KNOW-HOW: WHITEPAPER

Ten Key Issues Addressed in Equipment Leases for Bankers

By: Andrew J. Kalgreen

Equipment leasing presents a bank with an opportunity to open the door to new customer relationships and to satisfy its existing customer's need to acquire the use of equipment. An understanding of the unique features of equipment lease contracts should help bankers better serve their customers.

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Bankers Ask, "Why Do We Have These Terms in Our Equipment Lease?"
Ten Key Issues Addressed in Lease Agreements

From time to time, loan officers, credit staff, and other personnel at banks ("bankers") may be analyzing the terms and conditions of equipment lease contracts. Since the bankers may be expecting the lease contracts to be substantially the same as a loan document, they may wonder why certain additional terms are included in the lease agreement. This article addresses ten key issues that are unique to an equipment lease agreement as compared to an equipment loan and security agreement. This article is a general description of equipment lease terms and conditions. It is not comprehensive and does not cover all nuances of the selected provisions of a lease contract. It is a starting point designed to assist bankers who are not yet familiar with equipment leasing so that they will understand the unexpected terms in the lease agreement.

In this article, I assume that the bankers know certain basic features of an equipment lease such as: the bank will own the equipment during the lease term; the bank's return on investment comes from three sources - periodic rent payments plus the sale of the equipment to the customer or a third party at lease end plus taking depreciation deductions on the bank's federal income tax return; and many terms and conditions of the lease agreement will be the same as in a loan agreement (e.g., events of default, financial covenants, required financial reporting).

The unique terms of an equipment lease agreement are centered on three key issues: (1) risks to the revenue stream related to the residual value at lease end and income tax deductions; (2) risks due to ownership of equipment; and (3) termination risks.

REVENUE RISKS

END OF TERM PURCHASE AND RETURN OPTIONS: One of the revenue risks arises from the requirement that the lease be structured as a "true" lease for purposes of federal income tax laws. In simple terms, the bank must have a material unrecovered investment in the equipment at the end of the lease term (often called the booked residual value) and the bank may not compel the customer to pay for this unrecovered investment. However, the lease agreement will offer the customer the option (not a mandatory put) to purchase all (not just part) of the equipment at lease end for its appraised "fair market value," as this term is defined in the lease. If the customer does not exercise this purchase option, then the lease requires the customer to return all of the equipment to the bank and the equipment must be in the same condition as at the beginning of the lease subject only to reasonable wear, tear and depreciation resulting from normal and proper use. The "all and not less than all" requirement to purchase or return the equipment keeps the customer from cherry-picking the better items of equipment for purchase and returning the less desirable items. These purchase or return options will be documented so that the customer must give advance written notice of its lease-end decision (usually no less than 90 days). For specialized equipment, there will often be additional return requirements.

MAINTENANCE REQUIREMENTS: Another revenue risk is that the equipment might be in poor condition at lease end with the result that its fair market value when sold will be less than the bank's booked residual value. Since the customer is in the best position to protect the condition and value of the equipment, the lease contract will provide that, during the lease term, the customer must (a) maintain the equipment in good condition and working order, (b) use the equipment in a careful manner in the normal course of its business, (c) comply with all laws and regulations affecting the equipment, and (d) not make any alterations to the equipment without the bank's prior written consent. For specialized equipment, additional maintenance and use requirements may be included.

TAX BENEFIT PROTECTION: An important element of the bank's return on investment is realizing the depreciation tax benefits of owning the equipment. Therefore, the lease contract will include an indemnity against the bank's loss of this tax benefit. Most leases state that if the income tax benefits of owning the equipment are lost, disallowed or reduced (referred to as a "tax loss") due to acts or omissions of the customer or to any breach by the customer of its tax-oriented representations, then the customer will pay an additional amount so that the bank receives the same after-tax net economic yield that it would have received if the tax loss had not occurred.

