

Fair Market Value in Leasing

How Lessors Can Maximize Their Recovery

By Thomas E. McCurnin

MANY EQUIPMENT leases contain a fair market value purchase option. However, when the lease expires, and it comes time to enforce that provision, many lessors can be frustrated by an obstinate lessee, poor documentation and lack of legal options. Many lessees claim the equipment is a worthless pile of scrap (yet are resistant to returning it), or claim that soft costs, such as installation, software or unexpired service contracts, should be excluded from the calculation of fair market value. This article will discuss how these provisions can be enforced and the legal basis for enforcement and will finally offer some drafting tips to those lessors who utilize fair market value purchase options regularly.

The first issue is often who determines fair market value. The lessor naturally feels that it alone should determine fair market value, usually based on the amount of the lessor's booked residual, which may or may not have any relationship to the actual fair market value of the equipment. On the other hand, the lessee often feels that it is more qualified to determine fair market value. Legally, there are no cases that support the contention that the lessor can, in its sole and absolute discretion, determine fair market value. Therefore, the issue must be resolved in the lease terms.

Many leases do not provide a mechanism to determine fair market value, and it is prudent for the lessor to provide for some methodology in the lease. In larger-ticket leases, the lease may provide that, in the event of a dispute, the lessor appoints one appraiser, the lessee appoints a second and the two appoint a third. The trio of appraisers then comes up with a valuation that shall be deemed to be conclusive.

In small- to medium-ticket leases, the appraiser method simply is not cost-effective, and the lessor should provide a term in the lease that provides that fair market value may be determined by the lessor in its sole and absolute discretion. The lessee may still be unwilling to pay this sum, but it at least provides some legal footing for the figure that the lessee will ultimately propose.

In the event of a dispute, the courts will ultimately determine fair market value, unless there is an arbitration clause. The courts can be drawn into the picture in a variety of ways. If the lessor is not able to repossess the equipment, the lessor may want to file an application for a Writ of Possession/Replevin, and the court may determine the value in the context of a bond hearing. If the lessee chooses to bond around the Replevin, the matter will ultimately go to trial, at which time the court will determine fair market value. This process

may be lengthy and expensive, so an early arbitration or mediation is probably wise.

Valuation for Soft Costs

The capital expenditure of the lessor may include not only the equipment, but also significant soft costs of installation, software or service contracts. The lessor will naturally desire to have these costs included in the valuation. On the other hand, the lessee will want to have these costs excluded. Again, there is no specific case law on whether such costs are recoverable. However, by way of analogy discussed later in this article, an argument may be made that replacement value is the proper measurement of fair market value, which would probably include such soft costs. In any event, the lessor should include a definition as to what fair market value is, and the fact that it includes all costs associated with the equipment leased, including installation, software and unexpired service contracts.

Replacement Value

The issue of whether the true measure of fair market value should be the replacement value is often overlooked by many lessors. Essentially, the question is whether the fair market value is the equipment itself or

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the replacement value of the equipment to the lessee. Putting it bluntly, the equipment is worth far more to the lessee in place than it would be to remove the equipment and liquidate it. Indeed, if the lessee were required to shop for similar equipment, make the capital expenditure to purchase it and finally pay for installation and training, the true value of the equipment would nearly approach the value of new equipment, even if the lessor factors in depreciation.

Replacement value for personal property has broad support in case law. The typical application for replacement value occurs in a bankruptcy, in determining a creditor's secured status under Bankruptcy Code Sec. 506. *In re Winthrop Old Farm Nurseries Inc.*, 50 F.3d 72,74 (1st Cir. 1995) does not concern an equipment lease, but contains a good discussion as to why property should be valued as a going concern, and may be of assistance to those leasing attorneys faced with this issue.

As of this writing, the Supreme Court granted certiorari in a Texas case that held that Bankruptcy Code Sec. 506 does not require the court to value the creditor's interests by replacement value, and in that case, a Chapter 13 debtor retained a truck, which was valued by the lower court at liquidation value. *In the Matter of Rash*, 90 F.3d 1036 (5th Cir. 1996). *Rash* contained a strong dissent, based mainly on several Ninth Circuit decisions, and has been granted certiorari by the Supreme Court. It is expected, or at least hoped, that the Supreme Court will affirm the decisions of the majority of circuits that hold that, under Sec. 506, the proper value is the replacement value of the asset, not the wholesale liquidation cost.

Other cases, discussed below, do not directly concern equipment leases, but address the issue of the value of personal property, often in the context of litigation against the owner's insurance company for fire or loss.

In California, the replacement value principal is applied broadly. California courts have usually applied it by taking into consideration the new cost of the asset or equipment, factoring in installation costs and depreciating the equipment to its present value. California courts have even used replacement value in lieu of the Kelly Blue Book. *Jefferson Ins. Co. v. Superior Court*, 3 Cal.3d 398, 402 (1970).

In New York, the application of replacement value is more limited. The equipment must be classified as "specialty equipment" that is considered so unique as to require a valuation by replacement value. This includes equipment with significant custom features. *Albany Country Club v. State of New York*, 241 N.Y.S.2d 604, 606 (1963). Replacement value has also been applied to equipment that cannot be removed, except at a great cost. *Universal Empire Industries Inc. v. State of New York*, 566 N.Y.S.2d 442, 444 (1990). Finally, New York courts have applied replacement value to technical equipment with high installation costs, including wiring. *Gavish v. Rapp*, 485 N.Y.S.2d 407, 411-12 (1984). Many forms of leased equipment fall within these two categories, and may be susceptible to a valuation by replacement value.

To capitalize on this potential windfall, the lessor should consider including a provision in the lease that fair market value is determined by replacement value, including the costs of installation. Otherwise, lessors may be forced into arguing that their equipment is of a nature that replacement value is an appropriate measure of fair market value.

Drafting Tips for Lessors

The typical fair market value lease may be inadequate to protect the lessor's rights at the expiration of the lease. The lessor should consider incorporating some of the following provisions in leases with a fair market value purchase option:

- **Automatic Renewal.** While this may seem obvious, the lease term should be automatically renewed at the expiration of the lease. By including this provision, the lessor will be able to capture additional revenue, while, at the same time, providing an incentive to the lessee to resolve the valuation process quickly. The lessee may be more willing to negotiate with the lessor if monthly lease payments are accruing.

- **Dispute Resolution.** The lease should provide some mechanism for resolving how fair market value is determined. In large-ticket leases, a trio of appraisers and an arbitration proceeding are often used to determine fair market value. In small- to medium-ticket leases, the lessor should be granted the exclusive right to determine fair market value, and the lessor should consider utilizing arbitration or an early voluntary mediation to trim legal costs.

- **Soft Costs/Replacement Value.** The lease should provide that fair market value is defined as the sum that the lessee would pay to a dealer for comparable equipment, including installation and other soft costs.

In conclusion, lessors should take advantage of fair market value leases, and not let lessees use them to hold the lessor hostage. By understanding and utilizing fair market value lease resolution, these types of leases can be a profit center for the lessor, instead of a headache. ■



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