PERSONAL PROPERTY LEASE FINANCING—THE LENDER'S POINT OF VIEW*

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FINANCING on the security of leasehold interests in personal property is a comparatively new development in the field of corporate finance. Because leasing has become increasingly popular with many segments of American industry, the inevitable result is that a variety of new problems is presented to counsel for the institutional investors asked to supply long-term capital funds to implement these programs. This article is directed to a consideration of the quality of the lender's security rights in equipment leasing transactions; it also attempts to point out some of the pitfalls for the unwary, and to suggest workable methods of hurdling them. After an introduction to this subject in the section below headed "Reasons and Background," the discussion is first concerned with a consideration of the basic documents with which counsel must work in implementing a lease financing, and of some of the problems which arise in connection with them. This section of the article (called "Documents and Problems") is therefore subivided under the headings "Lease," "Chattel Mortgage," "Assignment" and "Security Agreement." The next section, entitled "Remedies," considers the enforceability of the lender's position as a secured creditor as against both the borrower-lessor and the principal source of credit, the lessee. There is then a brief survey of the various plans developed in this field, under the heading "Methods of Financing," and finally some miscellaneous matters of interest are included as "Other Considerations." Various other topics, examples of which are problems of drafting and analysis of the provisions and effect of particular statutes, have not been included in any detail, primarily because

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lease financings of the type dealt with here must be documented with particular attention to the law of all of the jurisdictions which may become applicable in determining the lender's rights as a secured creditor. Through the use of footnotes, however, reference has been made to some of the pertinent material bearing on such subjects.

REASONS AND BACKGROUND

From the point of view of a corporation which desires to acquire additional goods or equipment for use in its business, the choice of a lease transaction, rather than outright purchase, has several attractions. Many companies are familiar with leases as a result of their experience with them in the field of real property, and may have considered or successfully used the sale and lease-back device. Where real property is involved, the income tax deductibility of amounts paid as rent was certainly one of the dominant original reasons for leasing. However, the recent increase in the volume and variety of personal property leases is not entirely explained by the advantages of the tax laws, since if the purchase route is used, the owner may deduct as depreciation either the full value of the equipment or everything except its scrap value. With the introduction of the accelerated depreciation methods allowed by the Internal Revenue Code of 1954, the matter became one of timing the years in which maximum deductions were desired. As a result the decision to lease, insofar as it is based on tax considerations, depends a great deal on whether rent payment terms may be negotiated so as to afford the lessee the schedule which is desirable for its purposes, as opposed to flat level payment monthly installments. These must be compared with the payment arrangements of other alternatives such as purchases by conditional sale.[1] To many a corporate borrower, leasing offers the extra financial advantage of preserving capital for use in the business rather than having it dedicated to fixed asset accounts. The assumption underlying this is that the particular company not only needs the freed funds but can immediately put them to profitable use. It has also been persuasively argued that a modest amount of leasing provides a technique through which a growing company may enlarge the sources of credit available to it, without endangering its ability to borrow through traditional channels. The use of a

[1] Comment, *Acquisition of Industrial and Commercial Equipment through Leasing Arrangements*, 66 YALE L.J. 751, 754 (1957).

lease may also permit a corporation to present an improved balance sheet, or facilitate the acquisition of equipment otherwise impossible because of negative covenants in the documents evidencing its debt securities. Management may find that production experiments which require capital equipment too expensive to buy can be accomplished through leasing new or unusual machinery on a short-term basis. Companies performing United States defense contract work may obtain advantages which accrue because of their ability to recover rent in full (instead of just depreciation) under current government regulations. Other possible advantages are that problems of obsolescence and of servicing complex equipment may be mitigated, and cost accounting procedures improved.

The advantages of leasing listed above may justify the conclusion that under certain conditions this type of financing is based upon an economic need for this method of acquiring capital equipment. However, the prospective lessee should also be aware of the opposite side of the ledger. Usually the out-of-pocket cost of leasing is higher than that of more conventional methods of property acquisition, although in computing alternative costs it is only fair to point out that a great many financial factors should be considered. Another consideration is that the ownership of the equipment will almost always remain in the lessor. Other factors may influence the decision of a high-credit corporation as to whether or not to lease,[2] but for purposes of this article the foregoing truncated discussion may be sufficient, since the problems of the institutional investor arise after the management of its borrower has elected to enter into a lease transaction.

The fact that many areas of business have decided to include some lease financing in programs for additions to their capital equipment has resulted in a variety of devices designed to meet this new market. Although some manufacturers of equipment will lease their product either directly or through a subsidiary or affiliate, others prefer an outright sale, which immediately introduces either a professional leasing company or some other legal entity for the purpose of holding title to the equipment. The manufacturer-lessor seems to have been

[2] See Adkins & Bardos, *Leasing of Industrial Equipment*, 15 Bus. Law. 586 (1960); Greisinger, *Pros and Cons of Leasing Equipment*, Harv. Bus. Rev., March-April 1955, p. 75; Steadman, *Chattel Leasing—A Vehicle for Capital Expansion*, 14 Bus. Law. 523, 524-29 (1959).

the conventional pattern until quite recently, since the leasing business, as we know it today, had its best known origins in the field of shoe machinery.[3] However, other products were regularly leased in the early 1900's,[4] and among the primary reasons for these early leases were the manufacturer's desire to protect a patent position and to make "tying" sales of spare parts and other complementary products.[5] The lease technique used by the shoe machinery manufacturing industry established a permanence in the relationship between the lessor and its shoe manufacturing customers; when the machinery wore out, or the lease terminated, it was returned and new models were installed under new leases. This pattern was carried over to the field of business machinery, in which leases had a special appeal as the result of rapid technological changes in this industry. Other areas of manufacturing—examples of which are those involving precision machinery and custom-made items such as neon signs—adapted the leasing device to fit their purposes. In the middle 1950's there appeared a new vehicle, designed to act as lessor in cases where the manufacturer wanted an outright sale of its product. This was the professional leasing company, which seems first to have specialized in a single product, usually automobiles and trucks. Now, most leasing companies are willing to lease almost any sort of personal property. The popularity of these programs is illustrated by the fact that industrial corporations of substantial credit standing, such as General Motors Corporation, Sears, Roebuck & Co., and Radio Corporation of America, and highly rated public utility companies such as Boston Edison Company, Pennsylvania Light & Power Company, and American Electric Power Company, to name a few, are now renting equipment of the most varied type.[6]

The institutional investor's interest in programs of this kind is stimulated by a somewhat higher rate of return on lease investments. As a general rule, a premium ranging between 1/4 of 1% and 1%

[3] United States v. United Shoe Mach. Co., 247 U.S. 32 (1918); *Id.*, 258 U.S. 451 (1922); *Id.*, 110 F. Supp. 295 (D.C. Mass. 1953), *aff'd per curiam*, 347 U.S. 521 (1954). See also International Business Mach. Corp. v. United States, 298 U.S. 131 (1936); *Id.*, TRADE REG. REP. ¶ 68245 (S.D.N.Y. 1956).

[4] Lamson Consol. Store Serv. Co. v. Bowland, 114 Fed. 639 (6th Cir. 1902) (cash carrier equipment for department stores); Smith v. J. I. Case Threshing Mach. Co., 50 Pa. Super. 92 (1912).

[5] See cases cited notes 3 and 4 *supra*.

[6] Steadman, *supra* note 2, at 523. It should be noted that the lease obligations of these companies are very small in relation to total assets, being less than 1/2 of one per cent in the case of utilities.

over the rate of direct, long-term obligations of prime credits, such as those listed above, is commanded by an investment in a leasing company which has obtained a commitment from such a nationally recognized corporation. Under some circumstances it can be even higher. The premium is a function of traditional standards of degree of risk to the investor's principal, since uncertainties in the enforceability of rental obligations militate against their ranking on the same level in the hierarchy of priorities as direct promises to pay. Whether in any particular case the additional premium is sufficient, in view of the indirect nature of the lender's grip on the high-credit lessee's assets and earning power, is theoretically a matter of good business judgment, but the views of counsel for the lender are of particular importance in determining the relative value of the security offered in a lease transaction (as opposed to that in more conventional collateral), and, therefore, of the degree of risk involved. It has perhaps not been generally recognized that the institutional investor's decision as to any loan of this type will be influenced by many factors other than the credit standing of the prospective lessee. Thus the nature of the equipment to be financed, the character of the lessor's financial position, and the terms and legal enforceability of the documents which evidence the loan will all be significant in gauging the risk.

On one end of the financial spectrum, there are well-established patterns of lease financing. Perhaps the most conventional of these is the "Philadelphia-plan" equipment trust, in which the lender's rights are supported by the benefit of practical experience as to the enforceability of the documents.[7] The lender's return on a security of this sort is often less than the rate which the railroad could obtain on its direct obligation, owing perhaps to the special privileges afforded to this type of security by the Bankruptcy Act.[8] On the

[7] See Adkins & Billyou, *Current Developments in Railroad Equipment Financing*, 12 Bus. Law. 207 (1957); Duncan, Equipment Obligations (1924). It may be that inclusion in this article of any reference to equipment trusts is unwarranted, since those utilizing a lease grew up primarily to avoid the Pennsylvania courts' repugnance to conditional sales, and as a way of making sure that the collateral would not come under the lien of the railroad's general mortgage. They also usually contained the lessee railroad's guaranty of the debt. There are other reasons, however, which keep railroads interested in leasing, such as the general comments made earlier in this article, and the avoidance of the requirement of Interstate Commerce Commission approval for financing on a lease basis. See Duluth, So. Shore & Atl. Ry., 175 I.C.C. 117 (1931).

[8] The Bankruptcy Act § 77 (j), 49 Stat. 911 (1935), 11 U.S.C. § 205 (1958) [hereinafter cited as B.A.], prevents a court from exercising its usual power to enjoin proceedings

opposite extreme, institutional lenders are being offered securities which are comparative newcomers to the corporate financing community, and these carry rates which are most attractive. A typical example is the note of a borrower-lessor, which by hypothesis has little or no credit (having been formed for the sole purpose of owning and leasing the items of equipment in question), secured by the assignment of a lease to, or the rentals payable under a lease to, a corporation of national credit standing; the equipment may have no reasonably predictable depreciated value, it may be specially manufactured for the lessee, or it may be destined to be affixed to realty which the equipment-lessee owns or leases. Often such a note is not further supported by a chattel mortgage on the equipment being leased, the borrower's argument being that where there are many pieces to be covered the difficulties and costs of perfecting mortgages are too great to justify the work involved. Where the chattels are mobile and there is no federal recording statute to simplify the problem, counsel for an institutional investor may well be sympathetic with the borrower's position. However, the law as to a lender's security rights in such a case is still far from settled. Not only is the closest scrutiny required before any such proposal could be accepted, but, in view of the discussion of this subject later in this article, there would seem to be grave doubt as to the propriety of a long-term investment based solely on the security of an assignment of a lease or rentals.

The legality of any institutional investment must first of all be tested against the statutory requirements of the jurisdiction in question, and the novelty of personal property lease financing is such that little specific material seems to have been enacted on this subject for the guidance of counsel.[9] Often loans of this type can be justified within the ordinary statutory authority for investments in corporate obligations, unless the obligor is a specially formed corporation which is not capable of meeting an earnings test which is based on historical averages. In such an event resort may be had to the "basket" provision in those states having leeway for investments not described in the "sanctified" list, yet not prohibited. Assuming that enabling

to foreclose security interests on the debtor's property. The same privilege has been extended to certain transactions relating to financing of aircraft. See note 71 *infra*.

[9] See, however, MASS. GEN. LAWS ch. 175, § 63, cl. 14c (1932); PUB. ACTS OF TENN. ch. 224 (1961); WIS. STAT. § 206.34 (fc) (1957).

legislation is present, the transaction must next be examined in the context of its enforceability under all other legal rules pertinent to its validity. Without presuming to review the innumerable problems presented by the statute and case law available on this subject, the following discussion will point out some of the factors which become applicable in a three-party leasing transaction financed by long-term funds.

DOCUMENTS AND PROBLEMS

The minimum documentation of an investment secured by interests in leased personal property usually consists of the lease, a chattel mortgage, an assignment, and a promissory note. In many cases a so-called "security agreement," under which the lessee undertakes to guarantee the flow of rentals to the investor free of any intervening difficulties which may affect the lessor-borrower, is for practical purposes a required document. Often a formal purchase agreement is desirable, and the particular circumstances may well call for other commitments, such as a subordination agreement designed to protect the lender against the possibly superior interests of other creditors, an assignment of any security deposit which the lessee may have made, a pledge of the stock of a newly incorporated borrower, or powers of attorney to implement the lender's rights. In some financings, particularly in the automobile fleet leasing field, trust agreements have been popular. However, the four instruments reviewed here (the lease, assignment, mortgage and security agreement) are believed to be those most frequently encountered in a typical lease transaction.

