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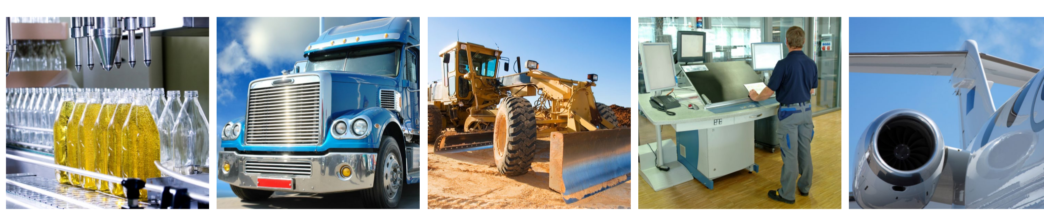

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Troubling States of Affairs: State Licensing and Usury Laws Affecting Equipment Finance

By Barry S. Marks and Bill Phillips

Equipment finance professionals have long debated the extent to which state licensing and usury laws apply to the industry. While nonbank lessors and lenders sometimes fretted over this issue, national banks and their subsidiaries and affiliates enjoyed immunity from most state regulatory and licensing laws under the federal preemption doctrine.[1] This safe harbor has been lost for the most part under recent federal legislation.

> Unfortunately for equipment finance professionals, the Dodd-Frank Act pushed back a significant amount of federal preemption of state laws. The act likely will result in increased scrutiny of both bank and nonbank lessors by state attorneys and regulators.

At the same time, recent economic pressure and public attention have increased the pressure on state officials to apply state laws to out-of-state lessors and lenders, whether or not they are bank affiliated. While many of these laws were designed to regulate lending, most lawyers agree that they most likely apply to leases that do not qualify as true leases and that their application to true leases is uncertain.

This article will address selected state licensing and usury laws that may affect equipment finance. The article is based on a series of memoranda surveying the laws of 50 states and the District of Columbia that the authors have prepared for both bank and nonbank clients.[2] Only commercial (nonconsumer) laws will be discussed, but readers should note that certain commercial loans, particularly microticket transactions, may be treated as consumer transactions for purposes of some states' licensing or usury laws. While leasing and lending are often lumped together as "equipment finance" for purposes of the article, distinguishing between the two may be important in interpreting specific laws.

THE EFFECT OF DODD-FRANK ON BANK AFFILIATES – AND OTHERS

The Consumer Financial Protection Act of 2010 was enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). As was widely reported, Dodd-Frank curtails federal preemption of state consumer financial laws with respect to banks.[3]

A second, less publicized change in law (and the one that we are concerned with in this article) eliminates all federal preemption with respect to bank subsidiaries and affiliates ("bank subsidiaries" in this article):

> 12 USCS § 25b
>
> (b) Preemption standard.
>
> (2) Savings clause. This title and section 24 of the Federal Reserve Act *(12 U.S.C. 371)* do not preempt, annul, or affect the applicability of any State law to any subsidiary or affiliate of a national bank (other than a subsidiary or affiliate that is chartered as a national bank).

> (h) Clarification of law applicable to nondepository institution subsidiaries and affiliates of national banks.
>
> (2) Rule of construction. No provision of this title or section 24 of the Federal Reserve Act *(12 U.S.C. 371)* shall be construed as preempting, annulling, or affecting the applicability of State law to any subsidiary, affiliate, or agent of a national bank (other than a subsidiary, affiliate, or agent that is chartered as a national bank) (12 USCS § 25b(h)).

On May 25, 2011, the Office of the Comptroller of the Currency (OCC) issued proposed revisions to its rules on the scope of preemption in response to the act. ("Office of Thrift Supervision Integration; Dodd-Frank Implementation," Department of the Treasury Office of Comptroller of the Currency 76 Federal Register 102 (May 26, 2011), pp. 30557–30572).) On page 30562 of the Proposed Rulemaking, the OCC acknowledged this in stating "[t]he Act eliminates preemption of state law for national bank subsidiaries, agents and affiliates."

These changes in law and regulations have led some banks to consolidate their equipment finance subsidiaries into the bank to regain some of the lost preemption. Other bank subsidiaries have undertaken a review of the state laws within their market area to assure compliance of their products.

Although the issue is essentially unchanged for lenders and lessors that are not bank related, Dodd-Frank may serve to raise the profile of these licensing and usury issues generally. It is likely that independent equipment finance companies as well as bank subsidiaries may face increased scrutiny by state regulators and attorneys general as well as increased attention from plaintiff's counsel looking for industries vulnerable to class actions.

OVERVIEW: LICENSING AND USURY

Licensing and usury laws are interwoven in many states. For example, in several states, obtaining a lender's license insulates the lender from application of state usury limitations (*see,* e.g., Cal. Fin. Code § 22002), and in others a license is only required if loans exceed the state usury limit or other stated rate (*see,* e.g., N.Y. Banking Law § 340).

In general, the regulatory system can be said to focus on several factors, each of which should be considered in approaching licensing and usury issues. These factors include the type of product offered (leases or loans?); the nature of equipment financed; the rate of interest charged or implicit in the calculation of rentals; the size of transactions anticipated; whether customers will include sole proprietors or entities other than corporations; and generally, the company's risk tolerance where civil or criminal penalties may be involved.

In addition to the foregoing, the effectiveness of choice of law and forum selection provisions, along with the common question of whether a corporation or other entity must qualify to do business as a foreign corporation,[4] should be considered. All of these will be touched on briefly.[5]

While states commonly require licenses for activities such as consumer and real estate lending and pawnshop operations, licensing is rarely required for general commercial lending and leasing.

LICENSING

General Lending Licenses

As a general rule, state licensing requirements are limited to specific activities. While states commonly require licenses for activities such as consumer and real estate lending and pawnshop operations, licensing is rarely required for general commercial lending and leasing.

A notable exception is California. Its Finance Lenders Law requires that lenders and brokers obtain a license from the Commissioner of Corporations (Cal. Fin. Code § 22100). The definition of "finance lender" includes any person engaged in the business of making commercial loans, which in turn may consist of lending money and taking as security "any contract or obligation involving the forfeiture of rights in or to personal property, the use or possession of which property is retained by other than the mortgagee or lender, or any lien on, assignment of, or power of attorney relative to wages, salary, earnings, income, or commission" (id. § 22009). The definition of "broker" includes "any person who is engaged in the business of negotiating or performing any act as broker in connection with loans made by a finance lender" (id. § 22004). Although banks are exempt from the license requirement, it is not clear that bank subsidiaries and affiliates are also exempt (Cal. Fin. Code § 22050).

Other licensing laws of broad application are on the books in Maryland: Md. Financial Institutions Code Ann. § 11-302; Md. Commercial Law Code Ann. § 12-1001 & 1002, and Vermont V. Stat. Ann. title 8 § 2201.

Small Loans

Several states impose licensing or usury limitations on "small loans." These statutes, which were probably intended to protect consumers, sometimes cover small commercial loans as well.

The Alaska Small Loan Lender License is required for companies making loans of less than $25,000 and charging an interest rate greater than the basic usury rate for Alaska (Alaska Stat. § 06.20.010). The basic usury rate is 5% above the annual rate charged member banks for advances by the 12th Federal Reserve District on the day on which the contract or loan commitment is made.

The definition of a "consumer finance loan" in Florida includes any loan for an amount less than $25,000 at a rate of interest greater than 18% per year (Fla. Stat. § 516.01(2)). An entity may not make such loans without a license (id. § 516.02(1)).

Motor Vehicles

Several states require licenses of motor vehicle lessors as well as dealers (e.g., Conn. Gen. Stat. § 14-15; Iowa Code §§ 321F.1 & 321F.2; La. R.S. 32:1254 & La. R.S. 32:1252; and ORC Ann. 4517.02(A)(3), ORC Ann. 4517.01(M), and ORC Ann. 4517.06)).

Some states go further and require a lessor to maintain a place of business in the state as well as obtain a license. These often confusing laws require a lessor to maintain a place of business within the lessee's state and to obtain a license for such location.[6] Such laws include KRS § 190.030 (Kentucky) and La. R.S. 32:1254 & La. R.S. 32:1252 (Louisiana).

Most usury prohibitions are contained in civil law statutes. Violations of these statutes result in monetary damages that differ from state to state. Many states also have criminal penalties for usury violations, usually involving higher rates of interest than the civil statutes.

Purchasers of Installment Sales Contracts

Vendor programs carry unique risks in that many states have laws regulating the financing of personal property sold by vendors. Although we have located no such laws applicable to financings by the vendors themselves, third-party financing, apparently including financing by captives or related entities, is subject to these laws.

Among others, laws regulating "sales finance companies" and other entities that routinely purchase installment sales contracts may be found in Delaware (5 Del. C. § 2902); Florida (Fla. Stat. § 520.52(1)); and Maryland (Md. Financial Institutions Code Ann. §§ 11-401 & 11-403).

Other states regulate only purchases of motor vehicle installment sales contracts (e.g., Miss. Code Ann. § 63-19-7 and Tex. Finance Code §§ 348.501 & 348.00).

USURY GENERALLY

Most usury prohibitions are contained in civil law statutes. Violations of these statutes result in monetary damages that differ from state to state. These penalties can include merely the loss of the interest exceeding the usury rate, the loss of all interest, the loss of all money loaned, and treble damages calculated based on the amount of the interest paid by borrower.

Many states also have criminal penalties for usury violations, usually involving higher rates of interest than the civil statutes. Moreover, criminal penalties may include incarceration of the owners or officers of the finance company. However, there are few published cases of criminal prosecution by states for violation of usury laws.[7]

Usury claims generally involve three elements: (1) a loan of money or forbearance in the collection of money; (2) an interest rate exceeding that allowed by applicable law; and (3) intent.[8] The most common defenses used by lenders to insulate themselves from usury claims,[9] other than the contractual provisions discussed below, operate to negate one or more of these elements.

Definition of "Loan" and "Interest"

Usury laws apply to interest charged on loans of money or forbearances of the collection of money. Interest is most frequently defined similarly to the definition found in the Georgia usury statute: as "a charge for the use of money computed over the term of the contract at the rate stated in the contract or precomputed at a stated rate on the scheduled principal balance or computed in any other way or any other form."[10]

Under this definition, equipment lessors may argue that lease financings are not subject to usury laws because (a) the lessee pays "rent"[11] and not "interest," and (b) the lessee's payment obligations serve to compensate the lessor for the lessee's use of property owned by the lessor (rather than being payment of principal and interest for a loan of money).

Some jurisdictions, such as Florida, clarify this distinction by statute.[12] Other jurisdictions contain case law that generally holds that a lessee may not assert a usury defense in an action to enforce provisions of a true lease.[13]

In the case of a lease intended as security, as opposed to a true lease, it may be imprudent to rely on the parties' designation of the transaction as a "lease" rather than "loan" or to rely on the argument that payments by the lessee constitute "rent" rather than "principal and interest." Because the economic reality and substance of the transaction is that of a loan, it is very likely that a court or regulator would recast the payment as principal and imputed interest, then calculate the imputed interest rate and compare it to the maximum rate under applicable law.

