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Equipment ABS Today: New, Improved!

By Stephen T. Whelan

Securitization of equipment leases and loans is on the upswing. Transaction volume has jumped over the last two calendar years. Moreover, delinquency performance has improved. Based on a recent Foundation study, this article evaluates some potential threats to continued growth of equipment asset-backed securitization.



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Equipment Finance Market Forecasting

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It is often assumed, but has never really been confirmed, that capital equipment spending (capex) is a driver of equipment finance volume. This article helps validate that assumption and, furthermore, demonstrates that equipment finance volume can be forecasted over the short term using capex and statistical regression techniques.

The role of market intelligence and market research is to provide insights and awareness of trends impacting a company's external market. Understanding markets is critical to sound business planning and execution. This work includes a number of activities such as finding growth opportunities, identifying industry trends, analyzing share, and profiling competitors.

Market sizing is a significant component of market intelligence and is usually difficult to come by in the leasing world. Market sizing is critical because quantifiable market data is necessary to analyze growth and determine share in business planning activities. Of course the key to market sizing is the availability of market data and the use of analytics to gain an understanding of market implications suggested by the data. Projecting markets

into the future is challenging, but where historical data is available, statistical forecasting can be used.

This article discusses market sizing in the equipment finance industry, provides insight regarding underlying relationships in the industry, and introduces a statistical forecasting model to project the equipment finance market into the short-term future. In this context *short-term* is defined to be two to four quarters into the future, depending on the frequency of the business planning cycle. The key relationship to be examined is the impact of capital equipment spending on the direction of the equipment finance market.

THE EQUIPMENT FINANCE MARKET

In 2014 U.S. businesses, nonprofits, and government

agencies made capital expenditures of about \$1.5 trillion in plant, equipment, and software. The equipment finance portion of the total capital expenditures excluding structures, referred to as capex, was about \$1 trillion in 2014.¹ The equipment finance market is comprised of many transactions ranging from micro-ticket to large ticket, where the majority falls within the small-ticket and middle-ticket categories. These transactions include many equipment types with some of the most popular being agriculture equipment, construction machinery, computers, trucks, and industrial machinery.

About 62% of the \$1.5 trillion, or approximately \$900 billion, is financed through loans, leases, and lines of credit according to the Equipment Leasing and Finance Association (ELFA).² Although undocumented, capital equip-

ment spending (capex) has been considered an indicator of equipment lease and loan market direction.

The parameter used to characterize equipment finance market growth is new business volume, which represents the dollar value of all lease and loan equipment transactions made in a specified period of time. Determining lease and loan equipment finance market direction requires the use of sample surveys along with estimating and analytical modeling. The equipment finance market is unlike the leveraged loan market, where actual industry transactions are available in an accessible database, which includes volume by individual competitor.

DATA SOURCES

The best data source for historical new business equipment

volume is the Monthly Leasing and Finance Index (MLFI-25) data available at www.elfa-online.org. The MLFI data is submitted monthly by 25 equipment finance companies that provide equipment leases and loans. These companies represent a good cross section of the equipment finance industry and include banks, captives, and independents.

Quarterly capex data can be found on the U.S. Bureau of Economic Analysis (BEA) website³ in Table 1.1.5, Gross Domestic Product (GDP). Capex is a component of GDP, and the GDP table of quarterly informa-

tion including capex is refreshed every month, with the third month of the quarter being the most complete view. Also, BEA makes a comprehensive retroactive adjustment to the GDP table in its July report.

Figure 1 provides a graphical display comparing quarterly MLFI new business volume and quarterly capex spending.

A review of Figure 1 provides the following insights regarding the relationship between MLFI and capex:

- MLFI and capex show very similar trend lines from 2009 through 2014.

- MLFI volume growth is more volatile than capex growth, which is not too surprising due to the sheer size of equipment capex spending.
- MLFI data exhibits a consistent seasonality trend where the fourth quarter volume is always the highest, the first quarter volume is always the lowest, and the second and third quarters are in the middle and relatively close to one another.

These insights provide the basis for building a statistical forecasting model.

FORECASTING

Fitting a curve to data using statistical regression techniques provides a methodology to project a time series into the future. The forecasting model can take different forms, but the most common is a linear relationship between the variable being forecasted (i.e., the dependent variable) and the explanatory or independent variable(s). This forecasting methodology is known as causal forecasting. The steps in the methodology include the following:

- Plot the time series to look for relationships between depen-

dent and potential independent variable(s) and compute correlations to evaluate relationships.

- Run statistical software with the dependent variable and potential independent variable(s) time series to explore possible regression equations.
- Evaluate potential independent variables using statistical measures and finalize the regression equation.
- Input forecasts of the independent variable(s) into the regression equation to calculate future values of the dependent variable.
- Test the model by backing off a sample of recent data points to see how well the model predicts the future.

In this application a multiple linear regression model is introduced with MLFI volume as the dependent variable, capex as one independent variable, and a seasonality factor as the other independent variable. (See Table 1 for complete time series data.)

Performance of the forecasting model can be measured in the following ways:

- Compare projections from the

forecasting model with actuals and compute a forecasting error. (Table 2 shows model forecasting performance results, comparing actuals and forecasts from the model for the first quarter of 2015, using data from 2009 to 2014.)

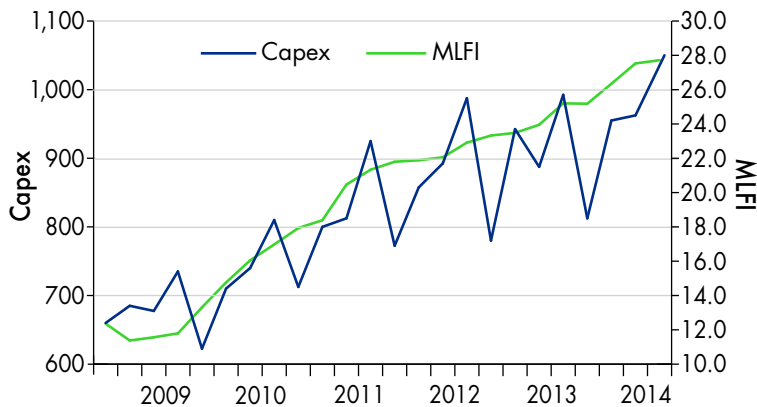
- Compute statistical measures that determine the “goodness” of the fitted data, as shown in Table 3.

The forecasting model can take different forms, but the most common is a linear relationship between the variable being forecasted (the dependent variable) and the explanatory or independent variables.

- Create a graphical display comparing the actual and fitted data. (See Figure 2.)

The small forecasting error in Table 2 helps validate the use of the model for forecasting purposes. Also, the linear regres-

Figure 1. Comparison of Quarterly MLFI Volume With Quarterly Capex Spending



Source: U.S. BEA, Table 1.1.5, Gross Domestic Product (June 2015) and ELFA MLFI data (June 2015).

Table 1. Time Series Data

Year/quarter	Dependent variable MLFI volume (\$B)	Independent variables	
		Capex (\$B)	Seasonality factor
2009:1	12.4	659.0	1
2009:2	13.4	634.4	2
2009:3	13.1	639.1	2
2009:4	15.4	644.8	3
2010:1	10.9	682.7	1
2010:2	14.4	719.0	2
2010:3	15.6	751.2	2
2010:4	18.4	774.4	3
2011:1	14.5	798.3	1
2011:2	18.0	809.7	2
2011:3	18.5	861.7	2
2011:4	23.0	883.3	3
2012:1	16.9	894.9	1
2012:2	20.3	897.1	2
2012:3	21.7	901.4	2
2012:4	25.5	922.8	3
2013:1	17.2	933.1	1
2013:2	23.7	937.0	2
2013:3	21.5	948.8	2
2013:4	25.7	980.0	3
2014:1	18.5	979.5	1
2014:2	24.2	1008.6	2
2014:3	24.5	1038.2	2
2014:4	28.0	1042.9	3
2015:1 Forecast	21.8	1053.1	1
2015:1 Actual	21.7		

Source: U.S. BEA (Report 1.1.5, June 2015) and ELFA MLFI data (June 2015)

Table 2. Comparison of Actual and Projected MLFI Volume (\$B)

Category	Value
Actual	21.70
Forecast	21.82
% forecasting error	0.6%

Source: Model forecast, ELFA MLFI data (June 2015).