The Lease

The lender is first of all concerned with the lease. It is clear that at the outset the document submitted to the lender for review must be a true lease, and not a conditional sale or anything else.[10] The

[10] See, *e.g.*, Giligian v. New England Truck Co., 265 Mass. 51, 163 N.E. 651 (1928); Singer Mfg. Co. v. D. Wolff & Co., 70 N.J.L. 127, 56 Atl. 147 (1903); Smull v. Delaney, 175 Misc. 795, 25 N.Y.S.2d 387 (Sup. Ct. 1941); United Shoe-Repairing Mach. Co. v. Asoumanakis, 172 Wis. 102, 178 N.W. 312 (1920). A "standard" form of lease is set out in United States v. United Shoe Mach. Corp., 110 F. Supp. 295, 314-18 (D. Mass. 1953). The form used by United States Leasing Corporation, and other forms, are quoted in the appendixes to Keenan, *Financing a Leasing Corporation*, a paper prepared in 1960 for the Stonier Graduate School of Banking, Rutgers University. A very short form is set forth in Western Contracting Corp. v. Commissioner, 271 F.2d 694, 697 (8th Cir. 1959).

traditional distinction between a lease and conditional sale being one of ownership, the absence of purchase options is a practical test in which the lender and the lessor may take comfort. Assurance that the document under consideration is not a conditional sale relieves the lender from most recording obligations, especially in those states where the Uniform Conditional Sales Act has been adopted, and facilitates the reclamation of the property in the event of the bankruptcy of the lessee.[11] Under the provisions of the Uniform Commercial Code, however, the lender must guard his position by the requisite notice-filing in order to preserve his rights as a creditor secured by an assigument of a lease which is a financing vehicle.[12] In some southern states any bailment for more than a fixed period of time may require recording if the reclamation rights of the owner are to be preserved, and a lessor of personalty should be aware of the possible impact of the statutory requirements of those jurisdictions.[13] Title is not only of interest to counsel; the question of ownership of residual values is always of importance to the lender as a business matter. A lessor may reduce the rental if it will still own the property at the end of the lease term, since presumably a profitable sale may be made (unless the equipment is competely useless) or the lease may be renewed on fully-paid-for property. Reduced rent obviously must never be allowed to jeopardize the lessor-borrower's ability to service its debt, but, even if it does not, as a matter of the arithmetic of a projected statement of cash flow it may result in such a thin operating margin for the lessor that the danger of insolvency is increased. This is particularly true in cases where the lessor has indeterminable costs which must be met out of the rental paid, the most frequent of these being an obligation to repair or service the leased equipment. In the atuomobile field, profit or loss at the termination of the lease is usually for the account of the lessee; if the scrap or resale price is greater than the depreciated value shown on

[11] See Comment, *supra* note 1, 761, 769-70; *In re* Tompkins Bus Corp., 22 F. Supp. 322 (E.D.N.Y. 1938).

[12] UNIFORM COMMERCIAL CODE SPONSOR'S 1958 OFFICIAL TEXT (hereinafter cited as U.C.C.) §§ 1-201 (37), 9-102. The exclusion of leases and rentals in § 9-104 (j) applies only to real estate. As to Article 9 of the Code generally, see Aldrich, *Life Insurance Investment—Some Trends and Legal Developments*, XIV PROCEEDINGS OF THE ASSOCIATION OF LIFE INSURANCE COUNSEL [hereinafter cited as A.L.I.C.] 895, 903 (1959) and SPIVAK, SECURED TRANSACTIONS (UNDER THE UNIFORM COMMERCIAL CODE), a pamphlet published in 1960 by the Joint Committee on Continuing Legal Education of the American Law Institute and The American Bar Association.

[13] Comment, *supra* note 1, at 770.

an agreed schedule, the lessee benefits, but if it is less, the deficiency is made good to the lessor by the lessee. Usually, however, the residual value of the property belongs to the lessor and constitutes an important incentive for the formation of leasing companies.

The provisions of a typical personal property lease are to some extent parallel to those of a net lease of real estate, concerning which much has been written.[14] The law of landlord and tenant is based upon real property concepts which have their origins in the English law of the 16th century. Leases of land and buildings are still concerned with doctrines of privity of estate, of covenants which "touch and concern" the land, and of evictions, constructive and otherwise. It almost belies the imagination to apply these concepts to a lease of trucks or machinery, yet they have been used by courts of respectable standing as precedents in cases involving personal property leases.[15]

As a matter of principle, contract law seems the logical body of rules to govern these transactions. The applicability of real property doctrines to personal property cases was rejected by the early English authorities. In Spencer's Case,[16] one of the recognized sources of real property law, the third resolution was: "that a covenant by the lessee of chattels would not run with them as against his assignee." The basis of refusing to encumber chattels with easements, covenants which run, and equitable servitudes may have been the concept that

[14] See, *e.g.*, McPherson, *Some Economic and Legal Aspects of the Purchase and Lease of Real Estate by Life Insurance Companies*, IX A.L.I.C. 641 (1948); Williams, *The High Credit Lease as Security–A Lawyer's Viewpoint*, XII A.L.I.C. 1 (1954).

[15] The Lamson Consolidated Store Service Company was involved in litigation on at least eight different occasions; three cases held that its rights as lessor of the cash carrier system it manufactured were to be decided on the basis of real estate concepts. *In re* Miller Bros. Grocery Co., 219 Fed. 851 (6th Cir. 1915), *reversing* 208 Fed. 573 (N.D. Ohio 1913); Lamson Consol. Store Serv. Co. v. Bowland, 114 Fed. 639 (6th Cir. 1902); *In re* Quaker Drug Co., 204 Fed. 689 (W.D.N.D. 1913). Others used different analogies. *In re* Gelino's Inc., 43 F.2d 832 (E.D. Ill. 1930), *cert. denied*, 284 U.S. 659 (1931) (language had been changed to "owner" and "user"); Lamson Co. v. Elliot Taylor-Wollfenden Co., 25 F.2d 4 (6th Cir. 1928) (real estate rules specifically rejected after language was changed to "owner" and "user"); *In re* Merwin & Willoughby Co., 206 Fed. 116 (N.D.N.Y. 1913) (conditional sale). The trend in the modern cases, however, appears to be in favor of using contract law. In addition to the more recent of the citations above, see New York Mail & Newspaper Transp. Co. v. United States, 154 F. Supp. 271 (Ct. Cl. 1957), *cert. denied*, 355 U.S. 904 (1957) (another Lamson litigation) and Commissioner of Insurance v. Massachusetts Acc. Co., 310 Mass. 769, 39 N.E.2d 759 (1942).

[16] 5 Co. Rep. 16, 77 Eng. Rep. 72 (K.B. 1583). See Chafee, *Equitable Servitudes on Chattels*, 41 HARV. L. REV. 945, 977-82 (1928). Prof. Corbin believes that the doctrine of constructive eviction in real estate lease litigation is actually an application of the law of mutual dependency in contracts. 3A CORBIN, CONTRACTS § 686 (1960).

free alienation was an essential ingredient of ownership of personal property. However, a distinction should be made between applying real estate concepts in a doctrinaire fashion to the rights of the parties in a chattel transaction and using them as a useful analogy in cases where their application does not stem from the basic differences between land and personal property. Thus where a lessor repossesses himself of equipment and yet seeks damages from a defaulting lessee, the concept that there has been a "surrender" of the property, terminating the liability for rent, is appropriate in a case involving land, which usually has some useful value, but should not be applied to equipment of special manufacture which is, in the words of one court, "little more than junk."[17] As another example, the ability of one of the parties to a personal property lease to terminate should depend upon the materiality of the breach, as judged by ordinary contract law principles. However, the question of whether an equipment lessee is bound to pay rent to a foreclosing mortgagee, as opposed to being able to "walk away from" the lease, has no parallel in commercial law, with the result that developments in the field of real property should be available as a basis for decision. The analogy is close and to some extent it may be assumed that the parties looked to the comparable real property situation as determinative of their rights. Perhaps this need to use the analogy only arises in cases where the investor does not have a close working relationship with the lessee, because in a negotiated transaction the lessee usually will agree to contract provisions whereby after foreclosure it will be bound by the lease and obligated to pay rent to the investor. But even though a personal property lease is admitted to be essentially contractual in nature and purpose, it would be a brave draftsman who could lightly dismiss the possibility that his client's rights might be governed by a court which would apply real property law without more ado. And once it is decided to observe the principles of real property law, caution is still needed. As an example, there is the question of priority. In the real estate loan which is based upon the high credit of a lessee, it is axiomatic that a lender will endeavour to obtain complete control in the event of foreclosure so that the lessee will still be bound to pay the specified rent. Although usually this is accomplished by recording the lease ahead of the

[17] *In re* Miller Bros. Grocery Co., 208 Fed. 573, 576 (N.D. Ohio 1913).

mortgage, in at least one jurisdiction, where foreclosure is in equity and not by power of sale, the desirable result is achieved only by ensuring that the mortgage is senior.[18] In the area of chattels, many states which have adopted the lien theory for real estate mortgages continue to apply the title theory with respect to mortgages of personalty.[19] It is therefore inadvisable to rely upon standard real estate practice when considering relative rights to leased personalty, and this proposition is also applicable to the drafting of default and remedy clauses. But from the point of view of federal income taxation, there would seem to be little distinction between transactions in real property and those in chattels.[20]

The principal difference between net real estate leases and their personal property counterparts is in the repair or servicing obligation. When the leased equipment is complex electronic machinery, one of the motivations for leasing may well be the lessor's undertaking to service the equipment regularly, and to supply expert technical assistance in connection with its operation. If the service contract runs to a party independent of the lessor, the normal procedure would be for the investor to take an assignment in order to be able to provide the necessary maintenance in the event of default. But where the lessor itself is obligated to provide service, the investor will want to be assured, should it take over the lease in the event of the lessor's failure, that it will be able to contract for equally competent service from some other source. In the real estate lease it is familiar law that ordinarily a breach of a landlord's covenant to repair is "independent" of the rental obligation, with the result that the tenant is still obligated to pay rent even if the landlord does not repair, but the reasons for this rule have their origins in concepts alien to a 20th century equipment lease. It is more probable that a court would and should apply contract law to such a situation, so that if the breach of the lessor's obligation to repair and service the equipment were material, the lessee would be entitled to terminate. On such a supposition, one might well question the desirability of lending on the basis of a so-called "gross lease" under the terms of

[18] Campbell, *Some Aspects of the Landlord-Tenant-Mortgagee Relationship*, VIII A.L.I.C. 499 (1950); Anderson, *The Mortgagee Looks at the Commercial Lease*, 10 U. FLA. L. REV. 484, 494 (1957).

[19] 2 JONES, CHATTEL MORTGAGES AND CONDITIONAL SALES §§ 699, 701 (Supp. 1951). [Hereinafter cited as JONES.]

[20] See note 23 *infra*.

which the lessor has affirmative duties such as that of maintenance, at least in the absence of appropriate protective covenants or some other form of assurance to the lender.[21] By the same token, a mortgagee foreclosing on personal property should not be obligated on the covenants of the lessor as he may be in the case of real estate, since that doctrine is again bedded on the concept that the liability arises if the covenant touches and concerns the land so as to run against the assignee of the reversion. If the lessee has made repairs for which the lessor is responsible, in real property cases he may be able to protect his investment through an equitable lien or charge against the land and buildings; in a chattel situation the same equity would seem persuasive enough for a court to impose a lien analogous to a repairman's or a garageman's lien.[22]

The lease must also meet other tests. It must be that sort of lease which clearly entitles the lessee to deduct rental payments in full for purposes of federal income taxation.[23] Absent this qualification, the entire financing scheme may be inoperative, and it is therefore incumbent upon counsel to be sure that the transaction will not be challenged by the Internal Revenue Service. One practical result of the "lease" being treated as a conditional sale for tax purposes might be that the lessor would be faced with taxable income in the amount of total rental payments less the cost of the equipment. Since this would all be payable in the first year, the inability of the lessor to meet the assessment might well result in the filing of a federal tax lien. Such a consequence would be most damaging to the lender, especially in view of the priorities which the United States enjoys through statutes and court decisions. Thus options to purchase and arrangements whereby a sale may be inferred because of the economic effect of the relationship between the rentals paid, the fair market value of the property, the purchase price, and the interest factor if a conditional sale had been involved, are all of significance. It is also always necessary to know the ordinary useful life of the chattels, since there may be questions raised by a revenue

[21] See text following note 74 *infra* for possible additional difficulties with service leases.

[22] See WILLIAMS, *supra* note 14, at 5-18; CHAFEE, *supra* note 16.

[23] See Moss, *Certain Federal Income Tax Aspects of Lease-Backs*, a paper read before the Association of Life Insurance Counsel on December 13, 1960. This paper discusses Rev. Rul. 55-540, 1955-2 CUM. BULL. 39, in which the Internal Revenue Service's position is set forth, as well as the cases.

agent if too great a proportion of the rentals are payable over a short lease term. Other significant points are whether the equipment has a readily ascertainable depreciated value, and what is current fair rental value would be. The lease will therefore normally be tied in with the economic life expectancy of the equipment, and amortization of the loan will be correspondingly scheduled. For example, with leased automobiles a basic lease term of fifty months can be expected, whereas in the case of machinery and railway cars something between ten and twenty years is not uncommon. Since the lessor will attempt to depreciate the equipment in accord with the rentals payable so as to achieve a tax-free position, it is of significance to the lender to be assured that there is a proper relationship between the lease term, the depreciation schedule, and the amortization schedule of the loan.[24] To some extent there may be a conflict between the lender's business interests, which view a relatively short-term lease as desirable in that the gap between the market value of the property and the unamortized balance of the loan is reduced more rapidly, and its legal interest, which is concerned that too short a term may result in tax problems. However, some items of leased equipment have no readily predictable depreciated value. One example is department store fixtures, where the counters and showcases are almost obsolete the moment they are installed. In this kind of financing the lender must, as a matter of business prudence, rely almost entirely on the lessee's covenant to pay the rent because, even if a chattel mortgage were obtained, the resale value of the property is almost negligible.

