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Clarifying the Ambiguities in Bonus Depreciation Rules

By Arnold E. Grant

Treasury regulations issued last September clarify the application of bonus depreciation to sale-leaseback transactions, syndication transactions, and rebuilt and self-constructed property. This article shows the benefits of bonus depreciation for true lease transactions, as an increased percentage of depreciation deductions shift to the start of the lease.

The Imperfect Fit: Making Form Leases Work for High-tech Equipment

By Barry S. Marks and James M. Johnson, PhD

Forms drive equipment leasing. However, the standard lease form typically is ill-suited to the leasing of desktop and notebook computers and other small, often portable technology equipment. In short, one size does not fit all. This article looks at some of the pitfalls of those standard forms, offering sound alternatives to traditional lease language.

Selling Lease Receivables in a Post-Enron World: True-sale Opinions and Revenue Recognition

By William S. Veatch

Auditors are increasingly interested in lessors' agreements for the sale of lease receivables. Some lessors' practices may be inconsistent with the notion of a nonrecourse, off-balance sheet, true sale of receivables. Here are some practical approaches to drafting agreements, taking into consideration FAS 140 and UCC Article 9.

A Quest for Clarity: 2004 Industry Future Council Report

The 23rd annual Industry Future Council report evidences signs of encouragement and enthusiasm, at least in the small- and medium-ticket segments. Lessors continue to closely monitor proposed legal and regulatory changes.

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The Imperfect Fit: Making Form Leases Work for High-tech Equipment

By Barry S. Marks and James M. Johnson, PhD

Like its nearest cousin, commercial lending, equipment leasing is form driven. The vast majority of middle-market and small-ticket transactions as well as a number of large-ticket transactions are closed using form documents designed to apply to a broad range of equipment.

Recent experience has shown that the standard equipment lease form may be ill-suited to the leasing of desktop and notebook computers and other small, often portable items of technology equipment (all of which we will sometimes call "small computer equipment" in this article). Most lease forms were designed for nontechnology equipment, and many technology lease forms were written with mainframe computers and other large, immobile equipment in mind. A number of computer lessors have used their legacy language "mainframe" forms for the leasing of PCs with few or no changes. Few of these template documents address certain important, and arguably unique, issues in small computer leasing.

The situation is exacerbated by the additional rights and options many lessees request in technology leases. These options are particularly troublesome for lessors when added onto form leases that were not designed to accommodate such flexibility.

Recent case law[1] indicates that lessors may be disappointed with the end-of-term results in leases of small computer equipment: The courts have not been kind in responding to lessor attempts to limit lessee rights and options, and have thrown out lessor casualty remedies in recent instances.

The purpose of this article is to explore the more common pitfalls in using lease forms for small computer equipment. We will deal with key issues in conceptual fashion, raising the issues we repeatedly encounter in lease negotiations and litigation. Our goal is to serve up a platform for reconsidering lease form language when leasing smaller and portable items of high-tech equipment.

Our observation is that fitting high-tech transactions into standard form leases presents the lessor with the dilemma of one forced to lie on the bed of the mythical Greek giant Procrustes: The circumstances will never fit and limbs may be stretched or lopped off if one tries.[2] If we believed that an off-the-rack lease form would suffice the needs of most lessors, we could dispense with this article and put up a sign indicating the new end-all technology form lease is now on sale in the lobby.

The reader may wonder the extent to which this article overlaps with the content of "The Lease Contract: Sales Tool Opportunities" article published previously in this journal.[3] That article focused on universal lease contract provisions that could benefit from a face-lift and thereby improve their user friendliness. The issues discussed in the present article are entirely different, emphasizing those (nonuniversal) provisions in small computer leasing contracts that seem either inappropriate or create difficulties in that market.

Recent experience has shown that the standard equipment lease form may be ill-suited to the leasing of desktop and notebook computers and other small, often portable items of technology equipment.

