lease agreement. Whether a default has occurred, as well as issues about repossession and other post-default rights and remedies under a true lease, are to be decided in the first instance by reference to the lease agreement.[61] Both judicial and self-help remedies are available.[62] Ordinarily no notice of default or enforcement need be given to the defaulting party.[63] Within reasonable limits, the parties to a lease are given freedom of contract to craft their own set of rights and remedies in the lease agreement.[64]

The statutory remedies in Article 2A are specific and detailed for both lessors[65] and lessees.[66] Article 2A's two sets of remedial provisions reflect the bilateral nature of obligations between the parties to a lease. In contrast, Article 9 sets out remedies only for the secured party, since the obligations between the parties to a security agreement are essentially unilateral.

2. Lessee's remedies.—The ordinary statutory (noncontractual) remedies available to lessees, in the event of a default by the lessor, include the rights to cancel the lease, to recover paid-in rents and security to the extent that is "just under the circumstances,"[67] and to obtain substitute goods and recover damages.[68] Where the lessor fails to timely cure nonconforming goods or delivery, the lessee has the option to reject or accept the goods.[69] Where the goods are unique, or in other proper circumstances, the lessee may compel specific performance of the lease agreement.[70] War-

---

61. U.C.C. §§ 2A-501, 2A-503 (1987).
62. *Id.* § 2A-501.
63. *Id.* § 2A-502.
64. Section 2A-503(2) provides:
> Resort to a remedy provided under this Article or in the lease agreement is optional unless the remedy is expressly agreed to be exclusive. If circumstances cause an exclusive or limited remedy to fail of its essential purpose, or provision for an exclusive remedy is unconscionable, remedy may be had as provided in this Article.

See also § 2A-501 comment.
65. §§ 2A-523 to -530.
66. §§ 2A-508 to -522.
67. The Comment to § 2A-508 states that this is a special rule: "Given the various types of installment leases, no bright line could be created that would operate fairly in all cases; in addition, this provision should further encourage the parties to set their own rules."
68. § 2A-508(1).
69. §§ 2A-509, 2A-510, 2A-513 & 2A-514.
70. §§ 2A-508(2)(b), 2A-521.

ranty breaches by the lessor are compensable in damages.[71] These well-established lessee remedies were derived from Article 2.

One interesting set of statutory provisions, which clarifies existing case law, concerns the lessee's right to dispose of the goods on the lessor's default. Theoretically, the lessor's ownership of the goods might bar the lessee from selling or otherwise disposing of the goods without the lessor's consent.[72] Where the lessee rightfully rejects the goods, Article 2A generally obligates the lessee to hold the goods for a reasonable time for the lessor's or the supplier's disposition.[73] Where perishable goods are involved, the lessee may be obligated to try to dispose of them.[74] The new statute, however, also authorizes the lessee to sell the goods, if the lease agreement does not provide to the contrary,[75] when the lessee rightfully rejects the goods or justifiably revokes acceptance.[76] In this situation, section 2A-508(5) provides that

> a lessee has a security interest in goods in the lessee's possession or control for any rent and security that has been paid and any expenses reasonably incurred in their inspection, receipt, transportation, and care and custody and may hold those goods and dispose of them in good faith and in a commercially reasonable manner, subject to the provisions of Section 2A-527(5).[77]

What is new here is the explicit recognition that a lessee under a true lease, who, unlike a buyer, has no equity in the goods,[78] never-

---

71. §§ 2A-508(4), 2A-520(2)(b).

72. *See, e.g.*, RESTATEMENT (SECOND) OF TORTS §§ 234, 252 *et. seq.* (1965).

73. These ordinary duties of the lessee contained in § 2A-512(1) apply except in the case of perishable goods and "subject to any security interest of a lessee (Section 2A-508(5)." The import of the lessee's security interest under U.C.C. § 2A-508(5) is discussed above. *See infra* text accompanying note 77.

74. Section 2A-511(1) provides that a merchant lessee, in the absence of instructions from the lessor and when the lessor or supplier has no agent at the market of rejection, "shall make reasonable efforts to sell, lease, or otherwise dispose of the goods for the lessor's account if they threaten to decline in value speedily."

75. The Comment to § 2A-508 emphasizes that "the lessor and the lessee can otherwise agree" and, among other things, "create a new scheme of rights and remedies triggered by the occurrence of the default."

76. §§ 2A-508, 2A-512.

77. § 2A-508(5). Section 2A-527(5) obligates the lessee to "account to the lessor for any excess over the amount of the lessee's security interest."

78. The Comment to § 2A-527 (on the lessor's right to dispose of goods) states that "the interest held by the lessee or the sublessee is not protected by a right of redemption under the common law or this Article." The Comment goes on to confirm "the basic premise that the lessee under a lease of goods has no equity of redemption to protect."

theless has a limited "security interest" in rightfully rejected goods to the extent that the lessee may lawfully sell the goods. The old common law of bailments did not give this right to lessees.[79]

Two statutory measures of damages are provided for the lessee on the lessor's default. Where the lessee "covers" by leasing substitute goods under a "lease agreement substantially similar to the original lease agreement and the lease agreement is made in good faith and in a commercially reasonable manner,"[80] the lessee's statutory damages are his *actual* out-of-pocket costs and consequential damages.[81] Otherwise, the lessee's damages are his *reasonable* out-of-pocket costs, as measured by reference to the "market rent" of the goods, plus consequential damages.[82] These provisions for the lessee mirror the statutory measure of damages for the lessor.

"Waiver" of the lessee's statutory rights and remedies under Article 2A is a subject that has received increased attention recently. Undoubtedly, contractual modifications or "waivers" of the

---

79. *See supra* note 72; *see also* Younger v. Plunkett, 395 F. Supp. 702, 707-11 & n.2 (E.D. Pa. 1975) (Common law possessory lien "was a very limited right in the debtor's goods. The goods could not be sold to satisfy the lien."); Metropolitan Vacuum Cleaner v. Douglas-Guardian Warehouse, 208 F. Supp. 195, 198 (S.D.N.Y. 1962) (bailee in possession of goods who disposes of the goods in a manner not authorized by the bailment is liable to bailor for conversion). *But see also* Tillman v. W.T.S. Farm Lines, Inc., 647 F. Supp. 94, 96 (E.D. Mo. 1986) (lessee can turn over equipment to secured creditor without "conversion," since lease gave lessee the right to "exclusive possession, control and use" for one year).

80. The Comment to § 2A-518 states that in light of "the many variables facing a party who intends to lease goods and the rapidity of change in the market place, . . . the decision of whether the new lease agreement is substantially similar to the original will be determined case by case." To make this determination, the Comment says the courts are to examine both the goods subject to the new lease agreement to determine whether they are the same type of goods or a commercially reasonable substitute, and the various elements of the new lease agreement, including "the term of the new lease" as well as

> the presence or absence of options to purchase or release, the lessor's representations, warranties and covenants to the lessee, and those to be provided by the lessee to the lessor, and the services, if any, to be provided by the lessor or by the lessee (because all of these factors allocate cost and risk between the lessor and the lessee and thus affect the amount of rent to be paid).

81. These statutory damages are defined as the sum of (1) the present value, as of the date of default, of the *difference* between total rent for the new lease and total rent for the remaining lease term of the original lease agreement, plus (2) incidental and consequential damages, minus (3) "expenses saved in consequence of the lessor's default." U.C.C. § 2A-518(2) (1987).

82. The lessee's statutory damages in this case are measured by the sum of (1) the present value of the *difference* between the "market rent" and the original rent, for the remaining lease term of the original lease, plus (2) incidental and consequential damages, minus (3) "expenses saved in consequence of the lessor's default." U.C.C. § 2A-519(2) (1987).

lessee's statutory remedies are allowed.[83] Such "waivers," however, must not be unconscionable.[84] Care should be taken to ensure that "waivers" are reasonable and brought to the attention of the lessee. This is particularly true where the lease is written on a form supplied by the lessor.

3. Lessor's remedies.—In the absence of agreement, true lease remedies are different from, and often more favorable to the lessor than, the remedies applicable to installment sales. This is reflected in Article 2A's provisions on lease remedies, which are derived from the common law on bailments and Article 2 on sales agreements.[85]

(a) Repossession and disposition.—Typically, the lease agreement gives the lessor a right to repossess the goods on the lessee's default. Section 2A-525 confirms this right of repossession. Advance notice to the lessee is not required. Ordinarily, the new statutory (not contracted for) remedies limit the lessor's damages as if mitigation of damages had occurred by sale or re-lease of the repossessed goods. But mitigation is not *required* by Article 2A. Instead, the decision whether to mitigate damages is left to the lessor and his assessment of his own self-interest. Only in limited circumstances does the statute provide for specific performance damages, without offset for mitigation: Where the lessee accepts the goods, or where conforming goods are lost or damaged soon after risk of loss passes to the lessee, or where the lessor is unable to dispose of the goods at a reasonable price after repossession, the lessor may repossess, hold the goods, and recover accelerated rentals as damages.[86]

These statutory remedies for lessors contrast sharply with Article 9 remedies for secured creditors, which generally require mandatory disposition of repossessed goods after advance notice to the debtor.[87] Old scattered case law, which directly or by analogy

---

83. *See* §§ 2A-103(4), 2A-501, 2A-503.

84. § 2A-108.

85. Only the introductory section on remedies (§ 2A-501 on procedures upon default) is modeled after Article 9, specfically § 9-501. This reflects the view of commentators that Article 9 was not an appropriate model for true lease remedies. *See, e.g.*, DeKoven, *supra* note 25, § 29B.05[5][c].

86. U.C.C. § 2A-529 (1987).

87. § 9-504.

applied Article 9 to post-default remedies by lessors under true leases,[88] is superceded by the new leasing statute.

(b) Damages.—Two types of provisions are contained in Article 2A which govern the damage remedies available to the lessor upon the lessee's default: those that apply to contractual liquidated damages clauses, and those that apply where the lease contract is silent or invalid on the issue of damages.

(i) Contractual liquidated damages clauses.—The sweeping language of section 2A-504(1) approves liquidated damages clauses that comply with a basic "reasonableness" test:

> Damages payable by either party for default, or any other act or omission, including indemnity for loss or diminution of anticipated tax benefits or loss or damage to lessor's residual interest, may be liquidated in the lease agreement but only at an amount or by a formula that is reasonable in light of the then anticipated harm caused by the default or other act or omission.[89]

This provision validates formulas as well as amounts[90] and eliminates some of the limitations on liquidated damage clauses that appear in section 2-718 on sales agreements. There is no requirement in section 2A-504(1), for example, that actual damages be difficult to ascertain or that it otherwise be inconvenient to obtain an adequate remedy before one can invoke a liquidated damages clause that is contained in a lease.[91] Tax benefit losses are recoverable by the lessor under a liquidated damages clause, even if such damages exceed the original price of the goods.[92] To the extent al-

---

88. *See, e.g.*, Leasing Service Corp. v. Broetje, 640 F. Supp. 51 (E.D. Wash. 1986); Business Finance Co. v. Red Barn, Inc., 517 P.2d 383 (Mont. 1973); Harris, *Recent Cases Relating to Equipment Leases*, in EQUIPMENT LEASING 1986 at 337-38.

89. U.C.C. § 2A-504(1) (1987). Where there is no contract provision specifying damages or where a liquidated damages clause is invalid under the principles of § 2A-504(1), the new statutory set of remedies will apply.

90. One example of a damage "formula" appears in Atlas Truck Leasing, Inc. v. First NH Banks, Inc., 808 F.2d 902, 904-05 (1st Cir. 1987) (court upheld lessor's damage award for lost profits measured by number of miles that leased vehicles would have been driven in normal use over original term of the lease).

91. Section 2-718 states that with respect to sales of goods, "[d]amages for breach . . . may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy." U.C.C. § 2-718 (1987); *see also* RESTATEMENT (SECOND) OF CONTRACTS § 356 (on "liquidated damages and penalties").

