

# MARKS & WEINBERG, P.C.

**“JUST BECAUSE YOU ARE PARANOID...”**

## **Preparing For The Continued Downturn**

Economic downturns present something of a “double whammy” for the leasing industry.

The first bad news is operational and entirely expected: Funding dries up, defaults mount and margins are squeezed in an effort to attract the remaining high-quality customers.

The second problem is more subtle but often more scary: New attempts to defraud the lessor are likely as customers become financially constrained and the truly crooked know that hard pressed salesmen will be even more eager to book a transaction. At the same time, deals that have been buzzing along with no apparent problem hit the proverbial wall and, on attempting to recover collateral many lessors find to their horror that the deal was fraudulent all along.

This article will discuss a few things that leasing companies and brokers should do to minimize the damage.

### **Avoiding Fraud**

There are ample resources around the internet and from the major leasing associations to avoid fraudulent transactions. The important thing is to take the time to educate sales and operational staff in how to spot the deals that are too good to be true and to recognize that, when things get bad even long-time customers and seemingly honest people can be induced to fake an invoice or otherwise engage in activity that is unethical, immoral and often downright illegal. Attention to detail in checking invoices and screening vendors is essential in times like these. References should be screened and any effort to take short cuts through standard procedures should be viewed with suspicion.

### **Existing Frauds**

The most common type of fraud occurs when the lessee and vendor defraud the lessor by arranging financing for non-existent, used or incorrectly described equipment. In many cases, the lessee has every intention of paying every penny of its “debt” and simply sees the arrangement as producing unsecured credit that the lessee cannot arrange from its banker.

The horror story occurs when, as is happening in today's economic environment, the lessee cannot make its payments and the lessor learns that it has been extending on an unsecured basis. This situation is becoming increasingly common as evidenced by the recent Wildwood and (H & L) frauds.

It would seem that there is not much that can be done and certainly, once a deal is in default it is too late to remedy the situation. Nevertheless, with regard to any type of fraud, there are actions that can be taken early on.

Our advice is to begin taking stock of your portfolio and consider an internal audit. Files that should be reviewed immediately include

- Those brought in by salespersons who have proven unreliable.
- Those with vendors who have given cause for concern.
- Those with unusual types of equipment or situations that should have raised a flag when the transaction closed.
- Customers who are currently experiencing difficulties and are slow paying or asking for concessions.

If, due to these or any other circumstances, there is reason to be concerned as to the bona-fides of the transaction, we recommend the following analysis:

- Pull a UCC search immediately and make sure you do not have double-financed equipment and had a good view of the customer's credit footprint when the deal closed (this will also give some indication as to whether the customer's debt has significantly increased since closing).
- Consider the type of equipment: If there is any possibility that the equipment could be deemed "inventory" this puts you at a significant additional exposure (see below).
- Consider making a spot check of the equipment or arranging for someone (a fellow association member, for example) to drop by the customer's place of business and make sure that the shop is open and your equipment identifiable.
- Ask for additional information about the customer under the "further assurances" clause of your lease: Current financial statements, bank statements, photographs or other information making you feel comfortable that the deal you have is the deal you intended.

## Specific Problems

Obviously, if the deal is fraudulent to begin with immediate action must be taken to recover as much cash as possible or to force the customer to pay off the loan or post other security.

Even where a transaction was legitimate when it closed, however there is a danger of the customer attempting to sell off the collateral.

Whether the lease is a "true lease" or a financing, sales of standard-type business equipment should be protected by, among the other things, UCC filings giving the prospective purchaser notice and, in the case of a financing, preserving the lender's interest. There is one notable exception to this rule, however: *Inventory*.

As we have warned for some time, in any situation in which the equipment is leased or financed for a customer who sales or rents similar equipment creates an inventory situation. It is easy to understand that a purchaser of inventory in the ordinary course of business is protected by the UCC and is immune to UCC filings or other action taken to protect the lender's interest. When you walk into Wal-Mart and purchase a toaster oven, you are not required to check the UCC to find out whether Wal-Mart floor planned its operation.

The situation is less obvious in the case of those who rent or lease equipment to others. Even if the customer is not in the routine business of selling equipment, any item that may be rented to a third party as part of the customer's business may be sold as inventory.

The bottom line to all this is that, if your review indicates that the equipment you leased might be deemed inventory your right to recover that equipment from a purchaser will be extremely weak. Customers who find themselves in dire financial circumstances may attempt a fire sale of equipment and the situation in which this equipment could be deemed inventory are not nearly as common or clear as expected.

Another problem that occurs post-closing is movement of the equipment. While most leases prohibit movement without at least notice, the practical efforts of a company closing its doors without have adequate records of where equipment is located can create an obvious headache.

Relations between the customer and vendor are another matter that may not become a problem until after a default has occurred. A surprising number of customers accept equipment and authorize payment to the vendor before properly inspecting the equipment. If problems arise later, there can be disputes between the parties and it is not unheard of for the lessor to find out long after closing that the vendor still has a claim for some additional equipment, unpaid services or other rights. Although most of these rights will be subordinate of the financing party, the need to rely on the vendor for remarketing or other assistance requires diligence if there is any possibility of a dispute.

Even worse, situations can become difficult where a progress payment or pre-funding arrangement or when multiple units are to be delivered over an extended period of time. The lessor should always be clear with the vendor as to where the obligation to pay lies and be in a position to recover its full cost after payment has been made if the lessee defaults.

### **What's In Your Wallet?**

These and other issues regarding portfolio performance are not just related to individual transactions. As portfolios (and their owners) mature, the prospect of a business sale or combination becomes more attractive. To often, it is not until due diligence is performed by a prospective purchaser or merger partner that the parties learn of defects in the portfolio causing a significant devaluation of its value.

Now, when money is tight and stress is building may seem a bad time to look for trouble and spend time and money addressing issues. For the successful lessor, however, it is absolutely the best time to do so.

Barry Marks and Kenneth P. Weinberg are founding partners of Marks & Weinberg, PC. They have significant experience in dealing with virtually every type of equipment and facility lease financing, have participated in leasing financings for more than a billion dollars of equipment and are recognized throughout the industry. If you would like more cases or articles on leasing, or have any questions or comments about this Article or other leasing issues, please visit [www.lease lawyer.com](http://www.lease lawyer.com) or contact Barry at 205-251-8303 or Ken at 205-251-8307.

