



**House
Legislative
Analysis
Section**

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UCC ARTICLE 2A: LEASES

**Senate Bill 462 (Substitute H-1)
First Analysis (3-9-92)**

**Sponsor: Sen. Dave Honigman
Senate Committee: Corporations &
Economic Development
House Committee: Corporations & Finance**

THE APPARENT PROBLEM:

The leasing of large-scale items ranging from oil-drilling platforms to automobiles is big business in this country, with an estimated dollar volume reaching \$150 billion, yet the laws governing leasing have not kept pace with the intricacies of today's leasing arrangements. Historically, financed purchase transactions have been thought of as conditional sales, which fall under Articles 2 and 9 of the Uniform Commercial Code (UCC). A leasing transaction, however, even though very similar to a conditional sale in many ways, is not clearly subject to the UCC. As a result, the rights and remedies of the lessor and lessee are not well defined, and courts have characterized these transactions differently from jurisdiction to jurisdiction. To fill this gap, the National Conference of Commissioners on Uniform State Laws in 1986 approved a new amendment to the UCC: Article 2A, which provides for the fundamentals of the lease contract, including its formation, express and implied warranties, and damages for breach. Article 2A has been adopted in some 20 states, and has been introduced in approximately 16 others.

THE CONTENT OF THE BILL:

The bill would add Article 2A to the Uniform Commercial Code to govern leases, and would add provisions governing, among other things, the formation and construction of a lease contract, the effect of lease contracts on the rights of third parties, express and implied warranties, performance of a lease contract, and default and the rights of parties to damages and equitable remedies. The bill states that whether a transaction created a lease or a security interest (which would be governed by Article 9) would be determined by the facts of each case, and specifies circumstances under which a transaction would create a security interest. Under the bill, "lease" would mean a transfer of the

right to possession and use of goods for a term in return for consideration; a sale or the retention or creation of a security interest would not be a lease. The bill would take effect September 30, 1992.

The bill contains specific provisions, and in some cases exceptions, for finance leases and consumer leases. A finance lease would be one in which the lessor did not select, manufacture, or supply the goods, and acquired the goods in connection with the lease. A consumer lease would be one made with an individual for his or her individual, family, or household purpose, if the total payments to be made under the lease contract did not exceed \$25,000. The following briefly summarizes the major portions of the bill.

General Provisions/Consumer Protections. In addition to being subject to Article 2a, a lease would be subject to certificate of title statutes of this state or another jurisdiction, and the Michigan Consumer Protection Act. Generally, if such a statute conflicted with Article 2A, the statute would control. If the law chosen by the parties to a consumer lease were that of a jurisdiction in which the lessee did not live when or within 30 days after the lease became enforceable, or a jurisdiction other than one in which the goods were to be used, the choice would not be enforceable.

If a court found that a lease contract or any clause of a lease contract was unconscionable at the time it was made, the court could refuse to enforce the contract, could enforce it without the unconscionable clause, or could limit the application of the unconscionable clause. If a court found that a consumer lease had been induced by unconscionable conduct or that such conduct had occurred in the collection of a claim under a consumer lease, the court could grant appropriate relief. A term allowing one party to accelerate

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payment or performance or require collateral "at will" when the party considered himself or herself insecure, would have to be construed to mean that the party could do so only if in good faith he or she believed that the prospect of payment or performance was impaired.

With respect to a motor vehicle or trailer, notwithstanding any other provision of law, a transaction would not create a sale or security interest merely because it provided that the rental price was permitted or required to be adjusted under the agreement either upward or downward by reference to the amount realized upon the sale or other disposition of the vehicle or trailer.

Formation and Construction. Generally, a lease contract would not be enforceable unless it were in writing, described the goods leased and the lease term, and was signed by the party against whom enforcement was sought or that party's authorized agent. A lease would be enforceable, however, if the total payments to be made under the contract, excluding payments for options to renew or buy, were less than \$1,000. A lease contract that did not meet the requirements for a written lease but was otherwise valid would be enforceable under certain circumstances. In addition, a lease contract could be made in any manner sufficient to show agreement, including conduct by both parties that recognized the existence of a lease contract.

