Roundtable Discussion Group

"Where the Rubber Meets the Road – Current Issues in Motor Vehicle Leasing"

TRAC LEASE/SPLIT-TRAC LEASE
ISSUES AND DEVELOPMENTS

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* Special acknowledgment to William P. Brady, Jr. and Philip R. Rosenblatt of Nutter McClennen & Fish LLP for providing the compilation of U.S. jurisdictions that have adopted state legislation addressing the treatment of TRAC leases, and to John J. Rogers of Edwards & Angell LLP for his able assistance with the legal research.
QUESTIONS AND ISSUES FOR DISCUSSION AND CONSIDERATION

1. **What is a TRAC Lease?**

   TRAC stands for terminal rental adjustment clause. These types of transactions are also sometimes referred to as open-end leases because the ultimate obligation of the Lessee is not determined until the end of the lease term. A TRAC Lease is a lease of motor vehicles where the Lessee is obligated to make up any shortfall, or receive any excess proceeds, upon a disposition of the equipment at the end of the lease term. At the outset of the transaction, the Lessor and Lessee agree on what is commonly referred to as the "Estimated Residual Value". This amount is generally a prediction of the fair market value of the motor vehicles at the end of the term. This Estimated Residual Value is compared to the Actual Residual Value established by sale to a third party, sale to Lessee or even by appraisal at the end of the lease term.

   The basic concept of a TRAC lease is to provide the Lessee with a financial incentive to maintain the motor vehicles in good condition, which makes perfect sense given the fact that in a finance lease the Lessee is in the best position to control the maintenance of the motor vehicles. Because the Lessor's residual risk has been effectively passed on to the Lessee through the operation of the TRAC provision, one would expect that a TRAC lease would be treated as a conditional sale (non-true tax lease) rather than a true lease for tax purposes. However, TRAC leases are given special treatment under the Internal Revenue Code (see Section 7701(h) attached as Exhibit A). This provision basically provides that if the transaction would, absent the TRAC provision, meet the requirements of a true tax lease it will be treated as such under the Code. Note that under Section 7701(h), the transaction must involve a motor vehicle (including trailers), and the motor vehicle must be used more than 50% of the time in the trade or business of the Lessee.

2. **What is a Split-TRAC Lease?**

   A split-TRAC lease follows the same basic principles as a TRAC lease except that Lessee's potential lease end exposure is limited to a portion of the Estimated Residual Value. Lessee's end of term payment amount is sometimes referred to as "Lessee's Guaranteed Residual Amount" or "Lessee's Maximum Payment Amount". The difference between a full-TRAC lease and a split-TRAC lease is best explained through a comparison of a TRAC lease and split-TRAC lease (for purposes of this example, I have assumed that the equipment is sold to a third party at the end of the lease for 10% of original equipment cost):
TRAC LEASE:

a. Estimated Residual Value: 25%
b. Sale to Third Party @ FMV: 10%
c. Lessee Responsible for Shortfall: 15%

Lessor receives 25% (10% from sale and 15% from Lessee's TRAC payment)

SPLIT-TRAC LEASE (Lessee's Maximum Payment Amount 10%):

a. Estimated Residual Value: 25%
b. Sale to Third Party @ FMV: 10%
c. Lessee Responsible for Shortfall: 15%
   (up to Lessee Maximum Payment Amount 10%)

Lessor receives 20% (10% from sale and 10% from Lessee's TRAC payment)

Lessor Shortfall: 5%
(stated otherwise Lessor has a 5% at risk position)

A split-TRAC lease still receives the favorable tax treatment of Section 7701(h) assuming the transaction meets all of the criteria set forth in said Section. Because the Lessor bears some residual risk depending on the value of the motor vehicles at the end of the term, the Lessor needs to focus on return conditions and how any purchase option to the Lessee is structured (see No. 6 below).

3. How are TRAC Leases treated under State law and why is it important?

Based on the foregoing, it is pretty clear that a properly structured TRAC or split-TRAC lease will be treated as a true lease for Federal tax purposes. How will such a transaction be treated under State law and why do we care? We care because this issue will most likely come up in the context of a bankruptcy proceeding of the Lessee where the Lessor is seeking to have the transaction treated as a lease so that the Lessor will be in a better position to obtain current payments or even to repossess the motor vehicles.

Since the enactment of Section 7701(h) of the Internal Revenue Code, many states have added provisions (often buried in the Certificate of Title Act or motor vehicle statutes of the state) providing that the mere inclusion of a TRAC provision in a lease transaction will not preclude the transaction
from being treated as a lease for commercial law purposes. For example, in Rhode Island the applicable provision is found in the Section of the General Laws dealing with motor vehicles and reads as follows:

"§31-3.1-27 Vehicle leases that are not sales or security interests. – In the case of motor vehicles or trailers, notwithstanding any other provision of law, a transaction does not create a sale or security interest merely because it provides that the rental price is permitted or required to be adjusted under the agreement either upward or downward by reference to the amount realized upon sale or other disposition of the motor vehicle or trailer."

Attached as Exhibit B as a compilation of the law of the forty-six (46) U.S. jurisdictions (including D.C.) that have adopted these types of provisions. The most recent state to adopt such a law is Idaho where the law has an effective date of July 1, 2004. The existence of these provisions has not gone unnoticed by the courts who have addressed the treatment of TRAC leases under state law. I have attached copies of two (2) cases which analyze the commercial law treatment of TRAC leases (see Exhibit C - In re Charles, 278 B.R. 216 (Bk.D.Kan. 2002) (Kansas TRAC Law) and Exhibit D - In re Beckham, 275 B.R. 598 (D.Kan. 2002) (also covering Kansas TRAC law). See also, In re Owen, 221 B.R. 56 (Bk.N.D.N.Y. 1990) (New York TRAC law); In re Architectural Millwork of Virginia, 226 B.R. 551 (Bk.W.D.Va. 1998) (Virginia TRAC law); In re Mepco 276 B.R. 94 (Bk.W.D.Va. 2001) (Virginia TRAC law), and In re Damron 275 B.R. 266 (Bk.E.D. Tenn. 2002) (Tennessee TRAC law – Court finds true lease for commercial law purposes despite the absent of a special statutory provision in Tennessee).

4. Can you have a TRAC Lease with an Estimated Residual Value of 0%?

At first blush, the concept of having an Estimated Residual Value of 0% would lead to one to conclude that in no way could this transaction be treated as a true lease for tax purposes. Even if the lease transaction provided the Lessee with a fair market value purchase option, the exercise of this option in conjunction with the TRAC provision (estimated residual of 0%) would result in the Lessee paying itself the amount of the purchase option. However, in Peaden v. Commissioner, 113 T.C. 116 (1999), the United States Tax Court strictly interpreted the provisions of Section 7701(h) and held that the TRAC clause cannot be taken into consideration to prevent true tax lease treatment, even if the effect of the TRAC clause was to allow the Lessee to acquire vehicles at the end of the lease term for an amount that would constitute a nominal purchase price. In the Peaden case, the Lessee was granted a purchase option to acquire
the trucks at fair market value. The court focused on the fact that this purchase option only became nominal as a result of the TRAC provision. The Court states in pertinent part:

"Consequently, we will adhere to the plain language of Section 7701(h). As required by that Section, we will analyze the lease transactions without the TRAC; that is, we will look at the lease transactions as if the lessors receive possession of the trucks at the end of the lease term without any obligation to sell them and remit to Country-Fed any proceeds which exceed the base price plus the cost of arranging the sale."

For a detailed description of how the combination of the TRAC provision and purchase option worked in reality, see footnote 11 of the Peaden case.

When ignoring the TRAC provision, the transaction had all of the other attributes of a true lease transaction, including the fact that the useful life of the trucks extended beyond the lease term. While the Peaden case is not directly on point with a transaction which expressly states that the estimated residual is 0%, it can be used to support an argument for true lease treatment of such a transaction because the Lessee in the Peaden case effectively acquired the trucks at the end of the lease term for a nominal price. While the Peaden case may be supportive of such treatment, it is my own feeling that such a transaction is very aggressive from a tax standpoint and would certainly be subject to intense scrutiny by the IRS.

5. **Lessee purchase options in TRAC Leases – how to structure.**

It is not unusual for a Lessee to be granted an end of term purchase option in a TRAC lease or split-TRAC lease transaction. The inclusion of such a purchase option in and of itself should not negatively impact the tax treatment of the transaction. However, in my view it is better to have a fair market value purchase option rather than a purchase option at the Estimated Residual Value because a purchase option at fair market value is more indicative of a true tax lease. From a practical standpoint you obtain the same result under either of these scenarios because to the extent the fair market value exceeds the Estimated Residual Value, this excess amount would be paid by the Lessee to itself when it exercises its purchase option. Also, as we have learned from the Peaden case referenced in No. 4 above, for purposes of Section 7701(h) the TRAC provision is ignored for purposes of true tax lease analysis. Setting the purchase option at fair market value avoids any consideration of whether or not the purchase option at Estimated Residual Value is adequate or
inadequate for tax purposes in determining whether the Lessor maintains a meaningful residual.

6. **Some pitfalls in split-TRAC Leases – the importance of return provisions.**

In general return and maintenance provisions are not as significant in TRAC transactions as in other transactions because the Lessee will be liable to the Lessor through its TRAC payment if the motor vehicles are returned in poor condition. Of course, return and maintenance provisions can still be important if there is an event of default during the term of the lease and the Lessor must repossess the motor vehicles and dispose of them. Also, return and maintenance provisions are important in split-TRAC transactions because the Lessor retains a portion of the residual risk. In split-TRAC transactions where the Lessee is granted a purchase option at fair market value, it is important that the Lessee only be entitled to exercise the purchase option if there is no event of default. It is also important to include a provision that states that fair market value is determined based on the assumption that the motor vehicles are in the condition required by the lease. The purpose of such a provision is to ensure that the Lessee cannot run the motor vehicles into the ground and not keep them in good repair and then exercise its fair market value purchase option (nominal given the condition of the vehicles) in which case the Lessor will be facing a shortfall. These two conditions provide a double protection to the Lessor from finding itself in this type of situation.

