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By Paul Bent

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By Phillip L. Durham and Marek Dubovec, SJD

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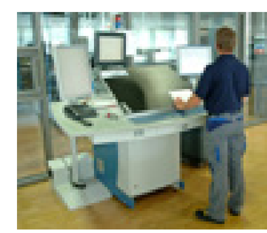

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The use of the hell-or-high-water (HOHW) provision in equipment leases has been ongoing since the beginning of equipment leasing as an independent discipline. Obligors under many forms of commercial transactions (including real property loans, trust deeds, mortgages, and personal property purchase money notes, to name a few) are required by these instruments to continue making timely payments regardless of the circumstances surrounding the possession and use of any property pledged to secure repayment. However, it has become customary to state this requirement in a specific contractual provision in equipment leases. This is the HOHW clause, and it is unique to our industry.

Although the actual language and formulation of the HOHW clause may vary from one transaction to another, virtually every U.S. equipment lease written over the past four decades has included such a provision. In a standard equipment lease or financing transaction, the lessee or borrower must expressly commit to continuing to make scheduled payments of rent (or of principal and interest) throughout the term of the transaction without regard to the physical condition, usefulness, or (in many cases) even existence of leased or collateralized assets (e.g., the loss by theft or physical destruction) without applying any setoffs or abatements and without the benefit of any defenses or counterclaims.

Such a provision has come to be considered essential in every equipment lease, primarily because it assures lessors and third-party funders alike of their right under all circumstances to continue receiving contractually defined streams of payments. Such provisions effectively limit the exposure of lessors and funders to considerations of obligor creditworthiness and ability to pay (and in some cases the realization of residual value) rather than to concerns over equipment repair, maintenance, availability, or value.

MANAGED SOLUTIONS TRANSACTIONS

In reality, however, HOHW provisions offer this protection only in transactions that are based on a defined term, fixed (or readily determinable) payment, fixed obligation structure, and the predictability of a lessee's or borrower's payment obligations over time. Because their lessees' obligations are nearly always well defined in this way,[1] equipment lessors have historically been insulated from virtually every foreseeable risk other than lessees' simple failure to pay rent as and when it becomes due; and the HOHW clause has historically played the largest role in this result.

By contractually preventing lessee disputes and forestalling defenses based on other lessee claims, including failures of leased equipment or of performance by third parties (e.g., equipment vendors or service providers), the HOHW clause has been the bulwark of lessors' and funding sources' confidence in equipment leasing transactions.

But what if equipment transactions were structured to include the features described in Table 1?

Such features together comprise the definition of managed solutions transactions (MSTs), sometimes referred to as managed equipment services (MES) agree-

In general, the more essential the solution is to the end-user's success, the greater the motivation for the end-user to remain current under an MST and the lower the risk of a failure to pay.

ments, variable use agreements, or bundled solutions. The essential characteristic is flexibility — in payment term, in payment amount, and in recourse for the failure of service providers to meet their continuing obligations to end-users.

Where will traditional HOHW provisions fit into this kind of structure? Where can they provide protection for funding sources? Or can they? Will they provide any protection at all? End-users that are becoming accustomed to the flexibility provided by MSTs are by definition becoming less receptive to the restrictions inherent in traditional equipment leases, equipment finance agreements, or conditional sales contracts, many of which spring from the use of the HOHW provision.

Given this fundamental shift in attitude toward traditional HOHW-based equipment lease structures, what is likely to happen to the HOHW clause itself as a trusted tool of equipment lessors?

THE HOHW CLAUSE IN RISK AND ASSET MANAGEMENT

Traditionally, funding sources' assessment of risk has been centered primarily on the obligor's ability to pay and much less on the use or management of the leased assets. Under an MST, however, it is the integrated customer "solution" that is the focus of the transaction, and the funder's assessment of the performance risk associated with specific service providers or vendors comes to the fore.

