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Selling Lease Receivables in a Post-Enron World –

True-sale Opinions and Revenue Recognition

By William S. Veatch

Many lessors, both independent and captive, currently find their agreements for the sale of lease receivables under an increased level of scrutiny from their auditors. To some extent, this is an unfortunate side effect of widely publicized abuses of the accounting rules by a small number of companies. But in part it is due to a recognition that certain practices have developed in the leasing industry in connection with the sale of lease receivables that may be inconsistent with the notion of a nonrecourse, off-balance sheet, true sale of receivables.

To further complicate matters, equipment lease receivables often include a software and/or a service fee component. This can have a profound effect on the way in which a sale of receivables is treated under the Uniform Commercial Code (UCC) as well as under the various applicable accounting and true-sale legal rules.

This article examines in detail some of the many ways in which accounting rules can influence how attorneys draft agreements for the sale and purchase of equipment lease receivables. It also examines some provisions of Article 9 of the UCC that are relevant to true sales of receivables.[1] This article assumes that the lessor's auditors have requested a true-sale legal opinion and that the volume of lease receivables sold is material to the lessor's business.

The goal of this article is to illustrate one possible way to meet the reasonable expectations of the lessor and the buyer of lease receivables, yet make it possible for the lessor's counsel to issue a well-reasoned true-sale legal opinion.

IS TRUE-SALE TREATMENT APPROPRIATE FOR THE TRANSACTION?

As a threshold matter, the lessor and the buyer should ask whether "true sale" treatment is appropriate for the transaction in question. As a general rule, in order to have a true sale, (1) the buyer must not have excessive recourse to the lessor, and (2) the lessor must be willing to give up control over the lease portfolio, including the right to any possible upside in the portfolio. Otherwise, the transaction looks more like a loan and should be treated as such under the applicable accounting rules.

For a variety of reasons, such as the following, a nonrecourse true sale may not be feasible.

Lessee credit risk. The buyer may not be willing to accept the credit risk of the lessees in the portfolio without recourse to the lessor. With limited exceptions discussed below, in order to be a true sale the sale must be without recourse to the lessor.

Control by the seller—recapture of upside. The lessor may not be willing to give up the potential upside in the portfolio and may desire an option to buy the portfolio back. With limited exceptions discussed below, the lessor must be willing to give up not only control over the portfolio but also the ability to recapture upside, if the lessor wants to achieve true-sale treatment.

Legal risk and documentation risk. In some heavily negotiated lease transactions, the underlying lease receivable may not constitute a firm, noncancelable payment obligation of the lessee. For example, the lease may not

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contain a strong hell-or-high-water clause or waiver of defenses against assignees. Another problematic example is where a lessor who is also the manufacturer uses a combined form of lease and maintenance service agreement. If the agreement is not properly drafted, a maintenance breach by the lessor can lead to a defense to payment of rent by the lessee. It is unlikely that a buyer will be willing to purchase a lease portfolio without recourse to the lessor, if the leases can be canceled upon a performance breach by the lessor.

Performance risk. Sometimes the receivables are "future receivables" that do not exist yet and have not yet been earned by performance of the lessor. For example, receivables that relate to future service obligations or future deliverables that have not yet been earned by performance may be difficult to sell on a nonrecourse basis. A buyer is often willing to accept lessee credit risk but not the risk that the receivable may not exist or be enforceable at all.[2]

In all the above examples, either (1) there are risks inherent in the lease receivables that the buyer is unwilling to assume, or (2) the lessor is not willing to give up the potential upside in the asset for the price that the buyer is willing to pay. As a result, the buyer may not be willing to purchase the lease receivables without recourse to the lessor, or the lessor may not be willing to give up control over the lease receivables.

In any of these cases, the parties should acknowledge the situation up front and not try to get off-balance sheet, true-sale treatment. If true-sale treatment is appropriate, then the legal counsel for the lessor and the buyer need to be aware of a number of drafting issues.

