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Is It a Sale or a Lease: The Implications of Article 2A and Revised U.C.C. Section 1-201(37) in North Carolina

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COMMENTS

IS IT A SALE OR A LEASE?: THE IMPLICATIONS OF ARTICLE 2A AND REVISED U.C.C. SECTION 1-201(37) IN NORTH CAROLINA

I. INTRODUCTION — WHAT IS ARTICLE 2A OF THE UNIFORM COMMERCIAL CODE?

Article 2A is the new Uniform Commercial Code (hereinafter referenced as "UCC") section on personal property leasing transactions. The American Law Institute and the National Conference of Commissioners on Uniform State Laws approved this new article and several corresponding amendments to Articles 1 and 9 in the early part of 1987.[1] Probably the most significant amendment to Article 1 was the change made to the definition of "security interest" in UCC section 1-201(37). Since the earlier version of section 1-201(37) had attempted to distinguish a security interest from a lease, the adoption of a new Article on personal property leases obviously required some amendment to the old definition of security interest.

Article 2A, which has five parts, contains sections on: (1) the formation and construction of the lease contract; (2) the effect of the lease contract on the lessee, lessor and creditors; (3) the performance of the lease contact, including repudiation, substitution and excuse; and (4) default by either the lessor or lessee and the appropriate remedies that will attach thereafter. This "comprehensive" treatment of personal property leases is a major change from the existing law, where "[l]eases of goods [were] almost ignored" by the UCC.[2] "Under present law, transactions of this type are governed partly by common law principles relating to personal property, partly by principles relating to real estate leases, and partly by reference to Articles 2 and 9 of the Uniform Commercial Code, dealing with Sales and Secured Transactions respectively."[3] "Although several portions of the Code have been amended, Article 2A is important because it represents the first successful effort to bring another body of

1. BOSS, *The History of Article 2A: A Lesson for Practitioner and Scholar Alike*, 39 ALA. L. REV. 575, 594 (1988).

2. COVINGTON, *The UCC has a New Article*, NCBA NOTES BEARING INTEREST, v. 7, no. 4, (Dec. 1987).

3. HAZARD, *Foreword* to U.C.C. Article 2A; 1987 Official Text of the UCC, compiled by Douglas G. Baird, COMMERCIAL AND DEBTOR-CREDITOR LAW: SELECTED STATUTES 1988 EDITION at 189 (Westbury, N.Y.: The Foundation Press, Inc., 1988).

commercial law within the scope of the UCC."[4]

Article 2A is also significant because it offers new uniform law to deal with an increasingly popular business format, the personal property leasing transaction. "The American Association of Equipment Lessors has reported that the worldwide leasing business grew from 100 billion dollars to 150 billion dollars in outstanding contracts in a span of only three years, from 1976 to 1979, and projected that by 1985 the figure would be 200 billion dollars worldwide."[5] In the United States, "[t]he volume of new equipment leases . . . rose steadily from 43.5 billion dollars in 1980 to an estimated 74.4 billion dollars in 1984" and "[t]oday, approximately twenty percent of all capital investment in the United States is directly attributable to equipment leasing, with over 310 billion dollars in lease receivables currently outstanding."[6] Since the number of and dollar amount involved with personal property leasing transactions continue to grow, statutory treatment of this transaction should be considered by all state legislatures. Several states have adopted and/or considered Article 2A,[7] and numerous authorities have praised the National Conference of Commissioners on Uniform State Laws and the American Law Institute's attempt to codify the law on personal property leases.[8]

These authorities also have started to interpret and criticize proposed Article 2A and the additional changes to the UCC that were made with the adoption of Article 2A. The state of North Carolina has preliminarily started this process,[9] but further review is necessary. One of the primary issues that must be discussed prior to the enactment of Article 2A in any

4. ALCES, *Surreptitious and Not-So-Surreptitious Adjustment of the UCC: An Introductory Essay*, 39 ALA. L. REV. 559, 560 (1988) (footnotes omitted). Professor Alces points out that the UCC has been amended, but no new provisions were added before the adoption of Article 2A. *id.* at 560, n. 4. For additional historical information on the UCC, see BOSS, *supra* note 1.

5. BOSS, *supra* note 1, at 577 (citations omitted).

6. *Id.* at 576-77 (citations omitted).

7. Article 2A has been adopted by Oklahoma, OKLA. STAT. tit. 12A, § 2A-101 *et seq.* (1988), and by California, Cal. Code § 10101 *et seq.* (Deering 1988). However, the California statute will not be effective until January 1, 1990. Similarly, the South Dakota legislature has recently adopted Article 2A, but will not make it effective until January 1, 1990. Telephone interview with Amelia H. Boss, author of Boss, *supra* note 1, and attorney with McCarter & English, Cherry Hill, N.J., (Apr. 3 1989). Article 2A has also been introduced into the legislatures of Connecticut, Massachusetts, Minnesota, New Hampshire, Washington, Colorado, Illinois, Rhode Island and Utah BOSS *supra* note 1 at 599 n 89. Lawmakers in Delaware have introduced the proposed statute to their legislature as well. HUDDLESON, *Old Wine in New Bottles: UCC Article 2A — Leases*, 39 ALA. L. REV. 615, 618, n 5 (1988). In North Carolina, the North Carolina Bar Association UCC/Consumer Credit Committee has recently considered Article 2A for North Carolina. COVINGTON, *supra* note 2, at 9.

8. BOSS, *supra* note 1; Alces, *supra* note 4; HUDDLESON, *supra* note 7; HARRIS, *The Rights of Creditors Under Article 2A*, 39 ALA. L. REV. 803 (1988); RAPSON, *Deficiencies and Ambiguities in Lessors' Remedies Under Article 2A: Using Official Comments to Cure Problems in the Statute*, 39 ALA. L. REV. 875 (1988); BENFIELD, *Lessor's Damages Under Article 2A After Default by the Lessee as to Accepted Goods*, 39 ALA. L. REV. 915 (1988); and MILLER, *Leases of Goods in Oklahoma: The New Rules*, 41 OKLA. L. REV. 417 (1988).

9. COVINGTON, *supra* note 2, at 9.

state is the changes made to section 1-201(37). This will be the focus of my study. The specific provisions of Article 2A are worthy of extensive review, but if the contract is considered a sale rather than a lease, Article 2A will not apply. One cannot determine whether the personal property transaction is a sale or lease without consulting UCC section 1-201(37) in North Carolina; therefore, a review of the old and new definitions of security interest in section 1-201(37) as well as the voluminous case law that has arisen around the old definition represents a good beginning for any discussion of proposed Article 2A.

II. WHAT CHANGES WERE MADE IN UCC SECTION 1-201(37)?

The older version of UCC section 1-201(37), which was adopted verbatim in North Carolina and is still in effect, says that

> "Security interest" means an interest in personal property or fixtures which secures payment or performance of an obligation. . . . Unless a lease or consignment is intended as security, reservation of title thereunder is not a "security interest" . . . . 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.[10]

This statute attempts to distinguish between two types of leases: (1) true leases and (2) leases which are actually security interests. A lease can be considered a security interest because, under section 9-102(1)(a), Article 9 of the UCC applies "to any transaction (regardless of its form) which is intended to create a security interest in personal property . . . ."[11] If the lease is a security interest, problems can arise for the lessor/creditor. One of the main problems occurs when the lessee/debtor files bankruptcy and the lessor/creditor attempts to reclaim the property free of any interest in the debtor. Obviously, the trustee in bankruptcy and other third party creditors will object to this reclamation when the lease actually looks as much like a secured sale as a lease. Lessors are at a great disadvantage if they have not filed a financing statement and the court decides that the lease is actually a security interest. In this case the security interest is unperfected and will consequently lack priority.