OWNERSHIP RISKS

THIRD PARTY LIABILITY PROTECTION: If someone is injured ("Injury") or someone's property is damaged ("Damage") due to the manufacture, ownership, possession, use, or operation of the equipment, then a claim could be made against the bank, as the owner of equipment, to pay for the Injury or Damage. Since the bank does not manufacture, select or operate the leased equipment, the bank will insist that the customer assume the Injury/Damage risks. These Injury and Damage risks to the bank are mitigated by two provisions in the lease agreement:

> **Indemnity Protection:** The lease will state that the customer assumes all risk and liability for any Injury or Damage and that if any claim is made against the bank for Injury or Damage, then the customer will indemnify the bank, and defend the bank, at the sole expense of the customer, against the Injury/Damage claim. Usually, this indemnity provision is written so that the customers' duty to indemnify the bank does not apply to Injury or Damage that occurs after the equipment has been returned to the bank or for Injury or Damage caused by the gross negligence or willful misconduct of the bank.
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> **Liability Insurance**: The lease will require the customer to secure, at its expense, third party liability insurance coverage from a reputable insurance company in an amount acceptable to the bank and to have this policy endorsed so that the bank is named as an additional insured. The customer is likely to have such insurance in place already to protect itself against risks of Injury or Damage, so the main impact of the lease agreement is to name the bank as an additional insured.

DISCLAIMER OF PRODUCT WARRANTIES: Another ownership risk is that the bank could be subject to a claim that it is liable for the performance of the equipment (a "product warranty"). Again, since the bank does not manufacture, select or supply the equipment, the lease contract expressly and conspicuously disclaims any product warranties by the bank and directs the customer to make any product warranty claims against the manufacturer or supplier of the equipment. The lease will also provide that all product warranties are assigned by the bank to the customer so that the customer may enforce them itself if needed.

TERMINATION RISKS

Since a lease is, in essence, a right to use equipment for a period of time, a customer may consider the contract to be one that it can terminate if it has a problem with the equipment or if its need for the equipment changes. This is how a short-term car rental is usually structured. However, the bank structures its lease agreement on the expectation that the customer will pay the rents for the full multi-year term. To solidify the long-term nature of the lease and to negate the customer perception that it may terminate the lease prior to its scheduled expiration date, the lease agreement includes several protections for the bank:

Hell-And-High Water Clause: The lease contract expressly states that the customer's obligation to pay all rent and other amounts due under the lease is absolute and unconditional under any and all circumstances and is not subject to prepayment, cancellation or termination by the customer for any reason. This is called the "hell-and-high water" clause and it makes the customer's duty to pay rent the same as the unconditional promise to pay principal and interest under a loan. If requested, the bank may add an early purchase option for the customer on a specified date during the lease term with the option price set at a fixed amount (which, for tax law reasons, must not be less than the fair market value of the equipment on the option date).

Casualty Loss: If equipment is damaged or destroyed in an accident or stolen, a customer may want to suspend or cancel the lease since it no longer has the equipment available for use in its business. However, the lease agreement states that if a casualty loss occurs: (a) the customer must continue to pay rent through the end of the lease term, and (b) the customer is obligated, at its expense, to repair the equipment or, if it cannot be repaired, either to replace the equipment with similar equipment in good working order <u>or</u> pay a liquidated damage sum (usually called the stipulated loss value or "SLV") which will clear the bank's books at no loss to the bank. Most leases include a schedule that shows the SLV amount as of each rent due date, although some leases use a formula to calculate the SLV by discounting to present value the remaining rents and the original estimate of the fair market value of the equipment at lease end. If the customer pays the SLV after a casualty loss occurs, then no further rent is payable to the bank. As a good business practice, the customer will have casualty loss insurance coverage which will provide a fund to pay the SLV and the lease will require that the bank be named as loss payee of this insurance coverage.

Default and money damages: If a customer defaults and the bank decides to terminate the lease and demand payment, the customer may think that a lease should allow it to return the equipment and walk away from any further obligations to the bank. To the contrary, one of the bank's remedies under the lease contract is the right to demand payment of a specified post-default sum. This money damage calculation is usually based on the same mechanism as is used to determine a casualty loss payoff. In other words, in addition to demanding payment of any past due rent, the bank may demand payment of the stipulated loss value of the leased equipment.

Acceptance of Equipment: Although the lease includes the hell-and-high water clause described above, the lease typically states that the lease term does not start and the duty to pay rent does not commence until the customer has taken delivery of the equipment and accepted it for purposes of the lease. For these reasons, a separate certificate of acceptance will be required from the customer. The bank should not get this document from the customer (and should not pay the vendor of the equipment) until the bank has confirmed that the customer has taken delivery of the equipment and accepted it as being satisfactory. Failure to follow this procedure may permit the customer to cancel a lease on the basis that it has not "accepted" the equipment in accordance with the terms of the lease.

Equipment leasing presents a bank with an opportunity to open the door to new customer relationships and to satisfy its existing customer's need to acquire the use of equipment. An understanding of the unique features of lease contracts should help a banker to better serve its customers.