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By Blake Reuter

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TRAC Vehicle Leasing

By Edwin E. Huddleson

Terminal rental adjustment clause (TRAC) vehicle leasing is the most popular means of leasing cars and trucks to commercial end-users. Occasionally, criticism and litigation still challenge the true lease status of vehicle leases. This article summarizes the legal and public policy rationale for the TRAC/state laws and demonstrates that the majority of court decisions now recognize the true lease character of these transactions.

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By Stephen T. Whelan

Securitization of equipment leases and loans is on the upswing. Transaction volume has jumped over the last two calendar years. Moreover, delinquency performance has improved. Based on a recent Foundation study, this article evaluates some potential threats to continued growth of equipment asset-backed securitization.

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Treasury/IRS rulings in the 1980s and a few recent court decisions held that motor vehicle leases containing terminal rental adjustment clauses (TRACs) should be treated as sales rather than true leases.[1] Those old precedents denied TRAC owner/lessors the tax benefits of ownership, threatened their commercial law remedies,[2] and diminished their rights of recovery if the TRAC lessee went into bankruptcy.[3]

Times have changed. With Congress's enactment of 26 U.S.C. §7701(h) in 1983 and the recent enactment of TRAC/state laws in all the states, there should no longer be any doubt that TRAC vehicle leases are true leases.

Not everyone agrees with this conclusion, however. Occasionally, criticism and litigation still attack the true lease status of TRAC vehicle leases. To address these disputes, this article summarizes the legal and public policy bases for the TRAC/state laws, shows the shortcomings of criticisms challenging the true lease character of TRAC vehicle leases, points out the overwhelming majority of court decisions that now recognize the true lease status of these vehicle leasing transactions, and lists the TRAC/state laws that are effective in the 50 states.

WHAT IS A TRAC VEHICLE LEASE?

Terminal rental adjustment clause motor vehicle leasing is now the most popular means of leasing cars and trucks to commercial (nonconsumer) end-users throughout the country. While specific transactions vary,[4] in general a TRAC clause permits (or requires) an upward or downward adjustment of rent to make up for any difference between the actual value of a vehicle that is determined at the end of the lease term (by sale to a third party, appraisal, or otherwise) and the originally projected residual value of the vehicle. (This value is determined from a schedule of estimates, made at the start of the lease, looking forward in time and estimating what the vehicle's value will be at various times in the future when the vehicle can be returned.)

After a minimum lease term of about one year, a typical TRAC vehicle lease can be renewed or extended by the lessee, on a month-by-month basis, until the lessee returns the vehicle. When the vehicle is returned, the lease term ends. The actual value of the vehicle at the end of the lease term is then determined, usually by sale at wholesale auction. A supplemental rental payment is made by the lessee or a credit given by the lessor to reflect the difference between the actual value of the vehicle at the end of the lease term, and the earlier originally projected estimate (made at the start of the lease, looking forward into the future) as to what the vehicle's value would be at the end of the lease term.

The objective of TRAC vehicle leases is to provide a financial incentive for the lessee/user, who is the party to the transaction best able to control the maintenance of the vehicle, to keep the vehicle in good repair. TRAC vehicle lessees like this form of commercial lease because of its cost savings and efficiency.[5] They create the continuing popular demand for TRAC motor vehicle leasing in the marketplace.

TRAC VEHICLE LEASES: "TRUE LEASES" UNDER ALL STATE LAWS

Over the past 20 years, all 50 states and the District of Columbia have clarified the earlier

split-case law by enacting a state statute that safeguards TRAC vehicle leasing. Enactment of these TRAC/state laws was accomplished with the support of many parties, including both commercial lessors and lessees of cars and trucks, state bar organizations, state trucking organizations, state banking organizations, and the Uniform Law Commission, which sponsors the Uniform Commercial Code (UCC).

The impact of these TRAC/state laws facilitates commerce by ensuring that state law that affects billions of dollars of vehicle-borne interstate commerce is the same (uniform and predictable) throughout the United States.

TRAC/state laws make it clear that TRAC vehicle leases are true leases (not "sales" or "security interests") for state law purposes. This simplifies and clarifies the law, accords with the weight and trend of court decisions, and establishes that TRAC vehicle leases should be treated like all other equipment leases are treated in the law.

TRAC/state laws have been cited by the courts as supporting the true lease status of TRAC vehicle leases in bankruptcy cases where the lessee is in Chapter 11 bankruptcy.[6] See, for example, *In re Owen,* 221 B.R. 56, 63-64 (Bk.N.D.N.Y. 1998).[7] These state statutes are helpful to TRAC vehicle lessors in other contexts as well, including cases involving remedies issues (i.e., must the lessor give advance notice to the lessee of a foreclosure sale, before the lessor can recover a deficiency judgment?), tax questions (e.g., the Streamlined State Sales Tax Project),[8] and any other setting where the question could arise whether TRAC vehicle leases should be treated as sales or true leases.

