Filling the "GAAP": Why Generally Accepted Accounting Principles Should Inform U.C.C. Article 9 Decisions*

I. Introduction: The "Perfect Circle of Lack of Responsibility"

In the 1992 comedy blockbuster *White Men Can't Jump*,[1] actors Wesley Snipes and Woody Harrelson are two basketball hustlers who team up to take on other streetball duos in Southern California. Though working together, they are constantly attempting to upstage each other, and their personal differences threaten to break up the successful team. It is only after the two settle their differences and learn to trust each other that they are able to elevate their performance as a team and become better individuals in the process.

Such is the relationship between attorneys and accountants. Though readily acknowledged as being "allied professions,"[2] attorneys and accountants are too often seen as discretely in charge of separate aspects of a transaction.[3] But this should not be the case. Such an attitude contributes to what Professor William Simon describes as a "perfect circle of lack of responsibility."[4] Professor Lawrence Cunningham describes this circle with an anecdote: "A familiar pass-the-buck *pas de deux* in deal meetings and conference calls occurs when the accountant says, after an impasse, 'that's a legal problem' while the lawyer says 'that's an accounting problem.'"[5]

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1. WHITE MEN CAN'T JUMP (20th Century Fox 1992).

2. *See* John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1417–19 (2002) (opining on how attorneys and accountants can successfully deal with failings within the "allied professions" regarding financial scandals).

3. *See* Steven L. Schwarcz, *Financial Information Failure and Lawyer Responsibility*, 31 J. CORP. L. 1097, 1108 (2006) ("[L]awyers and accountants speak fundamentally different languages. It is as if accountants are from Mars, lawyers from Venus.").

4. *See* Steven L. Schwarcz, *The Limits of Lawyering: Legal Opinions in Structured Finance*, 84 TEXAS L. REV. 1, 21 n.108 (2005) ("Professor William Simon argues for a more fully interdisciplinary regime [between attorneys and accountants] in order to avoid the possibility of a 'perfect circle of lack of responsibility.'" (quoting William H. Simon, Arthur Levitt Professor of Law, Columbia Law Sch., Remarks at the Columbia Law School Symposium: The Limits of Lawyering: Legal Opinions in Structured Finance (Mar. 21, 2005))).

5. Lawrence A. Cunningham, *Sharing Accounting's Burden: Business Lawyers in Enron's Dark Shadows*, 57 BUS. LAW. 1421, 1454 (2002).

There is no better illustration of this circle than the collapse of Enron. One of the most famous scandals in corporate America[6] put the deficient relationship between accountants and attorneys on center stage. Though Enron was guilty of numerous schemes,[7] at the heart of the fraud was the company's legal and accounting treatment of special purpose entities (SPEs).[8] These SPEs were set up as outside companies of Enron in order to house liabilities that could be kept off the company's balance sheet.[9] By keeping large amounts of debt off the balance sheet, Enron was able to fool investors into believing the company was in better financial condition than it was, resulting in higher stock prices.[10] When the fraud was discovered, sorting out liability became a mess.[11]

In keeping with the circle, Enron's attorneys denied any responsibility, pointing the finger at accountants.[12] However, this was not a credible argument because the accounting decision for SPE transactions was based in part on legal opinions issued by attorneys.[13] And what was the legal opinion required? It was a determination that is critical under Article 9 of the Uniform Commercial Code (U.C.C.), which governs secured lending: Did transfers from Enron to these SPEs constitute a "true sale"?[14] This is a critical determination because if these transfers were not true sales, but rather disguised loans, the parties to these transactions would be vulnerable in bankruptcy proceedings absent any proof of a "backup" security interest.[15]

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6. *See* Miriam H. Baer, *Linkage and the Deterrence of Corporate Fraud*, 94 VA. L. REV. 1295, 1313 (2008) (citing Enron's off-balance-sheet transactions as one of the most famous frauds in the last decade).

7. *See* Third Interim Report of Neal Batson, Court-Appointed Examiner at 26–30, *In re* Enron Corp., No. 01-16034 (Bankr. S.D.N.Y. June 30, 2003) [hereinafter Third Batson Report] (describing several of Enron's fraudulent transactions including prepay transactions, a Nigerian barge transaction, a minority interest transaction, and two related-party transactions).

8. *See id.* at 24 (asserting that Enron's corporate officers breached their fiduciary duties by engaging in SPE transactions meant to manipulate financial statements).

9. *See id.* (describing how SPE transactions produced a "false and misleading presentation of the financial condition of Enron").

10. Second Interim Report of Neal Batson, Court-Appointed Examiner at 15, *In re* Enron Corp., No. 01-16034 (Bankr. S.D.N.Y. Jan. 21, 2003).

11. *See* Third Batson Report, *supra* note 7, at 4–5 (describing the basis for liability of corporate officers, accountants, attorneys, and financial institutions in their role within Enron's collapse, yet admitting that each has potential defenses against the strict knowledge requirement).

12. *See* Defendant Vinson & Elkins L.L.P.'s Motion to Dismiss and Memorandum in Support at 3, 15, Newby v. Enron Corp. (*In re* Enron Corp. Sec. Litig.), No. H01-3624 (S.D. Tex. May 8, 2002) (arguing that SPE transactions were "largely a matter of the application of GAAP" and "properly the province of accountants, not lawyers," and that GAAP is "a subject not within the purview of lawyers").

13. First Interim Report of Neal Batson, Court-Appointed Examiner at 38 n.98, *In re* Enron Corp., No. 01-16034 (Bankr. S.D.N.Y. Sept. 21, 2002) [hereinafter First Batson Report].

14. *Id.*; *see also* U.C.C. § 1-203 (2009) (providing the definition of a security interest).

15. *See* First Batson Report, *supra* note 13, at 38 (describing how the characterization of asset transfers to SPEs as "true sales" would give lenders a basis for claiming recovery but otherwise these assets would be "shared generally by the Debtors' unsecured creditors").

Enron's fraudulent transfers provide the perfect example of the connection between the U.C.C. secured lending provisions and Generally Accepted Accounting Principles (GAAP). At any point, either accountants or attorneys could have pulled the plug on these fraudulent transfers simply by adhering to their respective standards. Additionally, the Enron case demonstrates why it is critical that the U.C.C. and GAAP inform each other in complex transactions. As transactions become more complex, there is an increasing overlap of work performed by attorneys and accountants.[16] This complexity often makes attorneys and accountants legally responsible for one another.[17] Certain accounting decisions require a legal opinion before the accountant can move forward.[18] Moreover, some legal decisions first require an accounting decision.[19] As a result, attorneys can be held responsible for misrepresentations within financial statements.[20]

In order to transcend the perfect circle of lack of responsibility, the legal community must attempt to incorporate elements of GAAP into commercial law. In describing this incorporation, this Note proceeds in five parts. Part II describes conceptual issues with incorporating GAAP into U.C.C. provisions. Part III describes the potential practical issues of doing so. Part IV applies these concepts to a real-world headache for Article 9—the characterization of agreements as either leases or security interests. Finally, Part V briefly discusses some broader implications of considering GAAP within Article 9 provisions.