The old section 1-201(37) definition tries to resolve this conflict between a sale and a lease with four basic comments:

> (1) For a lease to be a security interest, the parties must "intend" for the lease to be a security interest;

10. N.C. GEN. STAT. § 25-1-201(37) (1988).
11. N.C. GEN. STAT. § 25-9-102(1)(2) (1988).

(2) The intention of the parties will be determined by the facts of each case;

(3) The mere fact that the lease includes an option to purchase does not make the lease a security interest; and

(4) If the lease permits the lessee to purchase the property for nominal or no additional consideration, the lease will be considered one for security.

These comments have been little help to the attorneys practicing commercial law and the courts resolving issues regarding the sale/lease distinction. The problems that this definition has created are numerous. First, the lack of "detail" in this attempt to distinguish between a security interest and a lease, "and the notion that they are, in fact, different from one another," is simply confusing.[12] Second, the definition in section 1-201(37) is

> imperfect . . .[because] it fails to eliminate areas of uncertainty, [including] (1) when the lease term substantially equals the expected useful life of the property, and (2) when there is a "full pay-out lease" (i.e., when the rent reserved is substantially equal to the cash price of the chattel plus an amount equivalent to interest until the price will be paid as rent).[13]

Third, the court's focus on the party's intention "has resulted in a 'laundry list' of considerations repeatedly cited as indications of an intention that a lease is a secured transaction;"[14] furthermore, "[t]he application of any standard based on the intent of the parties, even with the best supplemental guidelines, is likely to be troublesome."[15] Frequent complaints like this led to the adoption of a revised section 1-201(37).

The new section 1-201(37) is significantly more detailed than the earlier version. In regard to leases, the new section 1-201(37) states that

> Whether a transaction creates a lease or security interest is determined by the facts of each case; however, 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

12. AYER, *On the Vacuity of the Sale/Lease Distinction*, 68 IOWA L. REV. 667, 669 (1983).

13. KRIPKE, *Some Dissonant Notes About Article 2A*, 39 ALA. L. REV. 791, 797-98 (1988).

14. MOONEY, *Personal Property Leasing: A Challenge*, 36 BUS. LAW. 1605, 1612 (1981).

15. COOGAN, *Leases of Equipment and Some Other Unconventional Security Devices: An Analysis of UCC Section 1-201(37) and Article 9*, 1973 DUKE L. J. 909, 916 (1973).

(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.

A transaction does not create a security interest merely because it provides that

(a) the present value of the consideration the lessee is obligated to pay the lessor for the right to possession and use of the goods is substantially equal to or is greater than the fair market value of the goods at the time the lease is entered into,

(b) the lessee assumes risk of loss of the goods, or agrees to pay taxes, insurance, filing, recording, or registration fees, or service or maintenance costs with respect to the goods,

(c) the lessee has an option to renew the lease or to become the owner of the goods,

(d) the lessee has an option to renew the lease for a fixed rent that is equal to or greater than the reasonably predictable fair market rent for the use of the goods for the term of the renewal at the time the option is to be performed, or

(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.

For purposes of this subsection (37):

(x) Additional consideration is not nominal (i) when the option to renew the lease is granted to the lessee the rent is stated to be the fair market rent for the use of the goods for the term of the renewal determined at the time the option is to be performed, or (ii) when the option to become the owner of the goods is granted to the lessee the price is stated to be the fair market value of the goods determined at the time the option is to be performed. Additional consideration is nominal if it is less than the lessee's reasonably predictable cost of performing under the lease agreement if the option is not exercised;

(y) "Reasonably predictable" and "remaining economic life of the goods" are to be determined with reference to the facts and circumstances at the time the transaction is entered into; and

(z) "Present value" means the amount as of a date certain of one or more sums payable in the future, discounted to the date certain. The discount is determined by the interest rate specified by the parties if the rate is not manifestly unreasonable at the time the transaction is entered into; otherwise, the discount is determined by a commercially reasonable rate that takes into account the facts and circumstances of each case at the time the transaction was entered into.[16]

Although new section 1-201 (37) will not resolve every issue regarding the sale/lease distinction, some would argue that it "represents the best thinking of many lawyers and scholars who are familiar not only with the

16. UCC § 1-201 (37) (1987).

cases . . . but also with the current practices."[17]

Other than the increased detail, the most noticeable change in section 1-201 (37) is the deletion of "all reference to the 'parties' intent."[18] The drafters of new section 1-201(37) recognized that "[r]eference to the intent of the parties to create a lease or security interest ha[d] led to unfortunate results;"[19] furthermore, the Official Comments state that "[i]n discovering intent [under the old version of section 1-201 (37)], courts have relied upon factors that were thought to be more consistent with sales or loans."[20] These factors developed into the laundry list discussed above;[21] however, "[m]ost of these criteria . . . are as applicable to true leases as to security interests."[22] Wisely, the drafters of amended section 1-201(37) eliminated the reference to "intent" with the hopes of terminating the use of the laundry list of factors and the unfortunate results" the factors caused.

Instead of a somewhat arbitrary laundry list, new section 1-201 (37) creates an improved schedule of guiding principles. Initially, the statute says that "the facts of each case" will be determinative, which reminds the reader that the drafters did not intend to create an "overly rigid definition woodenly resolving every imaginable case."[23] Thereafter, the statute shows that there are "four red flags" to look for when trying to determine if a lease is actually a security interest.[24] If any one of the "red flags" exists, the lease is a security interest.

> These four red flags include an initial lease term substantially parallel to the property's remaining economic life, a nominal option to renew the lease for the property's remaining economic life, a nominal purchase option, and whether 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.[25]

Furthermore, new section 1-201(37) offers the commercial law attorneys and courts several helpful comments by defining when additional consideration is or is not nominal and by stating that the "remaining economic life of the goods" is "to be determined with reference to the facts and circumstances at the time the transaction is entered into." By offering "four red flags" to distinguish between a lease and a security interest, some clarifying definitions, and a flexible factual premise, the drafters of

17. WHITE & SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE (3d ed. 1988).

18. UCC § 1-201 (37) Official Comment, (1987).

19. *Id.*

20. *Id.*

21. MOONEY, *supra* note 14, at 1612 and the official comment accompanying text.

22. UCC § 1-201 (37), Official Comment (1987).

23. HUDDLESON, *supra* note 7 at 626.

24. BURNS, *Uniform Commercial Code, Public Filing and Personal Property Leases: Questions of Definition and Doctrine*, 22 WAKE FOREST L. REV. 425, 477 (1987).

25. *Id.* (footnotes omitted).

new section 1-201 (37) have drastically improved the definition of "security interest" in the UCC.

To further eradicate some of the ambiguities that existed under old section 1-201(37), the drafters stated that the mere inclusion of any one of five different factors would not make the lease a security interest. These five factors were sometimes included in the laundry list as determinative of a security interest. The factors include a clarification of the effect of options and the present value of the option on the sale/lease determination and the effect of the lessee agreeing to take certain risks and obligations in the lease on the sale/lease determination. Additionally, amended section 1-201 (37) includes a definition of "present value" and a comment stating that the term "reasonably predictable" is "to be determined with reference to the facts and circumstances at the time the transaction is entered into," which provides some additional guidelines to use when reviewing these five factors. These factors and their definitional aids further help deter the problematical laundry list approach.