Finally, of course, the lease should incorporate many of the clauses which have proved desirable for the lender in real estate transactions. Thus it should be a net lease insofar as possible, so that upon foreclosure the lender will not be confronted with burdensome affirmative duties. Most personal property leases are net, in that the lessee covenants to insure the chattels, to pay all applicable taxes, and to use them in a prescribed manner and indemnify the

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[24] It is often helpful to require a statement from the lessor's certified public accountants as to the basis for the depreciable life selected. Section 167(d) of the Internal Revenue Code of 1954 permits a taxpayer to enter into a binding agreement with the Commissioner as to the rates used. Although this should operate as a complete protection against claims of over-acceleration, there is no guaranty that the rules will not be changed through judicial interpretation. See Hertz Corp. v. United States, 268 F.2d 604 (3d Cir. 1959), *aff'd*, 364 U.S. 122 (1960); United States v. Massey Motors, 264 F.2d 552 (5th Cir. 1959), *aff'd*, 364 U.S. 92 (1960).

lessor for any injury or violation of law. Loss payable clauses should run to the owner and the lender, as their interests may appear, just as in a standard first mortgagee endorsement of real property insurance. The document should permit or contain a consent to its assignment by the lessor, and it should cover the possibility of assignments or subleases to subsidiaries and affiliates of the lessee. Many other more routine provisions will be found largely parallel to the provisions of real estate leases. Some of these are indicated by the following examples: rent preferably should be payable directly to the lender, or become so payable on notice; the term must be stated with accuracy;[25] the default clauses should be clear;[26] the lessee should waive all rights of set-off or counter-claim arising out of defects in the chattels and agree to pay the rent without any deductions because of such claims (which may, however, be valid as against the manufacturer of the goods). The differences in a personal property lease stem from the nature of the property being leased. There is usually little, if any, mention of the problem of eminent domain. Often the lessee is required to post a fidelity bond covering the lender against the risk of fraudulent transactions in documents of title, and almost invariably identification of the property is required by marking, stencilling or some such means. Usually the lessee is asked to sign a broad indemnity which protects the lessor and the investor against every kind of unexpected claim or liability which might arise either out of the use of the property or as a result of any phase of the entire transaction. One other important exception is in the field of maintenance or service, which the lessor often undertakes. As pointed out above, in such a case the lender must make appropriate arrangements in the event his security rights are exercised. Assuming that the lease meets these requirements, questions arise with respect to its enforceability, both prior to bankruptcy and in the event of either the lessor's or the lessee's insolvency. These are considered later.

[25] The term may be fixed by use, as by number of miles for automobiles or number of operations for machines, either with or without a minimum guaranteed rental. Perhaps in some cases the economic situation of the lessor in the industry should be considered. The District Court in *United States v. United Shoe Mach. Corp.*, 110 F. Supp. 295 (D.C. Mass. 1953), decreed that the defendant not only had to offer its products for sale, but that if leased the term must be reduced from ten years, which was the defendant's previous practice, to five years.

[26] See notes 74 and 89 *infra*. DENONN, SECURED TRANSACTIONS 91-2 (1955) contains a brief discussion.

Various miscellaneous matters crop up in connection with the form of lease used in this type of financing, most of which are peculiar to the personal property aspect of the transaction. One concerns the lessor's sales department's effort to cater to prospective lessees of excellent financial stature by agreeing to the execution of a "master lease," which is designed to be the basis for many subleases, riders, or "individual leasing records." The master lease is naturally assigned to the lender, and it is comparatively easy to see to it that it is duly authorized, executed and delivered. Probably a recitation in the sublease that all of the terms of the parent document are incorporated by reference is sufficient to make it a part of the master, and therefore, subject to the assignment. The real problem arises when one is dealing with items of small value, and pressure is put on counsel for the lender to allow the lessee to use its purchasing department's standard procedures. Usually a nationally-rated company has a purchase order form which is so filled with fine print that it is almost impossible to detect any rights of the seller which have not been drastically reduced or completely negated. It would appear perfectly probable (unless a specific reference to the master lease is typed onto the form) that the normal reaction of a court would be to refuse to recognize one of these forms as constituting a sublease which had been properly assigned.

Another area of difficulty is that of the time gap between purchase of the equipment from a manufacturer and its acceptance by the lessee, if funds are to be advanced on a schedule which permits the borrower to use them prior to the time that the goods are covered under the lease. Careful documentation is required to be sure that loss of damage during this interim period is adequately covered by insurance, and that the lender is entitled to the proceeds. Where the lease has become effective, it should provide for full indemnities running from the lessee to the lessor to cover the possibility of claims or liabilities arising out of the ordering, delivery, non-acceptance, return or installation of the equipment. Manufacturers' warranties should be assigned so as to benefit the lender as well as the borrower. If employees of the borrower or the lessee are to be handling documents of title such as certificates of registration of automobiles, the lender will usually cover the possibility of loss or fraud by appropriately endorsed insurance or fidelity bonds.

The Chattel Mortgage

The second major document which the lender in these transactions expects to receive is a chattel mortgage on the equipment being financed. The so-called "business covenants" which the lender desires will normally be set forth here. Although in financing an independent leasing company or a lessor of substantial credit, these will not be numerous, it is essential (as in all directly placed loans) to require the furnishing of adequate financial reports by the borrower. This obligation is even more necessary with respect to the real source of credit, and will therefore be made applicable to the lessee through a covenant in the lease. It is also routine to insert a covenant preventing the lessor from amending or terminating the lease without the lender's consent. A more difficult problem is presented in assuring the lender that the mortgage notes may not be refunded by the borrower at a lower interest cost, assuming that the business terms have included a stipulation to this effect. The covenant should not only appear in the mortgage, but the lease should also back up the agreement by stringently limiting the lessee's ability to terminate for any cause, which is somewhat harder to negotiate to the point of absolute perfection.

Where the borrower-lessor is an affiliate of the lessee, or a subsidiary of either the lessee or an equipment manufacturer, the covenants may be far more detailed. One important area concerns whether the lender feels it necessary to police the credit standing of lessees under other leases which its borrower may undertake, and the terms of the documents. Almost all leasing companies operate on a very thin equity base, and one improvident lease may well have dangerous repercussions on the lessor's ability to handle the program initially approved by the lender. As a result, the lender may work out arrangements for multiple subsidiaries, each one of which handles only a specific lease or group of lessees. Alternatively, the lessor may be obligated to submit financial information on each new lessee, together with the proposed terms of the documents, and obtain the lender's approval in advance. Usually the lessor will not be permitted to incur debt to outside parties without the lender's consent, and probably it will covenant not to engage in any other business activity than that detailed in the mortgage. These provisions are helpful in controlling the risks attendant upon other commitments by the

borrower, and have the additional practical effect of reducing the number of possible creditors. Additional covenants of a business nature may be desirable, but they need no discussion here because in general they will be similar to those which appear in many other types of privately negotiated loans.

Where the mortgaged equipment is heavy machinery which is installed in a lessee's plant and is not likely to be moved from there, perhaps the only pertinent questions to arise are the fairly usual ones: the lender must be certain that the document is in customary form for the jurisdiction in question; that it is either prior to the lease or subsequent to it, as may be most advantageous to the lender; that it is properly recorded over the term of the loan; and that there are no conflicts with the lessor's or the lessee's outstanding general mortgage or covenants in other debt instruments. The form of the document and questions as to recording are probably to be resolved only upon the advice of local counsel, since the requirements of each state vary as to where to record (domicile of the mortgagor, place where the chattels are located, or both) and in precisely what form.[27] The significance of proper recording is vital where valuable equipment is covered by one mortgage which purports to protect the lender against other creditors, since a trustee in bankruptcy will be alert in finding imperfections in order to invalidate the secured position of the mortgagee. This subject is developed in more detail later, and is mentioned here only to emphasize the importance of perfecting all the lender's security rights in strict accordance with state law, which governs their validity as against the trustee and the creditors whose rights he is able to assert.

Where the equipment being financed is mobile, either because it consists of trucks or automobiles or because it is readily usable at different sites according to the lessee's needs, the problems of recording are compounded. Certain types of mobile equipment, such as railroad rolling stock, ships, aircraft, and vehicles used by some comon carriers, have the benefit of federal recording statutes, and, within the limits of the statutory language applicable to each, a very high degree of protection may be established in favor of the lender in these areas of inter-state commerce. These statutes have been

[27] The statutory requirements are best found in compilations such as CONDIT. SALE-CHAT. MORT. REP. See also 1 JONES §§ 248-98. One leading writer in this field characterizes the existing legislation as a "jungle of state laws." MACLACHLAN, BANKRUPTCY 261 (1956).

fully described elsewhere,[28] and it is beyond the scope of this paper to attempt any examination of their provisions. With respect to automobiles, a great number of states have adopted statutes which simplify the recording process by allowing a mortgagee's interest to be shown on the automobile certificate of title. The more effective of these statutes provide that notation of an encumbrance on the certificate of title to the vehicle constitutes constructive notice to all subsequent creditors; the effect of other legislation, providing for the notation but not specifying the consequences of following the statutory procedure, is in doubt.[29] These statutes may solve the problem of the removal of the property from county to county, and in general the validity of such a mortgage has been sustained as against adverse liens subsequently arising in a state other than that of original registration.[30] But no such legislation exists in favor of other types of equipment. The lender is therefore obligated to police the location of the particular chattel in question so as to be reasonably satisfied that if it is moved from one county to another, or from one state to another, a satisfactory recording of its secured position is accomplished in the new jurisdiction.[31] Since in some jurisdictions a difference may result according to whether or not the

[28] As to railroad equipment, see Interstate Commerce Act, ch. 104, pt. I, added by 66 Stat. 724 (1952), 49 U.S.C. § 20 (c) (1958), and Adkins and Billyou, *supra* note 7. As to vessels, see the Ship Mortgage Act ch. 250 § 30, 41 Stat. 1000 (1920), 46 U.S.C. § 911 (1958) and Rodgers, *Ship Financing—Particularly Legal Problems Relating to Security*, 12 Bus. Law. 145 (1958). As to aircraft, see Federal Aviation Act of 1958 § 503, 72 Stat. 772 (1958), 49 U.S.C. § 1403 (1958) and Adkins and Billyou, *Developments in Commercial Aircraft Equipment Financing*, 13 Bus. Law. 199 (1958). As to busses and trucks, see Interstate Commerce Act, ch. 104, pt. II § 213, added by 72 Stat. 812 (1958), 49 U.S.C. § 313 (1958).

[29] Silverstein, *The Effect of Motor Vehicle Registration Statutes on Security Transactions and Recordations*, 1951 Wash. U.L.Q. 539. See also Comment, *Automobile Financing in California as Affected by Registration*, 42 Calif. L. Rev. 315 (1954); Comment, *The California Used Car Dealer and the Foreign Lien—A Study in the Conflict of Laws*, 47 Calif. L. Rev. 543 (1959); Comment, *Mobile Equipment Financing: Federal Protection of Carrier Liens*, 67 Yale L.J. 1024 (1958); Comment, *Security Interests in Motor Vehicles under the UCC: A New Chassis for Certificate of Title Legislation*, 70 Yale L.J. 995 (1961).

[30] Restatement, Conflict of Laws, §§ 266, 268-71 (1934); Annot., 13 A.L.R.2d 1312 (1950). See note 29 *supra*.

[31] Some unexpected results can occur, however. Krause, *Multi-State Filing of Chattel Mortgages and Conditional Sales Agreements: A Limitation and Caveat*, 15 Bus. Law. 654 (1960). The Uniform Commercial Code is not helpful on the conflicts question since § 1-105 purports to make it applicable to any transaction having a connection with a Code state, subject to specific rules in §§ 9-102 and 9-103. However, adoption of the Code by a substantial number of states (hopefully by the important commercial jurisdictions) would be most helpful to counsel for institutional investors. Under these conditions § 1-105 becomes of real value.

mortgagee has consented to the transfer, it is desirable to include a negative covenant on this subject in the mortgage.

Loans on the security of mobile equipment are further complicated by questions of conflict of laws with respect to the validity of an out-of-state mortgage and of the assignment of the lease or of the rentals payable. Many of the high-credit corporations which lease chattels are doing business in a great many states; they understandably desire to use the leased equipment wherever the need may arise, and they may want to transfer it for the use of an affiliate or subsidiary which is active in a jurisdiction different from the original one. On this subject the lender may take some comfort from the ordinary conflicts rules that the validity and effect of a chattel mortgage is governed by the law of the state where the chattel is located at the time of execution of the mortgage, and that upon removal to another state the mortgagee's interest will be recognized there, whether or not the secured creditor has consented to the transfer, to the same degree that it would have been in the original state.[32] If, however, the new state's law provides for liens having a preference even over properly recorded mortgages, the chattel will be subject to the rights of the preferred creditors in the new state, for example, garagemen or repairmen.[33] Similar concepts apply to an assignment of receivables, and therefore presumably of the lender's right to rentals, in that the controlling law is that of the place where the assignment is executed and where the assigned obligation is to be performed (this presumably being the principal place of business of the assignor (the lessor-borrower)). If the lease itself has been executed in a state different from that of the assignment, a further complication is added.[34] The lender will naturally buttress his case

[32] RESTATEMENT, CONFLICT OF LAWS, §§ 257-60, 265-66 (1934); 1 JONES §§ 260, 260 (a) - (c), 299, 305.

[33] RESTATEMENT, CONFLICT OF LAWS, §§ 268-71 (1934).

