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THE BUSINESS OF LOANING ON LEASES: WHO'S RISK UNDER CLAUSE E?

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III. Introduction

A. Overview

It is common in the financial industry for banks and other lending institutions to establish lines of credit or make loans to lessors of equipment, vehicles, machines, etc. and take back the leases of such personal property as collateral for the line of credit or loan. This paper addresses whether or not there is or may be coverage under the Standard Form 24 Financial Institution Bond ("FIB") for losses incurred if the leases turn out to be forged, altered, or otherwise invalid.

The FIB provides coverage to financial institutions for a wide variety of risks in one policy.[1] Among those risks insured against is: (1) the risk of extending credit in reliance on a document that turns out to be forged or altered; and (2) the risk of acquiring for value a document that turns out to be forged or altered.[2] In particular, both Insuring Agreements (D) and (E) provide coverage for forged documents, albeit for different types of documents.[3]

1. Insuring Clause (E)

One commentator has observed that Insuring Agreement (E) is the only insuring agreement in the FIB that is responsive to the ever-increasing use of technology by sophisticated criminals to create forged or counterfeit documents.[4] Insuring Agreement (E) of the FIB specifically provides coverage for any:

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[1] *See Annotated Financial Institution Bond* at 1 (Michael Keeley ed. 2004).

[2] Insuring Agreement (E), Standard Form 24 FIB.

[3] Insuring Agreements (D) and (E), Standard Form 24 FIB. For a discussion regarding the interrelationship between the types of documents covered by Insuring Agreements (D) and (E), see Peter C. Haley, *Clause (E): The Continued Importance of Defined Terms and Causation Requirements*, *in Financial Institution Bonds* 253, 259 (Duncan L. Clore ed. 1998) [hereinafter Defined Terms].

[4] Haley, *Defined Terms*, *supra* note 3, at 256.

(E) <u>Loss resulting directly from</u> the Insured having, <u>in good faith</u>, for its own account or for the account of others,

(1) <u>acquired, sold or delivered, or given value, extended credit or assumed liability</u>, <u>on the faith of any original</u>

(a) Certificated Security
(b) Document of Title
(c) deed, mortgage or other instrument conveying title to, or creating or discharging a lien upon real property,
(d) Certificate of Origin or Title,
(e) Evidence of Debt
(f) corporate, partnership or personal Guarantee
(g) Security Agreement
(h) Instruction to a Federal Reserve Bank of the United States, or
(i) Statement of Uncertificated Security of any Federal Reserve Bank of the United States <u>which</u>
(i) bears a signature of any maker, drawer, issuer, endorser, assignor, lessee, transfer agent, registrar, acceptor, surety, guarantor, or of any person signing in any other capacity which <u>is a Forgery</u>, or
(ii) <u>is altered</u>, or
(iii) <u>is lost or stolen</u>

(2) guaranteed in writing or witnessed any signature upon any transfer, assignment, bill of sale, power of attorney, Guarantee, endorsement or any items listed in (a) through (h) above;

(3) acquired, sold or delivered or given value, extended credit or assumed liability, on the faith of any item listed in (a) through (d) above which is a counterfeit.

<u>Actual physical possession of the items listed in (a) through (i) above by the Insured, its correspondent bank or other authorized representative, is a condition precedent to the Insured's having relied on the faith of such items</u>.

A mechanically reproduced facsimile signature is treated the same as a handwritten signature. [5]

Based on the plain language of Insuring Agreement (E)(1), an Insured seeking to recover losses based on forged equipment leases must prove that: (1) it acted in good faith in acquiring or extending credit; (2) in reliance on the faith of an original equipment lease; (3) that was forged or altered; and (4) that the Insured suffered a loss as a direct result of acquiring or extending credit in reliance on the forged or altered equipment lease. In addition, an Insured seeking coverage under Insuring Agreement (E) must also demonstrate that it had "actual, physical possession" of the original forged or altered equipment lease that it relied on.[6]

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[5] *Id.* (emphasis added).

[6] *Id; see also First Fed. Sav. Bank v. Continental Cas. Co.*, 768 F. Supp. 1449, 1456 n.1 (D. Kan. 1991) (stating that coverage "exists . . . only if the insured acted upon the original of a document bearing a forged signature"). At least one court has made it clear that photocopies of an original are not sufficient. *See Hamilton Bank v. Ins. Co. of North Am.,* 557 A.2d 747, 751 (Pa. 1989) (holding that "mere photocopies of the original counterparts . . . do

Each of these elements presents obstacles to an Insured obtaining coverage for losses based on a forged or altered equipment lease. For instance, the insured may have difficulty proving that its loss resulted directly from the forgery or alteration of the equipment lease. Several courts have held that a loss does not result "directly" from a forged or altered document if the document would have been worthless notwithstanding that it was forged or altered.[7] The actual, physical possession requirement may likewise prove problematic if the insured did not have the original forged or altered equipment lease in its actual, physical possession at the time it purchased the equipment lease or extended credit in reliance on the equipment lease. While Insuring Agreement (E) does alleviate some of the harshness of the "actual, physical possession" requirement by providing that possession by the Insured's "authorized representative" is sufficient, the FIB does not define "authorized representative," and the few cases addressing what constitutes an "authorized representative" in the context of Insuring Agreement (E) are not particularly helpful.[8]

2. A Primary Consideration Is Whether Equipment Leases Are Covered by Insuring Agreement (E)

Of course, in addition to the elements and obstacles identified above, both the Insurer and Insured must consider a more fundamental requirement in analyzing whether the Insured may recover its losses: Are forged or altered equipment leases covered under Insuring Agreement (E)? The elements for coverage set forth above assume that the document that was forged, altered, or stolen is a "covered" document. Insureds frequently seek coverage under Insuring Agreement (E) for a loss based on a forgery without careful consideration of whether the forged document is covered under Insuring Agreement (E). This is particularly true in the case of Insureds seeking coverage for losses based on forged or altered equipment leases.

An Insured seeking coverage based on a forged or altered equipment lease has limited options under Insuring Agreement (E). While Insuring Agreement (E) provides coverage for nine categories of documents, only three of those categories of documents arguably might provide coverage for equipment leases: Documents of Title, Evidences of Debt, and Security Agreements. Of those three, Insureds will most likely find success by characterizing equipment leases as "Security Agreements." That, however, will not be an easy task.

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not qualify as 'original' documents").

[7] *See Jefferson Bank v. Progressive Cas. Co.*, 965 F.2d 1274, 1282-85 (3d Cir. 1992); *Reliance Ins. Co. v. Capital Bancshares, Inc.*, 685 F. Supp. 148, 151-52 (N.D. Tex. 1988) (holding that bank would have suffered an identical loss even if signatures on stock certificates were genuine); *Liberty Nat'l Bank v. Aetna Life & Cas. Co.,* 568 F. Supp. 860, 863 (D.N.J. 1983) (holding that coverage under a banker's blanket bond did not exist because the insured would have suffered a loss even if the signatures on the certificates of deposit that the borrower pledged as collateral were genuine and authorized); *K.W. Bancshares, Inc. v. Syndicates of Underwriters at Lloyds*, 965 F. Supp. 1047, 1054-55 (W.D. Tenn. 1997) (holding that the insured's loss was not a result of having extended credit on the faith of a forged letter, but rather because the letter contained untrue statements).

