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By Marc L. Hamroff and Robert S. Cohen

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A Practical Look at Bundling Transactions: Let's Bundle in the Jungle

By Marc L. Hamroff and Robert S. Cohen

A continuing trend in the leasing industry has been to combine or "bundle" maintenance and other soft costs with equipment in an equipment lease. Lessees have found such arrangements to be a practical, efficient, comprehensive solution to their needs, as the lessor would be financing all the goods and services necessary to operate the leased equipment.

Bundled leases are being used in all aspects of the marketplace. They are not simply limited to large-ticket technology deals. Examples of bundled leases range from leasing high-end, sophisticated medical equipment (inclusive of all software licenses, training, maintenance, and/or other supplies necessary to operate the equipment during the lease term) to a small-ticket, basic photocopier with maintenance for the term of the lease.

> Bundled leases are being used in all aspects of the marketplace, and there are a wide variety of ways to document them. Each method has advantages and disadvantages.

Bundled transactions are often required by the vendor and manufacturer in an effort to create "one payment" packages for both the equipment and services, perhaps to discount a prepaid maintenance agreement, to attempt to create hell-or-high-water protection for the entire payment, or to structure the transaction pursuant to certain tax or accounting considerations. Accordingly, lessors are assembling these packages in an effort to be more competitive in the marketplace.

This article will focus on the jungle created by a wide variety of methods of documenting bundled transactions. It will also examine the strengths and weaknesses of enforcing these documents should the need arise.

DOCUMENTATION OPTIONS

Lessors have several options when documenting their bundled transactions. In the following paragraphs, we will discuss some of the more common documenting techniques for structuring these transactions as well as the legal benefits and detriments of those methods. As the following will demonstrate, it may be more beneficial to the lessor to document certain bundled transactions differently from others.

THE TRADITIONAL EQUIPMENT LEASE

Many lessors are using their traditional lease documents, which were drafted for the sole purpose of leasing personal property assets such as equipment, when structuring a bundled lease transaction. Although this may be the most common documentation vehicle being used by lessors, it also has the most risk. The traditional equipment lease usually contains a section in the lease (or on an annexed schedule) to describe the equipment being leased. In a bundled transaction, it is not uncommon for services (such as maintenance) to be identified as a line item in the description of leased equipment, thus incorporating the services to be performed as part of the definition of "equipment." This is not an ideal solution to the bundling issue for a variety of reasons.

Our analysis begins with the definition of a lease under Article 2A of the Uniform Commercial Code. UCC 2A-103(1)(j) defines a lease as follows:

> "Lease" means a transfer of the right to possession and use of goods for a term in return for consideration, but a sale, including a sale on approval or a sale or return, or retention or creation of a security interest, is not a lease. Unless the context clearly indicates otherwise, the term includes a sub-lease.[1]

Accordingly, when the parties enter into a lease agreement, the lessor transfers the right to possession and use of "goods" for consideration.[2] Goods are defined in UCC Article 2A as follows:

> "Goods" means all things that are movable at the time of identification to the lease contract, or are fixtures (Section 2A-309), but the term does not include money, documents, instruments, accounts, chattel paper, general intangibles, or minerals or the like, including oil and gas, before extraction.

Based on the pure definition of "goods," the typical soft costs of service, maintenance, training, license fees, and similar items do not qualify as goods because they are not "movable" and therefore, arguably, those soft costs cannot be leased pursuant to UCC Article 2A.[3]

Furthermore, implicit in the definition of lease (which requires the transfer of a lessor's rights to possession and use of goods) is the lessor's lawful ability to transfer those rights.[4] This issue comes up regularly in the software context: in many situations, the lessee obtains a license to use the software directly from the owner of the software (but simultaneously pays for the software by leasing it from a lessor). In those situations where the lessor does not have the right to possess and use the software, a fundamental element of the definition of a lease is not satisfied.[5]

This analysis raises issues as to how the traditional equipment lease document (when used for a bundled transaction) will be treated, if enforced. Often, it will depend on the type and amount of soft costs included with the equipment. For example, certain warranty services are included with purchase of the equipment and are much less likely to create a bundling issue. In contrast, if a material portion of the lease obligation is devoted to soft costs, it is more problematic.

