
Business Entities Refresher

Before engaging in equipment finance transactions, it is crucial for equipment lessors and lenders to understand the type of business entity involved. This knowledge impacts various aspects of the transaction, including:

- **Credit Application:** The business type influences the financial and credit information required and the level of due diligence during underwriting.
- **UCC Filing:** Filing rules vary by entity type.
- **Documentation:** The entity type determines the type of documentation used and the authorization and signing requirements.
- **Compliance:** Different entities have distinct regulatory, licensing, tax, and legal requirements.
- **Bankruptcy Procedures:** Entity type dictates the procedures followed in case of customer bankruptcy.

Common Business Entities: There are several common types of business entities involved in equipment finance transactions, as further outlined.

Corporations: Corporations are separate legal entities from their owners (i.e., shareholders). Shareholders' liability is limited to their investment plus any personally guaranteed debts. They are governed by bylaws and Articles of Incorporation, which control transaction authorization and document execution.

The primary forms of corporations include:

- **C Corporation:** The basic corporate form with no limit on the number of shareholders. Profits are taxed at the corporate level, and distributions to shareholders are also taxed.
- **S Corporation:** Elects to be taxed like a partnership under IRS guidelines. IRS regulations limit shareholder numbers and types. Profits and losses flow to individual shareholders' tax returns.
- **Non-profit Corporation:** Formed to provide services like hospitals or charities, not profit-oriented. Known as 501(c)(3) or 501(c)(6) entities.
- **Professional Corporation (PC):** For specific professions like physicians, dentists, and attorneys, offering tax and pension benefits and limiting personal liability for business matters.

Limited Liability Companies (LLCs): Similar to Sub "S" corporations, profits or losses flow through to the owners' tax returns. LLC owners can be individuals or corporations, and there is no limit on the number of owners. Operating Agreements govern LLCs and can be managed by managers or members (i.e., owners) directly. It is crucial to determine who has the authority to bind the LLC to agreements. LLC members have no personal liability unless they personally guarantee the LLC's debts.

Partnerships: Involve two or more parties doing business together. General partnerships may not require formal agreements or registration, and all partners are liable for partnership debts.

Limited Partnerships (LP): Limited partnerships have general partner(s) liable for debts and limited partner(s) protected from liability.

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Limited Liability Partnerships (LLPs): General partnerships modified to provide liability protection like LLCs. They operate under partnership agreements and offer partners protection from LLP debts.

Sole Proprietorships: The simplest business entities, owned by one individual. They require minimal legal formalities, and business income is reported on the owner's personal tax return.

Other Business Entities: Include joint ventures, associations, and trusts. Joint ventures are formed for specific projects, associations are typically non-profit organizations, and trusts hold assets for beneficiaries. Each entity type has unique characteristics and requirements for equipment finance transactions.

Municipalities: Local government entities like states, cities, counties, or school districts. Municipalities typically cannot commit to leases or loans for more than one year. Still, longer-term obligations may include "fiscal funding clauses" allowing cancellation if funds are not appropriated in future budgets.

Federal Government: Can borrow funds as needed and issue long-term bonds. They generally avoid long-term lease obligations but may commit to multi-year leases in some cases. Different agencies have varied methods for leasing equipment.

For more information on Business Entities, please review Chapter 2 – Leasing Law of the CLFP Handbook (10th edition).



Using Artificial Intelligence in Equipment Finance

The Code of Hammurabi dates back to 1700 BC. Fast forward to the 1800s AD, and leasing began to become prevalent with the rise of the railroad industry. With the development of the personal computer in the early 1980s and the launching of the first website in the early 1990s, conducting business changed dramatically. And so did the risk of fraud.

According to various definitions of Artificial Intelligence (AI), AI refers to computer systems performing tasks typically/historically performed by humans/human intelligence. AI initially surfaced in the 1950s when British mathematician Alan Turing conceptualized that machines could think like humans. Over the decades, AI has continuously and rapidly advanced. Companies in various industries are adopting AI for several reasons, including increased efficiency, enhanced speed, improved accuracy, and enhanced decision-making capabilities.

