Leasing Law

All Bundled Up

As customers begin to demand single contracts for both equipment and soft costs, questions about special issues arise.

Merely providing services does not disqualify the contract as a lease.

Life used to be so simple. The owner of equipment would enter into a lease of that equipment with a lessee that wanted to use those goods for part or all of the useful life of the equipment. The lessee might have renewal options or a purchase option at the end of the lease term, or might have an early buyout option prior to the lease expiration date. Apart from the usual haggling over terms and conditions, the parties only had to worry about whether the contract was a “true” lease or a lease that “creates a security interest.”

These were the good old days of, say, five or six years ago. Now, some customers want a single contract for the use of equipment combined with a lease or license of software, perhaps along with substantial maintenance or other services. Many equipment vendors are happy to oblige, but wonder what special issues arise under such a bundled contract.

Last month, Paul Gamez explored “The Dangers of Bundling,” especially in the context of a funding source caught in the vortex of the Norvergence bankruptcy, where “the service provider fails to deliver the promised services/results.” While Paul’s article focused on “several key business issues” for lenders—due diligence process and the FTC regulatory role for consumer contracts—this article will address some of the key legal issues.

What kind of contract?

When is a lease not a lease? If it includes “too much” in the way of services or software? UCC section 2A-103(j) defines a “lease” as “a transfer of the right to possession and use of goods for a term in return for consideration.” The Official Comment to that section furnishes an example in which the owner of the equipment “provides all maintenance without charge to the lessee” under a month to month lease, with no obligation of either party to renew, concluding that the “transaction qualifies as a lease” and that “[s]ince there is no passing of title, there is no sale.” As such, merely providing services does not disqualify the contract as a lease.

In determining whether the contract is a lease, courts have tended to focus on which party maintains control and possession of the leased property. In circumstances where the lessor of a crane required that its personnel operate that equipment at all times while in use, or where the lessee of a drilling rig had no right to direct when it was to be used, courts have found the arrangement not to be a lease. However, if the lessee has a high degree of control (such as the ability to hire and fire) over the operators of the equipment, that arrangement may then be consistent with the contract being a lease rather than a service agreement. Even where the lessor provided a driver for the leased vehicle, reported cases have treated the contract as a lease. The analysis is always very fact-intensive.

How about software bundled with equipment? In Amplicon, Inc. v. CNB International, Inc. (W.D.N.Y. 2006), the court ruled that a purported lease, for software and related hardware, was not a “true” lease of the software where Amplicon “did not properly document the alleged transfer to it of rights” to the software. The decision, however, left open the possibility that a valid lease, of both software and equipment, could have existed even if the lessor had acquired a license to, rather than ownership of, the software.

Generally, courts have been inclined to respect the form of a transaction. In a case where services were contracted...
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separately from the leased goods, a bankruptcy court examined the claimant’s rights separately (and differently) under the service contract than under the lease (which was ruled to be intended for security), In re Greenville Auto Mall, Inc., 278 B.R. 414 (Bankr. N.D.Miss. 2001). Where a “flex lease” lessee termination option was bundled into a master equipment lease, courts ruled that the agreement was a unitary contract and that the bankrupt lessee could not assume the “flex lease” option without also assuming the underlying lease contract. In re Atlantic Computer Systems, Inc. (S.D. N.Y. 1994).

Can it be “hell or high water?”

If the contract is a lease, then the UCC is clear that the lessee’s obligations can be absolute and unconditional. In a 2005 decision involving DeLage Landen Financial Services, a Pennsylvania court upheld the lessee’s “hell or high water” obligations under a UCC 2A “finance” lease—even where the lease did not meet all the section 2A-407 conditions for a “finance” lease. Official Comment 6 to section 2A-407 declares, “other law” will “address whether a ‘hell or high water’ clause…is enforceable if included in…a lease that is not a finance lease” and notes that “courts have enforced [such] clauses.” For example, where UCC 2A had not yet been adopted by the governing law jurisdiction, a 1993 Tenth Circuit decision (Colorado Interstate Corp. v. CIT) upheld a common law “hell or high water” clause.

