**True and Disguised Leases**

Welcome to this podcast on True and Disguised Leases brought to you by CALI. I am Professor Jennifer S. Martin. The topic of this podcast is to evaluate when a transaction described as a “lease” will be considered a sale with a retention of a security interest and covered by Article 9. In particular, it will describe the situations that suggest that a lease is a true lease and those in which the lease is actually a disguised sale. The primary UCC provision associated with this inquiry is § 1-203, which contains the general rules of the road with respect to disguised leases.

Ok, so, recall that according to § 1-201(37), “security interest” means an interest in personal property or fixtures which secures payment or performance of an obligation. And recall that Article 9 applies to any transaction regardless of form that creates a security interest in personal property or fixtures. Remember, the language “regardless of form.” This means that transactions that fit the definition of a security interest come within the scope of Article 9 even though the parties don’t realize they’ve created a security interest and might have sought to avoid Article 9 in the first place. In many cases we will be able to determine readily that parties intended a security interest. It is always important to know how to characterize the transaction so we know which law to apply.

Sometimes we don’t readily know that parties intended to create a security interest. But, some of those transactions are in fact governed by Article 9. A common situation that is sometimes, but not always, governed by Article 9 is that of leases of personal property. There are two types of leases. First, true leases governed by UCC Article 2A, which are not governed by Article 9. Second, some leases are actually disguised sales and these leases are governed by Article 9 even though the agreement between the parties might be framed as a lease. An example of a true lease might be where you go and rent a car for the weekend when you are on vacation. At the end of the weekend you return the car to the rental company. Normally we think of a lease as a right to possession and use the goods for a term in exchange for some type of consideration. The lessor has a right to get the goods back at the end of the lease term, which we call a right of reversion. But, sometimes, it might not be clear that the transaction involves a lease. So, what is a lease? Luckily, we have some guidance on this in 1-203.

Section 1-203 tells us that in order to determine if the transaction that’s in the form of a lease creates a lease or a security interest must be determined by evaluating the facts of each case. The significance of the characterization as a lease should not be missed. The answer to the question of whether the transaction creates a lease or not is important because not only does it determine the rights of the parties to the lease, the lessor and lessee, but also the rights of third parties. If a transaction is a lease, the comments explain that the lessee’s interest in the goods is limited to a leasehold interest, whereas the residual interest belongs to the lessor. This would really be important when it comes to creditors of the lessee who would then be unable to proceed against the goods because the lessee simply does not own them. On the other hand, if the transaction is actually a sale of goods rather than a lease, then title vests in the buyer, and the buyer’s creditors could proceed against the goods in accordance with the applicable rules of Article 9 or bankruptcy.

If the transaction is in essence a sale, the Code will treat it as such and the lessor, who is really a seller, will have a security interest in the collateral. Let’s look at an example. Suppose I need a clarinet for my young son Marshall. Music City, the store, might propose to lease me the clarinet for three years with me paying $50 per month. At the end of the lease, I can buy the clarinet for one dollar. Is this transaction governed by Article 9? The simple answer is yes. This is actually a disguised sale and this transaction is governed by Article 9. Again, regardless of the form of a supposed lease, it creates a security interest. In this situation, as we will see shortly when we analyze more of the § 1-203 factors, Music City has created a security interest in the collateral even though they have called it a lease. That is, they obtained an interest in personal property, the clarinet, to secure payment of the obligation, the $50 per month for the clarinet.

In case we’re not certain, § 1-203 provides guidelines to distinguish true leases from security interests. Now this can get complicated, so stick with me here. Initially, we look to see if there is an obligation of the lessee to pay and use the goods for a term of the lease that is not subject to termination by the lessee. If it is subject to termination by the lessee, it is likely a true lease. For example, in the typical rent-to-own transaction, the lessee becomes the owner of the goods upon making all of the lease payments. However, because the lessee can terminate the transaction at any time, this is a true lease.