Table 3. Statistical Measures

Forecasting equation: $MLFI = -11.9 + .0291 (\text{Capex}) + 3.07 (\text{Seasonality factor})$

Measure	Value	Description
R-squared / Adjusted R-squared	96.2 / 95.8	R-squared reflects the explained variation divided by the total variation due to the fitted model. A value close to 100 would be expected for "a good" forecasting model. Adjusted R-squared also indicates how well terms fit a curve or line, but the statistic adjusts for the number of terms in a model. Adding additional terms will actually improve R-squared simply because of the addition of more independent variables.
s	0.98	s, the standard error of the estimate, is a measure of variability about the fitted regression function. The lower the s value, the better the fit.
t statistic		The t statistic is used to determine if the regression coefficients are statistically significant. A sizable value indicates statistical significance (In general, $t > 2$ or $t < -2$ where $n > 30$.)
- Constant	-8.58	
- Capex	18.67	
- Seasonality factor	10.73	
F statistic	264.1	The F statistic is used to test the overall significance of the regression model. A large F value suggests the model is statistically significant (In general, $F > 4$.)
Durbin-Watson statistic	1.91	The Durbin-Watson (D-W) statistic tests for auto correlation in the residuals of a fitted model. The statistic ranges from 0-4 and a value of 2 indicates no serial correlation.

Source: Author, using Minitab.

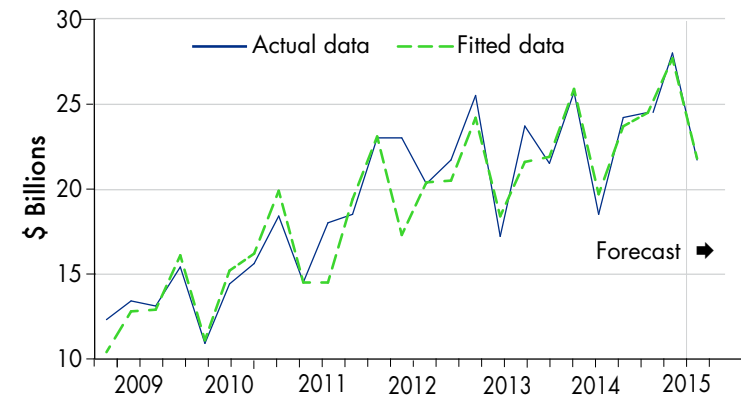
Note: In a perfect model a scatter diagram of residuals vs. fitted values shows a pattern of alternating positive and negative values with no autocorrelation. In this application there is a slight trace of autocorrelation.

sion statistical measures shown in Table 3 are equally impressive. For instance, the R-squared and adjusted R-squared statistics are 96.2 and 95.8, respectively.

The graphical display shown in Figure 2 best illustrates the effectiveness of the fitted curve to match the actual MLFI data. In forecasting parlance the capex variable picks up the overall MLFI trend, and the seasonality factor accounts for the seasonal

Figure 2. Actual Versus Fitted MLFI Volume

Forecasting model: $(MLFI) = -11.9 + .0291 (\text{Capex}) + 3.07 (\text{Seasonality factor})$



Source: ELFA MLFI data (June 2015), fitted model with forecast.

Based on all these results, the forecasting model passes the test: the forecasting error is small, the statistical measures are solid, and the actual and fitted data are very much in sync.

variation around the trend. Figure 2 shows the forecasting equation, actual and fitted historical MLFI volume data, and the forecast of the first quarter of 2015.

Based on all these results, the forecasting model passes the test: the forecasting error is small, the statistical measures are solid, and the actual and fitted data are very much in sync. Also, the results suggest that capex, along with the seasonality factor, is a strong indicator of MLFI new business volume.

USING THE MODEL

In order to produce MLFI forecasts, the capex data must be forecasted. Such forecasts are available from companies

that produce macroeconomic analysis and reports. The capex data is available quarterly and is based on the macroeconomic expertise of the supplier firm. If that data is not available, another class of forecasting models called exponential smoothing could be used to forecast capex. Also, the seasonality factor needs to be applied to complete the forecasting process. Details are shown in Table 4.

Table 4. Seasonality Factor

For both the historical and forecast periods, the seasonality factor is determined by assigning 1 to the first quarter, 2 to the second and third quarters, and 3 to the fourth quarter.

Quarter	Seasonality factor
First	1
Second	2
Third	2
Fourth	3

Source: Author.

An important consideration is the length of the forecasting period. In this application, with only 24 quarters of actual data, the forecasting period should be limited to between two to four quarters into the future, although there is no hard and fast rule in this regard. Of course the

forecasting period can be expanded as additional historical data becomes available.

Equally important is that every year in the July report, BEA makes a complete retroactive adjustment to the GDP components, including capex. All the data used in this article reflects the capex time series prior to the July 2015 adjustment. In practice, if it fits in with a firm’s annual planning cycle, the model should be refreshed at midyear, using the adjusted capex data from BEA.

CONCLUSION AND ADDITIONAL THOUGHTS

As part of the business planning process, it is important for a firm to know where its external market is heading. Sizing an external market is integral to business planning and strategy development. The sizing exercise provides an overall framework to lay out a growth strategy and develop tactical initiatives such as share analysis pricing, business development, and new product development.

Using a statistical-based approach provides consistent,

systematic forecasts of the market. In this application, projected MLFI volume growth rates serve as a good indicator of overall equipment finance market growth. A company can compare its internal volume growth projections with the external equipment finance market projections.

A final question: could the same approach be used to predict an individual company’s new business volume? Probably not, since individual company new business volume is generally even more volatile than the MLFI market volume.

However, a similar approach could be investigated. Resident within BEA’s supplemental accounts is Table 5.5.5.U, Private Fixed Investment by Equipment Type. This table includes estimated quarterly capex associated with 25 equipment types such as computers and peripheral equipment; construction machinery, metalworking machinery, and medical equipment. An individual company could use the table to select equipment types within its target market and compare the resultant quarterly capex with its own quarterly

new business volume associated with those same equipment types. Testing for correlation and building a forecasting model would follow to see whether the information could be used for forecasting individual company volume.

George Box, the famed statistician who produced pioneering work in time-series analysis, wrote that “essentially, all models are wrong, but some are useful.”⁴ Hopefully, the topics discussed in this article will prove useful to the equipment finance industry. In view of Box’s comment, it is worthwhile to consider some additional aspects encountered in this forecasting application:

- In addition to capex, other macroeconomic variables, such as industrial production and durable goods orders, were evaluated as possible independent variables. However, none of these variables produced the strong forecasting performance of the capex and seasonality combination.
- A one-quarter lead-lag relationship between capex and MLFI volume was evaluated. Such an approach would

With its economic stability, the 2009 through 2014 period does produce strong forecasting performance, which might not be the case with an expanded historical period, where capex becomes more volatile.

enable MLFI volume quarterly prediction from the last historical capex data point. Although there is some value in this approach, there was a decrease in statistical significance and forecasting accuracy. The coincident data approach was considered a better option.

- The capex data in this analysis is mostly monotonically increasing with time. It raises the question of whether time itself could be used as an independent variable instead of capex. The difficulty with the approach is in the forecasting period. Time can only increase, which forces the MLFI volume forecast to always increase, which is not

the case with using capex as an independent variable. If the capex forecast decreases, the MLFI volume forecast will decrease.

- Because this model is designed for short-term forecasting, the time frame selected is 2009 through 2014. The thinking is that the more recent past is more representative of the short-term future than a longer time frame. In fact, this is the logic behind exponential smoothing models. However, for a longer look into the future, an expanded time frame would be appropriate, and this expansion would pick up the recession years. With its economic stability, the 2009 through 2014 period does produce strong forecasting performance, which might not be the case with an expanded historical period, where capex becomes more volatile.
- Building forecasting models based on percentage change is more difficult, due to data volatility, than building models which forecast levels, as was done in this article. Theoretically, if a percentage change model could be constructed,

it would have the potential to predict turning points when the percentage change was forecasted to be less than zero. However, in practice some combination of explanatory variables, or perhaps a lead-lag relationship, would still be needed to predict a turning point. Note that the model based on forecasting levels presented in this article would show a turning point, if it is built into the capex forecast provided by economists.

Acknowledgments

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Endnotes

1. Technically, the term *capex* includes both equipment and structures. However, in this article it is defined to be equipment capex only.
2. See Equipment Leasing and Finance Association (ELFA) website, www.elfaonline.org.
3. See U.S. Bureau of Economic Analysis website, www.bea.com.
4. George E.P. Box and Norman Draper, *Empirical Model-Building and Response Surfaces* (New York: Wiley, 1987), 484.



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TRAC Vehicle Leasing

By Edwin E. Huddleson

Terminal rental adjustment clause (TRAC) vehicle leasing is the most popular means of leasing cars and trucks to commercial end-users. Occasionally, criticism and litigation still challenge the true lease status of vehicle leases. This article summarizes the legal and public policy rationales for the TRAC/state laws and demonstrates that the majority of court decisions now recognize the true lease character of these transactions.

Treasury/IRS rulings in the 1980s and a few recent court decisions held that motor vehicle leases containing terminal rental adjustment clauses (TRACs) should be treated as sales rather than true leases.¹ Those old precedents denied TRAC owner/lessors the tax benefits of ownership, threatened their commercial law remedies,² and diminished their rights of recovery if the TRAC lessee went into bankruptcy.³

Times have changed. With Congress's enactment of 26 U.S.C. §7701(h) in 1983 and the recent enactment of TRAC/state laws in all the states, there should no longer be any doubt that TRAC vehicle leases are true leases.

