

LETTER OF COMMENT NO.

From: Ralph Petta [mailto:RPETTA@ELFAONLINE.ORG]

Sent: Wednesday, October 03, 2007 12:01 PM

To: Danielle Zeyher **Cc:** Leslie Seidman

Subject: Legal Analysis for Leasing Project

October 3, 2007

Ms. Danielle Zeyher Financial Accounting Standards Board 401 Merritt 7, P.O. Box 5116 Norwalk, CT 06856-5116

Re: Leasing Project - Legal Considerations

Dear Ms. Zeyher:

A few months ago, on June 26, 2007, members of our organization, the Equipment Leasing and Finance Association, met with you and other members of the joint leasing project. At this informal meeting, our members suggested submitting a paper on the U.S. legal principles of equipment leasing. We thought such a paper would provide useful background information about characteristics and terms of common equipment leasing contracts consummated under U.S. law, which differ in certain important respects from leasing laws in other countries. The positive response to our suggestion led to the formation of a subcommittee of our Legal Committee, who authored the legal paper that accompanies this letter.

We believe an improved understanding of the U.S. legal principles of equipment leasing will allow the project team to provide decision useful background information in the Board's upcoming deliberations. We believe it contains information of immediate usefulness in the further analysis of the "simplified [equipment] lease contract" and in the scheduled deliberations on maintenance and return provisions.

As described in its Purpose and Scope section, the paper covers the general legal principles of equipment leasing. Please note that it does not cover specific laws relating to lease financing of aircraft, vessels, rolling stock, or power facilities. Nor does it cover real estate leasing. We encourage the project team to reach out to participants engaged in lease financing of such assets to gain a wider view.

In reviewing the legal paper, our Financial Accounting Committee noted certain potential accounting implications. These potential implications are discussed in a separate paper, which also accompanies this letter.

Our association appreciates the opportunity to provide information about the legal principles of equipment leasing. Please do not hesitate to contact me if you have any questions or need additional information.

Sincerely,

Ken Bentsen

Kenneth E. Bentsen, Jr. President, ELFA

Attachments

Ralph Petta
Vice President-Industry Services
Equipment Leasing & Finance Association
1825 K Street NW, Suite 900
Washington, DC 20006
(202) 238-3430
rpetta@elfaonline.org

The statements made in this paper have not been endorsed by the ELFA membership or individual companies but are made by the Legal/Accounting Subcommittee of the ELFA Legal Committee¹

Information for FASB/IASB Staff & Members

Topic: Leasing Accounting Project

Legal Principles of Equipment Leasing

Date: September 27, 2007

Purpose and Scope

1. The purpose of this paper is to provide information regarding the legal principles generally applicable to equipment leasing in the United States. These principles include an assessment of "economic realities" (substance over form) in determining the rights and obligations of a party to an equipment lease. Terms and definitions used in this paper have specific legal meanings and may differ or conflict with the terms used in the lease accounting papers prepared by the IASB/FASB staff or in accounting principles generally. Accordingly, this paper provides the legal definitions and general explanations of principles affecting equipment leasing in the United States.

- 2. This paper discusses the general legal concepts used to define and distinguish among a lease of, a sale of, and a loan secured by, equipment in the United States. The paper discusses certain contractual provisions which affect the obligations of the parties to the lease at inception, during the term, and at expiration or termination.
- 3. This paper focuses on "true leases" as the term is used in the United States and assumes that the changes in accounting for leases will have no impact on transactions which are in fact secured transactions or sales, regardless of the nomenclature used in the contract document (e.g. leases that automatically transfer ownership of the property to the lessee at the end of term or for nominal consideration).
- 4. As discussed extensively in Agenda Paper 7, Characteristics and Terms of Common Lease Contracts, from the Joint International Working Group on Leasing Meeting of February 15, 2007, equipment leasing covers a broad spectrum of equipment with lease terms often varying, dependent on the type of equipment leased. This paper addresses general legal principles applicable to all types of equipment leases but does not cover specific laws applicable to lease financing of aircraft, vessels, rolling stock, or power facilities. It also does not address real property or ground leases, where the application of state laws create rights and obligations which can vary significantly from state to state.