7. **What is the proper way to be designated on a certificate of title for a TRAC Lease (as owner or lienholder)?**

There is some debate in the leasing industry about how a Lessor should be designated on a certificate of title in a TRAC lease or split-TRAC lease transaction. Please note that how a Lessor may be designated on a certificate of title may be dictated by the particular certificate of title law in the state. The states vary greatly on this, and this is certainly one of the arguments for a Uniform Certificate of Title Act. Given the current case law trend holding that vehicle leases containing a TRAC clause or split-TRAC clause are true leases for state law purposes, combined with the fact that 45 jurisdictions have adopted specific statutory provisions addressing this issue, suggests to me that if possible the Lessor should be listed as the owner on the certificate of title. This is consistent with the true lease treatment of TRAC leases and split-TRAC leases for commercial law purposes. Even if the transaction is ultimately determined to be a secured transaction rather than a lease, the case law suggests that listing the Lessor as the owner rather than the lienholder will meet the "substantial compliance standard" for motor vehicle certificates of title. See In re Charles, 323 F.3d. 841 (10th Cir. 2002).
TRAC Leases - Internal Revenue Code Provision – 7701(h)

U.S. Code Title 26, Subtitle F, Chapter 79, Section 7701

(h) Motor vehicle operating leases

(1) In general

For purposes of this title, in the case of a qualified motor vehicle operating agreement which contains a terminal rental adjustment clause –

(A) such agreement shall be treated as a lease if (but for such terminal rental adjustment clause) such agreement would be treated as a lease under this title, and

(B) the lessee shall not be treated as the owner of the property subject to an agreement during any period such agreement is in effect.

(2) Qualified motor vehicle operating agreement defined

For purposes of this subsection –

(A) In general

The term "qualified motor vehicle operating agreement" means any agreement with respect to a motor vehicle (including a trailer) which meets the requirements of subparagraphs (B), (C), and (D) of this paragraph.

(B) Minimum liability of lessor

An agreement meets the requirements of this subparagraph if under such agreement the sum of -

(i) the amount the lessor is personally liable to repay, and

(ii) the net fair market value of the lessor's interest in any property pledged as security for property subject to the agreement,

equals or exceeds all amounts borrowed to finance the acquisition of property subject to the agreement. There shall not be taken into account under clause (ii) any property pledged which is property subject to the agreement or property directly or indirectly financed by indebtedness secured by property subject to the agreement.
(C) Certification by lessee; notice of tax ownership

An agreement meets the requirements of this subparagraph if such agreement contains a separate written statement separately signed by the lessee –

(i) under which the lessee certifies, under penalty of perjury, that it intends that more than 50 percent of the use of the property subject to such agreement is to be in a trade or business of the lessee, and

(ii) which clearly and legibly states that the lessee has been advised that it will not be treated as the owner of the property subject to the agreement for Federal income tax purposes.

(D) Lessor must have no knowledge that certification is false

An agreement meets the requirements of this subparagraph if the lessor does not know that the certification described in subparagraph (C)(i) is false.

(3) Terminal rental adjustment clause defined

(A) In general

For purposes of this subsection, the term "terminal rental adjustment clause" means a provision of an agreement which permits or requires the rental price to be adjusted upward or downward by reference to the amount realized by the lessor under the agreement upon sale or other disposition of such property.

(B) Special rule for lessee dealers

The term "terminal rental adjustment clause" also includes a provision of an agreement which requires a lessee who is a dealer in motor vehicles to purchase the motor vehicle for a predetermined price and then resell such vehicle where such provision achieves substantially the same results as a provision described in subparagraph (A).
EXHIBIT B

MEMORANDUM

April 13, 2004
99970-65

TO: Mr. David T. Miele

CC: Philip R. Rosenblatt, Esq.

FROM: William P. Brady, Jr.

RE: U.S. Jurisdictions that have adopted legislation addressing the issue of TRAC leases.

Of the 51 possible U.S. jurisdictions (including D.C.), 46 jurisdictions have passed legislation providing that, in the case of motor vehicles or trailers (and in some cases semi-trailers), certain transactions do not create a sale or security interest merely because they provide that the rental price is permitted or required to be adjusted under the agreement either upward or downward by reference to the amount realized upon sale or other disposition of the motor vehicle or trailer (or semi-trailer).

Washington has applied this TRAC treatment to all “goods” pursuant to the Washington Commercial Code. It is worth noting that federal TRAC treatment is only available for qualified motor vehicles, trailers and semi-trailers. Therefore, under the Washington Commercial Code, in connection with “goods” that are not motor vehicles, trailers or semi-trailers, it appears that the tax benefit would be limited to state taxes, whereas the federal TRAC treatment would still apply to motor vehicles, trailers and semi-trailers.

The jurisdictions that have enacted TRAC legislation, and the legislative criteria, are listed below. Copies of these statutes are attached to this memorandum.

(exception appears within the definition of “security interests” under the Commercial Code and applies to “motor vehicles” not used primarily for personal, family or household purposes; note that it also provides “nothing in this subparagraph affects the application or administration of the Sales and Use Tax Law”)

19. Maryland: Md. TRANSPORTATION Code Ann. § 13-211 (2003) (only if it is not leased, or used, primarily for personal, family or household purposes)
22. Minnesota: Minn. Stat. § 168A.17 (1)(a) (2003) (other than a vehicle used primarily for personal, family or household purposes)


   (which are not leased or used primarily for personal, family or household purposes)


   (not applicable to consumer lease agreements pertaining to a motor vehicle or trailer leased or used primarily for personal, family or household purposes)


   (not applicable to vehicles or trailers leased or used primarily for personal, family or household purposes)


   (“this provision shall not affect…the calculation of sales and use tax payable under Title 59, Chapter 12, Sales and Use Tax Act”)


46. Wyoming: Wyo. Stat. § 31-2-802(b) (2003) (not applicable to motor vehicles or trailers leased or used primarily for personal, family or household purposes)

The following 5 jurisdictions have not yet passed TRAC legislation:

1. Kentucky
2. Louisiana
3. Nebraska
4. New Mexico
5. North Carolina

WPB:wpb

1315356.2
Chapter 7 trustee brought adversary proceeding to avoid, in exercise of strong-arm powers, disguised security interest allegedly possessed by truck tractor lessor. The Bankruptcy Court, Robert E. Nugent, J., held that: (1) motor vehicle lease that obligated Chapter 7 debtor-lessee to continue making rental payments for full five-year term of lease was true "lease" rather than disguised sale and security agreement; and (2) even assuming that lease was disguised security agreement, secured creditor's error, in listing itself on certificates of title as "owner" rather than as "lienholder," did not render its security interest unperfected and subject to attack by trustee.

Judgment for defendant.

West Headnotes

[1] Bankruptcy 3101
51k3101 Most Cited Cases

Bankruptcy court had to look to state law to determine whether debtor's motor vehicle lease was truly a lease, as opposed to a disguised sale and security agreement.

[2] Bankruptcy 3101
51k3101 Most Cited Cases

To decide which state's law governed dispute regarding nature of debtor's vehicle lease, as true lease or disguised sale and security agreement, bankruptcy court had to look to choice of law rules of forum state.

[3] Secured Transactions 3.1
349Ak3.1 Most Cited Cases

Under Kansas law, parties to secured transaction are generally free to chose which state's law will govern disputes arising from that transaction.

[4] Bankruptcy 3101
51k3101 Most Cited Cases

While parties to motor vehicle lease had specified that any disputes arising under their lease would be governed by Oregon law, bankruptcy court in Kansas, in evaluating whether lease was true lease or disguised sale and security agreement for purpose of strong-arm avoidance claims asserted by Chapter 7 trustee, would apply Kansas law, since dispute arose in bankruptcy and involved more than rights of just debtor and alleged lessor. Bankr.Code, 11 U.S.C.A. § 544.

[5] Secured Transactions 10
349Ak10 Most Cited Cases

Under Kansas law, motor vehicle lease which obligated Chapter 7 debtor-lessee to continue making rental payments for full five-year term of lease, whereupon debtor would have option either of purchasing leased truck tractors for payment ($93,198.70) equal to their estimated residual value, or of returning them to lessor for sale, with debtor to be responsible for any shortfall in event that tractors were sold for less than what parties had estimated, was true "lease," rather than disguised sale and security agreement, though debtor was obligated to keep vehicles insured, to maintain them, and to pay taxes; $93,198.70 purchase price was not nominal. K.S.A. 84-1-201(37).

[6] Secured Transactions 10
349Ak10 Most Cited Cases

Under Kansas law, in distinguishing true lease from disguised sale and security agreement, court must engage in objective inquiry into nature of agreement based upon the facts of case, which disregards form of agreement or stated intent of parties, and instead looks at agreement's economic effect on parties. K.S.A. 84-1-201(37).
Even assuming that motor vehicle lease which obligated Chapter 7 debtor-lessee to continue making rental payments for full five-year term of lease could be regarded, not as true lease, but as disguised sale and security agreement, secured creditor's error, in listing itself on certificates of title as "owner" rather than as "lienholder," did not render its security interest unperfected and subject to attack by Chapter 7 trustee in exercise of strong-arm powers. Bankr.Code, 11 U.S.C.A. § 544; K.S.A. 8-135, 84-9-302.

*218 W. Thomas Gilman, Wichita, KS, for Debtors.

J. Michael Morris, Wichita, KS, trustee.

MEMORANDUM AND OPINION GRANTING SUMMARY JUDGMENT

ROBERT E. NUGENT, Bankruptcy Judge.

This matter is before the Court on the motion of U.S. Bancorp Leasing and Financial ("Bancorp") for summary judgment (the "Motion") on the Trustee's Complaint. In his Complaint, Trustee J. Michael Morris asserts that the arrangement under which Bancorp leased to debtors Robert and Jan Charles five Kenworth truck tractors is a disguised sale rather than a finance lease. The Trustee further argues that, since the transaction is a disguised sale and not a lease, Bancorp was obligated to perfect its security interest in the vehicles in strict compliance with Kan. Stat. Ann. § 84-9-302 [FN1] and Kan. Stat. Ann. § 8-135. After careful consideration of the parties' submissions, the Court concludes that the Trustee's argument fails on both counts and grants summary judgment to Bancorp.