Not everyone agrees with this conclusion, however. Occasionally, criticism and litigation still attack the true lease status of TRAC vehicle leases. To address these disputes, this

article summarizes the legal and public policy bases for the TRAC/state laws, shows the shortcomings of criticisms challenging the true lease character of TRAC vehicle leases, points out the overwhelming majority of court decisions that now recognize the true lease status of these vehicle leasing transactions, and lists the TRAC/state laws that are effective in the 50 states.

WHAT IS A TRAC VEHICLE LEASE?

Terminal rental adjustment clause motor vehicle leasing is now the most popular means of leasing cars and trucks to commercial (nonconsumer) end-users throughout the country. While specific transactions vary,⁴ in general a TRAC clause permits (or requires) an upward or downward adjustment of rent to make up for any difference between the actual value of a vehicle that is deter-

mined at the end of the lease term (by sale to a third party, appraisal, or otherwise) and the originally projected residual value of the vehicle. (This value is determined from a schedule of estimates, made at the start of the lease, looking forward in time and estimating what the vehicle's value will be at various times in the future when the vehicle can be returned.)

After a minimum lease term of about one year, a typical TRAC vehicle lease can be renewed or extended by the lessee, on a month-by-month basis, until the lessee returns the vehicle. When the vehicle is returned, the lease term ends. The actual value of the vehicle at the end of the lease term is then determined, usually by sale at wholesale auction. A supplemental rental payment is made by the lessee or a credit given by the lessor to reflect the difference between the actual value of the vehicle at the end of the

lease term, and the earlier originally projected estimate (made at the start of the lease, looking forward into the future) as to what the vehicle's value would be at the end of the lease term.

The objective of TRAC vehicle leases is to provide a financial incentive for the lessee/user, who is the party to the transaction best able to control the maintenance of the vehicle, to keep the vehicle in good repair. TRAC vehicle lessees like this form of commercial lease because of its cost savings and efficiency.⁵ They create the continuing popular demand for TRAC motor vehicle leasing in the marketplace.

TRAC VEHICLE LEASES: "TRUE LEASES" UNDER ALL STATE LAWS

Over the past 20 years, all 50 states and the District of Columbia have clarified the earlier

split-case law by enacting a state statute that safeguards TRAC vehicle leasing. Enactment of these TRAC/state laws was accomplished with the support of many parties, including both commercial lessors and lessees of cars and trucks, state bar organizations, state trucking organizations, state banking organizations, and the Uniform Law Commission, which sponsors the Uniform Commercial Code (UCC).

The impact of these TRAC/state laws facilitates commerce by ensuring that state law that affects billions of dollars of vehicle-borne interstate commerce is the same (uniform and predictable) throughout the United States.

TRAC/state laws make it clear that TRAC vehicle leases are true leases (not “sales” or “security interests”) for state law purposes. This simplifies and clarifies the law, accords with the weight and trend of court decisions, and establishes that TRAC vehicle leases should be treated like all other equipment leases are treated in the law.

TRAC/state laws have been cited by the courts as supporting

the true lease status of TRAC vehicle leases in bankruptcy cases where the lessee is in Chapter 11 bankruptcy.⁶ See, for example, *In re Owen*, 221 B.R. 56, 63-64 (Bk.N.D.N.Y. 1998).⁷ These state statutes are helpful to TRAC vehicle lessors in other contexts as well, including cases involving remedies issues (i.e., must the lessor give advance notice to the lessee of a foreclosure sale, before the lessor can recover a deficiency judgment?), tax questions (e.g., the Streamlined State Sales Tax Project),⁸ and any other setting where the question could arise whether TRAC vehicle leases should be treated as sales or true leases.

HISTORY: A LONG TREK FOR TRACS

The origins of TRAC vehicle leases can be traced back at least as far as 1947, when PHH in Maryland (now Element Fleet Management) began marketing them.⁹ This style of leasing provided a revenue stream to support the bank loans that PHH needed to buy cars for its clients while limiting the lessee’s charges to the actual cost of leasing (i.e., vehicle depreciation, plus interest on

PHH’s bank loans, and a fee for PHH’s services). TRAC leasing also keeps the client in a position to control the costs of leasing.¹⁰ And it eliminates disputes about who caused (and the amount of) vehicle damage.

Starting in 1948, PHH became the first company to offer TRAC leasing for fleets of cars and trucks. In the early 1950s, responding to customer demand, other vehicle fleet leasing companies similarly began to use the TRAC form of lease. Thereafter, in response to the Financial Accounting Standards Board’s issuance of Statement No. 13 (SFAS 13) in late 1976,¹¹ Wheels introduced the “split-TRAC” vehicle lease¹² in the fleet leasing industry. The split-TRAC qualified as an operating lease under SFAS 13, which meant that it could be explained in accountants’ endnotes instead of being listed as a full-bore liability on the lessee’s balance sheet.

To meet the growing customer demand, other corporate fleet lessors quickly began offering split-TRAC leases, which soon became the dominant form of leasing for commercial fleets of cars and trucks.¹³

In the late 1970s and early 1980s, however, some courts and Treasury/IRS rulings held that because TRAC clauses undercut the owner/lessor’s meaningful risk and reward in the residual, TRAC leasing transactions were not true leases.¹⁴ Federal tax law was amended in 1983 to overrule Treasury/IRS objections, adding 26 U.S.C. §7701(h) to make it clear that commercial TRAC vehicle leases, in widespread use throughout the country, should be treated as true leases for tax purposes.

Mirroring the federal tax statute validating TRAC vehicle leasing, the scope and coverage of the TRAC/state laws is limited to motor vehicles and trailers. This explains why TRAC/state laws commonly appear in state certificate of title laws (whose scope is limited to cars and trucks) instead of UCC Article 2A—Leases (which applies across the board to all types of equipment).¹⁵ The scope of TRAC leasing is limited by tax law, in any event, to commercial (nonconsumer) leases of cars, trucks and trailers (not other types of equipment). The state legislatures of all 50 states and the District of Columbia have

now enacted TRAC/state laws that recognize the “true lease” validity of this important mainstream commercial practice.¹⁶

OLDER SPLIT-CASE LAW SWEEP AWAY

TRAC/state laws resolve the earlier split-case law in favor of recognizing the true lease character of TRAC vehicle leasing.

Enactment of these TRAC/state laws was accomplished with the support of many parties, including both commercial lessors and lessees of cars and trucks, state bar organizations, state trucking organizations, state banking organizations, and the Uniform Law Commission.

Occasionally, a trustee in bankruptcy, hoping to overthrow the bargain originally struck by the parties to a TRAC lease in order to obtain more money for the bankrupt estate, may challenge the true lease character

of a TRAC vehicle lease. And sometimes practitioners fail to bring TRAC/state laws to the court's attention¹⁷ — a problem that continuing legal education programs, writeups and articles like this one may help to address.

TRAC/state laws provide that, for commercial leases of cars, trucks and trailers, the mere presence of a TRAC clause does not destroy true lease status or create a sale or security interest.

Other lingering criticisms leveled at the true lease character of TRAC vehicle leasing fail to come to grips with the fact that there are different kinds of TRAC clauses.¹⁸ The split-TRAC vehicle lease — which has long been the norm in commercial vehicle fleet leasing — utilizes a TRAC clause that is limited, as distinct from the wide-open unlimited TRAC clauses that are used to help create “true sales” in securitization deals. A split-TRAC vehicle lease is a lease¹⁹ that

gives the owner/lessor an entrepreneurial stake in the residual: that is, a minimum “at risk” stake in the vehicle (e.g., 20% of original cost) that is not subject to variation by the TRAC clause, and a maximum lease term that ensures that the lease does not use up the economic life of the vehicle.

Also overlooked by critics is the fact that, where motor vehicles are involved (as opposed to other types of equipment), a TRAC owner/lessor retains significant contingent liabilities for taxes, traffic tickets, and any violation of odometer laws (see 49 U.S.C. §§32705–32709, entailing both criminal and civil liabilities) — none of which are present in a “sale” or “loan” or “security interest.”²⁰ The split-TRAC vehicle lease is a true lease (not a “sale” or “security interest”) under any sound common-law analysis, and it also passes muster as a true lease under UCC § 1-203, the UCC provision that sharpens the distinction between a true lease and a security interest.²¹

TRAC/state laws were intended to, and should, short-circuit all the old objections to the true lease character of split-TRAC

vehicle leases. The short of it is that TRAC vehicle leasing is a well-established commercial practice of long standing, which now covers millions of commercially leased cars and trucks. It provides cost savings and efficiencies to commercial lessees, who create the continuing popular demand for it. There is no good reason to disrupt this mainstream commercial practice with recharacterization in bankruptcy proceedings, disadvantageous state sales and use tax treatment, or other legal penalties. To the contrary, the central purpose of the UCC is to support and facilitate mainstream commercial practices like TRAC vehicle leasing.²²

TRAC/state laws provide that, for commercial leases of cars, trucks and trailers, the mere presence of a TRAC clause does not destroy true lease status or create a sale or security interest. It should be clear, however, that the mere presence of a TRAC clause does not guarantee that a transaction will be a true lease. For example, a nominal \$1 purchase option (created independently of the TRAC clause) will destroy true lease status of any equipment or vehicle “lease” — whether the trans-

action is analyzed under federal tax law, state commercial law, or accounting principles. This is why the courts still must examine “the facts of each case” (UCC § 1-203) to determine the true lease/sale question in cases involving TRAC vehicle leases.