Unless otherwise unambiguously indicated by the language or circumstances, an offer to make a lease contract would have to be construed as inviting acceptance in any manner and by any medium reasonable in the circumstances. The benefit of a supplier's promises to the lessor under a supply contract and of all warranties, would extend to the lessee to the extent of the lessee's leasehold interest under a finance lease related to the supply contract, but would be subject to the terms of the warranty and of the supply contract and all defenses or claims arising from them.

Identification of goods as goods to which a lease contract referred could be made at any time and in any manner explicitly agreed to by the parties. The bill describes when identification would occur in the absence of explicit agreement. The bill also provides for a lessee's insurable interest in identified goods, including nonconforming goods, as well as a lessor's retention of an insurable interest until an

option to buy had been exercised and risk of loss had passed to the lessee.

Except in the case of a finance lease, risk of loss would be retained by the lessor and would not pass to the lessee. In the case of a finance lease, risk of loss would pass to the lessee. The bill specifies rules that would apply if risk of loss were to pass to the lessee and the time of passage were not stated. In addition, specific rules would apply if a lease contract required goods identified when the contract was made, and the goods suffered casualty before delivery without fault of the lessee, lessor, or supplier, or the goods suffered casualty before risk of loss passed to the lessee.

Warranties. Any affirmation of fact or promise made by the lessor to the lessee that related to the goods and became part of the basis of the bargain would create an express warranty that the goods would conform to the affirmation or promise. Any description of the goods that was made part of the basis of the bargain would create an express warranty that the goods would conform to the description. Any sample or model that was made part of the basis of the bargain would create an express warranty that the entire goods would conform to the sample or model.

A lease contract would contain a warranty that for the lease term no person held a claim to or interest in the goods that arose from an act or omission of the lessor, other than a claim by way of infringement or the like, that would interfere with the lessee's enjoyment of its leasehold interest. Except in a finance lease, a lease contract by a lessor who was a merchant regularly dealing in goods of the kind would contain a warranty that the goods were delivered free of the rightful claim of any person by way of infringement or the like. A lessee who furnished specifications to a lessor or a supplier would have to hold the lessor and supplier harmless against any claim by way of infringement or the like that arose out of compliance with the specifications. Generally, to exclude or modify a warranty against interference or infringement, the language would have to be specific, written, and conspicuous.

Except in a finance lease, a warranty that the goods would be merchantable would be implied in a lease contract if the lessor were a merchant with respect to goods of that kind. Merchantable goods would have to meet certain criteria, such as being fit for

the ordinary purposes for which goods of that type were used, and passing without objection in the trade under the description of the lease agreement. Other implied warranties could arise from course of dealing or usage of trade. Additionally, a lease contract--except in a finance lease--would contain an implied warranty that the goods would be fit for a particular purpose if the lessor at the time the contract was made had reason to know of any particular purpose for which the goods were required and that the lessee was relying on the lessor's skill or judgment to select or furnish suitable goods. The implied warranty of merchantability or fitness for a particular purpose could be modified or excluded only as described in the bill, although all implied warranties would be excluded by expressions like "as is" or "with all faults", unless the circumstances indicated otherwise. An implied warranty also could be excluded or modified by course of dealing, course of performance, or usage of trade.

An express or implied warranty to or for the benefit of a lessee would extend to any person who was in the family or household of the lessee or who was a guest in the lessee's home, if it were reasonable to expect that such a person would use, consume, or be affected by the goods, and who was personally injured by breach of the warranty.

Effect of Lease Contract. Except as otherwise provided in Article 2A, a lease contract would be effective and enforceable according to its terms between the parties, against purchasers of the goods, and against creditors of the parties; and each provision of the article would apply whether the lessor or a third party had title to the goods, and whether the lessor, the lessee, or a third party had possession of the goods.

The bill provides for the rights and remedies that would arise pursuant to a provision in a lease agreement that prohibited the transfer of a party's interest or the lessor's residual interest, or that made such a transfer an event of default. A provision that prohibited the creation of a security interest in a party's interest or a lessor's residual interest, or that made such a transfer an event of default, would be unenforceable except to the extent the lessee actually transferred his or her right of possession or use of the goods in violation of the provision, or there was an actual delegation of a material performance of either party in violation of the provision. In the event of a prohibited transfer,

the nontransferring party would have the rights and remedies of a party seeking to enforce a contract under which a lessor or lessee was in default. Under certain circumstances, the transferor would be liable for damages created by the transfer.