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16. *See* Final Report of Neal Batson, Court-Appointed Examiner at 22, *In re* Enron Corp., No. 01-16034 (Bankr. S.D.N.Y. Nov. 4, 2003) [hereinafter Final Batson Report] (observing that officers, directors, accountants, attorneys, and financial institutions all played a part in the complex SPE transactions of Enron); Schwarcz, *supra* note 3, at 1100 (declaring that the "increasing overlap of law and accounting" has brought about increased liability for attorneys because of responsibility for accountants' work).

17. *See* Schwarcz, *supra* note 3, at 1101 (noting that financial statements are primarily the responsibility of accountants but financial-transaction complexity has "further blurred the boundary between these legal and accounting duties" where these transactions have both legal and accounting consequences).

18. *See* FASB Transfers and Servicing, A.S.C. Section 860-50-25 (establishing that accounting treatment for transfers of assets turns in part on legal conclusions of true sale and nonconsolidation under bankruptcy law).

19. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784 (codified at 15 U.S.C. § 7245 (2006)) (stating the requirement that attorneys "report evidence of a material violation of securities law . . . to the chief legal counsel or the chief executive officer of the company"); Damaris Rosich-Schwartz, *Accounting Expertise and Attorney Compliance with the Sarbanes-Oxley Act of 2002*, 24 T.M. COOLEY L. REV. 533, 549–50 (2007) (noting that in order for attorneys to be able to fulfill their duty in reporting material financial misstatements, they must first make a reasonable determination of whether the violation is material).

20. *See* John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 338 (2004) (observing a "judicial shift—whether conscious or unconscious—toward imposing greater liability on gatekeepers," including attorneys in financial frauds).

II. Conceptual Issues with Incorporating GAAP into Commercial Law Analysis

A. The Purpose of GAAP: Accuracy in Financial Statements

The main argument against using GAAP to inform commercial law is the perceived difference of purpose.[21] The purpose of GAAP is to increase the accuracy of financial statements.[22] The purpose of Article 9 of the U.C.C. is to provide a system whereby lenders can secure collateral in an effort to recover should the debtor default on payments.[23] Additionally, different parties are served by each profession: accountants owe a professional duty to a third party or to the public at large while attorneys owe a duty to their client.[24] At first blush, it seems that these differences make it difficult, if not impossible, to have GAAP inform commercial law decisions. However, there are at least two reasons why this is not the case.

First, even if commercial law and accounting diverge in their overarching goals, this should not be dispositive in determining whether GAAP can inform commercial law. In fact, given that accounting and law are both critical to economic transactions, it would be helpful to see where their respective purposes diverge in order to more aptly describe how GAAP can fill holes within commercial law. Different purposes do not preclude the two related bodies of rules from interacting and informing each other.[25]

Second, I argue that the two do not have different purposes. The common characterizations of purpose for GAAP and Article 9 are, in reality, limited; they are merely statements of the end product produced by the two sets of standards. At such a limited level, it is easy to see that financial statements and status in bankruptcy are wholly different products. But one must take a step back in order to realize that the two bodies of rules have much in common.

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21. *See* Schwarcz, *supra* note 4, at 26–27 (concluding that the nature of the attorney's work in a transaction includes negotiating a legal opinion with outside parties, in essence an advocacy role, and that an accountant's goal of fair and objective presentation is "fundamentally different from the goals of traditional legal advocacy").

22. *See* Final Batson Report, *supra* note 16, at 25 ("The ultimate goal of GAAP is to set out financial information that is relevant, reliable and useful."); William W. Bratton, *Private Standards, Public Governance: A New Look at the Financial Accounting Standards Board*, 48 B.C. L. REV. 5, 26 (2007) (noting that the Financial Accounting Standards Board (FASB) chose external transparency as the primary goal of accounting theory).

23. *See* Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEXAS L. REV. 795, 807 (2004) ("The first purpose of a secured-credit regime is a workable system to permit a debtor to sell a post-default priority in certain collateral to a creditor . . . .").

24. Final Batson Report, *supra* note 16, at 27.

25. *Cf.* Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051, 1052–55 (1984) (explaining how the principles underlying the Modigliani–Miller hypothesis—a financial theory of how firm value relates to capital structure—informed an analysis of whether a legal regime favoring secured debt was justified).

From a wider perspective, the purpose of both accounting and commercial law is to correctly characterize the economic substance of transactions for the benefit of third parties to a transaction. From there, the product splits (accountants use economic substance to produce accurate financial statements; commercial attorneys use economic substance to determine which legal rules apply and how), but the underlying principles direct both professions to first determine the economic substance.

These underlying principles are readily found in the standards and accompanying interpretations.[26] Within the U.C.C., provisions such as the lease/security interest characterization directing economic substance to control the distinction[27] and even the general scheme that directs priority of claims based on the type of collateral are clear examples of Article 9's concern for economic substance identification.[28] Article 9 also gives third parties the ability to discover claims on property.[29] This is an important characteristic as it shows that aspects of Article 9 are intended to benefit third parties by providing information.[30] The same is true for GAAP. The main goal of GAAP is to produce reliable information that can be used by investors and creditors.[31] Thus, the two bodies of standards are not at odds in terms of broader goals.

B. The Accountant's Approach: Principles-Based Versus Rules-Based Methods

Other than the potential difference in respective purposes, another argument against using GAAP to inform commercial law focuses on the different approaches employed by accountants and attorneys. One characterization of legal advice is that it must necessarily be more nuanced than accounting advice.[32] This results from the different problems the professions

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26. The development of Article 9's functional approach, defining security rights based on the economic substance of the transaction, is discussed at length in 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 288–332 (1965).

27. U.C.C. § 1-203 cmt. 2 (2009).

28. *See* U.C.C. §§ 9-317, 9-320, 9-324 to -325, 9-327 to -330 (articulating the general priority rule (section 9-317) and the specific priority rules for separate types of collateral, including goods (section 9-320), purchase-money security interests (section 9-324), transferred collateral (section 9-325), deposit accounts (section 9-327), investment property (section 9-328), letters of credit (section 9-329), and chattel papers or instruments (section 9-330)).

29. *See* Charles W. Mooney, Jr., *The Mystery and Myth of "Ostensible Ownership" and Article 9 Filing: A Critique of Proposals to Extend Filing Requirements to Leases*, 39 ALA. L. REV. 683, 747 (1988) ("Thus, one benefit of the Article 9 filing regime is that it provides information to interested third parties who desire to uncover potential claims to the property of a debtor.").

30. *But see* Coffee, *supra* note 2, at 1417 (observing that attorneys design transactions but often do not provide certification to third parties).

31. Final Batson Report, *supra* note 16, at 25.

32. *See* Schwarcz, *supra* note 3, at 1107 ("Legal advice, in contrast [to accounting advice], usually focuses on explaining a nuanced range of likely consequences to clients, who then decide how to evaluate and act on the advice.").

address. Problems within accounting usually call for black-and-white solutions (for example, either cash received from a customer is revenue or it is not).[33] Problems for attorneys involve looking at the same information from multiple angles.[34]

The difference in approaches and their respective characterizations resembles the age-old rules-versus-principles debate. GAAP is often criticized as being a rules-based system.[35] Commercial law has been characterized as being a principles-based system.[36] The difference between the two shares a common theme with the above argument about approaches taken by attorneys and accountants. Principles are fair because of their ability to adapt to the facts of a situation.[37] Rules create more certainty than principles but may produce ridiculous results when blindly adhered to.[38] Rules-based accounting is seen as having contributed most greatly to the financial scandals of the early part of the decade[39] because management was able to obtain a desired result while still meeting the technical requirements of the rules. The variety and flexibility of commercial law interpretation and the resulting need for more nuanced advice suggest that commercial law is more principles based. If accounting decisions truly are black and white, then it would make sense that GAAP has adopted clear-cut answers to address commonly recurring problems.