TRUE-SALE OPINIONS RENDERED PURSUANT TO FAS 140

In recent months, accounting firms have increased the level of scrutiny of many forms of off-balance sheet financing, including true sales of lease receivables. In order to meet the requirement under FAS 140 that the transferred receivables have been "isolated beyond the reach of the transferor and its creditors," even in a bankruptcy of the transferor, the auditors are increasingly asking the lessor's counsel to provide a true-sale legal opinion.[3]

The true-sale legal opinion primarily turns on two key questions:

Has risk of loss shifted to the buyer? In order to constitute a true sale, the buyer must assume the risk that the lessee is financially unable to pay on the lease receivables. In other words, the buyer must not have excessive recourse to the lessor. Prohibited recourse can take many forms, including direct recourse, contract damages, put rights, holdbacks from the purchase price, reserves, guaranties, collateral, or subordination of other payment streams owned by lessor. Some forms of limited recourse that are permitted are discussed in detail below.

Has the buyer acquired the benefits of ownership of the lease receivable? In order to constitute a true sale, the buyer must be entitled to all the benefits of ownership, including any upside inherent in the lease receivables. For example, if the lessor sells a lease rental stream at a time when discount rates are high, the lessor might like the idea of having a repurchase right so that the lessor could repurchase the receivables and refinance them at a lower rate if discount rates should drop. However, this control over the lease receivables and ability to recapture upside is inconsistent with the notion of a true sale.

Although these concepts may appear simple and straightforward, the true-sale analysis in a typical lease portfolio sale transaction can become quite complicated. The following are some of the most important true-sale legal issues that arise in a typical lease portfolio sale. It is important to note that the true-sale analysis requires careful consideration of all the facts and circumstances, so in many cases no single factor is determinative.[4]

Intent of the Parties

The intent of the parties, as evidenced by both the words and the conduct of the parties, is an important factor in the true-sale legal analysis. As a result, both the lessor and the buyer should covenant to treat the sale of the lease receivables as a sale for tax, accounting, and all other purposes.

Notice to the Lessees of the Assignment

Failure to notify the underlying obligors of a transfer of receivables to a buyer has been deemed indicative of a secured loan rather than a true sale of receivables.[5] Although this factor may not in and of itself be fatal to the true-sale characterization, the parties should consider carefully whether it is really necessary from a business perspective to avoid giving notice of assignment to the lessees. Even if notice is given, the lessor may be able to collect the lease receivables as collecting agent for the buyer, although, as discussed below, collection by the lessor is a negative factor in the true-sale analysis.

Representations and Warranties

Customary representations and warranties are generally considered acceptable under the true-sale analysis if they are made as of the date of sale, they concern the nature of the receivables sold, and they do not go to the issue of collectibility or financial inability of the lessee to pay. If such an acceptable representation and warranty were breached, the buyer could have full recourse to the lessor for its damages.

For example, a representation and warranty that “the lessee is not bankrupt” would be acceptable if made as of the date of sale, but it would not be acceptable if the representation and warranty were brought down or restated on a regular basis with respect to the old receivables each time new receivables were purchased. In the latter case, the representation and warranty in effect would be transformed into a covenant or guaranty of the lessee’s solvency, which would violate the true-sale rules.

Covenants

As a general rule, in a true sale of receivables transaction, ongoing covenants after the date of sale should not give rise to recourse to the lessor that would in effect transform the purported sale into a loan transaction. Ideally, after the date of sale, there would not be any ongoing involvement between the lessor and the buyer, or the lessor and the sold receivables. As this frequently is not the case, any ongoing involvement or covenants need to be carefully scrutinized.

Also, in a true-sale transaction, as a general rule, covenant breaches should not give rise to a put right or other recourse that in effect requires the lessor to return the price that was paid for the lease receivables. If the lease receivables are noncancelable, fully earned payment obligations of the lessee, then the buyer is typically willing to purchase such receivables without recourse to the lessor.

Alleged Breach or Proven Breach?

Supposing that the representation and warranty is of an acceptable type, what is the appropriate standard for determining whether the lessor is in breach? A mere allegation of a breach by the lessor is probably not sufficient under the true-sale analysis, because every time a lessee is in default, it is apt to allege some breach by the lessor.

On the other hand, requiring the buyer to exhaust all remedies in connection with enforcement of the lease—and requiring a final judgment by the court that the nonpayment of rent by the lessee was justified due to the lessor’s breach—may not be a practical solution either. Sometimes the best solution is to be silent in the purchase agreement as to what the applicable standard is.