Furthermore, the definition of "security interest" in new section 1-201 (37) should be analyzed with reference to the definition of "lease" in section 2A-103 (1) (j), where the statute says that a " '[l]ease' means 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." This definition of "lease" attempts to define a lease by referring to the definitions of "sale" in section 2-106 (1) and "security interest" in section 1-201 (37). The definition of "security interest" in new section 1-201 (37) reflects the "old common law touchstone of a true lease — the lessor's meaningful residual interest."[26] "[B]y elaborating upon common-law principles in the amendment to section 1-201 (37), 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."[27]

In sum, amended section 1-201 (37) is a great improvement over its predecessor. "The draftsmen have correctly focused on the meaningful residual analysis as their underlying premise in drawing the security interest line of demarcation;"[28] furthermore, the expanded definition of "security interest" provides some necessary guidelines that did not exist under the old definition. The drafters noticed the significant problems that existed under the old version of section 1-201 (37) and tried to solve the problems with clear and defined language.

26. HUDDLESON, *supra* note 7, at 626; *See* BURNS, *supra* note 22, at 476-77.

27. HUDDLESON, *supra* note 7, at 626. However, in a footnote to this quote, Huddleson points out that the comments to the new UCC § 1-201 (37) say that "[a]n examination of the common law will not provide an adequate answer to the question of what is a lease." *See id.* at 626, n. 27.

28. BURNS, *supra* note 24, at 477.

The statute reflects a sincere effort to review and understand the voluminous case law that arose on the issue: Is it a sale or a lease? The old and new definition of "security interest" cannot be fully understood without a review of this case law; therefore, one must move forward to the cases in order to truly determine if amended section 1-201 (37), and its founding father, Article 2A, are worthy of adoption in North Carolina.

III. THE CASE LAW OF JURISDICTIONS OTHER THAN NORTH CAROLINA

A. *The "Laundry List" Cases*

Since the appellate courts in North Carolina have had few opportunities to distinguish a sale from a lease, the problems inherent in the old version of section 1-201 (37) are easier to show through a review of the case law in other jurisdictions. The cases in other jurisdictions clearly show that the focus on a "laundry list" of factors to determine the parties' intent can be arbitrary and confusing. The new section 1-201 (37) hopefully deletes this problem by refusing to include the parties' intent as a factor in distinguishing a security interest from a lease.

One of the first cases to use a "laundry list" of factors was *In the Matter of Brookside Drug Store, Inc.*,[29] where Bankruptcy Judge Krechevsky developed a list of sixteen factors to use when trying to determine whether a lease agreement is a security interest. *In Re Brookside Drug Store, Inc.*, the lessor of two cash registers brought an action to reclaim the leased property from a debtor who had filed a Chapter XI bankruptcy proceeding. In determining that the lease was actually a security agreement, Bankruptcy Judge Krechevsky began by noting that the parties' intention would determine whether the lease was, in fact, a security;[30] furthermore, he said the "[d]etermination of whether or not a lease is intended as security must be in accordance with the terms of the definition of a security interest found in UCC section 1-201 (37)."[31] Based upon his review of twelve cases,[32] Bankruptcy Judge Krechevsky concluded that

> a combination of some of the following factors [could be used] to determine that the lease agreement provided for a hidden security interest: (1) whether there was an option to purchase for a nominal sum, (2) whether there was a provision in the lease granting the lessee an equity or property interest in the equipment, (3) whether the nature of the lessor's business was to act as a financing agency, (4) whether the lessee paid a sales

29. 3 Bankr. 120, 122-123 (D. Conn. 1980).

30. *Id.* at 121-122.

31. *Id.* (App. 1986); at 122 (citations omitted).

32. *Id.*, at 122. Bankruptcy Judge Krechevsky cited twelve cases in footnote 2 that he used in developing his sixteen factors for distinguishing a lease from a security interest.

> tax incident to acquisition of the equipment, (5) whether the lessee paid all other taxes incident to ownership of the equipment, (6) whether the lessee was responsible for comprehensive insurance on the equipment, (7) whether the lessee was required to pay any and all license fees for operation of the equipment, and to maintain the equipment at his expense, (8) whether the agreement placed the entire risk of loss upon the lessee, (9) whether the agreement included a clause permitting the lessor to accelerate the payment of rent upon default of the lessee and granted remedies similar to those of a mortgagee, (10) whether the equipment subject to the agreement was selected by the lessee and purchased by the lessor for this specific lessee, (11) whether the lessee was required to pay a substantial security deposit in order to obtain the equipment, (12) whether the agreement required the lessee to join the lessor, or permit the lessor by himself, to execute a UCC financing statement, (13) whether there was a default provision in the lease inordinately favorable to the lessor, (14) whether there was a provision in the lease for liquidated damages, (15) whether there was a provision disclaiming warranties of fitness and/or merchantability on the part of the lessor, (16) whether the aggregate rentals approximate the value or purchase price of the equipment.[33]

Bankruptcy Judge Krechevsky applied these sixteen factors to the facts and determined that a security interest, rather than a lease, had been created. The Judge found that the lessee bore the responsibility of insurance, risk of loss, maintenance, tax and license fees, and the lessor disclaimed all warranties, could accelerate upon default, and could file a financing statement;[34] therefore, the lessor was unable to reclaim the cash registers because he had not perfected his security interest in accordance with Article 9. Numerous courts have cited *Brookside Drug Store* as authority for some or all of its sixteen factors.[35]

B. *The Problems with the "Laundry List" Approach*

The factors applied by the court in *Brookside Drug Store* can help show the existence of a disguised security interest. Other courts have applied similar factors to determine whether a lease is a security interest;[36] however, these factors are less than perfect. Some of the indicia of a security interest are almost as common in leasing agreements as they are in security agreements. For this reason, the courts are able to apply the factors very often. Yet, this does not make the factors valid indicators of

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33. *Id.* at 122-123.

34. *Id.* at 123.

35. *In re Rex Group, Inc.*, 80 Bankr. 774, 779 (E.D. Va. 1987); *In re Standard Fin. Management Corp.*, 79 Bankr. 100, 101-102 (D. Mass. 1987); *In re Mariner Communications, Inc.*, 76 Bankr. 242, 245 (D. Mass. 1987); *In re P.W.L. Investments*, 92 Bankr. 680, 684-85 (W.D. Tex. 1987); *In re Access Equipment, Inc.*, 62 Bankr. 642, 646-47 (D. Mass. 1986); *In re* Puckett, 60 Bankr. 223, 236-240 (M.D. Tenn. 1986); *In re Sprecher Bros. Livestock & Grain, Ltd.*, 58 Bankr. 408, 414 (D.S.D. 1986); and *In re Catamount Dyers, Inc.*, 43 Bankr. 564, 567 (D. Vt. 1984).

36. *See infra* notes 37, 41, 42, 44, 46, 47, 49, 52 and 53.

a security interest. Nine of the factors applied in *Brookside Drug Store* are particularly weak indicators of a security interest.

(1) Lessor as Financing Agency[37]

Bankruptcy Judge Krechevsky's third factor, regarding "whether the nature of the lessor's business was to act as a financing agency,"[38] is a prime example of a factor that should not be used to determine whether a lease is a security agreement. "The fact that the lessor is a financial institution should have no bearing on the nature of the underlying transaction if it has corporate authority to engage in leasing."[39] Simply because the lessor uses more financing agreements than leasing agreements is no reason to take his equity in the property away after the lessee has breached the agreement.[40] If a financing institution offers a leasing arrangement to a lessee/purchaser, the lessee/purchaser should become suspicious and question why he is not being offered a sales agreement. The failure to question the obvious distinction should not disadvantage the lessor, especially since most of these cases deal with sophisticated business parties. Lessors should not be penalized when they occasionally offer leasing options to their clientele.