A transfer of a lease or of a party's rights under a lease would be a transfer of rights and, unless the language or circumstances indicated the contrary, the transfer would be a delegation of duties by the transferor to the transferee. Unless otherwise agreed to by the lessor and the lessee, a delegation of performance would not relieve the transferor as against the other party of any duty to perform or of any liability for default. In a consumer lease, language that prohibited a transfer or made a transfer an event of default would have to be specific, written, and conspicuous. The bill specifies the interest that a subsequent lessee would obtain from a lessor of goods under an existing lease contract, from a lessor with voidable title, from a lessor who was a merchant, or from a lessor of goods covered by a certificate of title. The bill also specifies the interest that a buyer or sublessee would obtain from a lessee of goods under an existing lease contract, from a lessee with a voidable leasehold interest, from a lessee who was a merchant, or from a lessee of goods covered by a certificate of title.

If a person in the ordinary course of business furnished services or materials with respect to goods subject to a lease contract, a lien upon the goods in that person's possession given by statute or rule of law for those materials or services would take priority over any interest of the lessor or lessee under the lease contract or under Article 2A, unless the statute or rule of law provided otherwise.

Except as specified, a creditor of a lessee would take subject to the lease contract and a creditor of a lessor would take subject to the lease contract. This would not apply, however, if the creditor held a lien that attached to the goods before the lease contract became enforceable; the creditor held a security interest in the goods and the lessee did not give value and receive delivery of the goods without knowledge of the security interest; or the creditor held a security interest in the goods that was perfected before the contract became enforceable. A lessee in the ordinary course of business, however, would take the leasehold interest free of a security interest in the goods created by the lessor even though the security interest was perfected and

the lessee knew of its existence. A lessee other than a lessee in the ordinary course of business would take free of a security interest in future advances, under certain circumstances.

A creditor of a lessor in possession of goods subject to a lease contract could treat the contract as void if, as against the creditor, retention of possession by the lessor were fraudulent under any statute or rule of law, but retention in good faith and current course of trade by the lessor for a commercially reasonable time after the contract became enforceable were not fraudulent. Under similar circumstances, a creditor of a seller could treat a sale or an identification of goods to a contract for sale as void.

Fixtures and Accessions. Under Article 2A, a lease could be of goods that were fixtures or could continue in goods that became fixtures, but no lease would exist under the article of ordinary building materials incorporated into an improvement of land. The article would not prevent the creation of a lease of fixtures pursuant to real estate law. (Goods would be "fixtures" when they became so related to particular real estate that an interest in them arose under real estate law.)

The bill specifies circumstances under which the interest of a lessor of fixtures would have priority over a conflicting interest of an encumbrancer or owner of the real estate, depending on whether the lessor's interest were perfected. The interest of the lessor would be subordinate to the conflicting interest of an encumbrancer under a construction mortgage recorded before the goods became fixtures, if the goods became fixtures before construction was completed. In cases not otherwise provided for, priority between a lessor and an encumbrancer who was not the lessee would be determined by the priority rules governing conflicting interests in real estate. Under certain circumstances, if a lessor had priority over all conflicting interests of all owners and encumbrances, the lessor or lessee could remove the goods from the real estate, free of all conflicting interests, but would have to reimburse an owner or encumbrancer.

Goods would be "accessions" when they were installed in or affixed to other goods. The interest of a lessor or a lessee under a lease contract entered into before the goods became accessions would be superior to all interests in the whole. The

interest of a lessor or lessee under a lease contract entered into at the time or after goods became accessions would be superior to all subsequently acquired interests in the whole, except those existing at the time the contract was made unless the holders of such interests had consented in writing to the lease or disclaimed an interest in the goods as part of the whole. Certain exceptions to these provisions would be made for a buyer or lessee in the ordinary course of business or a creditor with a security interest. A lessor or lessee of accessions who held an interest that was superior to all interests in the whole could remove the goods from the whole under circumstances similar to those under which fixtures could be removed.