¹ Members of the Legal/Accounting Subcommittee of the ELFA Legal Committee contributing to this paper are: Chair, Teresa Davidson, Vice-President Legal & General Counsel, Volvo Financial Services North America; Robert Downey, Senior Corporate Attorney, Caterpillar Financial Services Corporation; Edward A Groobert, Partner, Dykema Gossett PLLC; Malcolm Lindquist, Partner, Lane Powell, PC; Pam Martinson, Partner, Bingham McCutcheon LLP; Ralph Petta, Vice-President Industry Services; ELFA: and Stephan T. Whelan, Partner, Thacher Proffit & Wood, LLP.

Introduction

This paper uses the example of a "simplified lease contract" as defined by FASB/IASB staff
in the lease accounting papers.

A piece of machinery is leased for a fixed term of 5 years; the expected life of the machinery is 10 years. The lease is non-cancellable, and there are no rights to extend the lease term or to purchase the machinery at the end of the lease term and no guarantees of its value at that point. Lease payments are due at regular intervals over the lease term after the machinery has been delivered; these are fixed amounts that are specified in the original agreement and are payable in advance. No maintenance or other agreements are entered into.

- 6. The "simplified lease contract" may be a lease or a secured loan contract under applicable law. This distinction will be determined by contractual provisions not included in the FASB/IASB staff definition of a "simple lease contract" and applicable law in the United States. The distinction between a "lease" and a "secured loan" is critical in determining a party's respective legal rights and obligations under an agreement identified as a "lease."
- 7. In the United States Article 2A of the Uniform Commercial Code ("UCC") is the legal framework for equipment leasing; loans secured by an interest in equipment are governed by Article 9 of the UCC. Sales of equipment are governed by Article 2 of the UCC. While each state has the ability to modify, and may have modified, a provision of the UCC, this paper will discuss the most recent "model provisions" of each Article as approved by the sponsoring bodies, the National Conference of Commissioners on State Laws and the American Law Institute. The UCC **does not** govern the sale or leasing of, or a loan secured by, real property.

"Assets and Liabilities" or "Rights and Obligations" under a Lease.

8. The FASB/IASB papers refer to "assets" and "liabilities" under a lease (e.g., FASB Board Meeting Handout, Leases, March 21, 2007). Legal analysis uses the terms "rights" instead of "assets" and "obligations" instead of "liabilities" so this discussion will use the terms "rights" and "obligations."

A "Lease" is not a "Sale" and is not a "Secured Loan"

- 9. Leasing is distinctive. Decades of statutory and judicial law have established that a lease is the temporary transfer of possession and control over property to the lessee, in exchange for payment of rental or other consideration, "with the expectation that the equipment will be returned to the owner with some expected residual interest of value remaining at the end of the lease term." White & Summers, Uniform Comm. Code section 13-2 (4th ed., 1995 Supp. 1999).
- 10. In contrast, a sale is "the passing of title to property from the seller to the buyer for a price, UCC section 2-106(1), and a "security interest" (granted in connection with a secured loan) is "an interest in personal property...which secures payment or performance of an

obligation [but] the right of a seller or lessor of equipment under Article 2 or 2A to retain or acquire possession of the equipment is not a 'security interest' [except that] retention or reservation of title by a seller of equipment [can constitute] reservation of a 'security interest'." UCC section 1-201(35) or (37) (depending on State UCC version)