(2) Who pays the taxes?[41]

Under constantly changing federal, state and local tax schemes, a les-

37. The courts that have applied or discussed this factor as helpful in distinguishing a sale from a lease include: *In Re Brookside Drug Store, Inc.*, 3 Bankr. 120 (D. Conn. 1980); *In re Falk Farms, Inc.*, 88 Bankr. 254 (Bkrtcy. 9th Cir. 1988); *In re Standard Financial Management Corp.*, 79 Bankr. 100 (D. Mass. 1987); *In re Brown*, 82 Bankr. 68 (W.D. Ark. 1987); *In re Mariner Communications*, 76 Bankr. 242 (D. Mass. 1987); Colonial Leasing Co. of New England, Inc. v. Larsen Bros. Constr. Co., 731 P.2d 483 (Utah 1986); *In re Access Equip., Inc.*, 62 Bankr. 642 (D. Mass. 1986); *In re Puckett*, 60 Bankr. 223 (M.D. Tenn.1986); United Leaseshares, Inc. v. Citizens Bank & Trust Co., 470 N.E.2d 1383 (Ind. Ct. App. 1984); *In re Catamount Dyers, Inc.*, 43 Bankr. 564 (D. Vt. 1984); and *In re Marhoefer Packing Co., Inc.*, 674 F.2d 1139 (7th Cir. 1982).

38. *In re* Brookside Drug Store, 3 Bankr. 120, 122 (D. Conn. 1980).

39. LEARY, *The Procrustean Bed of Finance Leasing*, 56 N.Y.U. L. REV. 1061, 1073-74 (1981).

40. The author recognizes that a litigant taking this position may encounter problems with UCC 1-205 (1987).

41. The courts that have applied or discussed this factor as helpful in distinguishing a sale from a lease include: *In re Brookside Drug Store, Inc.*, 3 Bankr. 120 (D. Conn. 1980); *In re Baker*, 91 Bankr. 426 (N.D. Ohio 1988); *In re Falk Farms, Inc.*, 88 Bankr. 254 (9th Cir. 1988); *In re Rex Group, Inc.*, 80 Bankr. 774 (E.D. Va. 1987); *In re Standard Fin. Management Corp.*, 79 Bankr. 100 (D. Mass. 1987); Morris v. Lyons Capitol Resources, Inc., 510 N.E.2d 221 (Ind. Ct. App. 1987); *In re Triple B Oil Producers, Inc.*, 75 Bankr. 461 (S.D. Ill. 1987); *In re Brown*, 82 Bankr. 68 (W.D. Ark. 1987); *In re Mariner Communications*, 76 Bankr. 242 (D. Mass. 1987); *In re P.W.L. Investments*, 92 Bankr. 680 (W.D. Tex. 1987); *In re Beker Indus. Corp.*, 69 Bankr. 937 (Bkrtcy.S.D.N.Y. 1987); Colorado Leasing Corp. v. Borquez, 738 P.2d 377 (Colo. App. 1986); H.M.O. Systems, Inc. v. Choicecare Health Services, 665 P.2d 635 (Colo. App. 1983); Lease Finance, Inc. v. Burger, 575 P.2d 857 (Colo. App. 1977); Colonial Leasing Co. of New England, Inc. v. Larsen Bros. Constr. Co., 731 P.2d 483 (Utah 1986); *In re Access Equip., Inc.*, 62 Bankr. 642 (D. Mass. 1986); Burton Compressor Corp. v. Stateline Forest Products, 79 Or. App. 626, 720 P.2d 386 (1986); *In re Puckett*, 60 Bankr. 223 (M.D. Tenn. 1986); *In re Sprecher Bros. Livestock & Grain, Ltd.*, 58 Bankr. 408 (D.

sor may have numerous reasons for allocating some tax burdens upon a lessee. The local, state and/or federal tax obligations placed upon a lessor in a given year can be somewhat complicated; therefore, the complications inherent in taxing make the decision of allocating the tax burden upon the lessee instead of the lessor merely a matter of contract negotiation. Both the lessor and the lessee may agree that it is best for both parties when the lessee assumes a particular taxing obligation. By assuming the taxing obligation, the lessee may be reducing his monthly rental. Since the decision regarding who will pay the taxes is simply a matter of contract negotiation, it should not be a factor in determining whether the lease is a security agreement.

(3) Who pays insurance and accepts risk of loss?[42]

Similarly, a lessor and lessee may legitimately bargain over the insurance and risk of loss obligations imposed upon one owning or leasing personal property. "[R]isk of loss is an allocation by contract of the cost of procuring insurance, and not an indicator of the nature of the transaction."[43] By contract, whether it is a leasing contract or a financing contract, either party can agree to be responsible for risk of loss or for insurance. If the lessee is responsible for either risk of loss or insurance, the monthly payments or the monthly rentals are reduced; therefore, the sixth and the eighth factors in *Brookside Drug Store* are weak factors for determining the sale/lease distinction.

S.D. 1986); Mejia v. Citizens & Southern Bank, 175 Ga. App. 80, 332 S.E.2d 170 (1985); McEntire v. Indiana Nat'l Bank, 471 N.E.2d 1216 (Ind. Ct. App 1984); United Leaseshares, Inc. v. Citizens Bank & Trust Co., 470 N.E.2d 1383 (Ind. Ct. App. 1984); *In re Catamount Dyers, Inc.*, 43 Bankr. 564 (D. Vt. 1984); and *In re of Marhoefer Packing Co., Inc.*, 674 F.2d 1139 (7th Cir. 1982).

42. The courts that have applied or discussed this factor as helpful in distinguishing a sale from a lease include: *In re Brookside Drug Store, Inc.*, 3 Bankr. 120 (D. Conn. 1980); *In re Baker*, 91 Bankr. 426 (N.D. Ohio 1988); *In re Falk Farms, Inc.*, 88 Bankr. 254 (9th Cir. 1988); *In re Rex Group, Inc.*, 80 Bankr. 774 (E.D. Va. 1987); *In re Standard Fin. Management Corp.*, 79 Bankr. 100 (D. Mass. 1987); Morris v. Lyons Capitol Resources, Inc., 510 N.E.2d 221 (Ind. Ct. App. 1987); *In re Triple B Oil Producers, Inc.*, 75 Bankr. 461 (S.D. Ill. 1987); *In re Brown*, 82 Bankr. 68 (W.D. Ark. 1987); *In re Mariner Communications*, 76 Bankr. 242 (D. Mass. 1987); *In re P.W.L. Investments*, 92 Bankr. 680 (W.D. Tex. 1987); *In re Beker Indus. Corp.*, 69 Bankr. 937 (Bkrtcy.S.D.N.Y. 1987); Colorado Leasing Corp. v. Borquez, 738 P.2d 377 (Colo. App. 1986); H.M.O. Systems, Inc. v. Choicecare Health Services, 665 P.2d 635 (Colo. App. 1983); Lease Finance, Inc. v. Burger, 575 P.2d 857 (Colo. App. 1977); Colonial Leasing Co. of New England, Inc. v. Larsen Bros. Constr. Co., 731 P.2d 483 (Utah 1986); *In re Huffman*, 63 Bankr. 737 (N.D. Ga. 1986); *In re Access Equip., Inc.*, 62 Bankr. 642 (D. Mass. 1986); Burton Compressor Corp. v. Stateline Forest Products, 79 Or. App. 626, 720 P.2d 386 (1986); *In re Puckett*, 60 Bankr. 223 (M.D. Tenn. 1986); Mejia v. Citizens & Southern Bank, 175 Ga. App. 80, 332 S.E.2d 170 (1985); McEntire v. Indiana Nat'l Bank, 471 N.E.2d 1216 (Ind. Ct. App. 1984); United Leaseshares, Inc. v. Citizens Bank & Trust Co., 470 N.E.2d 1383 (Ind. Ct. App. 1984); *In re Catamount Dyers, Inc.*, 43 Bankr. 564 (D. Vt. 1984); and *In re Marhoefer Packing Co., Inc.*, 674 F.2d 1139 (7th Cir. 1982).