> In the case of a lease intended as security, as opposed to a true lease, it may be imprudent to rely on the parties' designation of the transaction as a "lease" rather than "loan" or to rely on the argument that payments by the lessee constitute "rent" rather than "principal and interest."

The concept of a time-price differential is also used in a few jurisdictions to insulate lenders from the application of usury laws. These jurisdictions recognize that the increased price charged when a good is sold on an installment basis, instead of for an immediately payable amount, does not constitute interest. Some jurisdictions, such as Tennessee, clarify this distinction by statute.[14] Other jurisdictions have case law to this effect. (*See,* e.g., *Citipostal v. Unistar Leasing,* 283; 724 N.Y.S.2d 555 (4th Dep't 2001) (neither a credit sale nor a lease constitutes a loan or forbearance).)

Not all states draw this conclusion, however. (*See,* e.g., *Perez v. Rent-A-Center,* 186 N.J. 188; 892 A.2d 1255; 2006 N.J. LEXIS 176 (2005) (noting that time-price differentials are "interest" and subject to the criminal usury statute).) Relying on the concept of a time-price differential, where available, usually requires that the borrower acknowledge that it has elected to pay on time rather than in cash for the financed items.[15]

Choice of Law

Most loan and lease documents contain choice of law provisions. These provisions are essentially a stipulation by the parties that the contract will be governed by and interpreted under the laws of a certain state regardless of what state law would otherwise apply. For high interest rate loans, the effectiveness of the choice of law provision may determine whether the transaction is enforceable as is, or if the lender will be subject to sanctions for usury.

A good choice of law provision will designate a state either with no usury rate or a usury rate higher than any interest rate that the lender anticipates charging. The state should also bear a "reasonable relation"[16] (or "substantial relation,"[17] depending on the applicable law) to the transaction, as discussed below. For most states, the court will require some connection to the chosen state.[18] Lender documents frequently choose the law of the lender's home state or the state where the note and payments are accepted by the lender.

The Restatement of the Law (2d) of Conflicts of Laws (the Restatement) utilized by some courts in choice of law cases adds another issue: the possibility that a court will refuse to apply favorable state usury law as a matter of policy. These courts will not apply a choice of law provision if

> application of the law of the chosen state ***would be contrary to a fundamental policy of a state which*** has a

> materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties.[19]

A discussion of what constitutes a "fundamental policy of a state" is beyond the scope of this article. Such a standard means more than that the case would be decided differently under the law of the other state.

Generally, most courts have been willing to uphold a choice of law provision, otherwise appropriately made, where the issue of usury was raised. See, for example:

- *Woods-Tucker Leasing Corp. v. Hutcheson-Ingram Development Co.*, 642 F.2d 744 (5th Cir. 1981) (bankruptcy court sitting in Texas that originally held that a Mississippi choice of law provision was used by the lender to "evade the usury laws of Texas" and was therefore ineffective, but reconsidered and held the clause to be valid under UCC §1-105);
- *Kronovet v. Lipchin*, 288 Md. 30, 415 A.2d 1096 (1980) (Maryland court upheld a choice of law provision stating that Maryland law applied with respect to usury issues only and New York law to the balance of the contract);
- *Sarlot-Kantarjian v. First Pa. Mortgage Trust*, 599 F.2d 915 (9th Cir. 1979) (9th Circuit Court of Appeals honored a Massachusetts choice of law provision under the Restatement analysis, specifically noting that California's public policy against usury is not offended by the adoption of Massachusetts law);
- *Admiral Insurance Co. v. Brinkcraft Development, Ltd.*, 921 F.2d 591 (5th Circuit Court of Appeals honored a New York choice of law provision acknowledging New York bore a reasonable relationship to the transaction as required by Texas UCC §1-105);
- *Snow v. CIT Corp. of the South*, 278 Ark. 554 (1983) (Where four states had direct contact with a sales transaction which was contingent upon a Georgia corporation's willingness to finance it and the Georgia party insisted as a non-negotiable provision that the transaction be governed by Georgia law, it cannot be said that the choice of Georgia law was not a reasonable one or had been made to avoid Arkansas' usury laws);
- *Davidson Oil Country Supply Co. v. Klockner, Inc.*, 908 F.2d 1238 (CA5 1990) (Court enforced a New York choice of law provision rather than applying Texas law, citing UCC § 1-105); and
- *Mell v. Goodbody & Co.*, 10 Ill. App.3d 809 (1973) (Court enforced a New York choice of law provision rather than applying Illinois law).

However, contrary precedent exists. In *O'Brien v. Shearson Hayden Stone, Inc.* (90 Wash. 2d 680, 586 P.2d 830 (1978), *supplemented*, 93 Wash. 2d 51, 605 P.2d 779 (1980)), a class action suit over margin interest rates, the court examined the Restatement rule and determined that, as to a portion of the plaintiff class, Washington law would have applied but for a New York choice of law in the brokerage contracts. The court refused to apply New York law due to the disparity between the 25% rate in the contract and Washington's 12% limit, which was deemed a "fundamental policy."

One final note: it stands to reason that an effective forum selection clause,[20] combined with a choice of law provision, increases the probability that the law of the lender's chosen state will be applied. A forum selection clause is a contractual provision that stipulates that any lawsuit related to the contract may or must be tried in the courts of a chosen state.

Usury Savings Clauses

Many loan and lease forms include "usury savings clauses" that reduce interest rates to the highest rate permitted by applicable law, notwithstanding the stated or implicit interest rate in the contract. If the court applies this provision the loan will be recalculated and not usurious.

Unfortunately, a savings clause is not a panacea. Some courts will refuse to apply the clause on public policy grounds.[21] Although the clause would seem to indicate an intent to comply with state law, our research indicates the requisite usurious intent is usually presumed

Many loan and lease forms include "usury savings clauses" that reduce interest rates to the highest rate permitted by applicable law, notwithstanding the stated or implicit interest rate in the contract.

if the contract charges a rate in excess of that allowed by law, irrespective of a savings clause.

However, the Florida Supreme Court considered a usury savings clause as a factor in determining this intent without specifically enforcing its terms:

> [W]e conclude that a usury savings clause cannot, by itself, absolutely insulate a lender from a finding of usury. Rather, we approve and adopt the Fourth District's holding, that a usury savings clause is one factor to be considered in the overall determination of whether the lender intended to exact a usurious interest rate. Such a standard strikes a balance between the legislative policy of protecting borrowers from overreaching creditors and the need to preserve otherwise good faith, albeit complex, transactions which may inadvertently exact an unlawful interest rate (*Jersey Palm-Gross, Inc. v. Paper,* 658 So. 2d 531, 535 Fla. (1995)).

Criminal Usury

Lenders face additional risk when they rely on a choice of law provision or usury savings clause to make loans exceeding the interest rate of the customer's state. This risk is lower when a state appellate court has issued strong decisions supporting contractual choice of law.[22]

Lenders face additional risk when they rely on a choice of law provision or usury savings clause to make loans exceeding the interest rate of the customer's state.

When contracting with a borrower in a state with a low usury limit, even a lender that is comfortable with relying on a choice of law or a usury savings clause should carefully consider whether to rely on such provisions in a state with a criminal usury rate below the expected interest rates. First, the lender may face criminal sanctions if the contractual provisions are not honored and the contract is deemed usurious. Secondly, as a policy matter, it is questionable whether simply choosing the law of a favorable state will insulate a lender from criminal liability. One Georgia court summed up the argument concisely:

> The parties to a private contract who admittedly make loans to Georgia residents cannot, by virtue of a choice of law provision, exempt themselves from investigation for potential violations of Georgia's usury laws.[23]

Notable Usury Statutes

This section will briefly discuss the usury law of several states. We have included these states because of their size or notable usury provisions. This is by no means intended as an exhaustive list of states that need to be considered for usury purposes. As we discussed above, whether a finance company has usury compliance issues for a particular state can depend on a number of factors including the size of the loan and the type of property being financed.

Florida. In general, the maximum rate of interest is 18% simple interest (Fla. Stat. §§ 687.02 and 687.03(1)). If the loan is for an amount in excess of $500,000, the maximum rate of interest is 25%. Any person charging an interest rate exceeding 25% is guilty of usury misdemeanor and exceeding 45%, usury felony (id. §§ 687.02(1), 687.03(1), 687.071(2), 687.071(3)).

Georgia. With respect to loans for an amount of $3,000 or less, the maximum rate of interest is 16% simple interest (Ga. Code § 7-4-2(a)(2)). Also, under § 7-4-2 interest accruing on transactions between $3,000 and $250,000 must be **expressed in simple interest terms.** Based on this language, many practitioners advise that a note or equipment finance agreement must disclose the interest rate in simple interest terms.

Massachusetts. The criminal usury statute ALM GL Ch. 271 § 49 provides that a lender may not contract for interest and expenses (including all sums paid for brokerage, recording fees, commissions, services, extensions of loan, forbearance to enforce payment, and all other sums charged) greater that 20% unless it notifies the attorney general every two years of its intent to engage in transactions with over 20% interest and maintains records of the transactions.

New Jersey. The civil usury statute limits interest for business or agricultural purpose loans in the amount of $1,000 to $50,000 that are not secured by real estate to the greater of 16% or 5% in excess of the discount rate, including any surcharge thereon, or any 90-day commercial paper in effect at the Federal Reserve Bank of New York on the day when such loan is made (N.J. Stat. § 31:1). The civil usury limit does not apply to loans with a principal amount of $50,000 or more[24] (id. § 31:1-1(e)(1)).

New York. The maximum rate of interest in New York is 16%, except where indicated otherwise in the laws of the state (N.Y. Gen. Oblig. § 5-501(1) and N.Y. Banking Law §14-a).[25] For loans for an amount exceeding $250,000, the maximum rate of interest is 25%, and a rate exceeding that amount is subject to criminal penalties (N.Y. Gen. Oblig. Law § 5-501(6) (a) and N.Y. Penal Law §§ 190.40 & 190.42). If a loan or forbearance is in the amount of $2,500,000 or more, there is no limitation on the maximum rate of interest, and the criminal usury provisions of the penal law do not apply (N.Y. Gen. Oblig. Law § 5-501(6) (b) and N.Y. Penal Law §§ 190.40 & 190.42).

Interest charged on loans or forbearances made to corporations for business or commercial purposes in the amount of $100,000 or more and secured in compliance with the UCC Article 9 is not subject to any limitations or criminal usury law, if on the date when the interest is charged or accrued, such interest is not greater than 8 percentage points above the prime rate (N.Y. Gen. Oblig. Law § 5-526). Corporations and limited liability companies cannot assert a defense of usury (N.Y. Gen. Oblig. Law § 5-521(1) & N.Y. Limited Liability Company Law § 1104), but they may assert the defense of criminal usury if the rate exceeds the criminal usury rate (N.Y. Penal Law § 190.40).