- 11. Although leases and sales both involve transfer of possession of the equipment, a sale involves the unconditional transfer of title, possession and use; the seller retains no ownership or possessory interest (although it may retain a security interest, if the entire purchase price is not paid at the time of sale). The seller, presumably in exchange for a higher sale price, often will warrant that the sold equipment will perform in accordance with certain specifications, but this contingent liability on the part of the seller does not defeat the absolute nature of the sale (unless the contract contains express provisions for return of the sold equipment and refund of all or a portion of the purchase price).
- 12. Similarly, retention of a security interest by the seller, until payment of any deferred portion of the purchase price, does not undermine the absolute nature of the sale; if the buyer defaults in payment of the deferred price, then the seller must resort to the remedies of a secured party under the agreement(s) with the buyer and under UCC Article 9, rather than simply being able to rescind the sale.
- 13. There are many reasons for imposing a clear framework for determining legal ownership of equipment. Taxing authorities need to know who is the owner of the equipment, so that tax burdens (such as personal property taxes) or benefits (such as depreciation deductions) can be allocated accurately. Bankruptcy courts need to know whether the bankrupt company owns the equipment or whether the bankruptcy estate has a more limited interest in the equipment.
- 14. American courts have examined the economic substance of a transaction to determine whether its facial characterization accurately reflects the underlying realities (in this respect, American law departs from the laws of most other nations, which are guided almost exclusively by the stated form of the transaction). That is to say, if a purported sale contains so many ongoing seller obligations or buyer rights to refund or reduction of the purchase price, then the transaction in substance could be recharacterized as a lease or a secured financing rather than a sale.
- 15. For instance, a federal Court of Appeals cited the UCC provisions that a *sale* occurs only where there is a passage of title to the equipment. The court ruled that a "lessee" of an allegedly defective automobile was not a "buyer" for purposes of a particular statute and hence not entitled to remedies under the statute. And in a California bankruptcy case, the lessee alleged that it actually was the "owner" of the equipment and had entered into a "secured financing." The court rejected this claim, noting that the lessor was entitled to receive the equipment at lease expiration and that the residual values of the equipment were not expected to be nominal. This ruling was important because the court then awarded the lessor its remedies under the Bankruptcy Code section dealing with leases.
- 16. The UCC also recognizes significant differences between leases and sales. For example, if a buyer of equipment defaults on payment of the purchase price (or otherwise under the purchase contract) and the seller resells some or all of the equipment, then the net resale proceeds are applied against the buyer's unpaid obligation (and any other seller's damages). But in a lease the lessor continues to own the equipment throughout the lease

term and hence the resale proceeds are not to be automatically applied as a credit against the lessor's damages.

- 17. The UCC also uses the economics of a transaction to determine whether the transaction is a lease or secured loan. The following analysis, based on UCC principles as interpreted by the courts, is applied using the "simplified lease contract" example set forth in Paragraph 4 above:
 - a. Is the lease cancellable without substantial penalty by the lessee during the lease term?

If yes, the transaction is a lease. No need to proceed further. If no, proceed to b.

[In the example, the lease is non-cancellable, must proceed further with the analysis]

b. Is the original term of the lease equal to or greater than the remaining economic life of the equipment?

If yes, the transaction is a "secured transaction". If no, proceed to c.

[A fixed 5 year lease term for equipment with an expected economic life of 10 years – still a lease]

c. Is the lessee required to renew the lease for the remaining economic life or bound to become the owner of the equipment?

If yes, the transaction is a secured transaction. If no, proceed to d.

[there are no rights or obligations to extend the lease term. Lessee will not become the owner under the lease terms—still a lease.]

d. Does the lessee have the option of renewing the lease for the remaining economic life of the equipment for little or no additional rent?

If yes, the transaction is a secured transaction. If no, proceed to e.

[There is no option to renew – still a lease.]

e. Does the lessee have the option to become the owner of the equipment for little or no additional payment?

If yes, the transaction is a secured transaction. If no, proceed to f.

[There is no option to purchase – still a lease. If lessee had a right to purchase the equipment during the lease term for a bargain purchase price or ownership of the equipment automatically transferred upon payment of all rent, would be a secured transaction]

f. At lease inception, will it make economic sense for the lessor to retake possession of the equipment at the end of the lease term?

If no, the transaction is a secured transaction If yes, proceed to g.

[Unable to determine – not enough information is provided. If the equipment would suffer a substantial reduction in value if deinstalled or relocated or is customized with limited resale potential, or the cost of lessor-paid removal is expected to exceed the anticipated resale value, or the rent paid more than compensated lessor, could be a secured transaction!

g. Does the amount of rent to be paid by lessee change based on the amount received by lessor upon the disposition of the equipment.

If no, the transaction is a lease (analysis may not end here depending on all the economic terms and contract provisions).

If yes, is the equipment over the road motor vehicles used by the lessee more than 50% for business?

If yes, the transaction is a type of lease known as a TRAC (will be a lease if IRS TRAC requirements are met).

If no, the transaction is a secured transaction.

18. It is settled case and statutory law in the United States that, whether the context is bankruptcy, commercial law. or state or federal tax law, a *lease* is not a sale and is not a secured transaction.

Legal Principles of "Executory Contracts"

- 19. One practical effect of a contract being a "lease" as opposed to either a "sale" or a "secured transaction" is that a lease will be treated as an "executory contract" under applicable law. An "executory contract" is a contract where material performance remains due from each party to the contract to some extent. The performance due by each party need not be equivalent, but must be significant enough that a failure to perform would result in a material breach of the contract such that performance of the non-defaulting party is excused.
- 20. The term "executory contract" is not defined by statute in the United States, not even in the Bankruptcy Code, where the term has significant impact. The term is subject to interpretation by the courts.

