Lease or Security Interest: A Classic Problem of Commercial Law

By Joseph Epps Claxton*

I. The Statutory Framework

Article 9 of the Uniform Commercial Code[1] was drafted in such a manner as to cover almost all consensual security interests in personal property.[2] With relatively few exceptions,[3] the Article expressly applies "to any transaction (regardless of its form) which is intended to create a security interest in personal property."[4] Therefore, in any consideration of the possible application of Article 9 to a particular set of facts, the first and most basic question to be resolved is whether a security interest exists. Ordinarily, the result of such an inquiry is not particularly elusive, but this fact should not obscure the potential seriousness of the problem. As one distinguished commentator has noted, "[i]n most instances it will be obvious if a secured transaction is intended, but occasionally it will not be clear, and in any event 'security interest' is a defined term. Like all defined terms in the Code, its definition must be carefully examined."[5] The latter point is something of an understatement, to say the least. In fact, the complex issues of perfection, enforcement and priority, which are at the heart of so much of the Article 9 litigation, should not even be approached by the bench or the bar until it is clear that a security interest is actually present.

The U.C.C.'s definitional treatment of the term "security interest" is found in §1-201(37), a subpart of the portion of the U.C.C. devoted to general definitions. On the whole, the definition is a simple one.[6] Unfortun-

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1. All references to Article 9 of the U.C.C. are to the 1962 Official Text. Article 9 was revised in 1972, but the revisions had no impact on the subject of this discussion. See notes 56 and 57, *infra*, and accompanying text.

2. *See* Comment, U.C.C. §9-102.

3. *See* U.C.C. §§9-103 and 9-104.

4. U.C.C. §9-102(1)(a).

5. R. Henson, Handbook on Secured Transactions under the Uniform Commercial Code §3-1 (1973).

6. In its entirety, the §1-201(37) definition says: " 'Security interest' means an interest in personal property or fixtures which secures payment or performance of an obligation. The retention or reservation of title by a seller of goods notwithstanding shipment or delivery to the buyer (Section 2-401) is limited in effect to a reservation of a 'security interest.' The term also includes any interest of a buyer of accounts, chattel paper, or contract rights which is subject to Article 9. The special property interest of a buyer of goods on identification of such goods to a contract for sale under Section 2-401 is not a 'security interest,' but a buyer may also acquire a 'security interest' by complying with Article 9. Unless a lease or consign-

ately, however, that characteristic does not survive in the last part of the definition, which is devoted to the circumstances in which an erstwhile lease is to be treated, as a matter of law, as a security interest. On that topic, the U.C.C. provides:

> Whether a lease is intended as security is to be determined by the facts of each case; however, (a) the inclusion of an option to purchase does not of itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended for security.[7]

Few excerpts from the U.C.C. contain so many elements of uncertain meaning. The U.C.C.'s handling of leases is especially crucial in light of the fact that the leasing of equipment[8] is a widespread commercial practice. Such phrases as "the facts of each case" and "nominal consideration" open the door to a multiplicity of possible judicial constructions.

The necessity of drawing a distinction between a true lease and a security interest arises most frequently in bankruptcy cases. If a lease has characteristics of a security interest it may immediately come under attack by a bankruptcy trustee because of the "lessor's" failure to perfect by filing a financing statement.[9] As one bankruptcy judge has explained it:

> These transactions are vulnerable because the trustee in bankruptcy is vested [under section 70c of the Bankruptcy Act] with the rights, remedies, and powers of a lien creditor as to all the property upon which, at the date of bankruptcy, a creditor of the bankrupt could have obtained a lien. Furthermore, section 9-301(1)(b) of the Code provides that an unperfected security interest is subordinate to the rights of persons who become lien creditors without knowledge of the security interest and before it is perfected. The problem for the courts is, therefore, to determine at pre-

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ment is intended as security, reservation of title thereunder is not a 'security interest' but a consignment is in any event subject to the provisions on consignment sales (Section 2-326). Whether a lease is intended as security is to be determined by the facts of each case; however, (a) the inclusion of an option to purchase does not of itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended for security."