There are two responses to this argument. First, it is at least arguable that neither system can be characterized as rules based or principles based. In reality, both are a mixture of rules and principles.[40] Within GAAP, there are several rules that are principles based while others are often viewed as quintessentially rules based.[41]

Second, even if the characterizations of GAAP and commercial law are true, this only increases the value GAAP can add to commercial law. In any

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33. *See id.* at 1108 (characterizing legal advice as "rarely black and white," in contrast to accounting advice).

34. *Id.* at 1107–08.

35. *See, e.g.*, Coffee, *supra* note 2, at 1416–17 (arguing that the Enron scandal has exposed GAAP as a rules-based system).

36. *See* A. Michael Sabino & Joseph J. Geraci, *The "True Lease vs. Disguised Security Interest" Question Continues with a Rebel of a Case*, SECURED LENDER, Jan. 2004, at 8, 24 (suggesting that certain provisions within the U.C.C. are "more of a set of guidelines than actual rules").

37. Lawrence A. Cunningham, *A Prescription to Retire the Rhetoric of "Principles-Based Systems" in Corporate Law, Securities Regulation, and Accounting*, 60 VAND. L. REV. 1411, 1423–24 (2007).

38. *Id.*

39. *See id.* at 1412 ("Many attributed the [corporate scandals such as Enron] to weaknesses in the United States accounting system, which they classified as 'rules-based.'").

40. *See id.* at 1413 (asserting that a complex system of standards contains a blend of rules and principles and cannot be characterized as strictly rules based or principles based).

41. *Id.* at 1458–59.

complex legal system, there will be an interaction of principles and rules.[42] This interaction is a necessary and beneficial element in order to avoid extremes.[43] A completely rules-based system would provide certainty but would be perceived as less fair in special circumstances.[44] A principles-based system would allow for more leeway in special circumstances but would lack proper guidance for parties to plan ahead.[45] If the two bodies really do lean in opposite directions, then there are likely some rules within GAAP that may help to provide more certainty to areas of Article 9 governed by principles.

Because accounting is a complex system of regulations,[46] it is more likely that there can be no single characterization of GAAP or how accountants approach problems. However, even if GAAP more often provides rules than principles, this is not dispositive of including guidance from GAAP in future revisions to Article 9. On the contrary, it provides even more support for considering how GAAP can fill potential deficiencies within Article 9 principles.

III. Practical Issues with Incorporating GAAP into Commercial Law Analysis

Despite the above-discussed perceptions of GAAP and Article 9, there is no conceptual antagonism between their respective goals that would make it impossible to believe GAAP could inform Article 9 analysis. But when it comes to applying this gap filling, there may be practical problems that must be sorted through.

A. Control over the Process

Some concerns may arise over institutional control of standard setting. For legislators who enact the U.C.C. into state commercial code, it may be seen as an intrusion on sovereignty to accept accounting standards set by a federal governmental entity.[47] Aside from just territorial concerns of state legislatures, having the FASB dictate accounting guidelines that will be

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42. *Id.* at 1431.

43. *See id.* at 1433–34 (positing that specificity of rules is needed to prevent abuse of principles and that flexibility of principles is necessary to keep mechanical rule following from producing absurd results).

44. *Id.*

45. *Id.* at 1433.

46. *See* Neal Newman, *The "Carrot" Approach to Accounting Standard Setting*, 16 U. MIAMI BUS. L. REV. 227, 234 (2008) ("The United States has a complex and layered regime of standard-setters, complex and thorough accounting rules, as well as layers of oversight built into the financial reporting process . . . .").

47. *See, e.g.*, Sean J. Griffith & Myron T. Steele, *On Corporate Law Federalism: Threatening the Thaumatrope*, 61 BUS. LAW. 1, 21–22 (2005) (arguing that the flexibility of state laws may prove preferable to the inflexible federal preemption of corporate law).

incorporated into state commercial codes could run afoul of separation-of-powers principles in the Constitution.[48]

However, these concerns can be easily sidestepped upon realization of two facts. First, the process of creating uniform standards to be incorporated into state commercial codes is already removed from the state legislature. The U.C.C. is a body of standards sponsored by private organizations—the American Law Institute and the National Conference of Commissioners on Uniform State Laws.[49] Yet incorporating uniform standards has been seen as a benefit to state commerce because of its ability to support the free flow of goods.[50] As the earlier conceptual analysis suggests, incorporating uniform accounting rules into the U.C.C. may do much to further the purpose of the U.C.C. and aid in gap filling. Therefore, bringing in GAAP should not be seen as out of the ordinary in terms of the current process of commercial code standard setting.

Second, even in the current process, state legislatures have the ultimate power to determine what is and is not incorporated into state codes. Just as states have chosen not to incorporate certain parts of the U.C.C.,[51] states will have the ability to reject recommendations of incorporating GAAP into commercial standards. This should render moot any federalism concerns and put state legislators' minds at ease that they are not forced to accept outside standards.

Aside from state legislative concerns, there may be additional concerns once GAAP does become a part of interpretation of these standards. The principle question is, whose interpretation will be binding? For U.C.C. matters, courts interpret the commercial code enacted by a legislature in judging disputes.[52] In this regard, courts have had a tremendous impact on the development of U.C.C. provisions.[53] For GAAP, the FASB is in charge of giving any clarifications or interpretations.[54] This realization leads to an

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48. *See id.* at 19–20 (arguing that post-Enron federal legislation regulating board decision making and composition constitutes an encroachment into an area where states have traditionally been predominant).

49. Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1707 n.509 (2008).

50. *See generally* Fred H. Miller, *The Future of Uniform State Legislation in the Private Law Area*, 79 MINN. L. REV. 861, 866–67 (1995) (maintaining that "facilitating interstate economic relations" is one potential benefit of having uniform laws).

51. *See, e.g.*, *In re* APB Online, Inc., 259 B.R. 812, 823 (Bankr. S.D.N.Y. 2001) (noting that the Connecticut legislature has chosen not to update the state commercial code to reflect revisions in the U.C.C. regarding lease characterization).

52. *See* U.C.C. § 1-103 (2009) (urging courts to construe the code liberally "to promote its underlying purposes and policies").

53. *See* Sabino & Geraci, *supra* note 36, at 8 (noting that judges put their own "unique imprimatur" on commercial law issues in spite of uniformity in the Bankruptcy Code and the U.C.C.).

54. *See* Anthony J. Luppino, *Stopping the Enron End-Runs and Other Trick Plays: The Book-Tax Accounting Conformity Defense*, 2003 COLUM. BUS. L. REV. 35, 140 ("[T]he SEC has placed

important question: Will courts have to refer cases to the FASB and ask for interpretations of financial accounting standards?