- 21. Lease contracts are generally considered "executory" during the entire lease term because they typically contain multiple provisions where the performance of one party is conditioned on performance by the other party. For example, the lessee's obligation to pay rent may be conditioned on the lessor's obligation to provide the equipment or related services; the lessor's obligation to allow the lessee to use the equipment undisturbed usually is conditioned on the lessee's obligations to pay rent and all other costs of using the equipment, such as taxes, maintenance, insurance, etc. (this type of lease is often referred to as a triple net lease obligation). However a lease is nevertheless an "executory contract" even if the lessee's obligations are absolute and unconditional, so long as the lessor has some material unperformed obligation, such as the duty to keep the leased equipment free of liens arising through the lessor or the duty to allow the lessee to use the equipment without disturbance (referred to as "quiet enjoyment"). Thus the "simple lease contract" will be treated as an executory contract for both the lessor and the lessee for the entire duration of the lease term. This contrasts with the accounting papers' treatment as a lease as no longer being executory after either party has performed any of its obligations under the lease (IASB Agenda Paper 4C, Initial recognition of assets and liabilities in lease contracts, June 19, 2007, Paragraph 29).
- 22. In contrast with the legal definition of an executory contract, the IASB/FASB papers do not analyze the lease contract as a whole, but divide the contract into a series of individual promises, and uses the conditionality (or lack thereof) of each separate promise as the criteria for recognizing (or not) the existence of an asset or liability. Therefore, the accounting papers view the equipment lease contract, which is an "executory contract" for legal purposes, as a collection of separate assets, liabilities, and unrecognized items, which may or may not be executory. (See e.g., Joint Working Group, Agenda Paper 5, Identification of Assets and Liabilities Arising in a Simple Lease, February 15, 2007; IASB Agenda Paper 12A, Identification of assets an liabilities arising in a simple lease, March 22, 2007, Paragraph 36, and IASB Agenda Paper 4C, Initial recognition of assets and liabilities in lease contracts, June 19, 2007, Paragraphs 22-24). In a bankruptcy, the lessee has the ability to reject or assume (agree to perform the obligations and receive the rights) the entire lease contract but only in whole, not by parts or provisions.

Types of Equipment Leases Under Legal Principles

- 23. The accounting papers do not distinguish between the rights and obligations of a lessor who manufactures, sells, or selects the equipment for the lessee and those of a lessor who acquires title to the equipment expressly for the purpose of the lease contract. (See, e.g. *IASB Agenda Paper 4C, Initial recognition of assets and liabilities in lease contracts, June 19, 2007, Paragraph 19*). Legal principles do recognize the difference.
- 24. Article 2A of the UCC provides for two different types of lease transactions:
 - A lease is a "transfer of the right to possession and use" of equipment "for a term in return for consideration, but a sale . . . or creation of a security interest is not a lease."
 - A "finance lease" is a lease in which in addition to the transfer of the right to possession and use,
 - i. the lessor does not supply or manufacture the equipment and
 - ii. the lessor acquires the equipment in connection with the lease and

- iii. the lessee either receives a copy of the contract by which the lessor acquires the equipment before signing the lease OR the lessee's approval of the supply contract is a condition precedent to the effectiveness of the lease OR the lessee before signing the lease receives a complete copy of the supplier or manufacturer's warranties and disclaimers.
- 25. The simplified lease contract example could be either a lease or a finance lease depending on additional factors. For example, if the lessee selected the equipment at a selling dealer's location and the selling dealer was the lessor, the lease would not be a "finance" lease. If however, the lessor was a finance company (not the selling dealer) and the selling dealer gave the lessee a copy of the bill of sale to the finance company, the lease would be a "finance lease" (not to be confused with a capital or finance lease as such terms are used under current FASB 13).
- 26. Whether a transaction is a lease or a finance lease has legal significance due to the differences in the rights and obligations of the parties under applicable law. For example, a lessor who is also the seller of the equipment warrants to the lessee that the equipment is free of claims of any party. A finance lessor makes no such warranty in the lease or under applicable law.
- 27. Typically, under a "finance lease," a lessor's obligation to lease the equipment to the lessee does not occur until the lessee accepts the equipment as delivered by the supplier or vendor and executes a certificate of acceptance as required by the lease agreement. A finance lessor has no obligation to deliver the equipment to the lessee.
- 28. Once the lessee accepts the equipment subject to the lease, the lessee may not revoke its acceptance of the equipment if the lease is a "finance lease". However, in a non-finance lease, the lessee may revoke its acceptance of the equipment for a substantial impairment in the value of the equipment to the lessee due to the "non-conformance" of the equipment. In a finance lease, the lessee has no rights against the lessor for the improper or non-performing equipment. If lease is not a finance lease, the lessee may seek damages from the lessor after revocation of acceptance.