92. The Comment to § 2A-504 states that the allowance of tax benefit losses caused the drafters to omit any limitation referring to "unreasonably large liquidated damages."

lowed by the standard of "unconscionability," consequential commercial damages also may be liquidated, limited, or excluded altogether by the lease agreement.[93] Moreover, under the "reasonableness" test of section 2A-504, a lease agreement can incorporate by reference the statutory damages remedies set forth in Article 2A.

These significant clarifications of the law allow parties to a lease agreement wide latitude in crafting liquidated damages clauses. This is important since equipment leasing transactions often are predicated on the parties' ability to agree on an appropriate liquidated damages remedy for default. One purpose of the statute, the Comments suggest, is to "invite the parties to liquidate damages."[94]

The Comments provide little additional guidance, however, on how the "reasonableness" standard of section 2A-504 should be applied. One clarifying principle implicit in the statute is that what is "reasonable" for a long-term commercial lease may not be a "reasonable" measure of liquidated damages for a short-term lease. Three "common" liquidated damage formulas are identified in the Comments,[95] but their enforceability is said to depend on "the context of each case."[96] The courts are left to wrestle with these and several other recurring questions about liquidated damages clauses, as well as they can under the general standard of "reasonableness."

Traditionally, the burden of proving that a provision is an unreasonable penalty, rather than a proper liquidated damages clause, is on the party urging the penalty construction.[97] Case law holds that only reasonable attorney's fees may be recovered pursu-

---

> The impact of local, state and federal tax laws on a leasing transaction can result in an amount payable with respect to the tax indemnity many times greater than the original purchase price of the goods. By deleting the reference to unreasonably large liquidated damages the parties are free to negotiate a formula, restrained by the rule of reasonableness in this section.

U.C.C. § 2A-504 comment (1987).

93. § 2A-503(3).

94. *See* § 2A-504 comment.

95. *Id.*

96. *Id.*

97. *See, e.g.*, Farmers Export Co. v. M/V Georgis Prois, 799 F.2d 159, 162-63 (5th Cir. 1986); Hubbard Business Plaza v. Lincoln Liberty Life Ins. Co., 649 F. Supp. 1310, 1313 (D. Nev. 1986).

ant to a liquidated damages clause.[98] Presumably, these principles are not disturbed by section 2A-504.

Residual risks on the lessee. One recurring question concerns the validity of liquidated damages clauses that essentially place the entire risk with respect to residual value on the lessee. Whether such clauses are "reasonable in light of the then anticipated harm caused by the default"[99] will depend heavily on the length of the lease term. Especially where the original term of the lease runs for only a short time in relation to the expected useful life of the goods, it may be unreasonable to place the risk on the lessee that the market value of the lessor's residual will drop.

The impact of this principle makes clear the flaws in a suggested amendment to the statutory provisions on liquidated damages. As proposed by some equipment lessors in California,[100] the amendment would alter section 2A-504(1) by adding the following language to validate a common commercial liquidated damages provision:

> A provision in the lease agreement which states that damages in the event of the lessee's default and the lessor's sale of the goods shall equal any past due amounts plus the sum of the present value of future rentals, the lessor's costs of enforcing the lease, the lessor's reasonably predictable residual at expiration, reasonable compensation for any loss of tax benefits, or an equivalent amount, and any other damages suffered or to be suffered by the lessor because of the lessee's default, less the net proceeds of sale, is reasonable.[101]

This sort of liquidated damages clause may well be reasonable in a long-term commercial lease, particularly where the clause is conspicuous and specifically bargained for. It might be invalidated as unenforceable, however, if inserted in a short-term consumer lease. The proposed amendment to section 2A-504(1) is overbroad because it sweepingly validates a particular liquidated damages clause without regard to the context that determines whether or not the clause is reasonable.

Stipulated loss values. Typical liquidated damages clauses in wide-spread commercial use, setting the lessor's damages equal to

---

98. *See, e.g.*, Heller Fin., Inc. v. Barry, 633 F. Supp. 706 (N.D. Ill. 1986).
99. U.C.C. § 2A-504(1) (1987).
100. Letter from NVLA to Bion M. Gregory, California Legislature (May 13, 1987); Letter from WAEL to California Senator Robert Beverly (May 5, 1987).
101. *Id.*

the so-called "stipulated loss value" of the goods minus a credit to the lessee (up to the value of the goods' estimated residual value at the time of default), should be upheld as valid and enforceable provisions in long-term commercial leases.

Cumulative remedies. There are some old cases that improperly suggest that "cumulative remedy" provisions[102] may invalidate a liquidated damages clause.[103] Such provisions should be upheld under the new leasing statute, however, so long as the total cumulative remedy sought to be recovered does not result in more than single recovery and is "reasonable in light of the then anticipated harm caused by the default or other act or omission" triggering the liquidated damage clause.[104]

Accelerated rentals. Ordinarily, liquidated damages clauses which contain a provision for accelerated rentals are enforceable by the lessor if coupled with a contractual provision requiring the lessor to mitigate damages by sale or re-lease after repossession.[105] Without strong proof of reasonableness, however, a liquidated damages clause providing for acceleration of future rentals without requiring mitigation is likely to be invalidated.[106]

Moreover, the courts are likely to follow past precedent by holding that the lessor's recovery for future lost rentals must be discounted to present value.[107] As explained in the Comment to section 2A-103(1)(u) on "present value":

> Authorities agree that present value should be used to determine fairly the damages payable by the lessor or the lessee on default.

---

102. One example of a "cumulative remedy" provision in a liquidated damages clause would be as follows: "No remedy referred to in this Liquidated Damages Section is intended to be exclusive, but each shall be cumulative and in addition to any other remedy referred to in this Lease or otherwise available to Lessor at law or in equity."

103. *See, e.g.*, Fairfield Lease Corp. v. Fine Decorators, [1969-1973 Transfer Binder] Consumer Cred. Guide (CCH) ¶ 99,242 (N.Y. Sup. Ct. 1972).

104. U.C.C. § 2A-504(1) (1987).

105. DeKoven, *supra* note 25, § 29B.06[5][b].

106. The statute itself suggests that such a clause might be upheld where a merchant lessor proves that circumstances were such that any effort to dispose of the repossessed leased goods at a reasonable price would have been unavailing. *See* U.C.C. § 2A-529(1)(b) (1987).

107. *See, e.g.*, Heller Fin., Inc. v. Barry, 633 F. Supp. 706 (N.D. Ill. 1986) (court reduced accelerated future rentals to present value); *In re* Winston Mills, Inc., 6 Bankr. 587 (Bankr. S.D.N.Y. 1980) (court reduced accelerated future rentals to present value); *see also* Taylor v. Commercial Credit Equip. Corp., 170 Ga. App. 322, 316 S.E.2d 788 (1984) (court held accelerated damages, without reduction to present value, was an unenforceable penalty); U.C.C. § 2A-529(1)(b) (1987).

> Present value is defined to mean an amount that represents the discounted value as of a date certain of one or more sums payable in the future. This is a function of the economic principle that a dollar today is more valuable to the holder than a dollar payable in two years.[108]

The same Comment goes on to say that the statute

> allows the parties to specify the discount or interest rate, if the rate was not manifestly unreasonable at the time the transaction was entered into. In all other cases, the interest rate will be a commercially reasonable rate that takes into account the facts and circumstances of each case, as of the time the transaction was entered into.[109]

Section 2A-109 specifies that the lessor can invoke an acceleration clause only when he "in good faith believes that the prospect of payment or performance is impaired."[110]

Election of remedies. The "reasonableness" test of section 2A-504 overrules earlier cases[111] that required a lessor to elect between repossessing the equipment or suing for the accelerated rent and leaving the equipment in place. The old cases forcing such an election improperly extended the rule against double recovery. When some mitigation of damages is required, however, the lessor's repossession and simultaneous recovery of accelerated rents does *not* necessarily result in double recovery or unjust enrichment. No double recovery results, for example, where a defaulting lessee is credited with proceeds from the sale or re-lease of equipment following repossession.[112]

Partial invalidity. Will the invalidation of *part* of a liquidated damages clause nullify the whole clause, forcing the lessor to rely solely on the statutory remedies of Article 2A? Section 2A-504(2) provides that "[i]f the lease agreement provides for liquidation of

---

108. U.C.C. § 2A-103(1)(u) comment (1987) (citations omitted).

109. *Id.*

110. With respect to a consumer lease, the burden of establishing good faith is on the party invoking the acceleration clause; otherwise the burden of establishing lack of good faith is on the lessee. U.C.C. § 2A-109(2) (1987).

111. *See, e.g.*, Litton Indus. Credit Corp. v. Catanuto, 175 Conn. 69, 394 A.2d 191 (1978).

112. DeKoven, *supra* note 18, at 277-78. The Comment to § 2A-523 states: "This Article rejects the doctrine of election of remedy. Whether, in a particular case, one remedy bars another, is a function of whether [the] lessor has been put in as good a position as if the lessee had fully performed the lease contract. Sections 2A-103(4) and 1-106(1)." *See also* §§ 2A-501(4), 2A-529(1)(a) & comments.

damages, and such provision does not comply with [the "reasonableness" test of] subsection (1), or such provision is an exclusive or limited remedy that circumstances cause to fail of its essential purpose, remedy may be had as provided in this Article."[113] Equipment leases often provide alternative measures of liquidated damages so that no single alternative is "an exclusive or limited remedy." For such multi-part liquidated damage clauses, partial invalidity may not always be fatal to the whole clause, if the invalid part is reasonably separable from the whole. This result would be consistent with the new statutory section on "unconscionability." Under that section,[114] where a court finds a specific lease clause unconscionable, the court may refuse to enforce the whole contract *or* it may simply "blue pencil" out the offending clause and enforce the remainder of the lease contract.

(ii) Where the lease agreement is silent or held invalid on the issue of damages.—The only time Article 2A will control the measure of damages is when the lease agreement is silent or held invalid on the issue of damages. Two basic measure of damages standards are provided for the lessor. These apply in different situations: (1) where the lessor repossesses and then sells or releases the goods (sections 2A-528, 2A-527(2)); and (2) where the lessor repossesses and then, in certain circumstances without mitigating damages by disposing of the goods, simply holds the goods for the lessee for the remainder of the lease term (section 2A-529).[115]

(A) The single most important provision for lessor's damages may be section 2A-528. Ordinarily, when the lessor repossesses the goods following the lessee's default, the lessor's statutory damages are the sum of past unpaid rentals, reasonable lost future profits as measured by the present value of the *difference* between total scheduled future rentals and the "market rent" for future use of the goods,[116] and incidental damages less "ex-

113. § 2A-504(2).

114. § 2A-108.

115. Section 2A-504(3) limits the lessor's right to retain part of the price already paid without showing damage where "the lessor justifiably withholds or stops delivery of goods because of the lessee's default or insolvency." To the extent the lessor can show damage, or benefit to the lessee, § 2A-504(4) allows the lessor to keep all payments already made by the lessee in default.

116. When the goods are re-leased "by lease agreement substantially similar to the original lease agreement and the lease agreement is made in good faith and in a commer-

penses saved in consequence of the lessee's default."[117] The impact of the statutory "rent-to-rent" comparison in section 2A-528 is similar to requiring the lessor to mitigate damages following repossession. The statute does not *require* mitigation of damages, but it limits damages as if mitigation had occurred.

The concept of "market rent," as defined in section 2A-507, is essentially fair market rent "at the time of the default."[118] Thus the lessor has an economic incentive to prove that the "market rent" is lower than the originally scheduled rent in order to increase damages under sections 2A-528. In contrast, the lessee has an ecomonic incentive to prove that the "market rent" is higher than the originally scheduled rent in order to minimize damages under section 2A-528. With the concept of "market rent," Article 2A leaves mitigation of damages decisions to the lessor, who is the sole owner of the repossessed goods, while protecting the lessee against excessive damages where the lessor disposes of repossessed goods at an unreasonably low price.