HISTORY: A LONG TREK FOR TRACS

The origins of TRAC vehicle leases can be traced back at least as far as 1947, when PHH in Maryland (now Element Fleet Management) began marketing them.[9] This style of leasing provided a revenue stream to support the bank loans that PHH needed to buy cars for its clients while limiting the lessee's charges to the actual cost of leasing (i.e., vehicle depreciation, plus interest on PHH's bank loans, and a fee for PHH's services). TRAC leasing also keeps the client in a position to control the costs of leasing.[10] And it eliminates disputes about who caused (and the amount of) vehicle damage.

Starting in 1948, PHH became the first company to offer TRAC leasing for fleets of cars and trucks. In the early 1950s, responding to customer demand, other vehicle fleet leasing companies similarly began to use the TRAC form of lease. Thereafter, in response to the Financial Accounting Standards Board's issuance of Statement No. 13 (SFAS 13) in late 1976,[11] Wheels introduced the "split-TRAC" vehicle lease[12] in the fleet leasing industry. The split-TRAC qualified as an operating lease under SFAS 13, which meant that it could be explained in accountants' endnotes instead of being listed as a full-bore liability on the lessee's balance sheet.

To meet the growing customer demand, other corporate fleet lessors quickly began offering split-TRAC leases, which soon became the dominant form of leasing for commercial fleets of cars and trucks.[13]

In the late 1970s and early 1980s, however, some courts and Treasury/IRS rulings held that because TRAC clauses undercut the owner/lessor's meaningful risk and reward in the residual, TRAC leasing transactions were not true leases.[14] Federal tax law was amended in 1983 to overrule Treasury/IRS objections, adding 26 U.S.C. §7701(h) to make it clear that commercial TRAC vehicle leases, in widespread use throughout the country, should be treated as true leases for tax purposes.

Mirroring the federal tax statute validating TRAC vehicle leasing, the scope and coverage of the TRAC/state laws is limited to motor vehicles and trailers. This explains why TRAC/state laws commonly appear in state certificate of title laws (whose scope is limited to cars and trucks) instead of UCC Article 2A—Leases (which applies across the board to all types of equipment).[15] The scope of TRAC leasing is limited by tax law, in any event, to commercial (nonconsumer) leases of cars, trucks and trailers (not other types of equipment). The state legislatures of all 50 states and the District of Columbia have now enacted TRAC/state laws that recognize the "true lease" validity of this important mainstream commercial practice.[16]

OLDER SPLIT-CASE LAW SWEPT AWAY

TRAC/state laws resolve the earlier split-case law in favor of recognizing the true lease character of TRAC vehicle leasing. Occasionally, a trustee in bankruptcy, hoping to overthrow the bargain originally struck by the parties to a TRAC lease in order to obtain more money for the bankrupt estate, may challenge the true lease character

Enactment of these TRAC/state laws was accomplished with the support of many parties, including both commercial lessors and lessees of cars and trucks, state bar organizations, state trucking organizations, state banking organizations, and the Uniform Law Commission.

of a TRAC vehicle lease. And sometimes practitioners fail to bring TRAC/state laws to the court's attention[17] — a problem that continuing legal education programs, writeups and articles like this one may help to address.

TRAC/state laws provide that, for commercial leases of cars, trucks and trailers, the mere presence of a TRAC clause does not destroy true lease status or create a sale or security interest.

Other lingering criticisms leveled at the true lease character of TRAC vehicle leasing fail to come to grips with the fact that there are different kinds of TRAC clauses.[18] The split-TRAC vehicle lease — which has long been the norm in commercial vehicle fleet leasing — utilizes a TRAC clause that is limited, as distinct from the wide-open unlimited TRAC clauses that are used to help create "true sales" in securitization deals. A split-TRAC vehicle lease is a lease[19] that gives the owner/lessor an entrepreneurial stake in the residual: that is, a minimum "at risk" stake in the vehicle (e.g., 20% of original cost) that is not subject to variation by the TRAC clause, and a maximum lease term that ensures that the lease does not use up the economic life of the vehicle.

