Executive's Guide to
EQUIPMENT LEASE INSURANCE

{The following article was prepared for the ***Executive's Guide to Equipment Lease Documentation*** *to be published by the Equipment Leasing and Finance Association.}*

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Introduction

Standard lease agreements in the equipment leasing industry generally require lessees to insure the leased equipment and its use as a condition of the lease. Appropriate coverage includes both property insurance (protecting the equipment against loss) and liability insurance (protecting the lessor against legal claims based on equipment use by the lessee). On small- and micro-ticket portfolios, lessors usually use lease insurance to protect their lease portfolios.

The lease typically states that if a lessee fails to provide proof of the required insurance within a specified time, the lessor can purchase insurance to protect its own interests and bill the insurance related charges to the lessee. This is a legitimate purpose. It would not make sense to do without insurance. However, many prominent and reputable leasing companies have been targeted with Class Action lawsuits asserting that the lessor has structured the program to serve an ulterior purpose by enhancing the lessor's profits with inappropriate and excessive charges. None of the cases has ever gone to trial, but leasing companies have paid settlements ranging from $7.5 to over $50 million rather than incur the risk and expense of litigation.

Lease insurance programs can be effectively structured to achieve all of the appropriate goals without undue risk by taking protective measures that mainly consist of adhering to professional standards. Safe and effective lease insurance programs demand the following elements: (1) a professionally designed program that provides the appropriate insurance protection using the appropriate forms; (2) a well drafted lease insurance clause that carefully and clearly spells out the lessee's obligations with appropriate disclosures to protect the interests of the lessor; (3) administrative support and services that include tracking lessees' compliance, procuring the required coverage, billing, accounting, and mailing; and (4) an overall structure that avoids the risks of Class Action lawsuits.

This analysis has the following objectives. First, it provides an overview of lease insurance. Second, it analyzes the "nuts and bolts" of lease insurance, including an explanation of the forms and types of insurance. Third, it outlines the components of a lease insurance program including important elements of the lease. Fourth, it explains the principal risk factors exposed by Class Action lawsuits.

I. Overview of Equipment Lease Insurance

The purpose of lease insurance is to provide property and liability coverage on a lessor's portfolio through the life of the constituent lease agreements. Lease insurance coverage is typically available under a "Leased Equipment Insurance Policy" issued to the lessor by its professional lease insurance manager.

Lease insurance is used most commonly by small- and middle-sized businesses, and is often viewed as a true value-added service from the equipment lessor. Under a lease insurance program, a lessee may satisfy its insurance requirement at any time during the lease, either by arranging for alternative coverage through its own insurance agent, or by paying for lease insurance coverage under the lessor's policy.

Advantages of Lease Insurance.
Lessees who choose lease insurance generally get better affordable protection than is available under standard commercial insurance policies. Monthly insurance charges for lease insurance are fixed for the term of the lease, rather than being subject to periodic increases. Lease insurance typically has no deductible and always provides for full replacement of lost or destroyed equipment. If equipment is not replaced, lease insurance normally provides for the full payoff of the outstanding lease balance (i.e., the lessor's net investment in the lease).

A well-designed lease insurance program generates the highest acceptance by lessees by providing superior coverage conveniently and at a competitive charge. Because lessees have the choice of providing other coverage at any time, election of lease insurance is voluntary—unlike the use of "force placed" insurance common in consumer auto and mortgage lending.

A monitoring system run by a professional lease insurance manager supports high acceptance rates by assuring that lessees are at all times in compliance with their insurance obligations, while providing a valuable service to both parties to the lease agreement.

For the lessor, lease insurance coverage has the advantage of protecting the equipment at all times—at lease inception, at cancellation of other coverage, or at expiration of other coverage. It permits the lessor to fund leases at inception without waiting for documentation of other coverage. It also provides backup coverage where other insurance coverage cancels or expires without reinstatement or renewal. Additionally, lease insurance programs typically provide significant additional fee income to the high-volume, small-ticket lessor for administrative services provided to lessees using lease insurance.

II. The Nuts And Bolts of Equipment Lease Insurance

A. Property Insurance

The purpose of property insurance is to protect leased equipment from physical loss or damage throughout the term of the lease. The best form is no longer termed "All-Risks," because courts interpreted the term literally to cover all losses, regardless of policy coverage exclusions. Instead, the best form of property insurance is now known as "Special Form." Special Form coverage commonly includes accidental damage and theft, in addition to standard fire and extended coverage provided in the basic property insurance policy.