7. U.C.C. §1-201(37).

8. According to §9-109(2) of the U.C.C., goods are classified as "equipment" "if they are used or bought for use primarily in business (including farming or a profession) or by a debtor who is a non-profit organization or a governmental subdivision or agency or if the goods are not included in the definitions of inventory, farm products or consumer goods [also defined in section 9-109]."

9. For the procedures to be followed in filing, see U.C.C. §9-401. For the formal requisites of a financing statement, see U.C.C. §9-402.

cisely what point such purported lease transactions undergo the transition from a lease to a sale.[10]

In addition, if a lease is actually a security interest and is not perfected by the filing of a financing statement, the "lessor" runs a serious risk of losing his priority to a later but perfected security interest under §9-312(5) of the U.C.C.[11]

The purpose of this article is to provide a conceptual pattern for the reader to use in analyzing situations that are affected by the lease-related portions of §1-201(37). The article contemplates not an exhaustive review of every case dealing with the topic, but rather a synthesis of the major factors involved.

II. THE HISTORY OF THE PROBLEM

No discussion of the lease—security-interest problem would be complete without reference to the case of *Hervey v. Rhode Island Locomotive Works,*[12] decided one hundred years ago by the U.S. Supreme Court. In *Hervey* the court analyzed an agreement for the rental of a railroad locomotive for one year. The title to the locomotive was to vest in the lessee upon timely compliance with all the terms of the agreement; until that time the lessor reserved title. When the lessee encountered financial problems, a conflict arose between the lessor and the creditors of the lessee over rights in the locomotive.

The Supreme Court was quick to distinguish the agreement from a legitimate lease, and consequently it reached a result favorable to the "lessee's" creditors.

> Nor is the transaction changed by the agreement['s] assuming the form

10. Hiller, *Security Aspects of Chattel Leases in Bankruptcy*, 34 FORDHAM L. REV. 439, 440 (1966). The author of the article is the bankruptcy referee who handled the renowned case of *In re* Royer's Bakery, Inc., 56 Berks County L.J. 48, 4 CCH INSTALMENT CREDIT GUIDE ¶99,274 (Ref. Bkcy. E.D. Pa. 1963), discussed in notes 39-41 and 49-50, *infra*, and accompanying text.

11. U.C.C. §9-312(5) says:

> In all cases not governed by other rules stated in this section (including cases of purchase money security interests which do not qualify for the special priorities set forth in subsections (3) and (4) of this section), priority between conflicting security interests in the same collateral shall be determined as follows:
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> (a) in the order of filing if both are perfected by filing, regardless of which security interest attached first under Section 9-204(1) and whether it attached before or after filing;
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> (b) in the order of perfection unless both are perfected by filing, regardless of which security interest attached first under Section 9-204(1) and, in the case of a filed security interest, whether it attached before or after filing; and
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> (c) in the order of attachment under Section 9-204(1) so long as neither is perfected.

12. 93 U.S. 664 (1876).

> of a lease. In determining the real character of a contract, courts will always look to its purpose, rather than the name given to it by the parties. If that purpose be to give the vendor a lien [subject to recording requirements] on the property until payment in full of the purchase-money, it is liable to be defeated by creditors of the purchaser who is in possession of it.[13]

Much has changed since *Hervey*. Most significantly, the concept of title-retention, which was referred to in that case and which is a fundamental aspect of the so-called "conditional sale,"[14] has been swallowed up by the U.C.C.'s all-encompassing emphasis on security interests.[15] Yet after a century the *Hervey* opinion still holds the key to dealing with questionable leases. In *Hervey* the Court emphasized that "[i]t is true the instrument of conveyance purports to be a lease, and the sums stipulated to be paid for rent; but this form was used to cover the real transaction."[16] That conclusion now makes itself felt through §1-201(37) of the U.C.C.[17]

III. The Intention of the Parties and the Facts of Each Case

An initial difficulty in distinguishing a lease from a security interest is that, under the U.C.C., "[w]hether a lease is *intended* as security is to be determined by the facts of each case."[18] This language has been roundly critized, with substantial justification. In the words of one authority: "The application of any standard based on the intent of the parties, even with the best supplemental guidelines, is likely to be troublesome. . . . Moreover, the cursory statement . . . that the intent of the parties to a lease transaction is to be determined according to 'the facts of each case' is not helpful."[19]

There is not even complete agreement on how far a court may go in ascertaining relevant facts. Although it is uniformly acknowledged that parol evidence is admissible to determine the true nature of the transaction when the terms of a lease are ambiguous,[20] there is uncertainty about the validity of looking beyond the lease in other situations. For example, in *In*

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13. *Id.* at 672. The "lien" referred to in *Hervey* would, of course, be called a security interest under Article 9 of the U.C.C.