Also overlooked by critics is the fact that, where motor vehicles are involved (as opposed to other types of equipment), a TRAC owner/lessor retains significant contingent liabilities for taxes, traffic tickets, and any violation of odometer laws (see 49 U.S.C. §§32705–32709, entailing both criminal and civil liabilities) — none of which are present in a "sale" or "loan" or "security interest."[20] The split-TRAC vehicle lease is a true lease (not a "sale" or "security interest") under any sound common-law analysis, and it also passes muster as a true lease under UCC §1-203, the UCC provision that sharpens the distinction between a true lease and a security interest.[21]

TRAC/state laws were intended to, and should, short-circuit all the old objections to the true lease character of split-TRAC vehicle leases. The short of it is that TRAC vehicle leasing is a well-established commercial practice of long standing, which now covers millions of commercially leased cars and trucks. It provides cost savings and efficiencies to commercial lessees, who create the continuing popular demand for it. There is no good reason to disrupt this mainstream commercial practice with recharacterization in bankruptcy proceedings, disadvantageous state sales and use tax treatment, or other legal penalties. To the contrary, the central purpose of the UCC is to support and facilitate mainstream commercial practices like TRAC vehicle leasing.[22]

TRAC/state laws provide that, for commercial leases of cars, trucks and trailers, the mere presence of a TRAC clause does not destroy true lease status or create a sale or security interest. It should be clear, however, that the mere presence of a TRAC clause does not guarantee that a transaction will be a true lease. For example, a nominal $1 purchase option (created independently of the TRAC clause) will destroy true lease status of any equipment or vehicle "lease" — whether the transaction is analyzed under federal tax law, state commercial law, or accounting principles. This is why the courts still must examine "the facts of each case" (UCC §1-203) to determine the true lease/sale question in cases involving TRAC vehicle leases.

TRAC/STATE LAWS EFFECTIVE IN THE 50 STATES

All the TRAC/state laws are listed below.

1. **Alabama.** Code of Alabama §32-8-60.1 (effective July 29, 1991).

2. **Alaska.** Alaska Statutes §28.10.375 (applicable to transactions involving motor vehicles entered into on or after August 23, 1994).

3. **Arizona.** Arizona Revised Statutes §44-287 D (effective June 16, 1992).

4. **Arkansas.** Arkansas Code of 1987 §4-2A-110 (nonuniform amendment adding UCC 2A-110) (effective March 3, 1997).

5. **California.** California Commercial Code §1203(c)(7) (nonuniform amendment adding a new subsection to the California Commercial Code version of UCC 1-203) (covers commercial motor vehicles and states that "nothing in this paragraph affects the application or administration of the Sale and Use Tax Law") (effective January 1, 1996).

6. **Colorado.** Colorado Revised Statutes §42-6-120(3) (effective April 16, 1997).

7. **Connecticut.** Connecticut General Statutes §14-167a (Public Act 96-162) (effective October 1, 1996).

8. **Delaware**. 21 Delaware Code §2342 (effective July 3, 1996).

9. **District of Columbia.** District of Columbia Statutes §50-1217 (2001 ed) (effective March 17, 1993).

10. **Florida.** Florida Statutes §319.271 (effective January 1, 1991).

11. **Georgia.** Georgia Code §40-3-60 (effective July 1, 1995).

12. **Hawaii.** Hawaii Revised Statutes §286-52.4 (effective April 16, 2003).

13. **Idaho.** Idaho Code §49-512A (effective July 1, 2004).

14. **Illinois.** Illinois Vehicle Code §3-201.1, 625 ILCS 5/3-201.1 (effective January 1, 1992).

15. **Indiana.** Indiana Code §9-17-5-4 (effective July 1, 1995).

16. **Iowa.** Iowa Code §321.51 (effective July 1, 1995).

17. **Kansas.** Kansas Code §84-2a-110 (nonuniform amendment adding UCC §2A-110) (effective April 9, 1998).

18. **Kentucky.** Kentucky Revised Code §186A.191 (effective July 12, 2012).

19. **Louisiana.** Louisiana Revised Statutes §9:3317(A)(4), §9:3316 (A)(4), (effective July 13, 1985).

20. **Maine.** Maine Revised Statutes Annotated Title 10, chapter 209-A, §1305 (effective May 31, 1997).

21. **Maryland.** Maryland Code, Transportation, §13-211 (effective January 1, 1995).

22. **Massachusetts.** Massachusetts General Laws chapter 90D §21A (effective March 25, 1996).

23. **Michigan.** Michigan Compiled Laws §440.2810 (nonuniform amendment adding UCC 2A-110) (effective September 30, 1992).

24. **Minnesota.** Minnesota Statutes §168A.17.1a (effective May 18, 1989).

25. **Mississippi.** Mississippi Code §63-21-42 (effective July 1, 1994).

26. **Missouri.** Missouri Statutes §301.452 (effective September 19, 1991).

27. **Montana**. Montana Code §61-3-110 (effective October 1, 2003).