One objection to the "rent-to-rent" comparison in section 2A-528 is that the comparison makes it difficult to prove damages where the lessor repossesses and then *sells* the goods. The statutory "rent-to-rent" comparison has been utilized in California statutes to measure damages under a lease of goods.[119] Yet the comparison clearly takes a different approach to damages than the one often reflected in "finance lease" liquidated damage clauses that define the lessor's measure of damages as the sum of past unpaid rentals, the present value of accelerated future rentals, and the lessor's estimated residual value, minus the net proceeds from a commercially reasonable sale of the goods on the lessee's default (up to the point where the sale proceeds equal the present value of

---

cially reasonable manner," the lessor's *lost future rentals*, apart from other damages, are measured by the present value of the difference between the "total rent for the remaining lease term of the original lease" and the "total rent for the lease term of the new lease agreement." U.C.C. § 2A-527(2) (1987). Given the uncertainties about what constitutes a "substantially similar" lease agreement, *see supra* note 80, § 2A-527 may be controlling less often than § 2A-528.

117. U.C.C. § 2A-528 (1987).

118. § 2A-507(1).

119. CAL. CIV. CODE § 3308 (West 1987) permits liquidated damage clauses in a lease which provides that, after the lessee defaults and the lease has been terminated, the lessor may recover the present value of accelerated future rentals minus the "reasonable rental value" of the goods for the remainder of the lease term. Where this measure of damages is selected, it is exclusive.

accelerated future rentals plus the lessor's estimated residual value). This sort of contract clause places the risk on the *lessee* (not the lessor) that the residual value of the goods will *decline* after the lease is executed.[120]

True lessors own the residual and, on the lessee's default, the lessor's remedies should include recovery of the residual or the residual's value.[121] Article 2A's statutory damages scheme clearly permits this recovery. Moreover, section 2A-527(5) specifies that the "lessor is not accountable to the lessee for any profit made on any disposition." But the new statute places the burden on the *lessor* to recover the value of the residual through sale or re-lease. And it places the risk on the *lessor*, not the lessee, that the value of the residual might decrease after the lease is executed.

The drafters of Article 2A decided that this is exactly where the risk belongs for statutory measure of damages. When goods are leased for only a short time in relation to their useful life, it seems unfair, as not being in accord with the common expectations of the parties in the absence of an agreement on the point, to burden the lessee with the risk that the residual value of the goods will decline after the lease is executed. The only situations in which it might be fair to saddle the lessee with that risk, *by statutory fiat in the absence of any contractual agreement on the point*, are those involving "long-term" true leases.[122] This category might be difficult to define statutorily. Moreover, the statutory measure of damages in Article 2A applies only where the contract is silent or is invalidated, as unconscionable or otherwise unenforceable, on the measure of damages. The Article's drafters decided that there was no warrant to *guarantee* "long-term" true lessors a "home run"

120. The contract clause contained in the text guarantees the lessor a minimum fixed return from the lessee for the rental and ultimate disposition of the goods in the event of the lessee's default. This contrasts with "fixed-price" purchase options, which guarantee the lessee that he will have to make only a maximum fixed outlay for the lease and ultimate optional acquisition of the goods.

121. By contrast, when a seller seeks recovery from a defaulting buyer-debtor in a *sales* transaction, the buyer-debtor is entited to the value of the property offset only by the amount of the debt obligation. *See* U.C.C. § 9-504(2) (1987); G. Gilmore, Security Interests in Personal Property § 44.2 (1965). To the extent that this sales remedy is applied to a true lease, the lessor is improperly penalized. *See* DeKoven, *supra* note 18.

122. Of course, if the original term of the lease runs for essentially the entire remaining economic life of the goods and the lessee is obligated throughout the term so that he cannot simply "walk away" from the lease, then the transaction is not a true lease at all, but is a security interest governed by Article 9.

measure of damages in the statute, when all lessors could readily protect themselves by including appropriate liquidated damages clauses in their lease agreements.

The Comment to section 2A-528(1) indicates that "incidental damages" recoverable under that section should compensate the lessor for any loss of use of possession of the goods following the date of default.[123] This important clarification responds to a concern raised by the California Bar. It ensures that the damages award protects the lessor's residual interest in the goods. More generally, the Comment to section 2A-525 remarks that several provisions in the new statute "codify the lessor's common law right to protect the lessor's reversionary interest in the goods." These provisions are "intended to supplement and not displace principles of law and equity" protecting the lessor's residual.

Theoretically, section 2A-528(2) provides an important alternative measure of statutory damages to merchant lessors who lease out of inventory: lost profits "including reasonable overhead" plus incidental damages.[124] Though somewhat controversial,[125] this measure of damages should be available to the so-called "lost volume" lessor: This is the merchant lessor who possessed the

---

123. The Comment states:

> If, as of the date of default, the lessor has attempted and failed to obtain possession of the goods, the lessor has, among various additional rights and remedies, a cause of action against the lessee for damages due to loss of use of possession of the goods between the date of default and the date the lessor obtains possession of the goods.

U.C.C. § 2A-528 comment (1987); *see also* § 2A-525 comment. The Comments also make it clear that the "date of default" in the statute is different from an "event of default":

> An event of default under a lease agreement becomes a default under a lease agreement only after the expiration of any relevant period of grace and compliance with any notice requirements under this Article and the lease agreement. American Bar Foundation, *Commentaries on Indentures*, § 5-1, at 216-217 (1971). Section 2A-501(1). This conclusion is also a function of whether, as a matter of fact or law, the event of default has been waived, suspended or cured. Sections 2A-103(4) and 1-103.

U.C.C. §§ 2A-528 comment, 2A-527 comment (1987) (language appears in both comments).

124. Other lessors may qualify as well. The statutory remedy of "lost profits" applies generally to lessors who repossess and then sell or re-lease the goods, but who, under the statutory rent-to-rent measure of damages, would not wind up "in as good a position as performance would have" put them. *Id.* § 2A-528(2). Over the past several years, as a practical matter, equipment lessors have not often sought to recover lost profits from a defaulting lessee in addition to stipulated loss values aimed at minimizing the lessor's losses.

125. *Compare* Sebert, *Remedies Under Article Two of the Uniform Commercial Code: An Agenda for Review*, 130 U. PA. L. REV. 360 (1981) *and* Childres & Burgess, *Seller's Remedies: The Primacy of UCC 2-708(2)*, 48 N.Y.U. L. REV. 833 (1973) *with* Goetz & Scott, *Measuring Sellers' Damages: The Lost-Profits Puzzle*, 31 STAN. L. REV. 323 (1979).

inventory to make both the original lease contract and an additional transaction, and who shows that the sale or re-lease of the goods following the original lessee's default would have occurred even if the original lessee had not defaulted.[126] In this situation, the subsequent transaction is not a substitute for the original lease contract. The injured merchant lessor's statutory damages then are based on the net profit he lost as a result of the breach of the original lease contract.

(B) The other major provision on a lessor's statutory (not contracted for) damages is section 2A-529, which provides a remedy that is similar to specific performance. When the lessor repossesses the goods following a breach by the lessee, section 2A-529 indicates that the lessor sometimes may recover full damages, without offset for mitigation of damages by selling or re-leasing the goods. To qualify for the full statutory measure of damages under section 2A-529, the lessor need not mitigate when the goods were accepted by the lessee, when conforming goods were lost or damaged within a commercially reasonable time after risk of loss passed to the lessee, or when it proves impractical for the lessor to dispose of the goods at a reasonable price. When any of these circumstances exist, the lessor has the option of holding the goods for the lessee for the remainder of the lease term and recovering damages from the lessee equal to the sum of past rents due, the present value of accelerated future rentals, and incidental damages "less expense saved in consequence of the lessee's default."[127] The obligation of the lessor to hold the goods for the lessee prevents any double recovery by the lessor.

---

126. *Cf.* RESTATEMENT (SECOND) OF CONTRACTS § 347 comment f, illustration 16 (1964); *id.* § 350 comment d, illustrations 9 & 10.

127. This statutory remedy is optional. At any time before the collection of the judgment for this statutory remedy (accelerated rents), the lessor may choose to dispose of the goods by sale or re-lease, in which case his remedies are limited by the "rent-to-rent" test. U.C.C. § 2A-529(3) (1987). The Comment to § 2A-529(3) notes that if

> the lessor determines that the lessee is judgment proof, the lessor might be wise to dispose of the goods before the end of the remaining lease term, even though the amount that the lessor then will be allowed to recover from the lessee, as determined by the provisions of Section 2A-527 or 2A-528, is less than the judgment.

If the lessee pays the judgment for accelerated rents, then the lessee is entitled to "use and possession of the goods not then disposed of for the remaining lease term of the lease agreement." Ordinary post-judgment proceedings allowed by the civil rules (*e.g.*, Civil Rule 60(b) of the Superior Court of the District of Columbia) theoretically are available to ensure the lessor's compliance with these rules.

The statutory measure of damages in section 2A-529 may be particularly important for "merchant lessors." For several years, commentators have debated whether merchant lessors should be required to mitigate damages by selling or re-leasing the goods following default by the lessee and repossession by the lessor.[128] Section 2A-529(1)(b) accords the merchant lessor, or any other lessor, the full present value of accelerated rentals, without offset, where it is impractical for the lessor to dispose of repossessed goods at a reasonable price. Yet the statute parallels earlier case law[129] by limiting the lessor's damages and remitting him to section 2A-528 recovery as if mitigation of damages had occurred, when the lessee has not "accepted" the goods and mitigation is practical.[130]

The same statutory recovery for accelerated rentals without offset is also generally available under section 2A-529(1)(a) to the lessor in a statutory "finance lease" for goods accepted by the lessee. This seems appropriate. Typically, the finance lessee selects goods which often are uniquely suited for the lessee's business.

One amendment to section 2A-529 proposed by the California State Bar Committee would rewrite section 2A-529(3) to provide simply that "the lessor shall give credit . . . for any rent received"

---

128. One commentator recommended special damage rules for "merchant-lessors." *See* Hawkland, *The Impact of the Uniform Commercial Code on Equipment Leasing*, 1972 U. ILL. L.F. 446, 458 ("In the vendor leasing cases . . . the true lessor should not be compelled to compete against himself by being required to offer the repossessed goods in competition with his regular inventory."). Yet the Chief Reporter for Article 2A expressed the view that a "merchant lessor" should not be relieved completely from a duty to mitigate by selling or re-leasing the goods following the lessee's default. The merchant lessor, he suggested by analogy to § 2-708(b), should be permitted to recover lost profits together with "reasonable overhead." DeKoven, *Enforcement of the Equipment Lease: The Bankruptcy Code*, in EQUIPMENT LEASING-LEVERAGED LEASING 985-87 (B. Fritch & A. Reisman eds., 2d ed. 1980) [hereinafter EQUIPMENT LEASING—LEVERAGED LEASING].

129. *See, e.g.*, AMF v. Cattalani, 77 A.D.2d 779, 430 N.Y.S.2d 731 (1980) (court held equipment lessor had duty to mitigate damages); *cf.* RESTATEMENT (SECOND) OF CONTRACTS § 350 (1964) (on "Avoidability as a Limitation on Damages"); S. WILLISTON, CONTRACTS § 1353, at 3795-96 (rev. ed. 1936).