TRAC/STATE LAWS EFFECTIVE IN THE 50 STATES

All the TRAC/state laws are listed below.

1. **Alabama.** Code of Alabama §32-8-60.1 (effective July 29, 1991).
2. **Alaska.** Alaska Statutes §28.10.375 (applicable to transactions involving motor vehicles entered into on or after August 23, 1994).
3. **Arizona.** Arizona Revised Statutes §44-287 D (effective June 16, 1992).
4. **Arkansas.** Arkansas Code of 1987 §4-2A-110 (nonuniform amendment adding UCC 2A-110) (effective March 3, 1997).
5. **California.** California Commercial Code §1203(c) (7) (nonuniform amendment adding a new subsection to the California Commercial Code

version of UCC 1-203) (covers commercial motor vehicles and states that “nothing in this paragraph affects the application or administration of the Sale and Use Tax Law”) (effective January 1, 1996).

6. **Colorado.** Colorado Revised Statutes §42-6-120(3) (effective April 16, 1997).

7. **Connecticut.** Connecticut General Statutes §14-167a (Public Act 96-162) (effective October 1, 1996).

8. **Delaware.** 21 Delaware Code §2342 (effective July 3, 1996).

9. **District of Columbia.** District of Columbia Statutes §50-1217 (2001 ed) (effective March 17, 1993).

10. **Florida.** Florida Statutes §319.271 (effective January 1, 1991).

11. **Georgia.** Georgia Code §40-3-60 (effective July 1, 1995).

12. **Hawaii.** Hawaii Revised Statutes §286-52.4 (effective April 16, 2003).

13. **Idaho.** Idaho Code §49-512A (effective July 1, 2004).

14. **Illinois.** Illinois Vehicle Code §3-201.1, 625 ILCS 5/3-201.1 (effective January 1, 1992).
15. **Indiana.** Indiana Code §9-17-5-4 (effective July 1, 1995).
16. **Iowa.** Iowa Code §321.51 (effective July 1, 1995).
17. **Kansas.** Kansas Code §84-2a-110 (nonuniform amendment adding UCC §2A-110) (effective April 9, 1998).
18. **Kentucky.** Kentucky Revised Code §186A.191 (effective July 12, 2012).
19. **Louisiana.** Louisiana Revised Statutes §9:3317(A)(4), §9:3316 (A)(4), (effective July 13, 1985).
20. **Maine.** Maine Revised Statutes Annotated Title 10, chapter 209-A, §1305 (effective May 31, 1997).
21. **Maryland.** Maryland Code, Transportation, §13-211 (effective January 1, 1995).
22. **Massachusetts.** Massachusetts General Laws chapter 90D §21A (effective March 25, 1996).
23. **Michigan.** Michigan Compiled Laws §440.2810 (nonuniform amendment adding UCC 2A-110) (effective September 30, 1992).
24. **Minnesota.** Minnesota Statutes §168A.17.1a (effective May 18, 1989).
25. **Mississippi.** Mississippi Code §63-21-42 (effective July 1, 1994).
26. **Missouri.** Missouri Statutes §301.452 (effective September 19, 1991).
27. **Montana.** Montana Code §61-3-110 (effective October 1, 2003).
28. **Nebraska.** Nebraska Revised Statutes §60-164(5) (effective March 2, 2004).
29. **Nevada.** Nevada Revised Statutes §482.4215 (effective May 28, 2003).
30. **New Hampshire.** New Hampshire Revised Statutes §261:23-a (effective January 1, 1995).
31. **New Jersey.** New Jersey Statutes Ann. §39:10-5.1 (effective June 29, 1992).
32. **New Mexico.** New Mexico Statutes Ann. §66-3-101.1 (effective March 28, 2013).
33. **New York.** McKinney's Vehicle and Traffic Law §397-b (effective August 7, 1992).
34. **North Carolina.** North Carolina General Statutes §25-2A-103(j) (nonuniform amendment to UCC 2A-103(j)) (effective July 15, 1994), clarified by North Carolina General Statutes §20-78.1 (effective June 23, 2011).
35. **North Dakota.** North Dakota Century Code §39-05-17.3 (effective July 1, 1993).
36. **Ohio.** Ohio Revised Code §4505.13(D) (effective November 6, 1992).
37. **Oklahoma.** Oklahoma Statutes Ann. §47-1110 F (effective January 1, 1992).
38. **Oregon.** Oregon Revised Statutes (Vehicle Title and Registration) §803.098 (effective August 16, 1993).
39. **Pennsylvania.** Pennsylvania Consolidated Statutes Ann. 75 Pa.C.S. §1139 (effective September 4, 1995) (covers commercial motor vehicles).
40. **Rhode Island.** Rhode Island General Laws §31-3.1-27 (effective July 1, 1991).
41. **South Carolina.** South Carolina Code §56-19-720 (effective June 11, 1998).
42. **South Dakota.** South Dakota Codified Laws §32-3-38.2 (effective March 19, 2003) (covers commercial motor vehicles).
43. **Tennessee.** Tennessee Code §47-2A-110 (nonuniform amendment adding UCC 2A-110) (effective July 1, 1994).
44. **Texas.** Texas Transportation Code Title 7 §501.112 (effective September 1, 1991).
45. **Utah.** Utah Code Ann. 1953 §41-1a-609 (states "the provisions of this section do not affect ... the calculation of sales and use tax") (effective May 5, 2003).
46. **Vermont.** 23 Vermont Statutes Ann. §2048 (effective July 1, 1993).
47. **Virginia.** Virginia Code Ann. §46.2-640.1 (effective January 1, 1992).
48. **Washington.** Originally enacted in 1994 in Washington Revised Code §62A.1-201(37) (f) (2005) as a nonuniform amendment to UCC 1-201(37) (effective July 1, 1994), Washington State's TRAC/state law was inadvertently omitted from that State's statute books during statutory renumbering and updating of the UCC in 2012. Through the combined efforts of the Washington State Bar, the American Automotive Leasing Association, the Equipment Leasing and Finance Association, the Truck Rental and Leasing Association, the Washington Trucking Association, and the Washington State Bankers Association, TRAC/state legislation was re-enacted in the State of Washington, in West's Revised Code of Washington §62A.1-203(c)(7), effective prospectively starting from July 24, 2015 (nonuniform amendment to UCC §1-203).
49. **West Virginia.** West Virginia Code §17A-4A-16 (effective June 7, 1996).
50. **Wisconsin.** Wisconsin Statutes Ann. §342.03 (effective July 1, 1992).
51. **Wyoming.** Wyoming Statutes 1977 §31-2-802 (effective July 1, 2003).

TRAC/state laws are now the common, uniform state law of the United States. In seven states (Arkansas, California, Kansas, Michigan, North Carolina, Tennessee, and Washington), TRAC laws are in the UCC.²³

Before enacting the TRAC/state laws, state legislatures were fully apprised of the earlier split-

The overwhelming majority of courts now properly recognize the true lease character of split-TRAC vehicle leases in widespread use throughout the United States.

case law and the sound policy reasons for enacting the model TRAC/state law. See, for example, "New Developments: Article 2A Leases of Goods," 1993 Commercial Law Annual 115, 124-130 (spelling out the rationale for the TRAC/state laws). Consequently, the statutory text, placement, purposes, intent and consequences of the TRAC/state law all appear in the legislative history of the TRAC/state laws.²⁴ See, for example, "Leases," 64 Business Lawyer 1187, 1189-1190 & n.24, 25 (2009) (noting the legislative history of North Carolina's TRAC/state law, overlooked by the court in *Brankle Brokerage* (Bk.N.D.Ind. 2008),²⁵ where the court erroneously held that a TRAC lease was a sale under North Carolina law. (*Brankle Brokerage* was specifically overruled by clarifying North Caro-

lina legislation in 2011.) The Commissioners on Uniform State Laws supported the enactment of the TRAC/state laws.

