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WHEN IS EQUIPMENT NOT “EQUIPMENT”? INVENTORY LEASING OR LEASING TO RENTAL COMPANIES

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It is not unusual for a finance lessor to discover that its Lessee intends to enter into a contract with a third party whereby the Lessee delivers possession of the leased equipment to that third party. Although many finance lessors may be aware of the practical risks associated with having its leased property/collateral in the hands of a third party, many are unaware of the increased legal risks which result from such a situation and this article addresses some of the key issues. For the sake of clarity, the third party receiving possession and control of the leased equipment will be referred to in this article as a “Sublessee” and the agreement between the Lessee and the Sublessee will be referred to as a “Sublease”. It should be noted that a contract of service pursuant to which the Sublessee receives possession also constitutes a “Sublease” for purposes of this article.

The key legal distinction between this type of transaction and the standard finance lease is that the leased property is treated under the Uniform Commercial Code (the “UCC”) as “Inventory” in the hands of Lessee. It would have been ordinarily considered “Equipment” were it not for the Sublease. This classification results from the fact that, under Section 9-102(a)(48) of the UCC as Revised in 2001, goods constitute “Inventory” if they “are leased by a person as lessor [or] held by a person for sale or lease or to be furnished under a contract of service [or] are furnished under a contract of service.”

As will be discussed in more detail below, the classification of the leased property as “Inventory” raises perfection issues and also allows a Lessee, in certain circumstances, to provide a Sublessee with greater rights with respect to the equipment than Lessor originally provided to the Lessee.

I. Special Perfection Rules for Purchase Money Security Interest in Inventory.

In most circumstances, Lessors file a UCC Financing Statement that describes the leased property as collateral and Lessee as debtor. This filing is made in case the underlying transaction is, or is at least is deemed by a court to be, a "lease-intended-as-security" or loan instead of a "true lease." Making this filing is a fairly simple process with which most Lessors are familiar and Lessor usually does not need to conduct UCC searches, obtain any subordinations from existing lien holders or otherwise worry about prior liens. The ease of this process results from the fact that Lessor can generally obtain a "purchase money security interest" (also called a "pmsi") in the leased property by filing a financing statement within twenty days of the date Lessee receives possession of the leased property.

Of course, there are some situations where it is not possible to obtain a pmsi in this manner and UCC searches and subordinations are therefore sometimes necessary. Consider, for example sale-leasebacks or other circumstances that may result in Lessee having possession of the leased property for more than twenty days before Lessor is ready to consummate the transaction and file a UCC financing statement.

It is very important to understand that the purchase money security interest rules in Article 9 of the UCC that apply when the leased goods constitute "Inventory" under Article 9 are much different than when the leased goods constitute "Equipment." Unlike, the rule which applies to pmsi's in Equipment and allows a lessor/secured party to file its UCC within twenty days of the date the debtor/lessee receives possession of the leased property, the rule that applies to pmsi's in Inventory imposes additional burdens on lessors/secured parties.¹

Basically, obtaining a pmsi in Inventory requires that: (a) Lessor file its UCC financing statement *before* Lessee receives possession (i.e. the twenty day grace period does not apply);

¹ See §9-324(a) (pmsi in Equipment) and §9-324(B) (pmsi in Inventory).



and (b) Lessor send notices which must be received by holders of conflicting security interests within five years *before* Lessee receives possession of the leased goods.² These conditions not only require Lessor to file its financing statement much earlier than normal, they also require Lessor to conduct a UCC Search to learn of conflicting security interests and to send official notices to all holders of such interests.

II. Additional Risks when leased goods are “Inventory”

The general common law rule is that one cannot convey a better title to goods than he had.³ However, three distinct provisions in the UCC reverse this common law rule and address the broad rights that a Lessee can grant to a Sublessee with respect to the leased property. Each of these provisions has the potential of cutting off rights that Lessor would have to recover the leased property from a Sublessee even if the respective Lessee defaulted under the Lease. In all cases, Lessor would still have all contractual rights against Lessee but would not necessarily have full rights in the leased property as collateral.

