The Five Most Costly Equipment Leasing Terms and Conditions

1. **Open Ended Interim Rent**

Interim rent is the per diem charge for equipment which is accepted during a time period prior to the commencement of a lease schedule. Interim rent, as a concept, is a perfectly reasonable charge. As equipment is received the lessee pays some pro-rata fee for use of the equipment received until the requirements of the lease documentation have been met and the regular lease payments begin. However, these interim rent payments do not reduce the regular term rent commitment. They are simply additional payments made to compensate the lessor for use of the equipment prior to the lease proper beginning. If a Lessee has performed financial analysis and lease vs. buy analysis using numbers from the lease proposal, this interim rent amount was likely excluded and will often make the lease significantly more expensive.

Equipment leases may be structured to make ending the interim rent period and the commencement of the regular term difficult. Interim rent payments can go on for months, quarters, and sometimes years if the final few pieces of equipment identified on the proposal are not received by the lessee or the lease terms require special notice to begin regular term. Some companies (lessees) specifically exclude interim rent and refuse to pay it – but do make pro rata payments which are simply called something else in the lease documentation so refusing to pay "interim rent" may not reduce this exposure. These various payments are not frequently tracked by lessees as a separate cost related to leasing as is the best practice.

Since interim rent language can lead to material cost additions and is not frequently tracked by lessees, interim rent is one of the most costly elements of equipment leasing typically adding 5 to 15% (and sometimes much more) to the cost of an equipment lease program.

2. **End of Lease Notice Provisions**

Equipment leases commonly call for notice to be provided by the lessee to the lessor within a certain time period at specific points in the lease lifecycle, usually prior to the end of the lease term. Notice can also be required if certain other business events occur theoretically because these events increase the likelihood of or actually trigger default on the lease.

These notice provisions can be very stringently defined and difficult to meet. Some notice provisions may require the lessee to send the notice:

- Within a specific limited window of time *(i.e. no more than 120 days no less than 90 days)*
- Using a special method of delivery *(i.e. certified, prepaid mail)*
- To an address specified in the master lease and different from the usual contacts *(i.e. Lessor's General Counsel)*
- To notify the lessor of business events unrelated to the lease *(i.e. change of control)*

Failure to meet these notices can produce bad outcomes for the lessee which range from default to long lease extensions to loss of an end of lease option – such as a dollar buy out option and so on.

Because the implications of notice provisions are typically not well understood when leases are established and are therefore difficult to meet and trigger various bad outcomes for the lessee notice provisions are among the most costly equipment lease provisions.

3. **End of Lease Return Provisions**

Most companies enter into equipment leasing arrangements with the intention of returning the equipment at end of lease. However return provisions in the Master Lease and Schedule can make that almost impossible. Sometimes this is due to the parties using an agreement intended for one asset type for another. But some IT leases, in particular, contain return provisions which appear specifically designed to keep the rental payments flowing and or non-compliant return charges ringing up dramatically increasing the cost of an equipment lease. Some notable elements of return provisions include:

- All but not less than all of the equipment – including specific serial numbers
- A small window of time for return *(i.e. 10 days)*
- Return equipment in original packaging, with original manuals
- Equipment must be inspected and packed by manufacturer and meet manufacturers standards for warranty
- Return to an unspecified location

Failure to meet return provisions usually leads to costly extensions which are not tracked as a line item by the lessee and can lead to increase in all-in lease costs of 40-50% (and sometimes much more). These provisions are also not tracked by lessees and are one of the most important lease terms which increase all-in lease cost.

4. **Fair Market Value and Other End of Lease Options**

Since most lessees intend to return equipment at end of lease the other end of lease options such as Fair Market Value (FMV) frequently do not get the attention they deserve. Fair Market Value is often not defined at all, which provides the lessor with leverage at end of lease, or defined in a manner advantageous to lessors. Other end of lease options can be structured to be difficult or costly to actually execute against as well, which can leave the lessee with no option but to extend the lease indefinitely or return. Some notable FMV and end of lease provisions include:

- In place and in use by lessee as the reference point for valuation of FMV
- 1 year automatic extension if equipment is not returned
- Loss of $1 buy-out option if very specific requirements are not met
- Lessor's reasonable judgment to be used to establish Fair Market Value

Each of these provisions leads to additional lease costs by lessee, is not commonly planned for and provides the lessor with leverage and profit opportunities at end of lease. Unfavorable end of lease provisions can lead to additional costs of 15 to 100% or more at end of lease and are among the lease provisions that add the greatest cost to lease programs.

5. **Lessee Default**

Default remedy provisions are often draconian and provide for the lessee to pay all remaining rents, and any other amounts due and may be likely to become due, as well as seize the equipment, retain all deposits and other costly terms. These provisions are often not heavily negotiated by lessees because lessees typically understand their exposure to default to be equivalent to bankruptcy - an unlikely Armageddon scenario. However default in leases can be triggered by much more trivial events:

- Failure to meet notice of any kind
- Failure to make any payment within 10 days
- Failure to meet ANY requirement of the lease
- Change in any other financial obligation of the lessee and other forms of cross default

Lessors seldom invoke the full power of the default definition and remedies for which the contract provides. Lessors use the language as leverage to drive higher costs in other areas of the lease such as higher buyout costs, more lease extensions, retention of deposits and charging of accumulated late charges on a full portfolio of expired leases.

Because default leads directly to some charges and increases the likelihood and scale of other charges, it is not commonly negotiated aggressively by the lessee at beginning of lease and not commonly understood as an exposure by the lessee. Default is one of the most costly equipment lease finance terms.

Conclusion

Leasing documents are works of art. They are designed to shift power and profit opportunities to lessors and provide the lessor with leverage at each stage of the lifecycle. Each of these provisions may impact others and good work done in one area during lease negotiations may be undone in another if these and other lease terms are not rigorously interrogated and negotiated. Addressing risks in each of these five most costly lease terms is a good first step in establishing a low cost and risk equipment lease portfolio. Measuring the costs created by these risk areas is an important lease portfolio management best practice.