UNCONTROVERTED FACTS

There is little dispute as to the facts of this case. Debtors Robert Fritz Charles and Jan Aloise Charles filed their chapter 7 case in this Court on August 30, 2000. The Trustee filed this adversary proceeding on November 28, 2000. After written discovery was completed, Bancorp's Motion was filed on October 3, 2001.

On March 1, 2000, debtors signed a Master Lease Agreement with Bancorp pursuant to which they leased five Kenworth truck tractors for a five year period. Debtors also signed a Schedule to Lease Agreement ("Schedule"), a Delivery and Acceptance Certificate ("Certificate"), and a TRAC [FN2] Lease Addendum ("TRAC Addendum"). Taken together with the Master Lease Agreement, these documents form a memorandum which is the whole agreement of the parties concerning possession, use and return of the vehicles. For convenience, the Court refers to this memorandum the "Lease." Debtors breached the Lease by failing to make required monthly payments and, after the case was filed, Bancorp obtained stay relief, reclaimed the vehicles, and sold them for $285,000.00.

FN2. "TRAC" is an acronym for "terminal rent adjustment clause," a term of art in the leasing industry which refers to a lease which provides for the adjustment of the rents based on the variance of the value of the leased property from the stated "residual value" in the initial lease agreement. The TRAC clause applicable here is found in the TRAC Addendum.

The Lease provided that the debtors were obligated to make all of the payments and that their obligation was not subject to termination. Paragraph 5 of the Master Lease Agreement states "[t]his is a fully net, noncancellable contract of lease which may not be terminated for any reason except as otherwise provided herein." Paragraph 3 of the same document provides that "rental payments are specified in each Schedule." The Schedule references sixty (60) monthly payments of $8,128.64 being due, commencing on April 15, 2000. The TRAC Addendum states "[i]n addition to the rental payments specified, lessor is also entitled to recover a Residual Value equal to $93,198.70 ...." *219 The parties agree that the debtors duty to pay rent under the Lease is noncancellable.

The parties' rights upon termination are defined in the TRAC Addendum which provides that, at the close of the Lease term, the debtor may opt to (1) acquire the tractors for the amount of the Residual Value, plus a $500 termination fee or (2) not acquire the tractors, in
which case the lessee is required to either re-lease the tractors or sell them to the highest bidder. The present value of the payments yielded by the re-letting of the vehicles or the proceeds of their sale is defined as the "Market Value" of the vehicles. If, after deductions for recovery expenses, property taxes, and refurbishing, the Market Value is less than the Residual Value, the lessee would be obligated to make up the difference. On the other hand, if the adjusted Market Value exceeds the Residual Value, the lessee is entitled to the surplus.

A third possible outcome, a holdover, is also possible. If the lessee fails to either return the vehicles or purchase them, Bancorp may at its sole option extend the base lease term for six additional months with the debtors remaining obligated to follow all of the other terms and conditions of the Lease. Debtors would be required to pay six additional months' rent at the stated rate (a total of $48,771.84) and, at the end of the holdover term, would have the same two options outlined above: purchase the vehicles at the Residual Value plus a fee or return the vehicles for disposition and rent adjustment. According to the TRAC Addendum, however, none of the holdover rent is credited against the Residual Value or any other lessee obligation.

STANDARDS ON SUMMARY JUDGMENT

Rule 56 of the Federal Rules of Civil Procedure governs summary judgment and is made applicable to contested matters by Rule 9014 of the Federal Rules of Bankruptcy Procedure. Rule 56, in articulating the standard of review for summary judgment motions, provides that judgment shall be rendered if all pleadings, depositions, answers to interrogatories, and admissions and affidavits on file show that there are no genuine issues of any material fact and the moving party is entitled to judgment as a matter of law. Fed.R.Civ.P. 56(c); Fed. R. Bankr.P. 7056, 9014. "The mere existence of some alleged factual dispute between the parties will not defeat an otherwise properly supported motion for summary judgment, the requirement is that there be no genuine issue of material fact". [FN3] In determining whether any genuine issues of material fact exist, the Court must construe the record liberally in favor of the party opposing the summary judgment. [FN4] However, the opposing party's conclusive allegations are not sufficient to establish an issue of fact and defeat the motion. [FN5]


FN4. McKibben v. Chubb, 840 F.2d 1525, 1528 (10th Cir.1988) (citation omitted).

FN5. Id.

DISCUSSION

[1] The Court must determine whether the Lease as a matter of law creates a lease transaction or a security interest. If the Court determines that a security interest is created, it then must consider whether Bancorp has perfected same by showing itself as "owner" rather than as "lienholder" on the certificates of title issued by the Kansas Division of Vehicles for these tractors. In determining whether the Lease is *220 truly a lease as distinguished from a disguised sale or security agreement, the Court looks to state law and particularly to § 1-201(37) of the Uniform Commercial Code which contains the definition of "security interest". See Butner v. United States, 440 U.S. 48, 54-55, 99 S.Ct. 914, 91 L.Ed.2d 136 (1979) (the existence, nature and extent of a security interest in property is governed by state law). This uniform section was revised in 1986 and the revision adopted in Kansas in 1991. Kan. Sess. L.1991, ch. 295, § 82.

The threshold question before the Court is whether the Court should apply Oregon or Kansas law to govern the substantive issues raised by the parties. The Lease contains a choice of law provision designating that the Lease be interpreted pursuant to Oregon state law. Bancorp asserts that the law of Oregon should apply in this case, while the Trustee argues that Kansas law is more appropriate because Kansas has a more "reasonable relation" to this transaction. In reality, both states have a relation to the transaction, although Kansas clearly has more contacts. Bancorp has offices within Oregon and all documents have the Oregon office address, while Kansas has ties to the transaction because the debtor resides and the tractors are located in Kansas, the tractors were purchased and certificates of title issued in Kansas. Furthermore, while the Lease documents specify that Oregon law applies, it appears that the U.C.C. § 1-201(37), as enacted, is virtually identical in both jurisdictions, and that Oregon and Kansas case law on the applicability and enforceability of TRAC leases, particularly in the wake of the

[2]
enactment of "new" § 1-201(37) is equally undeveloped.


(1) "Except as provided hereafter in this section, when a transaction bears a reasonable relation to this state and also to another state or nation the parties may agree that the law either of this state or of such other state or nation shall govern their rights and duties. Failing such agreement this act applies to transactions bearing an appropriate relation to this state.

(2) Where one of the following provision of this act specifies the applicable law, that provision governs and a contrary agreement is effective only to the extent permitted by the law (including the conflict of law rules) so specified:

Perfection provisions of the article on secured transactions. K.S.A. 84-9-102 and amendments thereto.*

[3] Additionally, Kan. Stat. Ann. § 84-9-102(1) states that Article 9 shall apply to any transaction intended to create a security interest in personal property, and § 84-9-102(2) states that Article 9 applies to leases intended as security. Thus, under § 84-1-105, parties to a transaction are generally free to choose which state's law shall govern disputes arising from that transaction unless, among other things, the dispute falls within the scope of § 84-9-102. See also In re Bumgardner, 183 B.R. 224, 226-27 (Bankr.D.Idaho 1995).

[4] As noted by the Novack court in analyzing whether the apply Minnesota or Oklahoma law to determine if a lease was a true lease or disguised security interest, the application of Oregon law in this case would "violate a fundamental purpose of article 9: to create commercial certainty and predictability by allowing third party creditors to rely on the specific perfection and priority rules which govern the scope *221 of article 9." The court concluded that since the rights of third parties were at stake in the instant action, as here are the rights of the trustee, the Oklahoma court would apply Oklahoma law to determine the scope of article 9 of the Oklahoma U.C.C. 88 B.R. at 354. This Court agrees with this analysis, that it would violate third parties' right to apply Oregon law to determine whether the TRAC leases were true leases or disguised security agreements. Thus, the Court will apply Kansas law to determine whether the TRAC leases are true leases or disguised security agreements, however, since Oregon and Kansas have both adopted the "new" U.C.C. § 1-201(37), the outcome of this proceeding would be the same under the law of either state.

[5] The issue of whether so-called "finance leases" are in reality security agreements has vexed the courts for many years. Former U.C.C. § 1-201(37) contained a deceptively simple formulation which provided merely that a transaction which included an option to purchase was not necessarily a secured transaction, but that when the lessee had the option to become the owner of the leased goods for no or nominal consideration, the lease was in fact intended for security. The actual legal nature of the transaction was to be gleaned from the facts of each case and the courts were expected to divine the intent of the parties from the documents and surrounding facts. As the Official Comment to current Kan. Stat. Ann. § 84-1-201(37) states,

Reference to the intent of the parties to create a lease or security agreement has led to unfortunate results. In discovering intent, the courts have relied on factors that were thought to be more consistent with sales or loans than leases. Most of these criteria, however, are as applicable to true leases as to security interests ….. Accordingly, amended Section 1-201(37) deletes all reference to the parties intent. Off. Comm. ¶ 37, Kan. Stat. Ann. § 84-1-201(37) (Supp.2001).

New §1-201(37), with respect to leases, reads in part--

Whether a transaction creates a lease or security interest is determined by the facts of each case; however, a transaction creates a security interest if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee, and

(a) the original term of the lease is equal to or greater than the remaining economic life of the goods,

(b) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods,

(c) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement, or

(d) the lessee has an option to become the owner of
the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement .... Kan. Stat. Ann. § 84-1-201(37) (2001). A lease is defined in Kan. Stat. Ann. § 84-2a-103(i) as a transfer of the right to possession and use of goods for a term for consideration, but a sale or retention or creation of a security interest is not a lease. According to the Official Comment, "the task of sharpening the line between true leases and security interests disguised as leases continues to be a function of this §222 paragraph." Off. Comm. Kan. Stat. Ann. § 84-1-201(37) (2001).