[8] For instance, in *Nat'l City Bank v. St. Paul Fire & Marine Ins. Co.*, the court indicated only that the term "authorized representative" has an agency component. 447 N.W.2d 171, 176 (Minn. 1989) (citing *Citizens Bank v. Am. Ins. Co.*, 289 F. Supp. 211, 213 (D. Or. 1968)). Other courts have held that, when combined with "authorized," the term "authorized representative" encompasses entities given the authority to act on behalf of another. *Stop & Shop Co. v. Fed. Ins. Co.*, 136 F.3d 71, 74 (1st Cir. 1998); *Colson Servs. Corp. v. Ins. Co. of North Am.*, 874 F. Supp. 65, 68 (S.D.N.Y. 1994).

II. **Are Forged or Altered Equipment Leases Covered Under Insuring Agreement (E)**

C. Is an Equipment Lease a "Document of Title"?

1. FIB Definition of "Document of Title"

Insureds attempting to recover losses based on forged or altered equipment leases have argued that equipment leases are "Documents of Title," as that term is defined in the FIB. Insureds will likely find limited, if any, success arguing that an equipment lease is a document of title. The FIB defines "Document of Title" as a:

> bill of lading, dock warrant, dock receipt, warehouse receipt or order for the delivery of goods, and also any other document which in the regular course of business or financing is treated as adequately evidencing that the person in possession of it is entitled to receive, hold and dispose of the document and goods it covers and must purport to be issued by or addressed to a bailee and purport to cover goods in the bailee's possession which are either identified or are fungible portions of an identified mass.[9]

The FIB definition expressly identifies the "classic" "Documents of Title," such as bills of lading and warehouse receipts. No mention, of course, is made of equipment leases. Perhaps not surprisingly, no case has addressed the issue of whether an equipment lease falls within the FIB's definition of "Document of Title." Indeed, many of the cases involving claims based on forged or altered "Documents of Title" under Insuring Agreement (E) involve forged or altered bills of lading, which are expressly included within the definition of "Document of Title."[10] Consequently, those cases are not instructive. Moreover, no reported decision construes the "any other document" language contained in the FIB's definition of "Document of Title."

Because case law under the FIB does not provide much, if any, guidance, Insureds are forced to look elsewhere for guidance. The Uniform Commercial Code ("U.C.C.") is a natural first step. The U.C.C. provides a definition of "Document of Title" that is virtually identical to the definition set forth in the FIB.[11] Accordingly, case law construing the U.C.C. definition of "Document of Title" is likely to be instructive in determining whether a document is a "Document of Title" for purposes of coverage under Insuring Agreement (E).

Unfortunately, as with the case law under the FIB, there is no case law under the U.C.C. that addresses the issue of whether a lease is a "Document of Title." However, the *Bank of New York v. Amoco Oil Co.* decision provides some assistance because it discusses

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[9] FIB, § 1(h) (emphasis added).

[10] *See generally French Am. Banking Corp. v. Flota Mercante Grancolombiana, S.A.*, 925 F.2d 603 (2d Cir. 1991); *Republic Nat'l Bank of Miami v. Fid. & Deposit Co. of Md.*, 894 F.2d 1255 (11th Cir. 1990); *Societe Generale v. Fed. Ins. Co.*, 856 F.2d 461 (2d Cir. 1988).

[11] *See* U.C.C. § 1-201(16) (2003); *see also* David T. DiBiase*, Section 5 – Insuring Agreement (E) – Securities*, *in Annotated Financial Institution Bond* 248, 281 (Michael Keeley ed. 2004).

a lease agreement.[12] It also construes the "any other document" language, which appears to be the only portion of the FIB definition of "Document of Title" that might encompass equipment leases.

In *Bank of New York*, the court addressed the issue of whether "holding certificates" constituted "Documents of Title" under § 1-201(15) of the U.C.C.[13] As discussed above, the U.C.C. definition of "Document of Title" is virtually identical to the definition set forth in the FIB, providing that a:

> "Document of title" includes bill of lading, dock warrant, dock receipt, warehouse receipt or order for the delivery of goods, and also any other document which in the regular course of business or financing is treated as adequately evidencing that the person in possession of it is entitled to receive, hold and dispose of the document and the goods it covers. To be a document of title a document must purport to be issued by or addressed to a bailee and purport to cover goods in the bailee's possession which are either identified or are fungible portions of an identified mass.[14]

The plaintiff in *Bank of New York*, Amoco Oil Company ("Amoco"), leased platinum from various sources, including Drexel Burnham Lambert Trading Corporation ("DBL Trading"). The platinum was used to prepare catalysts used in oil refineries.[15] Amoco issued a "holding certificate" to DBL Trading as part of the lease agreement.[16] The holding certificate provided: (1) Amoco was holding platinum for the account or order of the precious metal company; (2) the platinum was free of all liens and encumbrances; and (3) the platinum was to be released on surrender of the holding certificate, if properly endorsed.[17]

Subsequent to leasing platinum to Amoco, DBL Trading entered into a lending relationship with the Bank of New York ("the Bank").[18] As part of that lending relationship, the Bank would accept holding certificates to collateralize the credit extended to DBL Trading.[19] In February 1990, DBL Trading defaulted on its credit agreement with the Bank. The Bank liquidated its collateral, including the platinum leased to Amoco.[20] Amoco initially refused to turn over the platinum collateralizing DBL Trading's line of credit, although it later capitulated.[21] The Bank ultimately sued Amoco for conversion, claiming that its rights to the platinum were superior to Amoco's and it was damaged by Amoco's initial refusal to surrender the platinum.[22]

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[12] 831 F. Supp. 254 (S.D.N.Y. 1993).
[13] *Id.* at 255.
[14] U.C.C. § 1-201(15).
[15] 831 F. Supp. at 256.
[16] *Id.* at 256-57.
[17] *Id.* at 257.
[18] *Id.*
[19] *Id.*
[20] *Id.* at 259.
[21] *Id.* at 256.
[22] *Id.* at 257.

The issue of who had superior rights in the platinum hinged on whether the holding certificates were negotiable "Documents of Title."[23] The court was required to construe the "any other document" language in § 1-201(15) to determine whether holding certificates where "Documents of Title." First, the court looked at whether the holding certificates were treated as "adequately evidencing that the person in possession of" the holding certificate was entitled to receive and dispose of the platinum.[24] The court looked to both the intent of the parties and industry standards to determine whether a holding certificate is treated as adequately evidencing that a person is entitled to receive and dispose of goods. The court concluded the holding certificate met the first criteria because, consistent with industry standards, the Bank treated the holding certificates as evidence it was entitled to receive and dispose of the platinum.[25]

Next, the court addressed whether the holding certificates purported to be issued by or addressed to a bailee and purported to cover the goods in the bailee's possession.[26] Amoco maintained it was not a bailee as defined under U.C.C. § 7-102(1)(a) because the holding certificates neither "acknowledg[ed] possession of the goods [nor] contract[ed] to deliver them."[27] Amoco further argued the only contractual obligation imposed was Amoco's lease of the platinum from DBL Trading.[28] The court rejected this argument because the holding certificates expressly provided for the release of the platinum to a specific person upon presentation of a properly endorsed holding certificate.[29] Further, the court noted even if Amoco was not a bailee, the holding certificates could still be "Documents of Title" because § 1-201(15) only required that Amoco purport to be a bailee.[30] The court held that by including language in the holding certificate requiring Amoco to surrender and deliver the platinum upon presentation of a properly endorsed holding certificate, Amoco had purported to be a bailee.[31]