14. *See* Uniform Conditional Sales Act (1923).

15. Section 1-201(37) of the U.C.C. specifically states that "[t]he retention or reservation of title by a seller of goods . . . is limited in effect to a reservation of a 'security interest'."

16. 93 U.S. at 673.

17. For additional historical material, see P. Coogan, *et al.*, 1 Bender's Uniform Commercial Code Service: Secured Transactions under the Uniform Commercial Code §4A.02 (1976).

18. U.C.C. §1-201(37) (emphasis added).

19. Coogan, *Leases of Equipment and Some Other Unconventional Security Devices: An Analysis of UCC Section 1-201(37) and Article 9*, 1973 Duke L.J. 909, 916.

20. *See* Sanders v. Commercial Credit Corp., 398 F.2d 988 (5th Cir. 1968).

re Wheatland Electric Products Co.,[21] dealing with a lease that provided that "there are no understandings, agreements, representations or warranties, express or implied, not specified herein," the court said that "we may look only to language of the lease itself" in evaluating the lease's true nature.[22] On the other hand, the opinion in *In re Walter W. Willis, Inc.*[23] expressed the view that "in a transaction where a lease is intended as security, *factors outside of the lease* as well as the contents of the lease itself must be considered in ascertaining the intent of the parties."[24]

The confusion that shrouds the matter of intent is thus compounded by the debate over the use of parol evidence. One must ultimately ask whether the question of intent leads anywhere. The answer, in all likelihood, is that it does not and cannot offer an overall solution to a lease—security-interest problem. Interestingly enough, the fallacy of relying upon a standard of intent was most clearly suggested over fifty years ago, long before the advent of the U.C.C., in an article that examined the old law of chattel mortgages.

> [T]he intention of the parties is not to be and cannot be properly considered in the construction of these instruments when there is a third party's interest at stake. . . . [T]he only question before the court can be whether the particular instrument is a chattel mortgage [now a security interest]—not whether it was intended as such but whether it has such character. . . . The subjective element has no place in an effort to discover whether an instrument is of a certain kind or nature when the very purpose of the inquiry is to determine the nature of the instrument objectively.[25]

The most that legitimately can be said about the intent of the parties is "that a 'lease intended as security' is one which has the ultimate intent of a sale."[26] That conclusion, of course, merely begs the question. Obviously, therefore, one must look further when attempting to distinguish a lease from a security interest.

IV. The Effect of an Option to Purchase

One should always remember that "the inclusion of an option to purchase does not of itself make the lease one intended for security."[27] Nevertheless, "[t]he existence of these provisions always presents a risk to one

21. 237 F. Supp. 820 (W.D. Pa. 1964).

22. *Id.* at 821. For another well-known case adopting the same position, see *In re* Atlanta Times, Inc., 259 F. Supp. 820 (N.D. Ga. 1966).

23. 313 F. Supp. 1274 (N.D. Ohio 1970).

24. *Id.* at 1278 (emphasis in original).

25. Levin, *The Intention Fallacy in the Construction of Title Retaining Contracts*, 24 Mich. L. Rev. 130, 135 (1925).

26. 259 F. Supp. at 826.