[34] RESTATEMENT, CONFLICT OF LAWS, § 350 (1934). Note that in determining whether a breach has occurred, the law of the place of performance is stated to be governing (presumably this is usually the assignor's principal place of business) but that no opinion is expressed as to whether it also determines questions of damages for anticipatory breach. § 370, comment *b*, caveat (1934). The rule stated in the text above was applied in an interesting opinion by Judge Goodrich. *In re* Rosen, 157 F.2d 997 (3d Cir. 1946), *cert. denied sub nom.* Fisch v. Standard Factors Corp., 350 U.S. 835 (1947). The case involved the rights of an assignee under New Jersey Law and arose as the result of the effort of a trustee in bankruptcy to set the assignment aside as preferential under section 60a of the Bankruptcy Act. For various reasons the court refused to apply the law of the state specified by the parties as controlling. Also see DENNON, *supra* note 26, at 57.

by inserting a "choice of law" clause in all the papers, and by trying, insofar as possible, to have execution, performance, and other incidents of each transaction take place in the jurisdiction of his choice. However, the uncertainties of the law in this area are almost legion, and the only wise course for the lender is to endeavor to comply with the law of each and every state which has a substantial connection with the transaction.[35]

In cases where there is a prior general mortgage on the lessee's plant, difficulties arise with respect to the conflicting claims of lessor and mortgagee, especially in the case of chattels which may be fixtures. Naturally it is important to examine the general mortgage, to determine whether after-acquired property clauses are present, and if so, their legal effect. Beyond that, however, agreement should be reached in writing to the effect that the chattel in question is not intended to be part of the real estate. Under the "intention" test which prevails in most states, such a written understanding will suffice as between the parties, even though there is some sort of physical annexation of the item to the realty.[36] However, as against outsiders and in those few states which follow the English rule holding that annexation or attachment to the real property conclusively makes a chattel part of it, the best possible solution would appear to be to file the papers in the appropriate real estate registry so as to put third parties on notice and obtain a subordination agreement of some sort from any known adverse lienholders. Marking or placarding the equipment to distinguish it as separate from the building in which it is located is another useful protection, and usually the lender will insist that the right to identify the equipment in this way appears in either the lease or the mortgage.[37] In the Uniform Com-

[35] The literature is also legion. A short bibliography may be found in 4 COLLIER, BANKRUPTCY ¶ 70.83, at 1678 n.61 (14th ed. 1962) [hereinafter cited as COLLIER].

[36] See generally 5 AMERICAN LAW OF PROPERTY § 19.1 (1952); 1 JONES § 123. The difficulties of being sure where fixtures are concerned are illustrated by Tibbetts v. Horne, 65 N.H. 242, 23 Atl. 145 (1891), holding that a recorded chattel mortgage of machinery was inferior to a subsequent real estate mortgage; the chattel creditor should have recorded his interest in the Registry of Deeds, since he knew the property would be affixed to the realty.

[37] In Western Machinery Co. v. Graetz, 42 Cal. App. 2d 296, 108 P.2d 711 (1940), a lessor was defeated by a subsequent mortgagee of the land and buildings leased by the lessee of the equipment, even though the lease recited that the machinery was personal property. The court held that the personal property lease was within the terms of a statute requiring the recording of "instruments—affecting real property" and noted that the mortgagee took in good faith without notice. So far as can be seen from the reported decision, no placards or markings, sufficient to constitute notice of the lessor's interests, were placed on the equipment.

mercial Code jurisdictions, the fixture problem remains as thorny as ever, since a lender can never be certain, in view of the conflicting decisions of the courts, that the item in question will ultimately be held to be personal property.[38] Therefore, prudence requires Code notice-filing of the security interest in the property, to cover the lender if it is determined that the items in question are personalty, as well as filing in the appropriate registry of deeds to take care of the alternative contingency.[39]

The same problem is also presented where the lessee desires to rent trade fixtures such as counters, showcases, or shelving. These items are usually placed in retail stores, and the real estate is often leased by a department store chain, subject to a mortgage of the land and buildings in favor of a lending institution which has financed the purchase of the land and the construction of the improvements. Besides the considerations set forth above, additional problems are presented stemming from the rights of the real property lessor, as the terms of his lease may give him rights to property placed on or affixed to the premises. Furthermore, trade fixtures are often almost fungible by nature, so that it seems almost imprudent to proceed without establishing a marking or stencilling program to cover this situation, even though the courts seem to have been fairly lenient in allowing enforcement of chattel mortgages where the goods are described with adequate certainty.[40] Trade fixtures are a type of property which has practically no determinable depreciated value, and therefore the value of the mortgage, as a business matter, is somewhat doubtful. Its importance in these cases lies primarily in the higher degree of enforceability afforded a lender holding both a mortgage and an assignment of the lease.

The desire of the lessee to have liberal rights as to substitution of collateral is also an area always difficult to resolve. It is particularly apt to become an issue in the case of equipment having a short useful life or subject to technological obsolescence, where the lessee may have chosen to lease in order to ensure the steady replacement of

[38] State law governs whether or not goods are fixtures, and also governs the creation and transfer of interests in real estate. UNIFORM COMMERCIAL CODE §§ 9-104 (j), 9-313 (i). If the goods are personal property, certain Code sections relating to priorities become applicable (*e.g.* § 9-313), but if they are real property, common law rules will govern.

[39] See Mass. Acts of 1960, c. 379, adding Sec. 9-409.

[40] For a discussion of the sufficiency of description, see 1 JONES §§ 53, 54; as to mortgages of fixtures generally, see § 123.

worn out or obsolete units. The conventional release provisions of a real estate first mortgage are not well adapted to this kind of situation. As a result, formulas have been devised under which substitutions may be made provided that the value, and sometimes the average age, of the units remaining under the lien meet certain requirements. This is feasible enough where only one lender is involved. In cases where the financing involves two or more lenders, each of which have purchased different series of notes issued at various dates, it is an ingenious draftsman who can specify with clarity the relative rights of the parties so as to afford each lender its pro-rata share of the collateral on the basis of the depreciated value of the equipment at any point of time. The question then arises as to the necessity or desirability of effecting proper recording of the new equipment which is added to the pool of collateral. Fine distinctions have been drawn as to whether the substituted property is an "accession," in that it is suited to the same use as the original item or is "substituted" material. If an accession is made in good faith, it is said to be subject to the mortgage,[41] but if after-acquired or substituted property is involved, the mortgagee, in the absence of further recording or other statutory authority, may obtain nothing better than an equitable lien which may or may not be superior to the rights of a trustee in bankruptcy, depending upon the pertinent state law.[42]

The mortgagee's counsel must also cope with common law doctrines which favored other creditors in situations where the mortgagor was permitted too much "dominion" over the property, or in which "ostensible" ownership by the mortgagor was said to be fraudulent.[43] The problems in this area are magnified by certain

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[41] 1 JONES §§ 148-52; 4 AMERICAN LAW OF PROPERTY § 16.106G, at 235.

[42] 1 JONES §§ 153, 170-72, discusses the English rule of Holroyd v. Marshall, 10 H.L. 191, 11 Eng. Rep. 999 (1862). As to the United States variations, see *Id.* § 173; 4 AMERICAN LAW OF PROPERTY §§ 16.34-16.36.

[43] See Benedict v. Ratner, 268 U.S. 353 (1925); Brown v. Leo, 12 F.2d 350 (2d Cir. 1926); B.A. § 70 (c), 11 U.S.C. § 110 (1958). *Benedict,* involving an assignment of accounts receivable, is the leading case as to unwarranted exercise of dominion; it has resulted in the incorporation into loan documents of elaborate controls on assignors. In *Brown,* the freedom of the debtor to exercise dominion over chattel property subject to mortgage resulted in the invalidation of the lender's rights to other collateral (real estate) which was otherwise clearly enforceable. It is some solace to counsel for the lender that Constance v. Harvey, 215 F.2d 571 (2d Cir.), *cert. denied,* 348 U.S. 913 (1954), holding that the hypothetical creditor of the bankrupt to whose rights the trustee is vested under § 70 (c) may "exist" so as to invalidate a chattel mortgage filed late, but more than four months

judicially developed concepts under bankruptcy law, which may result in the invalidation of all the security merely because the mortgagee's rights as to a part of it, namely the substituted property, are inferior to those of a trustee in bankruptcy exercising the rights of a lien creditor.[44] These problems for the mortgagee have their origins in the distrust of the common law for so-called "free handed mortgages," in which the debtor continued, without accountability to the creditor, to use and dispose of assets as to which he had purportedly granted a lien. Another aspect of this concept concerns whether the mortgagor has a power of sale, which raises the same considerations.[45] The lender's counsel must not only be aware of the possible adverse effect of these doctrines, but also should examine with care the stautory provisions of the jurisdictions which are involved. It is helpful to note that there is a growing tendency to protect mortgagees' rights to after-acquired or substituted property, assuming that the original document has been properly recorded.[46] For those states adopting the Uniform Commercial Code, substantial protection is afforded the lender, in that the *Benedict v. Ratner* rule is expressly over-ruled by Section 9-205, and security interests in after-acquired property are sanctioned by Sections 9-204 (1) and (3).[47]

before the date of bankruptcy, has now been overruled, and the rights of the trustee are limited, as the language of the statute states, to those "on the date of bankruptcy." Lewis v. Manufacturer's National Bank of Detroit, 364 U.S. 603 (1961).

[44] Moore v. Bay, 284 U.S. 4 (1931). The doctrine established by this case is that a transfer, which prior to bankruptcy was vulnerable to a minor degree, was totally invalidated in bankruptcy under § 70(e) because of the claim of the adverse creditor. In other words, the trustee's recovery was not limited to the amount of the claims of creditors who could have invalidated the chattel mortgage on their own behalf. See 4 COLLIER § 70.95, citing critical comment pro and con the merits of the decision, including the pungent remarks of Prof. MacLachlan in his text, BANKRUPTCY, §§ 284-85.

[45] Jones classifies twenty-three states as holding, either by statute or court decision, that the reservation of a power of sale is not fraudulent per se, but is prima facie evidence of fraud, a question for the jury. Twenty-one states are classified as holding that the power is conclusively fraudulent as a matter of law. 2 JONES § 415. See also Gilmore & Axelrod, *Chattel Security*, 57 YALE L.J. 517, 535 (1947).

[46] 1 JONES § 190 lists the legislation.

[47] It has been pointed out that the lender's security rights are still subject to defeat by a "buyer in the ordinary course of business," § 9-307 (1), or a purchase money lender. § 9-312 (3), (4). And, certain non-code principles are also still applicable. Coogan, *The Impact of Article 9 of the Uniform Commercial Code on the Corporate Indenture*, 69 YALE L.J. 203 (1959). The lender might consider, as a means of protection against a buyer in the ordinary course, taking physical possession of the lease where it is assigned as security, or stamping the document to give notice of his rights. Haydock, *Address Before New England Law Institute*, March 11, 1961. Because of the very substantial protection enjoyed by the holder of a purchase money security interest, it might be worthwhile for the lender to pay the manufacturer of the equipment direct, prior to the date of its delivery, in order to enjoy a priority position.

The Assignment

The third essential document is an assignment of the lessor's interest in the lease, or of his right to receive the rentals. Here the cautious lender must once again be sure of the governing state law. If the lease itself is sold, the financing aspect of the transaction is displaced by an outright transfer of title. Therefore, an assignment of the lease will usually be in terms of security for the debt, in which event the argument of the lessor's other creditors, or of its trustee in bankruptcy, will rest upon the proposition that the transfer amounts to a mortgage of the lessor's interest in the equipment and is invalid because not recorded,[48] or upon the theory that the lease is in truth a mortgage or conditional sale and the unrecorded assignment of it is invalid.[49] The first argument is difficult to maintain where the lessor also executes a chattel mortgage, and the second should fail where the lease clearly reserves title at all times in the lessor, even in those few states which require recording of the assignment of a chattel mortgage or of a conditional sale.

If the lender is concerned over such problems, he has the alternative of taking an assignment of rentals. In some states such a document is or may be within the accounts receivable statute, and must be recorded.[50] The problem of *Benedict v. Ratner* is present in a rent assignment, so that (unless its doctrine has been nullified by court decision or by legislation such as the Uniform Commercial Code) the lender must arrange for direct payment of rent from the lessee or else institute controls over the lessor sufficient to prevent any accusation that too much dominion was exercised over the accounts. Filing of notice is required under the Uniform Commercial Code, but a single filing in a central office is usually sufficient to perfect the lender's security interests.

The prevalent practice seems to favor an assignment of the lease as security.[51] There will be negated any transfer of duties or obliga-

[48] See Clark v. Williams, 190 Mass. 219, 76 N.E. 723 (1906); *cf.* Lynn Morris Plan Co. v. Gordon, 251 Mass. 323, 146 N.E. 685 (1925).

[49] See Comment, note 1 *supra*, at 764-66. Five jurisdictions are listed as requiring recording of an assignment of a chattel mortgage, two of a conditional sale.

[50] *Id.* at 766-68. Three states are classified as specifically requiring recordation and twelve as apparently requiring it. Sometimes it is very difficult to determine whether the statute includes a particular item: See, *e.g.*, CAL. CIVIL CODE § 3017 (1); Costello v. Bank of America Nat'l Trust & Sav. Ass'n, 246 F.2d 807 (9th Cir. 1957) (re Bankruptcy Act § 70 (c), proceeds of a construction contract).

[51] If the documents are not clear, it has been held to be a question of fact as to

tions incumbent upon the lessor, but all of the lessor's right, title and interest in the lease, including the right to receive any and all payments with specific reference to rentals, will be subjected to the assignment. Another valuable item usually assigned is the lessor's rights with respect to manufacturers' warranties concerning the leased equipment, and the same is true with respect to deposits by the lessee to secure rent payments. Usually the lessor will waive any rights of set-off or other defenses otherwise available against the lessee, and the document will recite that title or ownership is to remain in the lessor.