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As the document may not be considered a lease under this analysis, it follows that it also may not be considered a "finance lease."[6] If the inclusion or bundling of soft costs recharacterizes the lease as a loan, the effect of such a distinction could be significant, as the lessor would not be entitled to the benefits afforded a "finance lease" under the Uniform Commercial Code.[7] Those benefits include the provisions of UCC 2A-407, which essentially provide the lessor with the implied hell-or-high-water obligation to comply with the terms of the lease agreement.[8]

The absence of finance lease status does not render the document unenforceable. In fact, to the extent that the lease contains express disclaimers (which by their very nature are not dependent on achieving "finance lease" status), those disclaimers should still be enforceable. However, if the lessor documented the transaction with a traditional equipment lease, the standard disclaimers may not apply to the services to be provided. This raises the question of whether the lessee can create problems for the lessor in enforcing its lease documents if the third-party service provider fails to perform its services or the lessee simply claims that the services were unsatisfactory. Clearly in these factual scenarios, the enforcement of the lease document becomes more complicated and fact sensitive and may get bogged down in issues of service and maintenance—issues that lessors wish to avoid.

For example, if a lessee claims after a default that it was unsatisfied with the services (and if the services could not be technically "leased"), the court may be forced to address arguments regarding the true substance of the transaction (notwithstanding the fact that the document is titled a "lease").[9] Such an analysis would be very fact specific, but the arguments can range from (1) the lessor attempting to artificially sever the lease into a lease for the equipment and a secured loan to finance the services in order to collect on the equipment portion of the lease to (2) the lessee claiming that the lessor, by including the services in the description of the equipment, is now responsible to deliver those services (akin to the way it is responsible to deliver the equipment).

Although neither of those scenarios is particularly appealing, if the lessee convinces the court that the lessor is responsible for providing the services included in the lease, it would be highly problematic for the lessor. The lessor could be prevented from collecting the sums due and owing on the equipment portion of the lease until there is a determination as to whether the services were provided properly. Naturally, such a situation should be avoided by lessors.

Documenting the bundled transaction with the traditional lease may also raise issues regarding the calculation of damages. Courts may require lessors to divide their damages, and in certain circumstances a lessor may not be able to recover the accelerated sums due under a service contract if the third-party provider is not providing service. For example, the lessor may have to prove those sums attributable to the lease of the equipment, an upgrade, and/or each soft cost. This analysis may be necessary for the lessor to collect both its accelerated lease balance on the new equipment portion of the lease and those sums properly due for services.

Modifying the equipment lease to incorporate pass-through language is a material improvement over using the traditional equipment lease for bundled leases.

Needless to say, such a process could be difficult to document to the court based on a variety of circumstances including the issuance of discounts, incentives, and the negotiations regarding the total price—which may not have been specifically divided between the equipment leased and services/soft costs to be rendered.[10] Moreover, such an analysis can raise other issues that could likely complicate and delay the legal proceedings.

Although none of these complications should ultimately prevent the lessor from collecting the proper amounts due under the lease document (as it is still an enforceable agreement between the parties), because the traditional equipment lease was not designed for the bundling of services, it creates many ambiguities as to enforcement. Accordingly, for all the reasons set forth above, the use of a traditional equipment lease to finance services and other soft costs represents the classic insertion of a square peg into a round hole—it just doesn't fit. As a result, the use of this documentation to evidence a bundled transaction is the least attractive documentation option.

THE PASS-THROUGH APPROACH

Lessors could modify their traditional equipment lease to insert pass-through language that generally indicates that the services identified in the lease are being provided by a third-party vendor or service provider. This modified lease could further provide that even though the cost of the services to the third party is included in the monthly lease payment, the lessor is paying the third-party provider monthly on behalf of the lessee. In other words, the fees for the services are passed through the lessor to the third party each month.

To the extent the bundled services constitute a onetime, up-front cost such as installation or a onetime payment for a maintenance contract (as opposed to a pay-as-you-go maintenance agreement with monthly charges), lessors can consider having language placed in the lease that applies the initial rental payments to pay for those costs first. Such a mechanism may not be practical in all circumstances, but it should at least be considered.

Modifying the equipment lease to incorporate pass-through language is a material improvement over using the traditional equipment lease for bundled leases. When the lease is properly drafted, it will be clear that the lessor is not providing the services but solely collecting the monies to pay the service provider. The services would not be included in the definition of equipment, and it would be clear that the lessor is not providing the services. Once that can be established definitively by the lessor, it should prevent service issues from delaying the enforcement of the lease. Such an improvement cannot be overstated, and it underscores why it is imperative for lessors to use documentation that is designed to prohibit the lessee from successfully asserting defenses based on matters that cannot be controlled by the lessor—that is, dissatisfaction of services.