27. U.C.C. §1-201(37).

who asserts the lease is true."[28] When a lease does contain an option to purchase, a judge considering the lease must be acutely aware that, under the final clause of §1-201(37), "an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended for security."[29]

Peter Coogan, one of the foremost experts on Article 9 of the U.C.C., has noted with dismay the tendency that prevails in some quarters to read this language before making any reference to the point that, according to §1-201(37), the presence of an option does not automatically mean that an erstwhile lease is really a security interest.[30] Coogan correctly suggests that we should first look for "an essential fact which would counterbalance any option to purchase even at a nominal price (such as a right in the buyer to terminate)."[31] If such a fact is found, the matter of considera- *might* no longer be so vital.[32]

Once this point is recognized, however, it must be acknowledged that the issue of nominal consideration remains as the most significant and most frustrating aspect of the U.C.C.'s treatment of the lease—security-interest distinction. Therefore, it is an issue that must be examined in some detail.

V. The Effect of an Option to Purchase for a Nominal Consideration

If a lessee has an option to become the owner of the property for additional consideration, the U.C.C. requires that a determination of whether the consideration is merely nominal be made.[33] Only if that query reaches an affirmative result will the lease be deemed to be one intended for security.

What, then, is nominal consideration? Unfortunately, within the context of the lease—security-interest distinction that term has never been clearly defined. The only definite statement that can be made about it is that, on the basis of the U.C.C.'s language and existing judicial precedents,

28. Hawkland, *The Impact of the Uniform Commercial Code on Equipment Leasing*, 1972 Ill. L. Forum 446, 453.

29. U.C.C. §1-201(37).

30. Coogan, *supra* note 19, at 932.

31. *Id.* at 934-35.

32. Coogan insists that a right to terminate is so significant that if one is present, it completely negates the existence of an option for nominal or no additional consideration. *Id.* This would appear to be a somewhat extreme position, but in RCA Corporation v. State Tax Comm., 513 S.W.2d 313 (Mo. 1973), the court held that there was a true lease and used the theory that the existence of a right of termination made any other conclusion impossible.

33. No attention will be given in this article to options to purchase for no additional consideration, for it is the determination of what is "nominal" that raises the real issues regarding the consideration point. For cases involving purchases for no additional consideration, see Szabo Food Service, Inc. v. Balentines, Inc., 285 N.C. 452, 206 S.E.2d 242 (1974); Brandes v. Pettibone Corp., 79 Misc. 2d 651, 360 N.Y.S.2d 814 (1974); Karp Bros., Inc. v. West Ward Sav. & Loan Ass'n of Shamokin, 440 Pa. 583, 271 A.2d 493 (1970).

"[m]athematical guidelines cannot be set. What is a 'bargain price' to one person may not be that to another."[34] In many ways, a close examination of the best-known cases on the point serves to heighten rather than alleviate the confusion.

One avenue for approaching the problem is to fall back upon the view that "nominal consideration" must surely refer to nothing more than the monetary equivalent of a mere peppercorn. An example of this approach may be found in the case of *In re Wheatland Electric Products Co.*[35] That case dealt with a transaction in which the lessee of a machine was given an option "to purchase the machine at the list price at any time during the term of the lease or within the thirty days after its termination and further providing that 75% of the rentals paid prior to the purchase date would be applied to the list price up to but not exceeding 75% of that price."[36] The additional amount to be paid if the option was exercised, therefore, was at least 25% ($2,006.25) of the list price. The court said such an amount "is not a nominal consideration for the right to become the owner of the equipment, but represents a substantial proportion of the purchase price."[37] Thus, the lease agreement was not treated as one intended for security.

The court in *Wheatland* did not merely reveal its view of what *is not* nominal consideration. It also gave a strong hint about what *is*. The *Wheatland* opinion noted that "[t]he Courts, in referring to the term 'nominal consideration,' frequently use it interchangeably with the sum of $1.00 or some other small amount."[38] It is not clear whether the court actually adopted that view in *Wheatland*. It is apparent, however, that if such an approach is followed, the number of lease transactions that could legitimately be held to be for security would be severely limited.

The case that is most often contrasted with *Wheatland* is *In re Royer's Bakery, Inc.*[39] The *Royer's* lease contained an option to purchase upon payment of the list price ($4,650) of the machine referred to, " 'less 80% of the aggregate rental payments previously made . . . , up to, but not exceeding the list price of the piece of equipment. . . .' "[40] Thus the minimum sum that might have to be paid by the lessee was 20% of the list price, or $930. The referee in bankruptcy who decided *Royer's* concluded

34. Leary, *Leasing and Other Techniques of Financing Equipment Under the U.C.C.*, 42 TEMPLE L.Q. 217, 251 (1969).

35. 237 F. Supp. 820 (W.D. Pa. 1964). The use of parol evidence, another issue raised in *Wheatland*, was discussed in notes 20-24, *supra*, and accompanying text.