Security Interest in the Leased Equipment

As mentioned earlier, generally speaking,

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the lessor's granting of a security interest in assets of the lessor to secure the rent constitutes a form of prohibited recourse under the true-sale analysis. However, if a buyer purchases the rental stream under a lease but not the residual interest in the equipment under a true lease, does that mean that the buyer cannot take a security interest in the equipment or enter into some other title retention mechanism as security?

Given that the purchased rental stream represents the right to use the equipment for the lease term, it should be acceptable under the true-sale analysis for the equipment to secure the purchased rent payments. In other words, by granting a security interest in the leased equipment to secure the rent payments, the lessor is not giving up anything of value, since the rental stream representing the value of the equipment during the lease term was already sold. The residual interest in equipment that is retained by the lessor is, by its very nature, only what is left over after the rent is paid.

Stated another way, the lessor would receive a windfall upon a lessee's default if the lessor could dispose of the equipment and keep all the proceeds. However, since in the example the lessor did not sell the residual interest in the equipment, care must be taken to ensure that the excess value of the equipment—over and above the present value of the remaining rent—does not secure other amounts owing to the buyer. In other words, to protect the lessor's residual interest in the equipment, the security interest should secure only the lessee's rent obligation, not other amounts that might be owing to the buyer such as costs of collection.[6]

Upgrades Not Involving Termination of a Lease Schedule

In some circumstances, a lessee may want to replace, or obtain an add-on to, an item of leased equipment (collectively, an "upgrade"), which will result in an increase in rent. Often the parties desire to accomplish the upgrade without terminating the original lease. If so, there are several possible scenarios.

If the buyer of the rent under the original lease (the "original buyer") is willing to finance the upgrade, then the original lease can simply be amended to refer to the upgrade and the increased rent obligation.

If, however, the original buyer is not willing to finance the upgrade, then typically either (1) the lessor finances the upgrade itself, (2) a new funding source finances the upgrade, or (3) the lessee terminates the original lease and refinances the old equipment and the upgrade under a new lease that is purchased by the new funding source.

In these first two scenarios, the parties should enter into a simple intercreditor agreement providing for a pro rata sharing between the lessor and the original buyer, or between the original buyer and the new funding source, as the case may be. The third scenario, where the original lease is terminated, is discussed below. However, the one scenario that is likely not permitted under the true-sale rules is a put by the original buyer to the lessor. An obligation on the part of the lessor to repurchase lease receivables in the event of an upgrade would appear to be inconsistent with the notion of a true sale.

Upgrades Involving Termination of a Lease Schedule

Often in connection with an upgrade, the lessee wants the right to terminate the lease prior to the expiration of the original lease term. If such a right is negotiated by the lessee in the lease, then the lessor should exercise care to include an appropriate prepayment penalty to be paid by the lessee. Otherwise the lessor may have trouble selling the lease on a nonrecourse basis.

Another possible true-sale issue can arise if the lessor, on behalf of the lessee, negotiates in the agreement with the buyer a right to prepay the lease receivables. The problem is that such a prepayment right could allow the lessor to refinance lease receivables at a lower discount rate and for a higher purchase price, if interest rates drop. Such a right to refinance the lease receivables and recapture upside due to a drop in interest rates would appear to be inconsistent with the notion of a true sale. The key here is to exercise care in the drafting of any upgrade provisions. Ideally, the early termination right should be in the lease, not in the purchase agreement between the lessor and the buyer.

Taxes and Insurance

In a true-sale transaction, the buyer must accept both the benefits and the burdens of ownership of the transferred receivables. In a typical triple net lease, the lessee will bear the burden of taxes (other than taxes on the income of the lessor) and insurance. If, however, the lessee fails to pay taxes or insurance, then as between the lessor and the buyer of the lease receivables, the buyer should bear this risk for the term of the lease.

Maintenance of Leased Products

If the buyer purchases service fees, the purchase often can be with full recourse to the lessor. The reason for this is that the lessor typically cannot recognize revenue on the service fees until the services are performed anyway. Therefore, it is not necessary for the sale of maintenance and other service receivables to be documented as a true sale.