Corporations and limited liability companies cannot assert a defense of usury, but they may assert the defense of criminal usury if the rate exceeds the criminal usury rate.

In short: The civil usury rate is 16%, but corporations and limited liability companies cannot plead a usury defense if the rate is above 16% and below 25%. The criminal usury rate is 25%. However, for personal property-secured loans to corporations, the usury rate is the greater of 25% or 8% above the prime rate.

New York lenders and those choosing to apply New York law should also note that under New York law, a usurious note is void and the lender forfeits the entire loan balance (Gen. Oblig. § 5-511(1)).

Oregon. No person can make a business or agricultural loan of $50,000 or less at an annual rate of interest exceeding the greater of 12%, or 5% in excess of the discount rate, including any surcharge on the discount rate, on 90-day commercial paper in effect at the Federal Reserve Bank in the Federal Reserve district where the person making the loan is located, on the date the loan or the initial advance of funds under the loan is made (ORS § 82.010). The above restriction does not apply if the lender is a financial institution[26] or if the loan is secured by a first lien on real property[27] (id. §§ 82.010(3), 82.025). There are no restrictions on business or agricultural loans in excess of $50,000.

Tennessee. Tennessee uses a formula, referred to as the applicable formula rate, to determine the maximum rate of interest that parties may agree to by written contract[28] (Tenn. Code Ann. 47-14-103). The applicable formula rate is the greater of (a) formula rate in effect at the time or (b) the formula rate last published in the Tennessee Administrative Register prior to the date of the contract (id. § 47-14-102(3)). Formula rate is an annual rate of interest 4% above the average prime loan rate (or the average short-term business loan rate, however denominated) for the most recent week for which such an average rate has been published by the board of governors of the Federal Reserve System of the United States or twenty-four percent (24%) per annum, whichever is less (id. § 47-14-102(7)).

As noted above, however, Tennessee recognizes time-price differential calculations.

Texas. The Texas interest and usury laws are complex. The maximum interest rate for commercial transactions will range from 18% to 28% per annum when agreed to by the parties. The Office of the Consumer Credit Commissioner publishes the current usury rates on its website: www.occc.state.tx.us. Rate ceilings cannot be lower than 18% per annum or higher than 24% per annum, except that business, commercial and investment loans may have a ceiling of up to 28% per annum, and certain open-end account credit agreements may only have a ceiling of up to 21% (Tex. Fin. Code § 303.009). To determine whether a commercial loan is usurious, the interest rate is computed by amortizing or spreading, using the actuarial method during the stated term of the loan, all interest at any time contracted for, charged, or received in connection with the loan (id. § 306.004).

QUALIFICATION TO DO BUSINESS

Qualification involves obtaining a certificate of authority from the secretary of state of any state where a corporation transacts business but was not incorporated. These laws apply generally to corporations and in many states limited liability companies. In most states, these laws do not apply to banks, which are regulated by state banking laws. While the application of these laws to bank subsidiaries has never been clear, it would seem that Dodd-Frank now requires subsidiaries to comply. The Model Business Corporation Act provisions on qualification to do business were drafted to avoid conflicting with the commerce clause of the U.S. Constitution.

"Qualification" involves obtaining a certificate of authority from the secretary of state of any state where a corporation transacts business but was not incorporated. These laws apply generally to corporations and in many states limited liability companies.

This certificate is not the same as a state sales tax registration, a lender's license, a motor vehicle dealer's license, or any of the other licenses and registrations that a leasing company may need in various states. In some instances, however, the certificate of authority is a prerequisite to obtaining another license or registration.

Some corporations prefer not to obtain certificates of authority to transact business in states other than their home state, because they will be required to maintain a registered agent in the state for service of process (and might be sued in the state courts in the state). If qualified to do business, the corporation must file annual reports, pay franchise taxes or other annual fees, and incur additional costs.

Failure to qualify, if required, does not render contracts void or unenforceable, but it does deny the corporation the right to sue in the state courts. As discussed below, however, this right can generally be restored retroactively where desired before filing suit.

Sections 15.02(a) and (b) of the Revised Model Business Corporation Act provide that: ([(a) a] foreign corporation transacting business in this state without a certificate of authority shall not maintain a proceeding in any court in this state until it obtains a certificate of authority [and (b)] the failure of a foreign corporation to obtain a certificate of authority does not impair the validity of its corporate acts or prevent it from defending any proceeding in this state. The exact language, or almost identical language, to subsection (b) above is found in 32 states: Arizona, Arkansas, Connecticut, Delaware, Florida, Georgia, Hawaii, Idaho, Indiana, Iowa, Kansas, Louisiana, Maine, Mississippi, Missouri, Montana, Nebraska, New Hampshire, New Mexico, New York, North Carolina, North Dakota, Oklahoma, Oregon, South Carolina, South Dakota, Tennessee, Virginia, Washington, West Virginia, Wisconsin, and Wyoming.

Although the language is slightly different in other states, all states *other than Alabama* have a cure provision. If the issue is raised in these 49 states, the foreign corporation should be able to dismiss the litigation, qualify to do business, pay any penalties and fees due for failing to qualify when required, and initiate a new lawsuit. However, if the statute of limitations has run out on one's claim between the first lawsuit and the second, that claim may be permanently barred.

In determining whether a corporation is transacting business for the purpose of this requirement, state law generally follows either the Model Business Corporation Act or the Revised Model Business Corporation Act (both are hereinafter referred to as the MBCA). Under both, it is clear that isolated transactions and transactions in interstate (as opposed to intrastate) commerce do not constitute transacting business for purposes of requiring qualification. Indeed, the U.S. Constitution prevents a state from requiring a foreign corporation to obtain a certificate of authority to do business in the state if its participation in the trade is limited to wholly interstate business.[29] This limitation results from the fact that the Constitution grants the U.S. Congress exclusive power over interstate commerce and precludes states from imposing restrictions or conditions on this commerce.[30]

The MBCA also contains a nonexclusive list of activities that do not, in and of themselves, constitute transacting business such that qualification is required.

Of that list, the following generally apply to equipment finance:

(1) Maintaining, defending, or settling any proceeding.

(2) Maintaining bank accounts.

(3) Soliciting or obtaining orders, whether by mail or through employees, agents, or otherwise, if the orders require acceptance outside this state before they become contracts.

(4) Creating or acquiring indebtedness, mortgages, and security interests in real or personal property.

(5) Securing or collecting debts or enforcing mortgages and security interests in real or personal property.

(6) Transacting business in interstate commerce.

(7) Owning real or personal property.[31]

It should be noted, however, that not all of the states have enacted versions of the MBCA that include this entire list, and some states include no list at all.[32]

In addition to a list of activities that, in and of themselves, do not constitute transacting business, the MBCA has a cure provision under which qualification to do business retroactively cures any failure to obtain qualification for most purposes. Except for the payment of fees and penalties, the principal penalty for failure to qualify to do business in a state is that the foreign corporation will be barred from use of the state's courts.

In Alabama, retroactive cure is not permitted, meaning that the penalty for failure to qualify (if required to do so) is that the offending corporation may not enforce any contract executed in the state. For this reason, Alabama has developed more law on the definition of transacting business than other states. These cases are sometimes confusing and inconsistent, but at least one decision directly addresses leasing. In *Allstate Leasing Co. v. Scroggins* (541 So.2d 17 (Ala. App. 1989)), the Alabama court of appeals held that the lease was void and unenforceable because the lessor should have obtained a certificate of authority prior to entering into this transaction.

> Even if we concede that no agent of [the leasing company] has ever set foot in Alabama, it is clear that [the leasing company's] business consists of owning equipment and collecting rents thereon. ... These pieces of equipment are located in Alabama, on what is intended to be a permanent basis. Alabama citizens, on an ongoing basis, pay rent with respect to that equipment. [The leasing company's] activity in Alabama is not incidental to the sale, installation or servicing of the equipment. Owning that equipment in Alabama and collecting rent from citizens of Alabama are the sum and substance of [the leasing company's] business. Furthermore, this is not an isolated transaction; there have, since 1984, been thirty-one (31) transactions involving about $350,000 (541 So.2d at p. 18).

For this reason, any leasing company with a significant amount of business in Alabama is well advised to consider qualification to do business in the state. As to the other states, the general rule of thumb has long been that leasing companies without offices in a given state do not qualify to do business and simply rely on their right to cure any breach of the requirement, if it exists, when they need to.

> The general rule of thumb has long been that leasing companies without offices in a given state do not qualify to do business and simply rely on their right to cure any breach of the requirement, if it exists, when they need to.

Before getting too comfortable, however, funders should consider one more case. In North Carolina, *Lease-Comm Corp. v. Renaissance Auto Care* (122 N.C. App. 119, 468 S.E.2d 562 (N.C. App. 1996)) added an interesting issue where the lease originator was not qualified to do business. Although the assignee had obtained a certificate of authority in North Carolina, the originator had never "cured" its original failure to qualify. The court held that the assignee could not sue in North Carolina.

This case is not an aberration. It is supported by a strict reading of the law. If an originator has an office or is otherwise required to obtain a certificate of authority authorizing it to do business in a state and does not do so, any leases or loans it documents in its name may well be *unenforceable in the hands of a funder or other assignee that is qualified to do business in the state.*

THE NEW FEDERALISM?

Even Alexander Hamilton might blanch at the extent to which federal legislation affects state law regulation of commerce. Unfortunately, for equipment finance professionals Dodd-Frank pushed back a significant amount of federal preemption of state laws. Now even bank subsidiaries must look to the most restrictive state regulations in setting policy if they wish to steer clear of trouble including criminal penalties.

It will be years before we can gauge the full effect of Dodd-Frank on the leasing industry, but the act likely will result in increased scrutiny of both bank and nonbank lessors by state attorneys and regulators. Whether this results in protecting the citizenry or restricting its access to much-needed capital only time will tell.

One thing is certain: lessors and lenders should become familiar with laws of states in which their customers are located and should be aware that these laws, whether or not applied in the past, may be part of equipment finance in the future.

Endnotes

1. Because the Federal government regulates banks pursuant to the commerce clause of the U.S. Constitution, federal bank regulatory laws preempt state laws. Federal preemption has been held to apply to laws that significantly impair the ability of national banks to exercise their chartered powers. Barnett Bank v. Nelson, 517 U.S. 25, 32, 134 L. Ed. 2d 237, 116 S. Ct. 1103 (1996); see also Bank of America v. City and County of San Francisco, 309 F.3d 551 (6th Cir. 2002). The categories of laws for which bank subsidiaries previously enjoyed preemption include those set out in 12 C.F.R. §§ 7.4008(d), issued pursuant to Section 25 of 12 U.S.C. 371:

(d) Applicability of state law.

(1) Except where made applicable by Federal law, state laws that obstruct, impair, or condition a national bank's ability to fully exercise its federally authorized non-real estate lending powers are not applicable to national banks.