36. *Id.* at 821. The original lease was actually replaced by a "purchase option rider" with essentially the same terms.

37. *Id.* at 822.

38. *Id.* at 821-822. The reference to one dollar as nominal consideration was relied upon in *In re* Falco Products Co., Bankruptcy No. 29303, 5 UCC REP. SERV. 264 (E.D. Pa. 1968).

39. 56 Berks County L.J. 48, 4 CCH INSTALMENT CREDIT GUIDE ¶99,274 (Ref. Bkcy. E.D. Pa. 1963). Subsequent citations of this case will be to the CCH GUIDE.

40. 4 CCH GUIDE ¶99,274 at 89,632, quoting the lease.

that such a condition in a lease "readily provides a device for financing the purchase of equipment" and had the effect of creating in the lessee "an equity or pecuniary interest in the leased property."[41] Accordingly, the lease agreement was held to be intended as security. In *United Rental Equipment Co. v. Potts & Callahan Contracting Co.*,[42] a case decided in the same year as *Royer's Bakery*, a provision that 85% of the rentals up to the amount of the list price could be credited to the purchase of the leased item was held to create a security interest.

How much guidance do these cases give us? It is not being completely facetious to say that all they may do is tell us that a 15% or 20% option provision represents nominal consideration but a 25% provision represents substantial consideration. One would hope, though, that a bit more help than that may be garnered from these cases and similar ones. What needs to be kept in mind is that even though it is probably necessary to proceed on a case-by-case basis, it is possible to impose on the problem a general economic analysis that will fill many otherwise serious gaps. As one attorney has put it: "The test of whether a lease is intended as security is essentially an economic one. If the lessee obtains the right to acquire title for *relatively* little additional consideration beyond the initial lease payment[s], *or he has the right to enjoy the useful life of the equipment regardless of title,* under a term without renewals for the expected life of the equipment, then the lease may be one 'intended as security.'"[43]

The extent of the consideration to be paid should be evaluated in relation to the anticipated market value of the property that is subject to the lease at the time when the option may legally be exercised, not in relation to the value of the property when the parties to the lease enter into it. This point is consistently recognized by the commentators[44] but chronically overlooked (or at least blurred) in the cases.[45]

In considering whether the option price as of the projected time of the option's exercise is "reasonable" and thus whether that price is substantial or nominal, a number of points should be taken into account. Included among these are "the length of the lease, the amount of use to which the leased chattel is to be exposed, and the degree of technological obsolescence that is likely to occur to the chattel between the time of the execution of the lease on the one hand and the time it expires and the option to purchase is to be exercised."[46]

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41. *Id.* at 89,633.

42. 231 Md. 552, 191 A.2d 570 (1963).

43. Smith, *Drafting Equipment Leases*, 5 UCC L.J. 64, 67 (1972) (emphasis added).

44. *See* Del Duca, *Evolving Standards for Distinguishing a "Bona Fide Lease" from a "Lease Intended as Security"—Impact on Priorities*, 75 COMM. L.J. 218, 219 (1970); Hawkland, *supra* note 28, at 453.

45. *See, e.g.*, Continental Leasing Corp. v. Lebo, 217 Pa. Super. 356, 272 A.2d 193 (1970); General Electric Credit Corp. v. Bankers Commercial Corp., 244 Ark. 984, 429 S.W.2d 60 (1968).

