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Recent Case: UCC Article 9 - Lease/Option as a Security Agreement - Statute of Frauds [*In re Financial Computer Systems, Inc.*, 474 F.2d 1258 (9th Cir. 1973)]

John T. Mulligan

RECENT CASE

UCC ARTICLE 9 — LEASE/OPTION AS A SECURITY AGREEMENT — STATUTE OF FRAUDS

In re Financial Computer Systems, Inc., 474 F.2d 1258 (9th Cir. 1973).

It has long been held that a debtor may introduce extrinsic evidence to prove that a writing is actually a security agreement even though it appears to be something else.[1] Such a rule has been considered essential to protect the debtor's equity of redemption. The Ninth Circuit Court of Appeals, nevertheless, recently held in *In re Financial Computer Systems, Inc.*[2] that the statute of frauds barred inquiry into a bankruptcy trustee's claim that a purported lease was in fact a disguised security agreement.

Equitable Leasing Company had agreed in writing to lease two air conditioning units to Financial. The terms of the contract provided that the units would at all times be considered the "sole and exclusive" property of Equitable to be returned to Equitable upon the termination of the lease, and that the writing constituted the entire understanding of the parties and could not be altered or amended without the written approval of both parties.

In Financial's bankruptcy proceedings Equitable sought to reclaim the air conditioning units on the simple ground that it owned them. The trustee contested the reclamation by claiming that the written agreement did not embody the entire understanding of the parties despite its express provisions to the contrary. Over Equitable's objection, the trustee was permitted to introduce parol evidence that indicated Equitable had given Financial a verbal option to purchase the units for $1,094 at the expiration of the lease. The trustee maintained that this option arrangement converted what ap-

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[1] 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 2.6, at 47 (1965):

> The rule that the courts will determine the true nature of a security transaction, and will not be prevented from exercising their function of judicial review by the form of words the parties have chosen, long antedates the nineteenth century chattel mortgage. . . . Almost without question the rule was transplanted from the land mortgage to the chattel mortgage.

The rule can be traced back to 1470. W. WALSH, MORTGAGES § 3, at 7 (1934). *See* Dobbs v. Kellogg, 53 Wis. 448, 452-53, 10 N.W. 623, 624 (1881) (Irrespective of the statute of frauds, it is "well established" that a deed absolute on its face may be shown by parol evidence to be a mortgage.)

[2] 474 F.2d 1258 (9th Cir. 1973).

peared to be a simple chattel lease into a security agreement and that, since Equitable had failed to record and thus perfect[3] its interest, its claim was subordinated to the claims of third-party creditors of Financial.[4]

On appeal[5] Equitable argued that the subordination of its claim to the units through the recognition of the alleged oral option was in the nature of a forced sale to Financial and thus identical to the enforcement of an unwritten sales contract. To allow such subordination would violate the statute of frauds.[6] In response, the trustee asserted that the statute of frauds was not applicable since the evidence of the oral option was not introduced to enforce the option, but merely to prove that the agreement was a security device and not a lease.

The Court of Appeals for the Ninth Circuit rejected the trustee's distinction in a tersely written opinion. The court noted that the result of allowing the trustee to prove the existence of the option was tantamount to enforcing a sale under the option provision. It thus concluded that since the alleged security agreement acted as an instrument of sale (causing a transfer of title from Equitable to Financial's creditors), to uphold the agreement would be equivalent to enforcement of an unwritten sales contract. The court believed that the statute of frauds for the sale of goods was a clear mandate against such a result.[7] In applying the statute of frauds, the

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[3] CAL. COMM. CODE § 9302 (West 1964). The California Commercial Code is virtually identical to the Uniform Commercial Code in all sections that are pertinent to this discussion.

[4] CAL. COMM. CODE § 9301 (West 1964).

Both the bankruptcy referee and the federal district court that reviewed his findings held for the trustee; neither opinion has been reported.

[5] Equitable appealed under three other assignments of error: (1) that the oral evidence of the option was inadmissible under California Code section 2202 and the parol evidence rule, (2) that it was error to conclude that the "lease" was in reality a conditional sales agreement, and (3) that the referee erred in failing to offset, after it had been stipulated that there were rentals due Equitable under the terms of the lease. The court's opinion does not indicate how the trustee met these remaining assignments of error.

[6] CAL. COMM. CODE § 2201(1) (West 1964):

> . . . a contract for the sale of goods for the price of $500 or more is not enforceable by way of action or defense unless there is some writing sufficient to indicate that a contract for sale has been made between the parties and signed by the party against whom enforcement is sought or by his authorized agent or broker.

