Lease Construction

Holdover Provisions: An Ounce Of Prevention

By Anthony L. Lamm

THE GOAL OF a well-drafted lease is to avoid ambiguity and set forth from the outset the duties and obligations of both lessor and lessee. This type of clarity helps keep parties out of court, and narrows the issues should litigation occur. It's hard to believe, therefore, that so many leases fail to properly define the consequences for retaining leased equipment past the lease term.

In typical equipment leases, the gross value of the lease is measured by the number of months in it multiplied by the monthly payment plus the residual of the equipment if the lease has an option to purchase at the expiration. As you would imagine, the lessor prices the rate he will charge as a monthly payment on the cost of the equipment, its useful life after depreciation, and the expected amount for resale or release of the equipment (to a third party) if the lessee does not exercise a right to purchase it. Implicit in this pricing equation is the lessor's expectation that the lessee will either buy the equipment at the expiration of the lease or return it, at which time the lessor will either sell it at its market value or release it. If the lessee does not purchase the equipment or return it at the expiration of the term of the lease, the lessor is not receiving the amount it could have received if it had sold the equipment to a third party, or the amount it could have received from releasing it.

Bargain for Leverage

Therefore, the lessor must bargain for some leverage in the original lease contract, to ensure that above everything else the lessee should do to perform according to the terms of the lease, the lessee must also return the equipment at the expiration of the lease or pay a higher lease payment for each month that the lessee does not return the equipment at expiration. The optional leverage can take one of two forms.

The first manner of ensuring that the lessee will return the equipment on the expiration of the lease is to adopt a provision in the lease requiring the lessee to pay additional rent above the monthly payment prescribed in the lease. This provision can define the monthly lease payment that the lessee must pay post-expiration in terms of a greater percentage of the lease's monthly payment for each month (or day, for that matter) that the lessor keeps the equipment after the date that it was to be returned, or the lease provisions can require a higher monthly or daily rental rate than contained in the rate section of the lease or its lease schedules. Such a provision might read like this:

"If lessee shall, for any reason, fail to redeliver the equipment in good working condition back to lessor at its principal place of business, or such other place as lessor may specify, on expiration of the term of the lease, lessee shall pay as additional rent for each month, or fraction thereof, after the expiration of the lease, an amount equal to one hundred ten percent (110%) of the monthly payments set forth herein."

If the equipment is not returned to the lessor on the expiration of the term of a lease that contains a provision like the one used above as an example, the lessee is required to make higher monthly lease payments until the equipment is redelivered. In theory, the higher or additional rent that the lease requires the lessee to pay post-expiration compensates the lessor for any loss of revenue experienced as a result of the difference in the amount of the original pricing of the gross rent for the lease, and the revenue that could have been received from releasing or selling the equipment after the lease actually expires.

Another Motivation

The second means of motivating the lessee to return the equipment at the expiration of the lease is by adopting a provision in the lease contract that entitles the lessor to bind the lessee to an additional term at the same rental rate. In theory, by binding the lessee to an additional term, the lessor contracts to receive a certain amount of additional rent from the lessee that is more than the lessor had originally

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Anthony L. Lamm *is the founder of a financial services law firm in Montgomery County, Pa., specializing in workouts for banks and leasing companies. Telephone: (215) 672-6575.*

Married to a Form?

mance of or interest rates on, or other terms relating to, any of the lessee's obligations; or (b) renew, substitute, modify, amend or alter, or grant consents or waivers relating to any of the lessee's obligations, any other guaranties, or any security for any of the lessee's obligations or guaranties."