The role of vendor or service-provider due diligence becomes much more prominent in assessing such risk; and, rather than being considered secondary to credit underwriting, the vetting of vendors, service providers, and their forms of agreement with primary obligors becomes prevalent in a wide range of MST structures, types, and sizes.

Scrutiny of vendors and service providers becomes even more important based on the degree to which the underlying solution or service is essential to the end-user's business operation and applications. In general, the more essential the solution is to the end-user's success, the greater the motivation for the end-user to remain current under an MST and the lower the risk of a failure to pay.

Accordingly, the level of due diligence focused on the service provider is frequently related to the degree of essentiality of the solution being provided. Although the HOHW provision is often viewed as a kind of proxy for an obligor's ability to pay, the removal of the HOHW clause may be considered less of an impediment to credit approval in MSTs, under which the strength, support, and solutions rendered by the service provider are essential to the long-term financial health and strength of the end-user obligor.

Of course, traditional credit risk remains an important factor in MST underwriting as well, particularly in transactions involving a greater proportion of soft costs and less reliance on tangible goods to provide collateral credit support. Even when obligor credit underwriting is carried out in a more customary fashion, however, the role of the HOHW clause is likely to be diminished as MSTs place more focus on end-user flexibility and on overall solutions and relatively less focus strictly on the end-user's ability to make timely periodic payments throughout the term of the financing.

Accordingly, it is anticipated that the use of traditional HOHW provisions as a means of backstopping end-user obligations and customary payment risk exposure will decline, both as the use of MSTs by credit-worthy obligors and reputable service providers becomes more widespread and accepted by funding sources throughout the industry, and as proportionally less reliance is placed on traditional methods of assessing and managing transactional risk.

Conversely, decreasing reliance on the standard HOHW provision may lead to greater reliance on the role played by asset management in assessing the risk of an MST transaction. Whereas under a traditional equipment lease it is anticipated that the leased assets will be returned at the time of expiration or termination of the full term of the lease (or perhaps at

Table 1. Key Features of a Managed Solutions Transaction[2]

- The end-user (customer) enters into "solutions" agreements with one or more service providers that are not lessors.
- The solution includes access to equipment, software, ongoing services, and support.
- The end-user's payment may be based on usage, or it may be in the form of a subscription.
- The agreement may be cancelable at will by the end-user.
- The end-user may have broad rights to substitute and/or upgrade the equipment supporting the bundled solutions.
- The software and even the equipment may be owned by the service provider(s).
- The funding source (formerly a lessor) has no direct control over the equipment or software.
- The agreement may or may not be monetized by the service provider(s).

the predetermined time of an early termination option or early buyout option), under the more flexible MST arrangement the end-user may be able to return the assets at any time.

Consequently, under an MST a funding source must not only be aware of the value of the assets throughout the term of the transaction but also of their "utility" — that is, of the secondary market for such assets, of their usefulness in the hands of a typical end-user in the relevant space, and of the range of end-users that may be prospective users of these particular assets under applicable forms of MSTs.

THE HOHW CLAUSE IN TRANSACTION ACCOUNTING

Because the fundamental economic concept behind MSTs is the payment for bundled assets and services over a possibly indeterminate period of time, such transactions are generally viewed for financial reporting purposes as executory contracts. Long-standing rules for such reporting by vendors and service providers are most likely to be applied for MSTs as well. Thus, from a financial reporting and accounting point of view, the presence or absence of a customary HOHW provision is not expected to have any effect.

Perhaps the biggest accounting challenge for equipment vendors under such transactions is the matter of revenue recognition, including most notably the question of whether a vendor should pursue revenue recognition on the sale of the underlying assets or should focus on recognizing revenue that occurs over time throughout the life of an MST.

Because this determination, and the consequent treatment of the transaction for financial reporting purposes, is not generally affected by the characterization of the underlying end-user obligations (either as arising from a net lease or as subject to certain obligor defenses), the use of a traditional equipment lease HOHW provision is expected to have no bearing on the accounting treatment of the transaction.