The court also rejected Amoco's argument that the lease between Amoco and DBL Trading prevented the holding certificates from being "Documents of Title." The court concluded the holding certificates did not indicate the nature of the underlying transaction, but only provided that Amoco would surrender and deliver the platinum upon presentation of a properly endorsed holding certificate.[32] Thus, the court held the holding certificates were "Documents of Title" because the Bank treated the holding certificates as adequately evidencing its right to possess and dispose of the platinum, the holding certificates purported to be issued by or addressed to a bailee, and the holding certificates purported to cover the platinum.[33]

Amoco subsequently appealed the district court's ruling. On appeal, the Second Circuit Court of Appeals, in *Bank of New York v. Amoco Oil Co.* ("*Bank of New York II*"),

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[23] *Id.*
[24] *Id.* at 260.
[25] *Id.*
[26] *Id.* at 261.
[27] *Id.*; *see also* U.C.C. § 7-102(1)(a).
[28] 831 F. Supp. at 261.
[29] *Id.* at 262.
[30] *Id.*
[31] *Id.*
[32] *Id.*
[33] *Id.* at 263.

affirmed the district court's ruling.[34] The court in *Bank of New York II* began by noting that whether a particular document constitutes a "Document of Title" presents issues of both law and fact: the determination of whether a document "adequately evidences" the right to possess and dispose of goods is a question of fact, while the determination of whether a document purports to be issued by or addressed to a bailee is a question of law.[35]

With respect to the first requirement, the *Bank of New York II* Court held that there was ample evidence to support the district court's ruling that the holding certificates adequately evidenced the Bank's right to possess and dispose of the platinum.[36] The *Bank of New York II* Court went on to find that a:

> certificate issued by a lessee to a lessor evidencing the lessor's interest in the leased goods and promising to deliver the leased goods to the lessor upon demand accompanied by production of the certificate [is] analogous to a document of title issued by a warehouseman to the owner of goods that have been entrusted to the warehouseman's care for storage.[37]

The *Bank of New York II* Court noted that the mere fact that the lessee pays for the right to possess the goods does not prevent the certificate from becoming a "Document of Title."[38] Lastly, the *Bank of New York II* Court addressed the requirement that the goods covered by the document be either "identified" or "fungible portions of an identified mass," holding that identification of the platinum by quantity and by grade was sufficient.[39]

2. Equipment Leases Do Not Satisfy the Elements Required to Be "Documents of Title"

Based on the analysis in *Bank of New York* and *Bank of New York II*, an equipment lease would not constitute a "Document of Title." The decisions in *Bank of New York* and *Bank of New York II* made clear the first inquiry in the analysis is whether an equipment lease adequately evidences the Insured's right to possess or dispose of the goods the lease covers. There is no doubt an equipment lease grants the lessee the right to possess the equipment for the duration of the lease term. That is the very nature of a lease. However, it does not grant the Insured the right to possess the equipment. If the Insured acquires the lease or if the equipment lease is assigned to the Insured as collateral, then the Insured steps into the shoes of the lessor, which only has a right to possess the equipment at the end of the lease term or in the event the lessee defaults on the lease. Thus, an equipment lease does not satisfy the first "Document of Title" hurdle.

Additionally, as required by the U.C.C. definition of "Document of Title," an equipment lease does not purport to be issued by or addressed to a bailee. One of the key factors in the *Bank of New York* decision was that Amoco purported to be a bailee because the holding certificates required Amoco to surrender and deliver the platinum to the Bank

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[34] 35 F.3d 643, 650-54 (2d Cir. 1994)
[35] *Id.* at 651.
[36] *Id.*
[37] *Id.* at 653.
[38] *Id.*
[39] *Id.* at 654-55.

upon presentation of a properly endorsed holding certificate. An equipment lease lacks this critical component. Other than at the expiration of the lease term or in the event of default, nothing in the equipment lease requires the lessee to surrender the equipment to the lessor, or to the Insured standing in the lessor's shoes.

C. Is an Equipment Lease an "Evidence of Debt"?

Insureds have also sought to recover losses based on forged or altered equipment leases by characterizing the equipment leases as "Evidences of Debt." As with "Documents of Title," Insureds will likely have little, if any, success persuading a court that an equipment lease is an "Evidence of Debt." The FIB defines "Evidence of Debt" as any:

> instrument, including a Negotiable Instrument, executed by a customer of the Insured and held by the Insured which in the regular course of business is treated as evidencing the customer's debt to the Insured.[40]

The plain language of the FIB's definition of "Evidence of Debt" requires that the equipment lease reflect a debt owed to the Insured and that the equipment lease be executed by a customer of the Insured.

1. An Evidence of Debt Must Reflect a Debt to the Insured

The preeminent case construing the term "Evidence of Debt" appears to be *Merchants National Bank of Winona v. Transamerica Insurance Co.*[41] In this case, the court addressed the issue of whether construction contracts were "Evidences of Debt."[42] GHK Construction Company ("GHK") obtained several commercial loans from Merchants National Bank of Winona ("Merchants"), including two loans in 1980 and 1981 totaling $120,000.[43] As collateral for these loans, GHK assigned Merchants certain construction contracts.[44] GHK ultimately defaulted on the loans, and Merchants learned that the construction contracts pledged as collateral were fictitious and bore forged signatures.[45] Consequently, Merchants brought a claim under its FIB, Insuring Clause (E), claiming the construction contracts were either "Evidences of Debt" or "Security Agreements."[46]

Based on the testimony presented at trial, the trial court found that the construction contracts were not "Evidences of Debt." It concluded the construction contracts were "not, 'in the regular course of business,' 'treated as evidencing the customer's debt to the Insured.'"[47] Specifically, the trial court found that:

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[40] FIB, § 2(h) (emphasis added).
[41] 408 N.W.2d 651 (Minn. Ct. App. 1987); *see First Union Corp. v. United States Fid. & Guar. Co.*, 730 A.2d 278, 282 (Md. Ct. App. 1999) (stating that the "preeminent case addressing 'evidence of debt' is *Merchants Nat'l Bank of Winona v. Transamerica Ins. Co.*").
[42] 408 N.W.2d at 652.
[43] *Id.*
[44] *Id.*
[45] *Id.*
[46] *Id.* at 653-54.
[47] *Id.* at 653.

> [s]imply looking at the contracts alone, they do not truly evidence a debt even between [GHK's owner] and the fictitious customer and by no stretch of the imagination do the contracts themselves evidence a debt of [GHK's owner] to the Bank.[48]

The appellate court agreed with the trial court's finding, holding that "Evidence of Debt" refers to "primary indicia of debt, such as promissory notes or other instruments that reflect a customer's debt to the insured."[49] The court went on to hold that a construction contract is not a "primary indicia of debt."[50] Accordingly, the construction contracts did not constitute "Evidences of Debt," as that term is defined in the FIB.[51]

Another important decision is *Suburban National Bank v. Transamerica Insurance Co.*[52] The issue in that case was whether credit card sales slips constituted "Evidences of Debt."[53] Suburban National Bank ("SNB"), as a member of a VISA/MASTERCARD credit card program, was required to accept credit card sales slips from merchants crediting the account in the face amount of the credit card sales slips.[54] SNB forwarded the credit card sales slips to Northwestern National Bank ("Northwestern"), which would credit SNB's account for the same amount.[55]

In February 1986, Eden Travel, Inc. ("Eden"), one of SNB's merchants, deposited unauthorized sales slips into its account at SNB, and SNB credited Eden's account in the face amount of the sales slips.[56] Eden's president then withdrew the amount credited to Eden's account and fled the country.[57] SNB made a claim under its Banker's Blanket Bond for the loss sustained as a result of crediting unauthorized credit card sales slips. Transamerica denied the claim and a lawsuit followed.[58]

The trial court granted summary judgment in favor of Transamerica on SNB's claim, which was made under Insuring Agreement (B), based on the language of exclusion section (2)(e).[59] [(I would put in the relevant language of the FIB provisions cited.)] As an alternative ground for affirming summary judgment, the appellate court noted the sales slips were "Evidences of Debt" under exclusion section 2(e).