46. Del Duca, *supra* note 44, at 219.

A basic difficulty inherent in the economic-analysis approach to the lease—security-interest distinction, of course, is that even the most precise examination of the facts may leave the court adrift in a gray area somewhere between consideration that is merely "nominal" and consideration that is "substantial." This difficulty should not obscure the merits of the economic analysis. Certainly the alternative—a "black-letter" insistence that a certain sum or value percentage is nominal and anything above that is substantial—is not an attractive one. To take that approach would be to ignore the obvious intention of the draftsmen of the U.C.C. that courts bring to bear on the problem their own intellectual gifts. Far too often, lawyers and judges seem to forget that what is nominal in one situation may be substantial in another, and vice versa.[47] It is this tendency that has led to the lamentable references in some decisions to one dollar or a reasonably equivalent sum as the only truly nominal consideration.[48]

A second difficulty with the economic-analysis method, but one not directly attributable to the method itself, is the distortion and misapplication to which it is sometimes subjected. Such shortcomings are evident in the *Royer's Bakery* case. As noted earlier,[49] *Royer's* emphasized the fact that the lessee was able to develop "an equity or interest."[50] Section 1-201 (37) of the U.C.C. speaks in terms of a purchase for nominal additional consideration, not the extent to which periodic rental payments may constitute the build-up of an equity. In *Royer's,* the bankruptcy referee seemed to assume that the lease was necessarily one for security, because 80% of the rent payments (not to exceed 80% of the price) could be applied toward the purchase of the machine. Yet that fact in no way resolves the question whether 20% of the original list price (not depreciated value) of the machine was a substantial amount. Suppose, for instance, that the cost of acquiring another used machine of the type involved in *Royer's* and of the same age and condition as the *Royer's* machine at the time the lessee chose to exercise the option was less than the cost of exercising the option, which was based on a percentage of the list price. In that situation, the argument that the option could be exercised for nominal consideration would surely be rather weak.

Despite these difficulties, an economic analysis provides a workable set of tools with which to deal with the lease—security-interest distinction.

47. Many decisions do not even try to set forth any reason for a particular result. *See, e.g.,* Crowder v. Allied Inv. Co., 190 Neb. 487, 209 N.W.2d 141 (1973). Evidently these decisions rely upon what may generously be termed intuitive legal wisdom. Happily, at least one case has clearly recognized "that consideration may be sizable and still be 'nominal' within the meaning of §1-201(37)." Granite Equipment Leasing Corp. v. Acme Pump Co., Inc., 165 Conn. 364, 335 A.2d 294, 295 (1973).

48. See note 38, *supra,* and accompanying text. Of course, there can be little doubt that one dollar *is* a nominal amount. *See* Transamerica Leasing Corp. v. Bureau of Revenue, 80 N.M. 48, 450 P.2d 934 (1969).

49. See note 41, *supra,* and accompanying text.

50. 4 CCH GUIDE ¶99,274 at 89,633.

There is some question whether it may be supplemented by factors outside the strictly commercial sphere, specifically including certain tax considerations.

VI. Tax Considerations

Rental payments are a deductible business expense under the Internal Revenue Code.

> There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including . . . (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.[51]

The Internal Revenue Code's reference to an "equity" obviously takes us beyond the language of the U.C.C., and the Internal Revenue Service has set forth a Revenue Ruling that goes even further in its summarization of points to be considered in distinguishing a lease from a sale (with accompanying security interest). For tax purposes, a lease of such a questionable nature is called a "leveraged lease." The Ruling is important enough to be quoted at some length.

> Whether an agreement, which in form is a lease, is in substance a conditional sales contract depends upon the intent of the parties as evidenced by the provisions of the agreement, read in the light of the facts and circumstances existing at the time the agreement was executed. In ascertaining such intent no single test, or any special combination of tests, is absolutely determinative. . . . However, . . . it would appear that in the absence of compelling persuasive factors of contrary implication an intent warranting treatment of a transaction for tax purposes as a purchase and sale rather than as a lease or rental agreement may in general be said to exist if, for example, one or more of the following conditions are present:
>
> (a) Portions of the periodic payments are made specifically applicable to an equity to be acquired by the lessee.
>
> (b) The lessee will acquire title upon the payment of a stated amount of "rentals" which under the contract he is required to make.
>
> (c) The total amount which the lessee is required to pay for a relatively short period of use constitutes an inordinately large proportion of the total sum required to be paid to secure the transfer of the title.
>
> (d) The agreed "rental" payments materially exceed the current fair rental value. This may be indicative that the payments include an element other than compensation for the use of property.
>
> (e) The property may be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time of