[6] In plainer terms, Kan. Stat. Ann. § 84-1-201(37) directs a Court's inquiry toward an objective determination of the nature of the agreement based upon the facts of each case which disregards the form of the agreement or the stated intent of the parties and "instead must look at the agreement's economic effect on the parties." See E.C Hochstadter & J. Campo, FF & E and the True Lease Question: Article 2A and Accompanying Amendment to UCC Section 1-201(37), 7 Am. Bankr. Inst. L.Rev. 517, 523 (Winter 1999 Ed.) (Herein "Hochstadter"). At stake is whether, based on all of the facts, the lessor retains some valuable reversionary interest in the lease property. Id. In order that a security interest rather than a lease be found, the statute requires that: (1) the lessee's obligation to pay rent not be terminable (the so-called "hell or high water clause"); and (2) the lessor not retain any residual value or interest in the "leased" property. Determination of the degree to which the lessor does not retain residual value is based upon four factors outlined in the statute: (i) the term of the lease equals or exceeds the economic life of the property; (ii) the lessee is bound either to renew the lease for the economic life of the goods or to become their owner; (iii) the lessee has the option to renew the lease for the remaining economic life of the goods for no or nominal consideration; or (iv) the lessee has the option to buy the goods for no or nominal consideration upon compliance with the lease. The degree to which consideration is nominal is further addressed in the statute as discussed below.

The Trustee's arguments that the Bancorp lease is a disguised secured transaction can be summarized as follows. First, the Trustee argues that the lease is not terminable and that the debtors could have become owners of the tractors for what the Trustee believes is no consideration or nominal consideration. Second, the Trustee argues that a consideration of the economic realities of the transaction forces a conclusion that this transaction is in fact one intended as security. There is no question that the lease is non-terminable and that the first prong of the statutory two-part test for the existence of a security interest is met. The debtors were obligated to pay all of the rents due under the Lease. Where the Trustee errs, however, is in his contention that the second prong of the test, that pertaining to the retention by lessor of residual value, is met because the debtors could have acquired these tractors at the end of the Lease's term for nominal consideration.

As previously noted, had debtors completed the term of the lease and opted to acquire the tractors, they would have been required to pay the Residual Value of some $93,198.70 plus a termination fee of $500 for the vehicles. The Trustee argues that, under any of the three lease-end scenarios (purchase, surrender, or holdover), the debtors would have been required to pay the Residual Value and, thus, might as well have purchased the tractors. The Trustee relies on the terms of the TRAC Addendum which provide that Bancorp is "entitled to recover" not only the rents, but also the Residual Value. The Trustee offers as support the authority of In re Zerkle, 132 B.R. 316 (Bankr.S.D.W.Va.1991). In Zerkle, the bankruptcy court held that TRAC leases create an option to purchase for no additional consideration. This holding is based on the reasoning that, because the debtor is required to guarantee that the lessor receive either the Residual Value or the leased property plus payment for any diminution of Residual Value at the end of the lease term, the debtor's consideration to purchase is essentially nominal. This decision was taken, however, under the old version of § 1-201(37). This Court respectfully disagrees with the Zerkle court's view. Moreover, the Trustee's argument entirely overlooks Kansas' specific enactment on this subject, Kan. Stat. Ann. § 84-2a-110(a), which was enacted by the same 1991 Legislature that enacted new § 1-201(37) and which states that "an agreement involving the leasing of motor vehicle or trailer does not create a sale or security interest solely because the agreement provides for an increase or decrease adjustment in the rental price of the motor vehicle or trailer based upon the amount realized upon the sale or other disposition ... following the termination of the lease." This statute hobbles the Trustee's argument that TRAC leases are (at least as to vehicles and trailers), by definition sales or security transactions.

The TRAC Addendum provides that if the lessee decides not to purchase the vehicle, it must return the vehicle which is then sold. If the vehicle's sale brings...
less than the Residual Value, the lessee makes up the deficiency. If the vehicle brings more, the lessee is entitled to the surplus. When the lessee spurns the purchase option, he "pays" the Residual Value only in the sense that he returns the vehicle (and pays any shortfall between the realized value of the vehicle and the Residual Value). Were this the badge of a disguised sale, nearly every lease would be subject to the Trustee's attack. Rather than creating an arrangement which effectively forces the lessee to purchase, the TRAC provision instead provides valuable incentive to the lessee to maintain the vehicle so that, upon its return to the lessor, he will not be obligated for any Residual Value shortfall.

Whether the consideration for purchase of the property as lease's end is "nominal" is also addressed in Kan. Stat. Ann. § 84-1-201(37). The statute states, in part--

For purposes of this subsection (37):
(a) Additional consideration is not nominal if (i) when the option to renew the lease is grant[ed] to the lessee the rent is stated to be the fair market rent for the use of the goods for the term of the renewal determined at the time the option is to be performed, or (ii) when the option to become the owner of the goods is granted to the lessee the price is stated to be the fair market value of the goods determined at the time the option is to be performed. Additional consideration is nominal if it is less than the lessee's reasonably predictable cost of performing under the lease agreement if the option is not exercised:


The Lease does not provide for a contemporary determination of "fair market value" at which the lessee may purchase the goods. The Residual Value, determined at the outset of the Lease, is the option price. Subsections (a)(1) and (a)(2) thus do not apply. The statute does, however, set forth that additional consideration is nominal if it is less than the reasonably predictable cost of performing if the option is not exercised. Under Bancorp's Lease, if the lessee declines to purchase and instead returns the vehicles, his "reasonably predictable cost of performing" is limited to making up the shortfall between Residual Value and Market Value which, in the worst case, can only equal the Residual Value (assuming the Market Value of the vehicles as determined under the documents is zero). If he holds over, his liability to the lessor is six more months' rent, or $48,771.64. In the event of a holdover, the lessee's cost of performing is substantially less than the purchase option price. This Court therefore respectfully *224 disagrees with the Zerkle court's conclusion that TRAC clauses result in purchase option consideration being "nominal" under the current version of the U.C.C.

The Trustee's reliance on Percival Const. Co v. Miller Auctioneers, Inc. 532 F.2d 166 (10th Cir.1976) (holding under the old § 1-201(37) that a purchase option price of less than 25 percent of the original list price of the goods is per se nominal) and In re Fashion Optical, 653 F.2d 1385 (10th Cir.1981) (recognizing Percival as establishing the 25 percent rule) is misplaced, particularly in light of the enactment of "new" § 1-201(37). While this Court is bound by controlling Tenth Circuit precedent, the authority of these cases has been superseded by the 1991 enactment. Moreover, it is certainly possible that an option price of less than 25 percent might well constitute the fair market value of the goods being purchased and might well constitute more than a nominal sum. Indeed, White and Summers conclude that the enactment of new § 1-201(37) "disavows percentage tests." See White & Summers, Uniform Commercial Code § 30-3 (4th ed. 1995 & Supp.2001). Two federal courts sitting in Kansas agree. See In re Beckham. 275 B.R. 598 (D.Kan.2002) aff'g Morris v. Dealers Leasing, Inc. (In re Beckham), No. 99-12124, Adv. No. 00-5218 (Bankr.D. Kan. June 26, 2001). Under any theory, the amount required to be paid by the lessee under the Lease is simply not "nominal." To retain these tractors, lessee would have been required to pay over $93,198.70 plus the termination fee. Indeed, had the debtors held over for an additional six months (at a cost exceeding $48,000.00), they would still have been required to pay in this amount.

The Court must also look to the "economic reality" of the transaction before concluding its analysis. See In re Edison Bros. Stores, Inc., 207 B.R. 801, 811 (Bankr.D.De1.1997) (citing In re Zaleha, 159 B.R. 581, 586 (Bankr.D.Idaho 1993)). In support of his contention that Bancorp has retained no "entrepreneurial stake" in the tractors, the Trustee notes that the lessee is required under the documents to pay taxes and insurance on the vehicles, to provide for their maintenance, and generally to assume the risk of loss concerning them. This, he argues, indicates that the lessor has retained no reversionary interest in the vehicles. This position is not novel. The Trustee draws support from In re Tulsa Port Warehouse Co., Inc. 690 F.2d 809 (10th Cir.1982) (Where lessee required to insure, pay tax and license fees on goods, and to maintain them, even in the absence of an option to purchase, lessee holds all incidents of ownership except
bare title; lease in fact a secured transaction). Based on this authority, the Trustee asserts that TRAC leases are, as a matter of law in the Tenth Circuit, actually secured transactions. The Trustee even goes so far as to suggest that the revision to § 1-201(37) in no way displaces the holding in *Tulsa Port Warehouse* because the statute only served to shift the analysis away from the intent of the parties toward a review of the economic realities. This argument ignores the plain language of the new statute pertaining to economic realities. In fact, the statute states, *inter alia*—

A transaction does not create a security interest merely because it provides that
(a) the present value of the consideration the lessee is obligated to pay the lessor for the right to possession and use of the goods is substantially equal to or is greater than the fair market value of the goods at the time the lease is entered into,
(b) the lessee assumes risk of loss of the goods, or agrees to pay taxes, insurance, filing, recording, or registration fees, or service or maintenance costs with respect to the goods,
(c) the lessee has an option to renew the lease or to become the owner of the goods,
(d) the lessee has an option to renew the lease for a fixed rent that is equal to or greater than the reasonably predictable fair market rent for the use of the goods for the term of the renewal at the time the option is to be performed, or
(e) the lessee has an option to become the owner of the goods for a fixed price that is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed.

Kan. Stat. Ann. § 84-1-201(37)(Emphasis added). Trustee's argument is substantially undercut by the enactment of subsection (b), supra. While it is true that the indicators pointed out by the Trustee at one time were the badges of a secured transaction, "[c]ourts deciding cases under the new UCC follow the approach taken by the drafters, namely, that most of these case law factors are found in true leases." Hochstader at 550 (citations omitted). As this commentator has suggested,

"Courts interpreting both Old and New UCC 1-201(37) have consistently held that the principal characteristic of a lease, which distinguishes it from a secured transaction, is that it allows the lessee the right to use the property with an attendant opportunity to return the property to the lessor while it still has 'substantial useful economic life.' "

Hochstader at 533.