Likewise, the accounting issues that arise in such transactions (e.g., transitioning from "standard" lease management software systems to those that can accommodate MST structures, adapting to the new accounting rules concerning leases and related transactions generally) do not depend on the presence or absence of an HOHW provision in the transaction documents. Moreover, the use (or lack of use) of HOHW language for other purposes is not expected to bear on the financial reporting treatment of an MST.

THE HOHW CLAUSE IN TRANSACTION DOCUMENTATION

In contrast to their limited accounting implications, the nature and structure of MSTs are already having — and are expected increasingly to have — an impact on how such transactions are documented and, more generally, on how they are negotiated and treated from a legal standpoint. In particular, the continued use and usefulness of customary HOHW language in MST transaction documents is the subject of much scrutiny and reassessment throughout the equipment leasing industry.

The HOHW provision found in nearly all traditional equipment leases is, as noted above, built on the notion of long-term, fixed, and predictable periodic payments from a determinate obligor. Thus, the customary language used to document such provisions assumes limited flexibility, constrained responsiveness to changing circumstances, and an absence of end-user ability to adjust obligations based on third-party performance — all the elements that MST obligors increasingly expect.

Consequently, the ability of customary HOHW provisions simultaneously to accommodate the needs of transaction funders and the growing demands of MST end-users has become a challenge. Various methods are used by leasing companies and funding sources to address this conundrum, including those described in Table 2.

None of these structures offers (and most likely none is intended to offer) a direct substitute for the funder protections given under the customary HOHW provision, since each requires an assessment of transaction yield, risk, and operational details — quite different from those of a customary equipment lease HOHW clause. All those structures raise currently unanswered questions regarding funding sources' remedies, applications of creditors' rights, applications of long-standing principles under the Uniform Commercial Code, enforceability of contracts under current legal precedents, and other important issues. But all of them (or variations on them) are currently being used by equipment lessors and funding sources participating in the MST marketplace.

> From a financial reporting and accounting point of view, the presence or absence of a customary HOHW provision in an MST is not expected to have any effect.

Importantly, given the direction that transaction documentation appears to be going, as more MSTs are developed and documented throughout the industry, it is becoming more apparent that the customary HOHW provision that has been considered sacrosanct by lessors, their lawyers, and their funding sources throughout the history of U.S. equipment leasing is being replaced by alternative contractual structures and related contract language.

Companies offering solutions-based alternatives such as MSTs without customary HOHW provisions are in the near term likely to struggle to find third-party funding sources willing to advance substantial funds against such financial assets.

In particular, as the use of MSTs continues to expand, funding sources are tending to become more comfortable providing financing under documents that include comprehensive and specific provisions addressing the issues of end-user flexibility, essential use of assets, disposition of assets (e.g., in trade-ins, upgrades, and replacements), rights and obligations of all parties (including service provider(s)), and other details[3] in lieu of actual (and customary) HOHW language.

As MSTs become more accepted and more prevalent, largely as the result of customer demand and evolving market conditions and opportunities,[4] it is likely that the HOHW clause as we have known it for many decades will become less relevant and will eventually be superseded by other documentation alternatives that better address these market forces.

THE HOHW CLAUSE IN FUNDING AVAILABILITY

Perhaps the most important feature of the customary HOHW provision in leasing has been its effect in assuring third-party funding sources of the reliability and inviolability under every equipment lease of a predictable stream of periodic payments that will be realized "come hell or high water." The ability to collateralize third-party debt through equipment leases has nearly always required that the underlying contracts include some level of HOHW language.

It has traditionally been an article of faith in the equipment leasing industry that without the HOHW provision leases (and their concomitant rental streams) could not be assigned nor could equipment lessors adequately monetize their receivables and properly capitalize their businesses.