51. Int. Rev. Code of 1954, §162(a)(3).

> entering into the original agreement, or which is a relatively small amount when compared with the total payments which are required to be made.
>
> (f) Some portion of the periodic payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest.[52]

Tax-related considerations (especially the development of any equity) weighed heavily in the *Royer's Bakery* decision,[53] although that case did not expressly rely upon them. The extent to which commercial and bankruptcy cases ought to be governed by standards set by the Internal Revenue Service and the tax courts is debatable, because attention to tax considerations tends to obscure the role of the U.C.C. in such matters. The inability to reconcile the "tax approach" with the "commercial approach" is clearly unfortunate, for we frequently find situations in which tax and commercial motivations are so intertwined in the leasing of personal property that they are almost inseparable.[54] Although perhaps a bit draconian, it may be that the only way to handle the problem is to rewrite §1-201(37) of the U.C.C. It almost goes without saying, of course, that such a step does not seem likely to occur in the immediate future.[55]

VII. THE IMPACT OF THE 1972 VERSION OF ARTICLE 9

The impact of the "new" 1972 version of Article 9 on the lease—security-interest problem may be summarized quite simply: there is none. This represents one of the most significant failings of the 1972 version. Professor William D. Hawkland has complained:

> Perhaps it is too much at this time to expect the formulation of a test that will infallibly separate true from security leases, but an easy corrective step was open to the [Drafting] Committee and it did not take it. The Committee could have proposed an amendment to the Code that

52. Rev. Rul. 55-540, §4.01, 1955-2 CUM. BULL. 41-42.

53. 4 CCH GUIDE ¶99,274 at 89,633.

54. As one aspect of this situation, it is now apparent that "many lessees feel that accounting and tax advantages will be lost to them if they permit their lessors to file financing statements." Hawkland, *The Proposed Amendments to Article 9 of the UCC—Part 5: Consignments and Equipment Leases*, 77 COM. L.J. 108, 114 (1972). As a result, the simplest method of avoiding problems with §1-201(37) of the U.C.C.—a routine, formalized filing for every lease—is lost.

55. The IRS has recently promulgated a Revenue Procedure "to set forth guidelines that . . . [it] will use for advance ruling purposes in determining whether certain transactions purporting to be leases of property are, in fact, leases for Federal income tax purposes." Rev. Proc. 75-21, 1975-1 CUM. BULL. 715.

For readers who wish to examine these tax considerations in greater depth, a number of recent articles are available. Among them are Berlin, *Leveraged Leasing Transactions: An Analysis of the Service's Two Recent Rulings*, 43 J. TAX. 26 (1975); Javaras & Nelson, *The New Leveraged Lease Guidelines*, 53 TAXES 388 (1975); Mann & Schmidt, *The New Leveraged Lease Guidelines*, 6 TAX ADVISER 390 (1975); Rosenberg & Weinstein, *Sale—Leasebacks: An Analysis of These Transactions After the Lyon Decision*, 45 J. TAX. 146 (1976).

> would require a financing statement to be filed for all but very short-term leases on pain of making unfiled lease transactions vulnerable to all creditors and purchasers of the lessee.[56]

If nothing else, the existence of such a statutory mandate would quiet any fears that the mere precautionary filing of a financing statement would be seized upon in a tax case as evidence that an alleged lease was actually a sale protected by security.[57]

VIII. CONCLUSION

Although distinguishing a true lease from a lease intended for security is one of the most fundamental problems of commercial law, its solution is sometimes infuriatingly difficult. A step-by-step consideration of a particular set of facts along the lines followed in this article, however, should lead to a resolution of most (but regrettably not all) of the questions that may arise. Probably the most important point to remember is that some form of the economic-analysis approach ought to be applied, if only because the U.C.C.'s definitional treatment of the lease—security-interest distinction is so evidently couched in terms that lend themselves to that kind of analysis. In the long run, one of the most confusing aspects of the whole matter may be the degree to which a commercially-oriented economic analysis should be tempered by tax-related considerations.

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56. Hawkland, *supra* note 54, at 114.

57. See note 54, *supra*.