Here, the lessees' obligation to keep the vehicles insured, to maintain them and to pay taxes pertaining to them are entirely consistent with common net lease provisions and do not of themselves indicate of the creation of an equity in the lessee. Under the economic realities of this Lease, the lessees were left with no significant equity. Instead, they had the "option" to come up with over $93,000.00 to purchase the vehicles even after five years of rent payments. While there is no indication either in the Lease or in the record what the "fair market value" of these vehicles might have been at term's end, the Court notes that the vehicles were repossessed by Bancorp and sold for $285,000.00 a little less than one year into the five year lease term. This is approximately sixty-one percent of the acquisition cost described in the Lease. From this, the Court concludes that the Residual Value of $93,198.70 would likely be much greater than the actual fair market at the end of the five-year term. In short, Bancorp retained a significant reversionary interest in the vehicles leased under the Lease. The debtors obtained no meaningful equity in them. While under Old § 1-201(37) and the rule of *Tulsa Port Warehouse*, the Trustee might have prevailed on his complaint, the enactment of the new section requires another result. Bancorp is entitled to judgment as a matter of law that the Lease is indeed a financing lease rather than a secured transaction.

[7] While this determination renders moot the Trustee's contention that Bancorp failed to adequately perfect its alleged security interest in the vehicles, this Court notes its disagreement with that contention. Even had this Court found the Lease to create a secured transaction, Bancorp's security interests would be adequately perfected and the Trustee's hypothetical lien avoiding powers under 11 U.S.C. § 544 would be of no avail here. The Court rejects the Trustee's assertion that Bancorp's being named as an "owner" rather than a "lienholder" is not sufficient substantial compliance with the requirements of Kan. Stat. Ann. § 84-9-302 and *226 Kan. Stat. Ann. § 8-135*. In a decision entered in this same bankruptcy case, *Morris v. CIT Group/Equipment Fin., Inc. (In re Charles)*, 268 B.R. 575 (Bankr.D.Kan.2001), former United States Bankruptcy Judge (now District Judge) Julie A. Robinson held that CIT, who purported to hold a lease with these debtors, had substantially complied with the Kansas title statutes when it had itself named on the leased trucks' titles as an owner rather than a lienholder.
It is clear to this Court, as it was to Judge Robinson, that substantial compliance with the methods of perfection are what is required under former Article 9. As former Kan. Stat. Ann. § 84-9-402(8) states, "[a] financing statement substantially complying with the requirements of this section is effective even though it contains minor errors which are not seriously misleading." Moreover, old Kan. Stat. Ann. § 84-9-408 expressly provides that a lessor may file a financing statement covering its leased property, that such filing alone does not render the lease a secured transaction, and that if the lease is later found to be security agreement, the security interest is perfected by the filing. There is be no reason why a parallel rule should not apply with respect to motor vehicles. Professor Clark has suggested that when a motor vehicle lease is ultimately determined to be a secured transaction, placement of the secured party's name on the certificate of title as owner rather than lienholder "should be sufficient because no third party has been misled." 2 Barkley Clark, The Law of Secured Transactions Under the Uniform Commercial Code § 12.03, at 12-23 (Rev. ed.2001)(citing In re Skyland, Inc., 61 B.R. 314 (W.D.Mich.1986)). This Court notes that these authorities, along with Judge Robinson's original opinion, are cited with approval in United States District Judge Monti Belot's affirmance of Judge Robinson's decision, Morris v. CIT Group/Equipment Financing, Inc., No. 01-1375, slip op. at 6-7 (D.Kan. February 13, 2002).

This Court, like Judges Belot and Robinson, is hard put to see how any lien creditor viewing the record would be misled when discovering Bancorp's name on the these vehicles' titles as owner rather than lienholder. At a minimum, a competing lender or prospective buyer would be placed on notice that Bancorp had some form of interest in the goods and any such interested party could then engage in appropriate inquiry both of the debtors and of Bancorp to determine the nature and extent of Bancorp's interest. That, after all, is the purpose of perfection in the first place. Were the Lease to be found to have created a secured transaction, Bancorp's security interests created thereunder would be properly perfected.

Summary judgment is therefore granted to Bancorp. A Judgment on Decision will issue this day.
Chapter 7 trustee sued to avoid motor vehicle lessor's interest in certain vehicles in debtor's possession, as being in nature of disguised security interest which lessor had failed to properly perfect. The Bankruptcy Court entered judgment in favor of lessor, on theory that motor vehicle leases were true leases under Kansas law, and trustee appealed. The District Court, Wesley E. Brown, J., held that motor vehicle leases that debtor could not terminate prior to expiration of lease terms, under which he was responsible for all taxes, fees, and maintenance, and which required debtor, upon sale of vehicles by lessor at end of lease terms, to make up difference to extent that sales prices were less than vehicles' estimated residual values, were in nature of true "leases," not avoidable by trustee as unperfected security interests; parties anticipated that vehicles would have remaining economic value at end of lease terms, and record did not show that estimated residual values for which debtor was liable when leases ended had been set so high that debtor had no choice but to purchase vehicles. K.S.A. 84-1-201(37).


James R. Gilhousen, Crockett & Gilhousen, Wichita, KS, for Defendant - Appellee.

Memorandum and Order

WESLEY E. BROWN, District Judge.

This is an appeal from a ruling of the Bankruptcy Court denying the Trustee's complaint to avoid a security interest. The issue concerns two commercial vehicle lease agreements entered into by the debtor with defendant Dealers Leasing, Inc. The Trustee alleged that the lease agreements were in fact disguised sales and security agreements and filed a complaint to avoid the allegedly unperfected security interests. The matter was submitted to the Bankruptcy Court upon stipulated facts. The Bankruptcy Court denied the complaint after concluding that the agreements were true leases.
The Trustee timely filed this appeal to the U.S. District Court. The court finds that oral argument would not assist in deciding the issues presented.

I. Jurisdiction and Standard of Review.


II. Facts.

On July 24, 1998, the Debtor entered into a Commercial Vehicle Lease Agreement ("Agreement No. 1") with defendant Dealers Leasing covering a 1991 Freightliner truck. Also on July 24, 1998, Dealers Leasing purchased the 1991 Freightliner from Kansas Truck Center for the sum of $37,000. On September 1, 1998, the State of Kansas issued a Certificate of Title to the 1991 Freightliner showing Dealers Leasing as the owner of the truck. The Certificate of Title shows Intrust Bank as a lienholder. This is because Dealers Leasing borrowed funds from Intrust to purchase the truck.

On October 13, 1998, the Debtor entered into a second Commercial Vehicle Lease Agreement ("Agreement No. 2") with Dealers Leasing covering a 1995 Freightliner truck. Also on October 13, 1998, Dealers Leasing purchased the 1995 Freightliner from Kansas Truck Center for the sum of $59,085. On November 2, 1998, the State of Kansas issued a Certificate of Title to the 1995 Freightliner showing Dealers Leasing as the owner of the truck. The Certificate of Title shows Commercial Federal Bank as a lienholder. This is because Dealers Leasing borrowed funds from Commercial Federal to purchase the truck.

[FN1] The title for the 1995 truck lists the owner as:

DEALER LEASING INC C/O BECKHAM JOE
633 W 44TH ST S
WICHITA KS 67217

On May 28, 1999, the Debtor voluntarily surrendered both trucks to Dealers Leasing. The Debtor filed Chapter 7 bankruptcy on June 11, 1999.

The remaining economic life of each truck exceeded the original term of the respective leases.

The Commercial Lease Agreements, which are included as part of the record (Doc. 4, Exh. 10), are identical forms, but have different payment terms. The lease of the 1991 truck states that it is an "open end lease," for a term of 36 months, until August 1, 2001, with $289.29 due on delivery, "base monthly rentals" of $1121, and a "lease end residual value" of $6500. The lease of the 1995 truck states that it is an "open end lease," for a term of 48 months, until November 1, 2002, with $911.49 due on delivery, "base monthly rentals" of $1324 and a "lease end residual value" of $15,000.

Both leases provide that at the end of the lease, or in the event the lease is otherwise terminated, regardless of cause, the vehicle will be sold; and the sales price, the balance due on the lease, if any, and the residual value of the vehicle, will determine whether the lessee owes lessor additional monies, or whether the lessor owes lessee monies. This language, in what is commonly called a terminable rental adjustment clause (or "TRAC lease"), states:

At the termination of this lease, regardless of the cause, Lessor shall cause Vehicle to be sold at public or private sale, at Lessor's option, and the highest cash bid shall be accepted. Lessor and Lessee retain the right to bid at any such sale. If the Sales Price (after deducting reserve account balances) exceeds the Depreciated Value, the excess shall be paid to Lessee; if such net recovery is less than the Depreciated Value, Lessee shall pay such deficit to Lessor within ten (10) days of invoice date.

"DEPRECIATED VALUE" MEANS THE PRESENT VALUE OF THE UNPAID BALANCE OF THE TOTAL LEASE PAYMENTS FOR THE REMAINING TERM OF THIS LEASE PLUS THE LEASE END RESIDUAL VALUE, PLUS ANY OUTSTANDING BALANCES.

The leases also charge to the lessee any expenses lessor incurs in restoring the vehicles to "reasonable condition."

III. Lease v. Security Agreement.

[1] The issue of whether an arrangement is a true lease or a sales and security agreement is governed by state law. See Butner v. United States, 440 U.S. 485-54-55, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979) (the existence, nature and extent of a
security interest in property is governed by state law). See also 11 U.S.C. §101. Historical and Statutory Notes ("whether a ... lease constitutes a security interest under the bankruptcy code will depend on whether it constitutes a security interest under applicable State or local law.").

Under Kansas commercial law, a "security interest" is an interest in personal property or fixtures which secures payment or performance of an obligation. K.S.A. § 84-1-201(37). A "lease" means a transfer of the right to possession and use of goods for a term in return for consideration, but a sale or retention or creation of a security interest is not a lease. K.S.A. § 84-2a-103(j).

*601 Section 84-1-201(37) of the Kansas Commercial Code provides in part:

Whether a transaction creates a lease or security interest is determined by the facts of each case; however, a transaction creates a security interest if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee, and (a) the original term of the lease is equal or greater than the remaining economic life of the goods, (b) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods, (c) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement, or (d) the lessee has the option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement.

