



Distinguishing Leases, Sales, and Security Interests

Eric E. Johnson

ericejohnson.com



Konomark
Most rights sharable

Leases

- A lease:
 - The lessor has title to the goods.
 - The lessee gets to use the goods.
 - The lessor will get the goods back when they still have meaningful economic life.
- A sale:
 - The buyer has title.

Leases

- A lease:
 - The lessor has title to the goods.
 - The lessee gets to use the goods.
 - The lessor will get the goods back when they still have meaningful economic life.
- A sale with a security interest:
 - The buyer has title.
 - The secured party has a security interest that allows repossession and taking title to the goods if they buyer defaults on the loan.

Leases

- Both a lease and a sale with a retained security interest allow a buyer to get goods for which they don't have cash on hand to purchase outright.
- Leases also can have tax/ accounting advantages.

Leases

- When the "goods getter" (buyer/lessee) becomes insolvent, it matters a lot whether it's a sale without a security interest, a lease, or a sale with a security interest.
- Different parties have different interests in how to characterize the transaction.

Leases

In bankruptcy, from best to worst for the good supplier:

- If it's a lease, the good is not part of the bankruptcy estate, because it never stopped belonging to the lessor. The lessor gets the good.
- If it's a sale with a security interest, the bankruptcy estate has title, but the secured party has priority to take the good to satisfy the debt. That puts the secured party ahead of other creditors but doesn't necessarily mean full payment on the loan.
- If it's a sale on credit but unsecured, the seller can be stuck with getting only a fraction of its money from the debtor.

Leases

In bankruptcy, from best to worst for the good supplier:

- If it's a lease, the good is not part of the bankruptcy estate, because it never stopped belonging to the lessor. The lessor gets the good.
- If it's a sale with a security interest, the bankruptcy estate has title, but the secured party has priority to take the good to satisfy the debt. That puts the secured party ahead of other creditors. That means the secured party gets the good even if they haven't received full payment.
- If it's a sale on credit, the supplier is stuck with getting paid by the debtor.

Therefore, sellers have an incentive to characterize a sale with a security interest as a lease.

Leases

- So how do you know if something is a true lease as opposed to a disguised sale?
- In a true lease:
 - The lessor will get the goods back when they still have meaningful economic life.

Leases

- A lease:
 - The lessor has title to the goods.
 - The lessee gets to use the goods.
 - The lessor will get the goods back when they still have meaningful economic life.
- A sale with a security interest:
 - The buyer has title.
 - The secured party has a security interest that allows repossession and taking title to the goods if they buyer defaults on the loan.



There's more to unpack here ...

Leases

Useful economic life remaining

- For a short-term or medium-term lease with no options, there's no issue.
- But if a lease is very long term, it might be an issue.
- And if a lease has an option to purchase, it might be an issue.

Leases

Disguised sales

- A putative lease is really a disguised sale (and not a true lease) if the economic realities are such that it doesn't make sense that the lessor would get the goods back with useful economic life remaining.
- Ultra simple examples:
 - I lease new car to you for one year for \$30,000, and you have an option to purchase for \$1 after one year.
 - This is a disguised sale, not a true lease. The only rational economic choice for the lessee is to exercise the option for \$1
 - I lease a new car to you for \$2,000 a year for 3 years, after which it is projected to be worth about \$10,000, and you have an option to purchase for \$10,000.
 - This is a true lease. The lessor might or might not exercise the option.

Leases

- We've covered:
 - What is a lease
 - Lease vs. secured sale
- Now there's one more thing:
 - Finance leases

Leases

- What's a finance lease?
 - It's a true lease
 - where the lessor acquires the goods in connection with the lease, and
 - where the lessor does not select the goods.

Leases

- Why would a goods getter (buyer/lessee) structure a deal as a long-term lease instead of as a secured loan?
 - Because a finance lease might have tax and accounting advantages.
 - Because they might get better terms.

Leases

- Why would a lessor do a finance lease?
 - Because they are in the financing business.
- Why do we care?
 - Because it matters to UCC provisions on warranties, risk of loss