The complications from enforcing the pass-through lease stem from those situations when the lessee is not in possession of a separate agreement identifying the specific services to be performed by the third party (and, in many instances, the specific price for those services). Therefore in this scenario, although the lessee is aware

that a portion of its lease payment is being used to pay for the services, it may not know how much of its lease payment is being applied to those services.

Just as with the traditional equipment lease, such a situation could raise issues of fact, delays, and the need for hearings to prove the calculation of damages. Setting forth this explanation of damages may not be clear cut or particularly easy to demonstrate to the court (based on other internal costs, undisclosed yields, differing lease factors, and so on) and hence could affect how quickly the lessor can enforce the lease. Notwithstanding this issue, it is a far better method of documenting the bundled transaction than the unmodified, traditional equipment lease.

Moreover, in many cases, these common pass-through issues can be addressed by disclosure in the lease documents of both the equipment and service/soft-cost component of the rental payments (either in actual dollars or as a percentage) as well as a representation confirming that the lessee is in possession of the service/soft-cost agreement. These two additions, which are not particularly difficult to put into practice, improve both the effectiveness and applicability of the pass-through approach even further.

By its very definition, the bundled transaction is designed to minimize paperwork and provide the lessee with a mechanism by which it pays one lease payment each month for all the required services.

A HYBRID APPROACH

The basic premise to this article is that the lessor—due to market conditions, competition, or customer demand—has decided it is in its best interest to finance these bundled transactions. By its very definition, the bundled transaction is designed to minimize paperwork and provide the lessee with a mechanism by which it pays one lease payment each month for all the required services. The hybrid approach suggested in this section uses two separate agreements but creates a situation where the lessee makes only one payment per month. Such a method of documenting a bundled transaction has significant benefits to the lessor and lessee.

The hybrid approach would be accomplished by having the lessee execute a traditional equipment lease for solely the equipment to be leased in the transaction. Concurrently, the lessee would execute an agreement with the service provider for maintenance, installation, training, or the like. Moreover, the service agreement would identify with specificity the provider of those services as well as the relevant terms, conditions, and costs for those services. This service agreement would be drafted to allow payment to be made on a monthly basis and would further indicate the remedies upon a default. Both the lease and service agreement could contain cross-default language.

At this point in the transaction, there are two separate agreements in place between the parties: it is unbundled. However, at some point after the equipment is delivered and accepted by the lessee, the lessee and lessor (and perhaps the service provider) would enter into an agreement in which the lessee would request and authorize the lessor to collect the payments due under both the lease and service agreement, with the express understanding that said payments will be forwarded to the third-party provider (in much the same way as the pass-through lease is set up).

One approach could be to insert this language in the delivery and acceptance certificate executed in connection with the lease. Inserting the one-payment language into the acceptance certificate does not add additional documents to the "lease package" to be executed by the lessee—a result that is appealing to all parties. It is also beneficial for the one-payment agreement to be executed after the equipment is installed and operational. There are many other approaches associated with this alternative that increase its flexibility and allow the lessor to tailor it to its needs and include it within the framework of its normal documentation.

This hybrid approach may be an improvement over the pass-through lease in that there is no issue as to the monies due and owing upon a lease default, as the lease is only for the equipment. Therefore, an argument (linked to the services to be provided) should not be raised to prevent the lessor from being entitled to its accelerated lease balance upon a default. Similarly, the lessor should avoid the issue associated with calculating the monies

due, if any, under the service agreement (as it would provide its own remedies upon a default). The lessee should also find this documentation option attractive, because it has specific agreements identifying the terms and conditions of both the equipment lease and service agreement, and the lessee has the convenience of paying only one payment per month to one entity.

The only reluctance we have experienced in using such a hybrid approach is the disclosure to the lessee of the specific costs for the equipment and services. (Marketing concerns may affect this decision.) In those situations, lessors must weigh the benefits and detriments of this hybrid approach as to whether it justifies its implementation. However, from a strictly legal perspective, the hybrid approach has advantages over both the pass-through lease and traditional equipment lease: (1) the lessor should not be subject to the calculation of damages issue, (2) the terms and conditions of the service agreement are clearly expressed without the lessor being accused of providing the services, and (3) the service problem claims should not affect the lessor's entitlement to payment under the lease for the financing of equipment.