(2) A national bank may make non-real estate loans without regard to state law limitations concerning:

(i) Licensing, registration (except for purposes of service of process), filings, or reports by creditors;…

(iv) The terms of credit, including the schedule for repayment of principal and interest, amortization of loans, balance, payments due, minimum payments, or term to maturity of the loan, including the circumstances under which a loan may be called due and payable upon the passage of time or a specified event external to the loan; … and

(x) Rates of interest on loans.

2. The information in this article does not constitute a 50-state survey, but we will mention certain statutory or other authorities that illustrate the most significant issues. The research for this article was necessarily limited to statutory and some case authorities, although some regulatory information was located, and in some cases statutory interpretation was checked by calls to local government officials. The authors strongly recommend consultation with local counsel and focused research whenever a question arises.

3. 12 USCS § 25b

(b) Preemption standard.

(1) In general. State consumer financial laws are preempted, only if–

(A) application of a State consumer financial law would have a discriminatory effect on national banks, in comparison with the effect of the law on a bank chartered by that State;

(B) in accordance with the legal standard for preemption in the decision of the Supreme Court of the United States in Barnett Bank of Marion County, N.A. v. Nelson, Florida Insurance Commissioner, 517 U.S. 25 (1996), the state consumer financial law prevents or significantly interferes with the exercise by the national bank of its powers; and any preemption determination under this subparagraph may be made by a court, or by regulation or order of the Comptroller of the Currency on a case-by-case basis, in accordance with applicable law; or

(C) the State consumer financial law is preempted by a provision of Federal law other than this title.

4. Some of these issues are not new to national bank subsidiaries, as certain laws were never considered to be significant restraints on exercise of their powers.

5. We will not comment on various other state laws that may or may not be escaped due to a choice of law clause, such as Kentucky's unusual limitation on open-ended guaranties, KRS 371.065.

6. Many of these are "anti-curbstoning" laws designed to prevent apparently casual sales by dealers who seek to avoid taxes and liability for hidden defects in the vehicles or their titles.

7. The cases simply may not result in published opinions. As a result, it is frequently difficult to ascertain how a particular court would apply the criminal usury laws in these states.

8. Matthew Bender, *Consumer Credit Law Manual,* § 6.08. See also Henson v. Columbus Bank & Trust Co., 770 F.2d 1566 (11th Cir. 1985); Vickie Fogie v. Thorn Americas, Inc., 95 F.3d 645, 649 (8th Cir. 1996); and Korwin v. First National Bank of Chicago, 275 F.2d 755 (7th Cir. 1960) (New York law).

9. Defenses available on a case-by-case basis include: (a) no standing to assert usury (statutes are intended to protect

needy borrowers so only those obligated on the note should be able to assert a claim or defense of usury); (b) estoppel and waiver; (c) res judicata; and (d) statutes of limitations.

10. O.C.G.A. § 7-4-2. Note that certain fees and other charges might be included as "interest" if not clearly related to actual lender expenses or other reasonable purposes.

11. Note, however that merely labeling a loan payment "rent" and not "principal and interest" is not likely to avoid usury restrictions, as in the case of a lease intended as security. Michie, *Banks and Banking* Chapter XI § 32 (2007).

12. *See,* e.g., Fla. Stat. §§ 687.02 & 687.03.

13. *(See,* e.g., *Performance Systems, Inc. v. First American National Bank,* 554 S.W.2d 616 (Tenn.); *Orix Credit Alliance, Inc. v. Northeastern Tech Excavating Corp.,* 222 A.D.2d 796, 634 N.Y.S.2d 841 (3rd Dep't 1995) (holding that defaulting equipment lessee's defense of criminal usury was negated by the fact that a lease does not constitute a loan or forbearance and did not, therefore, fall within the definition of usury); and *Citipostal, Inc. v. Unistar Leasing,* 283 A.D.2d 916, 724 N.Y.S.2d 555 (4th Dep't 2001) (neither a lease nor a sale on credit constitutes a loan or forbearance) (citing Orix Credit).

14. *See,* e.g., Tennessee Code §§ 47-14-102(11) (definition of time-price differential) and 47-14-102(8) (the definition of interest which expressly excludes the time-price differential).

15. Note that such language might theoretically expose the lender to liability as a vendor and weaken the hell-or-high water clause.

16. Most states have adopted the version of the Uniform Commercial Code choice of law provision similar to the following Alabama statute: Code of Ala. § 7-1-301

Territorial applicability; parties' power to choose applicable law.

(a) Except as otherwise provided in this section, when a transaction bears a reasonable relation to this state and also to another state or nation the parties may agree that the law either of this state or of such other state or nation shall govern their rights and duties.

17. Substantial relation is the standard set out in Restatement of the Law (2d) of Conflict of Laws § 187 (1971).

> (1) The law of the state chosen by the parties to govern their contractual rights and duties will be applied if the particular issue is one which the parties could have resolved by an explicit provision in their agreement directed to that issue.
>
> (2) The law of the state chosen by the parties to govern their contractual rights and duties will be applied, even if the particular issue is one which the parties could not have resolved by an explicit provision in their agreement directed to that issue, ***unless either***
>
> (a) the ***chosen state has no substantial relationship*** to the parties or the transaction and there is no other reasonable basis for the parties' choice, or
>
> (b) application of the law of the chosen state ***would be contrary to a fundamental policy of a state which*** has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties.

18. New York is a notable exception. New York General Obligations law § 5-1401(1) provides that parties to any contract for $250,000 or more may agree that New York law will apply to the contract whether or not the contract has a connection to the state. Also compare the original and proposed revised versions of UCC 1-105.

19. Restatement of the Law (2d) of Conflicts of Laws § 187 (1971).

20. A judge is probably more likely to honor a choice of law provision selecting the law of his state rather than the law of another state because of the familiarity of the law to the judge and lawyers involved.

21. A Georgia appellate court held that honoring usury savings clauses to avoid criminal usury would encourage lenders to make blatantly usurious loans and, when discovered by knowledgeable borrowers, avoid prosecution by claiming a reduction under the usury savings clause. Einstein v. Diprimio 2000 Ga. App. LEXIS 1140; 2000 Fulton County D. Rep. 3899.

22. Tennessee has specific statutory support for choice of law provisions in the usury context: TCA § 47-14-119, which is part of Tennessee's general usury statutes. It provides that the parties may select the law of any jurisdiction that bears a reasonable relation to the transaction.

23. Bankwest, Inc. v. Oxendine, 266 Ga. App. 771 (2004).

24. The exception is loans where the security given is a first lien on real property on which there is erected or to be erected a structure containing one, two, three, four, five or six dwelling units, a portion of which structure may be used for nonresidential purposes.

25. Interest rate includes any and all amounts paid or payable, directly or indirectly, by any person, to or for the account of the lender in consideration for the making of a loan or forbearance. Id. N.Y. Banking Law § 14a.

26. "Financial institution" means insured institutions, extranational institutions, and credit unions. § 706.008.

27. Under § 82.025, there are other situations to which the restriction does not apply. We do not discuss them for purpose of this memorandum.

28. Contracts to which the applicable formula rate applies may provide for the payment of a fixed rate of interest, a vari-

able rate of interest or any combination of fixed and variable rates in any sequence, subject to certain limitations. Id. § 47-14-106.

29. *See* e.g. Goodwin Bros. Leasing, Inc. v. Nousis, 373 Mass 169.

30. *See* Model Business Corporations Act Annotated (3rd ed.).

31. *See* Model Business Corporation, Code (3rd ed.) § 15.01.

32. For example, the statutes enacted in Ohio vary substantially from the MBCA. Statutes in Illinois, Rhode Island, New Jersey, California, Minnesota, Utah, and Maryland all contain a modified version of the list omitting various of the specific activities which do not, in and of themselves, constitute doing business. *Please note that we have not undertaken to look at the list in all states with respect to this issue.*

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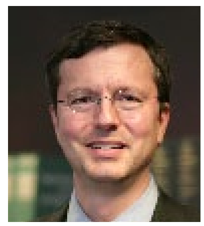

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Making the Case for an Enterprise Risk Management Program

By Steven E. Byrnes, Christine Williams, Samir Kamat, and Suresh Gopalakrishnan

"…lessons learned from the Great Recession… improve your ability to assess enterprise risk. – David Merrill[1]

Given the economic landscape of the past four years, a company's business model is challenged constantly by competitors and events that could give rise to substantial risks. Companies make money and increase stakeholder value by engaging in activities that engender risk, yet stakeholders tend to appreciate and reward some level of stability in their expected returns. Failure to identify, assess, and manage the major risks the company is facing may unexpectedly result in significant loss of stakeholder value. Thus, leadership must implement processes to effectively manage any substantial risks the company will confront.

While leaders of successful equipment leasing and finance companies have always had some focus on managing risks, it typically has been from a reactive standpoint or a silo approach rather than in terms of a proactive, integrated, across-the-organization perspective. These companies have managed credit risk on a per-transaction basis or across their portfolios as they age, or they have performed residual analysis by asset type or on individual transactions, typically on a historical basis.

> Enterprise risk management has emerged in recent years to offer a proactive, integrated, and holistic view of the capital and earnings risks facing equipment leasing and finance companies. ERM cuts across both business entities and core functions, and it helps companies create value for shareholders, employees, and clients.

However, most of these companies have not built a view of risk management that cuts across all aspects of the business. To correct such a situation (and this situation exists across many companies and industries), enterprise risk management (ERM) has emerged in recent years, taking an integrated and holistic view of the risks facing equipment leasing and finance companies.

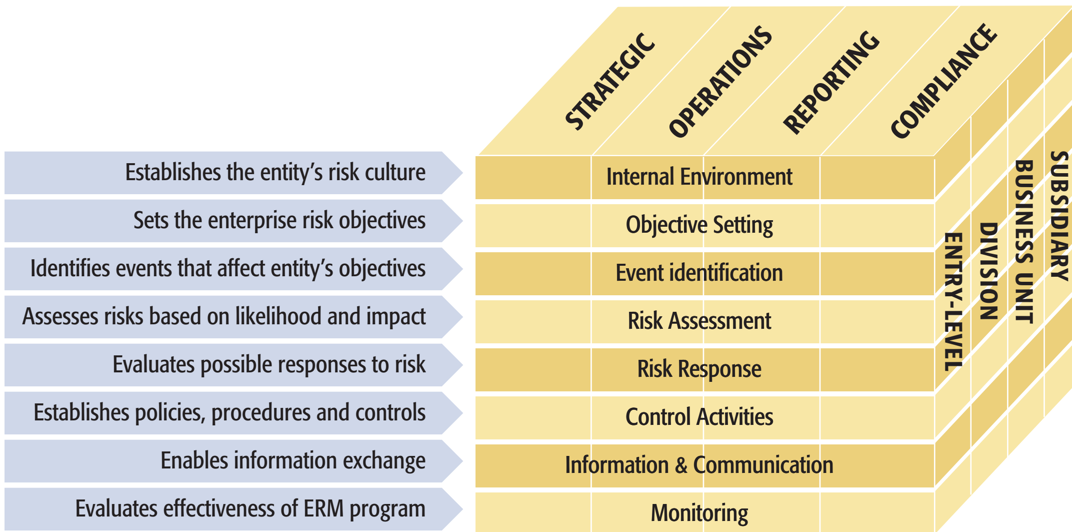
ERM is generally known as the process of planning, organizing, leading, and controlling the activities of a company in order to minimize the effects of risk on the company's capital and earnings. Figure 1 depicts ERM activities cutting across both business entities and core business functions—creating an integrated and holistic view of risk.