In doing so, the appellate court looked to Black's Law Dictionary, which defined "Evidence of Debt" as "a term applied to instruments which facially evidence the existence of a debt."[60] Thereafter, the appellate court looked to a Minnesota statute defining "instrument" as "any . . . writing which evidences a right to the payment of money and is not itself a security agreement or lease and is of a type which is in ordinary course of business

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[48] *Id.* (emphasis added).
[49] *Id.*
[50] *Id.*
[51] *Id.*
[52] 438 N.W.2d 119 (Minn. Ct. App. 1989).
[53] *Id.*
[54] *Id.* at 120.
[55] *Id.*
[56] *Id.*
[57] *Id.*
[58] *Id.* at 120-21.
[59] *Id.* at 121.
[60] *Id.* at 122 (quoting *Black's Law Dictionary* 499 (5th ed. 1979)).

transferred by delivery with any necessary endorsement or assignment."[61]

While neither the *Merchants National Bank* nor *Suburban National Bank* decision addresses the "Evidence of Debt" issue in great detail, both make clear a document must be a "primary indicia of debt" and reflect a debt to the Insured in order for it to be an "Evidence of Debt."[62] Unfortunately, those cases fail to address the more problematic requirement under the FIB that for a document to be an "Evidence of Debt," it must be executed by a customer of the insured.

2. Who is a "Customer" of the Insured?

Despite defining twenty-four different terms, the FIB does not define the term "customer." Insurers and Insureds will not find any guidance from the case law because there are no cases construing the term "customer" in the context of either Insuring Agreement (D)(1) or (E). Consequently, Insurers and Insureds are forced to look elsewhere for guidance.

The U.C.C. once again proves to be instructive.[63] The U.C.C. defines "customer" as a "person having an account with a bank."[64] The problem that Insureds face in characterizing equipment leases as "Evidences of Debt" is that the lessees are not "customers" of the Insured because the Insured is not a party to the lease. Creative Insureds may argue that the lessee becomes a "customer" of the insured to the extent the equipment lease has been assigned to the bank/insured as collateral. However, there appears to be little support for this position, perhaps because it stretches the definition of "customer" beyond the ordinary meaning.

Arguably one of the broadest definitions of "customer" in the banking context can be found in the Federal Deposit Insurance Company's ("FDIC") Privacy of Consumer Financial Information regulations ("FDIC Privacy Regulations").[65] These regulations address consumer privacy protection and "govern the treatment of nonpublic personal

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[61] *Id.* (quoting Minn. Stat. § 336.9-105(1)(i) (1988)) (emphasis added).

[62] *Merchants Nat'l Bank of Winona v. Transamerica Ins. Co.*, 408 N.W.2d 651, 653 (Minn. Ct. App. 1987); *Suburban Nat'l Bank v. Transamerica Ins. Co.*, 438 N.W.2d 119, 122 (Minn. Ct. App. 1989); *see also First Union Corp. v. United States Fid. & Guar. Co.*, 730 A.2d 278, 282 (Md. Ct. Spec. App. 1999) (holding that a forged "incumbency certificate," which stated that the individual who was seeking to borrow money was a high-ranking official of Philip Morris and authorized to act on its behalf, was not an "Evidence of Debt" because it did not reflect the borrower's debt to the insured bank.")

[63] At least one commentator has looked to the U.C.C. definition of "customer" in analyzing claims under Insuring Agreements (D)(1) and (E). *See* Robert Briganti, *Forgery or Alteration*, *in Financial Institution Bonds* 207, 213 (Duncan L. Clore ed. 1998).

[64] U.C.C. § 4-103(5) (2002) (emphasis added). The narrow approach in defining "customer" taken by the U.C.C. is also seen in other statutes. For instance, in an effort to curb money laundering, the Department of the Treasury has enacted a "Customer Identification Program" ("CIP"), which requires the banking industry to implement written CIP procedures for identifying and verifying new customers. The Department of the Treasury defines "customer" as a "person that opens a new account." 31 C.F.R. § 103.121(a)(3)(i). An "account" is defined as a "formal banking relationship to provide a product or service to an individual or entity." 31 C.F.R. § 103.121(a)(1)(i). Thus, for an individual to be a "customer" under the CIP, there must be an account that establishes a "formal banking relationship to provide a product or service."

[65] 12 C.F.R. § 332.2(h) (2003).

information."[66]

The FDIC Privacy Regulations define "customer" as a "consumer who has a customer relationship with" a bank.[67] Therefore, to be a "customer," the FDIC Privacy Regulations require that an individual must:

(1) fulfill the requirements of being a "consumer"; and,
(2) have a "customer relationship" with the insured.

Under the FDIC Privacy Regulations, a consumer is "an individual who obtains or has obtained a financial product or service from [a bank] that is to be used primarily for personal, family, or household purposes."[68] Similarly, the FDIC defines "Customer Relationship" as a "continuing relationship between a consumer and [a bank] under which [the bank] provide[s] one or more financial products or services to the consumer that are to be used for personal, family, or household purposes."[69] While the FDIC Privacy Regulations provide that an individual has obtained a financial product or service from a financial institution if the financial institution owns or holds the servicing rights to a loan, an equipment lease is not primarily for personal, family, or household purposes.[70] Therefore, even under the FDIC's broad definition of "customer," a lessee would not be considered a customer of the Insured.

3. Equipment Leases Do Not Satisfy the Elements Required to be "Evidences of Debt."

Considering that an "Evidence of Debt" must reflect a debt owed to the Insured and be executed by a customer of the Insured, it is difficult to conceive how an equipment lease could constitute an "Evidence of Debt." Equipment leases, like the construction contracts in *Merchants National Bank*, are not "primary indicia of debt." Moreover, like the construction contracts in *Merchants National Bank*, an equipment lease would not reflect a debt between the lessor and lessee, and the lease certainly does not reflect a debt owed from the lessor to the Insured. The amount of the rent payment set forth in the equipment lease merely reflects the consideration the lessee owes the lessor for the right to possess and use the equipment.