In making a choice as between an assignment of rents and an assignment of the lease as security, lenders may have been influenced by doubts as to their position as creditors in bankruptcy proceedings where only rentals were transferred. Although the enforceability of assignments of future rights is far too complex a subject for treatment here, it may be worthwhile to mention once again that determination of the choice of law problem is most significant, in that the view of the governing jurisdiction as to the rules of relative priority will affect the ability of a trustee to upset the transaction. It will perhaps be sufficient to point out that in some states the cases speak in terms of "merely equitable" rights accruing to the assignee of a chose in action.[52] In such a jurisdiction, a trustee in bankruptcy will prevail if a creditor holding a legal lien would have, in proceedings under state law, defeated such an assignee.[53] However, an assignment of the lease itself for security purposes may have a better chance of being held to convey "legal" rights. It may also have the further advantage of bringing the transaction within the protection of the *Rockmore v. Lehman* doctrine,[54] with the result

whether an outright sale or an assignment for security is involved. 4 CORBIN, CONTRACTS § 881 (1950); Lucius Beebe & Sons v. Wason, 274 Mass. 254, 174 N.E. 500 (1931).

[52] State Factors Corp. v. Sales Factors Corp., 257 App. Div. 101, 12 N.Y.S.2d 12 (1939). Some jurisdictions go even further and hold that not even equitable rights are obtained. Taylor v. Barton-Child Co., 228 Mass. 126, 117 N.E. 43 (1917).

[53] B.A. § 70 (c), 11 U.S.C. § 110 (1952) (see 4 COLLIER ¶ 70.62); B.A. § 70 (e), 11 U.S.C. § 110 (1952) (see 4 COLLIER ¶ 70.83); B.A. § 60 (a), 11 U.S.C. § 96 (1952) (see 3 COLLIER ¶ 60.37, at 884, ¶ 60.50); See also note 55 *infra*. Collier states that "the entire subject is in an extremely confusing condition." 4 COLLIER § 70.82, at 1431.

[54] 129 F.2d 892 (2d Cir. 1942), *reversing* 128 F.2d 564 (2d Cir. 1942), *cert. denied*, 317 U.S. 700 (1943) (holding that an assignment of advertising contracts was perfected when made, so that later payments were not preferential). It has been pointed out that the old common law courts were "unable to conceive of the possibility of transferring an incorporeal contract right to a new creditor by an act of assignment," but that under equity's competitive compulsion the result was accomplished by the face-

that the transfer, for bankruptcy purposes, will be held to have been made at the time of the original assignment and problems as to preferences during the four months period will be eliminated. The same problem exists, of course, with respect to the rights of a mortgagee in cases where there are defects in its execution, or in the place, time, or manner of its recordation.[55]

Assignments may or may not be on the basis of notice to the debtor. It is clearly preferable to the lender to have the lessee on notice of the assignment of the rentals, and even better to have provisions requiring payment of rent directly to it, either at all times, upon notice, or upon default of the lessor. Ordinarily the assignee of a non-negotiable contract right takes subject to the defenses available against the assignor. After notice, however, the lender, as an assignee for value, will not be subject to some defenses which the lessee may have against the lessor, to the extent that such rights arise subsequent to the date of the notice and are based on transactions extrinsic to the lease itself. This may be helpful in the event the lender asserts its rights as an assignee of the lease, as any claim of the lessee that the lessor had defaulted on obligations collateral to that in which the lender has a concern would not be effective as against the financing institution.[56] In some cases, however, notification meets with considerable resistance from the borrower, who alleges that for competitive reasons it is much easier to sell the transaction to a prospective lessee if there is no need to mention the possibility of third parties. While this may be acceptable to the lender in cases where the borrower-lessor has an established credit standing, it would seem almost imperative to obtain the right of direct payment in situations where the borrower's financial position is weak. Direct payment from the lessee to the lender not only constitutes a high degree of assurance that the flow of rent will be first dedicated to debt service, but also avoid completely any problems arising from the debtor-lessor's alleged dominion over or ostensible ownership of the assets in question. The ability of the

saving device of insisting that the assignee sue as the agent of the assignor, in his name. Remnants of this doctrine remain in the concept that an assignee obtains "only equitable" rights. 4 CORBIN, CONTRACTS § 903 (Supp. 1961, at 125), commenting on First State Bank of Medford v. United States, 166 F. Supp. 204 (D. Minn. 1958).

[55] See 4 COLLIER, *op. cit. supra* note 53, at ¶ 70.79-82 and other sources cited therein; Cohen & Gerber, *The After-Acquired Property Clause*, 87 U. PA. L. REV. 635 (1939); Stone, *The 'Equitable Mortgage' in New York*, 20 COL. L. REV. 519 (1920).

[56] 4 CORBIN, CONTRACTS §§ 892-903 (1950).

lessor's trustee to attack the transaction is similarly cut down, in view of the fact that such an arrangement prevents the lessor from coming into possession of anything but the equity in the rentals over and above currently due principal and interest on the lessor-debtor's notes. If direct payment is impossible to obtain under the business negotiation, notice to the lessee is of value to the lender in situations involving the ability of other creditors, or the assignor's trustee in bankruptcy, to upset the assignment, especially as to rents to become due, on the grounds that it constitutes an unperfected transaction which may be set aside in whole or in part.[57]

The Security Agreement

The final document in which the lender is interested is an agreement used in cases in which the borrower is a subsidiary or an affiliate of the lessee, or possibly an independently owned corporation which has little credit standing. Under its terms the lessee, as the real source of financial strength, agrees to keep the lessor solvent so as to ensure the continuing flow of debt service to the lender. Such agreements have been worked out in various forms and carry titles such as "Security Agreement," "Solvency Agreement" or "Deficiency Agreement."[58] They are essentially designed to protect the lender against intervening liens which may attach to the rentals, the creditor most often used as an example being the United States acting through the Internal Revenue Service. The form of this

[57] The attack could be under the Bankruptcy Act § 60 (a), 11 U.S.C. § 96 (1958), on the grounds that the assignment, if equitable, lacked full validity because an "overt act" necessary for its perfection had not been accomplished. See 3 COLLIER ¶¶ 60.38, 60.50; Kupfer, *Accounts Receivable Financing*, 2 PRAC. LAW. 50 (1956). The latter is a readable discussion of the perfection problem under the various state rules as to notice-filing statutes as opposed to "validation" statutes. See Corn Exch. Nat'l Bank & Trust Co. v. Klauder, 318 U.S. 434 (1943). Even though some leading texts make a convincing case for the lack of any necessity to distinguish between "legal" and "equitable" assignments, the Bankruptcy Act would seem to require a differentiation. 4 CORBIN, CONTRACTS § 858 (1950). Bank of Oakman v. Union Coal Co., 15 F.2d 360 (5th Cir. 1926), illustrates the value of notice under Alabama law, which honors after-acquired property clauses. The attack could also be predicated upon the "strong-arm clause," Bankruptcy Act § 70 (c), 11 U.S.C. § 110 (1952). See, as to the effect of real notice, 4 COLLIER ¶ 70.53; 3 REMINGTON, BANKRUPTCY ¶ 1604.2 (rev. ed. 1956) [hereinafter cited as REMINGTON].

[58] The possibility of conflicts between documents such as the security agreements discussed here and negative covenants in other instruments binding on the lessee, particularly those forbidding guarantees, has already been explored. Gustin, *Financing by Contract and by Lease—Some Considerations*, XIII A.L.I.C. 685 (1957). See especially 690, 694-95 (as to the security agreement itself), 706 (as to possible conflict between such an agreement and the negative covenants of the lessee's other security documents), and 689-706 (as to federal income taxes).

protective mechanism varies. The strongest commitment is a flat promise by the lessee to buy the notes at par plus accrued interest. In other cases the lessee agrees to keep the lessor's working capital at a prescribed minimum. Another device, which sometimes appears as a provision of the lease, is a provision specifying that if the lessor's property, particularly its interest in the chattels and the rentals accruing from their use, is attached, the high-credit lessee will supply funds to the lessor by way of subordinated debt or equity in amounts sufficient to enable the attachment to be lifted. Sometimes the lease calls for additional rent payments in amounts sufficient to accomplish the desired purpose, it being thought that such a covenant is less vulnerable to attack where there are restrictive covenants in other securities of the lessee. As experience with personal property leasing grows, however, lenders may find that the details of each transaction are scrutinized more closely. Were this to come about, it is possible that the existence of a security agreement would lead a lessee's auditors to conclude that a debt obligation, not just one to pay rent, had been incurred. Any such result would of course drastically reduce the value of the agreement to all the parties.

The threat of interruption of debt service because of tax liens is far from academic.[59] This is because the lessor is almost always depreciating the equipment at an accelerated rate so as to offset the rental received and achieve a tax-free position; if the Internal Revenue Service determines the depreciation has been taken in excessive amounts, the borrower is faced with the necessity of paying a large refund in cash. Although it is true that over a period of years the depreciation disallowed in the early years may be "spread" forward over the remaining years, the government will almost undoubtedly assert its rights as a lien creditor if the tax immediately due is not paid.

The priority of the United States in such situations derives from Section 6321 of the Internal Revenue Code:

> If any person liable to pay any tax neglects or refuses to pay . . ., the amount . . . shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

[59] Hamilton, *Federal Tax Liens; Priority, Enforcement and Release*, XIII A.L.I.C. 97 (1956). The priority of state tax liens should also be considered. *In re* Mercury Engineering, 68 F. Supp. 376 (S.D. Cal., 1946).

Since the lien arises upon failure to pay an assessed tax and continues until the liabilty is satisfied or the lien becomes unenforceable, irrespective of whether a notice of the lien has been filed in the office designated by the state involved, it can be an unrecorded, floating lien on all property of the debtor. However, the tax lien must be filed in order to be effective against certain creditors, which include mortgagees, pledgees, purchasers and judgment creditors.[60] An alternative basis of priority for tax claims, applicable even though no lien for such a claim has been made effective as against a mortgagee, is available to the United States under section 3466 of the Revised Statutes, which provides that "if . . . any person indebted to the United States is insolvent, . . . the debts due to the United States shall first be satisfied; . . ."[61] Taxes are included within the word "indebted." Finally, apart from the priorities enjoyed by the government pursuant to the Internal Revenue Code and the Revised Statutes, it also has the benefit of certain advantages in a Chapter X reorganization. Not only must the plan of reorganization meet the "fair and equitable" test, but section 199 seems to give the Secretary of the Treasury a veto power over the Court's confirmation of the plan unless he is satisfied as to the treatment given federal tax claims.

The difficulty with these statutes is that the lender is never completely certain that its security will entitle it to rank ahead of the competing tax claim, either in insolvency proceedings where the government relies on its priority under section 3466, or in bankruptcy where a section 6321 lien is asserted. These two statutes have been interpreted by the Supreme Court to give the government an extraordinary ability to deplete the estate of an insolvent borrower. In a series of decisions the doctrine of "choateness" has been de-

[60] INT. REV. CODE OF 1954, §§ 6322-23. United States v. Gargill, 218 F.2d 556 (1st Cir. 1955), is an application of section 6323 for the benefit of mortgagees; the court also refused to apply section 3466 to a bankruptcy situation. However, the government has refused to accept the *Gargill* decision insofar as it may indicate that advances under an "open-end" mortgage have priority over an intervening recorded tax lien. Rev. Rul. 56-41, 1956-1 CUM. BULL. 562. The Treasury maintains that a mortgage alone does not constitute an assignment of rentals; if an assignment is taken, it is said to be superior to the tax lien only to the extent of rentals accruing prior to the recording of the federal claim. I.T. 3347, 1940-1 CUM. BULL. 69. One commentator has said that the opinion in the *Gargill* case avoided any definite conclusion as to after-acquired property clauses, which are very usual in the personal property lease financing field. Plumb, *Federal Tax Collection and Lien Problems*, 13 TAX L. REV. 459, 496-97 (1958) (an exhaustive review of this entire subject). See United States v. Bruce Machine Co., 132 F. Supp. 525 (D.C. Mass. 1955).

[61] REV. STAT. 3466 (1875), 19 U.S.C. 931 (1958).

veloped, which may be briefly stated as follows: where a federal tax lien and another lien are competing for priority in the same fund of assets, the tax lien will be held superior unless the prior non-tax lien is sufficiently specific with respect to the identity of the lienor, the amount of the claim, and the identity of the property.[62] Thus where an assignment of an account receivable was fully perfected under state law, it has been held inferior to the government's lien, the assignment not being a "mortgage" within the protection of section 6323.[63] The same reasoning could be equally applicable to the assignment of rentals to be due. Among the many possible risks, a lender may find that its claim as a mortgagee asserted under an after-acquired property clause, valid pursuant to applicable state law, may be held inferior to a federal tax lien on the grounds that the property can not be identified specifically until it has been acquired and is subjected to the mortgage.