28. **Nebraska.** Nebraska Revised Statutes §60-164(5) (effective March 2, 2004).

29. **Nevada.** Nevada Revised Statutes §482.4215 (effective May 28, 2003).

30. **New Hampshire.** New Hampshire Revised Statutes §261:23-a (effective January 1, 1995).

31. **New Jersey.** New Jersey Statutes Ann. §39:10-5.1 (effective June 29, 1992).

32. **New Mexico.** New Mexico Statutes Ann. §66-3-101.1 (effective March 28, 2013).

33. **New York.** McKinney's Vehicle and Traffic Law §397-b (effective August 7, 1992).

34. **North Carolina.** North Carolina General Statutes §25-2A-103(j) (nonuniform amendment to UCC 2A-103(j)) (effective July 15, 1994), clarified by North Carolina General Statutes §20-78.1 (effective June 23, 2011).

35. **North Dakota.** North Dakota Century Code §39-05-17.3 (effective July 1, 1993).

36. **Ohio.** Ohio Revised Code §4505.13(D) (effective November 6, 1992).

37. **Oklahoma.** Oklahoma Statutes Ann. §47-1110 F (effective January 1, 1992).

38. **Oregon.** Oregon Revised Statutes (Vehicle Title and Registration) §803.098 (effective August 16, 1993).

39. **Pennsylvania.** Pennsylvania Consolidated Statutes Ann. 75 Pa.C.S. §1139 (effective September 4, 1995) (covers commercial motor vehicles).

40. **Rhode Island.** Rhode Island General Laws §31-3.1-27 (effective July 1, 1991).

41. **South Carolina.** South Carolina Code §56-19-720 (effective June 11, 1998).

42. **South Dakota.** South Dakota Codified Laws §32-3-38.2 (effective March 19, 2003) (covers commercial motor vehicles).

43. **Tennessee.** Tennessee Code §47-2A-110 (nonuniform amendment adding UCC 2A-110) (effective July 1, 1994).

44. **Texas.** Texas Transportation Code Title 7 §501.112 (effective September 1, 1991).

45. **Utah.** Utah Code Ann. 1953 §41-1a-609 (states "the provisions of this section do not affect … the calculation of sales and use tax") (effective May 5, 2003).

46. **Vermont.** 23 Vermont Statutes Ann. §2048 (effective July 1, 1993).

47. **Virginia.** Virginia Code Ann. §46.2- 640.1 (effective January 1, 1992).

48. **Washington.** Originally enacted in 1994 in Washington Revised Code §62A.1-201(37) (f) (2005) as a nonuniform amendment to UCC 1-201(37) (effective July 1, 1994), Washington State's TRAC/state law was inadvertently omitted from that State's statute books during statutory renumbering and updating of the UCC in 2012. Through the combined efforts of the Washington State Bar, the American Automotive Leasing Association, the Equipment Leasing and Finance Association, the Truck Rental and Leasing Association, the Washington Trucking Association, and the Washington State Bankers Association, TRAC/state legislation was re-enacted in the State of Washington, in West's Revised Code of Washington §62A.1-203(c)(7), effective prospectively starting from July 24, 2015 (nonuniform amendment to UCC §1-203).

49. **West Virginia.** West Virginia Code §17A-4A-16 (effective June 7, 1996).

50. **Wisconsin.** Wisconsin Statutes Ann. §342.03 (effective July 1, 1992).

51. **Wyoming.** Wyoming Statutes 1977 §31-2-802 (effective July 1, 2003).

TRAC/state laws are now the common, uniform state law of the United States. In seven states (Arkansas, California, Kansas, Michigan, North Carolina, Tennessee, and Washington), TRAC laws are in the UCC.[23]

Before enacting the TRAC/state laws, state legislatures were fully apprised of the earlier split-

The overwhelming majority of courts now properly recognize the true lease character of split-TRAC vehicle leases in widespread use throughout the United States.

case law and the sound policy reasons for enacting the model TRAC/state law. See, for example, "New Developments: Article 2A Leases of Goods," 1993 Commercial Law Annual 115, 124–130 (spelling out the rationale for the TRAC/state laws). Consequently, the statutory text, placement, purposes, intent and consequences of the TRAC/state law all appear in the legislative history of the TRAC/state laws.[24] See, for example, "Leases," 64 Business Lawyer 1187, 1189–1190 & nn.24, 25 (2009) (noting the legislative history of North Carolina's TRAC/state law, overlooked by the court in Brankle Brokerage (Bk.N.D.Ind. 2008),[25] where the court erroneously held that a TRAC lease was a sale under North Carolina law. (*Brankle Brokerage* was specifically overruled by clarifying North Carolina legislation in 2011.) The Commissioners on Uniform State Laws supported the enactment of the TRAC/state laws.