Common valuation methods for property insurance are "Replacement Cost" and "Actual Cash Value." Replacement Cost covers the cost of replacing lost or destroyed equipment with new equipment. Actual Cash Value pays only the depreciated value of lost or destroyed equipment—calculated by subtracting depreciation from replacement cost. In addition to covering total loss or destruction, property insurance also pays for repairs to damaged leased equipment.

Proof of Property Insurance Coverage.
Lessees' insurance agents and brokers typically provide proof of property insurance in either of two forms: "Certificate of Property Insurance" (ACORD 24) and "Evidence of Commercial Property

Insurance" (ACORD 28). "Evidence of Personal Property Insurance" (ACORD 27) is an equivalent form to ACORD 28 that may also be encountered, as it shows similar proof of coverage as discussed below for ACORD 28 under a homeowners policy rather than a commercial property policy.

Certificate of Property Insurance (ACORD 24).
A "Certificate of Property Insurance" (ACORD 24) is typically valid only on the date on which the certificate was prepared by the insurance agent. The Certificate specifically states that it is "issued as a matter of information only and confers no rights upon the certificate holder" and "does not amend, extend, or alter the coverage afforded by the policies [listed]."

Moreover, under the ACORD 24 Certificate, the insurer merely "endeavors" to provide notice of insurance cancellation. Failure to provide the lessor written notice of cancellation or expiration "shall impose no obligation or liability of any kind upon the [insurance] company, its agents, or representatives."

At best, therefore, an ACORD 24 Certificate provides merely an *indication* that property coverage may be in effect, and cannot be relied upon as a valid proof of property insurance coverage.

Evidence of Commercial Property Insurance (ACORD 28).
"Evidence of Commercial Property Insurance" (ACORD 28) is valid evidence that property insurance coverage is in effect within the policy term shown on the document. It specifically comprises "evidence that insurance [listed] has been issued, is in force, and conveys all rights and privileges afforded under the policy."

Unlike a Certificate, ACORD 28 Evidence requires the insurer to provide the lessor written notice of termination within the policy term (i.e., early termination). It states that, "should the policy be terminated, the company will give the additional interest identified below [usually 10 or 30] days written notice."

Accordingly, the ACORD 28 Evidence document can be regarded as valid evidence that property coverage exists on the leased equipment, *with one exception*. This coverage gap occurs with non-renewal at the end of the policy term—an event that is not subject to the mandatory notice requirement. The insurer or its agents have no obligation to notify the lessor when coverage expires at the end of any policy term. Only by actual tracking of expiration dates—and requesting renewal Evidence—is the lessor assured of continuous coverage on its leased equipment.

No Cost to Lessee for Requiring Evidence (vs. Certificate).
There is no cost to a lessee in obtaining ACORD 28 Evidence rather than an ACORD 24 Certificate. The lessor should therefore require the lessee to provide Evidence ("ACORD 28 or equivalent") in the lease agreement, as well as in any subsequent written requests for insurance information.

"Loss Payable" Endorsement vs. "Lender's Loss Payable" Endorsement.
The standard lease agreement typically requires the lessee to arrange an endorsement in the property insurance policy naming the lessor as a "loss payee" on the leased equipment. This standard "loss payable" endorsement does not provide payment to the lessor for losses on fraudulent or falsified claims by the lessee, or claims involving arson, on which all insurance payments are denied.

Conversely, a "Lender's Loss Payable" endorsement gives the lessor superior rights to secure payment on property insurance losses. This endorsement states that "the loss payee [i.e., the lessor] will still have the right to receive loss payment," even if the insurer denies the lessee's claim. Its coverage is not unlimited, however, as it does not cover losses where a lessee attempts "conversion" or "skips" with the equipment.

No Cost to Lessee for Requiring "Lender's Loss Payable" Endorsement.
There is no cost to a lessee in arranging for a "Lender's Loss Payable" endorsement in lieu of the standard "Loss Payable" endorsement. The lessor

should therefore require this "Lender's Loss Payable" endorsement in its lease agreement and in subsequent written requests for proof of insurance.

B. Liability Insurance

The purpose of liability insurance is to protect the lessor against legal claims for "bodily injury" and "property damage" to third parties arising from the use of the leased equipment by the lessee.