Two possible methods of avoiding the impact of these decisions have been suggested. The first relies upon the words of section 6321, that the federal lien attaches to "property belonging to the taxpayer." Where title has left the taxpayer, as for example where the mortgage of the leased property is a conveyance of ownership and the assignment is absolute subject to defeasance if the debt is paid, it may be that there is nothing of substance upon which the federal lien can operate.[64] Another stems from the decision of the Supreme Court in *United States v. Brosnan.*[65] In this case the Court held that a federal tax lien was extinguished by California proceedings in which the property had been sold privately pursuant to a power of sale reserved in a chattel mortgage. The state law provided for di-

[62] The "choateness" doctrine was first applied in cases arising under R.S. section 3466 (e.g., Illinois v. Campbell, 329 U.S. 362 (1946)) and was later extended to the section 6321 cases. Originally, state created statutory liens were subordinated (e.g., mechanics' liens in United States v. White Bear Brewing Co., 350 U.S. 1010 (1956)), but in United States v. R. F. Ball Constr. Co., 355 U.S. 587 (1958), the same doctrine was applied to a contractual or consensual lien. In the *Ball* case, the taxpayer was a subcontractor which had assigned its right to payments from the prime contractor to a surety company. The court held that when the assignment was made it was a contract for after-acquired property and that the rights of the surety company were inchoate, and therefore, inferior to the federal lien, until performance had been rendered.

[63] First State Bank of Medford v. United States, 166 F. Supp. 204 (D. Minn. 1958); Arthur Co. v. Chicago Paints, Inc., 175 F. Supp. 50 (D. Minn. 1959).

[64] Aquilino v. United States, 363 U.S. 509 (1960), suggests such a possibility. See Myers, *The Fall and Rise of the Security Interest*, 6 Prac. Law. 60, 71 (1960).

[65] 363 U.S. 237 (1960).

vestiture of federal tax liens and the Court found that Congress had not entered the field. Although the United States had not been joined as a party, the doctrine of sovereign immunity was thought to be inapplicable because no "suit" was involved. A sheriff's sale under Pennsylvania law was also involved in *Brosnan*, and it too was held to sever the federal lien. The four dissenting justices vigorously assert that the majority are opening the door for state legislation which will defeat federal liens through the mechanism of private or judicial sale without the government's having benefit of notice. As has been pointed out, however, the solution of "foreclose, foreclose and sell!" is subject to the necessity of state legislation on the subject and the absence of federal pre-emption of the field, and the practical difficulties of obtaining immediate foreclosure under bankruptcy conditions.[66] A further and more reliable solution has been offered by proposed amendatory legislation, in the form of an American Bar Association suggestion[67] which was considered, but not passed, by the last Congress.[68] Until legislative clarification of this subject has been obtained, the only path of prudence in this highly complex and unpredictable area is to take every possible precaution to immunize the transaction against the risk of unanticipated federal liens and to further provide in the event that they arise for a source of funds for their discharge at the first possible moment. It is for these reasons that the "Security Agreements" described above are often a vital part of the institutional lender's protection.

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[66] Note 64 *supra*. Foreclosure may be enjoined either in bankruptcy pursuant to section 2(a)15 or in Ch. X proceedings under section 116(4). See, *e.g.*, *In re* Maier Brewing Co., 38 F. Supp. 806 (S.D. Cal. 1941) (chattel mortgage on machinery). See note 8 *supra* as to limitations on the power to enjoin in the case of certain mobile equipment.

[67] Report of the Special Committee on Federal Liens, 84 Reports of American Bar Association 645 (1959); See MacLachlan, *Improving the Law of Federal Liens and Priorities*, 1 BOSTON COLLEGE INDUSTRIAL AND COMMERCIAL LAW REVIEW (1959). It is worth noting that this legislation would also clear up problems arising from the decision of the third circuit in In the Matter of Quaker City Uniform Co., 238 F.2d 155 (3d Cir. 1956), *cert. denied*, 352 U.S. 1030 (1957), in which a chattel mortgage, prior in time to all other claimants, was subordinated through a "circuity of priority" theory to costs of administration and wage claims under section 67 (c) of the Bankruptcy Act and to a landlord's distraint for rent which under Pennsylvania Law took precedence over the mortgage. Since the lender in the financings being considered here is usually both the landlord's assignee and the mortgagee, the doctrine of this case may not be too pertinent. Were it extended, however, to other statutory liens which under state law are granted a priority, the results could be most adverse to the lenders. See Kupfer, *A "Puzzlement": The Quaker City Uniform Case, Its Impacts and Aftermaths*, 12 BUS. LAW. 280 (1957).

[68] Federal Liens, Priorities and Procedure Bill, S. 1193, H.R. 4319, 87th Cong. 1st Sess. (1961).

REMEDIES

The quality of any security being dependent upon the creditor's abilty to enforce its rights in the event of default, it is necessary to consider the position of the investor financing a chattel leasing transaction not only as against its obligor, the lessor, but also under the contingency of default by the lessee.

Where the lessor, although still solvent, fails to observe the covenants of the mortgage, the lender has the usual right of acceleration of the notes, backed up by its ability to foreclose and either repossess itself of the equipment or continue to receive rents from the original lessee. If the lessee is in default but no insolvency is involved, the remedies of the lender, as assignee of the lessor, are spelled out in a variety of different ways, so as to be both alternative and cumulative: to terminate and repossess itself of the equipment, or to repossess itself of the equipment (without termination) with the right in each instance either to sell it or to relet it, holding the original lessee liable for any deficiency between the rental which would accrue over the term of the lease and the proceeds of reletting or sale (less costs). To these remedies there may be added provisions entitling the lessor to the full value of the rentals to be due over the remainder of the term, with or without provisions for its commutation to present value; offsets for resale, salvage, or scrap value; or statements as to liquidation of damages. A carefully drawn default section will also include many other points which experience has shown desirable. For example, its provisions will negate the remnants of certain common law doctrines by empowering the mortgagee to foreclose upon all the property (whether divisible or not) even though only part of the debt is due, and to bid for its own account at a sale made pursuant to a power reserved in the instrument.[69] The papers will also be written so as to assure complete cross-default protection, so that the lender may execute all its remedies simultaneously no matter where the difficulty arises. These provisions also apply to defaults caused by the insolvency of either party. Because the acid test of the lender's secured position is in this area, the remaining discussion of this subject will deal with the lender's rights as against lessor and lessee, both in straight bankruptcy and in Chapter X reorganization.

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[69] 2 JONES §§ 767-68, 806.

The enforceability of the lender's position as a secured creditor must be considered first of all as against the lessor-borrower. The lender's most conventional remedy, assuming he has obtained a valid chattel mortgage and an assignment of the lease, is to foreclose the mortgage, repossess himself of the equipment, and either sell it or rent it, whichever may be more profitable. In some jurisdictions adopting a title theory of chattel mortgages, there is no necessity for foreclosure; the lender may immediately repossess the equipment and sell it, since on default of the mortgagor title becomes absolute in the mortgagee. In lien theory states, however, the mortgagor's title must be divested by foreclosure and sale, and this may be the preferable procedure in all cases.[70] The lender's procedure will be influenced by whether the equipment is readily marketable and by the result of any given action with regard to retention of a desirable lessee. As a practical matter, where the lessor is in bankruptcy or Chapter X reorganization, the foreclosure action may be indefinitely stayed by orders of the court,[71] and it is therefore necessary to examine the question of whether in such situations the lessor's trustee can or may reject the lease as an executory contract. This question becomes particularly pertinent where there is no mortgage or where there are imperfections in a document intended to operate as a mortgage. The danger to the lender is the theory that disaffirmance of the

[70] 2 Jones §§ 699-701, 773-75 (a). Proceedings by foreclosure and sale prevents the mortgagor from later challenging the fairness of the transaction and preserves the mortgagee's right to a deficiency judgment. The statutes of the particular state must be consulted, particularly with respect to the mortgagor's right of redemption and the time period within which it must be exercised. Sixty days is fairly typical. Mass. Gen. Laws ch. 255, §§ 4, 7. The Uniform Commercial Code has probably extended the usual time period for redemption. UNIFORM COMMERCIAL CODE § 9-506. However, it also broadened the rights of the secured lender, subject to a new test, that of "commercial reasonableness." § 9-501. Where the collateral consists of fixtures, the Code frees the lender from the adverse consequences of the "industrial plant mortgage" doctrine. § 9-313 (5). See Spivak, *supra* note 12 at 118-19, 133-41. See also Comment, *The Commercial Code and the Bankruptcy Act: Potential Conflicts,* 53 Nw. U.L. REV. 411 (1959).

[71] 6 COLLIER ¶ 3.32; *In re* Maier Brewing Co., 38 F. Supp. 806 (S.D. Cal. 1941) (involving the statutory predecessor of § 116 (4) of chapter X). Note that if the property is railroad rolling stock or aircraft, the power to stay may not be exercised. B.A. § 77 (j), 11 U.S.C. § 205 (1958) (railroad equipment) and B.A. § 116 (5), 11 U.S.C. § 521 (1958) (to the effect that the title of a lessor or conditioned vendor of aircraft is not impaired in chapter X proceedings). See also note 8 *supra.* As to the right of reclamation of an owner such as a bailor on the bankruptcy of a bailee, there is no doubt. See, *e.g., In re* Tomkins Bus Corporation, 22 F. Supp. 322 (E.D.N.Y. 1938); B. F. Hoffman, Inc. v. Richman, 75 F.2d 823 (3rd Cir. 1935) (Pennsylvania bailment). A well drawn lease will provide that the lessee's financial difficulty entitles the lessor to terminate and repossess.

lease would leave nothing for the assignment to operate upon, so that with respect to the rentals, the lender would be relegated to the status of an unsecured creditor, sharing along with all other general creditors. Although in most cases the lessor's trustee will usually wish to affirm the lease as one of the assets of the estate, it would seem that power exists for its rejection, either in straight bankruptcy or in reorganization.[72]

There are limitations, however, on the power to reject. First of all, the power is exercisable under statutory authority relating to "executory contracts." Section 70b specifically refers to unexpired leases of real property, and so does the definition of executory contracts in section 106 (7) of Chapter X, but it appears perfectly clear that leases of personal property are just as much executory contracts, and should be so included.[73] In some cases, the contract is no longer executory at the time of bankruptcy, since by its own terms it terminates "ipso facto" upon the filing of a petition, or because the insolvent party has the option to terminate it, and in these situations it has been held that there is an automatic termination of the lease with no question of the power of rejection being present.[74]

Secondly, the rejection must be in the best interests of the estate, in the light of the benefits and burdens represented by the lease in question. Thus in a Chapter X proceeding the judge's discretionary power to reject is only to be exercised if the lease is detrimental or unduly onerous, as where the rent is out of proportion to the value of the property or the agreement contains covenants requiring burdensome duties of the lessor. The Supreme Court has stated: "Thus, the question of whether a lease should be rejected and if

[72] See B.A. §§ 70 (b), 116, 11 U.S.C. §§ 110 (b), 516 (1958). B.A. § 216 (4), 11 U.S.C. § 616 (4) (1958), provides an additional method of rejection in Chapter X proceedings as a result of the requirement that the plan of reorganization may so specify.

[73] 4 COLLIER ¶ 70.44, at 1237; 6 COLLIER ¶ 211; 2 REMINGTON § 852.26; *In re* Rodger Williams Bldg. Corp., 99 F.2d 212 (7th Cir. 1938), *cert. denied sub nom.* Provus Bros., Inc. v. Holman, 307 U.S. 635 (1938) (a 77b proceeding involving a bankrupt lessee of furniture and furnishings). Citations in this part of the paper will usually be to COLLIER, the more detailed of the two texts.

[74] Irving Trust Co. v. A. W. Perry, Inc., 293 U.S. 307 (1934). Provisions of this sort may allow the recovery of liquidated damages, but no claim may be asserted for future rentals. See the references to COLLIER cited in note 85 *infra*. The desirability of inserting such clauses into leases has therefore been questioned by commentators. 4 COLLIER ¶ 70.44, at 1238-39; MACLACHLAN, BANKRUPTCY 173-74. See also note 88 *infra*. For a case involving an alleged executory contract held not subject to rejection because fully executed by the debtor, see *In re* San Francisco Bay Exposition, 50 F. Supp. 344 (N.D. Cal. 1943).

not on what terms it should be assumed is one of business judgment" and that the determination of whether it is burdensome must consider "the sacrifices which other creditors are making."[75] The same is true of ordinary bankruptcy, but here failure to adopt within 60 days automatically results in rejection, where as in reorganization no time limit is set. Another difference is that only the judge may act in a Chapter X proceeding, whereas the trustee may in ordinary bankruptcy.

Thirdly, consideration must be given to the meaning and effect of a part of the statute which has received scant attention by the courts. In section 70b, which establishes the basic power of a trustee to reject or assume any executory contract, the second sentence reads: "Unless a lease of real property shall expressly otherwise provide, a rejection of such lease or of any covenant therein by the trustee of the lessor shall not deprive the lessee of his estate." The provision is apparently based on the theory that the tenant's possession is an executed matter, and, therefore, nothing can be rejected except the liability of the lessor on its covenants, for example, to furnish heat. Although the section 70b sentence is limited to a "lease of real property," the reasons for its inclusion in the statute appear to be equally applicable to personal property leases, and it is of interest that the drafts of the 1938 amendments to the Bankruptcy Act which introduced the section 70b sentence quoted above made specific reference to leases of personal property,[76] as well as to those of real estate. It is probable that this sentence is also applicable to Chapter X proceedings; although there are no square decisions, certain equity receivership cases indicate that in real property situations a tenant could not be evicted until the term was over, and most commentators support this view.[77]

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[75] Group of Institutional Investors v. Chicago, M., St. P. & P. Ry., 318 U.S. 523 (1943). This was a 77b case involving a reorganization plan for a lease, but the court quoted an equity receivership case involving a lessor, American Brake Shoe Co. v. New York Ry., 278 Fed. 842 (S.D.N.Y. 1922). In the *Brake Shoe* opinion, the court said that it would order disaffirmance of the lease if carrying out affirmative covenants such as the lessor's obligation to supply heat and electric current would cause "a positive loss or encroachment on the lessor's estate" (as opposed to honoring a bad bargain) and solved the problem by postponing the time within which the lessor's receiver could affirm or reject. *Id.* at 843. It would seem, however, that the Supreme Court did not fully endorse the idea that "burdensome" meant capital loss.