The overwhelming majority of courts now properly recognize the true lease character of split-TRAC vehicle leases in widespread use throughout the United States.[26]

Endnotes

1. *See, e.g.,* In re Tulsa Port Warehouse Co., 690 F.2d 809 (10th Cir. 1982); Swift Dodge v. Commissioner, 692 F.2d 651 (9th Cir. 1982); Leslie Leasing Co. v. Commissioner, 80 T.C. 411 (1983); *New Developments: Article 2A Leases of Goods,* 1993 Commercial Law Annual 115, 124-130 (reviewing the split case law on whether TRAC vehicle leases are properly viewed as sales or as true leases).

2. True leases long have been distinguished from sales for many purposes, including the commercial law of remedies, whether UCC filings are required and third-party rights, whether a transaction is covered by state usury laws, and a lessor's rights under §365 of the Bankruptcy Code when the lessee goes into bankruptcy. "New Developments: Article 2A Leases of Goods," 1993 Commercial Law Annual 115, 117 (collecting cases). *Accord:* 2 White & Summers, *UCC Treatise* §13-2 at 4 (4th ed. 1995) ("[I]f one is a lessor as opposed to a seller, one has different rights on default, on lessee bankruptcy, in regard to federal, state and local taxes, and under state usury laws, and the difference even extends to the lessor's and lessee's balance sheet"). For example, where a purported "lease" is found to be a disguised security interest, the "lessor" (secured party) may be barred from obtaining a deficiency judgment against a defaulting "lessee" (debtor) if it failed to give notice to the debtor as required by UCC §9-504(3). *See, e.g.,* Fleming v. Carroll Pub. Co., A.2d 1219 (DC App 1990). True leases, as opposed to disguised loans or "forebearances" of money, also may be exempt from state usury laws. *Compare* Kinerd v. Colonial Leasing Co., 800 SW2d 187 (Tex 1990) (court recharacterized "lease" transaction with nominal purchase option as a loan and secured sale, and imposed penalties for usury on the 'lessor").

3. True lessors of vehicles fare better than holders of "perfected security interests" who, in turn, are better off than holders of "unperfected security interests," when the lessee/debtor is in Chapter 11 bankruptcy reorganization. See "Leasing Is Distinctive!," 35 UCC L.J. 15, 17 & n.8 (2003) (collecting authorities). Oversimplified, true lessors are entitled to receive full current rental payments, or to repossess their equipment, under 11 U.S.C. §365, if the "lease" transaction is a true lease. *See, e.g.,* In re PSINet, Inc., 271 B.R. 1 (Bk.S.D.N.Y. 2001); In re Furley's Transport, Inc., 263 B.R. 733 (Bk.D.Md. 2001). By contrast, if a "lease" is viewed as a "perfected security interest" and not a true lease, then the "lessor" in this situation is entitled to receive only the smaller amount needed to provide "adequate protection" for the replacement value of its collateral (*see* Associates Commercial v. Rash, 520 U.S. 953 (1997)), which may be only 60% to 80% of contract rentals. And if the "lease" is viewed as an "unperfected security interest," the trustee in bankruptcy may be able to keep the equipment, without making current payments of any kind, and sell it. *See, e.g.,* Tulsa Port Warehouse Co., 690 F.2d 809 (10th Cir. 1982). There is no federal statutory definition of a lease, and federal bankruptcy law looks to state commercial law to define the difference between a true lease and a security interest. *See, e.g.,* In re Pillowtex, 349 F.3d 711, 716 (3d Cir. 2003); "Leases," 65 Business Lawyer 1229, 1231 n.14 (2010); "Leases," 58 Business Lawyer 1567, 1569 n.11 (2003)

4. *See, e.g.,* "New Developments: Article 2A Leases of Goods," 1993 Commercial Law Annual 115, 124-130 (citing cases involving early termination/TRAC clauses in remedies provisions, and split-TRAC operating leases in which the lessor maintains a minimum "at risk" investment not subject to variation by the TRAC clause throughout the term of the lease); "Old Wine in New Bottles: UCC Article 2A-Leases," 39 Alab.L.Rev. 615, 638-641 (1988) (describing one-sided TRAC provisions in which the lessor either protects against residual value loss, or shares in residual value gains with the lessee, but not both; TRAC-like provisions in remedies provisions that apply only when the lessee is in default; and split-TRAC operating leases leaving the lessor with a minimum "at risk" investment in the vehicle not subject to variation by the TRAC clause).