It is critical to the true sale of lease receivables, however, that a maintenance or other service breach not give rise to a right of the buyer to put the purchased lease receivables back to the lessor or a right to exercise some other form of recourse against the lessor. Otherwise, the purported sale starts to look more like a loan.

For example, if the buyer has a right to put the lease receivables back to the lessor upon a lessor breach of related service contracts with the lessees, then in the event of a liquidation of the lessor in bankruptcy—a situation where the lessor is not likely to be able to continue servicing—the buyer could put all the lease receivables back to the lessor. This is the exact opposite of the result required in order to have a true sale of receivables.

Replacement Maintenance Service Provider

One possible solution to the maintenance services issue is to provide that, in the event of a service breach by the lessor, the lessor will agree to assign the maintenance fees to a replacement service provider. This arrangement could also be supported by a security interest in the maintenance fees to secure this covenant, and a lockbox or collection account into which the maintenance fees are deposited, so that the maintenance fees can be redirected to the replacement servicer upon a service default by the lessor.

Of course, this approach assumes that the services are of a type that can be performed by a third-party replacement servicer and that the maintenance fees negotiated by the lessor are at a market rate. Otherwise, the buyer might have to cover any shortfall in the event that the replacement servicer charges a higher fee.

Collection of the Lease Receivables

Often the lessor wants to continue to collect the sold receivables after the sale to the buyer. This is typically done for valid business reasons, as the lessor has an interest in maintaining control over the customer relationship. The lessor may have other leases and/or service agreements with the same customer, and it is desirable from a business standpoint for the lessor to bill and collect amounts owing from that customer.

Although collection by the lessor is a negative factor in the true-sale analysis, it can often by outweighed by other positive factors, including (1) notifying the lessee of the sale, even though the lessor will continue to act as collecting agent for the buyer, and (2) giving the buyer an unfettered right to take over servicing at any time, or in any event upon a collection default by the lessor.

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Cost of Enforcement of the Lease

The cost of enforcement of the lease is one of the risks that a buyer accepts in a true sale of receivables. Therefore, the lessor must be careful that it does not inadvertently end up bearing the costs of enforcement. For example, provisions regarding the collection of receivables sometimes allow for a payment waterfall, where the buyer receives its costs and expenses of collection before the lessor receives its residual interest or related service fees. This subordination of residual interest and/or service fees is a negative factor in the true-sale analysis.

Remarketing of Equipment upon Lessee Default

One of the burdens that the buyer of lease receivables accepts in a true-sale transaction is the risk that the lessee may default and that the buyer may have to sell or foreclose on its security interest in the related equipment. In the vendor finance context, the buyer often wants the manufacturer-lessor to assist with remarketing the equipment.

Such remarketing assistance is permitted under the true-sale analysis, so long as (1) the lessor is receiving market rate compensation for its remarketing services, and (2) if the lessor retained the residual interest in the equipment, the lessor receives any excess proceeds of remarketing after the buyer recovers the net present value of the unpaid rents.

Naturally, if the buyer purchased the equipment residuals for fair value, then the buyer would keep all the remarketing proceeds. However, if the equipment is not so purchased, but title to it is nonetheless transferred along with the assigned rent, with title reverting back to the lessor for nominal consideration at the end of the lease term, the transfer would be deemed to be merely a security interest in the equipment, and the lessor would be entitled to any surplus proceeds of foreclosure.

Repurchase or Put Rights

Generally speaking, rights on the part of the buyer to cause the lessor to repurchase the lease portfolio as a remedy should be limited to breaches of customary representations and warranties made as of the date of sale, as discussed above. If the buyer's put right is more broadly exercisable upon other events, such as a credit default by the lessee, then the transaction will look more like a loan than a true sale.

Indemnities from the Lessor

In some circumstances the lessor may be permitted under the true-sale analysis to indemnify the buyer for third-party claims other than claims brought by the lessee. If, however, the lessor indemnifies the buyer for claims made by the lessee, resulting from an alleged breach by the lessor, this could be inconsistent with the notion of a true sale. In effect, the buyer could put the rent back to the lessor upon a mere allegation of a breach by the lessor.