The standard lease agreement typically requires the lessee to name the lessor as an "Additional Insured" with respect to liability insurance coverage on the leased equipment. In the absence of this endorsement, the lessor is not protected and has no coverage under the lessee's liability insurance policy.

The proper term for this insurance in the insurance industry is "liability insurance" or "casualty insurance." ("Casualty insurance" is *not* property insurance; it's simply another name for liability insurance.) "Liability insurance" is the term that should be employed in the lease agreement. It is not the same as "personal injury" insurance or "physical damage" coverage—terms that are sometimes mistakenly used to describe liability coverage requirements.

Certificate of Liability Insurance (ACORD 25).
Insurance agents provide proof of liability insurance using "Certificate of Liability Insurance" (ACORD 25). This is the only proof of liability coverage currently in use by the insurance industry. Lessees' insurance agents often use the ACORD 25 Certificate to document property insurance coverage, noting that the lessor is named as "loss payee" on Special Form property insurance protecting the equipment.

Unfortunately, the ACORD 25 Certificate has the same limitations as the ACORD 24 Certificate of Property Insurance described above. At present, there is no equivalent to ACORD 28 Evidence for liability insurance. An ACORD 25 Certificate is an "information only" document valid only on the date of the issuance—it does not prove that insurance is actually in place. It states that the insurance company merely "endeavors" to provide notice of cancellation during the policy term, and failure to do so imposes no liability on the insurer. It also fails to require the insurer to provide written notice if coverage expires at the end of the policy term. Thus, the ACORD 25 Certificate indicates that liability coverage may be in effect, but cannot be relied upon as a valid proof of liability insurance coverage.

Minimum business liability limits available today to business entities are typically $300,000 per occurrence and $600,000 annual aggregate, with $1 million per occurrence and higher aggregate limits available at additional premium cost.

III. Designing a Lease Insurance Program

The foundation for any successful lease insurance program is a properly drafted lease insurance clause that includes at least the following elements: (1) A requirement for the lessee to provide reliable evidence that it has obtained the necessary property and liability insurance; (2) A provision that the lessor has the right, but not the obligation, to obtain the required insurance if the lessee fails to do so; (3) Disclosure that the policy will only insure the equipment and the lessor, and will not directly insure the lessee; (4) Authorization for the lessor to pass the lease insurance charge to the lessee, including not just the insurance premium, but also related administrative charges; and (5) Disclosure that the charges are not limited to "cost" but may include a profit, and generally warn that the lease insurance charge billed by the lessor may be greater than what the lessee would incur if it obtained its own insurance.

The next element of a successful program is professional and qualified administrative support. Efficiency and economies of scale are essential because the amount of any single transaction is usually quite small. The lease insurance premium on a single lease may be only a few dollars a month, but the number of leases may be very large. The lessor bears the responsibility to monitor compliance, obtain insurance when necessary, cancel insurance if compliance is restored, and bill and collect the appropriate charges. Cost efficiency demands a capital investment in information technology and automation. Effectiveness depends on a skilled, trained and well-supervised work force. A small increase or decrease in the cost of a single transaction can have major impact if done in-house. Many lessors outsource all administrative support (except for billing and cash receipt) to professional lease insurance managers, who have specialized expertise and facilities to reduce the cost of a single transaction by spreading fixed costs over the aggregated requirements of many different lessors.

IV. The Problem of Class Action Lawsuits

Class Action lawsuits against leasing companies almost invariably target lease insurance programs that appear more concerned with enhancing the lessor's profit than protecting its interest in the leased equipment. To some extent, it is simply a matter of economics. The Class Action attorneys need a substantial damage award or settlement to justify their fee. The damage theory usually focuses on the lessor's profit. The bigger the profit, the better the chance of an attractive fee to plaintiffs' counsel.

However, there is another important element. The lessor's profit is often disguised—or at least not clearly disclosed—at the time of the lease transaction. If the sources of the lessor's profit are not fully disclosed to the lessee in the lease agreement, Class Action attorneys will call a foul.

Class Action lawsuits concerning lease insurance typically rely on some combination of three theories. The attorneys who bring the lawsuits are alert and inventive. New applications of the theories emerge on a regular basis, and by the time this analysis is published there will probably be new versions with different themes. It is important to consult qualified legal counsel for a current analysis. However, the following is a fair summary of the theories advanced in most of the Class Actions:

Unfair & Deceptive Acts or Practices.