130. The implicit duty to try to mitigate damages by disposing of the goods at a reasonable price before invoking the full measure of damages in § 2A-529 applies where the goods have been "identified to the lease contract," U.C.C. § 2A-529(1)(b) (1987), but not yet fully "accepted by the lessee," *id.* § 2A-529(1)(a). The Comment explains that § 2A-529(1)(b) "establishes a rule of recovery with respect to goods identified to the lease contract (but not accepted by the lessee—see subparagraph (1)(a)) only if the lessor is unable, after reasonable effort, to dispose of them at a reasonable price, or if circumstances indicate the effort would be unavailing." *Id.* § 2A-529 comment.

when the lessor obtains a judgment under section 2A-529 and then sells or re-leases the goods before the end of the original lease term. This proposed amendment is unsound. To begin with, it fails to cover the situation in which the lessor *sells* the repossessed goods after obtaining a judgment under section 2A-529. The vagueness of the proposed amendment also might permit a lessor to use the goods for his own account, while obtaining full recovery from a defaulting lessee, thereby providing the lessor with a form of double recovery. The sweeping language of the amendment would automatically put the risk on the *lessee*, not the lessor, that the residual value of the goods will *decline* after the lease is executed. As noted earlier, this result seems unwarranted except for "long-term" leases. The most troubling aspect of the California Bar's proposed amendment to section 2A-529(3) is that it lacks any standard of commercial reasonableness that would protect the lessee from the imposition of damages attributable to the lessor's selling or re-leasing the goods at an unreasonably low price. The current version of section 2A-529 clearly provides a fairer and more reasonable set of damage rules than the California State Bar proposal.[131]

C. *Warranties and Disclaimers*

The old common law, as well as UCC sections 2-314 and 2-315, recognized two implied warranties—merchantibility and fitness for a particular purpose—for transactions involving goods.[132] These implied warranties impose liability without regard to negligence or fault and, according to the weight of authority, apply to merchant lessors under true leases as well as to merchant sellers.[133] As a con-

131. The California Bar also proposed an amendment that would limit the scope of § 2A-529 by denying full undiminished recovery under § 2A-529 when it is impractical for the lessor to dispose of repossessed goods at a reasonable price. The impact of this proposed amendment may be slight, since the lessor in that situation might still be made whole under an expansive reading of the "lost profits" test of § 2A-528(2).

132. The old common law implied warranties as implementing the parties' presumed intention. This rationale created some difficulties in treating short-term leases and "finance leases." Yet before the development of the UCC the implied warranty of fitness for a particular purpose frequently was recognized by the common law on "bailments for hire." *See* Farnsworth, *Implied Warranties of Quality in Non-Sales Cases*, 57 COLUM. L. REV. 653, 655-60 (1957).

133. "The liability of merchants under an implied warranty theory in nonsales areas such as leases and bailments dates back more than 150 years." Carlin, *Product Liability for the Equipment Lessor? Merchant-Lessor versus Finance Lessor*, in EQUIPMENT LEAS-

sequence, well-drafted lease agreements long have been based on the assumption that these implied warranties would apply at least to merchant lessors who deal in goods, if not to "finance lessors" who advance money without special knowledge of the goods.

Article 2A codifies the majority rule of the earlier case law and thus clarifies and standardizes the law of warranties for true leases. The statute exempts finance lessors from implied warranties in the special case of statutory "finance leases," where the lessor does not select, manufacture, or supply the goods out of inventory.[134] Otherwise, the new statute essentially tracks Article 2 concerning the creation of express warranties,[135] implied warranties of fitness, title, and merchantibility,[136] and accumulation of warranties.[137]

The old sales Article's requirements for conspicuous disclaimers of warranties[138] are repeated in the new leasing statute.[139] Moreover, section 2A-214 and its accompanying Comment provide that, in general, "to exclude or modify the implied warranty of merchantability, fitness or against infringement the language must be in writing and conspicuous."[140] This clarifies existing law by eliminating some overly technical distinctions in Article 2 regarding the form of disclaimer required to exclude or modify various warranties.

Written waivers of the lessee's newly recognized statutory rights[141] also should be specific and conspicuous to ensure their en-

---

ING—LEVERAGED LEASING, *supra* note 128, at 851 & n.14 (citing authorities including 2 W. BLACKSTONE, COMMENTARIES *154). Comment 2 of § 2-313 specifically states that warranties may arise "in the case of bailments for hire" and that "the matter is left to the case law with the intention that the policies of this Act may offer useful guidance in dealing with further cases as they arise." The modern implied warranty cases for merchant lessors in the context of both "true leases" and leases "intended as security" are canvassed in EQUIPMENT LEASING—LEVERAGED LEASING, *supra* note 128, ch. 8, and in Harris, *supra* note 88, at 321-24.

134. *See infra* Part III.D.

135. U.C.C. § 2A-210 (1987).

136. § 2A-211 to -213.

137. § 2A-215.

138. *Compare* FMC Fin. Corp. v. Murphree, 632 F.2d 413, 418-20 (5th Cir. 1980) (warranty disclaimer found to be conspicuous and valid) *with* Henderson v. Benson-Hartman Motors, Inc., 41 U.C.C. Rep. Serv. (Callaghan) 782 (Pa. Commw. 1983) (court invoked § 2-316 to void inconspicuous disclaimer of implied warranties in automobile lease) *and* Baker v. City of Seattle, 79 Wash. 2d 198, 484 P.2d 405, 407 (1971) (citing §§ 2-316 and 2-719, court held that golf cart lessor could not insulate himself from liability with inconspicuous disclaimer clause).

139. U.C.C. § 2A-214 (1987).

140. § 2A-214 comment.

141. *See* §§ 2A-508 to -522.

forceability. Waiver of defense clauses, whereby the lessee agrees not to assert certain types of claims or defenses against the lessor's assignee,[142] are permitted by Article 2A to the same extent allowed by Article 9.[143] There is no new guidance, however, on the so-called "doctrine of close-connectedness," under which the relationship between the lessor and the assignee can be found to be so close as to render a waiver of defense clause unenforceable by the lessor's assignee.[144]

The rights of third-party beneficiaries of express and implied warranties are addressed in section 2A-216 in three alternatives, mirroring the provisions of Article 2 on this subject. Two of the alternatives, A and B, contain language which emphasizes that nothing in section 2A-216 preempts the future growth of case law in this area.

---

142. Equipment lessors frequently assign leases outright or for security purposes to third-party buyers or lenders. Section 2A-303(6) permits such assignments of a "right to damages for default with respect to the whole lease contract," despite agreements to the contrary.

143. The Comment to § 2A-303 explains:

> Section 9-206 sanctions an agreement by a lessee not to assert certain types of claims or defenses against the lessor's assignee. Section 9-318 deals with, among other things, the other party's rights against the assignee where Section 9-206(1) does not apply. Since the definition of contract under Section 1-201(11) includes a lease agreement, the definition of account debtor under Section 9-105(1)(a) includes a lessee of goods and Section 9-206 applies to lease agreements; thus, there is no need to restate those sections in this Article. However, the reference to "defenses or claims arising out of a sale" in Section 9-318(1) should be interpreted broadly to include defenses or claims arising out of a lease. This should follow as Section 9-318(1) codifies the common law rule with respect to contracts, including contracts of sale and contracts of lease. Further, Section 9-318(4) should be interpreted to allow the rule of this section to control with respect to transfers of leases.

Accord Leasing Serv. Corp. v. Crane, 804 F.2d 828 (4th Cir. 1986) (§ 9-206 applies to true leases as well as leases "intended as security").

144. *Compare* Chemical Bank v. Rinden Professional Ass'n, 126 N.H. 688, 498 A.2d 706 (1985) (court upheld "waiver of defense clause" asserted by assignee of lessor against commercial lessee, since there was an arms-length relationship between lessor and assignee) *with* Equico Lessors, Inc. v. Rockville Reminder, Inc., 4 Conn. App. 102, 492 A.2d 528 (1985) (court refused to enforce similar "waiver of defense clause," since assignee failed to satisfy § 9-206 by showing it took assignment of the lease from lessor in good faith and without notice of any claim or defense). *See also* United Counties Trust Co. v. Mac Lum, Inc., 643 F.2d 1140, 1142-43 (5th Cir. 1981); Tri-Continental Leasing Corp. v. Burns, 710 S.W.2d 604 (Tex. Ct. App. 1985). The opinions in this area suggest that "waiver of defense clauses" are more likely to be held valid where the lessee is a commercial entity, as opposed to a consumer. *See, e.g., Chemical Bank*, 126 N.H. 688, 498 A.2d 706.

With respect to breach of warranty issues, Article 2A contains special provisions for statutory "finance leases,"[145] but otherwise tracks Article 2. This is true, for example, for the lessee's remedies and damages,[146] and the lessee's rights to reject the leased goods.[147] The Comment to section 2A-214 confirms that remedies for breach of warranty can be limited contractually, in a liquidated damages clause or otherwise.

Article 2A's provisions do not define the relationship between Article 2A and the common law on products liability and strict liability in tort.[148] This reflects the Commissioners' view that products liability is a rapidly developing field and that Article 2A is basically a statement of "contract" rather than "tort" principles. The whole area of products liability of merchant lessors is left to be developed by the courts.[149]

D. Treatment of "Finance Leases"

Traditionally, a finance lessor has been thought of as a passive lessor, whose transactions remain functionally the equivalent of an extension of credit. It is typically the lessee, not the lessor, who selects the goods in a "finance lease." Moreover, a finance lessor often has neither the opportunity nor the expertise to inspect the goods in order to discover defects in them. Given the limited function of the lessor, the lessee relies almost entirely on the supplier for representations, covenants, and warranties. Recognizing these special circumstances, the cases and authorities consistently held

---

145. *See infra* Part III.D.

146. U.C.C. §§ 2A-508, 2A-518 to -520 (1987).

147. §§ 2A-509, 2A-517.

148. One commentator on products liability has explained that the "true lease"/sale distinction

> has no bearing on product liability. Instead, the criterion of superior knowledge of a merchant is the prerequisite to nonconsensual product liability. A merchant-lessor, as one who deals in goods and thus has superior knowledge, should be a target defendant. In contrast, a finance-lessor should remain immune from product liability as one who, in the ordinary course of business, makes advances against goods but is not a merchant.

Carlin, *supra* note 133, at 848.

149. Section 2A-503(3) does state, however, that the "[l]imitation of consequential damages for injury to the person in the case of consumer goods is prima facie unconscionable but limitation of damages where the loss is commercial is not."

that finance lessors did not owe implied warranties of fitness and merchantibility with respect to the leased goods.[150]

Article 2A's special provisions on "finance leases" are something of an oddity. Originally included in the statute as a sop to industry,[151] these provisions are deliberately narrow in scope. Their impact on the marketplace will depend on whether lessors structure their transactions to invoke the "finance lease" provisions of the new statute. When a lessor qualfies under Article 2A as a *statutory* finance lessor, the statute basically provides the lessor with *automatic* exemptions from implied warranties of fitness and merchantibility. But a lessor always can structure a lease contract to exclude warranties, making himself a finance lessor *by contract*. When a lessor writes the lease contract to exclude such warranties

150. The important differences between a "finance lease" and an "operating lease" are discussed in Fraser, *Application of Strict Tort Liability to the Leasing Industry: A Closer Look*, 34 Bus. Law. 605 (1979). The concept of a "finance lease" often has been discussed in the context of products liability law. *See, e.g.*, Cole v. Elliott Equip. Co., 653 F.2d 1031, 1034-35 (5th Cir. 1981); Francioni v. Gibsonia Truck Corp., 472 Pa. 362, 372 A.2d 736 (1977); U.S. Dep't of Commerce: Model Uniform Product Liability Act, 44 Fed. Reg. 62,714, 62,717-18 (Oct. 31, 1979); Comment, *Finance Lessor's Liability for Personal Injuries*, 1974 U. Ill. L. Rev. 154-58; *see also* Abco Metals Corp. v. Equico Lessors, Inc., 721 F.2d 583, 585-86 (7th Cir. 1983); Hawkland, *supra* note 128, at 449; Note, In re Leasing Consultants: *The Double Perfection Rule for Security Assignments of True Leases*, 84 Yale L.J. 1722, 1723 (1975). The implied warranties of fitness and merchantibility contained in the UCC often were held inapplicable to "finance lessors." *See, e.g.*, Agristor Leasing v. Meuli, 634 F. Supp. 1208 (D. Kan. 1986); Equico Lessors, Inc. v. Tow, 34 Wash. App. 333, 661 P.2d 597 (1983). Moreover, a wide variety of statutes and regulations have recognized that "finance leases" are *sui generis*. The "Superfund" statute, 42 U.S.C. § 9601(20)(A), for example, recognizes that finance lessors should be treated differently than "owners" for purposes of that statute. The Comptroller of the Currency's regulations on finance leasing, as well as the rules on finance leasing promulgated by the Board of Governors of the Federal Reserve System under its Regulation Y, also give separate treatment to finance leases. *See* Fraser, *supra*. The Federal Reserve Board's regulations allow bank holding companies to act as lessors of personal property only where, among other things, "[t]he lease is to serve as the functional equivalent of an extension of credit to the lessee of the property." 12 C.F.R. § 225.25(b)(5)(i) (1987).

