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‘Trial of the Century’ Takes on Hell or High Water

By Paul Bent

Among equipment leasing lawyers, there is perhaps no contractual provision more important, more universal, more indispensable — perhaps more sacrosanct — than the widely revered and utilized hell-or-high-water clause. Under this provision, which appears in one form or another in virtually every commercial equipment lease agreement signed over the past 40 years, the lessee agrees that the lease is non-cancelable, that the lessee’s obligations under the lease are irrevocable, that rental payments must continue to be made under any and all circumstances (including the loss or destruction of the leased equipment), and that all defenses, setoffs, and counterclaims to any action for enforcement of the lessee’s obligations are waived.

Such a provision (often abbreviated as the HOHW clause) offers several important benefits to equipment lessors.

- It insulates the lessor from concern over the lessee’s failure to pay for reasons other than actual credit failures or defaults.
- It shifts the risk of default arising from the operability, fitness, usefulness, condition, maintenance, or repair of the leased equipment to the lessee or to the equipment supplier or vendor.
- Perhaps most importantly, it provides contractual assurance to the lessor’s funding sources, to whom leases will most likely be assigned after they are signed by lessees and payments of rent have commenced, that the funders will receive the same benefits of operational insulation and risk shifting that accrued to the lessor under the original lease agreements (*i.e.*, that essentially the only risk the funders will assume is the credit of the lessee — the ultimate obligor).

But there is change afoot in the equipment leasing marketplace, and it portends a potentially seismic shift in the perception, usefulness and utility of the well-tested HOHW clause. So much so that the future of the HOHW provision was debated in a session dubbed the “Trial of the Century” at the recent 56th Annual Convention of the Equipment Leasing and Finance Association (ELFA).

Managed Solutions Transactions

As has been increasingly discussed throughout the equipment leasing industry in recent years, a cohort of younger equipment users and prospective lessees are making their way through the ranks and into decision-making positions in the equipment leasing industry. These are people who have grown up with mobile devices that can address many of their daily needs with no strings attached; who have learned that they can command services of all kinds without committing to any long-term obligations; and who can’t be bothered with long-term, fixed-rate, fixed-rent agreements when all they really want is the immediate and uncomplicated fulfillment of their near-term needs.

This trend has engendered a growing form of financing arrangement variously referred to as bundled transactions, managed solutions transactions (MSTs), managed equipment and services (MES) transactions, and other such names. What these all have in common is a term financing of

personal property coupled with the providing of related and ongoing services — software functionality, maintenance, upgrades, new features, and other intangible benefits — that combine to provide the lessee (or, more precisely in this context, the "user") with a fully integrated and bundled offering of equipment and services.

In this environment, how does the lessor compel the payment of a fixed amount of rent over a fixed period of time for the financing of hardware or other equipment when such payments are contractually coupled with the indefinite obligation of (often) a third-party service provider to deliver intangible services on a pay-as-you-go basis? How can a fixed obligation to pay for equipment be combined with a flexible obligation to pay for (frequently variable) future services? In legal terms, how can a fixed, firm, unconditional, irrevocable obligation to pay certain amounts at certain times over a period of years for the exclusive use of personal property ("goods") be integrated with a conditional obligation to pay for services (not goods) only if they are satisfactorily performed and which can be cancelled or modified at any time?

In short, in the world of MSTs and MES transactions, what happens to the famed HOHW clause, which is so revered in equipment leasing?

The Trial of the Century

This question was addressed in the ELFA Convention program in Orlando, FL. Titled "The Trial of the Century: Are Managed Solutions Forcing the Retirement of the Beloved Hell-or-High-Water Clause?" the convention breakout session undertook an exploration of the pros, cons, concerns, and future of using the HOHW provision in the coming generation of bundled financing solutions.

The program was presented in a lighthearted way, as a mock trial in which a prosecutor (played by Rafael Castillo-Triana, attorney and CEO of The Alta Group's Latin America Region) argued for the elimination of the "archaic" HOHW clause — and a defense attorney (played by the author) argued that the provision is still essential to the industry and must be retained; but the subject was nevertheless treated as a serious question to be considered by leasing professionals and attorneys. Of course, the Trial of the Century also had the benefit of a presiding judge, expertly (and comically) portrayed by Attorney Allan Umans, general counsel of Pacific Rim Capital, a California-based leasing company.