A transaction does not create a security interest merely because it provides that (a) the present value of the consideration the lessee is obligated to pay the lessor for the right to possession and use of the goods is substantially equal to or is greater than the fair market value of the goods at the time the lease is entered into, (b) the lessee assumes risk of loss of the goods or agrees to pay taxes, insurance, filing, recording, or registration fee, or service or maintenance costs with respect to the goods, (c) the lessee has an option to renew the lease or to become the owner of the goods, (d) the lessee has an option to renew the lease for a fixed rent that is equal to or greater than the reasonably predictable fair market value of the goods for the term of the renewal of the time the option is to be performed, or (e) the lessee has an option to become the owner of the goods for a fixed price that is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed.

[2] As the Bankruptcy Court noted, these standards focus on economic realities rather than on the parties' subjective intent or the labels placed upon the agreement. Employing the standards of §84-1-201(37), the Bankruptcy Court first concluded that the agreements in question implicitly granted the lessee a right to terminate, although the court recognized that upon termination the lessee would be obligated to pay the remaining lease payments (discounted to present value), plus the stated "residual value," minus the proceeds from the sale of the vehicle. Under this formula, the lessee might owe a substantial amount or might owe nothing, depending upon how much the vehicle sells for upon termination. The Bankruptcy Court found that this arrangement constituted a right to terminate the obligation and said the trustee thus failed to meet the first part of the test in K.S.A. 84-1-201(37) for a disguised security agreement.

The Bankruptcy Court went on to say that even assuming the first part of the test were satisfied the court would still reject the trustee's remaining argument, which asserted that the agreements granted the debtor an option to purchase the vehicles for nominal or no additional consideration upon termination. See § 84-1-201(37)(d). The court noted that the "lease end residual value," which was the minimum figure the lessee could pay to obtain the vehicle at the end of the term, was $6,500 for the first truck and $15,000 for the second. The Bankruptcy Court concluded that these figures did not constitute "nominal consideration."

*602 On appeal, the Trustee argues that the Bankruptcy Court erred in each of its findings. With respect to the court's finding that the debtor had a right to terminate, the trustee argues the court was incorrect because in the event of termination the lessee remained obligated to ensure that the lessor recouped the lease payments. With respect to the second part of § 84-1-201(37), the Trustee contends the court erred because the debtor had the option of purchasing the vehicles for "nominal additional consideration." With regard to the latter argument, the Trustee first points out that upon execution of the lease the debtor was obligated to ensure that the lessor recouped the "residual value" at the end of the lease period, so as a practical matter, the Trustee argues, the debtor
IV. Discussion.

The "lease v. security interest" debate has given rise to a substantial amount of litigation over the years. In an effort to bring some clarity to the issue, most states, including Kansas, have recently adopted the Uniform Commercial Code's "new" test for distinguishing between these types of interests. See K.S.A. § 84-1-201(37).

a. Two-part Test of § 84-1-201(37).

Under the "new" test, a transaction is judged based on the facts of each case, but it is conclusively regarded as creating a security interest if the two-part test in K.S.A. § 84-1-207(37) is satisfied. The first part of that test is met if "the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee...." The second part of the test is met if one of the conditions in subsections (a) through (d) of § 84-1-201(37) is present. The Trustee argues that subsection (d) is present in this case. Subsection (d) is met if "the lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement."

There is some authority supporting the Trustee's argument with respect to the first part of the test. See e.g., In re Taylor, 209 B.R. 482 (Bankr.S.D.Ill.1997) (lease buyout provision did not constitute right to terminate obligation); In re Architectural Millwork of Virginia, Inc., 226 B.R. 551, 555 (Bankr.W.D.Va.1998) (lease agreement similar to the instant case did not permit debtor to terminate obligation). But cf. In re Owen, 221 B.R. 56, 61 (Bankr.N.D.N.Y.1998) (option to terminate pursuant to "adjustment clause" was a right to terminate under UCC test). Even assuming the lessee's obligation to pay consideration in this case was not subject to termination, the court concludes that the condition in subsection (d) has not been shown under the stipulated facts before the court. Thus, the Bankruptcy Court correctly found that the two-part test of § 84-1-201(37) was not satisfied.

Under the agreements at issue, the lessor is required to sell the vehicles upon termination of the lease. The debtor, although he has no right to purchase the trucks, has the option of bidding at the "603" sale. The lessee is contractually obligated to make up any shortfall between the sale proceeds and the stated "residual value." Thus, if the lessee elects to purchase the trucks, he must pay at least the stated residual value ($6,500 and $15,000, respectively, for the two vehicles). The Trustee argues such payments would not be "additional consideration" because the lessee is already obligated to pay the residual value. Moreover, he contends the lessee would have no rational alternative but to purchase the vehicles: "The debtor-lessee has every incentive to 'purchase' the property for the residual value and he has no reasonable economic alternative, because in every circumstance, he will be liable for that amount." Aplt. Br. at 11.

Several courts have held that an arrangement which predictably gives the lessee no rational economic alternative but to purchase the goods at lease end (sometimes referred to as the "No Lessee in its Right Mind test") does not constitute the payment of additional consideration or is nominal consideration and is therefore a security agreement rather than a lease. See e.g., In re Taylor, 209 B.R. 482, 486 (Bankr.S.D.Ill.1997) ("Under this test, if only a fool would fail to exercise the purchase option, the option price is generally considered nominal and the transaction characterized as a disguised security agreement." (citations omitted)). There is a sound basis for this rule, but the Trustee has not shown that it applies in this case. Nothing about the arrangement of these leases compels the lessee to purchase the vehicles. For one thing, the Trustee overlooks altogether the question of fair market value. The lessee might reasonably expect to recoup the fair market value of a vehicle upon its sale to a third party. If the trucks' fair market value exceeded the residual value, the lessee might well choose to let the lessor sell the vehicles to a third party (or to the lessor itself) and collect any sale proceeds in excess of the residual value. Additionally, if the fair market value were approximately the same as the residual value, the lessee could rationally exercise or decline to exercise the option to purchase, depending on his particular circumstances or preferences. The lessee might be said to have some economic incentive to purchase the trucks if the vehicles had a
negligible fair market value well below the "residual value." But the Trustee has not alleged or cited any evidence to show it was reasonably predictable that the stated residual values would vary significantly from the fair market value at the end of the lease term. Nor does the record otherwise indicate that as a practical matter the lessee no rational choice but to purchase the vehicles. The court thus rejects the Trustee's contention that the purchase options are a "Hobson's choice" leaving the debtor no alternative but to pay the residual value and take the vehicles.

The court likewise rejects the Trustee's argument that an election to purchase the vehicles by the lessor would not constitute the payment of "additional" consideration. Although the lessee was obligated to ensure that the lessor recouped the stated "residual value," the lessee could likely satisfy this obligation without furnishing any additional consideration if the fair market value of the vehicle was the same as or greater than the residual value. [FN2] In that event, the lessee could allow the vehicle to be sold to a third party and, although he would not obtain the vehicle, he would owe the lessor nothing. If, on the other hand, the lessee elected to purchase the vehicle, he would have to come up with the consideration and would have to pay the lessor at least the stated residual value, if not more. In the court's view, this arrangement requires the lessee to pay "additional" consideration to obtain the vehicle.

FN2. As the Bankruptcy Court noted, a "terminable rent adjustment clause" like the one at issue gives the lessee a financial incentive to maintain the vehicle in good condition for the term of the lease.

Finally, the court rejects the Trustee's contention that Percival Constr. Co. v. Miller Auctioneers, Inc., 532 F.2d 166 (10th Cir.1976) and its progeny require application of a bright-line rule that an option to purchase for less than 25% of the original purchase price constitutes nominal consideration. [FN3] To the extent Percival endorsed a bright-line rule, the court concludes it has been superseded by the amendments to §84-1-201(37), including the following provision: "For purposes of this subsection (37): (a) Additional consideration is not nominal if ... (ii) when the option to become the owner of the goods is granted to the lessee the price is stated to be the fair market value of the goods determined at the time the option is to be performed." [FN4] A leading treatise on commercial law concludes that this provision "disavows percentage tests." See 4 White & Summers, Uniform Commercial Code § 30-3 (4th ed.). The court agrees that § 84-1-201(37), 2 subsection (d) requires more than just a percentage comparison of the purchase option price to the original purchase price. An option price of less than 25% may represent fair market value for certain goods and may constitute more than a nominal sum. [FN5]

FN3. If such a rule were applied here, one of the transactions would be characterized as a true lease and the other would not. The residual value of the 1995 Freightliner ($15,000) is 25.39% of the original list price ($59,085), while the residual value of the 1991 Freightliner ($6,500) is 17.57% of the original list price ($37,000).

FN4. The provision continues: "Additional consideration is nominal if it is less than the lessee's reasonably predictable cost of performing under the lease agreement if the option is not exercised[.]"

FN5. The court concludes the "fair market value" provision itself must be read in conjunction with the other provisions of § 84-1-201(37). Thus, an option to purchase for "fair market value" could be nominal in some circumstances, such as where the economic life of the goods was designed to be used up during the lease term and resulting "fair market value" is negligible, or where as a practical matter there is no market for the goods in question. See e.g., In re Owen, 221 B.R. 56, 61 (Bankr.N.D.N.Y.1998) (option to purchase for fair market value creates an inference that the consideration is not nominal unless it can be shown that the fair market value is negligible).

In the instant case the agreements provided for purchase of the vehicles at a stated "residual value" rather than fair market value. As was stated above, no suggestion or showing has been made that the stated residual values varied significantly from the reasonably predictable fair market value. Nor is there any question but that vehicles had economic life
remaining at the expiration of the lease terms, although the stipulated facts do not specify the extent of that economic life. Under the facts before the court, it cannot be said that 25% and 17% of the original purchase price of the vehicles are nominal sums; to the contrary, they represent substantial payments ($15,000 and $6,500) that may well have reflected the anticipated fair market value of the goods. See In re Architectural Millwork of Virginia, Inc., 226 B.R. 551, 555 (Bankr.W.D.Va.1998) (residual value clause constituted a fair estimate of the truck's value; option to purchase for $9,625 was not nominal consideration).

b. "Economic realities test".