151. Early drafts of Article 2A contained no special provisions for "finance leases." The Chief Reporter explained that since finance lease agreements could and commonly would be written with waiver of warranty and "hell or high water" clauses, no special statutory treatment of "finance leases" was necessary, given the statute's emphasis on freedom of contract. Some finance lessors, however, continued to push for special "finance lease" provisions in Article 2A. Whatever the reason for this push—whether distrust of the courts' treatment of contractual "finance lease" provisions, a belief that separate treatment of "finance leases" in Article 2A would help ensure that finance lessors would not be treated automatically like sellers, or simply a desire by finance lessors to "see their name in lights" in the new statute—Article 2A ultimately wound up with several special provisions on "finance leases" to accommodate the interests of the finance lessors.

and, in addition, qualifies as an Article 2A *statutory* finance lessor, he will have two independent grounds for exempting himself from such warranties. The statutory provisions, of course, only apply to "finance leases" that qualify as true leases.

1. Definition of statutory "finance lease".—To create a *statutory* "finance lease," the lessor essentially must have no role in picking the goods, serving merely as a conduit for the lessee to obtain the use of the goods. The statutory definition is contained in section 2A-103(1)(g):

> "Finance lease" means a lease in which (i) the lessor does not select, manufacture or supply the goods, (ii) the lessor acquires the goods or the right to possession and use of the goods in connection with the lease, and (iii) either the lessee receives a copy of the contract evidencing the lessor's purchase of the goods on or before signing the lease contract, or the lessee's approval of the contract evidencing the lessor's purchase of the goods is a condition to effectiveness of the lease contract.[152]

There is no limitation that a statutory finance lessor can supply only money or that the lessor must not perform maintenance.[153] To ensure the lessee's reliance on the supplier, not the lessor, the lessor must acquire the goods "in connection with the lease." The scope of the phrase "in connection with" is to be defined by the courts on a case-by-case basis.

One controversial part of Article 2A is the third requirement in the definition of a statutory "finance lease," that the lessee must receive a copy of or approve the supply contract at the outset of the transaction. No earlier authorities contained this requirement. The statute creates a prophylactic rule that essentially requires advance notice to the lessee of his warranty rights against the supplier. This seems a fair requirement before the statute cuts off the lessee's warranty rights against the lessor and subjects the lessee to automatic "hell or high water" clause liability under a

---

152. U.C.C. § 2A-103(1)(g) (1987).

153. When the lessor performs maintenance or other functions other than the supply of money the Comment to § 2A-103(1)(g) states that "express warranties, covenants and the common law will protect the lessee." This statement leaves open the possibility that a statutory finance lessor who performs maintenance under a so-called "operating lease" or "maintenance lease" may be held liable for negligently failing to discover defects in the goods during maintenance.

statutory "finance lease."[154] The Commissioners decided that, particularly in light of a lessor's ability to make himself a "finance lessor" *by contract*, the new statute should be conservative in giving lessors an *automatic* statutory exemption from warranty liability.

Taking all this into account, the "advance notice" requirement in the statutory definition of a "finance lease" seems harmless. It ensures that the lessee knows who the supplier is as well as which warranties cover the supplier's goods.[155] Ordinarily, "advance notice" can be given by providing the lessee with a copy of the supply contract on or before signing the lease contract. When the supply contract is not available and an oral supply contract or computer-placed supply order is used,[156] a transaction still can qualify as a statutory finance lease if the lessee's "approval" of the supply contract is "a condition to effectiveness of the lease contract."[157] This somewhat vague alternative apparently leaves it to the lessee to decide whether he will demand to see a copy of the supply contract or insist on specific knowledge of the terms of the supply contract. UNIDROIT's proposed rules on international financial leasing contain a somewhat similar requirement.[158]

---

154. U.C.C. § 2A-407 (1987).

155. One other purpose that might be imputed to the "advance notice" requirement—to specifically notify the lessee of the supplier's price for the goods—seems open to challenge. As the finance lessee typically selects the goods, he already should know what they cost. Moreover, advance notice of price seems irrelevant to the common law rationale for exempting finance lessors from implied warranty liability. With or without specific notice of price, the finance lessee is not relying on the finance lessor to select the goods, and the finance lessor typically has no expertise or opportunity to discover defects in the goods.

156. Oral supply orders and computer-placed supply orders are specifically mentioned in the Comment to § 2A-103(1)(g).

157. U.C.C. § 2A-103(1)(g) (1987).

158. UNIDROIT's proposed rules on international financial leasing contain a functional requirement that the "terms" of the supply contract be approved by the lessee. UNIDROIT Article 1 (April 1987) thus states in pertinent part:

> 1—This Convention governs a financial leasing transaction as defined in paragraph 2 of this article in which one party (the lessor)
>
> (a) on the specifications of, and on terms approved by, another party (the lessee), enters into an agreement (the supply agreement) with a third part (the supplier) under which the lessor acquires plant, capital goods or other equipment (the equipment) and
>
> (b) enters into an agreement (the leasing agreement) granting to the lessee the right to use the equipment in return for the payment of rentals.
>
> 2—The financial leasing transaction referred to in the previous paragraph is a transaction which includes the following characteristics:

The courts should take a functional approach and broadly interpret the lessee "approval" requirement of Article 2A. When reasonable, the lessee's informal advance "approval" of the supply contract should be sufficient. Yet lessors would seem well advised to document the lessee's "approval." When the "lessee approval" route is taken to achieve statutory "finance lease" status, the statute requires that the lessee's "approval" be "a condition to effectiveness of the lease contract." A lease contract, so conditioned, will not be binding on the lessee, if the lessee's "approval" of the supply contract is later found to be ineffective.

The mechanical difficulties of making oneself a statutory "finance lessor" have been significantly reduced in California by an nonuniform amendment to the "advance notice" requirement in section 2A-103(1)(g)(iii). California Senate Bill #1580 (as amended January 14, 1988) provides that the "advance notice" requirement is satisfied if, at the outset of the transaction, the lessee receives a copy of or approves the supply contract *or* "the lessor informs the lessee of the identity of the supplier, informs the lessee that the lessee may have rights under the contract evidencing the lessor's purchase of the goods, and advises the lessee to contact the supplier for a description of any such rights." This amendment to section 2A-103(1)(g)(iii) seems consistent with the core policies of the finance lease provisions.

The Comment to section 2A-103(1)(g) states that the leasebacks in many sales-and-leaseback transactions will qualify as statutory finance leases.[159] Moreover, lessors who are merchants with respect to goods of the kind subject to the lease may qualify as statutory finance lessors.[160] The Comment to section 2A-103(1)(g) also states that "where the lessor is an affiliate of the supplier [no special rule applies]; whether the transaction qualifies

---

(a) the lessee specifies the equipment and selects the supplier without relying primarily on the skill and judgment of the lessor;

(b) the equipment is acquired by the lessor in connection with a leasing agreement which, to the knowledge of the supplier, either has been made or is to be made between the lessor and the lessee; and

(c) the rentals payable under the leasing agreement are calculated so as to take into account in particular the amortization of the whole or a substantial part of the cost of the equipment.

159. U.C.C. § 2A-103(1)(g) comment (1987).

160. *Id.*

as a finance lease will be determined by the facts of each case."[161] Excluded from *statutory* finance lessor status are manufacturers and individuals who are regular dealers in the leased asset. Also excluded is the lessor who obtains the asset out of inventory, since that lessor did not acquire the asset for a particular lease transaction. Yet an independent automobile dealer-lessor who obtains a car for a particular lessee, for example, *may* be able to qualify as a *statutory* finance lessor under section 2A-103(1)(g). The Comment also states that, in the absence of fraud, duress, and the like, "a lease that qualifies as a finance lease and is assigned by the lessor or the lessee to a third party does not lose its status as a finance lease" under Article 2A.[162]

2. *Statutory "finance leases": special provisions.*—Article 2A makes it clear that a statutory finance lessor does not assume any implied warranties with respect to the lease.[163] Instead, the lessor is held only to express warranties[164] and the warranty of title.[165] Moreover, under a statutory "finance lease" that is not a consumer lease, the lessee's promises (especially to pay rent) are made irrevocable and independent.[166]

Only *commercial* "finance leases," not "consumer leases," qualify for the statutory imposition of automatic "hell or high water" obligations on the lessee under section 2A-407. This restriction was imposed "as a matter of policy" by the Commissioners,[167] who amended the Drafting Committee's proposals specifically to include this limitation. The impression of the Drafting Committee was that the majority of common-law cases recognized the validity of "finance leases" containing "hell or high water" obligations to

---

161. *Id.*

162. *Id.*

163. The statute states that the implied warranties of merchantibility and fitness have no application to a "finance lease." U.C.C. §§ 2A-212, 2A-213 (1987).

164. § 2A-210.

165. § 2A-211(1). These are not the only obligations of the statutory finance lessor, of course. When a finance lessor performs maintenance or other functions apart from the supply of money, "express warranties, covenants and the common law will protect the lessee." § 2A-103(1)(g) comment. The statute also does not affect the finance lessor's rights and obligations with respect to the supplier and third parties other than the lessee. § 2A-209 comment. Moreover, the lessee has a cause of action against the statutory finance lessor if the supply contract is modified or rescinded after the lessee enters the finance lease. § 2A-209(3).

166. §§ 2A-407, 2A-508(6).

167. *See* § 2A-407 comment.

pay rent for both consumer lessees and commercial lessees. The Comments to section 2A-407 leave open the possibility that the parties to a "consumer lease" can *agree* to a hell-or-high water clause in the lease agreement.[168] The Comments also make it clear, however, that other "consumer protection" statutes and evolving case law on consumer rights place severe restraints on the enforceability of such clauses in consumer leases.[169] Technically, Article 2A is silent on that issue, leaving existing law on consumer finance leases as it is.

Though "hell or high water" clauses are viewed as sacrosanct by most finance lessors, Professor Marion Benfield observed during the Drafting Committee discussions that there are other paths to the same end. Where valid and effective disclaimer of warranties clauses are included in a lease, the lessor may not need a "hell or high water" clause. Theoretically, the disclaimers might eliminate any possible legal excuse for non-payment of rent by the lessee, making a "hell or high water" clause superfluous, at least as between the lessor and the lessee.[170] Yet, in practice, finance lessors may prefer the double contractual protection of *both* "hell or high water" clauses *and* warranty disclaimers, particularly in light of the requirement that warranty disclaimers be conspicuous.[171]

---

168. The Comment states:

> This section is silent as to whether a "hell or high water" clause, *i.e.*, a clause that is to the effect of this section, is enforceable if included in a finance lease that is a consumer lease or a lease that is not a finance lease. That issue will be determined by the facts of each case. Section 2A-104, 2A-103(4), 9-206 and 9-318.

U.C.C. § 2A-407 comment (1987).

169. The Comment further states:

> That a consumer be obligated to pay notwithstanding defective goods or the like is a principle that is not tenable under case law (*Unico v. Owen*, 50 N.J. 101, 232 A.2d 405 (1967)), state statute (Unif. Consumer Credit Code §§ 3.403-.405, 7A U.L.A. 126-31 (1974)), or federal statute (15 U.S.C. § 1666i (1982)).

U.C.C. § 2A-407 comment (1987). Contrast *In re* O.P.M. Leasing Serv., 21 Bankr. 993, 1006 (Bankr. S.D.N.Y. 1982) (court enforced "hell or high water" clause in commercial lease).

170. The cases have held that conspicuous disclaimers of warranties, like "hell or high water" clauses, enable equipment lessors to collect rents notwithstanding defects in the goods. *See, e.g.*, Glenn Dick Equip. Co. v. Galey Constr., 97 Idaho 216, 541 P.2d 1184 (1975); Bakal v. Burroughs Corp., 74 Misc. 2d 202, 205, 343 N.Y.S.2d 541, 544 (N.Y. Sup. Ct. 1972).