Unfortunately to date, there has not been a significant focus on addressing ERM systematically within the equipment leasing and finance industry. Many members of the Equipment

Editor's note: This article is based on a Foundation research report titled "Enterprise Risk Management for Equipment Leasing and Finance Companies," published in March 2012. It may be ordered at www. leasefoundation.org.

Figure 1

COSO's* Enterprise Risk Management-Integrated Framework



* Committee of Sponsoring Organizations of the Treadway Commission

Source: AICPA, reprinted with permission.[2]

Leasing and Finance Association may not have been exposed to ERM, may not consider ERM in its totality, and may not be aware of its benefits or the risks of not having an effective ERM program and processes in place. This article provides a glimpse into the current state of ERM as well as a brief overview of an ERM program and its benefits, making the case for companies to be proactive in establishing an enterprise risk management program.

CURRENT STATE OF ERM

Enterprise risk management concepts have evolved rapidly over the course of the past 10 years. The first reason is improvements in the methodologies and frameworks supporting ERM, such as the Casualty Actuarial Society (CAS) Framework (2003), Committee of Sponsoring Organizations of the Treadway Commission (COSO) Framework (2004), and ISO 31000 (2009). The second reason is increased attention to and recognition of the impact of risk management by regulatory authorities in the form of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank); Basel III; the Equal Credit Opportunity Act; the proposed FASB/IASB lease accounting changes; and potential new provisions from agencies such as the Consumer Financial Protection Agency, the Consumer Financial Protection Bureau, and the Financial Stability Oversight Council.

> Enterprise risk management concepts have evolved rapidly over the course of the past 10 years. The first reason is improvements in the methodologies and frameworks supporting it.

Today, several catalysts are driving the need for enterprise risk management[3]:

- Greater transparency. The Dodd-Frank Act promotes systemwide financial stability by improving accountability and transparency in the financial system.
- Financial disclosures with more strict reporting and control requirements. The New York Stock Exchange requires the audit committees of its listed companies to "discuss policies with respect to risk assessment and risk management."
- Security and technology issues. As technology advances and becomes more mobile, there is a greater

risk of data breaches. The solution is not just IT based: it has to be addressed enterprise wide.

- Business continuity and disaster preparedness in a post-9/11 world. In creating a business continuity plan, the major risks a company could face have to be assessed and then mitigated. This includes not just the systems that help a business to run but also the processes and people that keep the business operating.
- Focus from rating agencies. Companies that fail to implement ERM in a formal, strategic way are in danger of suffering ratings downgrades (such as from Standard & Poor's), whereas companies that fully adopt ERM can improve their credit ratings.
- Regulatory compliance. Minimum levels of capital for credit, market, and operational risk must be maintained to meet Basel requirements.
- Globalization in a continuously competitive environment. Boards of directors are now required to review and report on the adequacy of the risk-management processes in the organizations they govern in a number of countries and industries.

The need for a sound ERM program has evolved to become more than a compliance requirement: it is an integral part of good management practices for all financial services companies. Implementation of sound ERM practices enables companies to have an effective linkage between business strategy, risk management, and corporate governance. ERM is an essential element in achieving business goals and delivering benefits through the integration of business practices, processes, and technology.

A good example of this is KeyCorp. Its board of directors approves its ERM program and policy, risk appetite, and risk tolerance for seven identified major risk categories. All employees are required to complete ERM training and to take the ERM program mission statement to heart: "to identify, measure, assess, monitor, control, and report risk in a manner that promotes prudent, effective decisionmaking, optimizes risk-reward, and instills accountability."

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OVERVIEW OF AN ERM PROGRAM

Definitions

"ERM is a rigorous approach to assessing and addressing the risks from all sources that threaten the achievement of an organization's strategic objectives. In addition, ERM identifies those risks that represent corresponding opportunities to exploit for competitive advantage." – report from Tillinghast-Towers Perrin[4]

Using the above definition, ERM for equipment leasing and finance companies typically involves the management of most, if not all, of the nine areas of risk defined below.

Credit risk: the risk of loss of principal or loss of a financial reward stemming from a borrower's failure to repay a loan or lease or otherwise to meet a contractual obligation.

Residual value risk: the risk of a decline in the value of a lessor's leased asset below the expected book value.

Market risk: the risk that the value of a portfolio—either an investment or a trading portfolio—will decrease due to the change in the value of market risk factors.

Liquidity risk: the risk that a given asset (or portfolio of assets) cannot either be borrowed against or traded quickly enough in the market to prevent loss or make a required profit.

Operational risk: as per Basel II, the risk of loss resulting from inadequate or failed internal processes, people, and systems, or from external events.

Country risk: the risk involved in investing or setting up business in different countries due to an ever-changing business environment. Examples of country risk or, more narrowly, political risk, are (a) fluctuations in exchange rates, devaluation, or regulatory changes specific to a particular country, or (b) political and social factors such as mass riots, civil war, and other such events.

Contagion risk: the risk that a financial crisis may spread from one institution to another, or the risk that the failure of a financial institution will threaten the stability of other institutions.

Reputational risk: the risk related to the trustworthiness of a business, or the risk that a company will lose potential business because its character or quality has been called into question.

Hazard risk: the risk of accidental losses due to unforeseen natural catastrophes, such as hurricane damage to plant and equipment.

Objectives

The main objective of an ERM program is to ensure that a company manages its risk-return tradeoff. In addition to this overarching objective, an ERM program should also

- Identify varying types of risks (as described above) and formulate a risk-management program that consists of identification, evaluation, assessment, management, monitoring, and reporting across the enterprise (Fig. 2).
- Ingrain risk management into business planning and the decisionmaking process from the top down, determining the appropriate risk appetite aligned to strategic objectives, given the company's risk tolerance (Fig. 3).
- Balance risk-reward tradeoffs in order to address risk not just as a threat but as an opportunity. That is, identify risks that can be pursued more successfully than peers (channel, product, or market selection).
- Ensure that risk management is the responsibility of all members of staff, where each and every process owner performs the role of the risk taker or risk manager (Fig. 4, Fig. 5).
- Have an enterprise risk management reporting system, which plays a key role in the constant monitoring process of all risks (Fig. 6).
- Address the needs of adequate internal control (Fig. 7).

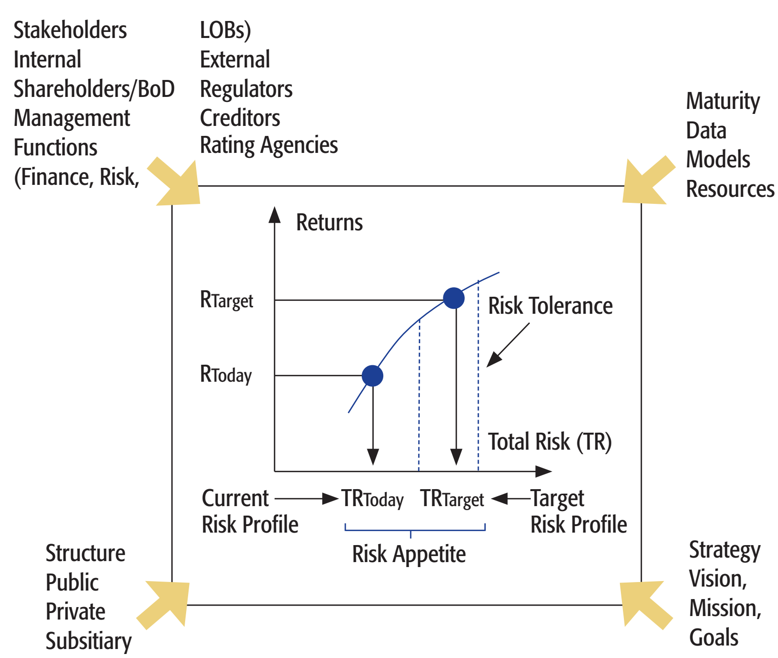
Figure 2

Risk Management Program Components

Source: Capgemini.

Figure 3

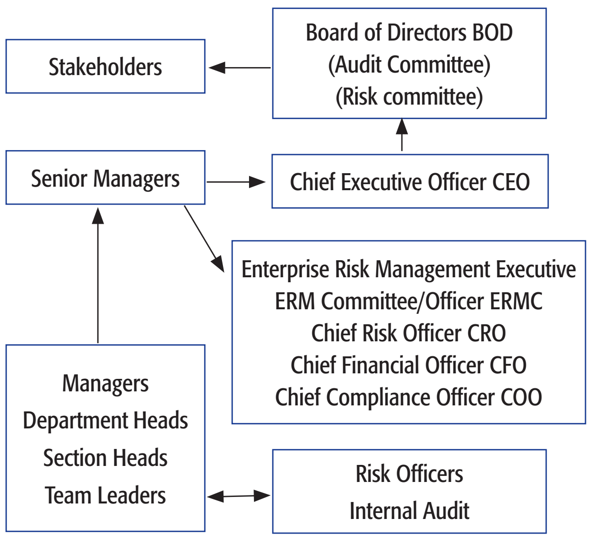
Risk-Return Tradeoff, Risk Appetite, and Risk Tolerances



Source: Capgemini.