The overwhelming majority of courts now properly recognize the true lease character of split-TRAC vehicle leases in widespread use throughout the United States.²⁶

Endnotes

1. See, e.g., *In re Tulsa Port Warehouse Co.*, 690 F.2d 809 (10th Cir. 1982); *Swift Dodge v. Commissioner*, 692 F.2d 651 (9th Cir. 1982); *Leslie Leasing Co. v. Commissioner*, 80 T.C. 411 (1983); *New Developments: Article 2A Leases of Goods*, 1993 Commercial Law Annual 115, 124-130 (reviewing the split case law on whether TRAC vehicle leases are properly viewed as sales or as true leases).

2. True leases long have been distinguished from sales for many purposes, including the commercial law of remedies, whether UCC filings are required and third-party rights, whether a transaction is covered by state usury laws, and a lessor's rights under §365 of the Bankruptcy Code when the lessee goes into bankruptcy. "New Developments: Article 2A Leases of Goods," 1993 Commercial Law Annual 115, 117 (collecting cases). *Accord*: 2 White & Summers, *UCC Treatise* §13-2 at 4 (4th ed. 1995) ("[I]f one is a lessor as opposed to a seller, one has different rights on default, on lessee bankruptcy, in regard to federal, state and local taxes, and under state usury laws, and the difference even extends to the lessor's and lessee's balance sheet"). For example, where a purported "lease"

is found to be a disguised security interest, the "lessor" (secured party) may be barred from obtaining a deficiency judgment against a defaulting "lessee" (debtor) if it failed to give notice to the debtor as required by UCC §9-504(3). See, e.g., *Fleming v. Carroll Pub. Co.*, A.2d 1219 (DC App 1990). True leases, as opposed to disguised loans or "forebearances" of money, also may be exempt from state usury laws. *Compare Kinerd v. Colonial Leasing Co.*, 800 SW2d 187 (Tex 1990) (court recharacterized "lease" transaction with nominal purchase option as a loan and secured sale, and imposed penalties for usury on the "lessor").

3. True lessors of vehicles fare better than holders of "perfected security interests" who, in turn, are better off than holders of "unperfected security interests," when the lessee/debtor is in Chapter 11 bankruptcy reorganization. See "Leasing Is Distinctive," 35 UCC L.J. 15, 17 & n.8 (2003) (collecting authorities). Oversimplified, true lessors are entitled to receive full current rental payments, or to repossess their equipment, under 11 U.S.C. §365, if the "lease" transaction is a true lease. See, e.g., *In re PSINet, Inc.*, 271 B.R. 1 (Bk.S.D.N.Y. 2001); *In re Furley's Transport, Inc.*, 263 B.R. 733 (Bk.D.Md. 2001). By contrast, if a "lease" is viewed as a "perfected security interest" and not a true lease, then the "lessor" in this situation is entitled to receive only the smaller amount needed to provide "adequate protection" for the replacement value of its collateral (see *Associates Commercial v. Rash*, 520 U.S. 953 (1997)), which may be only 60% to 80% of contract rentals. And if the "lease" is viewed as an "unperfected security interest," the trustee in bankruptcy may be able to keep the equipment, without making current payments of any kind, and sell it. See, e.g., *Tulsa Port Warehouse Co.*, 690 F.2d 809 (10th Cir. 1982). There is no federal

statutory definition of a lease, and federal bankruptcy law looks to state commercial law to define the difference between a true lease and a security interest. See, e.g., *In re Pillowtex*, 349 F.3d 711, 716 (3d Cir. 2003); "Leases," 65 Business Lawyer 1229, 1231 n.14 (2010); "Leases," 58 Business Lawyer 1567, 1569 n.11 (2003)

4. See, e.g., "New Developments: Article 2A Leases of Goods," 1993 Commercial Law Annual 115, 124-130 (citing cases involving early termination/TRAC clauses in remedies provisions, and split-TRAC operating leases in which the lessor maintains a minimum "at risk" investment not subject to variation by the TRAC clause throughout the term of the lease); "Old Wine in New Bottles: UCC Article 2A-Leases," 39 Alab.L.Rev. 615, 638-641 (1988) (describing one-sided TRAC provisions in which the lessor either protects against residual value loss, or shares in residual value gains with the lessee, but not both; TRAC-like provisions in remedies provisions that apply only when the lessee is in default; and split-TRAC operating leases leaving the lessor with a minimum "at risk" investment in the vehicle not subject to variation by the TRAC clause).

5. TRAC vehicle leasing has proven to be the most cost-effective way for many lessee/end-users to finance the vehicles that are essential to their business. TRAC credits and TRAC debits at the end of the lease term are determined by the sales price (or appraisal) realized at vehicle turn-in, usually in wholesale auctions of vehicles conducted every month by Manheim and other auction houses at a variety of different locations across the United States. This way of determining TRAC credits/debits, tied to a vehicle's realized end-of-lease sales price, minimizes disputes that otherwise might arise between lessors and lessees about

vehicle damage or excessive wear and tear.

6. See n.3 *supra* for an explanation of the differences in an owner/lessor's rights when the lessee is in Chapter 11 bankruptcy depending upon whether the "lease transaction" is viewed as a lease, a perfected security interest, or an unperfected security interest.

7. *Accord*: *In re HP Logistics*, 460 B.R. 291 (Bk.N.D.Ala. 2011) (same); *In re HP Distribution*, 436 B.R. 679 (Bk.D.Kan. 2010) (same); *In re Double G Trucking of the Arklatex*, 432 B.R. 789 (Bk.W.Va. 2010) (same); *In re Beckham*, 275 B.R. 598, 606 (D.Kan.), affirmed, 52 Fed.Appx 119 (10th Cir. 2002) (same); *In re Charles*, 278 BR 216, 224 (Bk.D.Kan. 2002) (same); *In re Damron*, 275 B.R. 266, 270 (Bk.E.D.Tenn. 2002) (same); *In re Architectural Millwork of Virginia*, 226 B.R. 551, 556 (Bk.W.Va. 1998) (same); *In re MEPCO, Inc.*, 276 BR 94, 103 (Bk.W.D.Va. 2001) (same). See also *In re Otasco*, 196 B.R. 554 (N.D.Okla. 1991), overruling 111 B.R. 976 (Bk.N.D.Okla. 1990); *Gibraltar Financial Corp. v. Prestige Equipment Co.*, 925 NE 2d 751, 757 (Ind.App. 2010); *In re Rebel Rents*, 291 B.R. 520 (Bk.C.D.Cal. 2003). See generally "Leases," 54 Business Lawyer 1855, 1858-1859 (1999) (surveying cases and authorities on TRAC vehicle leases).

8. The Streamlined State Sales Tax Project (SSTP) was organized in March 2000 to simplify and modernize state systems for collecting and administering sales and use taxes. Those systems often distinguish between sales and leases of equipment. The SSTEP was dissolved once the Streamlined Sales and Use Tax Agreement (SSUTA) became effective October 1, 2005. Twenty-four states have passed legislation to conform to the SSUTA. See

www.streamlinedslaestax.org (information on the streamlined sales tax).

9. Peterson, Howell & Heather (PHH) was founded in 1946 by three entrepreneurs: Duane L. Peterson, Harley W. Howell and Richard M. Heather. PHH became Element Fleet Management in 2014.

10. This account reflects Harley Howell's memoirs, now kept by Element Fleet Management, on the creation of TRAC vehicle leasing. Email interview with Paul Danielson, Senior Vice President and General Counsel of Element Fleet Management in Sparks, Maryland (August 17, 2015).

11. Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 13, Accounting for Leases (1976).

12. Typical TRAC vehicle leases, written to comply with accounting standards and federal tax Code §7701(h), are "split-TRAC" operating leases that (among other things) give the owner a minimum "at risk" stake in the vehicles (e.g., 20% of original cost) that is not subject to the TRAC clause, and that contain a maximum lease term that ensures that the lease does not use up the economic life of the vehicle. For example, while TRAC provisions vary, a typical TRAC clause in a split-TRAC lease may provide,

TERMINAL RENTAL ADJUSTMENT.

As an incentive to the Lessee to maintain the value of the Vehicle by good maintenance, repair and careful use during its Lease Term, the parties agree that the enhancement or reduction in value shall be compensated as follows:

a. **Refund of Rental.** If the Net Proceeds exceed the Book Value (as to each Vehicle), its Capitalized Cost as defined in the Rate Schedule, reduced by appropriate amortization, the Lessor shall retain

an amount equal to the Book Value, and remit the excess to the Lessee as a refund of rental.

b. **Rental Charge.** If the Net Proceeds are less than the Book Value, the Lessee shall pay the Lessor the amount of the difference. However, if the Net Proceeds are less than the Guaranteed Residual (defined below), this rental charge is limited to the amount of the difference between the Guaranteed Residual and the Book Value. The Guaranteed Residual is 20% of the Capitalized Cost at the end of the minimum Lease Term and thereafter, 20% of the Book Value as of the end of the prior month.