THE INFLUENCE OF EQUIPMENT CHARACTERISTICS

Several lease provisions are affected by the nature of the equipment being financed. Small computer equipment, by its very nature, is subject to fairly rapid obsolescence, raising a host of issues: Does the lessor rely on the equipment's collateral value in its transaction

As a threshold matter, the lessor should consider whether provisions in its lease form designed to protect the value of the leased equipment are truly valuable.

risk assessment? Does the transaction pricing assume a high residual value? How should upgrade or technology refreshment be addressed? What risks are inherent in the mobile nature of small computers? How important is it to enforce ongoing maintenance provisions during the lease term, given the eroding value of the equipment being maintained? These issues are discussed in this section.

RELIANCE ON COLLATERAL AND RESIDUAL VALUES

As a threshold matter, the lessor should consider whether provisions in its lease form designed to protect the value of the leased equipment are truly valuable. If the lessor acknowledges that the value of the equipment as collateral is not a significant determining factor in the credit process, and that the lessee's creditworthiness is the key factor, it might be reasonable for the lessee to request some relaxation of maintenance and return provisions.

On the other hand, small computer equipment is often leased to startup or "development stage"[4] lessees or those in emerging or potentially volatile industries. Although the resale market for desktop computers may not be very attractive, most lessors are unwilling to ignore their potential value altogether in the event of a lessee default.

Another important consideration is the significance of residual values to small computer equipment lessors and the effect of form language and lessee options on residual recoveries. In response to a highly competitive marketplace, some technology lessors have felt compelled to lower rental rates by making unrealistic (aggressive) residual value assumptions. Some lessors have rationalized these aggressive residual value assumptions by betting on the lessee's desire to exercise a fixed-price purchase option or to be persuaded to accept a relatively high fair market value purchase option. Some lessors may assume that, by creating impossible return standards,[5] they will be able to goad the lessee into paying an above-market purchase price for the equipment. To date, the results of this business practice have been mixed at best.

NATURE OF EQUIPMENT

The nature of high-tech equipment, particularly small computers, frequently lends itself to a desire on the part of the lessee to maintain cutting-edge technology. At the same time, the lessor may find even a "reasonable" residual assumption too high in the event that technology advances unpredictably rapidly during the lease term.

A solution to the need to maintain cutting-edge technology will often lie in some form of "upgrade" or "refresh" right.[6] Should the lessor insist on mandatory upgrade or refresh, with or without an increase in rent to protect or enhance the value of its assets? What if the change occurs during the last year of the term? How can the parties distinguish between a true upgrade and modifications of the equipment that benefit the lessee but adversely impact the lessor's remarketing ability?

Lessees may have a strong desire to upgrade when business needs dictate as opposed to when a lease expires. If the lessee needs to upgrade and the incumbent lessor will not provide assurances of upgrade financing, this places the lessee in a difficult situation. If the lessee adds upgrades to the lessor's property that the incumbent lessor chooses not to finance, it is unlikely that the lessee can persuade another lessor to finance an upgrade to another lessor's underlying asset. On the other hand, giving a lessee blanket contractual assurance that the lessor will provide upgrade financing would not protect the lessor should the lessee suffer a significant credit downgrade.

UPGRADES AND MOBILITY

The usual upgrade issues exist as well: Can the lessor, particularly a lease originator, commit to additional financing at inception of the initial lease term? Should the lessor have the right to use current market analysis in upgrade pricing and evaluate changes in the lessee's creditworthiness? If the lessor is committed to providing upgrade financing on "mutually agreeable" terms, is there a way for the lessee to be assured they will be on commercially reasonably terms? A number of experienced lessees believe that "mutually agreeable" upgrade terms mean little—especially if their internal equipment users consider an upgrade essential.

Physical aspects of the equipment should be considered as well, most notably the fact that the equipment's mobility (in the case of notebooks, desktops, and numerous other items) makes it more susceptible to theft, loss, and "mysterious disappearance." Also, relocation of the equipment can result in a change of tax treatment, both with respect to hardware and as to software used in connection with the equipment. This can create an administrative headache for the lessor, particularly when the equipment is brought into a jurisdiction where the lessor does not routinely transact business.

At the same time, mobility may be important to the lessee. Many lessees point to the fact that lease language prohibiting equipment relocation was drafted largely in response to the former version of Article 9 of the Uniform Commercial Code, requiring a filing where the equipment was located. Under Revised Article 9, the filing is made in the jurisdiction in which the lessee is organized, and a new filing is not required when the equipment is relocated.