Performance of a Lease Contract. A lease contract would impose an obligation on each party that the other's expectation of receiving due performance would not be impaired. If reasonable grounds for insecurity arose with respect to the performance of either party, the insecure party could demand adequate assurance of due performance. Until the insecure party received that assurance, if commercially reasonable the insecure party could suspend any performance. A repudiation of the lease contract would occur if adequate assurance of due performance were not provided to the insecure party within a reasonable time, which could not exceed 30 days after the other party received the demand.

The bill specifies actions that an aggrieved party could take if a party repudiated a lease contract with respect to a performance not yet due and the loss of the performance would substantially impair the contract to the other party. Also, until a repudiating party's next performance was due, the repudiating party could retract the repudiation under certain circumstances. The bill provides for substitute performance for cases in which agreed berthing, loading, or unloading facilities failed or the agreed type of carrier became commercially impracticable, or the agreed means or manner of payment failed because of domestic or foreign governmental regulation. Subject to those provisions, the bill specifies circumstances under which a lessor's or supplier's delay in delivery or nondelivery would not be a default, if the lessor or supplier allocated production and deliveries among his or her customers and gave notice that there would be delay or nondelivery.

The bill also would allow a lessee to terminate the lease contract or (except in a finance lease that was not a consumer lease) modify it because of delay or an allocation, under certain circumstances. In the case of a finance lease that was not a consumer lease, the lessee's promises under the lease contract would become irrevocable and independent upon the lessee's acceptance of the goods.

Default. The bill states that whether the lessor or the lessee was in default under a lease contract would be determined by the lease agreement and Article 2A. If either party were in default, the party seeking enforcement could reduce his or her claim to judgment, or otherwise enforce the lease contract by self-help or any available judicial or nonjudicial procedure. A lease agreement could include rights and remedies in addition to or instead of those provided in the bill and could limit or alter the measure of damages. Damages and consequential damages could be liquidated. A lessee would have a right to restitution if the lessor justifiably withheld or stopped delivery because of the lessee's default or insolvency.

On cancellation or termination, all obligations that were still executory (still to be performed) on both sides would be discharged, but any right based on prior default or performance would survive. A canceling party would retain any remedy for default of the whole lease contract or any unperformed balance. ("Cancellation" would occur when either party put an end to the lease contract for the other party's default. "Termination" would occur when either party pursuant to a power created by an agreement or law put an end to the contract other than for default.) An action for default, including breach of warranty or indemnity, would have to be commenced within four years after the cause of action accrued. The parties could reduce the period of limitations to not less than one year.

If a lessor failed to deliver the goods in conformity to the lease contract or repudiated the contract, or a lessee rightfully rejected the goods or justifiably revoked acceptance of them, the lessor would be in default and the lessee could: cancel the contract; recover as much of the rent and security as had been paid and was just; cover (seek goods from another source) and recover damages as to all goods affected or recover damages for nondelivery; and/or exercise any other rights or pursue any other remedies provided in the contract. If a lessor failed to deliver the goods in conformity to the lease

contract or repudiated the contract, the lessee also could recover the goods, if they had been identified, or, in a proper case, obtain specific performance of the contract or repossess the goods. If a lessor had breached a warranty, the lessee could recover damages. On rightful rejection or justifiable revocation of acceptance, a lessee would have a security interest in the goods in his or her possession or control for any rent and security that had been paid and any reasonably incurred expenses, and could hold the goods and dispose of them in good faith and in a commercially reasonable manner.

The bill contains specific provisions governing: a lessee's rejection or acceptance of goods that failed to conform to the lease contract; a lessor's or supplier's right to cure and make a conforming delivery; a lessee's obligation to pay rent for accepted goods; a lessee's burden to establish any default; rules that would apply if a lessee were sued for breach of warranty or other obligation for which a lessor or supplier was answerable; a lessee's revocation of acceptance of a lot or commercial unit; a lessee's right to cover after a lessor's default; the measure of damages; and, incidental and consequential damages.