In all likelihood, the answer to this question is no. Courts will not have to ask for GAAP interpretations from the FASB nor will a court's interpretation of GAAP be binding on the FASB. Part of the reasoning for this conclusion is based in administrative law.[55] We can also simply point to court precedent. Courts have already waded into opinions based on GAAP interpretations.[56] This is possible because (1) in addition to accounting rules, FASB often provides guidance and interpretations that are readily available to courts,[57] and (2) where there are questions of ambiguity in GAAP, courts are fully capable of making an interpretative decision. The next step for the court is to not only make GAAP conclusions, but to incorporate GAAP into legal analysis when deciding commercial law cases.

B. Updating Commercial Law

Another practical concern of incorporating GAAP into commercial law is implementation. There are two aspects to this problem.

First, by what process should GAAP be incorporated? There are many possibilities, all with varying degrees of effectiveness and efficiency. The current process of updating the commercial code is drafting by the sponsors of the U.C.C.[58] Redrafting the U.C.C. would likely be the most effective method because this would be in line with the goal of uniformity of commercial law.[59] However, considering that the U.C.C. is redrafted so

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substantial confidence (and authority) in the accounting profession and, since 1973, in the FASB, to fashion and interpret the GAAP rules that control financial accounting.").

55. The Supreme Court has instituted a highly deferential standard regarding agency interpretations of statutes and their own promulgated regulations. *See* Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs., 545 U.S. 967, 980 (2005) ("[A]mbiguities in statutes within an agency's jurisdiction to administer are delegations of authority to the agency to fill the statutory gap in reasonable fashion."). However, a discussion of administrative law is outside the scope of this Note.

56. *See, e.g.*, United States v. Simon, 425 F.2d 796, 805–06 (2d Cir. 1969) (holding that compliance with GAAP could not constitute a complete defense to material misstatements and stating that "the 'critical test' was whether the financial statements as a whole 'fairly presented the financial position of [the Company]'"); E. Coast Equip. Co. v. Comm'r, 222 F.2d 676, 677 (3d Cir. 1955) (noting that the purported buyer treated the transaction like a sale on its books); *In re* PSINet, Inc., 268 B.R. 358, 369 (Bankr. S.D.N.Y. 2001) (considering accounting treatment as a factor in determining whether a true sale took place).

57. *See* Luppino, *supra* note 54, at 133 (describing the FASB's efforts to promulgate accounting standards and promote uniform application of GAAP since the FASB's creation in 1973).

58. *See* Kettering, *supra* note 49, at 1707 n.509 (detailing the addition of "[e]lectronic chattel paper" to Revised Article 9).

59. *See In re* Ecco Drilling Co., 390 B.R. 221, 226 (Bankr. E.D. Tex. 2008) (observing that "changing business practices have led to changes in the statutory guidance [in the U.C.C.] provided to courts").

infrequently,[60] this might be the least efficient method. Because state legislatures ultimately decide what is included within commercial codes, individual state legislatures could act independently to incorporate GAAP. This might be only slightly more efficient, as some states could have more political will than others to move forward with GAAP incorporation; moreover, this would be substantially less effective in achieving uniformity. Courts on their own could begin to give greater weight to GAAP in U.C.C. cases.[61] Courts already include accounting determinations in their analysis,[62] so it would be consistent for courts to simply decide that in certain situations, GAAP determinations will be dispositive or at least have great weight. However, we again run into the problem of minimizing uniformity. Finally, contracting parties can simply write into the contract terms that GAAP determinations will be controlling. Considering that courts do not always honor the intent of parties,[63] it is questionable how effective this would be.

Second, exactly what parts of GAAP should be incorporated? GAAP is a complex regulatory system consisting of layers of opinions and interpretations.[64] GAAP deals with an array of financial matters from subjects as general as when to recognize revenue[65] to subjects as specific as when expected residual value for a specific type of asset must be adjusted.[66] However, though GAAP may be complicated, the FASB has made incorporating sections much easier with the completion of the Accounting Standards Codification project.[67] Now that GAAP is housed under one uniform code, searching for provisions and interpretations is not difficult. This should at

60. HARRY G. KYRIAKODIS, AM. LAW INST., PAST AND PRESENT ALI PROJECTS (2010), http://www.ali.org/doc/past_present_ALIprojects.pdf (listing the twenty-four revisions, amendments, and comments that have been made to the U.C.C. since the initial code was adopted in 1952).

61. *See In re* APB Online, Inc., 259 B.R. 812, 823 (Bankr. S.D.N.Y. 2001) (confirming that some Connecticut courts have applied revised sections of the U.C.C. in resolving disputes where such sections fill gaps in Connecticut law even though the Connecticut legislature has not adopted the revised sections).

62. *See supra* note 56 and accompanying text.

63. *See* U.C.C. § 1-203 cmt. 2 (2009) (explaining that the four tests used to determine if a transaction results in a lease or a security interest all "focus on economics, not the intent of the parties").

64. *See supra* note 46 and accompanying text.

65. FASB Revenue Recognition, A.S.C. Section 605-10-25.

66. FASB Leases, A.S.C. Section 840-30-35.

67. FASB adopted a new U.S. GAAP hierarchy effective July 1, 2009, pursuant to FASB Statement of Financial Accounting Standards No. 168. *Summary of Statement No. 168*, FIN. ACCOUNTING STANDARDS BD., http://www.fasb.org/cs/ContentServer?c=Pronouncement_C&pagename=FASB%2FPronouncement_C%2FSummaryPage&cid=1176156308679. As the SEC explained in an interpretive release published on Aug. 18, 2009, as amended on Aug. 19, 2009, "[t]he FASB Codification reorganizes existing U.S. accounting and reporting standards issued by the FASB and other related private-sector standard setters, and all guidance contained in the FASB Codification carries an equal level of authority." Guidance Regarding the FASB's Accounting Standards Codification, Securities Act Release No. 9062A, Exchange Act Release No. 60519A, 74 Fed. Reg. 42,772 (Aug. 25, 2009).

least facilitate the task of sifting through GAAP to decide which provisions to incorporate into the U.C.C.

C. *Education*

One final practical concern is how incorporating GAAP into commercial law might affect legal education. Specifically, does incorporating GAAP mean that attorneys must now be trained as accountants, well versed in the language and dogma of GAAP?

As a freestanding question, the answer is admittedly difficult. In order to make accurate judgments of provisions in the law containing GAAP references, it is likely that an attorney will need some level of accounting knowledge. However, this should be addressed as a relative question. In reality, attorneys today should already be familiar with some elements of GAAP.[68] As illustrated by the Enron case, complex transactions already call on attorneys to render judgment on the activities of accountants.[69] Attorneys not capable of doing this are likely not fulfilling duties to their clients.[70]

Because some level of GAAP knowledge is already required of attorneys, the question is not whether legal education should incorporate some measure of accounting but how much more accounting will be required by incorporating GAAP into commercial law. This is a more manageable question. Legal scholars have noted that accounting education in law school has decreased significantly in recent decades.[71] This may be one reason why the U.C.C. today does not incorporate GAAP provisions even though the two bodies of standards, as I have argued, have a common purpose. If the U.C.C. were to incorporate elements of GAAP, this would further the case that legal education should include more accounting knowledge. If the addition of GAAP to commercial law would strengthen our field's understanding of transactions, then the addition to legal education would be beneficial.