Return and Maintenance Conditions – Important Legal Obligations Under a Lease

- 29. While accounting staff has indicated that return and repair requirements are commitments to be consider at later dates (e.g. IASB Agenda Paper 12A, identification of assets and liabilities arising under a lease, March 22, 2007) important legal obligations of a lessee include the obligation to maintain the equipment in good working order during the term and to return the equipment in the same condition as when first leased, ordinary wear and tear excepted. The lessor has a contractual right to the equipment being maintained and returned in the condition required by the lease and has priced its rentals in reliance on the lessee bearing the cost and efforts of these requirements.
- 30. During the lease term, from a lessor's perspective the primary reason for the lessee to maintain the equipment in good working order is to maintain the value of the equipment belonging to the lessor. The duty has been expressed simply as keeping the equipment in good operating condition but the increasing complexity of many types of equipment means that the lessee's maintenance obligations have become much more rigorous. Frequently

the lessee is required now to maintain the equipment in accordance with the manufacturer's recommendations, as required by any applicable insurance policies and in any case, in accord with the prudent practices of similar entities in the same business as lessee. The periodic rentals would be significantly higher if the lessee did not assume these obligations.

- 31. The maintenance requirements for some specialized equipment, such as aircraft, on-highway trucks and construction equipment can be very detailed and precise. With this type of equipment the maintenance obligations may prescribe how often the equipment can be used and under what conditions as well as including specific and objective standards of maintenance. Frequently, the maintenance provider may be specified in the lease as well as the periodic requirements for such maintenance. In almost all cases, the lessee will be required to maintain detailed records of the maintenance performed on the equipment. A failure of the lessee to satisfy the maintenance and repair requirements is generally a default under the lease entitling the lessor to cancel the lease and repossess the equipment.
- 32. The condition of the equipment upon lease termination is also of paramount importance to the lessor. A significant pricing component (economic term of the lease contract) is the estimated lease-end value of the equipment. Under the "simple lease contract" where the lessee does not have an option to purchase the equipment, the lessor will try to lease or sell the equipment to a third-party. For the lessor's disposition to generate the estimated value of the equipment, it will have to be in the condition the lessor anticipated when lessor originally calculated both the rent to be paid and the estimated residual value of the equipment upon termination of the lease. Therefore, most equipment leases have detailed equipment return obligations relating to the condition of the equipment as well as other elements. Contrary to statements made in the accounting papers (see, e.g., Paragraph 8 of Agenda Paper 7) it is not accurate to assume that lessors generally purchase residual value insurance for equipment returned at the end of the lease term.
- 33. If the lease provides the lessee with an end-of-term option to purchase the equipment, the lease typically requires the lessee to notify the lessor far enough in advance of lease termination to permit the lessor to plan to dispose of the equipment if lessee elects not to purchase. This notice may be up to 180 days prior to lease term but in most leases it is not more than 90 days (and is rarely less than 30 days). Lessee will be required to return the equipment to a designated location, where lessor or its agent will inspect and refurbish the equipment, if necessary, at lessee's expense.
- 34. In addition to the equipment, the lessee is usually required to turn over to lessor at least one completely up-to-date set of service manuals, operating manuals, blue prints, process flow diagrams and maintenance records, and other technical data concerning the set-up and operation of the equipment. Upon return of the equipment to the designated location, a qualified technician, often at lessee's expense, will perform a comprehensive physical inspection, including testing all material and workmanship of the equipment, and will repair or replace the equipment to the extent necessary to get it in the condition required by the lease. As is the case with lease term maintenance provisions, the type of equipment often determines the scope and specific provisions of a lease's return provisions. Some equipment types, such as on-highway trucks, often have provisions that detail the condition the equipment is required to be in upon lease termination, including provisions as specific as addressing the amount of tread remaining on the tires.