43. LEARY, *supra* note 39, at 1072-73.

(4) Licensing and Maintenance Fees[44]

Deciding who will be responsible for licensing and maintenance of the property represents two further matters for contract negotiation. In many situations, it will simply be more convenient for the lessee to procure the proper license for the personal property as well as maintain the property; moreover, it seems only logical that the lessee have at least a partial duty to maintain any property that he leases. As one commentator noted, placing the responsibility for maintenance upon the lessee "is a cost allocation bargained for on the basis of efficiency and convenience, not on whether the transaction is a lease or sale;"[45] therefore, if the lessee agrees to pay for licensing and maintenance fees, the lessor should not suffer upon lessee's default.

(5) Acceleration Clauses[46]

The courts also use the existence of an acceleration clause as evidence of a security agreement; however, the existence of an acceleration clause does not adequately help distinguish a lease from a sale. In fact, real property leasing agreements sometimes contain acceleration clauses, but this does not make the real property leasing agreement a mortgage. The ability to accelerate rental payments upon default protects the lessor and does not create a disguised security agreement.

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44. The courts that have applied or discussed this factor as helpful in distinguishing a sale from a lease include: *In re Brookside Drug Store, Inc.*, 3 Bankr. 120 (D. Conn. 1980); *In re Baker, 91 Bankr. 426 (N.D. Ohio 1988); In re Rex Group, Inc.*, 80 Bankr. 774 (E.D. Va. 1987); *In re Standard Fin. Management Corp.*, 79 Bankr. 100 (D. Mass. 1987); *In re Triple B Oil Producers, Inc.*, 75 Bankr. 461 (S.D. Ill. 1987); *In re Mariner Communications*, 76 Bankr. 242 (D. Mass. 1987); *In re Access Equip., Inc.*, 62 Bankr. 642 (D. Mass. 1986); Burton Compressor Corp. v. Stateline Forest Products, 79 Or. App. 626, 720 P.2d 386 (1986); *In re Puckett*, 60 Bankr. 223 (M.D. Tenn. 1986); Mejia v. Citizens & Southern Bank, 175 Ga. App. 80, 332 S.E.2d 170 (1985); United Leaseshares, Inc. v. Citizens Bank & Trust Co., 470 N.E.2d 1383 (Ind. Ct. App. 1984); *In re Catamount Dyers, Inc.*, 43 Bankr. 564 (D. Vt. 1984); and *In re Marhoefer Packing Co., Inc.*, 674 F.2d 1139 (7th Cir. 1982).

45. LEARY, *supra* note 39, at 1073.

46. The courts that have applied or discussed this factor as helpful in distinguishing a sale from a lease include: *In re Brookside Drug Store, Inc.*, 3 Bankr. 120 (D. Conn. 1980); *In re Falk Farms, Inc.*, 88 Bankr. 254 (9th Cir. 1988); *In re Rex Group, Inc.*, 80 Bankr. 774 (E.D. Va. 1987); *In re Standard Fin. Management Corp.*, 79 Bankr. 100 (D. Mass. 1987); *In re Brown*, 82 Bankr. 68 (W.D. Ark. 1987); *In re Mariner Communications*, 76 Bankr. 242 (D. Mass. 1987); *In re Beker Indus. Corp.*, 69 Bankr. 937 (Bkrtcy.S.D.N.Y. 1987); Colorado Leasing Corp. v. Borquez, 738 P.2d 377 (Colo. App. 1986); H.M.O. Systems, Inc. v. Choicecare Health Services, 665 P.2d 635 (Colo. App. 1983); Lease Finance, Inc. v. Burger, 575 P.2d 857 (Colo. App. 1977); Colonial Leasing Co. of New England, Inc. v. Larsen Bros. Constr. Co., 731 P.2d 483 (Utah 1986); *In re Access Equip., Inc.*, 62 Bankr. 642 (D. Mass. 1986); Burton Compressor Corp. v. Stateline Forest Products, 79 Or. App. 626, 720 P.2d 386 (1986); *In re Sprecher Bros. Livestock & Grain, Ltd.*, 58 Bankr. 408 (D. S.D. 1986); McEntire v. Indiana Nat'l Bank, 471 N.E.2d 1216 (Ind. Ct. App. 1984); and *In re Catamount Dyers, Inc.*, 43 Bankr. 564 (D. Vt. 1984).

(6) Who selected and purchased the property?[47]

Bankruptcy Judge Krechevsky states that his tenth factor to use when distinguishing a sale from a lease as "whether the equipment subject to the agreement was selected by the lessee and purchased by the lessor for this specific lessee."[48] One can easily imagine a lessor agreeing to purchase equipment for a particular lessee with the intention of selling the used property at the end of the lease term to the highest bidder. The application of this factor penalizes the lessor who is a prudent investor and who is willing to purchase specific property, lease that property to a specific party, and sell the property to the highest bidder at the end of the lease term. This is an advantage of a leasing agreement over a sales agreements, and a lessor should not automatically lose after choosing this advantage of the leasing agreement.

(7) Security Deposits[49]

The eleventh factor of Bankruptcy Judge Krechevsky, regarding security deposits, "is probably listed because of its resemblance to a 'down payment' in a time-sales transaction;"[50] however, "it is a very customary provision in real estate leases.[51] Similarly, the parties may agree to a security deposit under a personal property lease to protect the lessor's interest in the property or reduce the monthly leasing payments; there-

47. The courts that have applied or discussed this factor as helpful in distinguishing a sale from a lease include: *In re Brookside Drug Store, Inc.*, 3 Bankr. 120 (D. Conn. 1980); *In re Falk Farms, Inc.*, 88 Bankr. 254 (9th Cir. 1988); *In re Rex Group, Inc.*, 80 Bankr. 774 (E.D. Va. 1987); *In re Standard Fin. Management Corp.*, 79 Bankr. 100 (D. Mass. 1987); Morris v. Lyons Capitol Resources, Inc., 510 N.E.2d 221 (Ind. Ct. App. 1987); *In re Mariner Communications*, 76 Bankr. 242 (D. Mass. 1987); *In re P.W.L. Investments*, 92 Bankr. 680 (W.D. Tex. 1987); *In re Beker Indus. Corp.*, 69 Bankr. 937 (Bkrtcy.S.D.N.Y. 1987); Colorado Leasing Corp. v. Borquez, 738 P.2d 377 (Colo. App. 1986); H.M.O. Systems, Inc. v. Choicecare Health Services, 665 P.2d 635 (Colo. App. 1983); Lease Finance, Inc. v. Burger, 575 P.2d 857 (Colo. App. 1977); Colonial Leasing Co. of New England, Inc. v. Larsen Bros. Constr. Co., 731 P.2d 483 (Utah 1986); *In re Access Equip., Inc.*, 62 Bankr. 642 (D. Mass. 1986); Burton Compressor Corp. v. Stateline Forest Products, 79 Or. App. 626, 720 P.2d 386 (1986); *In re Puckett*, 60 Bankr. 223 (M.D. Tenn. 1986); and McEntire v. Indiana Nat'l Bank, 471 N.E.2d 1216 (Ind. Ct. App. 1984).

