PROBLEMS: Leases

FACT PATTERN: Lease Co. owns widget machines. It leases these widget machines to manufacturing companies. Widget Co., a widget manufacturing company, leases three of these machines from Lease Co. You represent Lease Co. as outside counsel. Lease Co. has just called you to a meeting because Widget Co. has filed for bankruptcy protection under Chapter 11. Attending the meeting are Lois Lessor, the president of Lease Co., Fred Financial, the treasurer of Lease Co. and Smarty Pants, in-house counsel to Lease Co. Mark each statement that you agree with as TRUE and each statement that you disagree with as FALSE.

1. Smarty Pants opens the meeting by stating, "We should be in great shape because each transaction with Widget Co. is clearly marked as a lease and courts will look to this stated intent of the parties as extremely significant in determining that the transactions were leases rather than secured financings." (a) TRUE. (b) FALSE.
2. Lois expresses concern over the transactions because the lease payments exceed the value of the equipment leased. Smarty Pants remarks, "The present value of the lease payments can equal or exceed the fair market value of the machines without converting the transaction into a secured financing." (a) TRUE. (b) FALSE.
3. Fred remarks that the original term of Lease No. 1 exceeds the remaining economic life of machine No. 1 and that Widget Co. had assumed the risk of loss of machine No. 1. Smarty Pants remarks, "Darn. These two factors, in combination, convert the lease transaction into a secured financing. Lease Co. has no meaningful residual interest." (a) TRUE. (b) FALSE.
4. Fred remarks that the original term of Lease No. 2 is half the remaining economic life of machine No. 2 but that Widget Co. had agreed in the lease to renew the lease for a second term of equal length at the conclusion of the first lease term. Smarty Pants remarks, "This looks bad. However, this will not convert the lease into a secured financing unless the lease is not subject to termination by Widget Co." (a) TRUE. (b) FALSE.
5. Lois comments that she is very glad that she ordered outside counsel to file financing statements against all the lessees, naming Lease Co. as the lessor. Smarty Pants frowns and says, "Those filings have me worried. Filing the financing statements makes it look like we intended these transactions to be secured financings all along, and not leases." (a) TRUE. (b) FALSE.

6. Fred remarks that at the conclusion of the term of Lease No. 3, Widget Co. can purchase machine No. 3 for $1. Smarty Pants remarks, “This looks bad. Lease No. 3 will be a secured financing if Widget Co. may not cancel the lease.” (a) TRUE. (b) FALSE.
7. Lois points out that machine No. 1 has become obsolete and now has no real material value. Thus, the original term of the lease now exceeds the remaining economic life of the machine (though at the time the lease was entered into, the machine’s expected useful life exceeded the lease term by 3 years). Smarty Pants remarks, “This is acceptable. Useful life will be assessed at the time the lease was entered into, not with 20-20 hindsight.” (a) TRUE. (b) FALSE.