[76] 4 COLLIER § 70.44(2) n. 6. 2 REMINGTON § 852.095 discusses the "shall not deprive" sentence but without reference to its applicability to personal property leases.

[77] 6 COLLIER § 3.24(2). See also American Brake Shoe & Foundry Co. v. New York Ry., 278 Fed. 842 (S.D.N.Y. 1922); Payne, *The General Administration of Equity*

The application of the foregoing to a typical chattel lease financing leads to the conclusion, in an area of admittedly obscure law, that it is very improbable that the bankruptcy or reorganization trustee of a lessor would be permitted to reject the lease, but that if the limitations discussed above were satisfied, the court could allow disaffirmance of a burdensome and truly executory rental contract. The most pertinent decision on this point, *In re H. K. Porter Co.*,[78] supports this conclusion in a real estate lease situation under section 77b, specifically upholding an assignment of rents to an institutional mortgagee, and the leading text writers voice a tentatively similar view. In the *Porter* case, the court denied the motion of the bankrupt lessor's trustee "to disaffirm a written assignment of rents" to a trust company which held a mortgage. There appear to be two bases for the decision: (1) that "so far as the debtor is concerned, it is an executed contract" so that the trustee could not "play fast and loose" with the "absolute assignment," and (2) since under Pennsylvania law a mortgagee may take possession and collect rents on the mortgagor's default, it was "practically in possession and collecting rents" when the petition in bankruptcy was filed. The court did not discuss the second sentence of section 70b, to the effect that the estate of a real property lessee shall not be disturbed by rejection, since it was first contained in the 1938 amendments to the Bankruptcy Act and therefore was not applicable to the situation being decided. Commentators have interpreted this provision of the statute to have been declaratory of the prevailing view and a desirable protection for "the innocent lessee who had based his affairs on the term provided in the lease."[79] Thus if the *Porter* case were to be decided under present law, it would seem that section 70b provides a statutory basis for preventing disaffirmance by the representative of an insolvent lessor.

Receiverships of Corporations, 31 YALE L.J. 685, 694-95 (1922). *But see*, as to the applicability of the second sentence of section 70b to Chapter X, 48 YALE L.J. 1415 (1939) and text to note 81 *infra*.

[78] 24 F. Supp. 766 (W.D. Pa. 1938). No discussion of this case has been found in the law reviews.

[79] 6 COLLIER § 3.24(2), 2 REMINGTON § 1141.75. *In re* Hotel Governor Clinton, Inc., 96 F.2d 50 (2d Cir. 1938), *cert. denied sub nom.* Canter v. Ramsey, 305 U.S. 613 (1939), a 77b reorganization involving a real property lease which was expressly subordinated to a mortgage, holds that the court had power to cancel the lease. Perhaps because the reorganization was concerned solely with the rights of senior secured creditors, there was no mention of the second sentence of section 70b or any analogous doctrine. This case is the subject of the Note cited at note 77 *supra*.

In argument against the above conclusion there may be brought to bear the obvious point that the section 70b sentence specifically refers to an "estate" held under a lease of "real property" and therefore the words should read literally so as to exclude personal property leases.[80] Furthermore, one commentator has taken the view that in reorganization the "shall not deprive" sentence is inconsistent with the provisions of Chapter X (and therefore inapplicable pursuant to the direction of section 102) because the purpose of reorganization is to scale down the debtor's obligations and the court must be able to evict tenants to further this objective. It is submitted that this view is contrary to the meager authority available and ignores the words "unless a lease . . . shall expressly provide otherwise," which enables the parties to stipulate as to their intentions. If a court were to upset the lessee's right under the sentence being considered, it would not only be in difficulty under these particular words of the statute but also would come close to interpreting the power to reject as meaning that any executory contract may be terminated merely by giving the solvent party a right to damages, with the result that the discretionary aspect of rejection, based on fairness to all creditors in the light of the equities involved, becomes meaningless.[81] One often cited decision allowed rejection in a Chapter XII real property arrangement on the grounds that only in this way (despite the section 70b sentence) could a profitable sale be made free of a burdensome lease.[82] It is submitted, however, that the *Porter* decision is correct, and should apply to a personal property lease financing.

Where there is no mortgage, the first ground relied on in the *Porter* opinion is equally applicable in that the assignment, being absolute (subject to defeasance only upon payment of the debt) is executed and there is nothing left for the lessor's trustee to reject. In a true net lease, there are not even covenants to repair and other

[80] See the texts to notes 76 and 77 *supra.*

[81] The Note cited in note 77 *supra* mades the "scaling down" argument. FINLETTER, THE LAW OF BANKRUPTCY REORGANIZATION 240-41 (1939), rejects the "right to damages" interpretation in favor of a view that the debtor "has neither the right nor the power to reacquire possession" since there is an executed performance. However, it is clear that this does not prevent the debtor from rejecting truly executory covenants made by the lessor. *Cf.* American Brake Shoe & Foundry Co. v. New York Ry., 278 Fed. 842 (S.D.N.Y. 1922); *In re* Northern Indiana Oil Co., 180 F.2d 669 (7th Cir. 1950) (dictum).

[82] *In re* Freeman, 49 F. Supp. 163 (S.D. Ga. 1943). The case, in which there was a mortgage (although no specific assignment of rents or of the lease), has been criticized, 6 COLLIER § 3.24(2), and noted without comment pro or con, 2 REMINGTON § 1141.75.

affirmative duties which the lessor's representative may find burdensome. The pertinency of the second sentence of section 70b remains as an argument against rejection. The fundamental reason for allowing rejection in the case of bankrupt lessees, that the accelerated rent claim would overwhelm all other creditors, is not present in the lessor's case. It is therefore suggested that the result in the lease-only situation should be the same as the conclusion reached in the parallel mortgage and lease case. However, no case authority or text comment has been found to substantiate this view, and it can only be supported on the arguments presented above and by the equitable considerations which usually will be present in a chattel financing of this type. No matter which situation is being considered—lease alone or lease plus mortgage—the result must conform to the underlying purpose and philosophy of the Bankruptcy Act of preserving the assets of the estate to the greatest degree consistent with the claims of competing creditors. On a test of equities, it would seem that at least in a typical personal property financing they clearly favor the continuance of the lease. In many cases the anticipated rentals are far greater than the scrap or resale value of the equipment, and the expenses of repossession and sale might be heavy. The lessee will have a claim for damages in the event the lease is terminated, so that the estate will acquire yet another creditor, and if the equipment is an integral part of the lessee's commercial or accounting operations, the provable damages might be severe. The interests of the lender, one of the major creditors, should be considered in reorganization, and in straight bankruptcy the damage claim upon disaffirmance will be the total amount of principal and interest on the lender's notes. Finally, accepted commercial practice would be violated, leading to difficulties in other financing arrangements based on the assignment of intangible rights.

So far, consideration has been given to claims of the lender directly against its obligor, the lessor. In the more unlikely event of the bankruptcy or reorganization of the lessee (upon the credit of which the lender has placed its confidence), the same question of rejection of the lease is present. The statutory sections are identical, but as a practical matter it seems settled by the cases (in the absence of any clause specifying automatic or optional termination upon insolvency) that the trustee of a bankrupt lessee will be able to reject an equipment lease on the grounds that it is an unduly burdensome

executory contract.[83] However, an argument may be made against the rejection of such a lease if it can be shown that the rental is fair, that the use of the equipment in question is an integral part of the lessee's business and essential to continued operations, or that the estate will benefit in some other way by the availability of the leased machinery, automobiles, or other chattels. It might also be to the advantage of the lessee's trustee to affirm the lease if, because of an unusually advantageous rental, it could be profitably sold as an asset of the estate.

If a lease is rejected, a claim arises as against the bankrupt estate of either a lessor or a lessee.[84] The limits on a landlord's claim to one year's rent and to three years' rent, dependent upon the type of proceeding, appear immediately following the quoted language in each instance. It is clear, however, that these limits do not apply to the claims of a lessor of personal property, but only to those of a real property landlord.[85]

Once the claim is established, the lender's immediate interest is the measure of damages which may be recovered for the anticipatory breach. To some extent its recovery from an insolvent lessee may be influenced by whether the proceedings are in straight bankruptcy or under Chapter X. As a general rule, however, it can be said that for all practical purposes the lessor will be able to recover actual damages according to state law, although care must be exercised to avoid having the recovery stipulated in the papers disallowed on

[83] See, *e.g., In re* Chicago Rapid Transit Co., 129 F.2d 1 (7th Cir. 1942), *cert. denied,* 317 U.S. 683 (1942); 6 COLLIER §§ 3.23 (4), 3.24 (2); 3 COLLIER § 60.33; 4 COLLIER § 7044. For a discussion of the role of state public utility commissions in reorganization and the exception of "contracts in the public authority" from the rejection provision see this case and 6 COLLIER § 3.23 (9).

[84] The claim arises by virtue of the statement of B.A. § 63 (c), 11 U.S.C. § 103 (c) (1958), which provides that: "Notwithstanding any State law to the contrary the rejection of an executory contract or unexpired lease . . . shall constitute a breach of such contract or lease as of the date of the filing of the petition in bankruptcy, or of the original petition under Chapter X... of this Act," coupled with the provisions of B.A. § 63 (a), 11 U.S.C. § 103 (a) (1958), which provides: "Debts of the bankrupt may be proved and allowed against his estate which are founded upon... (9) claims for anticipatory breach of contracts, executory in whole or in part, including unexpired leases of real or personal property...." and those of B.A. § 202, 11 U.S.C. § 602 (1958), which provides: "In case an executory contract shall be rejected... any person injured by rejection shall... be deemed a creditor."

[85] See the discussion in 3 COLLIER, §§ 63.31, 63.33; 6 COLLIER § 3.23 (1), and sources cited *supra* n. 83. As to § 202, see 6 COLLIER, § 9.20. The proviso to § 63a (9) relating to the court's "scrutiny" of the circumstances of an assignment of future rent claims is not discussed here since it is assumed that the lender has paid full value for its assignment and in any event only holds it for security.

the grounds that a "penalty" is being enforced, which would work a forfeiture. Provisions for the acceleration of all rent to be due over the term of the lease have generally been disallowed as being a penalty.[86] Liquidated damages, thought by the court to bear a reasonable relationship to the injury, have been approved,[87] but the problem for the draftsman is only resolved by the most strict observance of the possibility that any particular clause will fail to meet the uncertain test of when such a "reasonable relationship" exists.[88] It may be that after consideration counsel will decide against a liquidated damage provision unless a very special situation exists, and will also be wary of notice clauses.[89] Assuming that the documents do not speak in liquidated terms, the usual measure of damages in personal property leases is the excess of (a) the total amount of the unpaid rentals due over the residue of the lease, *less* the cost of unperformed covenants (such as to repair and to pay taxes), commuted to a present cash value, over (b) the value of the property to the lessor on repossession (either for rental purposes, on resale, or as salvage).[90] Where there is absolutely no salvage or resale value in the property (a question which must, of course, be properly proved at the trial level), the accelerated rentals have been recovered in

[86] The leading case is Kothe v. R. C. Taylor Trust, 280 U.S. 224 (1930). See also Commissioner of Insurance v. Massachusetts Acc. Co., 310 Mass. 769, 39 N.E.2d 759 (1942).

[87] Irving Trust Co. v. Perry, 293 U.S. 307 (1934) (a leading case in the history of this subject); Bassett v. Claude Neon Fed. Co. of Kan., 65 F.2d 526 (10th Cir. 1933).

[88] *Compare* Lamson Co. v. Elliott-Taylor-Woolfenden Co., 25 F.2d 4 (6th Cir. 1928) *with In re* Gelino's, Inc., 43 F.2d 832 (E.D. Ill. 1930). The district court in the latter case called this question "one of the most perplexing and difficult inquiries encountered in the construction of written agreements." *In re* Gelino's, Inc., *supra* at 833.

[89] It seems prudent to avoid the use of liquidated damage clauses unless the nature of the equipment being financed is such that the proof of injury is uncertain and subject to controversy. Not only do courts look with disfavor on liquidation clauses, but on occasion advance stipulations of costs may work a hardship in that they limit the actual damages otherwise recoverable. See Arrow Petroleum Co. v. Johnston, 162 F.2d 269 (7th Cir. 1947), *cert. denied*, 332 U.S. 817 (1947). It also seems desirable to avoid clauses entitling either party to terminate on a certain number of days notice, in view of the possibility that damages may be limited to the notice period. *In re* Petroleum Carriers, Co., 121 F. Supp. 520 (D. Minn. 1954).