- 35. As the condition of the equipment is so important to the economics of the transaction and to lessor's ability to recoup in full its investment, the lessee's failure to comply with the equipment maintenance and return provisions is a default under most leases. The failure to so maintain and return the equipment might be a specific event of default or it may be covered by a default provision requiring lessee to comply with all its covenants, agreements and conditions contained in the lease. Some leases have excess usage or mileage fees which require the lessee to come out of pocket at lease end, depending on the lessee's use of the equipment.
- 36. Whether a specific default or otherwise, the breach of the equipment maintenance and return provisions is a material violation of the lease terms. Upon a breach of these provisions lessor is able to utilize its full battery of rights and remedies, whether contained in the lease or as a matter of law.

Rights and Remedies under a Lease and a Secured Loan

37. The rights of a lessor after a default by the lessee include terminating the lease, accelerating lease payments and asserting a damages claim in the amount necessary to place the equipment in the condition required by the lease terms. The rights and remedies available to a lessor under a lease and Article 2A differ from those available to a secured party under Article 9. For example, the lessor, as the owner of the equipment, is entitled to keep any proceeds received from the disposition or re-lease of the equipment, even if all of lessee's monetary obligations under the lease have been paid in full. If a transaction labeled a lease is in fact a secured transaction, all proceeds remaining after the lessee's monetary obligations have been satisfied must be returned to the lessee (borrower).

Conclusion

38. As this paper indicates, analysis of a lease transaction under legal principles is very fact specific. Those facts determine whether a transaction is a lease, sale, or secured transactions and the parties rights and obligations under the contract and applicable law.

The statements made in this paper have not been endorsed by the ELFA membership or individual companies but are made by the ELFA Financial Accounting Committee to facilitate FASB/IASB staff research in connection with the joint leasing project.

Information for FASB/IASB Staff

Topic: Joint FASB/IASB Project – Accounting for Leases

Potential Accounting Implications Related to the ELFA Paper

Entitled "Legal Principles of Equipment Leasing"

Dated September 27, 2007

Date: September 28, 2007

The purpose of this paper is to discuss potential accounting implications related to the ELFA's paper entitled "Legal Principles of Equipment Leasing" dated September 27, 2007. The comments made herein reflect certain observations by members of the ELFA Financial Accounting Committee in reviewing this legal paper. These members' observations are organized under the following four sections:

- I. Equipment Leasing under U.S. Commercial Law
- II. A Lease as an Executory Contract under U.S. Commercial Law
- III. Types of Lessors and Leases under U.S. Commercial Law
- IV. Maintenance and Return Conditions under U.S. Commercial Law

I. Equipment Leasing under U.S. Commercial Law

Background. As discussed at item 9 in the legal paper, U.S. commercial law for equipment leasing has been established over decades by statutes and judicial rulings. This body of law distinguishes a "lease" from other contractual arrangements ("sales" or "secured loans") based on the unique nature of the exchange. A lease involves a temporary transfer of possession and control to the lessee and the reversion of a meaningful residual value to the owner-lessor at lease expiration.

A contract determined to be a lease has distinctively different legal rights and obligations than a contract determined to be a sales contract or a secured loan. As discussed at item 37 of the paper, these differences become manifest in a default scenario and at the end of the lease term when the leased property reverts to the lessor. In such situations, the lessor has entitlement to proceeds and battery of remedies consistent with those of an owner.

U.S. commercial law for equipment leasing differs from the laws of most other countries in that the nature of the arrangement (lease, sale or secured loan) depends on its economic substance instead of the legal form of the contract. Item 17 of the paper provides a summary of the economic analysis inherent in U.S. commercial law. At this same item, it applies the legal analysis to the "simplified lease contact" and highlights the need for additional economic information to reach a conclusion about the nature of this contract.

Potential implications. The project team may want to consider if it is possible to mirror the substance over form analysis inherent in the U.S. commercial law as the starting point of a new lease accounting model. Under this approach, if the transaction is determined to be a (conditional) sale in substance, the parties would apply the same accounting as a note for property, plant or equipment (currently, Opinion No. 21, Interest on Receivables and Payables). If the transaction is determined to be a (secured) loan in substance, the parties would apply the same accounting as a note for cash (again, currently, Opinion No. 21). Finally, if the transaction is determined to be a "lease" in substance, the parties would then apply the new approach to the accounting for leases.