Lessors should bear in mind, however, that analysis of state sales/use and property tax is subject to change when equipment is moved across state lines. In addition, having knowledge of the location of equipment (collateral) is obviously essential to successful repossession and can affect end-of-term planning.[7]

MAINTENANCE: COVENANT OR RETURN PROVISION?

The reader may ask whether additional lessor protections, or requested lessee options, should apply only at the end of the lease term as opposed to the entire lease term. For example, if the lessee is concerned about maintaining its many notebook computers according to a high performance standard, should the lessor relax the maintenance requirement during the term so long as the lessee brings the equipment up to good working order at the end of the term? Should the lessor leave the standard form language requiring maintenance in "good operating condition" as is but assure the lessee that no one will care if a few items are not properly maintained?

Many will argue that standard maintenance provisions for small computer equipment are largely irrelevant, since new units are covered by a warranty, and are often not subject to "current engineering changes," or subject to periodic preventive maintenance by a maintenance organization affiliated with the lessor or other certified maintenance organization. However, a lessee suffering significant financial reverses during the lease term could potentially return units with relaxed maintenance standards in pieces.

Accordingly, we recommend that consideration be given to including the risk of a lessee default, requiring the lessor to look to the collateral value of the equipment. Another issue is whether the lessor, by knowing (whether or not admitted in writing) that the repair and maintenance requirements set too high a standard for the lessee to meet consistently, is acknowledging that the terms of the lease will be ignored—a fact that

If the lessor is committed to providing upgrade financing on "mutually agreeable" terms, is there a way for the lessee to be assured they will be on commercially reasonably terms?

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could influence a court's construction of the lease provisions.

CASUALTY LOSSES AND CURES

Damage Versus Destruction

As noted, items of small computer equipment are mobile and more likely to be lost or destroyed than, for example, a computer mainframe. The lessor's ability to inspect may be substantially reduced and any hope of tracking items such as notebook computers is lost at the outset. The difference in the burden on a lessor to inspect 10,000 notebook computers in 38 locations versus one mainframe is considerable.

Perhaps a greater issue, however, is the distinction between "damage" and "destruction." If a desktop computer continues to function properly but is so badly damaged that it is being held together with duct tape and would cost more to repair than it is worth in the open market, has it been destroyed? What is the definition of "material" damage for notice purposes and as applied to the definition of "event of loss"?

We are seeing more and more language variations addressing these issues. Is there a difference between "damaged beyond repair" and "damaged beyond economical repair"? In the opinion of many, yes. Suppose a unit under lease suffers damage. Further suppose the casualty value applicable is $600, fair market value (however determined) is $300, and the cost to repair is $400. Has the unit been destroyed? It depends on what was agreed to. If the agreement indicates a casualty has occurred if a unit is damaged beyond repair, the unit has not been destroyed because it is repairable. Good arguments can be made that the unit has, however, been damaged beyond economical repair, since the value of the unit is $300.

Many lessees press for special rights with respect to small computer equipment "consumables," which may include mouses, keyboards, manuals, cables, and other peripheral items that are most likely to be lost or destroyed during the term. What are "consumables" in a lease agreement? If consumables are lost, should lessee be required to replace them as part of routine maintenance, only at the end of the term or should they be covered by some form of casualty value calculation or not exceed value? Some substantial lessees have been pressing for language that requires the lessee to use its "best efforts" to return consumables, but faces no contractual liability in the event some are missing upon return.

Replacement Rights

One of the key issues in this area is the lessee's right to replace individual items that have been lost, stolen, or destroyed. The common "like kind" replacement language is usually spare, speaking in terms of replacement of equipment of the same make and model from the same manufacturer. In the case of small computer equipment, lessors might do well to consider modifying the like-kind language, should they be willing to permit it to begin with.

For example, may the lessee replace an item with an "improved" item that is less marketable at lease termination? Does the substituted unit have to be from the original manufacturer—even if said manufacturer no longer makes such equipment? If the original model has been discontinued, should the lessor require replacement with the improved model? We have been seeing more "if" lists being pursued by larger, creditworthy lessees on this issue. They seek like-kind language that permits equipment replacement from the same manufacturer if available, and of the same configuration if available. If neither can be complied with, then equipment may be substituted that is of at least comparable functionality, and equipment manufactured by another tier-one vendor (as defined by the Gartner Group), and so forth.