Even assuming an Insured could get past this obstacle, the Insured most likely would be unable to overcome the second obstacle, namely proving that the equipment lease was executed by its "Customer." The lessee clearly does not fall within the U.C.C.'s definition of "customer," assuming the lessee does not otherwise happen to have an account with the Insured. Additionally, even the broad definition of "customer" set forth in the FDIC Privacy Regulations does not appear to encompass a lessee under an equipment lease that has been acquired by or assigned to an Insured as collateral. The closest the FDIC Privacy Regulations come to providing support for the proposition that a lessee is the "Customer" of the Insured is that a person may be a "Customer" of a bank if the bank owns the servicing rights to the person's loan. However, this is not the case with an equipment

[66] 12 C.F.R. § 332.1(a).
[67] 12 C.F.R. § 332.3(h) (emphasis added).
[68] 12 C.F.R. § 332.3(e)(1).
[69] 12 C.F.R. § 332.3(h)(i).
[70] 12 C.F.R. § 332.3(e)(1).

lease. Accordingly, Insureds almost certainly will not be able to obtain coverage under Insuring Agreement (E) by attempting to characterize equipment leases as "Evidences of Debt."

C. Is an Equipment Lease a Security Agreement?

1. FIB Definition of "Security Agreement"

The lack of potential coverage for equipment leases as either "Documents of Title" or "Evidences of Debt" forces Insureds to argue that equipment leases are "Security Agreements." Fortunately for Insureds, this might be the most fruitful approach. The potential for success, however, will ultimately hinge on the specific terms of the equipment lease.

The problem both Insurers and Insureds face is that neither the FIB's definition of "Security Agreement" nor the case law construing it in the context of Insuring Agreement (E) address the issue of when a lease is a security agreement. The Standard Form 24 FIB defines "Security Agreement" as an:

> agreement which creates an interest in personal property or fixtures and which secures payment or performance of an obligation.[71]

One of the principal cases construing the term "Security Agreement" is *Merchants National Bank*.[72] As discussed above, the Insured in that case sought to recover losses it incurred as a result of extending credit based on forged construction contracts that were pledged as collateral.[73] In holding that the forged construction contracts were not "Security Agreements," the appellate court initially agreed with the trial court's conclusion that Insuring Agreement (E) covers documents that "have real value to the insured bank in the event of a borrower's default."[74] The appellate court went on to state that the FIB's definition of "Security Agreement" requires the creation of an interest in property.[75] The appellate court concluded the construction contracts had no value to the insured if the borrower defaulted on the loan.[76]

The court's decision in *K.W. Bancshares, Inc. v. Syndicates of Underwriters at Lloyd's* is also instructive on this issue.[77] The issue in that case was whether Insuring Clause (E) covers losses incurred by extending credit based on a forged letter.[78] Morris Whitman, an executive vice president at National Mortgage Company ("NMC"), applied for a $450,000 loan from Federal Savings Bank ("FSB").[79] Whitman told FSB he would repay the loan with his

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[71] FIB, § 1(f).
[72] 408 N.W.2d 651, 652 (Minn. Ct. App. 1987).
[73] *Id.*
[74] *Id.* at 654.
[75] *Id.*
[76] *Id.*
[77] 965 F. Supp. 1047 (W.D. Tenn. 1997).
[78] *Id.* at 1049.
[79] *Id.*

expected annual bonus to FSB.[80] Whitman also advised FSB that NMC would guarantee the loan.[81] As collateral for the loan, Whitman assigned a portion of his expected bonus.[82] As part of his proposal, Whitman submitted to FSB, among other things, a letter from Barbara Crenshaw, NMC's Vice President and Controller, stating that Whitman was to receive over half of an $811,500 bonus in May 1992.[83] Whitman also executed a "Certificate of Borrower," which confirmed Whitman's earlier representations that he was entitled to receive an $811,500 bonus from NMC.[84]

FSB loaned Whitman the $450,000, and Whitman executed a promissory note in favor of FSB. The promissory note was secured by an assignment of a portion of Whitman's annual bonus.[85] Whitman ultimately defaulted on the loan.[86] When FSB sought payment from NMC, it was advised that the Crenshaw letter, along with various other documents, were forgeries.[87] FSB brought a claim under Insuring Clause (E) of its FIB for losses sustained as a result of alleged forgeries. The Syndicates of Underwriters at Lloyd's ("Lloyd's") denied the claim. Thereafter, FSB filed a declaratory judgment.[88]

Lloyd's moved for summary judgment on the basis that: (1) FSB's loss "did not result directly from having made the Whitman loan on the faith of the Crenshaw letter," and (2) Insuring Agreement (E) did not cover FSB's losses because the Crenshaw letter and Certificate of Borrower were not "Security Agreements."[89] The district court granted summary judgment, finding that the Crenshaw letter did not "create any interest in personal property," nor did it "secure any payment or performance of an obligation for FSB," and FSB failed to show how the Crenshaw letter "could even reasonably be construed as" a "Security Agreement."[90] In granting summary judgment, the district court also relied on the language in *Merchants National Bank* that "Insuring Agreement (E) 'necessarily refers only to documents that have real value to the insured bank in the event of the borrower's default.'"[91] The court noted that the Crenshaw letter did not have any real value, as evidenced by the fact that FSB required Whitman and NMC to execute an Assignment of Bonus Payment.[92] Finally, the district court found, in conclusory fashion, that the "Certificate of Borrower cannot be construed as a security agreement."[93]

At first glance, the court's decision in *Merchants National Bank* that construction contracts are not "Security Agreements" appears to preclude the argument that equipment leases are "Security Agreements." The problem posed by the FIB's definition of "Security Agreements," and the case law construing that term, is that it completely ignores the issue of when a lease may qualify as a "Security Agreement."

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[80] *Id.*
[81] *Id.*
[82] *Id.*
[83] *Id.* at 1050.
[84] *Id.*
[85] *Id.*
[86] *Id.*
[87] *Id.*
[88] *Id.*
[89] *Id.* at 1054.
[90] *Id.* at 1055.
[91] *Id.* (quoting *Merchants Nat'l Bank*, 408 N.W.2d at 654).
[92] *Id.*
[93] *Id.*

2. U.C.C. Definition of "Security Agreement"

The FIB's definition of "Security Agreement" stands in stark contrast to the definition of that term contained in the U.C.C. The U.C.C. defines "Security Agreement" as "an agreement that creates or provides for a security interest."[94] "Security Interest" is, in turn, defined as "an interest in personal property or fixtures which secures payment or performance of an obligation."[95]

It is the definition of "Security Interest" that recognizes that, in certain instances, a lease is, in reality, a disguised "Security Agreement." Both Insurers and Insureds would be well served to acquaint themselves with the history of the U.C.C.'s provisions governing when a lease is a "Security Agreement." Both Insurers and Insureds alike should be forewarned, however, that this is not an easy task.

a. Pre-1987 Code and Case Law

Prior to the adoption of Article 2A in 1987, the U.C.C. § 1-201(37) provided in relevant part:

> [w]hether a lease is intended as security is to be determined by the facts of each case; however (a) the inclusion of an option to purchase does not of itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended for security.[96]

Numerous courts applying the former § 1-201(37) held that the most significant factor in determining whether a transaction was a true lease or disguised "Security Agreement" was whether the lessee had the option to purchase the goods for nominal consideration.[97] Courts took a variety of approaches to make this determination. For instance, many courts employed the "economic realities" test to determine whether consideration was nominal.[98] The "economic realities" test holds that if the lessee would be a fool not to exercise the purchase option contained in the lease, then the economic reality is that the transaction is a sale, not a lease.[99] Other courts determined whether the option price was nominal by comparing the option price to the one of the following amounts: (1) the total amount of the rental payments due under the lease; (2) the original purchase price of the leased equipment; or (3) the anticipated fair market value of the equipment at the end of the lease