On the other hand, an indemnity for third-party claims brought by other than the lessee for infringement of copyright or patent rights probably would be permitted as a customary indemnity, so long as there was no reason to believe that the technology embedded in the leased equipment actually violated some third party's intellectual property rights.

Although several examples of negative factors are illustrated in the examples above, it is important to note that the true-sale legal analysis requires a balancing of all of the facts and circumstances in the transaction. No one factor is necessarily determinative. Unfortunately, there is no safe harbor for true sales of receivables, so true-sale legal opinions are typically reasoned opinions that are complicated and can be very difficult to render. Even if the lessor's counsel renders a true-sale legal opinion, the lessor must still comply with all the other accounting rules set forth in FAS 140.

SELECTED ISSUES UNDER UCC

Perfection by Filing or Possession

UCC Article 9 governs the perfection and priority of both loans secured by lease receivables and true sales of receivables.[7] The basic rules are familiar to most lessors:

1. Loans secured by accounts, instruments, chattel paper, or payment intangibles can be perfected by filing a UCC-1 financing statement (UCC Sec. 9-310 and Sec. 9-312(a)).

2. Loans secured by tangible chattel paper or instruments can also be perfected by taking possession of the collateral (UCC Sec. 9-313).

3. Sales of accounts (unless covered by the automatic perfection rule) and tangible chattel paper can be perfected by filing a UCC-1 financing statement (UCC Sec. 9-310).

4. Sales of tangible chattel paper can also be perfected by taking possession of the tangible chattel paper (UCC Sec. 9-313).

5. Certain other sales of receivables are automatically perfected upon attachment, as discussed below (UCC Sec. 9-309).

Automatic Perfection

UCC Sec. 9-309 provides that certain transactions are perfected automatically upon attachment,[8] including, among others (1) an assignment of accounts (such as software license royalties) or payment intangibles (such as unsecured loans) that does not transfer a significant part of the assignor's outstanding accounts or payment intangibles,[9] (2) a sale of a payment intangible, or (3) a sale of a promissory note (such as an installment payment agreement used to finance software license fees).

The prevailing view at this time is that automatic perfection is the only means of perfecting the above sale transactions; in other words, filing a UCC-1 financing statement would be ineffective. One of the implications of this rule is that a buyer cannot lock in a date of priority with respect to future sales of such receivables by filing a UCC-1 financing statement, because the security interest does not attach until the seller has rights in the receivables.

In contrast, in the case of loans secured by receivables, the UCC allows a lender to prefile with respect to future advances, in effect locking in the date of priority to the date of filing of the UCC-1 financing statement. As a practical matter, the buyer of receivables governed by the automatic perfection rule must order regular UCC searches to ensure that there are no intervening secured loans since the last purchase was made.

Because the sales of receivables listed above are automatically perfected, a prior sale would not show up in a UCC search. Therefore, a buyer must rely on representations and warranties of the seller to ensure that there has not been a prior sale of such receivables, which of course could happen only if there had been fraud or gross negligence on the part of the seller.

Distinguishing Loans from True Sales Under UCC

Although UCC Article 9 provides rules for perfection and priority, it does not provide guidance for determining whether a purported sale of receivables is a true sale or a disguised loan. There are, however, several sections in UCC Article 9 that treat true sales and secured loans differently, including the following ones.

UCC Sec. 9-318(a). UCC Sec. 9-318(a) states that "A debtor that has sold an account, chattel paper, payment intangible, or promissory note does not retain a legal or equitable interest in the collateral sold." This section assumes, however, that the sale is a "true sale" and not a disguised loan, and this section does not provide any guidance for making the distinction between a sale and a loan, which is an issue governed by other state

Although UCC Article 9 provides rules for perfection and priority, it does not provide guidance for determining whether a purported sale of receivables is a true sale or a disguised loan.

A buyer of chattel paper or instruments is well advised either to take possession of the original paper or to legend the paper appropriately so as to put a subsequent purchaser on notice.

law. It would seem, however, that under the terms of the purchase agreement, a seller of receivables would be well advised to not retain any legal or equitable interest in the receivables sold, so as not to create a conflict with this section.