Companies within the finance industry are using AI and investigating the adoption of AI for a variety of purposes, including fraud detection. AI algorithms can rapidly analyze vast amounts of data to identify patterns and detect anomalies, potentially including fraudulent activities by applicants, vendors/equipment sellers, and existing customers. Additionally, AI algorithms might be able to quickly identify customers more likely to become delinquent with payments and/or default.

While there are many benefits and options available with AI, there are also risks and potential unintended consequences that need to be carefully considered. Automation biases, when humans trust computer-generated outputs even though their judgment or other data is telling them something different, is the most common risk. Some other risks include (but not limited to): privacy, cybersecurity, misinformation, incorrect decisions, lack of accountability, lack of transparency/explainability, etc.

A key component to successfully using AI within one's organization is that it should be used to support, but not replace, human decision-making. One way to achieve this is through manual audits, which look for errors or anomalies that AI may have missed or incorrectly classified. A second method, known as "red teaming," uses ethical hackers to simulate attacks so that vulnerabilities can be identified. Finally, regular training for those who use the AI system should be conducted so that these groups understand where it might fail and how to verify its outputs.

AI is relatively new, but like many new products and services developed over the centuries, its acceptance and usage are growing rapidly. Users seeking to leverage the numerous benefits of AI should be aware of the associated risks and ensure that adequate controls are in place.

SOURCES:

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ASC 840 vs ASC 842 for Lessors

ASC 842, also known as Topic 842, is a standard issued by the Financial Accounting Standard Board (FASB) that established several updates to lease accounting. While the overall framework for lessors remains similar to ASC 840 (Topic 840), there are some important changes. Here is a summary of some of these adjustments:

Lease Classification: One of the most noticeable modifications under Topic 842 is the new terminology used to classify a lease. Under ASC 840, lessors were required to classify their leases as either capital or operating leases. Now, ASC 842 requires lessors to adjust the lease classification criteria to:

- **Sales-Type Lease:** A lessor's lease that transfers ownership or meets criteria leading to profit recognition at lease commencement.
- **Direct Financing Lease:** A lessor's lease where the lease payments and residual value guarantee equals or exceeds significantly the asset's fair value, and the income is recognized over the lease term.
- **Operating Lease:** A lease that doesn't meet the criteria for sales-type or direct financing leases (typically involving rental arrangements without ownership transfer) and the income is recognized over the lease term.

However, it should be noted that at the time of adopting ASC 842, a lessor could choose to apply a package of practical expedients. This package includes the option not to reassess lease classification, and it must be consistently applied across all leases.

Another key update related to lease classification is that even if payment collection is uncertain, a lease can now be classified as a sales-type lease. However, if it is unlikely that the lease payments or any guaranteed residual value will be collected, any payments received must be recorded as a deposit, not as income, and the asset remains recorded in the books accordingly. If collectability is not probable for a lease that would otherwise be a direct financing lease, it must be classified as an operating lease. In such cases, income can only be recognized as cash is received, until it becomes probable that full payment will be collected.

Initial Direct Costs: ASC 842 narrows the definition of direct costs. Indeed, under the new standard, only incremental costs that are directly tied to obtaining the lease contract can be treated as initial direct costs. This is stricter than the old rules. Costs, such as legal fees and internal salaries, which were previously spread out over the lease term under ASC 840, must now be recorded as expenses when incurred. For some lessors, this means showing higher expenses upfront but greater income recognition later in the lease term.

Transfer of Control Test: Under ASC 842, buyers/lessors must now check if they truly "purchased" the underlying asset using the transfer of control test from ASC 606 (Topic 606: Revenue from Contracts with Customers). If it is not determined to be a sale/purchase, the transaction is treated as a loan, and the lessor records a receivable. If it is a sale, the asset is recorded as a non-financial asset, but the price must be adjusted if it is not at fair value.