Figure 4

Participants in an ERM Program



Source: Society of Actuaries, reprinted with permission.[5]

Figure 5

Allocation of Risk-Related Responsibilities

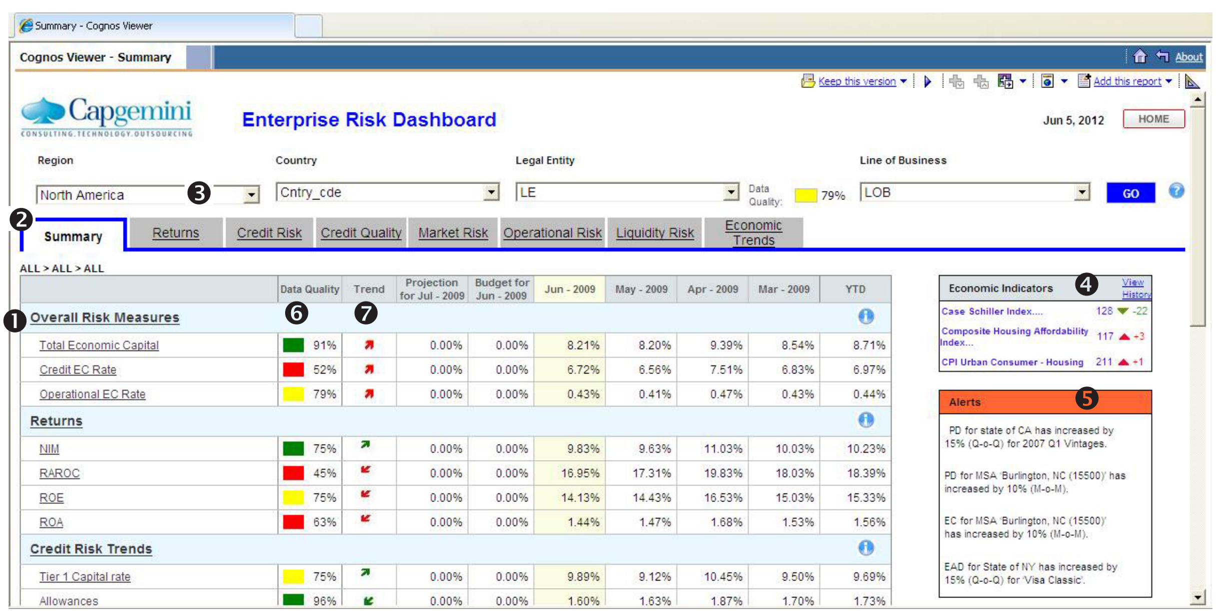
Allocation of Risk-Related Rights and Responsibilities					
Organizational Level	Detect	Mitigate	Report	Aggregate	Assess
Board or Committee					P
CEO					P
CFO				S	S
Division CEO			S	P	S
Division Controller		S	P	S	
Plant Manager		P	S		
Supervisor	S	P			
Contractor	P	S	S		
P	Primary Responsibility				
S	Shared Responsibility				

Source: RMA Journal, reprinted with permission.[6]

Figure 6

Reporting Framework and ERM Dashboard

A sound reporting framework is based on five components: (1) composition component, which identifies concentrations; (2) risk component, which profiles the portfolio and identifies potential problem areas; (3) profitability component, which optimizes the risk return trade-off (4) risk (credit) quality component, which helps manage losses; and (5) assessment component, which monitors performance.



❶ Uses best in class KPI's to manage risk

❷ Provides a holistic view of all risk types faced by the institution

❸ Allows drill downs to identify hot spots

❹ Integrates reference and market data benchmark performance

❺ Custom and automated alerts to zone into problem areas

❻ Data quality integrated with decision making

❼ Forward looking measures shown side by side with historical performance

Source: Capgemini.

Figure 7

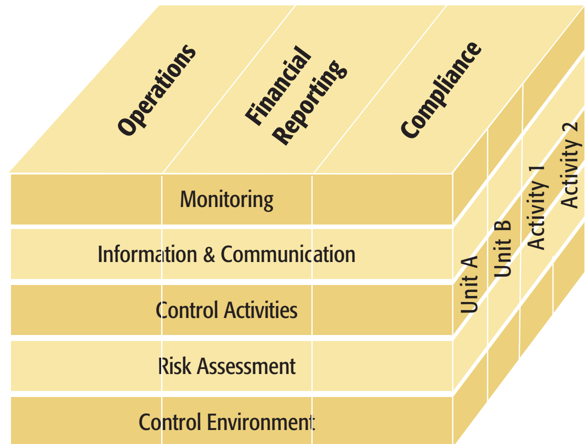
COSO's Five Components of Internal Control

Monitoring – As part of evaluating the performance of employees, employees complete self-assessments or obtain peer reviews.

Control activities – These help to reduce and manage the organization's risk. Passwords are an example.

Information and communication – Employees (and customers) have the ability to gather and express information.

Risk assessment and the control environment – The entire systems is involved in these, to evaluate the organization's overall goals and how they are accomplished.



Source: AICPA, reprinted with permission.[7]

Conceptual Framework

To achieve these objectives, ERM needs to be based on a framework. Modern ERM concepts stress a conceptual framework that consists of four interdependent elements: assessing risk, shaping risk, exploiting risk, and keeping ahead.

Assessing Risk

Risk assessment focuses on risk as a threat as well as an opportunity. In the case of risk-as-threat, assessment includes identification, prioritization, and classification of risk factors for subsequent defensive responses. In the case of risk-as-opportunity, it includes profiling risk-based opportunities for subsequent offensive treatments.

Shaping Risk

This defensive track includes risk quantification and modeling, mitigation, and financing the capability to manage the risk (Fig. 8).

Exploiting Risk

This offensive track includes analysis, development, and execution of plans to exploit certain risks for competitive advantage (Fig. 9).

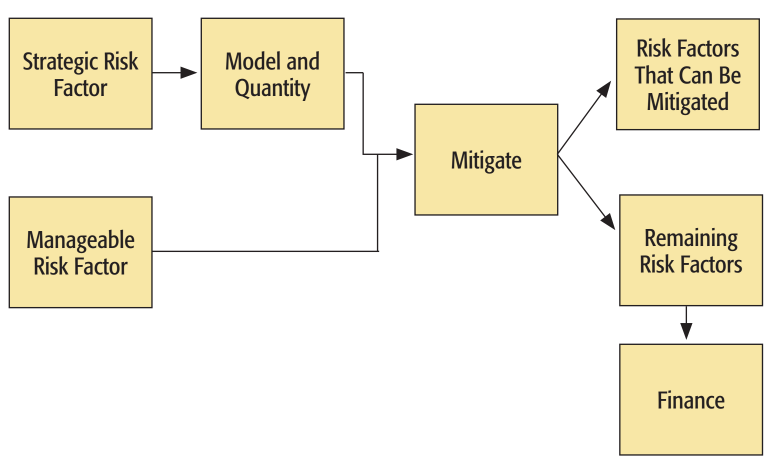
For example, a captive organization may have a better understanding of its parent's products and can optimize the secondary market, mitigating residual risk over independent lessors. Meanwhile a bank financial arm may be better prepared for new regulations than an

Figure 8

Shaping Risk

Manageable Risk Factor – A risk characterized by the fact that the environment in which they arise is familiar to the company, and the skills to remedy those risk factors are already in-house. However, for some reason, these risk factors had not been given the attention they deserve.

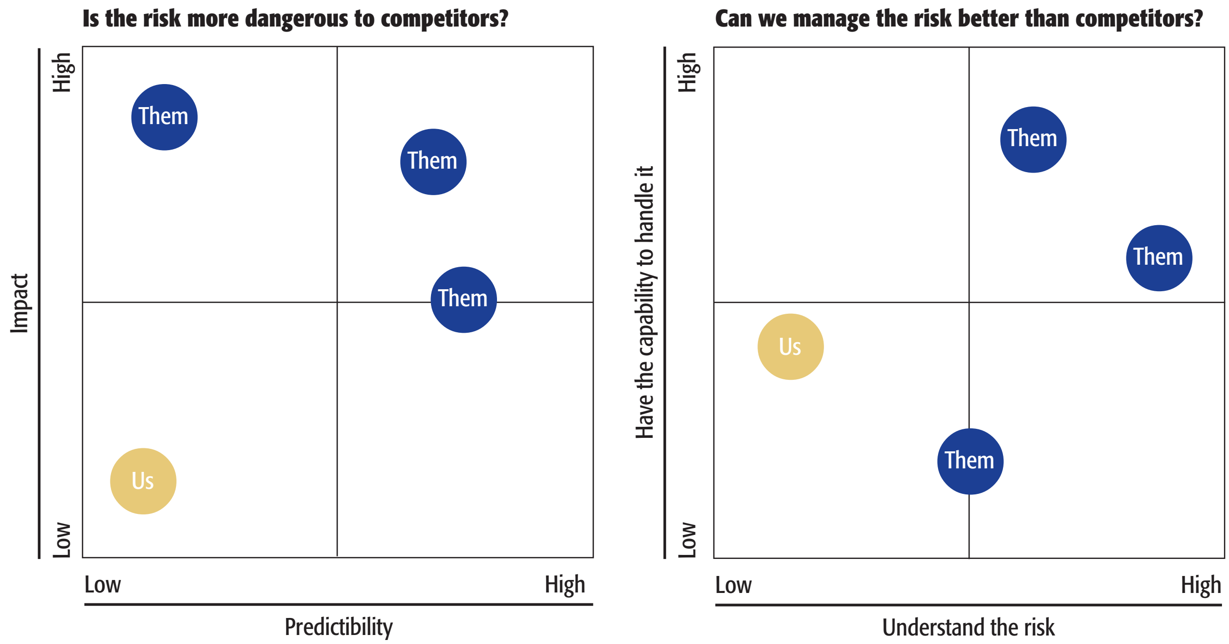
Strategic Risk Factor – risk factors that arise because the company enters unfamiliar business territory (due, perhaps, to a major acquisition, a powerful new competitor or a significant change in customer patterns), or the organization lacks the skills necessary to respond. These may require significant capital outlay and/or a major change in strategic direction.



Source: Capgemini.

Figure 9

Two Scenarios for Exploiting Risk



Source: Capgemini.

independent or captive, given that banks are so highly regulated and accustomed to managing compliance.

Keeping Ahead

Keeping ahead involves continuous monitoring of risk and developing course corrections. By monitoring ERM on an ongoing basis, the company is able to locate, confine, and correct the source of inaccuracies that would distort its risk-adjusted, strategic decisions or impair its ability to pursue long-term objectives. From this point of view, the act of monitoring channels complements upstream reporting lines. At the same time, the monitoring function may provide feedback for future improvements to the ERM infrastructure or processes.

By monitoring ERM the company is able to locate, confine, and correct the source of inaccuracies that would distort its risk-adjusted, strategic decisions or impair its ability to pursue long-term objectives.

BENEFITS

Enterprise risk management provides a framework for identifying both threats and opportunities across the enterprise, assessing their probability and possible impact, developing a response strategy, and monitoring the outcomes.

Recently, legislators, regulators, debt-rating agencies, and investor concerns have created a stronger urgency for companies to consider ERM as an essential, companywide approach to business controls—one that embeds a culture of active risk management from the operational levels to the board of directors. As a practical example, during the recent credit crisis many equipment leasing and finance companies suffered as a result of limited access to capital. A company's credit rating and overall risk-management capabilities became vital to its borrowing power. Standard & Poor's (S&P) developed a new rating approach whereby companies that fail to implement ERM in a formal, strategic way are in danger of suffering ratings downgrades. Conversely, companies that fully adopt ERM can improve their credit ratings, since this is part of the formal credit rating process.

ERM enables companies to pragmatically deal with uncertainty and associated risk and opportunity, thus enhancing their brand value and profitability. ERM helps in identifying and selecting among alternative risk responses: risk avoidance, reduction, transfer, and acceptance. It helps to ensure effective reporting and compliance with laws and regulations as well as avoid damage to the entity's reputation and associated consequences.