UCC Sec. 9-318(b). Under UCC Sec. 9-318(b), a seller of an account or chattel paper in an unperfected true-sale transaction can still sell the account or chattel paper to a second buyer, although it would amount to fraud or gross negligence on the part of the seller. If the second buyer perfects the second sale, then the second buyer will have priority over the first buyer who failed to perfect, notwithstanding the true sale to the first buyer.

Lessons to be learned from these rules are: (1) the first buyer of lease receivables in a true-sale transaction may not have priority over subsequent buyers or other secured creditors of the seller if the first sale is not perfected, and (2) implicit in UCC Sec. 9-318(b) is the assumption that perfection is not a necessary element of a true sale of accounts or chattel paper. Stated another way, a true-sale legal opinion should not be viewed as a perfection or priority opinion.[10] Clearly, if a buyer wants to have priority with respect to purchased lease receivables, then the buyer should perfect and take appropriate steps to ensure a first-priority position.

UCC Sec. 9-330(b) and (d). Note that sales of existing payment intangibles and promissory notes are automatically perfected upon attachment (that is, upon execution of the agreement of sale), so lack of perfection is not an issue in such transactions. However, UCC 9-330 provides that a second buyer[11] of chattel paper or instruments (including promissory notes) who takes possession of the original chattel paper or instruments in good faith, for value, and without knowledge that the purchase violates the rights of a secured party (and who meets certain other requirements) takes priority over prior buyers or secured creditors.

Lessons to be learned from these rules are:

1. Notwithstanding a perfected true sale of chattel paper or instruments to a first buyer, a seller can, albeit fraudulently or with gross negligence, sell to a second buyer and the second buyer will have priority in the transferred receivables if the second buyer takes possession of the original chattel paper or instrument.

2. Implicit in the UCC rules is an assumption that a first-priority security interest is not a necessary element of a true sale of chattel paper or instruments.

In light of these rules, a buyer of chattel paper (such as equipment leases) or instruments is well advised either to take possession of the original paper or to legend the paper appropriately so as to put a subsequent purchaser on notice. The buyer should not rely on a true-sale opinion as evidence of perfection or priority.

UCC Sec. 9-323(c) future advances. The rules in UCC 9-323(c) regarding future advances do not apply to sales of accounts, chattel paper, payment intangibles, or promissory notes.

UCC Sec. 9-601(g) duties of a secured party. UCC Sec. 9-601(g) provides that, except for certain exceptions in UCC Sec. 9-607(c) regarding the duty to act in a commercially reasonable manner, Part 6 of Article 9 of UCC "imposes no duties upon a secured party that is a consignor or is a buyer of accounts, chattel paper, payment intangibles, or promissory notes."

Interestingly, it is unclear how this section would be applied in the context of UCC Sec. 9-623, which gives the debtor a statutory right to redeem the collateral, which in the context of a sale could mean a right to repurchase transferred receivables. Although UCC Sec. 9-623 gives the lessor a right to redeem, the better view is that UCC Sec. 9-601(g) means that the buyer-secured party has no duty to comply with the lessor's request.

UCC Sec. 9-608(b). UCC Sec. 9-608(b) provides that "[i]f the underlying transaction is a sale of accounts, chattel paper, payment intangibles, or promissory notes, the debtor is not entitled to any surplus, and the obligor is not liable for any deficiency." As was the case with UCC Sec. 9-318, UCC Sec. 9-608(b) presumes that the purported sale is a true sale and not a disguised loan.

Risks Associated with Failure to Give Notice of Assignment

Note that there are certain risks to a buyer of receivables if a notice of assignment is not given to the lessee. For example, under UCC Sec. 9-404(a)(2), unless there is an enforceable waiver of defenses against assignees, the rights of the buyer are subject to defenses or claims against the lessor that accrue before the lessee receives notification of assignment. Also, under UCC Sec. 9-405(b)(2), prior to receiving notification of assignment, the lessor and lessee can enter into a modification of, or substitution for, an assigned lease; and the modification or substitution is effective against the buyer so long as it was made in good faith.

Therefore, under both UCC and under the true-sale rules, it is advisable for the parties to provide notice of assignment to the lessee under the assigned lease. Note that even if notice of assignment is provided, the lessor can still collect the lease payments on behalf the buyer with the buyer's consent.

