STATE OF KANSAS

Office of the Attorney General

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Curt T. Schneider
Attorney General

March 15, 1977

ATTORNEY GENERAL OPINION NO. 77- 95

Mr. George E. Grist
City Attorney of Maize
Suite 408 Bitting Building
107 North Market
Wichita, Kansas 67202

Re: Cities--Cash-Basis Law--Lease-Purchase Agreements

Synopsis: A contract providing for trade-in allowance, payment of interest, and payment of purchase price of leased property in 36 monthly installments is a lease-purchase agreement which is prohibited by the cash-basis law, K.S.A. 10-1113.

* * *

Dear Mr. Grist:

We have your letter of March 10, 1977, enclosing a copy of a lease agreement between the City of Maize, Kansas and a lessor of moving radar equipment. You inquire whether this provision violates the provisions of K.S.A. 10-1113.

The agreement provides for lease of described personal property for a period of 36 months and for payment of a fixed sum each of those 36 months "until paid in full." The agreement also recites the cash price, lease price, and interest on the item. The monthly payments total the amount of the "lease price." Clearly, the agreement is a lease-purchase agreement. Writing on the agreement indicates that the so-called "lease price" was computed by deducting the credit for a traded-in item of property from the sum of $2,385.00, and adding interest thereto in the sum of $416.85. The use of a "trade-in," together with payment of interest on the balance due under the agreement clearly reflects

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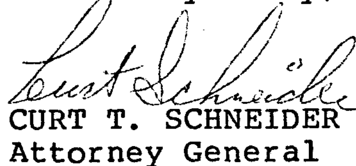
agreement, and not a bona fide lease or rental agreement. At the expiration of the agreement, the city has paid the full purchase price, and has full title to the property.

I enclose for your review a copy of Opinion No. 73-309 which discusses at some length the distinguishing features of a lease-purchase agreement. Although the lessee is authorized to cancel the agreement after making the first two payments by giving 30 days' notice and returning the property to the lessor, unless and until this privilege is exercised, the agreement continues in force as a lease-purchase agreement, and not a bona fide rental agreement. The privilege of cancelling the agreement does not change the contractual relationship itself, or the obligation which is created against the city. Thus, in my judgment, it is prohibited by K.S.A. 10-1113.

Yours very truly,



CURT T. SCHNEIDER
Attorney General

CTS:JRM:kj

Enclosure

OPINION 73-309, September 5, 1973, to Vernon D. Grassie, County Attorney, Girard

Re: SAME—*Leasing of Motor Vehicles and Road Equipment*

You inquire concerning certain contractual agreements between the Board of County Commissioners of Crawford County, and other parties involving the lease of motor vehicles and road equipment. The question common to each of these agreements is whether they establish the bona fide relationship of lessor-lessee, or whether the relationship is one vendor-vendee, *i. e.*, that of a conditional sale.

Under K. S. A. 10-1113, it is unlawful to create "an indebtedness in excess of the amount of funds actually on hand in the treasury . . . at the time for such purpose. . . ." It is within the power of the county, of course, to lease motor vehicles and equipment. When such a lease contains an option to purchase, it often becomes necessary to consider all the terms of the agreement to determine the precise legal relationship which has been created, whether it is indeed a lease with an option to purchase, or a conditional sales agreement. Generally speaking, the determination turns on the intent of the parties. As the court stated in *Brown v. Tri-State Ins. Co.*, 177 Kan. 7, 274 P. 2d 769 (1954),

> "It appears to be the general rule that whether a contract is one of conditional sale or a contract of a different character is a question of the intent of the parties as shown by the terms of the agreement. In arriving at the final conclusion, the whole of the contract is to be considered, and no detached term or condition is to be given prominence or effect over another. The question of intent is one of fact to be determined from the circumstances surrounding the transaction, the situation of the parties, their purpose, the thing they sought to accomplish and the method they employed." 177 Kan. at 10.

There are bona fide business reasons for leasing property. For example, it may be desired to use certain equipment on an experimental basis, to determine its utility or other merits before committing the county to a purchase. Fiscal conditions and considerations of economy may warrant a lease arrangement rather than purchases. Where an option to purchase is included, closer scrutiny is required. In *Breece Veneer & Panel Co. v. Comm'r of Internal Revenue*, 323 F. 2d 319 (7th Cir. 1956), the court described one test placed on an economic basis:

> "'A lease is substantially equivalent to a conditional sale when the buyer is bound to pay rent substantially equal to the value of the goods and has the option of becoming or is to become the owner of the goods after all the rent is paid. In such a contract "rent" means the purchase price and possession as "lessee" means the possession of a buyer under an executory contract of sale. That the buyer, in some cases, has the option of becoming the owner and thus a sale is not sure to take place. is of but small importance, for, as a practical matter, the buyer will always be willing to accept ownership, when he has paid the value."
>
> "In such cases it is clear that the form of the contract and the use of the words 'lease' and 'rent' are immaterial but the obvious distinction in each case is that the rent paid was substantially equal to the value of the goods and the buyer was bound to pay this amount."