A typical maximum lease term in a split-TRAC lease may provide, for example,

LEASE TERM. The noncancelable minimum Lease Term for each Vehicle is 367 days starting the date of the Lessee's acceptance. Thereafter, the Lessee shall be deemed to have elected to renew the Lease Agreement for each Vehicle on a month-to-month basis unless notice of surrender of such Vehicle is provided to Lessor. However, in no event shall the lease term for any vehicle Lease Term extend beyond fifty (50) months for automobiles, seventy-two (72) months for light trucks, and ninety-six (96) months for medium and heavy duty trucks, unless a different maximum lease term is set forth on any other Exhibit to this Master Lease Agreement."

13. Email interview with James S. Frank, Chief Executive Officer of Wheels Inc. in Des Plaines, Illinois (August 17, 2015).

14. See, e.g., In re Tulsa Port Warehouse Co., 690 F.2d 809 (10th Cir. 1982); Swift Dodge v. Commissioner, 692 F.2d 651 (9th Cir. 1982); and Leslie Leasing Co. v. Commissioner, 80 T.C.

411 (1983). There are important reasons why, as a general proposition, the common law should preserve the lessor's meaningful residual interest as the touchstone of the definition of a true lease. See *Leasing Is Distinctive!* 35 UCC IJ 15, 21-22 (Winter 2003); "Old Wine in New Bottles," 39 Ala.L.Rev. 615 (1988) at 626 ("The old common law touchstone of a true lease — the lessor's meaningful residual interest — is reflected in [UCC] Article 2A-Leases."), and at 632 ("As a matter of economic self-interest, a true lessor cares about the quality, energy efficiency, durability, and long-term value of the leased goods, since there is some legitimate possibility that he may get back the goods or otherwise have to dispose of them. * * * Ordinarily, all other things being equal, one might expect rental payments under a true lease to be lower than periodic payments under a disguised sale where the seller, at the outset of the transaction, plans never to deal with the residual. Viewed from the perspective of the economy as a whole, lessees will have more marketplace choices and will receive more meaningful information about the goods they wish to use when the law recognizes the substantive economic differences between a true lease and a sale. One essential difference between the two is that the lessor in a true lease retains a real, economically meaningful interest in the residual."). Yet TRAC vehicle leasing is a well-established commercial practice of long standing that has developed and grown so that today it is the dominant form of commercial vehicle leasing in America, covering millions of vehicles; it lowers lease rental rates and facilitates interstate commerce; and the split-TRAC vehicle lease in common use does preserve a meaningful economic interest in the residual for the lessor. See, e.g., *id.* 638-641; "New Developments: Article 2A Leases of Goods," 1993

Commercial Law Annual 115, 129-130 (canvassing the conflicting case law and spelling out the policy rationale for enacting TRAC/state statutes); and pp. 4-5 *infra* (split-TRAC leases in widespread use are true leases under the principles of the common law and UCC §1-203).

15. Washington state's recent experience illustrates another, additional reason why the TRAC/state laws are best positioned in a state's certificate of title laws and not in the middle of the UCC, where they are subject to being "wiped out" whenever the UCC is periodically updated (once every 5 to 10 years). Washington State first enacted a TRAC/state law in 1994. But that law was inadvertently repealed during a statutory renumbering exercise in 2012. This happened because, when UCC articles are revised or updated, all of the old articles are often deleted and replaced with the newest, multi-hundred-page versions. Unless special legislative efforts are made to preserve "non-uniform" amendments, those fall by the wayside whenever a UCC article is revised or updated in this fashion. Washington state had its 1994 TRAC/state law inadvertently wiped out in this manner, and it had to go to the trouble of re-enacting a TRAC/state law in 2015.

16. Traditionally, the UCC has accommodated and accepted (rather than upset) long-standing mainstream commercial practices like TRAC vehicle leasing. See, e.g., Gilmore, "On the Difficulties of Codifying Commercial Law," 57 Yale L.J. 1341 (1957) ("The principal objects of draftsmen of general commercial legislation — by which I mean legislation which is designed to clarify the law about business transactions rather than to change the habits of the business community — are to be accurate and not to be original."), *id.* at 1351 (in drafting UCC Article 2-sales, "a notable effort has been made to conform the law to current

business practice"). TRAC vehicle leasing of cars and trucks, starting in the 1940s, is older than the Uniform Commercial Code (UCC) drafted by Karl Llewellyn, which was first published as a proposed Code in the early 1950s (see, e.g., Barkley Clark & Louis Del Duca, "Hot Topics in Secured Transactions," 1993 Commercial Law Annual 501, 502 n.4).

17. See, e.g., In re Grubbs Construction Co., 319 B.R. 698 (Bk.M.D.Fla. 2005) (TRAC/state statutes never mentioned by the parties or the Court; unclear whether the case involved vehicles); In re Lash, 2010 WL 5141760 (Bk.M.D.N.C. 2010) (criticized as wrongly decided by "Leases," 66 Business Lawyer 1101, 1105 (2011), because neither the parties nor the Court makes any mention of the TRAC/state statutes enacted in every state).

18. One reason why disputes have arisen about TRAC vehicle leases may be that, historically, equipment lessors have used open-ended, double-edged, unbounded TRAC clauses and other provisions to destroy "true lease" status. This is important in securitization deals, where one must have a "true sale" in order to transfer assets to a bankruptcy-remote entity. But there are different kinds of TRAC clauses: they are not all the same. The overly simplistic view that any kind of TRAC clause destroys true lease status is as wrong as the simplistic, mistaken view that any kind of \$1 purchase option is a death knell for true lease status. See, e.g., In re Marhoefer, 674 F.2d 1139 (7th Cir. 1981) (court holds transaction a true lease despite \$1 purchase option, because lessee was not obligated to continue the lease for eight years until the \$1 purchase option arose).

19. In general: "A lease involves payment for the temporary possession, use and enjoyment of goods, with an expectation that the goods will be returned to

the owner with some expected residual value remaining at the end of the lease term. In contrast, a sale involves an unconditional transfer of absolute title to goods, while a security interest is only an inchoate interest contingent on default and limited to the remaining secured debt." White, Summers & Hillman, *Uniform Commercial Code Treatise* §15:2 n.2 (6th ed. 2015).

20. Compare Frank Lyon v. United States, 435 U.S. 561 (1978) (court holds lease in a sale-leaseback transaction is a true lease, based in part on the owner/lessor's contingent liability for taxes).

21. The overall philosophy of UCC §1-203 is to reject mathematical percentages and formulas (like those in SFAS 13), to avoid "dumbing down" equipment leasing and making equipment leasing into a commodity like a box of corn flakes (where the only competition is on price) and to leave room for creativity and competition in creating new lease products. See "Old Wine in New Bottles," *supra*, 39 Ala.L.Rev. at 628-632 (1988) (summary, history and analysis of the sharpened true lease definition in UCC §1-203, formerly UCC §1-201(37)). The statute was not designed to answer all questions about what is a true lease; instead, the statute is designed to serve the long-term public interest of the Nation by preserving creativity and competition. UCC §1-203 sets forth a common law definition of a true lease that reflects mainstream case law, overrules earlier unsound cases, and liberalizes the overly restrictive, stringent safe harbor standards in the *IRS Guidelines* for issuing advance rulings on leveraged leases in IRS Rev.Proc. 2001-28, 2001-1 C.B. 1156, incorporating old IRS Rev.Proc. 75-21, 1975-1 C.B. 715 (checklist for IRS rulings on leveraged leases).

22. See, e.g., UCC §1-103 (stating UCC's central purposes: "to simplify, clarify and modernize the law governing commercial transactions; [and] to permit the continued expansion of commercial practices through custom, usage and agreement of the parties"); Gilmore, "On the Difficulties of Codifying Commercial Law," *supra* n.16.

23. The original North Carolina TRAC/state law, enacted in the state's UCC in 1994, was clarified in North Carolina's certificate of title laws in 2011, as noted above in the text.

24. The statutory text and legislative history of all the TRAC/state laws are available from AALA General Counsel Edwin E. Huddleson, 1250 Connecticut Ave. N.W., Suite 200, Washington, DC 20036; (202) 543-2233; huddlesone@aol.com; www.edwinhuddleson.com.

25. In re Brankle Brokerage, 394 B.R. 906 (Bk.N.D.Ind. 2008).

26. See, e.g., court decisions listed in footnote 7 *supra*; *Leases*, 67 Business Lawyer 1245, 1248-1249 (2012) (collecting cases on TRAC vehicle leases) and compare Strauss, *General Governing Law: UCC Articles 1, 2A, and 9* (Rel #9 September 2014), in 1 *Equipment Leasing—Leveraged Leasing* §2:1.4[C] (Ian Schrank & Arnold G. Gough eds, 5th ed. 2014) (misguided attack on the true lease character of TRAC vehicle leases, unencumbered by any knowledge of TRAC vehicle leasing or common split-TRAC leases; or the history, purposes and rationale of the TRAC/state laws; or the support of the Commissioners on Uniform State Laws for TRAC/state laws; or the basic public policy purposes of commercial law (see, e.g., UCC §1-103; "New Developments: Article 2A Leases of Goods," 1993 Commercial Law Annual 115, 124-130 (canvassing earlier split case law and spelling out the rationale for the TRAC/state laws)).