An additional approach that lessors use to document these transactions is a combination of an equipment lease for the equipment and a note for soft costs.

PROMISSORY NOTE

An additional approach that lessors use to document these transactions is a combination of an equipment lease for the equipment and a note for soft costs. This is most common in the licensing context, whereby the lessor (1) finances the license fee with a note and (2) obtains an agreement with the licensor that, upon a default under either the lease or the note, the lessor may give notice to the licensor suspending the lessee's rights to use the licensed products and depriving the lessee of continued license and product support. Although this is not technically a bundled document, since the lessor is providing all the financing (whether through the lease or the loan/note), the lessee can pay one entity for the equipment and services (and the vendor/licensor achieves its own objectives).

There is nothing novel about using these documents, and in many situations, they remain the best alternative. These documents are particularly useful when the lessor is simply providing the financing (as evidenced by the note) for the soft costs. In contrast, the note cannot be used if the service agreement is a pay-as-you-go arrangement (unless the loan is structured as a line of credit to be used monthly for these payments). However, a traditional note can be used if the lessee pays for the maintenance or license agreement in full at the inception (with the note representing the amount paid to the service provider).

With a note there should be no genuine argument that the lessor is providing the services and/or that the lessor is not entitled to be repaid based upon a default. The structure of this transaction does not contain the same allure to lessors and lessees, because it is a material departure from the one-stop solution that is inherent in the bundled transaction. Moreover, the use of the note would add another layer of documentation for the lessee, as there may be an equipment lease, note, three-party agreement, and at least one service agreement.

LITIGATION STRATEGY

In many jurisdictions, lessors enforce their defaulted leases in the state or federal courts. Where appropriate, lessors move for summary judgment either to expedite obtaining judgment or to pressure the lessee into settling the dispute. Summary judgment motions have been a particularly effective tool to enforce defaulted leases in most jurisdictions. Notwithstanding, a summary judgment motion can be defeated by the raising of a genuine, triable issue of fact. There is a higher risk that a court will deny a summary judgment motion if the documentation used to evidence the bundled lease contains ambiguities or inherent inconsistencies (for example, services included in the description of the equipment). Those deficiencies could create an issue of fact to defeat a motion for summary judgment.

Moreover, such irregularities will unnecessarily complicate a trial. Therefore, it is critical to the lessor to document its bundled transaction in the best manner for that specific transaction. Doing so will materially affect a

lessor's litigation strategy and its ability to expedite the proceedings.

BANKRUPTCY CONSIDERATIONS

Should the lessee file for bankruptcy, in most circumstances, additional scrutiny will be placed on the documentation. Also, since the bankruptcy court is a court of equity, the court has more flexibility, as well as incentive, to fashion results that are in the debtor's interests. In bankruptcy, the possibility exists under the divergent approaches for (1) all or a portion of the lessor's claim to be treated as an unsecured claim and/or (2) recharacterization of the bundled structure.

Additionally, valuation for plan of reorganization and adequate protection purposes will be difficult, and appraisals of equipment "only" will not provide any compensation for the soft costs originally included in the transaction. This risk is lower if this is handled in a hybrid fashion as discussed above or perhaps by the leverage realized in the ability to terminate license or support rights if there is a note default. There are several more sophisticated concerns on the bankruptcy implications that are beyond the scope of this article, such as the lessor's advantages to compel assumption or rejection of the lease.[11]

Some courts have attempted to divide the monies due under the lease and apportion them to the services and equipment in an effort to allow the debtor to cherry-pick those services and lease obligations it desires to retain.[12] The benefits of the hybrid approach and the note allow the courts to clearly see the sums due and owing under those respective documents, thus avoiding the litigation risk as well as the time and expense of determining the apportionment of monies due and owing for equipment and soft costs.

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CONCLUSION

Lessors can use leases designed to accommodate the financing of services within them. Marketing concerns may favor one approach over another, but the important message to lessors is to think how best to document the bundled lease while recognizing the pros and cons of each of the above options. Choosing the wrong form of documentation can have a materially adverse effect on the speed and effectiveness of the lessor's enforcement strategy. However, documenting the bundled transaction properly will reduce certain risks of enforcement and provide for a much cleaner transaction.

