MARKS & WEINBERG, P.C.

PRE-FUNDING WOES

Clients have reported increasing pressure from vendors to pre-fund transactions. In some instances, this constitutes a requirement by the vendor that transactions be funded when equipment is shipped, rather than when it is accepted. In other cases, the vendor requires progress payments or payment upon acceptance of individual deliveries of equipment which are not themselves complete units.

Leasing companies take several routes to satisfy these vendor concerns. In some cases, an agency-type agreement is used, in which the Lessee agrees to accept partial deliveries as agent for the leasing company. The equipment is, therefore, technically under the lease and the Lessee begins making partial rent payments with the lease term commencing when the final delivery occurs (prior deliveries are considered part of interim rent).

Another type of transaction involves a Progress Payment Agreement. Under a PPA, the Lessor actually acts as a lender to the Lessee, advancing funds for the Lessee's benefit directly to the vendor. As the equipment described in a PPA is either not yet manufactured or, if manufactured and delivered, is not yet a complete functioning unit, the Lessor has a security interest in the equipment until such time as the final delivery occurs and the lease term begins.

A well drafted PPA will require the Lessee to pay principal and interest under what is more-or-less a line of credit secured by the equipment. If the Lessee does not accept the total delivery

under the lease, the "note" contained in the PPA becomes immediately due and payable. Also, the Lessee may be subject to a PPA default if it experiences a substantial change in its business or defaults on making PPA payments.

In some (too many) cases, the Lessor has neither of these protections and simply sends a check to the vendor without the benefit of having the Lessee commence the lease term by execution of the acceptance certificate. The better practice in this unattractive scenario is for the Lessee to sign an agreement acknowledging that, unless the equipment is accepted by the Lessee on a specified future date, the Lessee will pay to the Lessor the full amount of the Lessor's advance to the vendor, with interest.

In other words, if the Lessee refuses to accept the equipment for any reason (good or bad), the Lessee assumes the risk of the prefunding and will pay the Lessor all of its lost funds. One way of structuring such an agreement would be to require the Lessee to purchase the equipment from the Lessor if it does not execute the acceptance certificate. This puts the Lessee in the position of going back to the vendor for breach of warranty or other claims, which is precisely the legal position the Lessee should be in but for the Lessor's prefunding commitment.

Whatever version of prefunding arrangement is used, it is essential that a UCC financing statement be filed at the outset. Even if the underlying lease is a "true lease", the PPA or prefunding arrangement will probably be deemed straight debt. If the Lessee files for bankruptcy protection before the lease term commences, the Lessor will find itself in a very uncomfortable position is the UCC has not been filed. Remember that filing too early is not a problem. Filing too late is always a problem.

Another issue is identification. It is unlikely that, at the time the UCC is filed or even when the equipment is delivered, that partial units can be clearly identified. The best legal description possible should be used in the UCC and, if necessary, partial equipment deliveries should be labelled or segregated so that they can be easily identified should the worst occur.

Marks & Weinberg, PC is law firm with significant experience in dealing with virtually every type of equipment and facility lease financing. The lawyers of the firm 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.leaselawyer.com or contact Barry Marks at 205-251-8303 or Ken Weinberg at 205.251.8307.