Even more basic than the definition of like-kind is the working of the event-of-loss section itself. The classic event-of-loss provision often requires the lessee to notify the lessor in the event of a loss and elect promptly whether to replace the equipment or pay the casualty value. Lessees are likely to complain that they will not have the ability to notify the lessor of the loss of small computer equipment and may structure the notice obligation, if any, to knowledge by a senior officer, or knowledge at end of term.

Reasonable as this may sound, it leaves the lessor exposed to the lessee's "discovering" the loss of equipment on the last day of the term. This creates a de facto purchase option, allowing the lessee to pay casualty value for the "lost" items or to replace the item at the end of the term, whether or not the lessor had intended to give the lessee a purchase option or substitution right (discussed below). On the other hand, what injury has the lessor suffered if it has received full rent payments throughout the lease term and has only to dispose of the equipment?

If nothing else, casualty values for the end of the term should be calculated to cover the lessor's anticipated residual fully, even if (arguably) higher than projected fair market value. Lessors typically book a lower residual value than they expect to realize to avoid an unpleasant surprise at lease end or to avoid writing down a diminished residual value during the lease term. If the lessee is unable to produce all leased units at the end of term, the lessor has lost its ability to realize the value originally anticipated. Thus, one would expect the end-of-lease casualty to exceed the residual value booked by the lessor.

Consideration should be given as to what is embedded in casualty values, however. Higher is not always better. Casualty values set at a level that enriches the lessor can create a moral hazard problem, and may be construed by a court as a penalty and (accordingly) discarded as a remedy.

If a lease is worth considerably more dead than alive, there will be an incentive to kill it. For example, suppose that at the end of a lease, equipment has a fair market value of $200, and the casualty table translates into a value of $650. Pieces of equipment are returned with damage, which is not allowed under the express terms of the lease. If returning damaged units is a breach of the agreement, the lessor might press for invoking the casualty value, if that is an express remedy. Is this a penalty? Good question, and one to be addressed by the court, should events move to litigation.[8]

If nothing else, casualty values for the end of the term should be calculated to cover the lessor's anticipated residual fully, even if (arguably) higher than projected fair market value.

MAINTENANCE AND ALTERATION

In this section, we raise issues relative to maintenance requirements, alterations to equipment, and software considerations.

Structural Issues

Many leases of small computer equipment require maintenance to be performed by either the manufacturer of the equipment or an approved maintenance organization. Is this really appropriate for small computer equipment, particularly in light of the likelihood that the warranty on such equipment may extend for the entire term of the lease? What is there to maintain if a warranty is in place?

Another issue regarding warranties should be considered carefully, particularly in light of recent litigation.[9] Embedded software and certain hardware functions may result in significant warranty payments or rights. In many cases, these payments or rights address issues affecting residual value as well as functional value of the equipment during the lease term. Many form leases provide that, so long as the lessee is not in default, the lessee has the right to all warranty recoveries.

On the other hand, should the lessee be allowed to handle its own maintenance or to allow the actual equipment users to drop

Forms prepared for nontechnology equipment rarely include language applicable to the incorporation of software used with leased hardware. In fact, many form agreements prepared by technology lessors are silent as to software issues as well.

the equipment off at the local computer discount store for maintenance? Once again, the contract requirements as to maintenance should be influenced by collateral and lessee creditworthiness considerations. If a lessee is highly creditworthy and makes all lease payments, does it not agree to return the equipment in good repair and function? However, a development stage lessee may not be able to honor the same promise as its creditworthy counterpart, and thus contractual requirements may differ appreciably between the two.

Software Issues

Forms prepared for nontechnology equipment rarely include language applicable to the incorporation of software used with leased hardware. In fact, many form agreements prepared by technology lessors are silent as to software issues as well. In many cases, the only relevant language deals with "alterations and modifications" or "accessions," none of which is likely to cover the most important issues to lessors of small computer equipment.