171. U.C.C. § 2A-214 (1987). Even then, of course, some courts may find that the lessee can escape some or all of the obligations of a finance lease. *See, e.g.*, United States for Use & Benefit of Moretrench Am. Corp. v. McClure Elec. Constr., 402 F. Supp. 701 (N.D. Fla. 1975) (court found "failure of consideration," entitling lessee to offset notwithstanding lessor's valid disclaimer of warranties, where goods were not "in good working order"); Frantz Lithographic Serv., Inc. v. Sun Chem. Corp., 38 U.C.C. Rep. Serv. (Callaghan) 485

The statutory finance lessee is the automatic beneficiary of all the supplier's warranties under the supply contract.[172] But such a lessee generally cannot revoke acceptance of the goods.[173] To have any rights against the lessor, the finance lessee would have to reject goods immediately upon receipt. Other special rules governing statutory finance leases include the provision that the risk of loss pass to the lessee, not the lessor.[174]

These special finance lease provisions in Article 2A mirror the provisions that are commonly found in most finance lease contracts.

Two separate and independent kinds of "finance leases" will exist in the wake of Article 2A: contractual "finance leases" and statutory "finance leases." One effect of this new regime is to short-circuit the courts' development of a common law definition of "finance lease" in the law of warranties.[175] When the written lease agreement does not cover warranties, a transaction must fall within the narrow Article 2A definition of a statutory "finance lease" to exempt the lessor from implied warranty liability. This seems of minimal practical significance, however, since the nearly universal practice of finance lessors is to "contract out" of warranties in their lease agreements.

Overall, the "finance lease" provisions of Article 2A will provide certainty and some additional protections to lessors who qualify as statutory finance lessors. Typical vendor leasing programs, sales-and-leasebacks, and large leasing transactions often will qualify as finance leases under section 2A-103(1)(g). Other lessors can qualify themselves as finance lessors by contract. The

---

(E.D. Pa. 1984) (court refused to grant summary judgment to defendant lessor, in suit for breach of warranty, ruling that despite warranty disclaimer lessee might revoke acceptance of equipment under § 2-608).

172. U.C.C. § 2A-209(1). The importance of the lessor's residual interest in the goods may lead some lessors to write their lease agreements to retain some warranty rights against the supplier.

173. §§ 2A-516, 2A-517(1).

174. § 2A-219.

175. Yet the courts will continue to develop a common law definition of "finance lease" in the law of products liability. Since World War II, courts which have dealt with warranties and products liability issues increasingly have recognized that a "finance lease" is very different from a traditional rental. *See supra* note 150.

Comment to section 2A-103(1)(g) provides a check list of statutory "finance lease" provisions[176] and observes that "[u]nless the lessor is comfortable that the transaction will qualify as a finance lease, the lease agreement should include provisions giving the lessor the benefits created by the subset of rules" applicable to statutory "finance leases" under Article 2A.[177]

E. "Consumer Lease" Issues

The storm of controversy surrounding Article 2A largely has focused on the Article's "consumer lease" provisions. Article 2A does not deal comprehensively with "consumer protection." This is left to other law. But the Article does contain some special rules having no counterpart in the sales Article, governing the leasing of goods to consumers. These new "consumer lease" provisions recognize the evolution of consumer protection laws since 1952, when Article 2 was initially drafted, and the existence of modern federal and state legislation affecting consumer leases.[178]

---

176. *See also* U.C.C. § 2A-406(1)(b).

177. § 2A-103(1)(g) comment.

178. Two federal statutes are particularly significant for consumer leases:

(1) The Consumer Leasing Act of 1976, 15 U.S.C. §§ 1667-1667e (1982), and its implementing Regulation M, 12 C.F.R. pt. 213 (1987), apply to "consumer leases" of personal property primarily for personal, family, or household use for a period exceeding four months where the consumer's total contractual obligation does not exceed $25,000. This statute requires the lessor to provide the lessee with a clear written statement, before consummation of a "consumer lease," identifying the costs, warranties, and termination rights of the parties, *see* 15 U.S.C. § 1667(a) (1982); it limits the lessee's liability on expiration or termination of the consumer lease, *see id.* § 1667(b); and it imposes civil liability on a lessor for failure to comply with these statutory requirements, *see id.* § 1667(d). The Federal Reserve Board's Regulation Z on leasing, 12 C.F.R. pt. 226 (1987), also supplements the Consumer Leasing Act. *See generally* Thomka v. A.Z. Chevrolet, 619 F.2d 246 (3d Cir. 1980) (court applied statute and Regulation Z to "open-end" vehicle lessor).

(2) The Magnuson-Moss Warranty—Federal Trade Comission Improvement Act bars any "supplier," including lessors, from completely disclaiming implied warranties to a consumer with respect to a consumer product, if the lessor makes a written warranty to the consumer or enters into a service contract with the consumer concerning the product. *See* 15 U.S.C. § 2308 (1982); *cf.* Henderson v. Benson-Hartman Motors, 41 U.C.C. Rep. Serv. (Callaghan) 782, 788-93 (Pa. Ct. Comm. Pl. 1983) (court voided inconspicuous disclaimer of implied warranties in automobile lease).

(3) Other federal and state statutes also may affect "consumer" leases. *See, e.g.*, Motor Vehicle Information and Cost Savings Act, as amended by the Truth in Mileage Act of 1986, 15 U.S.C. §§ 1901-2034 (Supp. IV 1986); NAT'L CONF. OF COMM'RS ON UNIFORM STATE LAWS, UNIFORM CONSUMER CREDIT CODE: 1974 OFFICIAL TEXT WITH COMMENTS.

Whether new Article 2A should include *any* special protections for consumer lessees was debated by the Drafting Committee. The Commissioners concluded that the political acceptability of the statute would be enhanced if the Article contained some basic protections for consumer lessees. The inclusion of the protections differentiates Article 2A from the older sales Article, which generally omits special consumer provisions even though some were proposed.[179] Article 9 on secured transactions similarly was drafted to omit special provisions on consumer finance, leaving the development of consumer protection almost entirely to other law, statutory or decisional.[180] UNIDROIT's proposed rules on international financial leasing also deliberately omit any special rules on consumer leasing. Article 2A thus marks something of a breakthrough for "consumer rights" advocates.

The consumer rights "breakthrough," however, seems entirely modest. The scope of the new "consumer lease" provisions is fixed by the definition of "consumer lease" contained in section 2A-103(1)(e):

> "Consumer lease" means a lease that a lessor regularly engaged in the business of leasing or selling makes to a lessee, except an organization, who takes under the lease primarily for a personal, family, or household purpose, if the total payments to be made under the lease contract, excluding payments for options to renew or buy, do not exceed $25,000.[181]

This definition will expand the scope of "consumer lease" protections in some state jurisdictions. Whereas the federal Consumer Leasing Act of 1976 defines "consumer lease" in terms of leases covering "a period of time exceeding four months,"[182] Article 2A

179. The original drafter of the sales Article, Karl Llewellyn, intended Article 2 to recognize the different status of consumers and professional merchants. *See* Wiseman, *The Limits of Vision: Karl Llewellyn and the Merchant Rules*, 100 HARV. L. REV. 465 (1987). The only explicitly stated consumer law rule in Article 2 states that "[l]imitation of consequential damages for injury to the person in the case of consumer goods is prima facie unconscionable but limitation of damages where the loss is commercial is not." U.C.C. § 2-719(3) (1987). Other protections for consumers in the sales Article are implicit, not explicit. *See* Miller, *Leases With Consumers under Uniform Commercial Code Article 2A*, 39 ALA. L. REV. 957, 959 (1988).

180. *See* G. GILMORE, *supra* note 121, §41.5, at 1093. Section 9-203(4) provides that other state statutes, including consumer protection statutes, may apply to transactions covered by Article 9.

181. U.C.C. § 2A-103(1)(e) (1987).

182. 15 U.S.C. § 1667(1) (1982).

covers even shorter-term "consumer leases."[183] The statutory limitation that the lessee must take its interest "primarily for a personal, family, or household purpose" means that a lease executed primarily for an agricultural purpose falls outside the "consumer lease" protections of Article 2A.

The major "consumer lease" provisions in the new statute include section 2A-106, which limits the inclusion of abusive choice-of-law and choice-of-forum clauses in consumer leases; sections 2A-108(2) and (4), which provide that when a court finds a consumer lease contract or a claim collection activity under a consumer lease to be "unconscionable," it may grant appropriate relief including attorneys' fees; and section 2A-109(2), which places the burden on the lessor to justify acceleration of rentals in a consumer lease.[184] The Commissioners and the Drafting Committee rejected proposals to include other "consumer protection" provisions in Article 2A, such as the proposal based on the Uniform Consumer Credit Code to give consumer lessees a sweeping statutory right to "cure" defaults caused by nonpayment of rent.[185]

Vehicle leasing critics of the new statute have pointed out that the "consumer lease" provisions of Article 2A are modeled after some of the "consumer protection" provisions of the Uniform Consumer Credit Code, which has been adopted in only a minority of states.[186] They also complain that consumer leases are excluded

183. Other differences are noted in the Comment to § 2A-103(1)(e):

> [T]he lessor can be a person regularly engaged either in the business of leasing or of selling goods, the lease need not be for a term exceeding four months, a lease primarily for an agricultural purpose is not covered and the limitation of $25,000 is not subject to adjustment as the Consumer Price Index changes.

U.C.C. § 2A-103 comment (1987).

184. Other Article 2A provisions concerning "consumer leases" are listed in the Comment to § 2A-103(1)(e). These include § 2A-504(3)(b) (limiting lessor's right to retain part of price already paid by consumer lessee, where lessor can show no damage and "the lessor justifiably withholds or stops delivery of the goods because of the lessee's default or insolvency") and § 2A-516(3)(b) (consumer lessee not required to notify lessor of litigation for infringement). *See* U.C.C. § 2A-103 comment (1987). All these "consumer lease" provisions are discussed in detail in Miller, *supra* note 179.

185. This rejected proposal would have given consumer lessees a statutory right to "cure" defaults caused by failure to pay rent, at any time until 20 days after receipt of special written notice from the lessor advising the consumer lessee of his right to cure. *Cf.* U.C.C. § 2A-502 (1987) (notice of default generally not required).

186. *See* Letter from National Vehicle Leasing Association (NVLA) to Minnesota Senate on Minnesota Senate Bill 156 (UCC Article 2A-Leases) 3 (Apr. 1987).

from the scope of some sections of the new statute[187] that benefit lessors in "finance leases" other than consumer leases. Yet these lessors can protect themselves in the written lease agreement, to the extent that courts do not find their contract provisions overreaching and unconscionable. Article 2A does make a distinction between consumer and business leasing. As pointed out in the Comment to section 2A-407, however, both courts and legislatures already have recognized that consumer leasing stands on a different footing than commercial business leasing.[188]

Equally without merit are criticisms of the statute by "consumer protection" advocates in Connecticut who claim that the statute does not sufficiently protect consumer lessees. The statute does not attempt to establish a comprehensive set of consumer protection measures. Instead, Article 2A generally leaves consumer protection to other statutes and other law.

One other "consumer lease" provision in the statute which warrants brief comment concerns the award of attorneys' fees under section 2A-108. The statutory standard triggering attorneys' fees liability against the lessor—unconscionability in a consumer lease or in collection activity—may be somewhat easier to satisfy than the "bad faith" test of the "American rule" on attorneys' fees.[189] The statute contains a check on frivolous claims, however. When a lessee knowingly makes a groundless claim of unconscionability, section 2A-108(4)(b) obligates the court to award attorneys' fees to the lessor.[190] Other limits on frivolous lessee claims may be

187. *E.g.*, U.C.C. § 2A-407 (1987).

188. Today it seems inevitable that there are and will be statutes and evolving case law on "consumer protection." The strength and popularity of the "consumer protection" movement seem established facts of contemporary life. Moreover, twentieth-century American law generally has tended to hedge-in voluntarily assumed "contractual" understandings with imposed obligations. *See* G. GILMORE, *supra* note 51.