[7] Although the court's rationale is not exactly clear, it seems to have been based on the following:

(a) As a hypothetical, a suit by Financial to force Equitable to sell the units pursuant to the option would fail for lack of a written contract of sale.

court gave the written lease an invincibility new to the California laws of either real or personal property.[8]

The problems presented by this case could have been analyzed and resolved under the provisions and comments of the Commercial Code.[9] Article 9 expressly declares the right and the duty of a court to investigate beyond the written document. California Code section 9102(1)(a) states that article 9 is to apply "to any transaction (regardless of its form) which is intended to create a security interest in personal property. . . ."[10]

Official Comments to the Uniform Commercial Code (UCC) affirm the drafters' commitment to preserving the rights of debtors. Comment 4 to UCC section 9-203 states:

> [T]he requirement of this Section that the debtor sign a security agreement is not intended to reject, and does not reject, the deeply rooted doctrine that a bill of sale although absolute in form may be shown to have been in fact given as security. Under this Article as under prior law a debtor may show by parol evidence that a transfer purporting to be absolute was in fact for security and may then, on payment of the debt, assert his fundamental right to return of the collateral and execution of an acknowledgment of satisfaction.

(b) Recognition of the oral option would change the lease into an unperfected security agreement and thus result in Equitable's loss of the units to the trustee.

(c) The court, through the statute of frauds, avoided recognition of the oral option and thus achieved the same result — Equitable's reclamation of the units — as would have been achieved in the sale situation.

[8] California courts have repeatedly held that a deed absolute on its face may be shown to be a mortgage even by parol evidence. As far back as 1859 the Supreme Court of California addressed this issue in Pierce v. Robinson, 13 Cal. 116, 126 (1859), and stated emphatically that "[a]s the equity upon which the Courts act arises from the real character of the transaction, it is of no consequence in what manner this character is established, whether by deed, or other writing, or by parol." A basis for the court's policy of looking beyond the instrument was the fear that "[u]nless the parol evidence can be admitted . . . the equity of redemption will elude the grasp of the Court, and rest in the simple good faith of the creditor." *Id.* at 126-27. Since *Pierce*, the California courts have uniformly followed that rationale. This California case law authority, which manifests what Professor Osborne calls the "'traditional solicitude of the courts towards a mortgagor's redemption right" (G. OSBORNE, THE LAW OF MORTGAGES 123 (2d ed. 1970)), is complemented by state statute: "[t]he fact that a transfer was made subject to defeasance on a condition, may, for this purpose of showing such a transfer to be a mortgage, be proved . . . though the fact does not appear by the terms of the instrument." CAL. CIV. CODE § 2925 (West 1954).

In contrast to the present case, California state courts have transferred this solicitude from the mortgage laws to the law of personalty. *E.g.*, Silverstein v. Kohler & Chase, 181 Cal. 51, 183 P. 451 (1919); Lundy Furniture Co. v. White, 128 Cal. 170, 60 P. 759 (1900).

[9] "Commercial Code" is used to indicate both the Uniform Commercial Code and the California Commercial Code. See note 3 *supra.*

[10] CAL. COMM. CODE § 9102(1)(a) (West 1964).

Although this comment does not envisage the facts of *Financial Computer Systems*, its rationale is relevant to the lease/option situation. In addition, comment 4 to UCC section 9-501 offers further support for judicial protection of the debtor:

> In the area of rights after default, our legal system has traditionally looked with suspicion on agreements designed to cut down on the debtor's rights and free the secured party from his duties. . . . The default situation offers great scope for overreaching; the suspicious attitude of the courts has been grounded in common sense.

Despite this tradition of "suspicion," the court in *Financial Computer Systems* did not consider the impact of article 9 on this situation; nor did it discuss the protection of Financial's creditors whose interests the trustee represented. The need for such protection should have brought article 9 into consideration; the policy behind article 9 mandates no less. The comment to UCC section 9-101 expressly states, "The rules set out in this Article are principally concerned with the limits of the secured party's protection against purchasers from and creditors of the debtor."

Two commentators have recently noted that the ability of article 9 to protect deserving creditors is severely undercut by an inflexible adherence to evidentiary rules regulating the sale of goods.[11] Indeed, use of the statute of frauds in the instant case seems contrary to the statute's policy[12] of preventing fraud and perjury. Imposing a statute-of-frauds barrier to full judicial inquiry in situations like that in *Financial Computer Systems* could serve to *promote* fraud by permitting avoidance of the requirements of article 9 by ingenious drafting.[13]

Two sections of the Commercial Code dictate that judicial inquiry must be comprehensive enough to prevent this sort of scheme. Section 1201(3) defines an agreement to mean "the bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of

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[11] Peden, *Treatment of Equipment Leases As Security Agreements Under the Uniform Commercial Code*, 13 WM. & MARY L. REV. 110, 140 (1971): "The purpose of Article 9 would be frustrated if evidentiary rules could be used to shield sham transactions."; Note, *Leases as Security: Some Problems of Identification*, 8 B.C. IND. & COMM. L. REV. 764, 768 (1967): "Obviously sections 1-201(37) and 9-102(1)(a) and (2) look to an identification of actual intent regardless of form, and any exclusionary rule which would tend to inhibit the success of this inquiry must be regarded suspiciously."

[12] *See* Joseph E. Seagram & Sons, Inc. v. Shaffer, 310 F.2d 668, 673 (10th Cir. 1962); J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE § 2-8 (1972).