II. A Lease as an "Executory Contract" under U.S. Commercial Law

Background. The paper discusses an important practical effect of a contract determined to be a "lease," that is, it will be treated as an "executory contract" under U.S. commercial law. Upon the occurrence of a material breach of such a contract due to non-performance by the defaulting party, the continuing performance of the non-defaulting party would be wholly excused. Further, in a bankruptcy proceeding, the lessee has the ability to reject or assume the *entire* lease contract. Absent a new agreement by parties, the lessee cannot reject or affirm individual provisions.

Item 21 of the paper explains why lease contracts are considered to be "executory" during the entire lease term and provides illustrative examples. Lease contracts contain multiple provisions where one party's performance is conditioned on its counterparty's performance. For example, for leases that include the rendering of significant services in connection with the operation or maintenance of the leased asset, the lessee's performance would be excused if the lessor's failure to perform constitutes a material breach. More generally, the lessor's obligation to allow the lessee to use the equipment undisturbed ("quiet enjoyment") is usually conditioned on the lessee's obligation to pay rent and executory costs.

Potential implications. The project team may want to consider the impact of the executory nature of a lease upon the recognition and measurement of assets and obligations within the context of the conceptual framework project. Under one approach, the project team could suggest criteria under which future performance should be assumed for accounting purposes, leading to recognition of assets and liabilities regardless of any underlying contingencies at law.

Perhaps, the project team could evaluate "remoteness of occurrence" as the appropriate conceptual basis for assuming continuing performance of a lease. This criterion is used in FTB 79-10, Fiscal Funding Clauses in Lease Agreements. A lease with a fiscal funding clause (a provision under which a government unit as lessee can cancel the lease if the legislature or other funding authority does not appropriate the funds necessary to fulfill the lease obligation) is to be considered "noncancelable" if the likelihood of exercise is assessed as being "remote" (as defined in Statement 5).

Where future performance has been assumed for accounting purposes, as in other areas of accounting that involve uncertainties (e.g., most recently tax positions), the project team would necessarily need to develop derecognition criteria. For example, in a troubled lease scenario, the project team should consider when previously recognized assets and liabilities should be adjusted or removed from the balance sheet (on the formal lease rejection date or some earlier date).

Finally, since leases are executory contracts that are either wholly in force or wholly terminated, the project team should consider whether the accounting for leases should reflect this holism by, say, "linking" any separately recognized assets and liabilities in recognition, measurement, and presentation.

III. Types of Lessors and Leases Under U.S. Commercial Law

As noted at item 23 of the legal paper, U.S. commercial law distinguishes between rights and obligations of a lessor who manufacturers, sells or selects the equipment for the lessee and those of a lessor who acquires title to the equipment expressly for the purpose of the lease contact. Further, as discussed at item 24, U.S. commercial law provides for two different types of lease transactions, a lease and a "finance lease" (a distinct legal term not to be confused with finance lease as used in FAS 13). The key distinguishing characteristics of a finance lease are set forth at items 26-28, as summarized below:

- The lessor does not warrant to the lessee that the equipment is free of claims by any party;
- The lessor has no obligation to deliver the equipment to the lessee and the lease does not become effective until the lessee accepts the equipment as delivered by the supplier or vendor and executes a certificate of acceptance as required by the lease agreement.
- Once the lessee has accepted the equipment, it may not revoke its acceptance of the lease.

In the U.S, third party lessors (notably, banks and independent finance companies) generally enter into finance leases because these transactions involve rights and obligations closer to those of a financier than a seller or manufacturer.

Finance lessors generally fund 100% of the purchase price of the equipment and related soft costs, or the same amount that the lessee would have paid and capitalized to purchase the equipment outright and place it in service. This level of funding reflects both the fundamental purpose of leasing and the requirements under U.S. income tax law. For the lessor to qualify as the tax owner, U.S. income tax law generally requires the lessor to pay "fair market value" and precludes the lessee from paying any part of the acquisition cost (making any investment in the leased property).