189. *See* Alyeska Pipeline Serv. Co. v. Wilderness Society, 421 U.S. 240 (1975). The origin, history, and scope of the familiar "American rule" generally requiring each party to bear the cost of its own attorneys' fees, as well as various exceptions to the rule (specific statute, willful violation of a court order, common fund, bad faith) are discussed in 10 C. WRIGHT, A. MILLER & M. KANE, FEDERAL PRACTICE AND PROCEDURE: CIVIL § 2675 *et. seq.* (2d ed. 1983).

190. The statutory language is:

> In an action in which the lessee claims unconscionability with respect to a consumer lease . . . [i]f the court does not find unconscionability and the lessee claiming unconscionability has brought or maintained an action he [or she] knew to be groundless, the court shall award reasonable attorney's fees to the party against whom the claim is made.

found in court rules and the "American rule" on attorneys' fees, which apply to civil litigation generally. The Comment to section 2A-108 also makes it clear that the statute "will not override a term in the lease agreement that provides for the payment of attorney's fees."[191]

F. UCC Filings (or Notice) Not Required for Leased Personal Property

Another major issue confronting the drafters of Article 2A was whether to establish a mandatory system *requiring* the filing of UCC financing statements for personal property covered by a true lease. The Drafting Committee received several suggestions for mandatory filing, with special exceptions proposed for short-term leases, "consumer leases," and leased goods of limited dollar value.[192] With the single exception of "fixture" filings,[193] however, the Commissioners rejected the concept of mandatory filings.

Today many lease transactions involve goods that are subject to certificate of title statutes. Article 2A was expressly made subject to those statutes, with the result that goods covered by certificate of title statutes generally must comply only with the fil-

---

U.C.C. § 2A-108(4)(b) (1987). This does not require a lessee to conduct an investigation before claiming unconscionability. Moreover, under § 1-201(25), "knew" means actual knowledge. But court rules may well require the lessee's attorney to investigate before making such a claim. *See, e.g.*, Civ. R. 11, Superior Court of the District of Columbia. The ordinary operation of such court rules, which envision sanctions including attorneys' fees for frivolous claims, is not impaired by Article 2A.

191. U.C.C. § 2A-108 comment (1987).

192. One such suggestion was that "lessors under leases other than consumer leases and leases with a duration of 21 days or less, be required to file UCC-1 financing statements to perfect their interests as against reliance creditors." This suggestion was later amended to propose that, consistent with §§ 2A-105 and 9-302(3)(b), equipment covered by state certificate of title statutes also should be exempted from mandatory UCC filings for leased equipment.

Earlier commentators also had suggested that the filing of a UCC financing statement be required to "perfect" commercial equipment leases. *See, e.g.*, Coogan, *supra* note 41, at 1047 n.61 (suggesting that "a universal filing requirement" for leases with a term over one year "might be very beneficial"); Kripke, *supra* note 41, at 728 (suggesting requirement for "perfection of the lessor's security interest, usually by the filing of an appropriate financing statement" for all "lease[s] for a term," with the *de minimis* exception of "leases of short duration, *e.g.*, one year or less"); Hawkland, *The Proposed Amendments to Article 9 of the UCC-Part 5: Consignments and Equipment Leases*, 77 COM. L. J. 108, 114-15 (1972); Levie, *Security Interests in Chattel Paper*, 78 YALE L. J. 935, 941 (1969).

193. *See infra* Part III.G.

ing or notice requirements contained in those statutes.[194] The question remained, however, whether there should be a general filing or notice requirement for leases of goods *not* subject to certificate of title statutes, with a list of exceptions covering short-term leases and other "special cases" where filing would be impractical.

Traditionally, equipment lessors have *not* been required to file UCC financing statements or to give other public notice of their interests in the goods under a true lease.[195] The Drafting Committee received conflicting comments on whether current law on filing and notice should be changed. But no clear need was demonstrated for requiring UCC filings or other public notice for leased goods.

What is at stake here is a weighing of competing interests in fairness, convenience, and efficiency. The ostensible benefits of mandatory filing for leases are far from clearcut. Though leases are sometimes said to present the dangers of a "secret lien," it is also said that lenders today commonly rely on a prospective debtor's financial statement (up-to-date versions of which can be demanded) and personal guarantees, rather than an inventory of the items in the prospective debtor's possession.[196] What "the players

---

194. The classic example of goods covered by state certificate of title statutes is motor vehicles. The impracticality of mandatory UCC filings for leased motor vehicles, and lack of justification for such filings, was immediately acknowledged by the Drafting Committee. Title and licensing statutes in every state already require extensive periodic public filings for motor vehicles. This makes public both ownership and the lease relationship concerning a leased motor vehicle. There are no "secret liens" here. Moreover, mandatory UCC filings for leased motor vehicles would impose excessive administrative costs in comparison to the value of motor vehicles themselves, which often cost less than $10,000. The cost of such filings ultimately would be borne by lessee-users. Today, many motor vehicle lessors do *not* file precautionary UCC-1 financing statements, since it would be impractical, given the cost and administrative burden, to make multiple UCC filings for each of the thousands of mobile motor vehicles they lease.

Section 9-302(3)(b), and the various state certificate of title statutes, commonly exempt motor vehicles not held as inventory from UCC filing requirements. *See generally* G. Gilmore, *supra* note 121, § 20.8; Meyers, *Multi-State Motor Vehicle Transactions Under the UCC*, in 1C P. Coogan, W. Hogan, D. Vagts & J. McDonnell, *supra* note 2, ch. 30A. Tracking the language of § 9-302(3)(b), § 2A-104 and § 2A-105 preserve the primacy of the certificate of title statutes.

195. *See, e.g.*, *In re* Marhoefer Packing Co., 674 F.2d 1139 (7th Cir. 1982); *In re* Leasing Consultants, Inc., 486 F.2d 367 (2d Cir. 1973); Allen v. Cohen, 310 F.2d 312 (2d Cir. 1962).

196. *See, e.g.*, Coogan, *Leasing and the Uniform Commercial Code*, in Equipment Leasing—Leveraged Leasing, *supra* note 128, at 832 (creditors today "rely primarily on the debtor's financial statement and seldom count the items in his possession").

actually do now, under the existing legal regime," may be illuminated by future empirical research of the sort suggested by Professor Mooney's article in this Symposium.[197] To be sure, mandatory UCC filings might reduce litigation concerning the "true lease" status of questioned transactions. But such litigation would not disappear. Even where a "true lease" was covered by mandatory UCC filings, the "true lease"/security interest determination still would have to be made by the courts in a variety of contexts (*e.g.*, bankruptcy law, remedies, and usury law).

Technical faults in filing (misdescription of goods or failing to file in all the right places, for example) should not be controlling on a lessor's rights to multi-million dollar equipment, the AAEL argued. For the lessor concerned about possible technical faults in filing, it is no answer to say that his interests would be subordinated "only to secured creditors who have fully complied with the perfection requirements of Article 9."[198] The imposition of mandatory filing requirements would place onerous burdens on lessors who lease large numbers of small-cost items. Earlier commentators had noted the impracticality of UCC filing or other public notice requirements for every lease.[199] The cost of mandatory filings ultimately would be borne by lessees. Moreover, additional filings of UCC financing statements might overwhelm an already overburdened UCC filing system. When the issue of mandatory UCC filings for leased goods was discussed within the American Bar Association, the majority of lawyers polled was opposed to the concept.

Taking these factors into account, the Commissioners concluded that existing law on UCC filings and notice was working reasonably well. There was no good reason to disturb it. Article 2A therefore generally rejects the concept of mandatory UCC filings or other required notice for personal property covered by a true lease.

---

197. *See* Mooney, *The Mystery and Myth of "Ostensible Ownership" and Article 9 Filing: A Critique of Proposals to Extend Filing Requirements to Leases*, 39 ALA. L. REV. 683 (1988).

198. The statement quoted in the text is from *Secret Lien Concern: Personal Property Act Proviso to Require Filing of Long-Term Equipment Leases*, LEADER'S EQUIPMENT LEASING NEWSL., Aug. 1985, at 7. Thoughtful commentators have pointed out that complex issues are raised in any attempt to construct a fair and workable set of priority rules, including the effects of nonfiling, under a regime which would mandate (in some fashion) filing for leases. *See* Mooney, *supra* note 197.

199. *See, e.g.*, Coogan, *supra* note 196, at 741-42, 746.

UNIDROIT's draft rules on international "financial leasing," by contrast, contemplate that American lessors often will be required to make some sort of public filing overseas for goods sent overseas. The only exception concerns "equipment such as ships and aircraft subject to registration pursuant to an international convention."[200] Typically, international financial leasing involves large transactions, with multi-million dollar equipment that is leased under an agreement designed by lawyers in arms-length negotiations. Ordinarily, large numbers of small-cost items are not involved. In this context, the proposed "public notice" requirements in UNIDROIT may aid the community of international lending institutions without being a significant impediment to international commerce. One wonders, however, whether the proposed "public notice" requirements of UNIDROIT will inhibit the development of some international commerce in the future by stifling cross-border leasing of large numbers of small-cost items.

1. "Vendor in possession" doctrine for sales-and-leasebacks abolished.—Article 2A also *abolishes* the so-called "vendor in possession doctrine" which has long created state law difficulties for sales-and-leasebacks of equipment. This will be welcome news to practitioners. The old "vendor in possession" doctrine, which made retention of possesion by the vendor fraudulent *per se* or *prima facie* fraudulent, is an ancient anachronism that has been recog-

200. UNIDROIT Article 5 (Apr. 1987), which is apparently modeled, in part, on the French system of registration introduced for financial leases in 1972, provides as follows:

1—The lessor's real rights in the equipment shall be valid against the lessee's trustee in bankruptcy and creditors, including creditors who have obtained an attachment or execution.

2—Where by the applicable law the lessor's real rights in the equipment are valid against a person referred to in the previous paragraph only on compliance with rules as to public notice, those rights shall be valid against that person only where they are valid according to such rules.

3—For the purpose of the previous paragraph the applicable law is:

(a) [in the case of ships, aircraft, vehicles or other equipment subject to registration pursuant to the law of a State, the law of the State of registration];

(b) in the case of all other [mobile] equipment [normally used in more than one State], the law of the State where the lessee has its principal place of business; and

(c) in the case of all other equipment, the law of the States where the equipment is situated at the time when the person referred to in paragraph 1 is entitled to invoke the rules referred to in paragraph 2.

4—This article shall not affect the rights of any creditor of the lessee having a lien on or a security interest in the equipment.

nized in one form or another in many states.[201] Even the oldest cases recognized that "a lease is a reason for possession with no color of fraud."[202] Given this history, wooden application of the "vendor in possession" doctrine to modern equipment leasing was essentially a plague upon modern industrial society. One memorable comment by Professor Hogan during the Drafting Committee deliberations was that "vendor-in-possession" was a "silly" doctrine that ought to be abolished. Section 2A-308(3) does that for transactions in which the buyer "bought for value and in good faith."[203] The statute also expressly provides that separation of ownership and possession *per se* does not affect the enforceability of a lease contract.[204] The old, unlamented "vendor-in-possession" doctrine for sales-and-leasebacks is no more.

2. Optional UCC filings permitted.—The optional filing of UCC financing statements is permitted under Article 2A, as under current law, for any true or doubtful lease.[205] Incentives remain for lessors to file UCC financing statements. Though amended section 1-201(37) clarifies the definition of a true lease, it does not eliminate all ambiguities. UCC filings for leases provide protection to the person filing if it is later determined that the "lease" was a

---

201. The old "vendor in possession" doctrine can be traced back to 17th century English law. *See, e.g.*, Twyne's Case, 3 Coke 80 b, 76 Eng. Rep. 809 (1601). In America, this doctrine was often based on outdated cases, decided well before the Civil War. *See* Coogan, *supra* note 196, at 827-46. The antiquity of these old "vendor in possession" cases is indicated by the fact that a fair number of them involved slaves as the "goods." *See, e.g.*, Gibson v. Love, 4 Fla. 217 (1851); Askew v. Reynolds, 18 N.C. 366 (1835).