IV. Incorporation in Action: Lease/Security Interest Characterization

At this point I have explained why, both conceptually and practically, GAAP can be incorporated into commercial law. In neither case is GAAP incompatible to a degree that makes incorporation impossible. However, it

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68. *See* Rosich-Schwartz, *supra* note 19, at 552–53 (explaining that an attorney must determine whether revenue recognition is in compliance with GAAP before he can determine whether a change in accounts receivable on a Form 10-Q constitutes a material misrepresentation as required by Sarbanes-Oxley).

69. *See supra* notes 18–20 and accompanying text.

70. *See* Rosich-Schwartz, *supra* note 19, at 538 (arguing that without any accounting expertise or understanding of a client's financials, a corporate attorney is not competent and will not be able to determine if a material violation of securities law has occurred).

71. *See* Cunningham, *supra* note 5, at 1439–41 (citing a study confirming that accounting teaching in law schools has declined since 1975 and offering the rise in modern finance theory as an explanation).

would be helpful to the analysis to provide a practical example of how GAAP can assist attorneys in making important commercial law determinations.

I am examining the lease/security interest characterization question because it is one of the most litigated issues in commercial law.[72] As such, it is a question that is in need of some assistance in resolving. Additionally, lease accounting has been criticized as one of the weakest areas of GAAP.[73] Thus, if GAAP can offer some assistance to the U.C.C. in this area, *a fortiori*, it should be able to assist in other U.C.C. provisions.

A. U.C.C. Rules for Lease Characterization: All over the Map

The lease/security interest characterization provisions of the U.C.C. become an especially important issue in bankruptcy proceedings.[74] If a transaction constitutes a lease, then the lessor can have past defaults cured and will either receive the property back or continue to get rent payments depending on whether the debtor's estate chooses to continue the lease.[75] If a transaction is characterized as a financing, then the lessor is only entitled to the same rights as other lenders under the Bankruptcy Code, which are often less advantageous.[76]

Bankruptcy courts have consistently held that state law will determine whether an agreement is a lease or a financing.[77] The U.C.C. provisions are

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72. *See In re* Grubbs Constr. Co., 319 B.R. 698, 709–10 (Bankr. M.D. Fla. 2005) (describing the lease/security interest characterization as a "vexatious and oft-litigated" issue under the U.C.C.); Steven C. Strong, Presentation at American Bankruptcy Institute's Rocky Mountain Bankruptcy Conference: Selected Issues Under Bankruptcy Code § 365 (Jan. 22, 2009), *available at* http://www.abiworld.org/committees/newsletters/busreorg/vol8num1/Branding_the_Cattle.pdf (calling the lease/security interest characterization one of the most litigated issues under Section 365 of the Bankruptcy Code).

73. *See* Cheri L. Reither, *What Are the Best and the Worst Accounting Standards?*, ACCT. HORIZONS, Sept. 1998, at 283, 284–85 tbl.1 (indicating that a survey completed by academics, standard setters, regulators, public accountants, and financial analysts revealed that accounting for leases was voted the worst accounting standard).

74. *See* Tracy L. Treger & Mark F. Hebbeln, *Is 'Lease' a Financing Agreement in Disguise?*, J. CORP. RENEWAL, July 2004, at 1, 2 (noting that whether a transaction is a true lease "rarely comes into play outside of a bankruptcy proceeding").

75. Thomas C. Homburger & Karl L. Marschel, *Recharacterization Revisited: A View of Recharacterization of Sale and Leaseback Transactions in Bankruptcy After Fifteen Years*, 41 REAL PROP. PROB. & TR. J. 123, 134 (2006).

76. *Id.*

77. *See In re* Ecco Drilling Co., 390 B.R. 221, 226 (Bankr. E.D. Tex. 2008) (observing that whether a lease constitutes a security interest under the Bankruptcy Code depends on state law); WorldCom, Inc. v. Gen. Elec. Global Asset Mgmt. Servs. (*In re* WorldCom, Inc.), 339 B.R. 56, 63 (Bankr. S.D.N.Y. 2006) ("[S]tate commercial law determines whether a contractual agreement is to be characterized as either a lease or security arrangement."); Ford Motor Credit Co. v. Hoskins (*In re* Hoskins), 266 B.R. 154, 157 (Bankr. W.D. Mo. 2001) (noting that courts must look to state law to determine property rights).

included in Section 1-203.[78] U.C.C. Section 1-203(a) provides that "[w]hether a transaction in the form of a lease creates a lease or security interest is determined by the facts of each case."[79] However, despite this assertion, U.C.C. Section 1-203(b) then provides a "bright-line test"[80] for making an initial determination whether a transaction is in fact a security interest:

> A transaction in the form of a lease creates a security interest if the consideration that the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease and is not subject to termination by the lessee, and (1) the original term of the lease is equal to or greater than the remaining economic life of the goods; (2) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods; (3) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or for nominal additional consideration upon compliance with the lease agreement; or (4) the lessee has an option to become the owner of the goods for no additional consideration or for nominal additional consideration upon compliance with the lease agreement.[81]

In reality, this bright-line test gives the courts little guidance.[82] Though the first two elements provide clear rules, the court more often finds itself analyzing whether additional consideration is nominal.[83] The court must then rely on U.C.C. Section 1-203(d), which states,

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78. Note that this section refers to the most recent amendments of the U.C.C., which have been incorporated by most states. However, some states continue to use older versions of the U.C.C. provisions. *See In re* APB Online, Inc., 259 B.R. 812, 817 (Bankr. S.D.N.Y. 2001) ("There are at least three versions of [the older provision] in effect throughout the nation."). For the most part, these older provisions are still consistent with the substance of the amendments, but some states continue to use the former intent-of-the-parties test. *See id.* (noting that Connecticut continues to use the 1972 version, which directs the court to determine the intent of the parties).

79. U.C.C. § 1-203(a) (2009).

80. *See In re Ecco Drilling*, 390 B.R. at 227; *WorldCom*, 339 B.R. at 65 (both referring to U.C.C. Section 1-201(37) (1987) as a "bright-line test").

81. U.C.C. § 1-203(b).

82. *See WorldCom*, 339 B.R. at 64 ("Though the concepts expressed in [Section] 1-201(37) are rather easily defined, the means to distinguish between [leases and financing agreements] in a rigorous manner has often eluded the courts."); David A. Hatch & Mark G. Douglas, *When Is a Lease Not a Lease? Seventh Circuit Adopts "Substance Over" Form Test for True Lease Determination*, JONES DAY (Jan.–Feb. 2006), http://www.jonesday.com/newsknowledge/publicationdetail.aspx?publication=3122 (arguing that the Bankruptcy Code does not provide adequate guidance for determining whether a transaction is a security interest in sold assets or a lease).