Preemption by Federal Law Regarding Copyrights

It is important to note that, although beyond the scope of this article, perfection of security interests in registered copyrights and proceeds of registered copyrights is preempted by federal law. Therefore, a purchaser of accounts that are royalties under a software license would be well advised to file a notice of the sale in the U.S. Copyright Office if the software license relates to registered copyrights.[12] This issue can arise in connection with the purchase of a lease portfolio if the products financed are software. If the software license relates to unregistered copyrights, a UCC-1 financing statement may be sufficient to perfect the security interest.[13]

However, there is always the risk that the owner of the unregistered copyright may subsequently register the copyright, at which point the secured party who filed only a UCC-1 financing statement would become unperfected. As a result, some secured parties require the debtor to register all material copyrights.

Another argument holds that a true sale of copyright proceeds, as opposed to a loan secured by copyright proceeds, should not be governed by the Copyright Act.[14] However, it will be interesting to see how the courts interpret the relevant cases and statutes in light of the fact that the definition of "security interest" as used in revised UCC Article 9 after July 2001 now includes the interest of a buyer of software license royalties, whereas it did not prior to July 2001.

CONCLUSION

In the current post-Enron environment, lessors who are interested in selling their lease receivables need to reexamine both their standard customer lease documentation and their agreements for the purchase and sale of lease receivables. With care in drafting, lessors can draft documents that both comply with the applicable true-sale legal rules and meet the reasonable expectations of both the buyer and the seller of lease receivables.

However, it is equally important for the parties to recognize that not all transactions are deserving of off-balance sheet, true-sale treatment, in which case the parties would be well advised to acknowledge this fact early on and structure the deal accordingly. Where true-sale legal opinions are required, the legal counsel rendering the opinion should closely scrutinize any continuing involvement between the lessor and the transferred

Both parties should recognize that not all transactions are deserving of off-balance sheet, true-sale treatment, acknowledge this fact early on, and structure the deal accordingly.

In addition to meeting the requirements of the true-sale rules, it is critical to consider the UCC rules regarding perfection and priority, as these perfection and priority rules go beyond the scope of the true-sale analysis.

receivables, or the lessor and the buyer, carefully considering the effect that such continuing involvement would likely have on the true-sale analysis should the characterization of the transaction be challenged.

In addition to meeting the requirements of the true-sale rules, it is critical to consider the UCC rules regarding perfection and priority, as these perfection and priority rules go beyond the scope of the true-sale analysis.

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Endnotes

[1] This article focuses on FAS 140 and the requirement for a true-sale legal opinion. There are, however, other accounting guidelines, such as SOP 97-2, that may have a profound effect on the drafting of agreements for the sale of receivables, but that are beyond the scope of this article.

[2] There is also a performance risk issue that is codified in UCC Sec. 9-405(b)(1), which states that a modification or substitution for an assigned lease is effective against an assignee if made in good faith and "[t]he right to payment or a part thereof under an assigned contract has not been fully earned by performance." The purchase agreement between the lessor and the buyer could provide that a modification or substitution without the buyer's approval would be a default under the purchase agreement, but the change to the lease would still be effective.

[3] Note that there are a number of proposed changes and amendments to FAS 140 in progress. See generally, www.FASB.org/project/qualifying_spe.shtml for an update. For example, one proposed SFAS 140 amendment would require that the transferred assets in a true sale be beyond the reach of creditors that have a "legal right of offset." The implications of such an amendment could be significant.

[4] Cases discussing the true-sale legal issue include the following:

—*Bear v. Coben (In re Golden Plan of California Inc.)*, 829 F.2d 705, 709 (9th Cir. 1986). ("Whether the parties intended outright sales or loans for security is determined from all the facts and circumstances surrounding the transactions at issue.")

—*Mapco Inc. v. United States*, 556 F.2d 1107, 1111-12 (Ct. Cl. 1977). (Buyer's failure to report receivables purchased as income earned deemed evidence that the transaction was a loan.)

