

CLIENT ADVISORY

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PROTECTING YOUR RIGHTS AS A LESSOR/CREDITOR

The importance of distinguishing a “true lease” from a “conditional sale”

Are your commercial equipment leases “true leases” within the meaning of Uniform Commercial Code Article 2A? Or are they conditional sales governed by UCC Revised Article 9? Knowing the answer to this question can mean the difference between successfully protecting your rights as a creditor or relinquishing those rights in favor of the debtor or its other creditors.

Generally, whether a personal property lease is considered a “true lease” or a conditional sale depends on the residual value of the property at issue. Where the residual value is less than 15% of the contract amount, courts tend to interpret it as a conditional sale “disguised” as a lease. Where the residual value of the equipment is 15% or more, the courts tend to see it as a “true lease.” Too often, lessors unwittingly convert the more favorable true leases into conditional sales with diminished residual value by amending or revising lease agreements to provide for lease payments to be applied toward a purchase of the property. Without realizing it, the lessor becomes a secured creditor in the event the lessee files for bankruptcy. Many of the protections afforded the creditor as a lessor, then disappear.

Here are just a few examples:

- Under a true lease covered by Article 2A, a creditor who has reason to feel insecure about the debtor’s likelihood of meeting lease payment obligations has a right to demand “adequate assurance” of future performance by the debtor. No such safeguard for the creditor exists with conditional sales agreements governed by Revised Article 9.
- Because conditional sales are secured transactions subject to Revised Article 9, the creditor’s disposition rights regarding the equipment is subject to extensive notice obligations: notice to the debtor, to any guarantors or other third persons affected by the debt, other lien creditors holding rights in the collateral and lien creditors who have given the creditor notice of their claims. No such notice requirements exist under true leases covered under Article 2A.

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- Under Article 2A lease agreements, no particular warranties arise to third party purchasers upon disposition of the equipment. If Revised Article 9 governs the disposition of the equipment, then warranties of title and quiet enjoyment as well as warranties of fitness and merchantability will apply unless effectively discharged.

It is imperative that the individuals in your company responsible for negotiating the terms of equipment leases understand the differences between a true lease and a conditional sale. For further information, please contact Bob Bernstein or Chuck Bobinis at the Bernstein Law Firm, P.C. Bob can be reached at 412-456-8101 or toll free at 1-800-927-3197; email: bob@bernsteinlaw.com. Chuck can be reached at 412-456-8102 or toll free at 1-800-927-3197; email: cbobinis@bernsteinlaw.com.

Bernstein Law Firm, P.C. is a full service creditors' rights and bankruptcy law firm, providing a comprehensive range of services in all aspects of creditor and bankruptcy representation.

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