Other articles have treated software issues, but relevant considerations include these: Who owns the software? (Is it licensed to the lessor or lessee?) Should the lessee be required to remove the software at the end of the lease term and "scrub" the system prior to return? Is it clear that all software necessary to maintain the value of the equipment must remain on the equipment? Software issues are becoming a bigger deal and need to be addressed by lessors. However, the primary focus of this article is hardware issues. Thus we will sidestep these software issues for now as being beyond the scope of this article.

RETURN OF EQUIPMENT

No issue is more vexing for lessors (or lessees) of small computer equipment than the end-of-term situation. In many cases, the lessor is hoping that the lessee will exercise its purchase option because it may be facing a potential loss or weaker profits if the lessee elects to return the equipment instead. Not surprisingly, much unpleasantness and litigation has cropped up in recent years when notebooks, desktops, and other small items of technology equipment are returned, or attempted to be returned.

At the same time, lessees are pushing for additional options and rights as part of their request for proposal, often at the advice of lessor consultants and active intercompany communication networks on the Internet.

Perfect Return

Some lessees demand a clear definition of "reasonable wear and tear" that focuses solely on the ability of the equipment to function in its desired manner. This means that the lessor may find itself with notebooks with broken hinges or latches, cracked screens, and other "cosmetic" deficiencies.[10] From the lessor's standpoint, reasonable wear and tear language may be as unattractive as it is to the lessee and should be clarified.

As will be further discussed below, perfect return also requires that all items are returned simultaneously. Much confusion and litigation has arisen over the interplay of this requirement with various lessee-requested options and overt language in the lease giving the lessee the right (at least arguably) to return less than all of the equipment. From the lessee's perspective, this merely reflects the fact that some of the equipment is highly likely to be lost or destroyed during the term. From the lessor's viewpoint, it means that the lessee has the option to cherry-pick the equipment, keeping the units that are in the best condition and returning those that barely come in under the definition of reasonable wear and tear.

The perfect return concept also raises issues regarding extensions of the term and what happens if some of the equipment, but not all, requires substantial repair or modification either to qualify for maintenance

recertification or simply to be in good operating condition. Does the entire lease (or schedule) extend? Does the lessee pay a per diem only for the equipment being repaired? Does an automatic renewal provision for an extended term kick in if all units are not returned at end of lease? What is the intention of the parties if the problem is not discovered until after the notice period for exercise of any purchase option has passed?

Substitution of Like-kind Equipment

It is not surprising that lessees want the right to return any similar small computer item if the particular one they leased could not be found at the end of the term or if return is simply inconvenient. Some lessors, however, insist on being paid casualty value in the event the equipment cannot be located at the end of the term. Should a casualty value apply to units that are not returned—or to all units because compliance with the return provision is "defective?" Other lessors, often because of commitments to remarket the equipment en masse, may insist on a "perfect return" with all items being returned or all items being purchased under the lease.

Depending on how event-of-loss language is drafted, it may give the lessee the right either to replace or pay the casualty value for individual items even if the language does not appear as an alternative to perfect return. Also, some master leases provide for return of items from different schedules as allowable to satisfy the return provision for a specific schedule that has come to term. Such "cross-schedule substitution" can provide the lessee with a degree of (unexpected?) flexibility if multiple schedules are employed.

As in any other replacement or substitution, the definition of acceptable like-kind equipment should be considered carefully. Some contracts employ a rather elaborate hierarchy of permissible substitutions, starting with same manufacturer, make and model if available, down to a comparable tier vendor with equipment of at least comparable functionality.

Serial Number Substitution

Another commonly sought lessee option is the right to "substitute serial numbers." This language is often used to mean that the lessee may return other items leased by the lessor out of schedule, meaning that an item that does not come off lease for several months might be returned early while a similar item is returned late.

Consider the effect of this if the items are listed on different schedules and the schedules have been assigned to different lenders or funders. Consider also that the effect of this might be that the lessee returns many items early that, due to improper contract drafting, are not truly identical. They may be from a different manufacturer, model, vintage, and configuration. The result could very well affect the lessor's collateral value in the later months of the lease and create remarketing problems. Finally, it significantly increases the potential for a lessee cherry-picking its leased portfolio.