But where breach of substantial lessor performance is involved, courts sometimes have backed away from enforcing “hell or high water” clauses. In Eureka Broadband Corp. v. Wentworth Leasing Corp. (1st Cir. 2005), for instance, the lessor failed to pay the vendors for the purchase price of the leased equipment, leading the vendors in turn to sue
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the lessee for return of the goods. The court upheld the lessee’s cancellation of the leases under UCC section 2A-508, permitting the lessee to recover not only rentals previously paid but also consequential damages. The court ruled that the lessor’s fraudulent conduct rendered the “hell or high water” clause unenforceable. And, as Gamez’s article intimates, if lessor-provided services or software (whether bundled or under a separate contract) are essential to functioning of the leased equipment, the government might challenge the hell or high water nature of an equipment lease.

If the contract is a security agreement, or a lease that creates a security interest, then UCC section 9-403 validates waiver of defenses clauses by an “account debtor” if an assignee of the contract takes the assignment for value, in good faith, without notice of any third party claim to the payments and other property assigned, and without notice of defenses such as duress or illegality. An “account debtor” is “a person obligated on an account, chattel paper, or general intangible,” such as a lessee. The term “chattel paper” has been expanded to include “a security interest in specific goods, a security interest in specific goods and software used in the goods, a security interest in specific goods and [a] license of software used in the goods, a lease of specific goods, or a lease of specific goods and [a] license of software used in the goods.” Likewise, the UCC definition of “account” was recently expanded to include “a right to payment… whether or not earned by performance… for property…sold, leased, licensed [and] for services rendered or to be rendered.”
Applicable non-UCC law will determine the enforceability of a hell or high water clause in a contract not covered by UCC Article 2A or Article 9.

So the UCC has broadened the categories of contracts and rights which can be subject to valid waiver of defenses clauses for the benefit of assignees—what about the original lessor/seller/licensor/lender? Official Comment 4 to section 9-403 provides that “other law, and not [Article 9], determines the effectiveness of an account debtor’s undertaking to pay notwithstanding, and not to assert, any defenses or claims against an assign or—e.g., a “hell-or-high-water” provision in the underlying agreement.” This means that applicable non-UCC law, such as the previously mentioned Colorado Interstate decision, will determine the enforceability of a hell or high water clause in a contract not covered by UCC Article 2A or Article 9, such as a non-true lease where the lessor does not assign or pledge the contract. It also remains open whether a hell or high water clause will be upheld in a contract where the lessor/licensor/service provider materially defaults in performance.

Can it be sold or pledged?

Whether or not the contract is “hell or high water,” the lessor/licensor will want to know if it can sell or pledge a bundled contract. By making unenforceable any lease provision that prohibits free transferability, UCC section 2A-303(3) is intended to facilitate such a transfer by lessors of their rights to payment under the lease. UCC section 9-406(d) provides similarly for “the assignment or transfer of, or the creation…of a security interest in, the
account [or] chattel paper," except that sales of or security interests in leases must comply with sections 2A-303 and 2A-407. All of these UCC sections relate to sale or pledge of rights to payment, rather than to assignment of the obligations of the lessor or licensor. The headline news, however, is that rights to payment for services, software licenses, or leases of equipment and software all can be sold or pledged. There is no suggestion in the text or Official Comments of the UCC Articles 2A or 9 that bundling any two or more of those categories would reduce or preclude the lessor or licensor’s rights to sell or pledge under the UCC.

Beware, though, of the special rules for software under Article 9. The term “goods” includes equipment (including fixtures) as well as “a computer program embedded in goods and any [related] supporting information” if the program customarily is considered part of the goods or the owner of the goods acquires the right to use the program in connection with the goods. The Official Comments to sections 9-102 and 9-408 emphasize that “‘goods’ and ‘software’ [definitions] are also mutually exclusive” and that although section 9-408 permits a security interest “in a general intangible, such as an agreement for the nonexclusive license of software,” the secured party from such a licensee “is not entitled to enforce the license or to use, assign, or otherwise enjoy the benefits of the licensed software.” Consequently, sales or pledges of bundled contracts involving software will have to be structured and documented with special care, because the pledgee will not enjoy the same remedies for software as it does with equipment.

Of course, there remain other issues, such as whether a bundled lease is a “true” lease or one intended for security, how to handle sales and use taxes on the equipment and the bundled payments, and how to structure a sale of payments under a bundled contract so that it constitutes a “true” sale under the Bankruptcy Code.

However, as the volume of bundled contract transactions continues to grow, there will doubtlessly be further articles on those subjects.

ELT thanks Stephen T. Whelan, Thacher Proffitt & Wood LLP, for this month’s article.