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Edwin E. Huddleson is a Washington, D.C.-based lawyer with a general civil practice dating back to 1977, including commercial, vehicle, and equipment leasing; complex civil litigation, and constitutional and administrative law. He has a wide-ranging private practice including Silicon Valley companies, and he is outside counsel to the D.C. Public Service Commission. In 1977, Mr. Huddleson originated the ongoing Harold Leventhal lectures, which are available online. Twice he has co-chaired the D.C. Bar Administrative Law Section, the bar's 2005 section of the year. His practice has represented the vehicle and equipment leasing industries in court (e.g., *Graham vs. Dunkley*, 852 NYS2d 169 (2008) as well as before Congress, the U.S. Treasury and IRS, the Environmental Protection Agency, other federal agencies, and state legislatures. He was involved in drafting UCC Article 2A—Leases (1987, 1990, and 2003) and served on the drafting committee revising UCC Article 5—Letters of Credit. He is active in the American Bar Association (equipment leasing) and the American Law Institute, and belongs to the bar associations of California, Washington, D.C., Maryland, and New York. In addition, he is general counsel to the American Automotive Leasing Association. Mr. Huddleson earned his bachelor's degree from Stanford University (California) and his J.D. from University of Chicago Law School, where he received the Casper Platt Award for his work on the law review. He was law clerk to Judge Charles M. Merrill (USCA9th Circuit).

Equipment ABS Today: New, Improved!

By Stephen T. Whelan

Securitization of equipment leases and loans is on the upswing. Transaction volume has jumped over the last two calendar years. Moreover, delinquency performance has improved. Based on a recent Foundation study, this article evaluates some potential threats to continued growth of equipment asset-backed securitization.

Editor's note: This article is based on the September 2015 Foundation study *Securitization: A Renaissance for Equipment Finance?* researched by Stephen T. Whelan. The study is available at www.leasefoundation.org.

Securitization of equipment leases and loans has evolved in many significant respects since the Equipment Leasing and Finance Foundation published its study in 2011.¹ Not only has annual transaction volume jumped during the last two calendar years (see Figure 1), but also loss and delinquency performance has improved.² This article will discuss recent changes in the equipment asset-backed securitization (ABS) marketplace, evaluate some potential threats to continued growth, and hazard a guess at some future developments.

RECENT CHANGES

Industry participants have observed several developments since the Foundation's 2011 study: securitization of equipment residual values, resecuritization of equity cash flows, and the emergence of new equipment ABS asset classes.

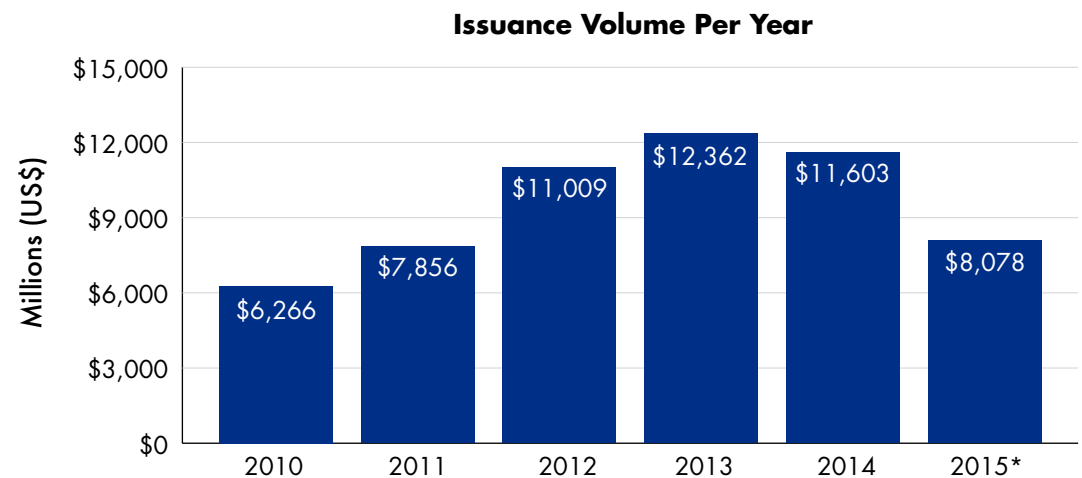
So-called "true" leases contain two assets: the rentals payable by the lessee and the residual value of the equipment at expiration of the lease. When the first equipment ABS financings were closed in April 1985, investors and rating agencies would not finance any of the projected equipment residual values. Not surprisingly, they insisted that all proceeds of

disposition of the equipment — whether at expiration or following default by the lessee — be deposited into the collection account (for all cash flow from the securitized assets) to be allocated in accordance with the securitization waterfall. This insistence resulted in moving the issuing lessor's residual cash flow to the final allocation in the cash flow waterfall,

only after all other expenses, interest, and principal due that month had been paid.

Recent successful securitizations have relied on the ability of lessors to produce several years of residual realization data to support cash flow projections from equipment resale or re-lease. This data has enabled once-skeptical rating agencies

Figure 1. U.S. Equipment Leasing Securitizations



Source: *Asset-Backed Alert*.

*Issuance amount only for second quarter of 2015.

Because government cash grants and tax credits for solar energy are set to expire in the near future, solar energy providers have turned to securitization for financing.

to include a reasonable percentage of projected residual cash flows in the principal amount for an equipment ABS issue in April 2015. Earlier this year, a DBRS-rated note issue monetized a portion of the lessor's booked residual values, using the assumption that 30% of the projected residual value would be received six months after expiration of each true lease contract, hence enabling the sponsor to receive a portion of expected residuals at closing rather than over time.

Similarly, lessors have encountered greater investor acceptance for resecuritization of equity cash flows from prior equipment ABS financings. Resecuritizations (or resecs) involve each issuer of earlier securitiza-

tions selling to a newly formed special purpose entity (SPE) its rights to "bottom bucket" cash flow. The new SPE will issue notes collateralized by those cash flows. The size of the note offering will depend on the lessor's loss, delinquency, and residual realization experience.

Because the resec investors will need reassurance that this equity cash flow actually will be paid to the trustee or paying agent for the resecuritization, it is desirable that the financial institution playing that role be the same one that acts as indenture trustee for the underlying securitizations.

The creativity of securitization finance has been demonstrated as the equipment ABS market has grown from small- and middle-ticket office equipment to include titled motor vehicles, marine containers, and alternative energy equipment (see Figure 2). Recent transactions have highlighted the growth of this market segment to include alternative energy receivables and have increased attention to aviation equipment.

Alternative energy equipment, especially rooftop solar panels and football-field-size solar

arrays, has grown as an asset class because businesses, consumers, and government agencies increasingly seek to reduce their energy costs as well as the dependence of the U.S. economy on fossil fuels. PricewaterhouseCoopers has estimated that residential and commercial capacity for photovoltaic energy is expected to grow at a 22% annual rate between the years 2010 and 2020.³

Because government cash grants and tax credits for solar energy are set to expire in the near future, solar energy providers have turned to securitization for financing.

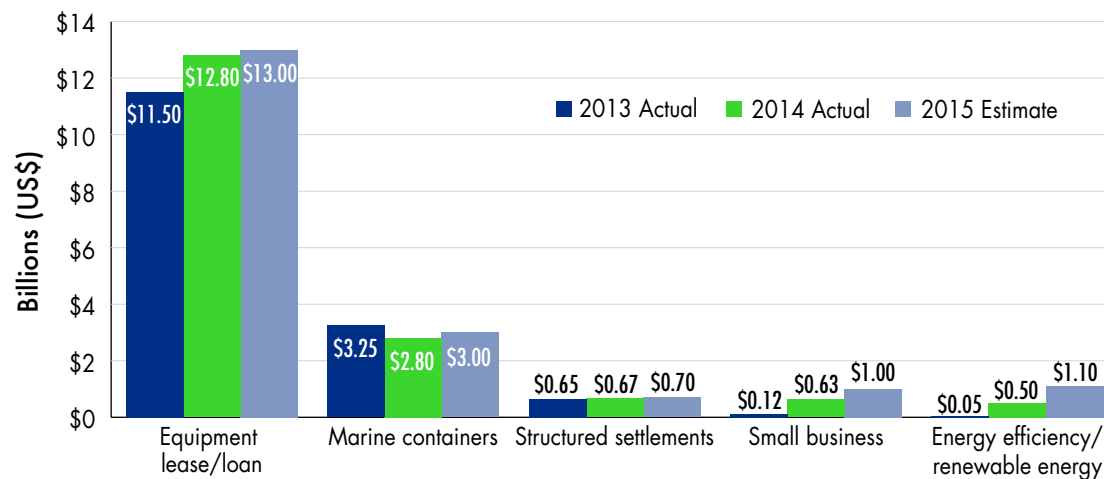
Solar energy receivables chiefly arise from leases and power purchase agreements (PPAs). SolarCity, a California-based company, has completed several successful alternative energy ABS financings with both leases and PPAs comprising the underlying contracts. The first deal, in November 2013, was rated only BBB+ by Standard & Poor's but nonetheless was sold at an attractive interest rate of 4.8%.