[94] U.C.C. § 9-102(73) (2003).
[95] U.C.C. § 1-201(37).
[96] U.C.C. § 1-201(37) (1986).
[97] *In re Edison Bros.*, 207 B.R. 801, 810 (Bankr. D. Del. 1997); *Aoki v. Shepherd Mach. Co.*, 665 F.2d 941, 946-47 (9th Cir. 1982); *Dicap Indus., Inc. v. Starr*, 113 B.R. 481, 483 (Bankr. S.D. Ill. 1990); *Sight & Sound of Ohio, Inc. v. Wright*, 36 B.R. 885, 890 (Bankr. S.D. Ohio 1983).
[98] 4 James J. White & Robert S. Summers, *Uniform Commercial Code*, at 13 (4th ed. 1995); *In re Edison Bros.*, 207 B.R. at 810.
[99] *In re Edison Bros.*, 207 B.R. at 810.

term.[100]

In the absence of nominal consideration, other courts employed the "laundry list" approach, which required courts to consider, as the name suggests, a list of factors in determining whether the lease was, in reality, a disguised "Security Agreement."[101] Some of the factors considered by courts include the following:

(1) whether the total rental exceeded the fair market value of the property at the time the lease is entered into;
(2) whether the lessee had an obligation to insure the equipment against loss;
(3) whether the lessee had an obligation to pay the full lease amount regardless of loss of the property, or loss of its use;
(4) whether the lessee was unable to terminate its obligation under the lease by return of the property;
(5) whether the lessee had an obligation to indemnify the lessor from liability arising in connection with the goods;
(6) whether the lessee had an obligation to pay taxes on the property;
(7) whether future rent was accelerated in the event of default;
(8) whether the value of the property to the lessee in place vastly exceeded its value upon removal to the lessor;
(9) whether there was an exclusion of all warranties on the property; and
(10) whether the lessor was the original owner, manufacturer, or supplier of the property that is the subject of the lease.

Application of the former § 1-201(37) was rife with problems. To begin with, the various approaches used by courts to determine whether a transaction was a lease or disguised "Security Agreement" were flawed.[102] The principal problem, however, arose from the "intended as a security" language. As one court observed, application of former § 1-201(37) "usually led juries and courts into a murky assignment—to ascertain the true intent of the parties as an issue of fact through an examination of the relevant facts and circumstances of the case."[103] Indeed, the use of these various tests to determine the

[100] *In re Edision Bros.*, 207 B.R. at 811, n.12 (citing *Orix Credit Alliance v. Pappas*, 946 F.2d 1258, 1262 (7th Cir. 1991); *In re Marhoefer Packing*, 674 F.2d 1139, 1144-45 (7th Cir. 1982); *Percival Constr. Co. v. Miller & Miller Auctioneers, Inc.*, 532 F.2d 166, 171 (10th Cir. 1976); *Nat'l Equip. Rental v. Priority Elects. Corp.*, 435 F. Supp. 236, 238-39 (E.D.N.Y. 1977); *In re Herold Radio & Elecs.*, 218 F. Supp. 284, 286 (S.D.N.Y. 1963); *In re Hispanic Am. Television*, 113 B.R. 453, 459 (Bankr. N.D. Ill. 1990); *NYNEX BISC v. Beker Indus.*, 69 B.R. 937, 940 (Bankr. S.D.N.Y. 1987)).
[101] White & Summers, *Uniform Commercial Code, supra* note 98, at 14-16, 16 nn.37-44.
[102] White & Summers, *Uniform Commercial Code*, *supra* note 98, at 14-18. With respect to courts' resort to percentages to determine whether consideration is nominal, such an approach does "not really tell who holds the entrepreneurial stake" in the goods. *Id* at 15. As for the laundry list approach, White and Summers contend that the list of factors generally used: (1) is vague, and (2) contains factors that "should not be there because they are equally consistent with a document's being a security agreement or a lease." *Id* at 17-18.
[103] *In re Triplex Marine Maint., Inc.*, 258 B.R. 659, 666 (E.D. Tex. 2000).

subjective intent of the parties frequently resulted in unreliable and inconsistent results.[104]

b. 1987 Amendment

As the use of the commercial lease substantially increased, the drafters of the U.C.C. recognized that an ambiguous definition of "Security Agreement" was problematic because the determination of what constitutes a lease not only affects the parties to the agreement, but it affects third parties as well.[105] Consequently, the drafters of the U.C.C. amended the U.C.C. to add Article 2A, which specifically governs commercial leases, and revised the definition of "Security Interest" to clarify the distinction between a lease and a security agreement.[106] In doing so, one of the principal goals of the drafters of the revised § 1-201(37) was to shift the focus from the intent of the parties to the "economics of the transaction."[107] The official comment to the U.C.C. reveals that "[r]eference to the intent of the parties to create a lease or security interest has led to unfortunate results," including, among other things, courts relying on inappropriate factors.[108] For that reason, the drafters of amended § 1-201(37) deleted all references to the intent of the parties.[109]

i. *Security Agreements as a Matter of Law*

In attempting to shift the focus to the economics of the transaction, the revised § 1-201(37) provides that whether a lease is, in reality, a "Security Agreement" depends on the facts of each case.[110] Nevertheless, the drafters qualify that language by establishing a bright-line test for determining whether a lease constitutes a "Security Agreement" as a matter of law.[111] That bright-line test is composed of two parts. The first part requires consideration of whether the lessee has the ability to terminate the lease prior to the expiration of the lease term.[112] Specifically, § 1-201(37) provides that a "transaction creates a security interest if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease <u>not subject to termination by the lessee</u>" and if one of the additional four enumerated criteria is met.[113] A

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[104] White & Summers, *Uniform Commercial Code*, *supra* note 98, at 11.

[105] U.C.C. § 1-201(37) (2003) (Official Comment). Indeed, the drafters observed that the lease/security agreement distinction has "significant implications to the lessee's creditors." *Id.*

[106] *Id.* (stating that the "focus of the changes was to draw a sharper line between leases and security interests to create certainty in commercial transactions").

[107] U.C.C. § 1-201(37) (Official Comment); *In re Kim*, 232 B.R. 324, 329 (Bankr. E.D. Pa. 1999); *In re Copeland*, 238 BR. 801, 804 (Bankr. E.D. Ark. 1999).

[108] U.C.C. § 1-201(37) (Official Comment); *see also In re Triplex Marine Maint., Inc.*, 258 B.R. at 666.

[109] U.C.C. § 1-201(37). Importantly, though, while the drafters deleted all references to the intent of the parties, courts have generally viewed the amended § 1-201(37) as a "clarification of the old rule, not a substitute for it." U.C.C. § 1-201(37) Official Comment. Thus, some courts still look to the pre-1987 § 1-201(37) in considering whether a lease is a true lease or security agreement. *See* John P. Campo & Carolyn Hochstadter Dicker, *FF&E and the True Lease Question: Article 2A and Accompanying Amendments to UCC Section 1-201(37)*, Am. Bankr. Inst. L. Rev. 517, 520 (Winter 1999).

[110] U.C.C. § 1-201(37).

[111] *Id.*; *In re Taylor*, 209 B.R. 482, 484-85 (Bankr. S.D. Ill. 1997); *In re Owen*, 221 B.R. 56, 60-61 (Bankr. N.D.N.Y. 1998); *In re Copeland*, 238 B.R. at 803.

[112] U.C.C. § 1-201(37).