Accordingly, companies offering solutions-based alternatives such as MSTs without customary HOHW provisions (or other features closely resembling them) are in the near term likely to struggle to find third-party funding sources willing to advance substantial funds against such financial assets. Traditional funding sources are accustomed to relying on the contractual obligations of end-users, supported by HOHW provisions, for assurance of future payments throughout a fixed term of obligations.

Although certain structural alternatives are being used with increasing frequency, including the requirements for end-users to make certain minimum payments and for service providers or vendors to meet certain minimum uptime or service level requirements,[5] there is still most often a mandate imposed by funding sources that some form of HOHW language be included in transactions intended for assignment and discounting. Thus, some form of HOHW provision is expected to be used for the time being by originators and "bundlers" who intend to "back leverage" or discount their transactions in the traditional bank or institutional lending marketplace.

Table 2. Methods of Documenting MSTs

- Some of the methods used by leasing companies and funding sources to document MSTs include:
- The bifurcation of transaction documents into separate sections (or even separate agreements) representing the service components and the financing components of the transaction
- The use of separate agreements running between funding sources and vendors (or service providers) under which funders may avail themselves of remedies tailored specifically to failures to provide adequate service levels, response times, maintenance, uptime, or other services to the end-user, with such agreements often incorporating various contractual protections (e.g., financial covenants) traditionally found in financing agreements between funders and end-users
- The integration of service agreements with financing agreements, with specific provisions addressing the rights and remedies of all three parties (end-user, service provider, and funding source)
- The use of indemnification or hold harmless provisions as a kind of substitute for the assurance of payment that has traditionally been provided by HOHW language, particularly with respect to the risk presented under MSTs, which now may rely on the continued performance of third-party vendors or service providers, which typically were not party to the agreements entered into between lessees and lessors

CONCLUSION

The venerable and time-honored hell-or-high-water clause has been the mainstay of equipment leasing structuring and documentation for decades, particularly in connection with the underwriting of payment risk and the assignment of rental obligations to third-party funders. In the emerging marketplace of highly flexible MSTs, however, the usefulness and applicability of the HOHW clause are increasingly open to question.

As new payment structures, new ideas regarding the undertaking of risk by originators and by third-party funders, and new alternatives for providing combinations of flexible service with hardware and tangible assets and platforms continue to evolve, it is expected that the HOHW provision will slowly but inevitably be replaced by alternative methods of risk-sharing and flexible financing.

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Endnotes

1. Setting aside the risk of material changes in residual values under true leases, while noting that in any event the true lease structure appears to be on the wane throughout the equipment leasing industry.

2. See "Managed Solutions: Evolutionary or Revolutionary?," Equipment Leasing & Finance Foundation, 2016.

3. Often combined with more robust service provider due diligence.

4. See note 2 above.

5. Such alternatives may frequently be found in the office imaging industry, which pioneered the MST concept and has used it successfully for many years, and increasingly in the energy industry.

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Paul Bent is a senior managing director of The Alta Group and manager of its legal services practice. He joined the consultancy in 2003 and is based in Long Beach, California. With experience as an investment banker, equipment leasing CEO, and transaction attorney, he has been involved in all facets of leasing and corporate financing. He advises Alta clients on assessing strategic and tactical business plans and alternatives; developing and implementing leasing transactions and structures; reviewing business and documentation practices; and analyzing asset-based financing alternatives. In addition, Mr. Bent is founder, president, and general counsel of GoodSmith & Co. Inc., a financial services firm specializing in large-ticket leasing, leveraged leasing, and asset-based corporate financing. The author was last published in this journal's Spring 2008 issue, with an article titled "Investing in Alternative Energy Equipment and Projects." He served on ELFA's legal committee and continues to serve on the amicus subcommittee and federal regulatory subcommittee. In addition, he has been a speaker at ELFA's Legal Forum and Credit and Collections Conference. Mr. Bent holds a BA, cum laude, in mathematics and computer science from the University of California, Los Angeles, and a JD from Southwestern University School of Law in Los Angeles.