It should also be noted that all three of the provisions described below protect "*buyers* in ordinary course" although one provision *also* protects "*lessees* in ordinary course." To the extent a provision only protects a "buyer in ordinary course," it would only benefit a Sublessee if a court considers Sublessee to be a *buyer* of the leased property. As such, before delving into each of the UCC provisions that may affect Lessor's rights in the leased property, it is helpful to address the concepts of and "*buyers* in ordinary course" and the role of the classification of the leased equipment as "Inventory."

² See UCC. §9-324)(b) and Official Comment No. 4.

³ See Hawkland, Uniform Commercial Code Series, §2-403:1 (discussing the common law concepts of caveat emptor (buyer beware), nemo dat quod non habet (no one can give more than he has), voidable title, void title and related concepts).



A "buyer in ordinary course" is defined be someone "that buys goods in good faith, without knowledge that the sale violates the rights of another person in the goods, and in the ordinary course from a person . . . in the business of selling goods of that kind."⁴ It is a term limited almost exclusively to buyers out of Inventory.⁵

Another concept in the UCC is that of a "purchaser". One may think that buyers and purchasers are the same, but the world of the UCC is not always that simple. Under the UCC, the term "purchaser" is anyone who takes by purchase⁶ and the term "purchase" is defined to include "taking by sale, discount, negotiation, mortgage, pledge, lien, security interest, issue, gift or *any other voluntary transaction creating an interest in property*."⁷

The result is that the term "buyer" is generally held to include a much smaller group of purchasers.⁸ The official comments to UCC §2A-304 indicate, without detailed discussion, that a lessee from a merchant who deals in goods of that kind does not qualify as a buyer in ordinary course.⁹ As such, there is some possibility that a Sublessee who does not buy the leased property from a Lessee may not be able to successfully claim the benefits of some of the provisions outlined below. However, this issue is not currently addressed by the law in a clear manner and there is no guaranty as to how a given court would address this issue.

A. Buyer in Ordinary Course of Business Under Revised Article §9-320(A)

Revised Article 9 provides enhanced rights to certain parties who purchase inventory, stating: "a buyer in ordinary course of business. . . takes free of a security interest created by the buyer's

⁴ Article 1-201(9).

⁵ Barkley Clark, *The Law of Secured Transactions Under the Uniform Commercial Code*, Vol. 1, ¶3.04(1).

⁶ UCC §1-201(33).

⁷ UCC §1-201(32)

⁸ *See e.g.* Quinn's Uniform Commercial Code Commentary and Law Digest (2nd ed.), §1-201[A][3] (Noting that the definition of a buyer in ordinary course "applies not to any and all purchasers, but only to a person who "buys.")

⁹ Official Comment No. 3, UCC §2A-304



MARKS & WEINBERG, P.C.

seller, even if security interest is perfected and the buyer knows of its existence.¹⁰ This rule is used to invalidate a perfected security interest in a debtor's inventory when that inventory is sold in a manner that "comports with the usual or customary practices in the kind of business in which the seller is engaged or with the seller's own usual or customary practices."¹¹ The idea is that inventory lenders expect for their debtors to sell inventory to make profits and that this rule does not adversely impact the inventory lender since the lender's interest in the inventory is not cut off by Section 9-320 until the goods are actually sold by the debtor and since the lender's security interest will continue in identifiable proceeds generated by the sale.¹² The rule also encourages the marketability of goods and protects the interest of buyers who assume that they have clear title to goods they purchase from vendors in the business of selling goods of that kind.¹³

This section of the Uniform Commercial Code will only come into play if the lease between Lessor and Lessee is deemed to be a "disguised lease" or a "lease intended as security" under Section 1-201(37) instead of a true lease. In such a situation, the leased property would be owned by Lessee and Lessor would merely have a perfected security interest. Assuming that Lessee is in the business of selling goods of this sort, this provision of the UCC grants Lessee the right to transfer title to a Sublessee or other purchaser and invalidate any security interest held by Lessor in the leased property even if Lessor's security interest is properly perfected. It should be noted, that even if a Sublessee knows of the security interest, that Sublessee would still take free of such security interest unless it knew that the sale violated Lessor's rights.