Aside from the two-part test in § 84-1-201(37), the Trustee contends a consideration *605 of all the circumstances shows that the agreements are disguised sales and security agreements. Among other things, the Trustee points out the leases cannot be terminated by the debtor; the debtor is responsible for all taxes, fees and maintenance; the debtor bears the risk of loss; the lessor disclaims all warranties; and the lessor, like a traditional lender, is guaranteed to receive all payments provided for in the agreement but nothing more and nothing less. In other words, the Trustee argues, the lessor has no "entrepreneurial stake" in the vehicles, but stands in the role of a traditional lender holding a security interest in the vehicles. Citing 4 White & Summers, Uniform Commercial Code, Pp. 720-21 (4th ed.).

The Trustee's argument is to some degree undermined by the recent amendments to the Kansas commercial code. In 1998, the legislature adopted a specific provision on terminal rental adjustment clauses which provides in part: "Notwithstanding any other provision of law, an agreement involving the leasing of a motor vehicle or trailer does not create a sale or security interest solely because the agreement provides for an increase or decrease adjustment in the rental price ... based upon the amount realized upon sale or other disposition of the motor vehicle or trailer following the termination of the lease." K.S.A. § 84-2a-110. [FN6] Additionally, the "new" test of § 84-1-201(37) makes explicit that a transaction does not create a security interest merely because it provides that the lessee assumes the risk of loss and agrees to pay taxes, insurance, and maintenance costs with respect to the goods.

The lease agreements in this case purport to be--and appear to meet the requirements of-- finance leases under Article 2A of the commercial code. See K.S.A. § 84-2a-103(g). As such, Dealers Leasing's principal role in the transaction was to provide financing, as the Trustee argues, but this fact alone does not indicate the agreements were actually security agreements. Although many attributes of finance leases were considered indicators of a security interest under the "old" test, the amendments to § 84-1-201(37) and Article 2a of the Kansas commercial code recognize that such attributes are as consistent with a true lease as with a security agreement.

The court has considered all of the circumstances surrounding these transactions. Although some factors could be considered indicative of a security interest, substantial evidence indicates that the agreements are in fact true leases, and the Bankruptcy Court's finding to that effect is not clearly erroneous. Foremost among this evidence is the matter of the residual value of the vehicles. It is undisputed that the economic life of the trucks extends beyond the lease terms. See FF & E and the True Lease Question: Article 2A and Accompanying Amendments to UCC Section 1-201(37), 7 Am. Bankr.Inst. L.Rev. 517, E. C. Hochstader Dicker & J. Campo (Winter 1999 Ed.) ("Courts interpreting both Old and New UCC 1-201(37) have consistently held that the principal characteristic of a lease, which distinguishes it from a secured transaction, is that it allows the lessee the right to use the property with an attendant opportunity to return the property to the lessor while it still has 'substantial useful economic life.' "). The lessee cannot obtain these vehicles for a nominal sum at the end of the lease terms but must make substantial payments to acquire them. (The lessor likewise has an option to purchase the vehicles). There is *606 no evidence that the "lease end residual value" was set at a price less than the anticipated fair market value of the vehicles. Cf. K.S.A. § 84-1-201(37), 3rd ¶, subsection (e) ("A transaction does not create a security interest merely because it provides that ... the lessee has an option to become the owner of the goods for a fixed price that is equal to or greater than the reasonably predictable fair market value of the goods...."). See also In re Murray, 191 B.R. 309, 316 (Bankr.E.D.Pa.1996) (a fixed price purchase option does not create a security interest where the price is equal to or greater than the reasonably predictable fair market value). This

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FN6. This section further provides that it "clarifies existing law and shall be given effect in all court cases brought on or after the effective date of this act [Apr. 9,1998]."
arrangement does not appear to be one that would likely create any significant equity by the lessor in the vehicles. *Cf. In re Architectural Millwork of Virginia, Inc.*, 226 B.R. 551, 557 (Bankr.W.D.Va.1998) (a residual value that is approximately equal to anticipated fair market value indicates that the debtor would not acquire an equitable interest in the vehicle, and that the agreement was in fact a true lease). In a practical sense, the lessor retains the reversionary interest in the vehicles. Additionally, there is no evidence that the rental payments required by these leases were excessive as compared to typical lease payments. Nor is there any evidence that the debtor was required to pay a substantial, non-refundable security deposit. Finally, no showing has been made that the present value of the lease payments equals or exceeds the purchase price of the vehicles. *Cf. In re Owen.*, 221 B.R. 56, 63-64 (Bankr.N.D.N.Y.1998). In sum, the court concludes that the record supports the Bankruptcy Court's determination that these agreements are true leases. In view of this finding, the court need not address the Trustee's additional argument that the alleged security interests created by the agreements were unperfected.

V. Conclusion.

The judgment of the Bankruptcy Court is AFFIRMED.

275 B.R. 598, 48 UCC Rep.Serv.2d 852

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UPDATE ON LESSOR VICARIOUS LIABILITY

David T. Miele*
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Providence, Rhode Island  02903

* Special acknowledgment to Elaine Litwer, National Vehicle Leasing Association – Legislative Coordinator for providing the compilation of U.S. jurisdictions where vicarious liability can still be an issue (albeit in most of the jurisdictions liability is limited)
UPDATE ON LESSOR VICARIOUS LIABILITY

1. **What is Lessor Vicarious Liability?**

Lessors of dangerous implements such as motor vehicles have always realized that liability could be imputed to them, whether or not they were negligent, by the application of strict liability or vicarious liability case law or statutes. Simply stated, lessor vicarious liability imposes liability on the Lessor/owner of a motor vehicle for the negligence of the operator. The fact that the Lessor/owner of the motor vehicle has no control over its operation is immaterial; the imposition of the liability on the Lessor/owner is "strict". Many of the laws on which lessor vicarious liability are based were enacted before vehicle leasing even existed. These laws were put in place when only the very wealthy were able to own motor vehicles which were generally operated by the owner's employees/drivers. These laws were designed to prevent the wealthy vehicle owners from pushing liability onto their employees/drivers.

The issue of lessor vicarious liability recently came to the forefront when Chase Manhattan Automotive Finance Corp. suffered a $28 million jury verdict in the summer of 2002 arising out of a horrific automobile accident which occurred in 1998. The Rhode Island Supreme Court upheld the lower Court's interpretation of the lessor vicarious liability statutes in Rhode Island. For a more complete discussion of how this matter arose in Rhode Island and the legislative remedy which was enacted in 2003, please see the article which I authored, entitled "Rhode Island Legislature Addresses Auto Lessor's Liability" attached as Exhibit A.

2. **What states do I have to worry about?**

The good news is that the number of states in which lessor vicarious liability is an issue have dwindled in the last several years. The bad news is that one of the largest states in which commerce passes (New York) still retains the concept of unlimited lessor vicarious liability. Attached as Exhibit B is a compilation of U.S. jurisdictions where lessor vicarious liability can still be an issue. This compilation was prepared by Elaine Litwer, National Vehicle Leasing Association – Legislative Coordinator and a staunch proponent of bringing up to date these archaic lessor vicarious liability statutes. This compilation only sets forth those states where liability may be imposed against the Lessor. Please note that in most of these states, the liability imposed on the Lessor is limited. In many instances, this compilation refers to insurance policy limits. These are dollar amount limits separated by a slash. The first amount refers to limits for bodily injuries to one person. The second amount refers to bodily injuries in any one accident. Where listed, the third amount refers to limits on damages to property of others. If a state is not listed in this
compilation, you can assume that either by case law or by statute, there is authority whereby the negligence of the Lessee is not imputed to the Lessor.

3. **The real effects of Lessor Vicarious Liability.**

The Chase Manhattan case in Rhode Island caused leasing companies throughout the country to reconsider whether or not to offer leases in states where they could be faced with unlimited vicarious liability claims. This was particularly true in the case of consumer leases of automobiles. On March 25, 2004, Bloomberg reported that effective May 1, 2004, DaimlerChrysler would stop offering car and truck leases in New York State. The same Bloomberg article reported that General Motors and Ford will likely follow suit to present a "unified front". Other vehicle leasing companies such as Honda and Toyota Motor Corp. have increased their vehicle leasing fees in New York State by over $500 per vehicle to "partially offset damages" from lawsuits.

Elaine Litwer has recently reported to me that her organization continues to work to change the law in New York, and they are also engaged in a Federal effort.

4. **What can I do to protect my client or my leasing company?**

Other than the impractical solution of including a provision in your lease agreement that requires Lessee's to stay out of the State of New York, there are several practical things that can be done to help protect your leasing company. Some of these which you may wish to consider are:

(a) Make sure your lease documentation contains strong indemnification provisions from the Lessee.

(b) To the extent practical, avoid New York law as the choice of law in your lease agreements involving motor vehicles. While the situs of the accident will be an important factor, having New York law as the governing law will make the imposition of lessor vicarious liability even more certain.

(c) Review the minimum insurance requirements in your lease documentation and be sure that your leasing company monitors Lessee certificates of insurance to confirm that they are up to date and meet these minimum requirements.
(d) Be sure that your leasing company maintains an umbrella liability coverage policy which would protect against a catastrophic suit like the Chase Manhattan case in Rhode Island.

(e) Support legislative efforts to have these laws changed.
Rhode Island Legislature Addresses Auto Lessor's Liability

July, 2003

By: David T. Miele,
Senior Vice President and General Counsel
For Citizens Leasing Corporation and
Citizens Bank Dealer Financial Services Group

Consider this scenario: You sell a new car to Mary Jones, who elects to finance the purchase. Later the same day, you lease a new car to John Smith, who decides to lease the vehicle. Several weeks later both are involved in serious accidents resulting in severe personal injuries to the occupants of the other vehicles and your lessee and borrower were clearly negligent in causing the accidents. In Rhode Island, prior to July 3, 2003, you could have been held liable for a multi-million dollar personal injury award as the lessor of John Smith's vehicle. You would have no such liability as the holder of the loan on Mary Jones' vehicle. This incongruous result was the focus of the argument that was made to the Rhode Island legislature to fix Rhode Island's antiquated vicarious lessor liability law. Simply stated, lessor vicarious liability means that a lessor of a motor vehicle (as owner) is held responsible for the acts of the operator regardless of whether or not the lessor had control over the operation of the vehicle. This issue was thrust into the limelight when Chase Manhattan Automotive Finance Corp. suffered a $28 million jury verdict in the summer of 2002, which was appealed and later settled for less. In the wake of the Rhode Island Supreme Court decision, several automobile leasing companies, including Chase, stopped offering leasing in Rhode Island or threatened to leave the State if the law was not changed by the Rhode Island legislature.