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TOWARD A MORE WORKABLE LEASE CONTRACT

This article, by design, has raised more questions than it has answered. Most of the issues we have addressed require negotiation by fully informed lessors and lessees willing to break from typical lease form language and draft creative solutions. Our position in this article is that technology lease contracts should not be viewed as Procrustean beds: One size does not fit all, and lessors differ considerably as to their objectives and tactics.

We advise that these solutions should not simply be contained in an addendum or alternate lease form that does not fully reexamine standard lease language. This is necessary so that new provisions such as substitutions of like-kind equipment at the end of the lease term can be read against existing lease language, for example. In any event, much of the language in traditional equipment lease forms should be rethought

The definition of acceptable like-kind equipment should be considered carefully. Some contracts employ a rather elaborate hierarchy of permissible substitutions.

Allow movement if reasonable, preferably with notice to lessor and only within a geographic area acceptable to the lessor, taking into account the possibility or default or early return.

when leasing notebooks, desktops, and other small computer equipment.

In creating a lease form to address these issues, the lessor should consider the following alternatives to traditional lease language:

1. Get ahead of the curve with the lessee by offering a reasonable upgrade or refresh option that allows for reexamination of the lessee's credit and valuation of new or upgraded equipment, as well as adjustment for market conditions at the time of upgrade.

2. Consider and adjust language for the importance of equipment location. Allow movement if reasonable, preferably with notice to lessor and only within a geographic area acceptable to the lessor, taking into account the possibility or default or early return.

3. Examine maintenance language and consider whether it is essential to residual assumptions that maintenance criteria be specified, during the term, upon return, or both.

4. Look closely at the definition of casualty and consider how "minor" damage might affect residual value.

5. Before presenting the agreement to lessee counsel, consider the effects of replacements, substitutions, returns of other leased items and other end-of-term rights commonly requested by many technology lessees. Once again, be prepared with a reasonable alternative before the lessee presents its version.

Endnotes

[1] See, e.g., *Digital Storage Inc. v. ePlus Group Inc.*, 65 Fed Appx 37, 2003 W.L. 21054656 (6th Cir. 2003); *Relational Funding Corp. v. TCIM Services Inc.*, 2002 W.L. 655479 (D. Del. 2002).

[2] In Greek mythology, Procrustes was an infamous robber in Attica who would place his victims on a bed and either cut off their limbs until they fit if they were too short.

[3] James M. Johnson and Barry S. Marks, "The Lease Contract: Sales Tool Opportunities," *Journal of Equipment Lease Financing* , Vol. 15, No. 2 (Fall 1997), pp. 14-17.

[4] A development stage firm is one that has yet to produce a commercially viable product or service.

[5] "Impossible" return standards can take many forms, but the common theme is that it would be extremely unlikely for the lessee to comply with the provision or provisions. Such return standards have been used both to extract a higher agreed-to purchase price from the lessee and to assert the lessee's breach and attempt to pursue a casualty value remedy. Examples include the requirement to return all but not less than all equipment under lease; a return condition that requires no repair, functional damage, or cosmetic damage, no missing cables or manuals; and return of equipment in original packaging materials.

[6] The authors will, for purposes of this article, use "upgrade" to mean additions or modifications to existing equipment and "refresh" to mean replacement of existing equipment with a new and improved model.

[7] For more particulars regarding equipment relocation issues arising from both former and Revised Article 9, see "How Revised UCC Article 9 Will Affect Your Lease Documents," by Edward K. Gross, *Journal of Equipment Lease Financing*, Vol. 19, No. 1 (Spring 2001), pp. 29-52; and "Post-Filing Actions by Lessees That May Affect Your Security Interest," by Kenneth P. Weinberg, *Journal of Equipment Lease Financing*, Vol. 21, No. 1 (Spring 2003), pp. 44-53.

[8] See *In re Montgomery Ward*, 325 F. 3d 383 (3d Cir 2003).

[9] For example, *Ethan Shaw and Clive D. Moon v. Toshiba American Information Systems et al.*, 1:99 CV0120, U.S. District Court for the Eastern Division of Texas, Beaumont Division, in which a class action alleging a relatively minor software defect resulted in one of the largest settlements in any computer related litigation.

[10] Note the interplay between the maintenance requirement, the definition of "destruction/damage," and "reasonable wear and tear" for return purposes.

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