Given the substantive differences in legal rights and obligations between lessor and lease type, we make the follow recommendations:

- The project staff should expand the "simplified lease contract" (or create a variation) to make an analysis of the rights and obligations approach operational in the context of leasing within the U.S. legal framework. As noted in item 25, the simplified contact does not contain the requisite information to identify the standing of the lessor or the lease type under U.S. commercial law.
- The project team should evaluate whether the legal distinctions impacts initial recognition, measurement, the pattern of income recognition, and the accounting for contingencies. Presumably, a finance lessor should initially recognize leased assets and obligations upon delivery and acceptance by the lessee.
- The project team should consider maintaining the current definition of the fair value of the leased property. If the definition was changed, it could cause the legal, tax and accounting disciplines to work at cross-purposes. For example, as noted above, in the case of finance lessors, U.S. tax law generally requires the transaction price to reflect entry value.

IV. Maintenance and Return Provisions under U.S. Commercial Law

Background. As discussed at items 29-36 of the paper, maintenance and return provisions impose obligations on the lessee as an integral part of the bargain for the purpose of securing lease approval and in setting periodic rentals. To qualify the contract as a lease and the lessor as the tax owner, the lessor must retain a meaningful unguaranteed interest in the residual value, unprotected by maintenance and return provisions or any other forms of protection such as residual guarantees or insurance.

"Onerous" maintenance and return provisions would in themselves cause the transaction to be characterized as a (conditional) sale or (secured) loan for U.S. commercial law and U.S. income tax purposes. These provisions can only serve to reduce uncertainty about the condition of the returned used equipment and its redelivery point. They cannot protect the lessor from the risks of ownership, e.g., adverse market changes or obsolescence risk. The lessor must look solely to the market, not the lessee or third parties, to recovery its requisite unguaranteed residual value.

U.S. equipment lessors can use residual guarantees or residual value insurance on a situational basis. However, they cannot use such protections to reduce the first loss unguaranteed risk position below a certain threshold. U.S. equipment lessors generally must accept unguaranteed residual risk of at least 10-20% of the original cost, dependent on the type of leased equipment, the lease term, and other surrounding facts and circumstances.

U.S. equipment lessors who obtain residual value insurance or lessee guarantees generally do so to achieve capital lease classification. For examples, a lessor may obtain a minor "last loss" residual value coverage (commonly referred to as "FAS 13 insurance") that is sufficient enough to qualify a lease as a capital lease for accounting purposes but insufficient in terms of its impact on legal standing or income tax purposes. Accordingly, the statement made at paragraph 8 of the project team's Agenda Paper 7 may accurately describe leasing in certain jurisdictions; however, it does not accurately describe U.S. true leasing activity.

Potential implications. We believe the accounting for maintenance and return provisions should remain symmetrical between leased and owned equipment, or recognized when incurred under current GAAP. If changes in the accounting for maintenance and return provisions are contemplated for leased assets, then we believe a symmetrical change in the accounting for owned assets should also be made. With regard to accounting for residual value guarantees or insurance, we believe the elimination of the "bright line" distinction between capital leases (currently direct finance, leveraged, or sales type) and operating leases from the standpoint of the lessor would result in more cost effective accounting treatment.

In conclusion, we believe the economic underpinnings of U.S. legal principles of equipment leasing may provide a basis to achieve some symmetry in the accounting for leases. However, we are concerned that, if the U.S. legal and accounting disciplines significantly diverge, the new approach to the accounting for leases could introduce undue complexity and compliance cost.

Lessors engaged in "qualified motor vehicle" leasing (e.g., leases of autos, trucks, trailers) commonly obtain substantial residual value protection, generally by means of a "terminal rental adjustment clause" ("TRAC"), which transfers the risk and reward of residual realization to the lessee. Under a TRAC lease, at the end of the term, the lessee must either purchase the vehicle for a fixed price or sell the vehicle to a third party and retain the excess above the purchase option amount or pay the lessor the shortfall between the purchase option amount and the net sales proceeds. Code Section 7701(h), sometimes referred to as the "TRAC statute," provides that a "qualified motor vehicle operating agreement" will be treated as a true lease if, "but for such terminal rental adjustment clause," the agreement would be treated as a true lease under otherwise applicable law. Some TRAC lessors offer a "split TRAC" where the lessee retains all of the upside but has a stipulated maximum first loss guarantee. This "split TRAC" variation may include lessee purchased residual value insurance for the benefit of the lessor, generally to qualify the lease as a direct finance lease from the standpoint of the lessor.