[90] Electrical Prods. Consol. Co. v. Sweet, 83 F.2d 6 (10th Cir. 1936). Compare *In re* Gelino's, Inc., 43 F.2d 832 (E.D. Ill. 1930). Both cases involved leases of specially made neon signs. This measure of damages has also been applied in non-bankruptcy cases. Rentways, Inc. v. O'Neill Milk & Cream Co., 282 App. Div. 924, 125 N.Y.S.2d 282 (1953), *aff'd*, 308 N.Y. 342, 126 N.E.2d 271 (1955). Sometimes damages are expressed in purely contract terms. See the discussion in the dissenting opinion of Littleton, J., in New York Mail & News Transp. Co. v. United States, 154 F. Supp. 271 (Ct. Cl. 1957), *cert. denied*, 355 U.S. 904 (1957) as to inclusion of anticipated profits.

full, but these cases do not necessarily run counter to the general rule just stated, being a special application of it to unusual factual situations.[91] The claim then must be liquidated according to the rules and procedures established by section 57d of the Bankruptcy Act, as a pre-requisite of allowance.[92]

If the defaulting party is the lessor, the lessor's trustee is faced with the lender's direct claim on the note or other evidence of indebtedness, and the lessee has a contingent claim against the estate, which arises under section 63a (8). Since in ordinary bankrupcty the lessee's possession may not be disturbed by the default, the lessee's claim is often limited to the recovery of security deposits or damages for the breach of the lessor's covenants, such as to provide maintenance. In reorganization, the lessee is a creditor by virtue of Section 202, and may, therefore, have a similar claim allowed subject to its being adequately liquidated.[93] To the extent that these demands are not unduly burdensome to the estate of the bankrupt lessor, the lender is benefited, since under these circumstances its recovery is limited to its interests as a secured creditor against the lessor's estate plus whatever deficiency judgment it may be able to enforce. As mentioned above, the lender's recovery may not be precisely the same in reorganization as in ordinary bankruptcy, a possibility which arises because of a difference in the theory underlying each proceeding. Thus in cases where the lessee of real property is bankrupt, rejection does not terminate the lease in the sense of severing the landlord-tenant relationship (unless the lease specifically so provides); it does give the injured lessor a claim for damages. In a reorganization, however, there is no dual concept of a bankrupt (who can stay as a tenant) and his estate, which is liquidated for the benefit of creditors. It has therefore been said that in reorganization the landlord-tenant status is terminated by rejection,[94] with the lessor remitted to whatever claim he may have against the estate. Since after a discharge a corporate bankrupt will usually be dissolved so that the lessor's claim will be unenforceable, it seems doubtful that the foregoing distinction between the effect of bank-

[91] *In re* Grodnik's Inc., 128 F. Supp. 941 (D.C. Minn. 1955). Compare *In re* Diana Shoe Corp., 80 F.2d 827 (2d Cir. 1936).

[92] 3 COLLIER § 57.15. The leading case as to liquidation is Maynard v. Elliott, 283 U.S. 273 (1931).

[93] Royal Petroleum Corp. v. Smith, 127 F.2d 841 (2d Cir. 1942) (involving real property).

[94] *Compare* 4 COLLIER § 70.44 (2) *with* 6 COLLIER § 3.24 (1)- (2).

ruptcy and that of reorganization has much practical significance. In any event it would appear that this adverse factor is inherent in any loan of this type, and therefore the lender is forewarned at the time of making the original investment on the faith of the lessee's credit. The lender can perhaps justify its position on the grounds that the lessor's recovery will inure to its benefit and the equipment will hopefully have a resale or re-rental value sufficient to make up the difference, as it would be unlikely that the typical lessor would have sufficient assets to pay the deficiency. The lessee may have an additional liability for occupying the premises after the date of the petition for bankruptcy or reorganization. If the trustee adopts the lease, the payment is usually according to the contract, and the rent claim enjoys a priority position as an expense of administration within section 64a (1).[95] Where there is rejection, the liability is only for the fair value of the use of the equipment between the date of rejection and its return.[96]

METHODS OF FINANCING

Various plans have been developed in order to implement financing through the use of personal property leases. Counsel must not only judge their legal effectiveness, but necessarily must consider how well each handles certain practical obstacles. One question is to determine which party must bear the burden of handling the administrative paper work involved in this type of loan and the attendant overhead costs. In a lease of a single piece of heavy equipment for a period of years, this factor is negligible. But in situations involving many items of small unit value, in those where substitution of collateral is significant, and in mobile equipment cases, there is a considerable amount of bookkeeping which the ordinary institutional investor is not equipped to handle. Monthly and sometimes daily entries must be made, involving—in an extreme example—such matters as the motor numbers and serial numbers of each vehicle of a large fleet, its whereabouts, registration number, chattel mortgage recording data and statutory renewal dates, lease dates, amount of rent due, amortized value for loan and for insurance purposes, etc.

[95] When an executory contract is adopted, the trustee takes both the benefits and the burdens, and the latter includes an assignment to a financing institution of the proceeds of the contract. *In re* Italian Cook Co., 190 F.2d 994 (3d Cir. 1951).

[96] As to adopted leases, see 3 COLLIER § 64.102; 4 COLLIER § 70.44 (4); 6 COLLIER § 3.24, at 711. As to those rejected, see 4 COLLIER § 70.44 (4), at 1375; 6 COLLIER § 3.23 (8).

The professional leasing companies offer to do this job, taking as their compensation a certain percentage of the rentals paid, and some commercial banks and trust companies are equipped to give the same service, either for their own account or as the lender's fiscal agent.[97] A second matter of business importance is the ability of the borrower-lessor to carry the cost of the equipment during the period between its purchase and the advance of funds by the institutional investor, either on its own working capital or by current lines of credit. Although sometimes these may be simultaneous transactions, more often the investor is not willing to advance its money until the lessor has bought the equipment, delivered and perhaps installed it, and obtained an executed lease, mortgage and assignment. The delivery dates will vary according to the ability of the manufacturer to supply the goods and the need of the lessee to put them to productive use.

As opposed to the purchase of the direct obligation of the lessor, which is usually in the form of a secured note, a bank may be active in financing the lessor, and desirous of funding some of its line of credit with a long-term lender. Such a procedure may present the opportunity of purchasing certificates of interest in the bank's loans to the leasing company, the investments to be made according to a prearranged agreement as to minimum dollar amounts and time periods between "take-downs." The certificate recites that the investor owns a specified dollar amount of the bank's loan, is entitled to repayment of principal and interest as it is received by the bank, and has an interest in the mortgages and lease-rights (held by the bank) proportionate to the dollar amount it has purchased. The advantage to the institutional lender in the certificate of interest method is that the bank constantly operates an account with the borrower, debiting the cost of new purchases and crediting repayments of principal and interest, while the insurance company or other financing agency buys and holds certificates which represent a fixed original amount against which payments of principal and interest are made in accordance with the schedule agreed upon. The bank also

[97] The fees charged vary dependent on the circumstances, including the credit standing of the parties, the services performed, and other factors, so that generalizations are almost impossible. A bank will also be recompensed by the use of the compensating balance which it will probably require the borrower to maintain. Keenan, note 10 *supra*, at 41. Because of the right of set-off, the bank will be ahead of a term lender to the extent of the borrower's deposits with it.

holds the collateral, with the result that the investor is always in a secured position and yet does not have to be concerned with the details of substitution of units, proceeds of insurance, and so forth. The transfer of the administrative burden to a bank protects the coupon rate of return for which the long-term lender has bargained, and allows flexibility in the program as between the lessor, the lessee, and the supplier of the equipment.

There may be legal flaws in this system. When more than one lender is involved, the provision of many regulatory statutes which forbid "participations" may present difficulties,[98] although it seems doubtful that the intent of such legislation is to prevent the joint holding of collateral by two or more institutional lenders through a common agent. As a result the agency relationship is probably acceptable enough, especially in the certificate of interest transaction, even though most counsel would prefer to avoid all problems by having the bank undertake to be a trustee for their mutual benefit. Further, the investors should be sure to retain power to direct the bank as to the choice and manner of enforcement of remedies, usually by a two-thirds in interest vote, in order to obviate any criticism that the disposition and control of their property has been delegated to persons not authorized by statute.[99] A further precaution for the lender is to obtain the agreement of the lessee that payments will be made directly to the bank, in accordance with the terms of the bargain, and sometimes the certificate is endorsed to show the lessor's undertaking to guarantee payment of the certificate, and possibly performance of other covenants, directly to the lender. Although this endorsement by the lessor-borrower is in a form somewhat reminiscent of a railway company's undertaking in an equipment trust, the vital distinction is that in the latter case the principal source of credit, the lessee, is making the guarantee of payment. However, it nevertheless carries some substance in the situations being considered here, in that the lender may thereby assert a claim against the receiver of an insolvent lessor, and to that extent, be further secured than if its derivative rights through the bank were the only remedies available.

In some personal property lease situations the evidence of the

[98] *E.g.*, MASS. GEN. LAWS ch. 175, § 66 (1932); INSURANCE LAWS OF NEW JERSEY, § 113; N.Y. INS. LAW § 78 (2).

[99] *Ibid.*

lender's loans consists of certificates issued by a trustee, who holds title to the leased chattels and acts as mortgagor, lessor, and debtor. Such a financing method has been used in the automobile field, and may have been modelled on the Philadelphia plan equipment trust. The purpose is usually to segregate ownership of a particular group of chattels which are the collateral for a specificed financing, and such a plan may reduce the number of states in which the leasing company must qualify as a foreign corporation. Often, with cost-savings in mind, it is proposed that an individual be named rather than a national bank or trust company. Although this may be an adequate temporary solution to the question of increased charges, the lender is well advised to reserve the right to remove the individual at will (with the option of substituting a bank or trust company of its choosing) and to receive regular financial reports of the individual trustee's affairs, preferably by certified public accounts. Even with these qualifications, such arrangements are far from satisfactory. The danger always exists that the trustee, who usually is an employee of the real party at interest (either a leasing company or the lessee itself), will be held to be nothing more than an agent. And, if affirmative duties are not imposed, there is the possibility that a court would disregard the trust on the theory that as a "dry" trust it was merely fictional.[100]

Another lease financing arrangement involves the acquisition of title to the property by the institutional investor. These plans represent a variation from the commercial financing being discussed here, and seem to have been primarily used in connection with transportation equipment such as railroad cars, ships, and aircraft. Some of the problems discussed above are pertinent to plans of this type, but it is beyond the scope of this paper to comment on this method of utilizing a personal property lease.

Other Matters

With reference to closing procedures pertinent to an investment of this type, the documents required by an institutional lender to evidence a loan of this nature will include the usual corporate papers asked for in any direct placement loan.[101] It appears prudent to

[100] See *In re* Ford, 138 N.Y.S.2d 694 (Surr. Ct. 1954), and *In re* Benjamin's Will, 139 N.Y.S.2d 16 (Surr. Ct. 1955), applying N.Y. Real Property Law §§ 92-93 to trusts of personal property.

[101] See Johnson, *Special Counsel on Direct Loans*, XII A.L.I.C. 327 (1955).

obtain the certificates of incorporation, by-laws and certified copies of the pertinent votes of the board of directors (and of the stockholders, where required) of both the lessor and the lessee, along with evidence of the good standing of each in the states involved. If it is impracticable to demand full documentation from the lessee, as it may be in a transaction where the negotiation is essentially between the lender and the lessor, it would seem that the lender nevertheless should attempt to obtain a minimum of assurance as to the lessee's being bound. Such evidence might consist of a directors' vote or counsel's opinion as to the lease being duly authorized and legally binding on the lessee. Usually these basic documents are supplemented by others, peculiar to the transaction. Thus, whether the manufacturer of the equipment sells it, either to an affiliate or subsidiary which is dedicated to the leasing business or to a corporation which is a stranger to the transaction, an appropriate bill of sale, preferably with warranties, should be obtained. All pertinent records should be examined, since it is important to determine, to the best practicable extent, that there are no outstanding liens on the equipment arising prior to or incident with the financing arrangements. Although usually a bona fide sale in the ordinary course of business is sufficient to pass good title to a purchaser for value without notice, it should be realized that the possibility of adverse liens entitled to priority exists to a greater extent in this field than when dealing with real estate. These factors having been developed at some length elsewhere in this article, no further comment is needed, except perhaps to point out that the opinion of counsel for the lender cannot be expected to certify that a first mortgage of personal property is valid and enforceable, free and clear of all encumbrances, in the same manner as does a real estate opinion. On the other hand, special counsel for the lender should be able to state that he has examined a bill of sale, chattel mortgage and other pertinent records and possibly certificates from the borrower's officers, and that on such basis he concludes that the borrower has good title to the equipment to be mortgaged, free and clear of adverse liens which should be revealed by the precautionary measures taken. In some instances the opinion should also cover statutes such as Traders' Acts and Bulk Sales laws, although they are rather infrequently applicable. Perhaps the lender should also be careful in situations where its borrower has a contingent liability to the lessee by way of an agree-

ment to indemnify for patent infringement under a transaction involving complicated patent rights; if the lessor has obtained a parallel indemnity from the manufacturer of the equipment, it should run to the benefit of the lender as assignee of the lease, and special counsel's opinion should verify that the lender is adequately protected. The other usual items included in direct placement opinions should present no difficulties.

One further issue in this field has been vigorously debated among members of the accounting profession and is of more significance to the financial analysts of the lender than to its lawyers. The question is: should the rentals payable by the lessee under a long-term lease of personal property be capitalized and shown on the balance sheet, or is it sufficient to refer to them by footnote; in other words, are they not debt? There has been much written on this subject,[102] but for our purposes it seems fair to conclude that a proposed investment may safely be made so long as the financial covenants made by the lessee in its prior outstanding securities permit the lease obligations in question to be incurred and maintained, provided that at least the minimum requirements of sound accounting practice are satisfied, in that proper disclosure has been made, by footnote or otherwise, of the amount of annual rent and the term of the lease.

[102] Gant, *Illusion in Lease Financing*, HARV. BUS. REV., March-April 1959, p. 121; Vancil and Anthony, *The Financial Community Looks at Leasing*, HARV. BUS. REV., Nov.-Dec. 1959, p. 113; Zises, *Disclosure of Long Term Leases*, 111 J. ACCOUNTANCY 40 (1961); SEC Reg. S-X, 17 C.F.R. § 210.3-18 (1949).