202. Coogan, *supra* note 196, at 832.

203. The statute states in pertinent part:

> (3) A creditor of a seller may treat a sale or an indentification of goods to a contract for sale as void if as against the creditor retention of possession by the seller is fraudulent under any statute or rule of law, *but retention of possession of the goods pursuant to a lease contract entered into by the seller as lessee and the buyer as lessor in connection with the sale or identification of the goods is not fraudulent if the buyer bought for value and in good faith.*

U.C.C. § 2A-308(3) (emphasis added). The Comment to § 2A-308 confirms:

> Notwithstanding any statute or rule of law that would treat such retention as fraud, whether *per se*, *prima facie*, or otherwise, the retention is not fraudulent if the buyer bought for value (Section 1-201(44)) and in good faith (Sections 1-201(19) and 2-103(1)(b)). Section 2A-103(3) and (4). This provision overrides Section 2-402(2) to the extent it would otherwise apply to a sale-leaseback transaction.

204. *See id.* § 2A-302 & comment.

205. The Comment to § 2A-301 states: "Those lessors who are concerned about whether the transaction creates a lease or a security interest will continue to file a protective financing statement."

secured sale. Moreover, the filing of a UCC financing statement may not be considered as a factor in determining whether or not the transaction is a true lease or a secured sale.[206]

G. Fixtures: Modest Reform

Over the years, the subject of "fixtures"[207] has triggered many disputes between real estate interests and equipment lessors.[208] Article 2A attempts to resolve some of the recurring problems in this area by imposing new UCC filing requirements for leased fixtures. This is the only instance in which Article 2A imposes new filing requirements.

Two basic sets of priority rules are contained in Article 2A to determine the priority of competing interests in "fixtures": one for unfiled lessors and the other for lessors who have made a "fixture filing" in the office in which a mortgage on the real estate would be recorded. When a fixture lessor fails to make a "fixture filing" in real estate records, under section 2A-309(7) his interest may lose out to real estate interests. This statutory encouragement of "fixture filings" reinforces common leasing industry practice and implements the views of thoughtful commentators.[209] Traditional priority rules on fixtures are retained in section 2A-309, with a modest expansion of the category of "readily removable" goods.

---

206. *See* § 9-408.

207. The Committee draftsmen of Article 2A did not attempt to clarify the definition of "fixtures." The main reason given was the difficulty of writing a satisfactory definition. *See* Coogan, *The New UCC Article 9*, 86 HARV. L. REV. 477, 487-90 (1973); Kripke, *Fixtures Under the Uniform Commercial Code*, 64 COLUM. L. REV. 44, 64 (1964). Thus § 2A-309(1)(a) simply states the truism that "goods are 'fixtures' when they become so related to particular real estate that an interest in them arises under real estate law."

208. The pre-Code struggles in this field are reviewed in G. GILMORE, *supra* note 121, § 28.1-28.7, § 30.1. The original 1952 version of § 9-313 generally gave priority to chattel security interests in fixtures, as against competing real estate interests. *See id.* § 30.2. In 1972 this section was amended to limit the priority to certain specified security interests. U.C.C. § 9-313(4) & (5) (1972). The 1972 amendments also recognized the priority of prior-recorded construction mortgages over purchase money security interests in the fixtures, where the goods became fixtures before the completion of construction. *Id.* § 9-313(6). These amendments were largely responsive to criticisms and pressure by real estate interests. *See* PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, PROPOSALS FOR CHANGES IN ARTICLE 9 OF THE UCC AND RELATED CHANGES IN OTHER ARTICLES WITH REASONS THEREFOR AND COMMENTS 126, 197-205 (1971) (Final Report of the Review Committee for Article 9 of the UCC).

209. *See* G. GILMORE, *supra* note 121, § 30.5; Leary, *supra* note 28, at 1089-93.

Moreover, section 2A-309(8) makes it clear that when a lessor of fixtures has priority over conflicting real estate interests, either the lessor or the lessee may *remove* the goods on the lessee's default, as well as in other circumstances, so long as he pays "the cost of repair of any physical injury."[210]

1. Unfiled lessors of fixtures.—When a lessor of fixtures has made no UCC filings he may prevail, under general real estate law, over later-acquired real estate interests that were obtained with knowledge or notice of the lessor's interest.[211] Otherwise, the unfiled fixture lessor will have priority over conflicting real estate interests under section 2A-309(5) only if: (a) the fixtures are certain "readily removable" equipment; (b) the conflicting real estate interest was obtained by legal proceedings after the lease is enforceable; (c) the competing encumbrancer or owner gave written consent to the fixture lease;[212] or (d) the *lessee* has a right to remove the goods as against the encumbrancer or owner of the real estate. These provisions mirror the protections in existing law for unfiled lessors of fixtures.[213] When the unfiled lessor of fixtures

---

210. The specific language of the new statute gives the lessor or the lessee the right to remove the goods from the real estate, on the other party's default (as well as in other circumstances), but requires that he

> must reimburse any encumbrancer or owner of the real estate who is not the lessee and who has not otherwise agreed for the cost of repair of any physical injury, but not for any diminution in value of the real estate caused by the absence of the goods removed or by any necessity of replacing them. A person entitled to reimbursement may refuse permission to remove until the party seeking removal gives adequate security for the performance of this obligation.

U.C.C. § 2A-309(8) (1987). This rejects the pre-Code cases from New Jersey and Pennsylvania which required the remover of goods to compensate real estate interests for "economic," as well as "physical," injury. *See* G. GILMORE, *supra* note 121, § 28.6, at 770, § 30.2, at 804-07. At the same time, § 2A-309(8) protects real estate interests against over-enthusiastic activity by equipment lessors pursuing their repossession remedies. *See also* Jones v. Joseph Greenspon's Son Pipe Corp., 381 Ill. 615, 46 N.E.2d 67 (1943) (conditional seller held justified in removing pipe and casing cemented into oil well by exploding bomb inside well to tear equipment loose) (discussed in G. GILMORE, *supra* note 121, § 28.7, at 772).

211. U.C.C. § 2A-309(7) (1987).

212. One commentator has suggested that it is good practice for lessors of fixtures to obtain waivers and/or subordinations from all parties with an interest in the real estate and who may claim an interest in the leased equipment. Leichtling & Paretts, *Protecting the Lessor If Equipment's Value Can Only Be Realized Through Real Property*, LEADER'S EQUIPMENT LEASING NEWSL., Feb./ Mar. 1986.

213. Thus, for example, § 2A-309(5)(d) reflects the earlier Article 9 and common-law provisions allowing removal of trade fixtures. *See* U.C.C. § 9-313(5)(b) (1987); Lemmons v. United States, 496 F.2d 864, 869-72 (Ct. Cl. 1974); *see also* 3 WITKIN, SUMMARY OF CALIFORNIA LAW, *Personal Property* §§ 60-66, *Real Property* §§ 469-70.

falls outside these provisions, he may well lose to competing real estate interests, since under section 2A-309(7) the priority of the lessor's interest will be determined by real estate priority rules where priorities are not specifically resolved by the statute.

One new wrinkle was added here: Article 2A expands slightly on the section 9-313(4)(c) category of "readily removable" leased fixtures that can be repossessed by a lessor even where the lessor has made no UCC filings. One commentator had suggested that such "readily removable" collateral should include all readily removable "equipment" and "farm products," as well as "readily removable replacements of domestic appliances which are consumer goods."[214] Two states, Arizona and Iowa, essentially adopted this view in Article 9. Though the drafting Committee for Article 2A did not go this far in defining "readily removable" fixtures, section 2A-309(5)(a) does give an *unfiled* lessor of fixtures priority over competing real estate interests if

> the fixtures are readily removable factory or office machines, *readily removable equipment that is not primarily used or leased for use in the operation of the real estate*, or readily removable replacements of domestic appliances that are goods subject to a consumer lease, and before the goods become fixtures the lease contract is enforceable.[215]

The Comment to section 2A-309 indicates that aside from leased equipment that is "integral to the operation of real estate" (*e.g.*, heating and air conditioning equipment), other "readily removable equipment" constituting fixtures can be repossessed by an unfiled lessor.[216] Owners and encumbrancers of real estate, on the other hand, will be able to rely on the continuing availability of fixtures that are essential to the operation of the land and building itself.

2. Lessors who have made a "fixture filing".—As a matter of common practice, lessors of fixtures make double UCC filings in both personal property and real estate records. Quite apart from the benefits of an unfiled lessor, under section 2A-309(4) the lessor who has made a "fixture filing" also will have priority if (a) the conflicting real estate interest arose before the goods became fix-

214. Coogan, *supra* note 207, at 497.

215. U.C.C. § 2A-309(5)(a) (1987) (emphasis added). At one point, the Drafting Committee agreed that readily removable "farm products" could be repossessed by an unfiled lessor. This did not appear in the final language of § 2A-309, however.

216. § 2A-309 comment.

tures, the lessor filed in real estate records before the goods became fixtures or within ten days thereafter, and the lessee has a recorded real estate interest or is in possession of the real estate;[217] or (b) the lessor filed in real estate records before the competing real estate interest was recorded, the lessor had priority over any predecessor in title of the conflicting real estate interest, and the lessee has a recorded real estate interest or is in possession of the real estate.

The Commissioners may well revisit the subject of "fixtures" again in the future. Though the search continues for the most reasonable balance between competing real estate interests and lessors of fixtures, Article 2A provides some helpful clarification in this overly technical area of the law.

IV. Conclusion

The impact of new UCC Article 2A-Leases will underline the importance of careful drafting for leases of motor vehicles and equipment. Liquidated damages clauses are encouraged. Moreover, the discount rate for calculating measure of damages can be specified. Contractual "finance lease" provisions remain important. Waivers of warranties must be conspicuous and in writing. A lease agreement may vary statute of limitations periods[218] and provide for the lessor to "use" repossessed goods after the lessee's default in order to preserve the goods.[219] Two other minor drafting points are also raised by the statute: A lease must specifically and conspicuously ban assignment of the lease,[220] and it must bar the lessee from selling the equipment after rejection (or revoked acceptance)[221] in order to ensure those results. The overall emphasis of the statute is on "freedom of contract."

---

217. There is a caveat here with respect to construction mortgage liens. Under § 2A-309(6) the lessor's interest is subordinate to the conflicting interest of a construction mortgage lien recorded before the goods become fixtures, if the goods become fixtures before construction is completed. U.C.C. § 2A-309(6) (1987).

218. § 2A-506.

219. § 2A-529 comment.

220. *Compare* § 2A-303(7).

221. *Cf.* § 2A-508(5).

Though the statute is by no means perfect, it marshals an impressive array of benefits and improvements over existing law for the equipment leasing industry. The statute clarifies the difference between a true lease and a "security interest." Moreover, it provides clarity and uniformity in state law, particularly in the troublesome areas of warranties and lessors' remedies. UCC filings are not required for leased equipment, although lessors who filed in the past probably will want to continue to do so. New "fixture filings" in real estate records will protect lessors of fixtures. The statute also improves the position of unfiled lessors of "readily removable" fixtures in priority disputes with competing real estate interests. The old "vendor-in-possession" doctrine is abolished for sales-leasebacks. The modest "consumer lease" provisions in the statute largely mirror existing law.

Threatened stormy opposition to the new UCC Article 2A seems overstated and unwarranted. One leasing company executive, Bernard J. McKenna, President of Chicago-based Sanwa Business Credit, commented: "The new statute rejects a simplistic approach that might have blurred the distinction between a true lease and a financing."[222] Moreover, the statute follows well-established law and defers to the lease agreement on most issues. McKenna went to the heart of the matter: "If you can't write a good solid lease agreement, you're in trouble. That's always been true, and it always will be true, with or without the new Uniform Commercial Code provisions on leasing."[223]

222. Telephone interview with Bernard J. McKenna, President of Sanwa Business Credit Corporation (Feb. 24, 1987).

223. *Id.*