83. *See In re Ecco Drilling*, 390 B.R. at 228 (finding that the only dispute under the bright-line test was whether the purchase options could be considered nominal); *In re APB Online*, 259 B.R. at 818 (noting that only the question of nominality matters in the dispute).

> Additional consideration is nominal if it is less than the lessee's reasonably predictable cost of performing under the lease agreement if the option is not exercised. Additional consideration is not nominal if: (1) when the option to renew the lease is granted to the lessee, the rent is stated to be the fair market rent for the use of the goods for the term of the renewal determined at the time the option is to be performed; or (2) when the option to become the owner of the goods is granted to the lessee, the price is stated to be the fair market value of the goods determined at the time the option is to be performed.[84]

Courts have found that this definition of nominal consideration has not been helpful.[85]

If the bright-line test is not met (and courts often cannot make a determination using the bright-line test[86]), then courts return to the catchall provision of U.C.C. Section 1-203(a) and must consider the specific facts of the case.[87] At this point, there is a massive divergence of opinion about which factors determine whether an agreement is a lease or a security interest. Under the old version of the test, the U.C.C. specifically asked courts to determine the intent of the parties based on the facts of the case.[88] Under the new version, there is no such explicit direction as to what should be the driving determination when considering the facts of the case.[89] The only guidance the U.C.C. provides is that the economic substance of the agreement should control the decision, rather than the intent of the parties.[90]

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84. U.C.C. § 1-203(d). According to U.C.C. § 1-203(e), "[t]he 'remaining economic life of the goods' and 'reasonably predictable' . . . fair market value . . . must be determined with reference to the facts and circumstances at the time the transaction is entered into."

85. *See In re Ecco Drilling*, 390 B.R. at 228–29 (criticizing the nominality test in the U.C.C. as offering little assistance when circumstances are not extreme and declaring that as a result the court must revert to common law tests); *WorldCom*, 339 B.R. at 66 n.8 ("There is a certain lack of conceptual clarity evident in the case law concerning the various tests courts apply to determine nominality.").

86. *See WorldCom*, 339 B.R. at 70 (holding that a determination based on the bright-line test could not be made); *In re APB Online*, 259 B.R. at 824 (holding that the court could not conclude whether an agreement constituted a lease or a security interest).

87. *See* Mason v. Heller Fin. Leasing (*In re* JII Liquidating, Inc.), 341 B.R. 256, 268 (Bankr. N.D. Ill. 2006) (noting that if the bright-line test is not satisfied, the court must continue to analyze the facts of the case); *WorldCom*, 339 B.R. at 65 (stating that the "second test" following the bright-line test is to examine the facts of the case to determine whether a security interest was created); Ford Motor Credit Co. v. Hoskins (*In re* Hoskins), 266 B.R. 154, 161 (Bankr. W.D. Mo. 2001) (declaring that the court's analysis continues to the catchall test if the bright-line test is not met).

88. *See In re Ecco Drilling*, 390 B.R. at 226 (recognizing that under revised Section 1-201(37) "the intention of the parties has been abandoned as a proper tool by which to distinguish a true lease from a disguised security interest").

89. *See WorldCom*, 339 B.R. at 71 ("[T]he statute does not provide any standards for determining which facts are relevant or how relevant facts should be weighed in the final determination.").

90. *See* U.C.C. § 1-203 cmt. 2 (2009) (noting that a reference to the intent of the parties led to unintended results and explaining that the new framework for the lease/security interest characterization focuses on economics and the facts of each case).

The four factors direct the court to determine whether the lessor has retained any "residual value."[91] Though courts and commentators have mostly followed this indication,[92] there is no such explicit direction included in the U.C.C. The U.C.C. has provided a list of factors that *do not* necessarily cause a lease to be characterized as a security interest, but there is no "smoking gun" as to when a lease is in fact a security interest. Furthermore, there is no fundamental difference between the old test and the new.[93] If the drafters of the U.C.C. had hoped to provide guidance to reduce confusion about the lease/security interest distinction,[94] the revisions have not been successful.

Because courts are left to fashion tests more or less on their own,[95] court opinions have considered a wide variety of factors. Some courts have focused exclusively on whether any reasonable economic actor would exercise a lease option making it clear that the parties never intended for equipment to return to the lessor.[96] Some of these courts have looked to whether it was

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91. *See* Duke Energy Royal, L.L.C. v. Pillowtex Corp. (*In re* Pillowtex, Inc.), 349 F.3d 711, 718 (3d Cir. 2003); *In re Ecco Drilling*, 390 B.R. at 227 n.32; *WorldCom*, 339 B.R. at 65 (all referring to the four U.C.C. factors as "residual value factors").

92. *See In re Ecco Drilling*, 390 B.R. at 227 (observing that in a lease agreement the lessor gives up the right to possess the item but retains the right to residual value after the lease termination); *WorldCom*, 339 B.R. at 71 ("The majority of courts and commentators have agreed that the principle inquiry is 'whether the lessor has retained a *meaningful reversionary interest* in the goods.'" (quoting Addison v. Burnett, 49 Cal. Rptr. 2d 132, 136–37 (1996))); Mooney, *supra* note 29, at 691 ("The essence of a true lease is the existence . . . of a meaningful residual interest for the lessor at the expiration of the lease term."); Strong, *supra* note 72, at 12 (concluding that U.C.C. Section 1-203(b) focuses on whether the lessor has retained a meaningful economic interest in the leased property).

93. In *Ecco Drilling*, the court noted two key findings. First, because nominal consideration guidance is inadequate in the U.C.C., the court must revert to common law tests to determine nominality. *In re Ecco Drilling*, 390 B.R. at 229. Second, because nominality is a consideration in the catchall facts-and-circumstances test, there is no difference whether a decision is reached as a result of the bright-line test or the catchall test. *Id.* at 229 n.38. Therefore, one can conclude that the catchall facts-and-circumstances test dominates the court's analysis and relies on old common law tests. *See* Ford Motor Credit Co. v. Hoskins (*In re* Hoskins), 266 B.R. 154, 161 (Bankr. W.D. Mo. 2001) (noting that the factors relied upon by courts prior to the U.C.C. amendments are still relevant if the bright-line test is not met).

94. *See* Mason v. Heller Fin. Leasing (*In re* JII Liquidating, Inc.), 341 B.R. 256, 267 (Bankr. N.D. Ill. 2006) (highlighting that the U.C.C. revisions were intended to resolve an issue that "has created considerable confusion in the courts"); *WorldCom*, 339 B.R. at 64 (stating that the revised U.C.C. test "attempts to provide a more rigorous statutory standard to guide the courts in their analysis of the security interest question").

95. *See WorldCom*, 339 B.R. at 71 ("[C]ourts have been forced to fashion judicial standards and tests to analyze 'the facts of the case.'"); Homburger & Marschel, *supra* note 75, at 154–55 (observing that courts are split as to whether sale and leaseback transactions should be characterized as leases or loans and that this split is a result of varying opinions regarding the courts' freedom to examine economic substance).