Furthermore, it is important to note that not all guaranty forms are continuing in nature. It is commonplace in the leasing industry for a guarantor to only obligate himself or herself with respect to a specific lease and not agree to guaranty all of the lessee's obligations to the lessor of every nature at any time arising. Lessors should be reminded to review the terms and conditions of their form guarantees, to ensure that the guaranty will work as it is intended. If there is any question, counsel should be consulted. ■

Read Those Policies Carefully

Court Invalidates Lessor's Insurance Exclusion

TWO AXIOMS are often tested and are nearly always confirmed. First, that things are rarely simple when large insurance claims are made. And, second, that claims invite challenges to previously untested contracts. When money changes hands, contracts become subject to heightened scrutiny, and loopholes are sought to mitigate losses. Therefore, it should go without saying that both lessors and lessees must be certain that all documents protecting their assets are airtight.

Royal Indemnity Co. v. Providence Washington Insurance Co., 98 N.Y. 0172 (1998), involved a transaction that seemed simple enough. The only problem was that neither the lessor nor the lessee knew exactly what their insurance coverage really meant.

Deliverance Road Transport leased a tractor-trailer for its business and, pursuant to the lease, obtained a liability policy issued by Royal Indemnity. The policy covered accidents that occurred when the truck was being used in the business of Deliverance. In addition, the lessor also had an insurance policy to cover nontrucking use. This policy, written by Providence Washington Insurance, was a "bobtail" policy, designed to cover "all instances when the driver was neither pulling a load, nor returning empty from such a delivery, nor otherwise using the truck for business purposes."

In the line of business, Deliverance's truck struck a bicyclist, who was seriously injured. The bicyclist's guardian ad litem brought a state court action against the truck's owner, the driver, and Deliverance in New York. Because it provided liability coverage, Royal undertook the defense and eventually settled the matter for $900,000, plus $29,163 in legal fees. Then, relying on a contribution clause in Providence's policy, Royal filed a declaratory action in the U.S. District Court for the Northern District of New York, seeking indemnification for half of the $929,163. The district court granted Royal's motion for summary judgment, and Providence appealed. The U.S. Court of Appeals for the Second Circuit then certified the indemnity issue to the New York Court of Appeals.

The New York high court was presented with two questions:

'"(1) whether a nontrucking-use exclusion from coverage in an insurance policy obtained by the owner of a commercial vehicle is valid under New York law, despite the absence of express language in the policy stating that the exclusion is effective only if the vehicle's lessee is required to obtain insurance coverage, where the insurer has established that its standard underwriting policy is not to issue a policy containing such an exclusion unless the vehicle owner has provided proof that the vehicle's lessee has insurance coverage; and

'"(2) if the nontrucking-use endorsement is not valid to exclude coverage entirely, whether such an endorsement is nonetheless valid to limit liability to the financial security minima required by New York law."'

Both questions were answered in the negative. The court ruled that the policy exclusion was not valid, because it was not expressly conditioned on the lessee's obtaining its own liability coverage.

New York's Vehicle and Traffic Law "requires that an owner's liability policy must provide the assurance that a party injured by the negligent operation of a motor vehicle has 'recourse to a financially responsible defendant.'" In addition, New York case law states that "a nontrucking-use exemption not limited by its own terms to circumstances in which the vehicle's lessee has trucking-use insurance, violates New York law and public policy." *Randazzo v. Cunningham*, (56 A.D.2d. 702, aff'd 43 N.Y.2d 937).

Randazzo further held that the "bobtail exclusion was not validated by the fact that the owner leased the truck to a carrier which was engaged in interstate commerce and was therefore required under Interstate

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anticipated, and can be important if the lessor does not think it can re-lease or sell the equipment easily. Such a provision might read:

> "Should lessee fail to return the equipment in accordance with the terms contained in this lease, at lessor's option this lease will automatically be extended on all of the terms and conditions as stated herein for a period of one year, without the necessity of the execution of any further instrument or document, and shall continue from year to year thereafter under the same terms and conditions until terminated."

Through these illustrations, a rent escalation and an additional term provision (in your lease document) are proposed as drafting devices for the lessor to avoid having a jury determine whether there was an intention by both parties for an additional term, and at what rate. ■