Corrective legislation was introduced into the Rhode Island legislature in the spring of this year. The legislation faired quite well in the Rhode Island Senate but met intense opposition in the Rhode Island House particularly from the trial lawyers who, while clearly protecting their own self interest in having an available deep pocket, attempted to cloak their opposition in the banner of consumer protection. While the battle was being waged in Rhode Island, similar legislation was being introduced in the States of Connecticut and New York which are the only other two (2) states to strictly impose vicarious liability on lessors.

Back in Rhode Island, an industry group called the "Preserve Vehicle Leasing Coalition", was formed to lobby legislators and inform the public that the availability of a competitively priced lease option in acquiring a new vehicle was in jeopardy. As the end of the legislative session grew near, it appeared that the legislation was inextricably stuck in a House committee and would not come up for a vote. However, as a result of an eleventh hour push by the Coalition and some intensive behind-the-scenes negotiations, the Rhode Island legislature, in the wee hours of the morning of Thursday, July 3, 2003, passed a bill that addresses the lessor vicarious liability issue in Rhode Island.

The good news is that a bill was passed. The bad news is that it is only an interim measure. As a result of intense wrangling between the car leasing companies and the trial lawyers, the legislation which was passed, while providing some relief, complicates the issue (through a convoluted sunset provision) and basically defers a definitive resolution until next year. The legislature ultimately wanted to take more time.
to fully study the issue and also to call the car leasing companies’ bluff and see if they actually returned to the State now that the corrective legislation is in place (at least temporarily).

In summary, the bill revises the two (2) Rhode Island statutes which created the issue to provide that the lessee rather than the lessor will be the "owner" for purposes of negligence liability so long as the lessee holds a valid motor vehicle liability insurance policy with minimum specified coverages. Where the lessee does not have valid or sufficient insurance, the lessor's financial responsibility as an "owner" of the vehicle is limited to the insurance minimums: $100,000 for bodily injuries to any one person, $300,000 for bodily injuries for any one accident, and $50,000 for damages to the property of others in any accident.

The complicating factors come into play in the "sunset" provision which was negotiated into the law as a final compromise. Basically, the amendments to the existing statutes are repealed as of July 1, 2004 which means that the Legislature will have to address this issue on a more permanent basis next year. The application of the sunset provision as written creates two (2) concepts. First, is the Lease Agreement one that would be covered by the statute? The statute, as amended, would cover leases existing before July 3, 2003 as well as any lease entered into after July 3, 2003 so long as the lease is entered into before July 1, 2004. The second concept focuses on when the accident occurs. The statute would protect the lessor for any accident involving a qualifying lease (as described above) occurring after July 3, 2003, provided, however, that the accident occurs during the earlier of the term of the Lease Agreement or within thirty-nine (39) months from the inception of the Lease Agreement. The thirty-nine (39) month provision is simply an arbitrary number which the trial lawyers insisted they have in the last-minute negotiations. Obviously, this provision makes no sense in the law as leases can be for less than or more than thirty-nine (39) months. Please note that it appears that the statute does not disqualify leases with terms longer than thirty-nine (39) months but only provides protection from lessor liability during the thirty-nine (39) month period. Obviously, this will have to cleaned up with more permanent and sensible legislation next year. In the interim, and to protect themselves in the event the legislation is not corrected next year, it is likely that vehicle leasing companies will not offer leases with terms greater than thirty-nine (39) months in Rhode Island.

The bottom line is that the legislation which was passed is a win for leasing companies, particularly given the fact that as recently as late June, it appeared that the bill would die in the House. Obviously, time and effort will have to be spent next year to make the legislation permanent and clean up some of the unusual provisions.

While all of this was going on in Rhode Island, there was both good news and bad news from the other states. In June Connecticut passed legislation which effectively eliminated lessor vicarious liability. Unfortunately, in New York, the legislation died in Committee before coming to the floor for a full vote.

Disclaimer: This article is not intended to constitute, and is not a substitute for legal or other advice. This article is intended to provide general information only regarding the topic covered. You should consult appropriate counsel or other advisors, taking into account your relevant circumstances and issues.
EXHIBIT B

Vicarious Liability States

Prepared by Elaine Litwer, National
Vehicle Leasing Association – Legislative Coordinator

May 29, 2003

<table>
<thead>
<tr>
<th>State</th>
<th>Vicarious Liability Status</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>District of Columbia</td>
<td>Unlimited</td>
<td>D.C. law holds that the operator of the vehicle is an agent of the owner. Therefore, the owner is held liable. (DC Sec. 50-1301.08)</td>
</tr>
<tr>
<td>Maine</td>
<td>Unlimited</td>
<td>Vicarious liability is not formally imposed in Maine. Maine gets to the owner of the vehicle by making the owner and the operator jointly and severally liable for damages caused by the operator. In a leading case on this subject, the court found the lessor and lessee jointly and severally liable.</td>
</tr>
<tr>
<td>New York</td>
<td>Unlimited</td>
<td>Vicarious liability is imposed upon the owner of the vehicle. Entities that hold liens or security interests on motor vehicles are specifically exempted from liability. However, companies that lease or rent motor vehicles are fully liable for damages caused by the lessee. (NY Sec. 388)</td>
</tr>
</tbody>
</table>

Limited Vicarious Liability States

<table>
<thead>
<tr>
<th>State</th>
<th>Vicarious Liability Status</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>California</td>
<td>Limited 15/30/5</td>
<td>Vicarious liability is limited to a statutory limit of $15,000/$30,000. Court cases in California have held that an owner's liability is always secondary to the liability of the operator.</td>
</tr>
<tr>
<td>Connecticut</td>
<td>Limited 100/300 – cars 2 mil - trucks</td>
<td>Vicarious liability is imposed by statute on any person renting or leasing to another any motor vehicle. Vehicles less than 10,000 lbs. that are leased for one year or more are exempt from vicarious liability if the vehicle is insured for at least $100,000/$300,000. Vehicles 10,000 lbs. or more are exempt if the vehicle is insured for at least $2 million. (CT Sec. 14-154a)</td>
</tr>
<tr>
<td>Florida</td>
<td>Limited 100/300/50</td>
<td>Vicarious liability is imposed by case law &amp; by statute. A lessor is not liable vicariously as long as an insurance policy for at least $100,000/$300,000/$50,000 or $500,000 combined is in effect; otherwise the lessor may be liable up to 1 million dollars. Motor vehicle rentals are subject to vicarious liability up to 100/300/50. However if the owner does not hold a minimum $500,000 coverage on the vehicle, then the owner is liable for up to an additional $500,000 in economic damages only. (FL Sec. 324.021)</td>
</tr>
<tr>
<td>State</td>
<td>Vicarious Liability</td>
<td>Financial Responsibility</td>
</tr>
<tr>
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</tr>
<tr>
<td>Idaho</td>
<td>Vicarious liability imposed by statute, but the statutory liability is limited to $25,000/$50,000. (ID Sec. 49-1212)</td>
<td></td>
</tr>
<tr>
<td>Iowa</td>
<td>Vicarious liability imposed by statute. Vicarious liability has been repealed for lease transactions of 12 months or more and for short-term rentals of vehicles greater than 7,499 pounds if the contract requires an insurance policy covering at least the minimum levels of financial responsibility. (IA Sec. 321.493)</td>
<td></td>
</tr>
<tr>
<td>Michigan</td>
<td>Vicarious liability is imposed by statute for short-term rentals. The owner’s liability for short-term rental transactions is limited to $20,000/$40,000, the minimum level of financial responsibility for motor vehicles in Michigan. (MI Sec. 257.401)</td>
<td></td>
</tr>
<tr>
<td>Minnesota</td>
<td>Vicarious liability is imposed by statute. Minnesota courts have held that in rental situations, rental car companies are liable for the damages caused by unauthorized drivers, only to the limits of 100,000/$300,000/ $50,000. Short-term rental of vehicles over 26,000 pounds may remain exposed to unlimited vicarious liability. There is no vicarious liability for leases of 6 months or more. (MN Sec. 65B.43 &amp; 65B.49)</td>
<td></td>
</tr>
<tr>
<td>Nebraska</td>
<td>The owner of any truck, truck-tractor, whether with or without trailer, or trailer leased for a period of less than thirty days or leased for any period of time and used for commercial purposes, shall be jointly and severally liable with the lessee and the operator for any injury or death or damage or destruction of property, except that the owner shall not be jointly and severally liable if there is in effect at the time the claim arises a valid liability insurance policy with coverage limits in the minimum amount of one million dollars per occurrence. (NE Sec. 25-21,239)</td>
<td></td>
</tr>
<tr>
<td>Nevada</td>
<td>Short term lessors, (30 days or less) must provide insurance of 15/30/10. If the company does not provide the insurance then the owner is held jointly and severally liable with the short-term lessee for any damages caused by the negligence of the lessee in operating the vehicle. (NV Sec. 482.305)</td>
<td></td>
</tr>
<tr>
<td>Rhode Island</td>
<td>Legislation passed in 2003 to cap liability for rental vehicles at 250/500/25. Under a long-term lease, the lessee will be considered the owner for liability purposes if the lessee maintains insurance of at least 100/300/50. These vicarious liability provisions will apply to the first 39 months of all lease and rental agreements entered into prior to July 1, 2004. These provisions of law expire on July 1, 2004. (RI Sec. 31-33-6 and Sec. 31-34-4)</td>
<td></td>
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</tbody>
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