5. TRAC vehicle leasing has proven to be the most cost-effective way for many lessee/end-users to finance the vehicles that are essential to their business. TRAC credits and TRAC debits at the end of the lease term are determined by the sales price (or appraisal) realized at vehicle turn-in, usually in wholesale auctions of vehicles conducted every month by Manheim and other auction houses at a variety of different locations across the United States. This way of determining TRAC credits/debits, tied to a vehicle's realized end-of-lease sales price, minimizes disputes that otherwise might arise between lessors and lessees about vehicle damage or excessive wear and tear.

6. *See* n.3 *supra* for an explanation of the differences in an owner/lessor's rights when the lessee is in Chapter 11 bankruptcy depending upon whether the "lease transaction" is viewed as a lease, a perfected security interest, or an unperfected security interest.

7. *Accord:* In re HP Logistics, 460 B.R. 291 (Bk.N.D.Ala. 2011) (same); In re HP Distribution, 436 B.R. 679 (Bk.D.Kan. 2010) (same); In re Double G Trucking of the Arklatex, 432 B.R. 789 (Bk.W.D.Ark. 2010) (same); In re Beckham, 275 B.R. 598, 606 (D.Kan.), affirmed, 52 Fed.Appx 119 (10th Cir. 2002) (same); In re Charles, 278 BR 216, 224 (Bk.D.Kan. 2002) (same); In re Damron, 275 B.R. 266, 270 (Bk.E.D.Tenn. 2002) (same); In re Architectural Millwork of Virginia, 226 B.R. 551, 556 (Bk.W.D.Va. 1998) (same); In re MEPCO, Inc., 276 BR 94, 103 (Bk.W.D.Va. 2001) (same). *See also* In re Otasco, 196 B.R. 554 (N.D.Okl. 1991), overruling 111 B.R. 976 (Bk.N.D.Okl. 1990); Gilbraltar Financial Corp. v. Prestige Equpment Co., 925 NE 2d 751, 757 (Ind.App. 2010); In re Rebel Rents, 291 B.R. 520 (Bk.C.D.Cal. 2003). *See generally* "Leases," 54 Business Lawyer 1855, 1858-1859 (1999) (surveying cases and authorities on TRAC vehicle leases).

8. The Streamlined State Sales Tax Project (SSTP) was organized in March 2000 to simplify and modernize state systems for collecting and administering sales and use taxes. Those systems often distinguish between sales and leases of equipment. The SSTP was dissolved once the Streamlined Sales and Use Tax Agreement (SSUTA) became effective October 1, 2005. Twenty-four states have passed legislation to conform to the SSUTA. See

www.streamlinedslaestax.org (information on the streamlined sales tax).

9. Peterson, Howell & Heather (PHH) was founded in 1946 by three entrepreneurs: Duane L. Peterson, Harley W. Howell and Richard M. Heather. PHH became Element Fleet Management in 2014.

10. This account reflects Harley Howell's memoirs, now kept by Element Fleet Management, on the creation of TRAC vehicle leasing. Email interview with Paul Danielson, Senior Vice President and General Counsel of Element Fleet Management in Sparks, Maryland (August 17, 2015).

11. Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 13, Accounting for Leases (1976).

12. Typical TRAC vehicle leases, written to comply with accounting standards and federal tax Code §7701(h), are "split-TRAC" operating leases that (among other things) give the owner a minimum "at risk" stake in the vehicles (e.g., 20% of original cost) that is not subject to the TRAC clause, and that contain a maximum lease term that ensures that the lease does not use up the economic life of the vehicle. For example, while TRAC provisions vary, a typical TRAC clause in a split-TRAC lease may provide,

> **TERMINAL RENTAL ADJUSTMENT.** As an incentive to the Lessee to maintain the value of the Vehicle by good maintenance, repair and careful use during its Lease Term, the parties agree that the enhancement or reduction in value shall be compensated as follows:
>
> a. **Refund of Rental.** If the Net Proceeds exceed the Book Value (as to each Vehicle), its Capitalized Cost as defined in the Rate Schedule, reduced by appropriate amortization, the Lessor shall retain an amount equal to the Book Value, and remit the excess to the Lessee as a refund of rental.
>
> b. **Rental Charge.** If the Net Proceeds are less than the Book Value, the Lessee shall pay the Lessor the amount of the difference. However, if the Net Proceeds are less than the Guaranteed Residual (defined below), this rental charge is limited to the amount of the difference between the Guaranteed Residual and the Book Value. The Guaranteed Residual is 20% of the Capitalized Cost at the end of the minimum Lease Term and thereafter, 20% of the Book Value as of the end of the prior month.