If a lessee wrongfully rejected or revoked acceptance of goods, failed to make a payment when due, or repudiated, the lessee would be in default and the lessor could: cancel the lease contract; proceed respecting goods not identified to the lease contract; withhold delivery of the goods and take possession of goods previously delivered; stop delivery of the goods by any bailee; dispose of the goods and recover damages, retain the goods and recover damages, or recover rent; or exercise any other rights or pursue any other remedies provided in the contract. The bill contains specific provisions governing these actions.

If a third party dealt with goods that had been identified to a lease contract in a manner that caused actionable injury to a party to the contract, the lessor would have a right of action against the third party, and the lessee would have a right of action against the third party if the lessee 1) had a security interest in the goods, 2) had an insurable interest in the goods, or 3) bore the risk of loss under the contract or had since the injury assumed that risk and the goods had been converted or destroyed. In addition to any other recovery permitted by Article 2A or other law, a lessor could

recover from the lessee an amount that would fully compensate the lessor for any loss of or damage to the lessor's residual interest in the goods caused by the lessee's default.

Security Interest. A security interest arising solely under Article 2A would be subject to the provisions of Article 9 except to the extent that and so long as the debtor did not have or lawfully obtain possession of the goods and the following rules applied:

- * no security agreement was necessary to make the security interest enforceable;
- * no filing was required to perfect the security interest;
- * the rights of the secured party on default by the debtor were governed by Article 2A in the case of a security interest arising solely under that article.

(Similar provisions currently apply in regard to security interests arising solely under Article 2 on sales.)

A transaction would create a security interest if the consideration the lessee was to pay the lessor for the right to possession and use of the goods were an obligation for the term of the lease not subject to termination by the lessee, and any of the following applied:

- * The original term of the lease was equal to or greater than the remaining economic life of the goods;
- * The lessee was bound to renew the lease for the remaining economic life of the goods or was bound to become the owner of the goods;
- * The lessee had an option to renew the lease for the remaining economic life of the goods for no additional or for nominal consideration upon compliance with the lease agreement.

MCL 440.1105 et al.

HOUSE COMMITTEE ACTION:

The House Corporations and Finance Committee adopted Substitute H-1, which adds an effective date of September 30, 1992 and makes various technical changes to the Senate-passed version of the bill. (3-4-92)

FISCAL IMPLICATIONS:

The Financial Institutions Bureau says the bill would not affect state or local budget expenditures. (3-5-92)

ARGUMENTS:

For:

The changes in leasing transactions in recent years make it clear that modernization is long overdue. States now depend on common law to resolve disputes over lease contracts. This creates considerable uncertainty, particularly for companies that conduct business in more than one state, since case law differs from one jurisdiction to the next. Uniformity is as important to the conduct of leasing transactions as it is to sales transactions. While derived largely from the sales article of the UCC, Article 2A is adapted to the peculiarities of the leasing transaction. The article provides basic contract rules, including matters of offer and acceptance, statute of frauds, warranties, assignment of interest and remedies upon breach of contract, and represents a comprehensive advance in commercial law.

For:

Perhaps the most important question answered in Article 2A is when leases are subject to Article 9 on secured transactions, which sets forth rules of priority and generally requires the filing of a financing statement for the secured interest of creditors. Under Article 2A, so-called "true leases" are distinguished from conditional sales or disguised security interests, and are governed by the new article. In a true lease, the lessor gives the possession of and right to use the goods to the lessee for a fixed period of time in return for rent. Although the general rule under Article 2A is that the facts of each case determine whether a transaction creates a lease or a security interest, the article identifies factors that eliminate true-lease status and, thus, create a security interest. Under these provisions, a secured transaction essentially occurs when the lessor has no meaningful residual rights in goods when the lease expires: If the contract terms indicate that the lessor's right to the residue is valueless, then it can be inferred that the lease actually amounted to a conditional sale of goods.

POSITIONS:

The Michigan Bankers Association supports the bill.
(3-4-92)

The Michigan Credit Union League supports the
bill. (3-4-92)

The Michigan League of Savings Institutions
supports the bill. (3-4-92)

The Financial Institutions Bureau believes the UCC
Act in Michigan needs to be modernized to reflect
current consumer and finance leasing practices, but
has no position on the bill. (3-5-92)