By using ERM to proactively address risks and opportunities, companies can create value for their shareholders, employees, and client base by analyzing not only strategic, operational, and financial risks but also compliance with applicable laws and regulations. A company with a holistic, 360-degree view of risk can better uncover and manage its business challenges, including operations and procedures, management styles and strategies, industry issues, and emerging risks.

ERM helps a business entity get to where it wants to go and avoid pitfalls and surprises along the way. In constructing an ERM program, a company must first understand the challenges, various risk domains, and risk areas relevant to the business. Secondly, it must understand the different ERM activities that need to be carried out to successfully implement an ERM program.

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SUMMARY

In conclusion, multiple advantages accrue to companies that implement enterprise risk management.

- Better risk identification is one of the key benefits of implementing ERM. Risk mapping, uniform risk language, and appropriate tools and processes lead to improved risk identification, thus enabling the enterprise to have a clear list of risks to be addressed.
- Use of systematic, quantitative, and predictive analytics leads to better decisions, which in turn lead to improved business performance over time. Usage of ERM methodologies also increases effectiveness in identifying emerging issues and notifying the appropriate executives at the earliest possible time, thereby enabling optimal responses.
- ERM equips the company with information about risks, risk responses, risk measures, risk processes, risk incidents, best practices, and the status of improvement plans. Furthermore, it enables improved performance as well as knowledge-sharing across the enterprise. Integrating risk management with key performance indicator (KPI) reporting helps management and executives monitor and address significant risks.
- An efficient ERM implementation leads to a reduction in the number of loss events and the ability to demonstrate the same against the industry average, constituting clear evidence of superior performance.
- Consistent revenues, cash flows, and earnings over time take a company toward higher P/E, ROE, and ROA multiples against its peers. A systematic and proactive risk evaluation process—the product of improved measures and preventive internal controls—can be attributed to an effective ERM program.
- Once a company is recognized as being proactive regarding risk management, it encourages ratings agencies, regulators, and financing institutions to differentiate it from those lacking an ERM program. The declaration by S&P that it would consider ERM as a factor in its ratings testifies to this benefit. Having such a reputation also reduces the cost of capital, which in turn increases the profitability and growth prospects of the company.

The holistic approach that characterizes the present trend of risk management aims at dealing with the many uncertainties facing organizations. In the business context, for the equipment leasing and finance industry, it is important to manage all risks and their impacts, not just the known risks or the ones that can be easily measured.

Managing risk at an enterprise level is imperative, because it gives organizations a true perspective on the magnitude and importance of different risks and facilitates the identification of the correlation among risks.

Moreover, it avoids the duplication of risk-management efforts. The rationale behind this approach is that value is maximized when the decisionmakers set strategy and objectives to strike the optimal balance between growth and return goals and their related risks, along with efficiently and effectively allocating resources in pursuit of the entity's objectives.

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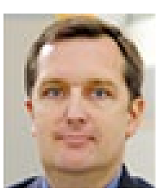

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The Economics Fueling IT Cloud Computing

By Susan G. Middleton

Increasingly, discussions about commercial information technology (IT) systems have become peppered with references to IT cloud computing and its many forms; however, for non-IT professionals, these discussions can seem a bit nebulous. The term "cloud" theoretically signifies abstraction of technology resources and their locations, which are vital in building integrated computing infrastructure (including networks, systems, and applications). All cloud computing models rely heavily on sharing of resources to achieve coherence and economies of scale similar to a utility (like the electricity grid) over a network (typically the Internet).

In 2011, the Equipment Leasing and Finance Foundation commissioned IDC, a market research firm specializing in IT, telecommunications, and consumer technology markets, to survey enterprise IT professionals. The study was intended to explore the IT cloud phenomenon and its impact on IT technology providers, end-user IT strategies, and the IT leasing and financing industry. As part of this undertaking, IDC conducted in-depth executive interviews with senior IT leasing executives, a statistical survey of IT end users currently participating in an IT cloud project, and a quantitative survey of senior IT leasing and financing executives on what they believed were the motivations behind the current movement to the IT cloud.

> At its core, the IT cloud revolution signifies a transition to both a new IT business model and a new technology platform. For IT leasing and financing providers, this means transitioning from providing capital to delivering a broader spectrum of end-user services. This report addresses the factors that will drive continued expansion and adoption.

Based on 603 surveys of these enterprise IT professionals, our firm found that approximately 15% of their budget was allocated to IT cloud initiatives in 2011. These same respondents expect 55% of their IT budget to be focused on IT cloud computing by 2020.

Before we discuss the economic motivations behind the cloud transition, it is important to broadly define the IT cloud. First, "cloud" cannot be sufficiently understood as a standalone phenomenon in the IT market; rather, it should be viewed as a core ingredient of a larger transformation of the IT industry — and many other industries using IT to transform themselves.

Other ingredients enabled by cloud (and, in turn, accelerating cloud adoption) include the expanding "species" of mobile devices, the explosion of mobile applications, the growing availability of wireless broadband, and the upsurge of big data tools. The cloud model goes well beyond prior online delivery approaches: it combines efficient use of multitenant (shared) resources with radically simplified packaging, self-service provisioning, highly elastic and granular scaling, flexible pricing, and broad leverage of Internet standard technologies. The result is that offerings are dramatically easier and cheaper to consume.

Editor's note: This article is based on a Foundation research report titled "Financing the Cloud – A Market Study," published in December 2011. It may be ordered at www.leasefoundation.org.

Virtually all IT leaders and business executives within buyer organizations have been exposed to the term "cloud computing," but as industry best practices, nomenclature, and industry offerings continue to evolve rapidly, internal discussions, strategy formulation, and sourcing evaluations can often be confusing and frustrating. Because "lower cost" is often cited as a chief advantage of cloud computing, business executives frequently seek to embrace new options without a fully reasoned discussion of the options.

In our conversations with business executives and IT leaders, typically three major topics are discussed: (1) a definition of cloud computing options and how the options may map to the organization's requirements; (2) security, governance, or regulatory constraints and how they are best addressed; and (3) the timing of cloud computing deployment. These discussions often reveal whether the organization is considering, is in the process of deploying, or has already implemented some form of cloud computing (albeit with some concerns or reservations). The forms of cloud computing include applications hosted in a third-party public cloud, on internal applications, or in an internal private cloud.

For many organizations, the key reason for embarking on an IT cloud project was to reduce costs. In this turbulent economic environment, senior IT executives are faced with increased demands for improved productivity despite decreasing budgets. Therefore, in the ongoing battle against the cost of complexity, CIOs continue to pursue solutions that simplify their application and infrastructure portfolios.

The expectation is that reduced complexity will deliver cost savings, as we have seen from virtualization, cloud services, and offshore initiatives. The goal is that these savings will enable more innovative projects that extend the efficiency and profitability of the enterprise. Now that we have defined the IT cloud and the rationale for utilizing this new IT business platform, let us explore end users' motivations for moving projects and applications to the cloud.

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UNDERSTANDING MOTIVATIONS OF SENIOR IT EXECUTIVES

In November 2011, IDC conducted a survey that asked IT executives about IT cloud computing issues, challenges, and strategies, and the respondents' answers varied widely. As shown in Figure 1, senior IT executives are interested in deploying the IT cloud because of the expected cost savings, speed of deployment, and goals of standardization. Their concerns about implementing an IT cloud project vary and include questions of reliability, security, performance, and hidden costs.

The issues shown at the very top and bottom of Figure 1 are the concerns that were raised most frequently. Specifically, respondents' most common concerns are economics, time to deploy, and, of course, security.

Economics

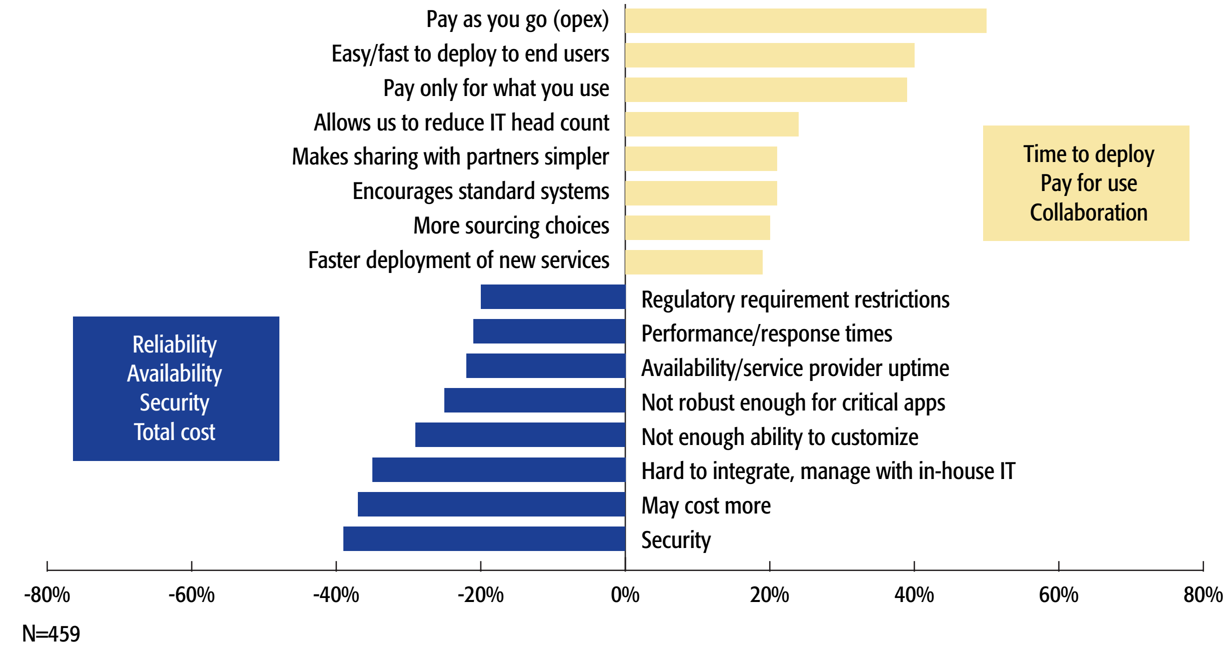
The economics discussion is particularly interesting because it cuts both ways. On one hand, the ability to access IT resources using a services consumption model is very attractive; on the other hand, a vocal minority raises concerns about the need to pay "forever." In addition, many IT professionals explain that they have compared the costs of moving to an IT cloud with their organizations' fully loaded internal costs and found external sourcing to be more expensive. Although it is difficult to know the accuracy of these claims of lower internal costs, the point is that many IT professionals often passionately make this assertion.

Time to Deploy

Once the discussion moves beyond economics, the second most frequently discussed topic is time to deploy, or the speed with which infrastructure (infrastructure as a service) or applications (applications as a service) can be deployed. IT shops that have experience with platform-

Figure 1

Reasons for Interest in Cloud Computing



Source: IDC's *Cloud Computing CIO Survey,* November 2011.

as-a-service deployments report that the development and deployment times were more favorable than they expected. Again, a small but vocal minority often voices its skepticism about the validity or relevance of those experiences.