48. *In re Brookside Drug Store, Inc.*, 3 Bankr. at 123.

49. The courts that have applied or discussed this factor as helpful in distinguishing a sale from a lease include: *In re Brookside Drug Store, Inc.*, 3 Bankr. 120 (D. Conn. 1980); *In re Baker*, 91 Bankr. 426 (N.D. Ohio 1988); Woods v. General Electric Credit Auto Lease, Inc., 369 S.E.2d 334, 187 Ga. App. 57 (1988); *In re Standard Fin. Management Corp.*, 79 Bankr. 100 (D. Mass. 1987); *In re Mariner Communications*, 76 Bankr. 242 (D. Mass. 1987); *In re P.W.L. Investments*, 92 Bankr. 680 (W.D. Tex. 1987); *In re Beker Indus. Corp.*, 69 Bankr. 937 (Bkrtcy.S.D.N.Y. 1987); Colonial Leasing Co. of New England, Inc. v. Larsen Bros. Constr. Co., 731 P.2d 483 (Utah 1986); *In re Access Equip., Inc.*, 62 Bankr. 642 (D. Mass. 1986); *In re Puckett*, 60 Bankr. 223 (M.D. Tenn. 1986); *In re Sprecher Bros. Livestock & Grain, Ltd.*, 58 Bankr. 408 (D. S.D. 1986); and *In re Catamount Dyers, Inc.*, 43 Bankr. 564 (D. Vt. 1984).

50. LEARY, *supra* note 39, at 1075.

51. *Id.*

fore, the existence of a security deposit should not indicate an intention to create a security agreement.

(8) Was a UCC financing statement filed?[52]

Another example of problems created by Bankruptcy Judge Krechevsky's "laundry list" is found in his twelfth factor, where he said that the filing of a UCC financing statement indicated an intention to create a security agreement. UCC section 9-408, which permits a lessor to file a financing statement, says "filing shall not of itself be a factor in determining whether or not the . . . lease is intended as security (Section 1-201(37))." Section 9-408 shows the obvious weakness in Bankruptcy Judge Krechevsky's twelfth factor and proves that this factor does not reflect the true intent of the UCC.

(9) Disclaimer of Warranties[53]

If a lessor and lessee agree that the lessor will disclaim all warranties under the leasing agreement, the two parties are simply deciding a matter of contract negotiation. "A disclaimer by a lessor is only the shifting of any potential losses to the supplier" and "[i]t offers no aid to classification;"[54] therefore, the existence of a disclaimer should not evidence an intent to create a security interest.

In sum, there are numerous problem areas in the "laundry list" of factors created by Bankruptcy Judge Krechevsky in *Brookside Drug Store* and used by other courts in varying forms. These problems lead to one simple conclusion: "Reference to the intent of the parties to create a lease or security interest has led to unfortunate results."[55] The best way

52. The courts that have applied or discussed this factor as helpful in distinguishing a sale from a lease include: *In re Brookside Drug Store, Inc.*, 3 Bankr. 120 (D. Conn. 1980); Woods v. General Electric Credit Auto Lease, Inc., 369 S.E.2d 334, 187 Ga.App. 57 (1988); *In re Standard Fin. Management Corp.*, 79 Bankr. 100 (D. Mass. 1987); *In re Brown*, 82 Bankr. 68 (W.D. Ark. 1987); *In re Mariner Communications*, 76 Bankr. 242 (D. Mass. 1987); *In re P.W.L. Investments*, 92 Bankr. 680 (W.D. Tex. 1987); *In re Access Equip., Inc.*, 62 Bankr. 642 (D. Mass. 1986); Mejia v. Citizens & Southern Bank, 175 Ga. App. 80, 332 S.E.2d 170 (1985); and *In re Catamount Dyers, Inc.*, 43 Bankr. 564 (D. Vt. 1984).

53. The courts that have applied or discussed this factor as helpful in distinguishing a sale from a lease include: *In re Brookside Drug Store, Inc.*, 3 Bankr. 120 (D. Conn. 1980); *In re Rex Group, Inc.*, 80 Bankr. 774 (E.D. Va. 1987); *In re P.W.L. Investments*, 92 Bankr. 680 (W.D. Tex. 1987); Colonial Leasing Co. of New England, Inc. v. Larsen Bros. Constr. Co., 731 P.2d 483 (Utah 1986); Colorado Leasing Corp. v. Borquez, 738 P.2d 377 (Colo. App. 1986) H.M.O. Systems, Inc. v. Choicecare Health Services, 665 P.2d 635 (Colo. App. 1983); Lease Finance, Inc. v. Burger, 575 P.2d 857 (Colo. App. 1977); *In re Standard Fin. Management Corp.*, 79 Bankr. 100 (D. Mass. 1987); *In re Mariner Communications*, 76 Bankr. 242 (D. Mass. 1987); *In re Access Equip., Inc.*, 62 Bankr. 642 (D. Mass. 1986); *In re Puckett*, 60 Bankr. 223 (M.D. Tenn. 1986); *In re Sprecher Bros. Livestock & Grain, Ltd.*, 58 Bankr. 408 (D. S.D. 1986); and *In re Catamount Dyers, Inc.*, 43 Bankr. 564 (D. Vt. 1984).

54. LEARY, *supra* note 39, at 1074.

55. UCC § 1-201 (37) Official Comment (1988).

to eliminate the problems is by "delet[ing] all reference to the parties' intent" from the old version of section 1-201 (37).[56] The drafters of amended section 1-201(37) did this and have created a much more comprehensible and precise definition of "security interest." The new definition of "security interest" focuses on the "economics" of the facts rather than the intent of the parties, which creates an improved definition.[57] For this reason and others,[58] the North Carolina General Assembly should strongly consider adopting Article 2A and amended section 1-201 (37) in the near future.

IV. THE CASE LAW OF NORTH CAROLINA

The North Carolina appellate courts have had few opportunities to determine whether a particular transaction is a sale or a lease; however, this is no reason to consider Article 2A and amended section 1-201 (37) unimportant for North Carolina. If this state wants to expand its business opportunities for the twety-first century, the Legislature must keep the statutes as modern as possible. The attorneys will not want to rely upon a mixture of common law principles, real estate leasing law doctrines, and rules from Articles 2 and 9,[59] when a prospective business client walks in the office and asks for advice on a personal property leasing transaction. Likewise, no court will want to develop their own "laundry list" of factors to use.[60] A "laundry list" test is too abstract and very hard to apply. By amending North Carolina General Statute section 25-1-201 (37), the General Assembly can help the North Carolina courts avoid many of the problems that have occurred when courts in other jurisdictions have attempted to distinguish a sale from a lease; furthermore, clarifying the sale/lease distinction is just one advantage of the adoption of Article 2A. Article 2A also provides rules on the formation and construction of the leasing contract, the effect of the leasing contract, performance of the leasing contract, and default; therefore, the fact that little North Carolina litigation has focused on the sale/lease distinction should not prevent the General Assembly from seriously considering the numerous advantages for adopting Article 2A and amended section 1-201 (37).