Such a test was applied in *Pastorek v. Lanier Systems Co.*, 249 S. 2d 224 (La. Ct. App. 1971):

> "The distinction between a valid lease with an option to purchase and a disguised conditional sale is that in the former, there is an option to give additional consideration in order to purchase the leased item at the end of the contract term, while in the latter, there is an obligation to pay the full price regardless of whether the option is exercised or not. . . . The agreement here is a disguised conditional sale, since upon completion of the lease term, a payment of only $1.00 is required to exercise the option. The purpose was obviously to retain title until payment of the purchase price. Such a contract has been properly held to still constitute a sale." 249 S. 2d at 227.

Thus, an agreement that upon compliance with the terms of the lease, the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended for security. See, *e. g., In re Walter W. Willis, Inc.*, 313 F. Supp. 1274 (N. D. Ohio 1970).

At 68 Am. Jur. 2d, *Secured Transactions,* § 99, the writer states thus:

> "[G]enerally [under pre-Uniform Conditional Sales Act law] a true conditional sale was characterized as a sale in which the buyer or vendee received the possession and right of use of the goods sold. However, the title to the property was reserved in the seller or vendor until the performance of some condition . . . usually the full payment of the purchase price. . . .
>
> "Under the Uniform Conditional Sales Act, 'conditional sale' was defined to mean . . . any contract for the bailment or leasing of goods by which the bailee or lessee contracts to pay as compensation a sum substantially equivalent to the value of the goods, and by which it is agreed that the bailee or lessee is bound to become, or has the option of becoming, the owner of such goods upon full compliance with the terms of the contract."

In an opinion dated July 23, 1958, Attorney General John Anderson, Jr., stated thus:

> "As to whether such lease sets up a bona fide relationship between the lessee and the owner of the sweeper is a question of fact. We have heretofore suggested that the legal relationship arising out of such an instrument can be determined by such incidents: (1) does title remain in the lessor; (2) does the lessor continue to pay taxes on the equipment; (3) is there any indication that interest is being charged on the overall transactions; (4) is insurance carried by the lessor or the lessee; (5) is there a trade-in arrangement included in the terms of the instrument."

Under one agreement, dated August 10, 1972, the county, as "second party," leased a Polara Dodge automobile for a term of twenty-four months, for a total sum of $4,159.25, which incidentally equals the agreed upon purchase price of the automobile, and which sum the county "agree to pay . . . for said vehicle so long as it has money currently available that it is lawfully entitled to expend for said purpose." The agreement includes a provision whereby the county at any time during the term of the agreement shall

> "have the right, option and privilege of purchasing the said vehicle by paying the amount of said sale price; it being agreed and understood that upon the exercise by second party of such option that the second party shall pay to the said first party the amount of said sale price, less the amount of the rentals paid by second party hereunder and less any interest or carrying charges included in the sale price prorated to the date of the second party's exercise of its option; *and that upon the payment of said sale price, either by its exercise of such option or by making the payments as herein provided, said vehicle shall be and become the property of the second party.*" [Emphasis supplied.]

The county "assumes all responsibility and costs and expense for licensing and registration," agrees to carry such insurance as is required by law, and assumes responsibility for all service, materials and repairs during the term of the agreement.

Notwithstanding the underscored language above, whereby the county becomes owner of the car upon making the payments provided for in the lease, an additional paragraph provides, somewhat to the contrary, that

> "upon the expiration of this Agreement, should second party fail to exercise the said option hereinbefore set forth, that the vehicle above set forth shall be delivered over to said first party, and it is agreed and understood that the only remedy of the first party, as against the second party, for any reason, shall be to repossess said vehicle and cancel this Agreement."

The last paragraph again provides, however, that "by making all payments as herein provided, then said first party shall give to the second party a Bill of Sale transferring title to said property to said second party free and clear of any liens or other encumbrances."

This is the unmistakable language of a conditional sales agreement whereunder by making all payments due under the lease, the county has thereby acquired title to the automobile in question.

Under the second agreement which you include with your letter, the county leased for a period of eighteen months equipment identified as Austin Western, Model 200 SR, paying the sum of $1,467.79 per month. The lease recites that lease payments total $34,847.71, and that with a credit applied of $8,427.50, a cash balance remains of $26,420.21. It provides that title to the equipment shall remain in the lessor,

"until, if ever, the second party shall purchase and fully pay for it, under the terms of this agreement. Upon full payment therefor the first party shall transfer the ownership to the second party by bill of sale."

An option is provided the county thus:

"At any time while the second party is in possession of said equipment, according to the terms of this agreement, the second party shall have and is hereby granted the right to purchase said equipment by paying to the first party or its assigns all of the lease payments, herein provided for, which shall at any time remain unpaid, plus any amounts paid by the first party for taxes upon said equipment during the term of this lease. . . ."

Once again, upon payment of all sums due under the lease, the county becomes *ipso facto* owner of the property in question. Under the so-called "economic test," the lease becomes in fact a conditional sales agreement.

The "Rental Agreement and Option" entered into with Victor L. Phillips Co. for the lease of a Case Model W24B Loader appears to be a bona fide lease. The equipment was leased for a period of five months at $600.00 per month, the county having an option to purchase at the end of that period for the sum of $28,920.00. This agreement is clearly, in our view, a lease with an option to purchase, and not a conditional sales agreement or a so-called "lease-purchase" agreement.

JRM