96. *See Hoskins*, 266 B.R. at 162 (holding that the "pivotal factor" in characterization is whether an agreement contains an "absolute obligation" to purchase the equipment).

reasonable going into the agreement to expect this.[97] Others have looked to facts and conditions at the end of the agreement period.[98] Some courts have created an absolute standard as to what amount is considered nominal.[99] Other courts have gone even further in rejecting direct guidance from the U.C.C.[100] Still, some courts have looked to lease characterization in tax courts,[101] while others have not.[102] This variety of considerations has resulted in continued confusion for parties entering a lease agreement as litigation is almost made necessary.[103]

B. Incorporating GAAP

Lease accounting rules have been described as one of the weakest parts of GAAP.[104] Yet criticism is focused on the characterization that lease accounting rules are too formal.[105] As discussed in the principles-versus-

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97. *See In re Ecco Drilling*, 390 B.R. at 230 (holding that the court must account for the parties' expectations of concluding value and not consider the actual value at the end of the lease term).

98. *See In re* Beam, No. 97-82752, 1998 WL 34065623, at *7 (Bankr. C.D. Ill. July 31, 1998) (holding that the "measuring rod" for determining whether an option price is nominal is the value of the leased property at the end of the agreements); *In re* Lerch, 147 B.R. 455, 458 (Bankr. C.D. Ill. 1992) ("The most significant factor in distinguishing the conditional sale masquerading as a lease and a true lease is the relationship of the option price to the value of the goods at the end of the lease term." (quoting *In re* Access Equip., Inc., 62 B.R. 642, 646 (Bankr. D. Mass. 1986))). Note that this is in direct contrast to guidance provided by the U.C.C. Yet because guidance is lacking, courts still continue to use factors they independently feel are important.

99. *See In re* Metrobility Optical Sys., Inc., 279 B.R. 35, 36–37 (Bankr. D.N.H. 2002) (holding that the nominality test is automatically satisfied when the option price is $1).

100. *See In re* Grubbs Constr. Co., 319 B.R. 698, 711 (Bankr. M.D. Fla. 2005) (commenting that some courts believe that the U.C.C. revisions were not intended to change the substantive law even though comments within the U.C.C. provide that the purpose of the revision was to shift the focus to "economic realities").

101. *See* United Air Lines, Inc. v. HSC Bank USA (*In re* UAL Corp.), 307 B.R. 618, 631 (Bankr. N.D. Ill. 2004) ("[C]onsistent with the legal standards developed under the UCC and federal tax law, a 'lease' under [Section] 365 of the Bankruptcy Code requires that the lessor retain significant 'risk and benefits as to the value of the . . . real estate at the termination of the lease.'"); Burke Investors v. Nite Lite Inns (*In re* Nite Lite Inns), 13 B.R. 900, 907 (Bankr. S.D. Cal. 1981) ("The [c]ourt will also place substantial reliance . . . on the approaches taken by the federal courts in tax cases.").

102. *See In re* PWS Holding Corp., 228 F.3d 224, 247 (3d Cir. 2000) ("[J]ust because a transaction is a sale or exchange for tax purposes does not mean that it is a sale within the meaning of the [Bankruptcy] Code.").

103. *See* WorldCom, Inc. v. Gen. Elec. Global Asset Mgmt. Servs. (*In re* WorldCom, Inc.), 339 B.R. 56, 74–75 (Bankr. S.D.N.Y. 2006) (holding that despite the fact that equipment could not physically be returned to the lessor because it was unidentifiable, the court was unable to conclude whether a lease or security interest had been created); *In re* APB Online, Inc., 259 B.R. 812, 824 (Bankr. S.D.N.Y. 2001) (holding that whether the agreement was a true lease was a question that could not be answered in summary judgment).

104. *See* Reither, *supra* note 73, at 283–85 tbl.1 (reporting the results of a survey of seventy-five professionals—academics, FASB standard setters, regulators, accountants, and financial analysts—and stating that the standard for accounting for leases is the overall worst standard).

105. *See id.* at 288 (listing, for example, the abuses resulting from the bright-line rule for lease capitalization as a reason for the standard's low marks).

rules analysis of Part II, it may be that this "weakness" is just what lease rules within the U.C.C. need in order to give stronger guidance to frustrated courts.[106]

The concern for distinguishing a lease from a financing is similar under lease accounting rules. Whereas for the U.C.C. the concern is treatment of the property in bankruptcy proceedings, under GAAP the concern is presentation within the financial statements. If an agreement is a lease, then the financial statements may reflect lease costs as operating costs and do not have to show the lease obligations as a liability on the balance sheet.[107] If an agreement is truly a sale or a financing, then the financial statements must reflect the property as a capital investment and show the obligations as a liability on the balance sheet.[108] This is an important distinction in accounting because the amount of debt on a balance sheet affects capital ratios, which in turn could affect credit ratings and the ability to obtain financing.[109] Though the end products produced by GAAP and the U.C.C. might be different, the purpose is the same: the economic substance of the agreement will determine how it is characterized under the standards.[110]

Lease accounting rules provide a four-part test to determine whether a lease is actually a sale and therefore capital. A.S.C. Section 840-10-25-1 of FASB Leases provides the following:

> a. Transfer of ownership. The lease transfers ownership of the property to the lessee by the end of the lease term. This criterion is met in situations in which the lease agreement provides for the transfer of title at or shortly after the end of the lease term in exchange for the payment of a nominal fee, for example, the minimum required by statutory regulation to transfer title.
>
> b. Bargain purchase option. The lease contains a bargain purchase option.
>
> c. Lease term. The lease term is equal to 75 percent or more of the estimated economic life of the leased property . . . .
>
> d. Minimum lease payments. The present value at the beginning of the lease term of the minimum lease payment . . . equals or exceeds

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106. *See In re* Ecco Drilling Co., 390 B.R. 221, 230 n.42 (Bankr. E.D. Tex. 2008) (noting that "everyone in the transaction treated [the agreement] as a capital lease for accounting purposes" and that this accounting treatment conformed with the economic reality of the transaction); Mason v. Heller Fin. Leasing (*In re* JII Liquidating, Inc.), 341 B.R. 256, 271 (Bankr. N.D. Ill. 2006) ("*Unfortunately*, no 'bright line' test exists for determining whether consideration is nominal." (emphasis added)).

107. FASB Leases, A.S.C. Subtopic 840-20.

108. FASB Leases, A.S.C. Paragraph 840-30-50-4.

109. Newman, *supra* note 46, at 242.

110. *See* Laurel A. Franzen et al., Capital Structure and the Changing Role of Off-Balance-Sheet Lease Financing 4 (Aug. 14, 2009) (unpublished manuscript), *available at* http://www.frbatlanta.org/filelegacydocs/seminars/seminar_simin_101609.pdf ("The capital lease is a financing vehicle for the purchase of an operational asset and is essentially secured debt.").

> 90 percent of the excess of the fair value of the leased property to the lessor at lease inception . . . .[111]

A comparison of GAAP and the U.C.C. shows that there are many similarities. The focus for both tests is on economic substance and not form.[112] Both pinpoint that the lease term and the presence of lease options will be primary indicators of where residual value lies.