Most Class Action lawsuits involve the violation of a duty to disclose. There are at least three different sources of that duty. First, Article 2A of the Uniform Commercial Code imposes an implied covenant of good faith in every lease, whether or not such a duty is actually mentioned. The covenant of good faith requires "honesty in fact and the observance of reasonable commercial standards of fair dealing" in all lease transactions. UCC §§2-103(1)(b) and 2A-103(2). Second, § 5(a)(1) of the FTC Act, 15 U.S.C. 45(a)(1), forbids "unfair or deceptive acts or practices in or affecting commerce." The FTC Act does not itself provide for private enforcement actions. However, many states have adopted "Baby FTC Acts" that authorize private actions to recover damages—and sometimes awards of enhanced damages and attorneys' fees—for unfair or deceptive acts or practices. Third, the common law imposes its own covenant of good faith, whose precise definition may vary from one state to the next, and provides business tort theories such as "fraudulent suppression" of relevant information and conspiracy.

Unregulated Insurance.

Some lessors have adopted so-called "risk management" or "loss damage waiver" programs that do not involve insurance. Instead they charge a fee that supposedly compensates the lessor for the risk of uninsured loss.[1] Some such programs provide that the lessor will replace the equipment or waive the balance due in case of loss, but they rarely consider loss experience—as would be typical with insurance. Some of the programs provide little if any protection for the interests of the lessees. Class Action lawsuits typically allege that risk management and loss damage waiver programs are merely an artifice to avoid insurance regulation. In other words, the lawsuits allege that these are really just an illegal form of insurance.

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[1] Other names for such programs include "risk charges" and "property damage surcharge." The same analysis applies in any case that involves a fee for failure to provide insurance coverage that does not involve a substitution of other insurance—regardless of the label.

The National Assn. of Insurance Commissioners ("NAIC") has developed a Creditor-Placed Insurance Model Act, which has been adopted in four states and is reflected in the regulations of several others. The Model Act requires that the premiums of creditor placed insurance be reasonable in relation to the risk.

Similar principles are likely to apply even in states that have not followed the Model Act in any formal sense. Risk damage or loss waiver programs that provide substantially greater profit than compliant insurance programs are likely to be seen as evasion of insurance regulations.

Unreasonable Liquidated Damages
That Violate Public Policy Against Penalties.
Charges that bear no relation to reasonably anticipated loss or expenses may run afoul of the public policy against liquidated damage provisions that include disguised penalties. In this analysis, the risk management and/or loss damage waiver fee, or any other charges imposed on lessees who violate the obligation to provide insurance, is essentially a form of liquidated damages to compensate the lessor for the risk and inconvenience. However, the amount of the fee or charge is often set without regard to reasonably anticipated loss experience or costs. The relevant legal principle is summarized in RESTATEMENT (SECOND) OF CONTRACTS, §356(1) (1981):

> Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. *A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty.* (Emphasis added).

If challenged with a Class Action, the lessor would have the burden to show that the amount was reasonable. It would likely be a difficult and complicated burden.

Since none of the Class Action lawsuits has ever gone to trial, there is little judicial guidance as to what is or is not permissible. The important point—for purposes of this analysis—is that prominent and reputable leasing companies have chosen to pay multi-million dollar settlements to avoid the risk and expense of going to trial. The wisest course is a proactive strategy to avoid the type of conduct that typically precipitates Class Actions.

V. Managing The Risk

Sound business strategies are usually matters of common sense. Certainly, this is true of lease insurance. It involves technical transactions that should comply with high professional standards of both the insurance industry and the law. The risks of Class Action lawsuits continue to evolve and change as the plaintiffs' attorneys discover new issues. Prudent companies will design their lease insurance programs to meet current professional standards including a well-drafted lease, use of the appropriate insurance documents and appropriate administrative support. Since the legal and insurance industry standards are constantly changing, they will regularly review their lease insurance programs with outside legal counsel and professional lease insurance manager to stay current. Most importantly, they will respect the fundamental purpose of lease insurance—to protect the legitimate interests of the lessor—and not allow it to become mainly a program that taxes lessees with opportunistic or excessive profits to the lessor.

Dated: July 12, 2005