¹⁰ Revised Article 9-320 (paralleling Former Article 9-307).

¹¹ Article 1-201(9).

¹² Of course Inventory lenders also often take a security interest in accounts generated by the sale of the Inventory rather than merely relying on the proceeds rules of Article 9 of the UCC.

¹³ Barkley Clark, *The Law of Secured Transactions Under the Uniform Commercial Code*, Vol. 1, ¶3.04(1).



B. Power to Transfer and Entrusting Under Section 2-403

Section 2-403(3) of the UCC contains a similar provision often called the "entrustment provision." This section states, in pertinent part: "any entrusting of possession of goods to a merchant who deals in goods of that kind gives him power to transfer all rights of the entruster to a buyer in ordinary course of business."¹⁴

For example, if an owner takes his watch to a jeweler for repairs and the jeweler is in the business of selling watches that are both new and used, a sale by the jeweler to a buyer in the ordinary course of business will cut off the owner's right to the watch. The owner would still have a cause of action for conversion against the jeweler who had the power but not the right to convey title to the buyer. Although there has been much criticism of this fairly radical shift from the common law, the concept of the entrustment provision has been supported by many commentators. The general idea is that, in most cases, the equities between the entrustor-owner and a buyer in the ordinary course are equal and that the balance is therefore tipped in favor of the later because doing so frees that marketplace and promotes commerce.

There are a few key elements that are necessary to establish an entrustment claim. First, there must be an actual "entrustment" of the goods by delivery of possession of those goods. Second, the party who receives the goods must be a merchant who deals in goods of that kind. Third, the merchant must make a sale of the goods to a buyer in ordinary course of business.¹⁵

With respect to the first element, the term entrusting is defined very broadly to include "any delivery and any acquiescence and retention of possession regardless of any condition expressed between the parties to the delivery or acquiescence and regardless of whether the procurement of the entrusting or the possessor's disposition of the goods had been such as to be larcenous under

¹⁴ UCC §2-403(2).

¹⁵ Prenger v. Baker, 542 N.W.2d 805(Iowa 1996)



MARKS & WEINBERG, P.C.

the criminal law.¹⁶ Given this broad definition, it is extremely likely that a Lessor's delivery of the leased property to a Lessee will constitute an entrustment.

Indeed, there is specific authority on point in the leasing context. For example, in *Carlson v. Rivera*, the court found there to be an "entrustment" when a company leased an automobile to a person who is in the business of selling automobiles, thereby allowing the lessee to convey full title to a purchaser of those automobiles.¹⁷ In *Sumner v. Fel-Air*¹⁸, the court noted that a lessee with an option to purchase an airplane had been sufficiently entrusted with the plane to convey good title to a third party purchaser given that the lessee was a merchant who regularly sold used planes.

Although there are a few cases in California with opposite holdings,¹⁹ those cases turn on non-uniform UCC language. The California legislature added language to the standard UCC definition of "entrustment" found in §2-403(3) so that delivery must have been provided to the merchant "for the purpose of sale, obtaining offers to purchase, locating a buyer, or the like."²⁰ As such, this article does not rely on those California cases as precedent.

With respect to the second element, the term merchant means "a person who deals in goods of the kind or otherwise by the person's occupation holds that person out as having knowledge or skill peculiar to the practices or goods involved in the transaction" ²¹ Whether a Lessee qualifies as a merchant is a question of fact.²²

¹⁶ UCC §2-403(3).

¹⁷ 382 So. 2d 825 (1980, Fla App D4).

¹⁸ 680 P. 2d 1109 (Alaska, 1984).

¹⁹ See e.g. Mercedes-Benz Credit Corporation, 110 Cal.App.4th 53 (2003) and Budget Rent-A-Car of Southern California v. Bergman, 121 Cal. App. 2d 256 (1981).