[113] U.C.C. § 1-201(37) (emphasis added). The decision to add in the lease termination requirement, often referred to as a "hell or high water clause," was specifically intended to rectify the decisions of courts construing the pre-1989 § 1-201(37). *See* Campo & Dicker, *supra* note 109, at 534-35; Peter F. Coogan, *Leasing and the Uniform Commercial Code*, *in* 1 *Equipment Leasing-Leveraged Leasing* 677, 711 (1988).

lessee has the right to terminate a lease where "a lessee is free to cease performance under the contract without incurring further obligation."[114] If the lessee does have the ability to terminate the lease, then the lease does not constitute a security interest as a matter of law.[115]

If it is determined that the lessee does not have the right to terminate the lease prior to the expiration of the lease term, courts must then look to the second part of the bright-line test. The second part requires courts to consider whether any of the following enumerated criteria are met:[116]

> b. The original term of the lease is equal to or greater than the remaining economic life of the goods;
>
> d. The lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods;
>
> f. The lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement; or,
>
> h. The lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement.[117]

If the lease does not permit the lessee to terminate the lease prior to its expiration and one of the four above-referenced criteria is satisfied, then the lease constitutes a security agreement as a matter of law.[118]

Thus, the critical consideration is whether any of the above criteria are met. This analysis requires consideration of two factors: (1) the "remaining economic life of the goods" that are the subject of the lease; and (2) "nominal consideration."[119] At the outset, Insurers and Insureds should be mindful that the inclusion of these four criteria was intended to once again place the emphasis on the principal characteristic of a lease, namely the "reservation of an economically meaningful interest to the lessor at the end of

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[114] *In re Taylor*, 209 B.R. at 485; *cf. In re Hoskins*, 266 B.R. 154, 160 (W.D. Mo. 2001) (stating that "a termination provision in a contract which provides that a lessee remains financially liable to the lessor after termination of the lease for payments that become due after the date the lease is terminated does not constitute 'termination' within the meaning of section 1-201(37)").
[115] U.C.C. § 1-201(37); *In re Hoskins*, 266 B.R. at 159; *In re Owen*, 221 B.R. at 60-61. Importantly, the fact that the lessee can terminate the lease does not make the lease a true lease as a matter of law. *In re Copeland*, 238 B.R. at 806.
[116] *In re Owen*, 221 B.R. at 60-61.
[117] U.C.C. § 1-201(37).
[118] U.C.C. § 1-201(37); *In re Triplex Marine Maint.*, 258 B.R. 659, 669 (E.D. Tex. 2000); *In re Owen*, 221 B.R. at 60; *In re Kim*, 232 B.R. 324, 330 (Bankr. E.D. 1999); *In re Wakefield*, 217 B.R. 967, 970 (Bankr. M.D. Ga. 1998); *In re Taylor*, 209 B.R. at 484; *In re Southern Star Foods, Inc.*, 202 B.R. 784, 788 (Bankr. E.D. Okla. 1996).
[119] U.C.C. § 1-201(37).

the lease term."[120] With that in mind, the U.C.C. does not provide much guidance for determining the "remaining economic life of the goods." The U.C.C. merely provides that the "remaining economic life of the goods" is to be "determined with reference to the facts and circumstances at the time the transaction is entered into."[121]

The U.C.C. provides more guidance for determining whether consideration is nominal; however, the U.C.C.'s pronouncement on what constitutes nominal consideration is still vague. For instance, the U.C.C. provides that consideration is not nominal when the renewal option or the purchase option states that the rent under the renewal or the purchase price under the purchase option is to be the fair market rent or fair market value at the time the option is to be exercised.[122] There appears to be a divergence of views as to whether § 1-201(37) mandates a determination that the consideration is not nominal where the lease provides that the option price is to be the fair market value at the time the option is exercised. Several courts have expressly held that § 1-201(37) consideration is not nominal as a matter of law where the option price is to be determined by the fair market value.[123] This approach appears to be consistent with the express language of § 1-201(37). A minority of courts, however, have taken the approach that a lease provision setting the purchase price at the fair market value merely creates a rebuttable presumption that the consideration is not nominal.[124] One court taking the rebuttable presumption approach to fair market value observed that:

> [a]t first glance, the inclusion of a potential reference to fair market value in the determination of the option amount would seemingly preclude any examination of the nominality of the purchase option[;] . . . such a mechanical application of that subsection without recognition of the existing realities of the transaction belies the very standard that [§ 1-201(37)] seeks to impose.[125]

The U.C.C.'s pronouncement that consideration is not nominal when the option price is to be the fair market value of the goods is helpful. However, at what point does consideration become nominal if the consideration is less than the fair market value of the goods? The U.C.C. provides some guidance in resolving this issue, providing that consideration is "nominal" if the consideration is "less than the lessee's reasonably predictable cost of performing under the lease agreement if the option is not exercised." As with the "remaining economic life of the goods," "reasonably predictable is "to be determined with reference to the facts and circumstances at the time the transaction is

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[120] White & Summers, *Uniform Commercial Code*, *supra* note 98, at 18; *see also* Campo & Dicker, *supra* note 105, at 533 (stating that the hallmark of a lease is that the "lessee [has] the right to use the leased property with an attendant opportunity to return the property to the lessor while it still has 'substantial economic life'"); *In re Allen*, 174 B.R. 293, 295 (Bankr. D. Or. 1994); *In re Murray*, 191 B.R. 309, 313 (Bankr. E.D. Pa. 1996); *In re Copeland*, 238 B.R. at 804.

[121] U.C.C. § 1-201(37).

[122] *Id.*

[123] *In re Paz*, 179 B.R. 743, 748 (Bankr. S.D. Ga. 1995).

[124] *In re Triplex Marine Maint.*, 258 B.R. 659, 671 (E.D. Tex. 2000); *In re Owen*, 221 B.R. 56, 61 (Bankr. N.D.N.Y. 1998); *In re Howell*, 161 B.R. 285, 290 n.4 (Bankr. N.D. Fla. 1993).

[125] *In re Triplex*, 258 B.R. at 671.

entered into."[126]

Courts considering whether the option price is less than the lessee's reasonably predictable cost of performance have recognized that the new test set forth in § 1-201(37) is merely a "codification of what has traditionally been referred to as the 'economic realities' test."[127] As discussed above, that test holds that an option price is "nominal" and a lease is, in reality, a disguised security agreement if "only a fool would fail to exercise the purchase option."[128]

The U.C.C. does not provide much guidance for determining whether consideration is nominal in cases where the consideration is not less than the reasonably predictable cost of performance. Unfortunately, the drafters did not establish a bright line test for these situations.[129] In fact, the drafters intentionally left this determination of when consideration is "nominal" up to the courts. As noted U.C.C. commentators observed, "nominality is merely a proxy for 'Is the option price so low that the lessee will certainly exercise it and will, in all plausible circumstances, leave neither risk nor benefit as a reversion for the lessor."[130] It is impossible to neatly divide the cases dealing with nominal consideration because, as White & Summers observe, the "cases on nominality are in disagreement and many are mistaken."[131]

ii. *Security Agreements: Case - by - Case*

While courts have held that satisfaction of the two-part test outlined above mandates a finding that the lease is a security as a matter of law, the converse is not necessarily true: a determination that a lease does not satisfy the two-part test does not mandate a finding that the lease is a true lease as a matter of law.[132] Instead, if a lease fails the two-part test, courts will look to the "economics of the transaction" to determine whether a lease is a true lease or security agreement, which includes looking at the four factors outlined in section 1-201(37) to determine whether the economic realities of a transaction create a security interest.[133]