The most recent case applying North Carolina General Statute Section 25-1-201 (37) to determine whether a transaction was a sale or a lease is *In re Boling*.[61] In *Boling*, the trustee and debtor in a Chapter 11 bankruptcy proceeding brought an action contending that leases of four com-

56. *Id.*
57. *Id.*
58. This study is not intended to determine all the advantages of Article 2A of the UCC.
59. HAZARD, *supra* note 3, at 189.
60. MOONEY, *supra* note 13, at 1612.
61. 13 Bankr. 39 (D. Tenn. 1981).

mercial trailers were intended for security, rather than true leases, and the lessor failed to perfect the security interest. The first three leases were identical. In each, the lessee/debtor agreed to lease a 1979 Great Dane trailer for a price of $680.87 per month for a period of 42 months. A nonrefundable deposit of $2400.00 was required and the original cost of each unit was estimated to be $24,000.00. The three leases gave the lessee/debtor the option to purchase the trailers at the end of the lease term for the "estimated Fair Market Value at the end of the Lease,"[62] which was stated at $2400.00 in the leases. The fourth lease provided for 36 monthly payments of $481.00 and a $1400.00 nonrefundable security deposit in return for the use of a 1974 Timpte Trailer. There was also a purchase option in the fourth lease at the "estimated Fair Market Value at the end of [the] Lease as determined by the Lessor," but the lease did not state that value like the parties had stated in the first three leases.[63]

In determining that these transactions were true leases rather than leases intended for security, Bankruptcy Judge Bare began by noting that "[g]enerally, the intention of the parties will determine the character of the transaction."[64] Regardless of the proper outcome of this case, herein lies the primary reason that the North Carolina Legislature should consider amended section 1-201 (37). By focusing on the party's intention, the courts in North Carolina will develop the same "laundry list" problems that exist in other jurisdictions. One of the primary purposes of amending section 1-201 (37) was to eliminate the "unfortunate results" that occurred with the "[r]eference to the intent of the parties to create a lease or security interest."[65] Amending North Carolina General Statute section 25-1-201 (37) would eliminate the focus on intent and the problems caused by this focus.

Under the facts of *Boling*, Bankruptcy Judge Bare also had the opportunity to determine whether the consideration to purchase the trailers at the end of the lease term was nominal under North Carolina General Statute section 25-1-201 (37). He noted that

> [f]our tests have been used by courts in jurisdictions other than North Carolina to determine whether consideration is nominal within the meaning of section 1-201 (37). The first test requires a comparison of the option price and the market value of the property at the time the option is exercised. The second is whether the option to purchase gives the lessee "no sensible alternative" but to exercise the option. The third involves a comparison of the option price and the original cost of the property. The fourth involves a comparison of the option price and the total rentals

62. *Id.* at 41.
63. *Id.*
64. *Id.* at 42.
65. UCC § 1-201 (37) Official Comment (37), at 21 (1988).

required under the lease.[66]

The single fact that Bankruptcy Judge Bare was forced to review four different tests to determine whether the consideration was nominal or not shows an inherent problem in the old version of section 1-201 (37). Although amended section 1-201 (37) would not eliminate all the tough questions, it would have clarified the format within which Bankruptcy Judge Bare could have made his determination.

After looking at these four tests, Bankruptcy Judge Bare said the "test requiring a comparison of the option purchase price and the market value at the time of purchase has been stated to be the 'best' test."[67] He thereafter "conclude[d] that the option price for the purchase of the three Great Dane trailers at the end of the lease term for $2400.00 bears a reasonable resemblance to the fair market price of the trailers;"[68] therefore, under the first and allegedly "best test," Bankruptcy Judge Bare determined that these contracts were true leases;[69] however, Bankruptcy Judge Bare did reference the second test when he stated that "[w]hile it is true that Boling may have no 'sensible alternative' other than to exercise the option to purchase, the purchase price cannot be said to be 'nominal' based upon a comparison of the purchase price with the value of the trailers at the end of the lease period, and the intention of the parties."[70] This comment points out two weaknesses in the old version of section 1-201 (37). First, Bankruptcy Judge Bare had to refer to more than one test in order to make and support his determination. Second, the reference to the party's intent shows a weakness of old section 1-201 (37) previously discussed. These weaknesses in North Carolina General Statute section 25-1-201 (37) amplified by the court's dicta, as well as the other problems discussed hereinabove, help show why the North Carolina General Assembly should seriously consider adopting Article 2A and amended section 1-201 (37).

In his opinion, Bankruptcy Judge Bare referenced three earlier North Carolina cases which discussed the sale/lease distinction under North Carolina General Statute section 25-1-201 (37).[71] In reference to one of these cases, *Szabo Food Service, Inc., of North Carolina v. Balentine's,*

66. 13 Bankr. at 43 (*citing* ANNOTATION, 76 A.L.R.3d 11, 19 (1977)).

67. *Id. citing* Peco, Inc. v. Hartbauer Tool & Die Co., 11 U.C.C. Rep. 383 (Ore.S.Ct. 1972).

68. *Id.* at 45.

69. In regard to the fourth lease for the Timpte trailer, Bankruptcy Judge Bare also concluded that this was a true lease. He reasoned that the trailer would be purchased at the fair market value since there was no purchase price actually furnished when the lease was executed. The agreement lacked a purchase price because the trailer allegedly would have little or no value at the end of the lease term. *Id.*

70. *Id.*

71. Szabo Food Service, Inc. of North Carolina v. Balentine's, Inc., 285 N.C. 452, 206 S.E.2d 242 (1974); Borg-Warner Acceptance Corat v. David, 32 N.C. App. at 559, 232 S.E.2d 867, *disc. rev. denied*, 292 N.C. 640, 235 S.E.2d 61 (1977); NYTCO Leasing, Inc. v. Dan-Cleve Corp., 31 N.C. App. at 634, 230 S.E.2d 559 (1976), *disc. rev. denied,* 292 N.C. 265, 233 S.E.2d 393 (1977).

Inc.,[72] Bankruptcy Judge Bare said "the North Carolina Supreme Court examined a somewhat unusual transaction and held it to be a lease."[73] The unusual facts of this case do not create any strong arguments for amending North Carolina General Statute section 25-1-201 (37), but the North Carolina Supreme Court's focus on the party's intention when determining that the transaction was a lease again shows an inherent problem with the statute.

In *Szabo Food Service*, the lessor of restaurant equipment sought a declaratory judgment to determine whether the lessee or the lessor was responsible for listing and paying personal property taxes on the equipment. In the lease, the lessor had agreed to pay these taxes; however, the lessee's testimony at trial indicated that if the lessee rented the property for the entire lease period, he would thereafter own the property. Lessor argued that the agreement was actually a conditional sale rather than a lease under North Carolina General Statute section 25-1-201 (37). Yet, the court held that the agreement was a true lease and the lessor was responsible for the ad valorem taxes.