—*Major's Furniture Mart Inc. v. Castle Credit Corp.*, 602 F.2d 538, 545 (3d Cir. 1979). (Seller retained full risk of account uncollectibility.)

—*Reaves Brokerage Co. Inc. v. Sunbelt Fruit & Vegetable Co. Inc.*, 336 F.3d 410 (5th Cir. 2003). (The court determined that despite the parties' labeling of the transaction as a true sale and the required notice to the account debtors, certain "recourse" provisions—including a security interest in favor of the assignee covering assets in addition to the purportedly sold accounts receivable—overrode the purported nature of the transaction and caused it to be a secured loan.)

[5] See *Commercial Security Co. v. Holcombe*, 262 F. 657, 661 (5th Cir. 1920); *People v. Service Institute Inc.* 421 N.Y.S.2d 325 (Sup. Ct. 1979).

[6] Note that under UCC Sec. 9-330(c)(2), a purchaser having priority in chattel paper also has priority in proceeds of chattel paper consisting of the specific goods covered by the chattel paper or cash proceeds of the specific goods, even if the purchaser's security interest in the proceeds is unperfected. The priority may be limited, however, to the present value of the rent during the lease term. (See Comment 11 to UCC Sec. 9-330.) Therefore, strictly speaking, a buyer of chattel paper does not need to take a specific security interest in the leased good unless it wants to (1) take a security interest in the lessor's residual interest in goods under a true lease (which may create a true-sale issue), or (2) avoid potential disputes with the lessor's inventory lender, if any, as to the scope of the buyer's priority under UCC Sec. 9-330.

[7] See the definition of "security interest" in UCC Sec. 1-201 and UCC Sec. 9-109, which defines the scope of transactions covered by UCC Article 9.

[8] Under UCC Sec. 9-203(b), generally speaking, attachment occurs if each of the following conditions is satisfied: (1) value has been given, (2) the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party, and (3) the debtor has authenticated a security agreement. In the context of a sale of future receivables, attachment is not likely to occur until the debtor has rights in the receivable.

[9] Interestingly, there is no guidance in the UCC for determining what is a "significant part." This rule would seem to require (1) some inquiry on the part of the buyer regarding the total outstanding accounts or payment intangibles of the lessor on each date of sale, and (2) a determination of whether the amount purchased is significant.

[10] Of course, it remains to be seen how the courts will interpret the 2001 revisions to UCC Article 9. Notwithstanding the approach taken in Article 9 where the true-sale issue is treated as a separate issue from perfection and priority, it is conceivable that a bankruptcy court might hold that perfection is a necessary element of a true sale.

[11] Note that Sec. 9-330(b) and Sec. (d) each use the term "purchaser," which under UCC 1-201 (when read together with the definition of "purchase" in UCC Sec. 1-201) includes both a buyer in a true sale and a lender who takes a security interest in property.

[12] See generally, *In re Peregrine Entertainment, Ltd.*, 116 B.R. 194 (C.D. Cal. 1990); *Zenith Prods. v. AEG Acquisition Corp. (In re AEG Acquisition Corp.)*, 161 B.R. 50 (B.A.P. 9th Cir. Cal. 1993); and *In re Avalon Software*, 209 B.R. 517 (Bankr. D. Ariz. 1997). A host of other complicated issues involving copyrights is beyond the scope of this article. For example, if the royalties arise from a sublicense of an exclusive license of a copyright, then the exclusive license should also be registered. Also, material modifications of a copyright need to be registered from time to time.

[13] See *Aerocon Engineering Inc. v. Silicon Valley Bank (In re World Aux. Power Co.)*, 303 F.3d 1120 (9th Cir. Cal. 2002).

[14] See *Broadcast Music v. Hirsch*, 104 F.3d 1163 (9th Cir. Cal. 1997). In Hirsch, the 9th Circuit stated, "It is sufficient that this case does not involve an assignment of a security interest—there is no evidence that Miller owned a copyright and had a security interest he could assign. Rather, this is a case of outright assignments of a right to receive royalties for the purpose of satisfying a debt. Thus, the rationale for recordation underlying the Peregrine case—to provide notice to prospective creditors or purchasers of the copyright who may rely to their detriment on the appearance of ownership of rights under a copyright—is inapposite."

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