In addition to the factors outlined in § 1-201(37), courts will consider a variety of other factors. This approach bears some resemblance to the "laundry list" approach described above. For instance, courts will consider whether the lessee has an "absolute obligation" to purchase the property being leased.[134] Courts have also traditionally

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[126] *Id.*
[127] *In re Taylor*, 209 B.R. 482, 486 (Bankr. S.D. Ill. 1997); *see also Brown v. Kempker*, 104 B.R. 196, 203 (Bankr. W.D. Mo. 1989).
[128] *In re Taylor*, 209 B.R. at 486; *In re Hoskins*, 266 B.R. 154, 161 (W.D. Mo. 2001). This test is also referred to as the "sensible person test" because some courts have articulated the test as holding that a lease was intended to be a security interest "where the terms of the lease and option to purchase are such [that] the only sensible course of the lessee at the end of the lease term is to exercise the option and become the owner of the goods." *Steele v. Bebetsberger*, 653 F.2d 1385, 1389 (10th Cir. 1981).
[129] *In re Taylor*, 209 B.R. at 486.
[130] White & Summers, *Uniform Commercial Code*, *supra* note 98, § 30-3 at 26.
[131] *Id.*
[132] *In re Taylor*, 209 B.R. at 484-85; *In re Hoskins*, 266 B.R. at 161.
[133] *In re Owen*, 221 B.R. 56, 61 (Bankr. N.D.N.Y. 1998); *In re Taylor*, 209 B.R. at 484-85; *In re Hoskins*, 266 B.R. at 161; *In re Triplex*, 258 B.R. at 669; *In re Murray*, 191 B.R. 309, 315 (Bankr. E.D. Pa. 1996).
[134] *In re Hoskins*, 266 B.R. at 161-62; *Carlson v. Tandy Computer Leasing*, 803 F.2d 391, 396 (8th Cir. 1986).

considered: (1) whether and to what extent the purported lessee acquires an equity interest in the property; (2) whether a purported "option" is in fact unconditional; (3) the past practices of the particular case; and (4) the terms of the agreement relating to such matters as insurance, risk of loss, acceleration, and repossession.[135] Additionally, some courts have even considered whether the lessor is in the business of leasing equipment or whether it is a financing company.[136] On the other hand, courts will not give much weight to whether the parties refer to the agreement as a "lease" or to the parties to the agreement as "lessee" and "lessor."[137] This list of factors, of course, is not exhaustive, but rather serves as a starting point for analyzing the "economic realities" of a transaction.

Importantly, while courts look to a wide variety of factors in considering whether a lease is a "Security Agreement," Insurers and Insureds should be aware that the U.C.C. specifically identifies certain factors that, by themselves, do not evidence the existence of a "Security Agreement' as a matter of law. Those factors include:

(a) the present value of the consideration the lessee is obligated to pay the lessor for the right to possession and use of the goods is substantially equal to or is greater than the fair market value of the goods at the time the lease is entered into;
(b) the lessee assumes risk of loss of the goods, or agrees to pay taxes, insurance, filing, recording, or registration fees, or service or maintenance costs with respect to the goods;
(c) the lessee has an option to renew the goods or become the owner of the goods;
(d) the lessee has an option to renew the lease for a fixed rent that is equal to or greater than the reasonably predictable fair market rent for the use of the goods for the term of the renewal at the time the option is to be performed; or
(e) the lessee has an option to become the owner of the goods for a fixed price that is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed.

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[135] Erwin S. Barbre, Annotation, *Equipment Leases as Security Interest Within Uniform Commercial Code § 1-201(37)*, 76 A.L.R.3d 11 (1977).
[136] *L.C. Williams Oil Co. v. NAFCO Capital Corp.*, 502 S.E.2d 415, 418-19 (N.C. Ct. App. 1998); *Litton Indus. Credit Corp. v. Lunceford*, 333 S.E.2d 373, 375 (Ga. Ct. App. 1985); *In re Rex Group*, 80 B.R. 774, 780 (Bankr. E.D. Va. 1987).
[137] *Commercial Credit Equip. Corp. v. Parsons*, 820 S.W.2d 315, 319 (Mo. Ct. App. 1991); *In re Triplex*, 258 B.R. at 666; *In re Homeplace Stores, Inc.*, 228 B.R. 88, 93 (Bankr. D. Del. 1998); *In re Owen*, 221 B.R. at 62; *In re First Baptist Church of Margate, Florida*, 17 U.C.C. Rep. Serv. 1098 (Bankr. S.D. Fla. 1975). Thus, in *In re Triplex*, the court held that a lease created a security agreement as a matter of law notwithstanding a provision in the lease that provided "you agree that this is a 'true lease' and not one intended for security purposes of section 1-20(37) (sic) of the Uniform Commercial Code." 258 B.R. at 666.

3. Application of the Bright-Line Test and Case-by-Case Approach

As one commentator has observed, the determination as to whether a particular lease is a disguised security agreement has proven difficult because the U.C.C.'s attempt to distinguish between leases and security agreements has been "uniformly elaborated upon by the courts."[138] Indeed, that same commentator has cautioned that the "only safe norm, therefore, is a careful study of the case law in the relevant jurisdiction or jurisdictions, which may or may not yield a firm result."[139] Even still, "a crystal ball, or at least considerable luck, may be necessary."[140]

For these reasons, it would be unproductive to analyze whether one particular form of equipment lease is a "Security Agreement" because the number of variations of equipment leases depends on the number of individuals willing to lease equipment. This does not mean that Insurers and Insureds are left in the dark as to whether a particular equipment lease is a "Security Agreement" under Insuring Agreement (E).

When faced with a claim based on a forged or altered equipment lease, both Insurers and Insureds should first look to the U.C.C. and, in particular, the bright-line test set forth in § 1-201(37). If the equipment lease does not satisfy the U.C.C.'s bright line test, both Insurers and Insureds should engage in a rigorous analysis of whether any of the other factors traditionally considered by courts are present. The factors listed above provide a good starting point; however, both Insurers and Insureds should look to the relevant jurisdictions to determine which factors courts place more emphasis on. Armed with the bright-line test, the factors listed above, and perhaps a crystal ball, both Insurers and Insureds should be able to more accurately predict whether a particular lease constitutes a "Security Agreement" under the U.C.C. and, therefore, a security agreement under the FIB.

III. Conclusion

Equipment leases will most likely not be deemed either "Documents of Title" or "Evidences of Debt." They may, however, be deemed "Security Agreements." The U.C.C. provides a mechanism for an equipment lease to be deemed a "Security Agreement" as a matter of law or on a case-by-case basis. In either case, whether an equipment lease is deemed a "Security Agreement" will depend heavily on the facts and circumstances of each case, as well as the specific terms of the equipment lease in question. If a particular equipment lease falls within the U.C.C. definition of "Security Agreement," then, assuming the remaining elements are satisfied, there most likely will be coverage under Insuring Agreement (E) for the Insured's loss.

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[138] 1 Thomas M. Quinn, *Quinn's Uniform Commercial Code Commentary and Law Digest*, 1-83 (2d ed. 2002).
[139] *Id.*
[140] *Id.*