[13] *See* Corbin, *The Uniform Commercial Code — Sales; Should it be Enacted?*, 59 YALE L.J. 821, 829 (1950) (court enforcement of detailed formal requirements fosters dishonest repudiation without preventing fraud).

trade. . . ."[14] And, more importantly, section 1201(37) states that "[w]hether a lease is one intended as security is to be determined by the facts of each case. . . ."[15] This language has long been understood as requiring the court to inquire beyond the wording of the agreement in order to discover the true intention of parties who purported to be contracting for a lease.[16]

Quite possibly such a full inquiry would have disclosed to the court that Equitable Leasing possessed nothing more than a lessor interest even if the evidence of the alleged option had been admitted. Indeed, California Code section 1201(37) specifically states that the inclusion of an option to purchase in a lease agreement does not of itself give rise to a security interest. The court could have concluded that, option or no option, the agreement between Financial and Equitable was not one intended for security. Had the court reached that conclusion, it could have reversed the referee's decision on Equitable's second assignment of error — that it was incorrect to conclude that the lease was in reality a conditional sales agreement. The key to such a determination would have been an economic analysis of the alleged $1,094 option price. Section 1201(37) declares that "an agreement that upon the 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 [makes] the lease one intended for security." The $1,094 option price "is additional consideration"; the determination of whether or not it is nominal consideration depends on such factors as the fair market value of the air conditioning units at the beginning of the lease, the amount paid under the lease, and the market value of the units at the expiration of the lease.[17] Although numerous courts have used an economic

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[14] CAL. COMM. CODE § 1201(3) (West 1964); UNIFORM COMMERCIAL CODE § 1-201(3).

[15] CAL. COMM. CODE § 1201(37) (West 1964); UNIFORM COMMERCIAL CODE § 1-201(37).

[16] *E.g., In re* Walter W. Willis, Inc., 313 F. Supp. 1274, 1278 n.2 (N.D. Ohio 1970):

> One can argue that the Court's approach in viewing evidence outside the lease is violative of the parole evidence rule. . . . The Court disagrees. . . . [T]he provision reads that the facts in each case determine whether a lease is intended as security. To the Court, this implies that facts within and without the lease must be viewed in ascertaining the intent of the parties to the transaction.

See also In re Transcontinental Industries, Inc., 3 UCC REP. SERV. 235 (N.D. Ga. 1965).

[17] A recent California bankruptcy referee's decision, *In re* Washington Processing Co., 3 UCC REP. SERV. 475 (Ref. Dec. S.D. Cal. 1966), focused on the market value

analysis approach under similar circumstances,[18] the court in *Financial Computer Systems* did not make such a comparison, nor did it mention the market value of the air conditioning units at the time the alleged option could have been exercised.

Perhaps the court's decision in *Financial Computer Systems* resulted in the correct disposition of the disputed air conditioning units. However, in reaching this determination without the full analysis demanded by articles 1 and 9 of the California Commercial Code, the court has established a questionable precedent. Creditors may now be able to thwart a debtor's right to redeem his collateral by using an instrument purporting to be other than a security agreement and objecting to the introduction of external evidence to prove otherwise. Third-party creditors of the debtor, who have a right to look to his equity interests for satisfaction of their claims, will be unjustly denied access to the totality of those interests.

Ironically, this fraud would result from invoking a statute whose purpose was to prevent fraud. Further, the Article 2 statute of frauds is inapplicable in the context of security interests where an analysis of the economic facts of a lease/option agreement is essential if a court is to determine whether or not a security interest was intended. The chance of fraud is minimized where a court engages in a thorough probe; where it fails to do so, as in *Financial Computer Systems*, the chances of successful fraud are increased.

JOHN T. MULLIGAN

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at the expiration of the lease and concluded that an option price of $1,350 was "nominal consideration" for goods which at the time of the exercise of the option had a market value of nearly $10,000.

[18] One approach is market value analysis. As indicated by CAL. COMM. CODE § 1201(37) (West 1964), where the option price is nominal, the agreement most likely will be deemed a security device. *In re* Universal Medical Sources, 8 UCC REP. SERV. 614 (Ref. Dec. E.D. Pa. 1970); *In re* Oak Mfg., Inc., 6 UCC REP. SERV. 1273 (Ref. Dec. S.D.N.Y. 1969); *In re* Alpha Creamery Co., 4 UCC REP. SERV. 794 (Ref. Dec. W.D. Mich. 1967). On the other hand, if the option price were nearly equivalent to the market value at the time of the option, it would indicate that the lessee was actually paying true rent based on normal wear and tear plus an allowance for profit for the lessor. J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE § 22-3 (1972).

Under a second approach, if the option price amounts to more than 25 percent of the list price, the purported lease is not deemed a security interest. *In re* Alpha Creamery Co., 4 UCC REP. SERV. 794 (Ref. Dec. W.D. Mich. 1967); *In re* Wheatland Elec. Prods. Co., 237 F. Supp. 820 (W.D. Pa. 1964).

A third approach involves an analysis of the relationship of the actual rent paid and the fair rental value of the item. A lease will generally be upheld as a lease and not considered a sale if the actual rent paid does not exceed the fair rental value and if the lessee has the right to discontinue the lease and return the goods to the lessor. DeRocha v. Macomber, 330 Mass. 611, 116 N.E.2d 139 (1953).