However, there are key differences between the rules. Under the U.C.C., the fact that the present value of payments is greater than the cost of the equipment is not dispositive of the existence of a lease. Under GAAP, the 90% test mandates that the present value of payments be less than 90% of the cost of the equipment. The U.C.C. provision was a recent amendment and was meant to overrule decisions of some courts in determining lease characterization.[113] The reasoning behind this was to allow the calculation of interest to be a larger factor within lease payments.[114] But GAAP guidelines are much more intent on providing clear guidance and so have drawn the 90% as a clear, bright-line determination. Additionally, it is difficult to imagine lease payments totaling more than the cost of the equipment while the lease term is not equivalent to the economic life of the equipment. If the lease term is less than the economic life of the equipment, yet lease payments are still greater than the equipment's cost, it is hard to imagine that the interest calculated into the payments is not borderline usury.[115] GAAP is able to defend its 90% test because of another key difference, the requirement that the lease term cannot exceed 75% of the economic life of the equipment.

One main argument against incorporating GAAP mirrors the rules-versus-principles argument. Perhaps the U.C.C. drafters intended for the lease characterization test to be principle driven and for courts to have wide

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111. FASB Leases, A.S.C. Paragraph 840-10-25-1.

112. *See* United Airlines, Inc. v. HSBC Bank USA, 416 F.3d 609, 612 (7th Cir. 2005) ("Although the statute does not answer [whether substance or form of a transaction distinguishes a true lease] . . . , every appellate court that has considered the issue holds . . . that substance controls . . . ." (citations omitted)); Newman, *supra* note 46, at 243 ("The aim of [lease accounting rules] is to have . . . economic reality reflected in the accounting treatment for that transaction.").

113. *See* WorldCom, Inc. v. Gen. Elec. Global Asset Mgmt. Servs. (*In re* WorldCom, Inc.), 339 B.R. 56, 64 n.4 (Bankr. S.D.N.Y. 2006) (explaining that the U.C.C. test incorporates several standards that were developed by courts under the previous provision and observing that the test also "clearly rejects" other standards). *But see In re* Ecco Drilling Co., 390 B.R. 221, 232 n.50 (Bankr. E.D. Tex. 2008) (suggesting that the agreement's requirement to make payments that were greater than the purchase price of the equipment further supported the determination that the agreement was not a true lease).

114. *See* Raymond T. Nimmer, U.C.C. Article 2A: The New Face of Leasing?, Address at the DePaul Business and Commercial Law Journal Symposium: Out with the Old, in with the New? Articles 2 and 2A of the Uniform Commercial Code (Apr. 7, 2005), *in* 3 DEPAUL BUS. & COM. L.J. 559, 566 (2005) (reasoning that the theory behind allowing higher present-value payments than the cost of the equipment is to allow lessees to "make a bad deal" and still be subjected to full payment).

115. *See id.* (explaining that under the U.C.C. a transaction can still be a lease even if full payment of the lease is more than the present value of the good).

discretion. There are two responses. First, given the revisions that were made, this does not seem to be the likely intent of the drafters.[116] It is doubtful that the U.C.C., with the goal of creating uniformity in commercial law, would allow courts to develop independent tests. A second question is whether the adoption of bright-line rules is warranted.[117] The answer depends on policy considerations. One key policy concern is the desire to reduce litigation. Under the current U.C.C. test, litigation is often necessary even when all the facts and circumstances are known.[118] The current test does not alleviate this confusion among courts. Another key policy consideration is whether parties in a lease agreement would be able to more readily abuse the U.C.C. guidelines. A common complaint against lease accounting standards is that they lend themselves to abuse by company management.[119] Would the same be true for parties if the U.C.C. was to incorporate GAAP into lease-distinction guidance? The answer to this is complicated. It is likely that some degree of abuse is ongoing even under the current U.C.C. provisions. Determining whether increased abuse would occur would likely need empirical evidence that is currently unavailable. One policy argument that can be made is that there is nothing inherently wrong with "creative compliance."[120] Parties to a transaction are allowed to set up the agreement in a way that is most advantageous to them. If they attempt to favor a certain legal conclusion, as long as they are not disingenuous about the economic substance or deliberately colluding in fraud, parties should be allowed to contract as they wish.[121] From this perspective, nothing should be seen as fundamentally wrong with making lease transactions more clear for the parties. Should they desire to enter into these kinds of agreements, the fact that there is more legal certainty is beneficial because it facilitates transactions.

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116. *Compare* U.C.C. § 1-201(37) (1972) (leaning heavily on the parties' intent to determine whether a transaction creates a security interest), *with* U.C.C. § 1-203(b) (2009) (specifying in detail circumstances when a lease creates a security interest).

117. *See* Cunningham, *supra* note 37, at 1470 (arguing that the choice between principles- and rules-based standards is a "false dichotomy" and that the real issue is which type of standard is better for a given situation).

118. *See supra* note 103 and accompanying text.

119. *See* Reither, *supra* note 73, at 288 (describing a survey of accounting experts who, considering prolific abuse, named accounting for leases the worst accounting standard).

120. *See* Cunningham, *supra* note 37, at 1478 ("To an extent, creative compliance is unobjectionable, as when structuring a business combination to avoid triggering shareholder voting or appraisal rights, or designing a lease to obtain capital treatment."). *But see generally* Victor Fleischer, *Regulatory Arbitrage*, 89 TEXAS L. REV. (forthcoming Dec. 2010) (providing a comprehensive theory of regulatory arbitrage and positing that parties who take advantage of gaps between the economics of a deal and its regulatory treatment contribute to distortions in regulatory competition and an overall lack of transparency and accountability).

121. *See* Cunningham, *supra* note 37, at 1478 (explaining that if a company is too aggressive with creative compliance, it can lead to unlawful results).

V. Future Implications

I have now laid out arguments as to why GAAP should be incorporated into commercial law. Despite opinions to the contrary, there are no conceptual or practical concerns that are so difficult to overcome that incorporating GAAP into commercial law is impossible. As demonstrated in the leasing example, elements of GAAP can help commercial law become clearer for parties engaging in transactions. Additionally, the merging of law and accounting in complex transactions means that attorneys must be more knowledgeable of accounting rules. Incorporating GAAP into commercial law creates more of an incentive for attorneys to stay abreast of this critical aspect of their client duties.

Looking forward, using GAAP to supplement commercial law could have even greater implications for commercial transactions. The FASB is currently undertaking a project along with the International Accounting Standards Board (IASB) to change accounting rules and require that all leases be characterized as capital leases.[122] This change is rooted in the belief that there is no way around the fact that leasing creates a long-term obligation that fits the definition of a liability.[123] As a result, the FASB is shifting towards viewing all lease agreements as financing arrangements. This shift of the FASB towards treating all leases as capital leases could provide a concrete justification for requiring all lease agreements to be accompanied by the filing of a financing statement. Though this topic is outside the scope of this Note, should commercial law take GAAP seriously, this Note would provide a basis for arguing for the elimination of the lease/security interest distinction under the U.C.C.

—Omar Ochoa

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122. *See generally* Fin. Accounting Standards Bd., *Leases: Preliminary Views* (Financial Accounting Series, Discussion Paper No. 1680-100, 2009) (presenting the FASB and IASB's view on the current accounting model for lessees and proposing possible fixes).

123. *See id.* ¶ 3.26 ("The boards tentatively decided to develop a new approach to accounting for leases that would result in the recognition of the assets and liabilities identified as arising in a lease contract.").