Prosecutor Castillo-Triana presented an opening argument pointing out that in today's managed solutions environment, the HOHW clause may only be providing lessors with a false sense of security; that without the fixed tenor, fixed rent, term obligation to acquire equipment that leasing attorneys have historically utilized, there may not really be a "lease" involved at all — and the HOHW provision in reality serves little or no purpose in a truly flexible and adjustable bundled transaction.

On the other hand, as the defense attorney, I opened my case with the argument that universal adoption of MSTs or MES transactions in the equipment leasing industry is still some way off in time, no matter how exciting and intriguing they may be to today's up and coming practitioners; and that at least for the foreseeable future, the reality of enforcing fixed rent lessee obligations will remain at the heart of negotiating, structuring, and funding personal property lease agreements — *i.e.*, that the HOHW clause still is tried and true and still has a long life ahead of it.

In addition to the attorneys representing both sides, the Trial of the Century involved a number of expert witnesses who testified in depth both for and against the proposition that the HOHW provision should be retired. Scott Thacker, CEO of Ivory Consulting Corporation, testified about the benefits of predictive analytics and the increasing use by lessors of modern analytical methods to underwrite credits and forecast the likelihood of lessee defaults, thereby reducing the long-term need to rely on such draconian measures as HOHW provisions. The prosecution also

enlisted the expertise of Diane Croessmann, managing director of Lenovo Worldwide Financial Services before recently joining Alta, who testified regarding the increasing irrelevance of hardware and equipment components in the emerging world of managed and bundled solutions, which rely increasingly on the capabilities of software and service providers. (In fact, one of Ms. Croessmann's presentation graphics referred to robotic equipment without accompanying software and services as simply "an expensive coat rack.") As the proportion of financing devoted to the equipment portion of transactions continues to dwindle, the need for HOHW protection becomes less relevant as well.

Not surprisingly, the defense also called upon industry experts in presenting its case for the retention of HOHW language in equipment leasing contracts. Attorney Dominic Liberatore, deputy general counsel of De Lage Landen Financial Services, who has drafted and negotiated scores of MES transactions, testified that in his experience the need for HOHW protection does not seem to be headed for the dustbin any time soon. He pointed out that established law continues to support the use of HOHW clauses, and in fact § 9-403(b) of the Uniform Commercial Code (UCC) on its face appears to favor enforcement of MES transactions in the hands of assignees.

Finally, Henry Duncan, Chief Risk Officer of Société General Equipment Finance, testified as to one of the most important aspects of the HOHW provision itself, *i.e.*, its use in providing third-party assignees and funders with the comfort and fungibility required for them to make capital available to equipment lessors and originators without having to fully re-underwrite every lessee in a lease portfolio. He pointed out that without the inclusion of HOHW language it would be difficult for many, if not most, equipment leases and/or related rental streams to be sold or assigned to third-party funders that have not carried out their own extensive underwriting, but who instead know they can rely on the strength of the HOHW clause included in every assigned lease.

The Verdict

Of course, the Trial of the Century would hardly be worthy of the name if it did not result in a verdict as to the question at hand. In the emerging world of MSTs and MES transactions, should the venerable HOHW provision found in virtually every U.S. equipment lease be retired to the pages of history? In this breakout session, that question was put to the "jury" (in the form of the audience attending the session), which voted electronically on the issue.

The resulting verdict was about 18% in favor of retiring the HOHW clause and 82% in favor of retaining it (at least for the time being). While this is not particularly surprising for a jury made up primarily of equipment lessors (who presumably relish the comfort provided for lessors and creditors by the tried and well-tested HOHW clause), it may nevertheless indicate the beginning of a view toward fashioning new ideas and new approaches for the enforcement of equipment financing contracts that bundle equipment leasing together with related services and "soft" customer considerations.

It will be interesting to watch this nascent trend as new and creative approaches are actually written into agreements and tested in the courts. And there is at least one lesson that may certainly be drawn from the Trial of the Century presented in Orlando: As equipment leasing lawyers, we are in for some interesting and innovative times ahead.

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