A typical maximum lease term in a split-TRAC lease may provide, for example,

> **LEASE TERM.** The noncancelable minimum Lease Term for each Vehicle is 367 days starting the date of the Lessee's acceptance. Thereafter, the Lessee shall be deemed to have elected to renew the Lease Agreement for each Vehicle on a month-to-month basis unless notice of surrender of such Vehicle is provided to Lessor. However, in no event shall the lease term for any vehicle Lease Term extend beyond fifty (50) months for automobiles, seventy-two (72) months for light trucks, and ninety-six (96) months for medium and heavy duty trucks, unless a different maximum lease term is set forth on any other Exhibit to this Master Lease Agreememt."

13. Email interview with James S. Frank, Chief Executive Officer of Wheels Inc. in Des Plaines, Illinois (August 17, 2015).

14. *See, e.g.,* In re Tulsa Port Warehouse Co., 690 F.2d 809 (10th Cir. 1982); Swift Dodge v. Commissioner, 692 F.2d 651 (9th Cir. 1982); and Leslie Leasing Co. v. Commissioner, 80 T.C. 411 (1983). There are important reasons why, as a general proposition, the common law should preserve the lessor's meaningful residual interest as the touchstone of the definition of a true lease. *See Leasing Is Distinctive!* 35 UCC LJ 15, 21-22 (Winter 2003); "Old Wine in New Bottles," 39 Ala.L.Rev. 615 (1988) at 626 ("The old common law touchstone of a true lease — the lessor's meaningful residual interest — is reflected in [UCC] Article 2A-Leases."), and at 632 ("As a matter of economic self-interest, a true lessor cares about the quality, energy efficiency, durability, and long-term value of the leased goods, since there is some legitimate possibility that he may get back the goods or otherwise have to dispose of them. * * * Ordinarily, all other things being equal, one might expect rental payments under a true lease to be lower than periodic payments under a disguised sale where the seller, at the outset of the transaction, plans never to deal with the residual. Viewed from the perspective of the economy as a whole, lessees will have more marketplace choices and will receive more meaningful information about the goods they wish to use when the law recognizes the substantive economic differences between a true lease and a sale. One essential difference between the two is that the lessor in a true lease retains a real, economically meaningful interest in the residual."). Yet TRAC vehicle leasing is a well-established commercial practice of long standing that has developed and grown so that today it is the dominant form of commercial vehicle leasing in America, covering millions of vehicles; it lowers lease rental rates and facilitates interstate commerce; and the split-TRAC vehicle lease in common use does preserve a meaningful economic interest in the residual for the lessor. *See, e.g., id.* 638- 641; "New Developments: Article 2A Leases of Goods," 1993 Commercial Law Annual 115, 129-130 (canvassing the conflicting case law and spelling out the policy rationale for enacting TRAC/state statutes); and pp. 4-5 infra (split-TRAC leases in widespread use are true leases under the principles of the common law and UCC §1-203).

15. Washington state's recent experience illustrates another, additional reason why the TRAC/state laws are best positioned in a state's certificate of title laws and not in the middle of the UCC, where they are subject to being "wiped out" whenever the UCC is periodically updated (once every 5 to 10 years). Washington State first enacted a TRAC/state law in 1994. But that law was inadvertently repealed during a statutory renumbering exercise in 2012. This happened because, when UCC articles are revised or updated, all of the old articles are often deleted and replaced with the newest, multi-hundred-page versions. Unless special legislative efforts are made to preserve "non-uniform" amendments, those fall by the wayside whenever a UCC article is revised or updated in this fashion. Washington state had its 1994 TRAC/state law inadvertently wiped out in this manner, and it had to go to the trouble of re-enacting a TRAC/state law in 2015.

16. Traditionally, the UCC has accommodated and accepted (rather than upset) long-standing mainstream commercial practices like TRAC vehicle leasing. *See, e.g.,* Gilmore, "On the Difficulties of Codifying Commercial Law, " 57 Yale L.J. 1341 (1957) ("The principal objects of draftsmen of general commercial legislation – by which I mean legislation which is designed to clarify the law about business transactions rather than to change the habits of the business community – are to be accurate and not to be original."), *id.* at 1351 (in drafting UCC Article 2-sales, "a notable effort has been made to conform the law to current business practice"). TRAC vehicle leasing of cars and trucks, starting in the 1940s, is older than the Uniform Commercial Code (UCC) drafted by Karl Llewellyn, which was first published as a proposed Code in the early 1950s (*see, e.g.,* Barkley Clark & Louis Del Duca, "Hot Topics in Secured Transactions," 1993 Commercial Law Annual 501, 502 n.4).