Cloud Security

Cloud security remains an important concern for IT organizations—in spite of the fact that relatively few security breaches have made the headlines. Many IT organizations that use public IT cloud services report encrypting data to contain potential losses. In conversations with IT buyers, the dialogue often centers around the fact that IT cloud computing remains an emerging technology and as such inherently holds higher risk than other IT platforms that have 20+ years of field deployment.

These benefits align with a consistent thread that our firm has been discussing for a year: the pressure on CFOs to reduce both the costs and the complexity of IT. For some customers, moving to the IT cloud alleviates that pressure. Because most enterprise IT organizations are already using some type of IT cloud computing, they are rapidly gathering experience with the concept. The majority of organizations are planning on implementing some type of IT cloud project. Data from our 2011 Foundation study underscores the trend because many end-user respondents have already implemented an IT cloud project or plan to implement one soon.

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IT Cloud Economics and Senior IT Leasing and Financing Executives

One of the questions our survey asked was, "What do you believe is driving customer demand for cloud computing?" Many of the responses revolved around economics. Following are verbatim responses from the quantitative survey:

- "They're looking for the economies that cloud computing can bring them. The typical commercial customer is only going to do something if he sees some economic or productivity gain from doing it. The economics of a cloud installation as a price performer are what's driving customers to make that decision."
- "Obviously there's economics; everybody is looking for higher levels of productivity. I think shifting risk and responsibility for equipment—I'm just talking mainly about hardware now—I think there's just a big move to shift risk and responsibility to providers, getting it off the balance sheet, matching revenue to expenses. We're getting into the usage-based stuff here, which I think is becoming a bigger and bigger driver. Doing that without paying a premium is another thing. That's kind of where the rubber hits the road here, to the extent that the more utility or the more usage-based capability you give them, you can't give them at the same price that you can give them a hardware lease for a fixed term."
- "I think the customers today want both—they want you to take all the risk, and they want the pricing of the old days when they were taking the risk. So that's where the market is getting pushed and squeezed. Up to this point, there haven't been any real good usage-based models, but to the extent they've existed, they have had premiums built into them."
- "Again, part of the cloud panacea is nobody wants to own anything, and by ownership I mean have title to it. And I think one of the things that's been beneficial overall to the finance business is that, and one of the things that I like about the cloud hype, is kind of traditional title and ownership is becoming less; it's not part of the cloud discussion, and in fact, not owning is part of the cloud discussion. No one wants to own infrastructure. Everyone wants to use it—everybody wants it to be current, flexible, agile—but no one really wants to own it, and overall that conversation certainly helps us from the finance side because, in essence, owning the infrastructure assets is exactly what we do."

> The business case for transitioning to the cloud is much more than saving money and product innovation: it is that the cloud has the ability to improve the effectiveness and efficiency that IT organizations deliver to the business.

The quotes above illustrate the key role that economics play in the IT cloud decision process, at least in the view of senior IT leasing and financing executives. To further underscore that point, other IDC research has consistently reached the same conclusion: senior business executives are expecting the IT cloud to provide cost savings.

However, in our view, the business case for transitioning to the cloud is much more than saving money and product innovation: it is that the cloud has the ability to improve the effectiveness and efficiency that IT organizations deliver to the business. Buying more technology is not a useful exercise; implementing technology to resolve a business problem should be the goal. At their core, IT organizations are in place to support the business, and they need to have tools and to build business case scenarios that will deliver full value and maximum output.

NEXT STEPS TO THE CLOUD

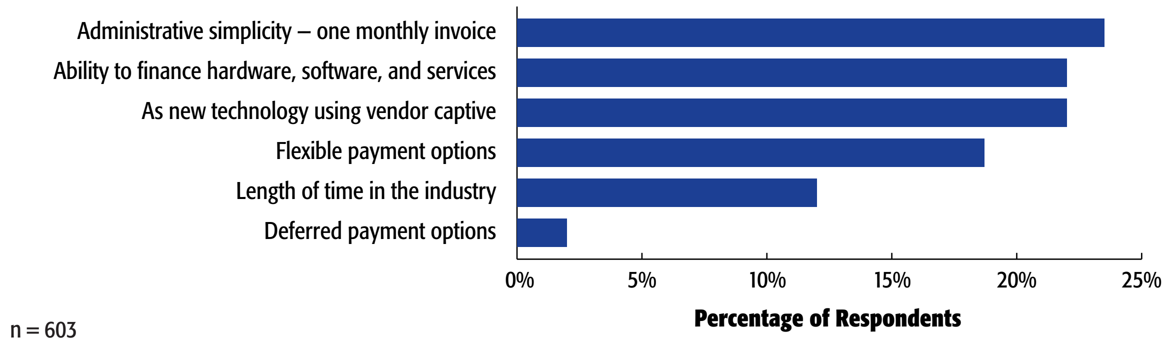
As clients embark on the IT cloud provider or project selection phase, ideally they will be considering a business problem framed with the technology service options that address and resolve the dilemma. Building a business case is helpful in obtaining executive-level support, budget, and project support consensus.

All stakeholders should clearly understand the business ramifications. Ranking business priorities is helpful when there are multiple business objectives. IT organizations have many value scenarios to define, such as customer, IT, business, and process value, which can and should come from technology projects. For the initiative to be successful, it is critical to define the value objectives for each technology project. From a measurement perspective, IT organizations should clearly define metrics to measure project value and completion of each milestone.

Figure 2

Key Selection Criteria in Choosing Financing Provider for Cloud Projects

Survey Q.16. Regardless of whether you would use external financing or not, when selecting a financing provider for cloud projects, which of the following do you think would be the key selection criteria?



Source: IDC.

From our vantage point, where the business needs and technology selection process intersect could be the perfect position for IT leasing and financing providers to provide value. End users, whether senior IT executives or IT datacenter managers, will be seeking the advice of trusted advisors to help them throughout this process. The challenge is advancing the dialogue to a more robust discussion of the opportunities, risks, and potentially differentiating competitive advantages associated with using a new IT platform—whether by accelerating new capabilities, lowering costs, or obviating the need for major capital investments in IT infrastructure.

To succeed in this new area of growth, independent financing firms will need to invest in internal and back-office protocols to support the escalating growth in software and services.

Figure 2 shows key selection criteria for choosing a partner for cloud projects. End users are considering using a partner because moving to the IT cloud is a new initiative requiring new technology.

GROWTH OPPORTUNITIES FOR IT LEASING AND FINANCING PROVIDERS

The opportunity for independent financing firms in the IT cloud economy resides within the private IT cloud infrastructure space. To succeed in this new area of growth, independent financing firms will need to invest in internal and back-office protocols to support the escalating growth in software and services. These two areas will become the more critical components in private cloud infrastructure and will displace the focus on equipment.

Because the transition to the IT cloud is still in the early adoption phase, current financing offerings for IT cloud projects are a combination of traditional tools and new, innovative structures. We expect clients' future needs will require a new blend of financing products that will increase the use of pay-per-use and metering tools as well as increase the comfort level with intangibles financing. Additionally, we have noted requests for much more flexibility in leasing and financing contracts. We believe that challenges to the traditional 36-month IT lease structure are a change IT cloud computing has already brought to the IT leasing and financing industry—a change that is here to stay and that will likely accelerate in years to come.

Furthermore, the transition to the cloud and the buildout of IT cloud infrastructures may lead to new IT capital requirements or "leasing as a service." This will require new thinking about leasing operations and procedures, such as the elimination of hell-or-high-water clauses from existing contracts. Rather, expect loan-based products to be the financing instrument of choice for public cloud data centers, with the transactions often linked to long-term buyer contracts. In essence, the financing options for the datacenter will actually look more like long-term receivables discounting. Expect cloud adoption to accelerate as vendors increase the rollout of products for this space. Growth will start slowly and increase rapidly.

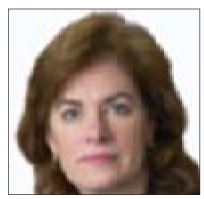
For some IT organizations evaluating public IT cloud services, the issue of existing investments in IT infrastructure raises potentially material financial issues. “Infrastructure” in this sense includes capitalized datacenter buildings and leasehold improvements in leased facilities as well as capitalized but as yet not fully depreciated equipment or software. Accounting guidelines in most geographies require existing assets not being used to be revalued (i.e., written off). As a result, we counsel IT leaders and other business executives evaluating cloud services to survey their own internal financial landscape to fully understand the consequential financial implications for incorporation into the business plan.

Our firm expects the cloud to undergo a technology evolution and maturation and, at the same time, a period of business process revolution enabled by this new technology platform. In its current form, cloud computing has many potential roles within a typical IT organization. The issue is recognizing the state of technology maturation and matching it to the appropriate business requirements. In a phrase, it is all about “suitability to task.”

FLEXIBILITY AND ADOPTION OF NEW STRUCTURES ARE KEY

We believe that IT cloud computing has the potential, much like the PC revolution did, to change and expand the industry, requiring billions of dollars in both traditional leasing and financing products and new types of IT leasing and financing products. It is important to understand that the IT cloud is much more than a new technology platform. It will require a major transformation of the IT business model and bears critical consequences for the entire IT ecosystem.

At its core, the IT cloud revolution represents a transition to a new IT business model as well as a new technology platform. We further believe that this will impact directly both IT vendors and the IT leasing and financing industry. For IT leasing and financing providers, this means transitioning from providing capital to delivering a broader spectrum of end-user services, including functioning as a financing service provider. In our opinion, the change will be enormous and the potential implications far reaching, with unlimited upside for organizations that are willing to adapt and embrace the IT cloud wave.



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2011 Article of the Year

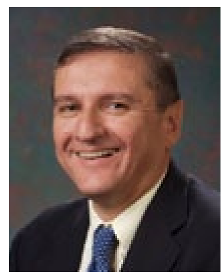
Understanding the UNIDROIT Model Law on Leasing

By Rafael Castillo-Triana

Rafael Castillo-Triana, a principal in The Alta Group, is the recipient of the 2011 Article of the Year award from the *Journal of Equipment Lease Financing*. His article, which appeared in the Spring 2011 issue, is titled "Understanding the UNIDROIT Model Law on Leasing." It may be viewed at www.store.leasefoundation.org/cgi-bin/msascartdll.dll/ProductInfo?productcd=JELFSpr11Unidroit or at the Foundation online library.

The award is based on secret ballots of members of the journal's editorial review board. Excluded from voting are articles based on research generated or commissioned by the Equipment Leasing and Finance Foundation (publisher of this journal) and the Equipment Leasing and Finance Association.

Mr. Castillo-Triana, who also is Alta's managing principal for Latin America, was instrumental in drafting the leasing laws of El Salvador and Tanzania. He has represented Colombia on the advisory board of UNIDROIT for the Model Law on Leasing, including the third draft, adopted in 2008. He received both his master's in economics and JD from Javeriana University in Bogota, Colombia.



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