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Expanded Disclosure Requirements: ASC 842 requires more robust disclosures. To comply with the new rules, lessors must expand the disclosures in their financial reports to include:

- **Qualitative (descriptive) information:** This includes key accounting judgments and estimates made, as well as how leases are structured (such as variable payments or options to end or extend the lease). Additionally, it describes how the lessor manages the risk of the asset losing value, including the use of residual value guarantees.
- **Quantitative (numbers-based) information:** This includes maturity analysis, sales-type and direct financing, interest income, income from operating leases, and variable leases.

In conclusion, while ASC 842 retains much of the lessor accounting structure from ASC 840, it introduces some notable changes. Lessors must carefully evaluate these changes to ensure compliance and accurate financial reporting.

Retrieved from: ASC 842 Lessors. Available at: <https://kpmg.com/us/en/frv/reference-library/2021/asc-842-lessors.html>

Navigating Defaults: Strategies for Risk Mitigation in Equipment Finance

Default is not a new concept in the equipment finance industry. It is a reality that every equipment finance company needs to be prepared to manage. A variety of departments can often feel the pulse on trends and potential issues within an organization, which makes cross-functional communication on adverse trends key. These conversations can help establish risk parameters and identify any necessary adjustments to mitigate potential losses.

The primary goal with any default situation is to minimize legal fees and write-offs while maximizing recoveries. Strong portfolio management is one tactic to help in these situations. Regular monitoring of contracts and ongoing credit reviews can help identify potential at-risk accounts early, allowing for timely intervention. This often includes an asset management review of the collateral involved. The approach a company takes can vary depending on the type of financing structure. For example, a Fair Market Value (FMV) lease will have a different asset management approach than an Equipment Finance Agreement (EFA). Understanding changes in valuations as well as how assets are used within various industries or regions will ensure accurate and realistic assessments. Proper asset valuation at origination has a direct impact on recovery outcomes in the event of default.

Establishing and maintaining acceptable reserves for potential losses on a portfolio is another way a company can remain profitable in the event of unforeseen defaults. Continually monitoring and adjusting these reserve levels can ensure the company stays aligned with its financial goals.

Equally important for an equipment finance company is a clear understanding of lawful and effective collection techniques. As you may recall from the CLFP Handbook, the Fair Debt Collections Practices Act (FDCPA) governs the debt collection practices for personal/consumer debt. The FDCPA sets forth a myriad of restrictions regarding the practices that debt collectors may use in their efforts. Recently, California passed a law extending debt collection rules to certain commercial transactions of \$500,000 or less. Under California law, certain commercial transactions originated after July 1, 2025, will now fall under the protection of the Rosenthal Fair Debt Collections Practices Act (RFDCPA), which will apply to debt collectors as well as creditors. One of the main differences between the FDCPA and the RFDCPA is that the RFDCPA applies to those collecting on their own debts (i.e., creditors).

While the RFDCPA will not apply to debtors who are commercial legal entities (i.e., corporations or limited liability companies), it will apply to any personal guarantors of those companies, as well as to individuals who incur commercial debt. This is an expansion of the restrictions set forth by the FDCPA, specifically prohibiting certain methods of collection that could be deemed harassing or threatening. Some additional requirements under the RFDCPA may include providing a validation of debt letter or a statute of limitations disclosure. The few exceptions to the RFDCPA include debts that are not yet delinquent and combined debts exceeding \$500,000 with a debtor (i.e., the total of all combined contracts). At this time, the RFDCPA is only applicable to debtors residing in California or contracts governed by California law; however, it remains to be seen if other states follow suit.

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Default mitigation is an ongoing process that requires proactive communication and informed decision-making. By staying ahead of regulatory changes, maintaining strong portfolio oversight, and fostering internal collaboration, equipment finance companies can effectively minimize losses and navigate the complexities of contract defaults with confidence.

For more information on this topic, please review Chapter 9 – Portfolio Management in the CLFP Handbook (10th Edition).

SOURCE:

[The Rosenthal Act, It Is A-Changing: A Creditor's Guide to the SB 1286 Amendment Expanding the Rosenthal Fair Debt Collection Practices Act – Monitordaily](#)