17. *See, e.g.,* In re Grubbs Construction Co., 319 B.R. 698 (Bk.M.D.Fla. 2005) (TRAC/state statutes never mentioned by the parties or the Court; unclear whether the case involved vehicles); In re Lash, 2010 WL 5141760 (Bk.M.D.N.C. 2010) (criticized as wrongly decided by "Leases," 66 Business Lawyer 1101, 1105 (2011), because neither the parties nor the Court makes any mention of the TRAC/state statutes enacted in every state).

18. One reason why disputes have arisen about TRAC vehicle leases may be that, historically, equipment lessors have used open-ended, double-edged, unbounded TRAC clauses and other provisions to destroy "true lease" status. This is important in securitization deals, where one must have a "true sale" in order to transfer assets to a bankruptcy-remote entity. But there are different kinds of TRAC clauses: they are not all the same. The overly simplistic view that any kind of TRAC clause destroys true lease status is as wrong as the simplistic, mistaken view that any kind of $1 purchase option is a death knell for true lease status. *See, e.g.,* In re Marhoefer, 674 F.2d 1139 (7th Cir. 1981) (court holds transaction a true lease despite $1 purchase option, because lessee was not obligated to continue the lease for eight years until the $1 purchase option arose).

19. In general: "A lease involves payment for the temporary possession, use and enjoyment of goods, with an expectation that the goods will be returned to

the owner with some expected residual value remaining at the end of the lease term. In contrast, a sale involves an unconditional transfer of absolute title to goods, while a security interest is only an inchoate interest contingent on default and limited to the remaining secured debt." White, Summers & Hillman, *Uniform Commercial Code* Treatise §15:2 n.2 (6th ed. 2015).

20. *Compare* Frank Lyon v. United States, 435 U.S. 561 (1978) (court holds lease in a sale-leaseback transaction is a true lease, based in part on the owner/lessor's contingent liability for taxes).

21. The overall philosophy of UCC §1-203 is to reject mathematical percentages and formulas (like those in SFAS 13), to avoid "dumbing down" equipment leasing and making equipment leasing into a commodity like a box of corn flakes (where the only competition is on price) and to leave room for creativity and competition in creating new lease products. *See* "Old Wine in New Bottles," *supra,* 39 Ala.L.Rev. at 628-632 (1988) (summary, history and analysis of the sharpened true lease definition in UCC §1-203, formerly UCC §1-201(37)). The statute was not designed to answer all questions about what is a true lease; instead, the statute is designed to serve the long-term public interest of the Nation by preserving creativity and competition. UCC §1-203 sets forth a common law definition of a true lease that reflects mainstream case law, overrules earlier unsound cases, and liberalizes the overly restrictive, stringent safe harbor standards in the *IRS Guidelines* for issuing advance rulings on leveraged leases in IRS Rev.Proc. 2001-28, 2001-1 C.B. 1156, incorporating old IRS Rev.Proc. 75-21, 1975-1 C.B. 715 (checklist for IRS rulings on leveraged leases).

22. *See, e.g.,* UCC §1-103 (stating UCC's central purposes: "to simplify, clarify and modernize the law governing commercial transactions; [and] to permit the continued expansion of commercial practices through custom, usage and agreement of the parties"); Gilmore, "On the Difficulties of Codifying Commercial Law," *supra* n.16.

23. The original North Carolina TRAC/state law, enacted in the state's UCC in 1994, was clarified in North Carolina's certificate of title laws in 2011, as noted above in the text.

24. The statutory text and legislative history of all the TRAC/state laws are available from AALA General Counsel Edwin E. Huddleson, 1250 Connecticut Ave. N.W., Suite 200, Washington, DC 20036; (202) 543-2233; huddlesone@aol.com; www.edwinhuddleson.com.

25. In re Brankle Brokerage, 394 B.R. 906 (Bk.N.D.Ind. 2008).

26. *See, e .g.,* court decisions listed in footnote 7 *supra; Leases,* 67 Business Lawyer 1245, 1248-1249 (2012) (collecting cases on TRAC vehicle leases) *and compare* Strauss, *General Governing Law: UCC Articles 1,2A, and 9* (Rel #9 September 2014), in 1 *Equipment Leasing–Leveraged Leasing* §2:1.4[C] (Ian Schrank & Arnold G. Gough eds, 5th ed. 2014) (misguided attack on the true lease character of TRAC vehicle leases, unencumbered by any knowledge of TRAC vehicle leasing or common split-TRAC leases; or the history, purposes and rationale of the TRAC/state laws; or the support of the Commissioners on Uniform State Laws for TRAC/state laws; or the basic public policy purposes of commercial law (*see,* e.g., UCC §1-103; "New Developments: Article 2A Leases of Goods," 1993 Commercial Law Annual 115, 124-130 (canvassing earlier split case law and spelling out the rationale for the TRAC/state laws)).

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