In holding that the agreement was a lease, the court in *Szabo Food Service* said "[w]hether an agreement constitutes a conditional sale or a contract of a different character is a question of the parties' intent as shown by the language they employed."[74] Again, the focus on intent creates the problem that the drafters of new section 1-201 (37) hope to avoid.[75] The court reviewed North Carolina General Statute section 25-1-201 (37) and section 25-9-102, but found "the Official Comment to section (a) of G.S. 25-9-102" particularly enlightening because of its focus on intent:

> Except for sales of accounts, contract rights and chattel paper [the subject of section (b)] the principal test whether a transaction comes under this Article is: Is the transaction intended to have effect as security? . . . Transactions in the form of consignments or leases are subject to this Article if the understanding of the parties or the effect of the arrangement shows that a security interest was intended. . . . When it is found that a security interest as defined in Section 1-201 (37) was intended, this Article applies regardless of the form of the transaction or the name by which the parties may have christened it.[76]

This focus on intent by the highest court in North Carolina leads to the simple conclusion that North Carolina courts would encounter the same problems of other jurisdictions had the appellate courts reviewed the sale/lease issue on a more frequent basis. The fact that this case presents

72. 285 N.C. 452, 206 S.E.2d 242 (1974).
73. *In re Boling*, 13 Bankr. at 43.
74. *Szabo Food Service*, 285 N.C. at 461, 206 S.E.2d at 249.
75. UCC § 1-201 (37), Official Comment (37) (1988).
76. *Szabo Food Service*, 285 N.C. at 459-60, 206 S.E.2d at 248.

an unusual set of facts should not weaken this conclusion.[77]

Actually, the appellate courts in North Carolina have had several additional opportunities to discuss the sale/lease distinction. *In Borg-Warner Acceptance Corp. v. David*,[78] the North Carolina Court of Appeals was faced with a civil action brought by a personal property lessor to recover certain equipment subject to a lease. The lessee claimed that the contract was actually a security agreement. In a short opinion in which the court made no mention of North Carolina General Statute section 25-1-201 (37), the court held that the agreement was a lease based on a number of factors. These factors included, *inter alia*, the designation of the agreement as a lease "on its face," title retention in the lessor, lessee's agreement to repair and maintain the property, and, "more importantly," the inability to renew the lease or purchase the property under the agreement.[79] The facts of this case were very easy to apply and it was unnecessary to review North Carolina General Statute section 25-1-201 (37); however, if the facts had been any more intricate, amended section 1-201 (37) would have provided more guidelines for the Court of Appeals without changing the outcome of this simple case whatsoever.

The North Carolina Court of Appeals has had one other opportunity to review the sale/lease issue. In *NYTCO Leasing, Inc. v. Dan-Cleve Corp.*,[80] the lessee of motel furniture, equipment and fixtures claimed that the "purported 'lease agreement' executed by the parties [was] in reality a conditional sale contract."[81] While rejecting this argument, but without citing North Carolina General Statute section 25-1-201 (37), the court took note of several facts:

> Not only does the document contain all indicia of a lease, a provision that the property would be returned to plaintiff [lessor] at the expiration of

77. Near the beginning of their discussion of this case, the court premised their argument with the following comment:

> At the outset we note that the purpose of this action is to determine which of two parties to a purported lease agreement is required by the taxing statute to list the equipment in the demised premises for taxation. This is not a suit brought by lessor-creditor under the provisions of the Uniform Commercial Code (G.S. 25-1-101et seq.) . . . to enforce against the lessee-debtor, or one claiming through him, a security interest in property which the debtor holds under an alleged security agreement.

285 N.C. at 458, 206 S.E.2d at 247. This comment may be seen as weakening any holding the court may have in regard to N.C. GEN. STAT. § 25-1-201 (37). However, two points can be used to refute this contention. First, the court extensively discussed and applied the rules from section 25-1-201 (37). The court would not fully review this statute unless they wanted their argument to carry some weight. Second, when Bankruptcy Judge Bare was faced with a true sale/lease distinction issue, he thought the North Carolina Supreme Court's discussion was worthy of citation. *Boling*, 13 Bankr. at 43.

78. 32 N.C. App. 559, 232 S.E.2d 867, *disc. rev. denied*, 292 N.C. 640, 235 S.E.2d 61 (1977).

79. 32 at 561, 232 S.E.2d at 869.

80. 31 N.C. App. 634, 230 S.E.2d 559 (1976), *disc. rev. denied*, 292 N.C. 265, 233 S.E.2d 393 (1977).

81. *Id.* at 639, 230 S.E.2d at 562.

> the lease period, but the record also shows that plaintiff was not engaged in manufacturing or selling the property in question but, pursuant to a list furnished by defendants, went into the market place and purchased the property for the defendants.[82]

These facts led the court to the conclusion that the document was a true lease rather than a conditional sale contract. Again, like the decision in *Borg-Warner*, the Court of Appeals did not face a very tough factual scenario and the extensive guidelines of amended section 1-201 (37) could have only aided the court in their determination.

However, the Court of Appeals in *Borg-Warner* did apply one of the factors from *Brookside Drug Store*. The Court of Appeals found it important that the lessor purchased this property specifically for the lessee.[83] This factor should not be used to distinguish a sale from a lease. As discussed hereinabove, the court should not penalize lessors for being prudent investors and for choosing the option to lease rather than the option to sell.[84] This shows the beginning of a "laundry list" in North Carolina; therefore, the seemingly simple conclusion in *Borg-Warner* should not trick the General Assembly to believe that amended section 1-201 (37) is unnecessary.

Despite the easy conclusions in *Borg-Warner* and *NYTCO Leasing*, the General Assembly should still consider amending North Carolina General Statute section 25-1-201 (37) and adopting Article 2A. Under amended section 1-201 (37), the easy cases are not made more complicated and the hard cases are made much easier to resolve. Presently, North Carolina General Statute section 25-1-201 (37) is "vague and outmoded."[85] Specifically, the reliance upon the parties' intent as a standard of determination will not provide the proper guidelines that the courts in North Carolina will need in the future. The best way to prevent these problems, as well as adopt a comprehensive and scholarly set of rules regarding personal property leases, is to enact Article 2A and amended section 1-201 (37).

V. CONCLUSION — ARTICLE 2A AND AMENDED §§ 1-201 (37) SHOULD BE ADOPTED

Article 2A and amended section 1-201 (37) represent an excellent transition into the modern business world. By focusing on the intent of the parties, the judicial system was effectively closing the door on a new and innovative way to structure personal property business deals. The General Assembly of North Carolina should reopen that door and allow

82. *Id.*
83. *Id.*
84. *See* Part II(B)(6) hereinabove and the text accompanying notes.
85. UCC § 1-201 (37) official comment (37) (1988).

a very progressive form of business deal, the personal property leasing transaction, to push forward into the 21st century. By continually holding that personal property leases are security interests, the courts are scaring away the lessors of the future. If the lessors must worry about losing the property they actually "intended" to lease, they will stop using the personal property lease and thereby destroy some innovative business deals before they start.

Article 2A and amended section 1-201 (37) provide some appropriate guidelines for the future development of personal property leasing law. The state of North Carolina will be hindering its business community by not considering these statutes as soon as possible. In the words of Amelia Boss:

> Admittedly, Article 2A [and amended section 1-201 (37) are] not perfect, but there is little in this world that is perfect. Indeed, it is doubtful whether more years of study, reflection, and revision would result in anything substantially better. As the California Bar Report concluded, "it is a good statute, a desirable alternative to the existing state of affairs," and as such should be adopted.[86]

Edwin Huddleson had a similar view:

> 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.[87]

With all these advantages, there is no reason the General Assembly of North Carolina should not immediately push for the adoption of Article 2A and amended section 1-201 (37) in the near future. In the very least, the adoption of amended section 1-201 (37) would eliminate the potential "laundry lists" and "unfortunate results" that have become the norm in other jurisdictions.

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86. BOSS, *supra* note 1, at 147 (*citing* Preliminary Draft 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) (May 18, 1987), p. 5 (emphasis by BOSS)).

87. HUDDLESON, *supra* note 7, at 681 (emphasis added).

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