But the inquiry does not end with the question of whether the lessee has the right to terminate the lease. Additionally, the Code looks at a number of factors to determine whether there is really a lease. Let’s look at these one by one. First, is the term of the lease equal to or greater than the economic life of the goods (in our example, is the life of the clarinet more or less than three years? If it was less than three years, then there is nothing of value to return to the lessor at the end of the three years, so it is not likely a true lease). Second, is the lessee bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods (in our example, do I have to continue to renew the lease for the clarinet). Third, does the lessee have an option to renew the lease or become the owner of the goods for no additional consideration or for nominal consideration (in our example, do I have an option to renew the lease or just own the clarinet for no additional consideration or for some nominal payment).

Well, as it turns out this last factor is the one used by Music City. Remember, the proposed lease would allow me to purchase the clarinet at the end of three years for one dollar, which surely would seem to lead to my becoming the owner for nominal consideration. I often tell my students that a good rule of the road is to look at the substance of the transaction when in doubt. Is the transaction one such that the lessor is likely to get the goods back at the end of the term or would a reasonable person exercise the option to purchase? My suspicion is that for one dollar I am going to purchase the clarinet and Music City will not see that clarinet again. In such cases, Article 9 will treat the transaction as a sale with a retention of a security interest, even though the parties called it a lease. If I fail to pay the $50 per month for the clarinet, then Music City can enforce its security interest under Article 9 in the same manner as other secured creditors. And, importantly, because I own the clarinet, my other creditors might be able to proceed against the clarinet in the event that I failed to pay other obligations.

You might wonder if there are factors that don’t necessarily transform the lease into a security interest. As it turns out there are actually several that indicate that the transaction may well be a lease and not a security interest. First, whether the present value of consideration paid is equal to or greater than the fair market value of the leased goods (in our example, the amount paid under the lease for the clarinet could be the same or more than the fair market value of the clarinet; for instance, $100 rather than $1). Second, whether the lessee assumes the risk of loss for the goods (in our example, it doesn’t matter if Music City places the risk of damage to the clarinet on me). Third, whether the lessee pays taxes, insurance, filing, recording, registration or service, or maintenance costs for the goods (in our example, if I have to pay for the maintenance cost of the clarinet it might still be a lease). Fourth, if the lessee has an option to renew the lease or become the owner of the goods at fair market rates (in our example, just because I can renew or the lessee can buy the goods, it could still be a lease).

You might ask what the Code means to be nominal. Basically, consideration is not nominal when tied to fair market rates. The Code also tells us that we make this determination based upon the parties’ determination at the time they entered the transaction, and not at the conclusion of the lease. In our example, assume we determined at the time we entered the lease that the fair market value of the clarinet at the end of the lease would be $100, and I had an option to purchase it for that amount. But by the end of the lease term, the fair market for clarinets had exploded and the new value was $200. Even though I got a steal, this would still be an option to become the owner of the goods for fair market value and would not be considered nominal consideration.

We will talk about perfection of a security interest in another podcast, but it is worth noting that if the transaction is a security interest and not a true lease, then the lessor will need to protect itself against the claims of other creditors by perfecting its security interest. This is why the issue of whether a transaction is a true lease or not often comes up in bankruptcy, when the unperfected secured parties generally lose out to the secured creditors who are perfected.

At this point, you should be able to recognize transactions that are governed by Article 9 because a disguised sale is actually involved. You should also be able to recognize transactions that are not governed by Article 9 when there is a true lease.

I hope you’ve enjoyed this podcast on True and Disguised Leases.

Lawdibles are produced and distributed by CALI, The Center for Computer-Assisted Legal Instruction. Find more Lawdibles at www.cali.org/lawdibles. Send your questions and feedback to lawdibles@cali.org. The Lawdibles theme music is “Ask Me No Question” by [Learning Music](http://freemusicarchive.org/music/Learning_Music/). Lawdibles are for educational purposes only. Please seek an attorney if you need legal advice.

CREDIT: Ask Me No Question by Learning Music is licensed under an [Attribution-Noncommercial-Share Alike 3.0 United States License.](http://creativecommons.org/licenses/by-nc-sa/3.0/us/)