Endnotes

1. See UCC 2A-103(1)(j).

2. See UCC 2A-103(1)(k), which defines a lease agreement as the "bargain, with respect to the lease, of the lessor and the lessee in fact as found in their language or ..." Therefore, a lease agreement essentially evidences the parties' agreement to lease.

3. It should be noted that various courts have deemed "goods" to include computer software. See *RRX Industries Inc. v. Lab-Con Inc.,* 772 F.2d 543, 546 (9th Cir. 1985); *Architectronics Inc. v. Control Systems Inc.,* 935 F.Supp. 425, 432 (S.D.N.Y.1996); and *Communications Groups Inc. v. Warner Communications Inc.,* 138 Misc.2d 80, 82-83, 527 N.Y.S.2d 341, 343-344 (N.Y. Civ. Ct., 1988).

4. *In re CNB International Inc.,* 307 B.R. 363, (Bankr. W.D.N.Y. 2004).

5. Id. at 369 370 (The software vendor "never transferred either a possessory right or a conditional right in its intellectual property to [the lessor] so [the lessor] had no intellectual property interest that it could transfer to the debtor [lessee]." In *CNB International,* the court went on to state that the parties could have structured their relationship so that the lessor had the ability to transfer the use of the computer software but did not, thus stressing the necessity to document bundled transactions properly. Id. at 370.

6. See UCC 2A-103(g) ("'Finance lease' means a *lease* with respect to which ...") (emphasis added).

7. See UCC 2A-407, Irrevocable Promises: Finance Leases: (1) In the case of a finance lease that is not a consumer lease the lessee's promises under the lease contract become irrevocable and independent upon the lessee's acceptance of the goods. (2) A promise that has become irrevocable and independent under subsection (1): (a) is effective and enforceable between the parties, and by or against third parties including assignees of the parties; and (b) is not subject to cancellation, termination, modification, repudiation, excuse, or substitu-

tion without the consent of the party to whom the promise runs. (3) This section does not affect the validity under any other law of a covenant in any lease contract making the lessee's promises irrevocable and independent upon the lessee's acceptance of the goods.

8. Id.

9. Although not a "lease," collecting a stream of payments under a third-party service agreement is enforceable but has different considerations from those of a lease. See, generally, Philip R. Rosenblatt, Steven J. Patterson, and Richard S. Rosenstein, "The Impact of Bundling on Equipment Lease Syndications From the Purchaser's Perspective," *Journal of Equipment Lease Financing* 26, no. 3 (Fall 2008).

10. The issues associated with allocating a portion of a lease payment to either the equipment or services in a bundled transaction are regularly raised in the context of accounting and tax treatments of these leases. See Shawn D. Halladay, "Financial Reporting Aspects of Bundled Transactions," *Journal of Equipment Lease Financing* 26, no. 3 (Fall 2008). See also *Modern Handling Equipment of New Jersey Inc. v. Director of Division of Taxation,* 17 N.J. Tax 270 (1998) (classification from a tax perspective of what constitutes leased goods and services). See also *Cardinal Health, 301 Inc. v. County of Orange,* 167 Cal. App. 4th 219, 84 Cal. Rptr. 3D 59 (Sept. 30, 2008) (analysis of a bundled lease including software from a tax perspective).

11. 11 U.S.C. Sec. 365.

12. It is not uncommon for a bankruptcy court, a court of equity, to allow the debtor to sever what purports to be one agreement into more than one agreement for the purpose of properly assessing and valuing the creditor's claims. See, e.g., *Stewart Title Guaranty Co. v. Old Republic National Title Insurance Co.,* 83 F.3d 735, 741, 29 Bankr. Ct. Dec. 184, 10 Text. Bankr. Ct. Rep. 170 5th Cir. (5th Cir. 1996) ("we believe that a determination of indivisibility 'would result in a new and different contract not intended by the parties' [citation omitted]. Thus, based on the way that the parties structured Lease, we conclude, that the Lease was a severable contract, divisible into two separate agreements") ... If a single contract contains separate severable agreements the debtor may reject one agreement and not another [citation omitted]. See also *Pacific Express Inc. v. Teknekron Infoswitch Corp.,* 780 F.2d 1482, 14 Bankr. Ct. Dec. 69 (9th Cir. 1986); *Pollock v. Pollock,* 139 B.R. 938, (B.A.P. 9th Cir. 1992).

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