Demonstrating the staying power of this emerging equipment ABS segment, SolarCity has issued several other solar ABS financings, with investor interest heightened by inclusion

of a six-month interest reserve account and the underlying equipment averaging only one year old since manufacture. S&P's reports on the SolarCity financings emphasized the importance of the sponsor's ability to address any equipment functionality issues, any obligor defaults, and remarketing of the related equipment.

In contrast, aircraft and engine securitization has been a market segment for more than 10 years, despite significantly suffering during the 2007 financial crisis. In May 2014, S&P reported that "[A] revival of aircraft ABS issuance is underway ... the most since 2007."

Figure 2. ABS Issuance, 2014 Actual versus 2015 Estimate



Source: DBRS, Inc.

In January 2015, Kroll Bond Rating Agency (KBRA) released a research report, concluding “that the overall credit quality of aircraft lessors will continue to strengthen,” and in May 2015 Fitch Ratings released a lengthy report on aircraft operating lease ABS. The headwinds that this asset class encountered appear to have subsided.

Consequently, panelists at the February 2015 Structured Finance Industry Group (SFIG) discussion of aircraft securitization provided an upbeat viewpoint, noting that the current fleet of commercial aircraft is expected to double over the next two decades, with capital markets anticipated to provide roughly 35% of the financing needs for new aircraft.

The panelists also observed that aircraft ABS typically offers investors attractive interest rates compared to the risks that are unique to this asset class. Those risks include greater concentration of values among the underlying contracts; the disconnect between the usual lease terms and the much longer aircraft useful life; the greater length of time required to refurbish off-lease aircraft before it can

be sold or re-leased; fuel price volatility; and technological obsolescence, especially after a particular model of airframe has been manufactured for more than 10 years.

POTENTIAL THREATS

Like all securitized asset classes, equipment ABS faces several threats, both economic and regulatory. Industry professionals, surveyed for the 2015 Foundation study of securitization, identified inflation and rising interest rates as threats to Equipment ABS. Specifically, they noted that the U.S. economy has experienced a significant secular decline in long-term interest rates since 1982, and predicted that the Federal Reserve Board will increase the federal funds rate, starting in late 2015 or early 2016.

Countervailing considerations include the KBRA forecast that the dollar yield curve is likely to flatten, thereby reducing the immediate impact of any Federal Reserve Board increase in short-term interest rates. Other commentators believe that any inflation in asset values would have the effect of increasing nominal equipment residual

values, thereby making equipment ABS more secure.

The greatest source of uncertainty, though, arises from whether the exceptionally good lessee and borrower performance of recent years can continue, especially if competitive pressures prevent leasing companies from hiking rental and borrowing rates to compensate for a higher interest rate environment.

Regulatory threats arise from the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, specifically its provisions for risk retention, obligor data disclosure, and random assignment of rating agencies for all securitized issuances.

Risk retention is required under recently issued Regulation RR, effective December 24, 2016, for equipment ABS and other nonmortgage securitizations. A person who organized and initiates an ABS transaction by selling or transferring assets, either directly or indirectly (including through an affiliate), to the issuer of the ABS must retain the aggregate credit risk equal to 5% of the fair market value of the assets underlying

the equipment ABS issue. This can occur through horizontal ownership (ownership of the unsecuritized cash flow, including equipment residual values, and one or more of the most subordinated classes of ABS) or vertical ownership (ownership of the same percentage of every class of the ABS interests, including the equity in the issuer). An eligible reserve account, as has been used for many years in most equipment ABS, also can contribute to satisfying the risk retention requirement.

Thanks in large part to advocacy efforts by the Equipment Leasing and Finance Association, Regulation RR did not contain certain pernicious elements which, however inadvertently, would have disadvantaged equipment ABS. However, the final regulation requires that the sponsor of an ABS deal disclose the methodology by which it has calculated how its risk retention for that deal complies with the required level. These calculations would involve projected default and recovery experience for the collateral pool, along with an explanation of how the anticipated residual values were estimated, and hence implicate the

sponsor’s proprietary formula for estimating residual realization.

All this data would be revealed to potential investors and inevitably could be shared with other investors and competitors of the sponsor — a source of considerable discomfort to sponsors. Some clue regarding how this disclosure might be accomplished can be discerned starting in December 24, 2015, when Regulation RR becomes applicable to mortgage-backed securities issued on or after that date.

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Another dilemma under Dodd-Frank relates to the possibility that sponsors may have to disclose to potential investors data on each lease and loan in the collateral pool. When the

Software lease and license agreements both involve scheduled cash flow, often utilizing a hell-or-high-water installment payment agreement to enable vendors to finance receivables with institutional investors that are familiar with equipment finance.

SEC promulgated its asset-level data requirements for certain securitization transactions, it hinted that consideration was still underway regarding whether asset-level data would be required, at a later date, for equipment ABS.

ELFA and SFIG have protested that this disclosure could enable competitors to reverse-engineer that data to identify proprietary trade metrics of the sponsor, to determine particular clients of the sponsor, or to invade the privacy of those obligors — and in any event would increase compliance costs. In the industry survey that was

part of the 2015 Foundation study of securitization, one company protested that “if loan-level disclosure is required by the SEC for equipment ABS, it will cause a major disruption to the sector due to competitive issues with releasing confidential marketing data.”

A third threat to equipment ABS that could arise under Dodd-Frank is the mandate under the Restore Integrity to Credit Rating Amendment (the Franken Amendment) that the SEC issue rules requiring random assignment of rating agencies to provide the “initial” rating for any mortgage-backed or asset-backed security, unless (as Dodd-Frank states) the SEC were to declare that another system would provide superior protection for ABS and MBS investors than the Franken Amendment.

Observers have perceived the disruption that could result from the Franken scheme, not only because the assigned rating agency might not possess the expertise with equipment ABS that the agencies mentioned in the 2015 Foundation study have demonstrated, but also because the assigned agency would possess veto power

over the sponsor’s legal right to obtain a rating from any other agency until the assigned agency had issued its opinion. That veto power arguably could enable the gatekeeper agency to insist on legal opinions that never had been given in equipment ABS transactions or that might not even be accurate as a matter of law.

CRYSTAL BALL TIME

Securitization is complex, time-consuming, and expensive — especially for a sponsor’s first equipment ABS transaction. New regulatory requirements are expected to increase the cost of this kind of financing. Plus, it takes only one transaction participant (such as counsel for one of the trustees) to drive up overall deal expenses, by raising issues (not encountered in previous securitizations) that all deal players have to confront. The sponsor’s inside counsel and CFO will have to devote considerable time and problem-solving effort to managing issues as they arise, or else the external costs of securitization will balloon. Especially in the titled equipment sector, a sponsor must have the foresight to document ownership of and

security interests in its financed vehicles, in order to accommodate a future equipment ABS transaction.

Nevertheless, the opportunities presented by equipment ABS financing outweigh these regulatory and cost concerns. For one thing, the growing acceptance of electronic chattel paper (ECP) leases and loans holds the promise of facilitating both the contract checkin process as well as the transfer of document control from the sponsor to the SPE, and then to the equipment ABS indenture trustee.

ECP also streamlines the substitution or release of contracts from the ABS collateral pool. DBRS examined this advantage in its May 11, 2015, weekly alert, “Use of E-Contracts in Asset-Backed Securitization,” noting that e-contracting can reduce fraud risk and improve access to real-time information on contract modifications.

Other opportunities abound. In addition to the aircraft and alternative energy classes, observers have identified several emerging asset classes for equipment ABS. Businesses increasingly have insisted that

leasing companies provide bundled solutions encompassing software and services as well as equipment. Software lease and license agreements both involve scheduled cash flow, often utilizing a hell-or-high-water installment payment agreement to enable vendors to finance receivables with institutional investors that are familiar with equipment finance.

Recently, limited amounts of software receivables have been included in the collateral pool for equipment ABS transactions. Many commentators predict that the software proportion will grow (based on demand from business users of equipment), and they speculate that eventually an entire ABS collateral pool will consist of receivables under software installment payment agreements. One rating agency has mused that future ABS may even include equipment service fees (from reputable service providers) as securitization collateral.

Equipment ABS issuance has surged since 2011, fueled largely by favorable loss and delinquency experience and by the perception that equipment ABS is one of the safer ABS classes. Despite the daunting

costs and potential regulatory hurdles, the emergence of new equipment ABS classes, coupled with the creative uses to which securitization can be applied, suggest a robust future for equipment ABS.

Endnotes

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