²⁰ 110 Cal. App.4th at 58.

²¹ UCC §2-104(1).

²² 542 N.W.2d at 808.



With respect to the third element, there must be a sale to a "buyer in ordinary course." This issue was addressed earlier in this article. The key points are that: (a) the UCC definition of "buyer in ordinary course" is much more narrow than the definition of "purchaser"; (b) protections afforded by the entrustment provisions only protect "buyers" in the ordinary course; and (c) there is some indication that certain sublessees may not qualify as buyers and, as such, to the extent Sublessee does not "buy" Equipment from Lessee, it may not be able to claim the benefits of this provision.

If the underlying transaction between Lessor is a "disguised security interest" or a "lease intended as security" instead of a "true lease," this entrustment provision provides the exact same protection to a Sublessee as does §9-320 addressed above. This overlap occurs since Lessor is the "secured party" and the "entruster" in such situations.²³ However, if the underlying transaction were a true lease, Sublessee would be unable to rely on §9-320 since Lessor would not have any security interest to be extinguished. In that event, Sublessee would rely much more heavily on this entrustment provision.

C. Rights of Buyers and Sublessee in Ordinary Course under Section 2A-305.

Section 2A-305 provides a similar mechanism to that found in 2-403 addressed above and states "a buyer in the ordinary course of business or a sublessee in the ordinary course of business from a lessee who is a merchant dealing in goods of that kind to whom the goods were entrusted by the lessor obtains, to the extent of the interest transferred, all of Lessor's and lessee's rights to the goods, and takes free of the existing lease contract."²⁴

²³ In other situations where the entruster is not the Secured Party, these two provisions address different issues. For example, consider a Secured Party with a security interest in all of Debtor's assets. If the Debtor "entrusts" certain assets to a merchant and that merchant sells the assets to a buyer in ordinary course, §2-403(2) would provide the buyer only with all of the entruster's rights (which were still subject to the Secured Party's security interest). Since §9-320 only voids security interest created by the *buyer's seller*, the Secured Party's security interest would not be voided by that provision either.

²⁴ UCC §2A-305(2).



MARKS & WEINBERG, P.C.

This section provides a Lessee who is a merchant dealing in goods of that kind with the ability to convey to Sublessee greater rights than Lessee has under the Lease. As stated by one well-respected commentator: "if an owner leases goods to a dealer and the dealer is in the business of dealing in such goods both new and used, a sale by the dealer to a buyer in the ordinary course of business will cut off the owner's rights, and a lease to a lessee in the ordinary course of business will cut off the owner's rights to the extent of the lease."²⁵

Again, there is substantial overlap between this provision and Section 2-403 addressed above. Although there is more than one difference between the two provisions,²⁶ the most important one for this article is that §2A-305 provides protections for "sublessees in ordinary course of business" and not merely "buyers in ordinary course." Although the term "sublessee in ordinary course of business" is not defined in the UCC, the term "lessee in ordinary course of business" means "a person who in good faith and without knowledge that the lease to him or her is in violation of the ownership rights or security interest or leasehold interest of a third party in the goods leases in ordinary course from a person in the business of selling or leasing goods of that kind" ²⁷

As noted earlier, §§9-320(a) and 2-403(2) only benefit and Sublessee who can establish itself to be a "*buyer* in ordinary course." However, §2A-305 also protects "lessees in ordinary course" to

²⁵ Hawkland, Uniform Commercial Code Series, §2A-305:02.

²⁶ However, the official comments note that "[t]here appears to be substantial overlap between Section 2-403(2) and Section 2A-305(2) with respect to a buyer in ordinary course of business [but that] an examination of [Article 2A's] definition of buyer in ordinary course of business makes clear that this reference was necessary to treat entrusting in the context of a lease." Indeed, the definition of buyer in ordinary course found in Article 2A differs from the standard definition of a buyer in ordinary course found in UCC §1-201(9) in that the buyer must not know "that the sale to him or her is in violation of the ownership rights or security interest *or leasehold interest* of a third party in the goods. . . ." UCC §2A-103(1)(a). This distinction does not really impact Lessor rights since it would be claiming either ownership or a security interest in the leased property.

²⁷ UCC §2A-103(1)(o)



the extent of their leasehold rights. To the extent a Sublessee were unable to establish itself as a "buyer in ordinary course" it may try to rely on rights as a "lessee in ordinary course."

III. Summary and Recommendations

Lessors that allow Lessees to sublease the leased property to a Sublessee or otherwise provide Sublessee with use and possession of the leased property under a contract of service should be aware of special issues stemming from the resultant classification of the leased property as "Inventory" under the UCC. First of all, special perfection rules apply and Lessor must be much more diligent in this regard by: (1) conducting a UCC Search; (2) notifying existing lien holders of Lessor's intent to obtain a purchase money security interest in inventory; and (3) finishing the work described in (1) and (2) and filing its financing statement before Lessee ever receives possession of the leased property.

In addition, Sublessees may be able to claim they received better rights from Lessee than Lessee was permitted to convey pursuant to the terms of the Lease. In such an event, Lessor may be unable to repossess leased property from a Sublessee even through the respective Lessee is in default.

Section 9-320 of the UCC applies only in the event the underlying transaction between Lessor and Lessee is deemed to be a "disguised security interest" rather than a true lease. As long as Sublessee is "buying" the leased property from Lessee, there is a decent possibility that it would take free of Lessor's security interest under this provision. Although there is some support that the term "buy" would only refer to situations where Lessee has been conveyed ownership of the asset by, for example, a bargain purchase option in the Sublease, broad language in the UCC definitions of "purchase" and "purchaser" and lack of much authority may make litigating this issue somewhat risky.



MARKS & WEINBERG, P.C.

A Sublessee may also try to invalidate Lessor's interest pursuant to the "entrustment theory" found in UCC §2-403(2) and (3) which grants a merchant the ability to convey to a buyer in ordinary course all of Lessee's rights in the leased property and all of Lessor's rights of the leased property. This provision can be used even if the underlying transaction between Lessor and Lessee is deemed to be a true lease instead of a "disguised security interest." Once again, this provision should only benefit a Sublessee if it is "buying" the leased property.

Section 2A-305 is a modified version of the entrustment theory which applies in the leasing context. It gives a Sublessee who cannot qualify as a "buyer in ordinary course" the chance of qualifying as a "lessee in ordinary course." If a Sublessee is successful in establishing itself as a lessee in ordinary course, its leasehold rights could trump Lessor's rights in the leased property.

Due to the complex and unsettled nature of this area of the law, we recommend that Lessors proceed cautiously when leasing Inventory to a Lessee. Lessors should also consider the following strategies to lessen their exposure if moving forward with such transactions:

A. The Lessor could require Lessee and Sublessee to execute a Security Sublease and Assignment of Sublease which: (1) operates as a pledge by Lessee to Lessor of Lessee's rights under the Sublease; and (2) contains an acknowledgement to be executed by Sublessee confirming that Sublessee's rights are subject and subordinate to Lessor's rights.

B. Since the UCC definitions of "buyer in ordinary course" and "lessee in ordinary course" require that Sublessee not know that its rights under the Sublease violate Lessor's ownership or security interest in the leased property, Lessor can take precautions to make sure Sublessees have notice of Lessor's rights in the leased property, including Lessor's ability to repossess and dispose of the leased property in the event of a default by Lessee. For example, Lessor could send a notice to the Sublessee and could place a legend on the leased equipment which clearly reflects Lessor's rights. Although this type of protection is not as strong as that outlined in A above, a Lessor would likely be treated fairly well by a court if Sublessee received a notice from



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Lessor prior to the time Sublessee executed the Sublease which advises Sublessee of Lessor's rights under the Lease and Lessor's interest in the leased property.

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