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DISPATCHES FROM THE TRENCHES

This issue of Dispatches from the Trenches discusses: (1) why you should file precautionary UCC Financing Statements even for true leases; (2) the "sensible person" test used to determine whether a lease with a fair market value purchase option is a true lease; (3) the requirement that a resale or release of equipment after a lessee default be commercially reasonable; (4) risk management fees assessed when a lessee fails to provide proof of insurance; and (5) the voluntary payment doctrine.

In re Triplex Marine Maintenance, Inc., 45 UCC Rep. Serv.2d 977 (Bankruptcy Ct., Texas, 2000)

Triplex Marine Maintenance ("Lessee") was in need of immediate cash and entered into two sale-lease back transactions in which it sold substantially all of its assets to CMC ("Lessor") and then immediately leased the property back from Lessor. The purchase option in the lease was for the greater of fair market value or 10% of the equipment cost. Lessor perfected its security interest in five vehicles in accordance with the applicable certificate of title law but did not file UCC Financing Statements with respect to the rest of the equipment subject to the lease.

Lessee filed for bankruptcy and Lessor sought relief from the automatic stay so it could repossess the property. The Trustee in bankruptcy objected with respect to all equipment other than the five vehicles, arguing that the lease was a financing arrangement instead of a true lease

and that Lessor, who merely held an unperfected security interest that was subordinated to the Trustee, had no interest that was entitled to adequate protection.

This case serves as a valuable reminder as to why precautionary UCC Financing Statements should be filed even when lessors reasonably believe the leases in question are true leases. The Trustee, who notably refrained from objecting to any relief from the stay with respect to the vehicles in which Lessor had perfected its security interest, would almost certainly not have raised any objection at all with respect to the remainder of the assets had Lessor properly perfected its interest.

In analyzing whether the lease was a true lease or a disguised security interest, the Court utilized the objective standard expressed in Section 1-201(37) of the Uniform Commercial Code (the õUCCö) to determine whether the parties anticipated that any significant value would remain in the leased property for return to Lessor at the end of the lease term. The Court first noted that it would consider a 10% purchase option to be nominal. It then undermined a long-standing belief by many in the equipment leasing industry that the inclusion of language that allowed for the purchase option to be the *greater of fair market value* and 10% alleviates the problem. The Court noted: "such a mechanical application of [the UCC definition of "security interest"] without recognition of the economic realities of the transaction belies the very standard that [the UCC] seeks to impose."

The Court applied what it referred to as a "sensible person" test. Under that test "if only a fool would fail to exercise the purchase option, the option is generally considered nominal and the transaction characterized as a disguised security agreement." In the case at bar, Lessee has leased substantially all of its business assets. The Court determined that Lesseeøs only meaningful option was to purchase the equipment. It only other options were to: (1) renew the lease (at substantial fees), (2) pack up and return all equipment and engage in a comprehensive program to locate and purchase replacements for its entire asset portfolio; or (3) return the equipment and cease its business activities entirely, since it would have no assets with which to operate its equipment. Since the only sensible choice was to purchase the equipment, the Court held the lease to be a disguised security interest.

Allco Enterprises, Inc. v. Goldstein Family Living Trust, 51 P.3d 1275 (Ct. of Appeals, Oregon, 2002)

When the lessee defaulted under two equipment leases, the lessor took possession of the equipment, had it sold at auction, and then brought an action against the lessee and its guarantor to recover the deficiencyô i.e. the difference between the total amount due under the leases less the net proceeds from the auction of the equipment. The lessee and its guarantor claimed that the sale of the equipment was not commercially reasonable and that the lessor therefore lost its rights with respect to any deficiency.

It should be noted that the requirement that any sale of leased assets upon a lessee default be commercially reasonable is part of Article 9 of the Uniform Commercial Code (the õUCCö). That article governs loansô sometimes referred to as õleases intended as securityö. True leases are governed by Article 2A of the UCC and are not subject to the same standard. In this particular case, the terms of the leases explicitly required any disposition to be commercially reasonable. Since it was already a contractual requirement, the Court did not need to address whether the lease was a true lease or a loan.

At trial, the lessee and its guarantor produced expert testimony from an auctioneer outlining several actions that caused the expert to opine that the sale was not commercially reasonable. The lessor did not produce any expert testimony but did cross-examine the lesseeøs expert. The Trial Court found the sale to be commercially reasonable and the lessee appealed.

The Appellate Court provides a nice description of the UCCøs general definition of a commercial reasonably disposition. However, the Court also noted that the issue of commercial reasonableness must be decided on a case-by-case basis. According to the Court, the testimony of the lesseeøs experts that the disposition of the equipment was commercially unreasonable õwas not so clear, convincing, plain and complete that by rational process an intelligent mind could not reject it.ö As such, the Court upheld the determination of the Trial Court that the sale was commercially reasonable.

This case provides a clear framework that allows the reader to understand the requirement and importance of a commercially reasonable disposition. Equally important, it serves as a warning

to all lessor counsel that they should try to avoid any language in leases that may contractually require a commercially reasonable sale or at least limit the language to leases that provide bargain or mandatory purchase options. Since the issue of commercial reasonableness is decided on a case-by-case basis and can lead to costly litigation, lessors should only have to address it in connection with loans. Even then, it is beneficial to place the additional burden on the lessee of convincing the court that the lease is, in fact, a loan covered by Article 9 of the UCC.

Chris Albritton Construction Company v. Pitney Bowes Inc., 2002 WL 2008200 (5th Cir., Mississippi, 2002)

The insurance provision in the lease required the lessee to maintain insurance naming the lessor as loss payee. It also required the lessee to provide evidence of insurance and stated õ[if Lessee] fail[s] to provide such evidence, [Lessor] will have the right, but no obligation to include the Equipment under [Lessorøs] own risk management program . . . and to charge [Lessee] a fee.ö

The lessee never provided the lessor with proof of insurance the lessor began adding an insurance fee on each invoice. It labeled the fee a õValueMAXö charge and made a small profit. The lessee sued the lessor for breach of contract, fraud and misrepresentation. The lessee argued that the lessor was required to *request* proof of insurance *prior* to billing the lessee for its failure to provide such proof and that the lessor hid the insurance fee by mislabeling it in order to boost its fees. The lessor did not dispute its obligation to request proof of insurance prior to charging a risk management fee but argued that it systematically mailed, and that the lessee had received one or more, computer generated letters requesting proof of insurance.

The Court quickly dismissed the fraud and misrepresentation claims. It stated that õ[a] breach of a promise of future action is not fraud unless it is ÷made with the present intent not to perform.øö In addition, the court did not feel that the term ValueMAX operated to conceal the nature of the charge, especially since the charge was not buried amongst a long list of other charges and there was a toll free number that the lessee could have used if it had any questions about the bill. In fact, the Court determined that none of the facts suggested by the lessee amount to any omission, affirmative concealment or misrepresentation of fact that would later turn out to be untrue.

The court also dismissed the breach of contract claim pursuant to the õvoluntary payment doctrine.ö According to the Court, õa voluntary payment is a payment made, without compulsion or fraud, and without any mistake of fact, of a demand which the payor does not owe, and which is not enforceable against him, instead of invoking the remedy or defense which the law affords against such demand.ö The lessee had no claim against the lessor and could not recover the payments already made since it paid the ValueMAX fees notwithstanding that: (1) it was aware the risk management fee and when it was owed (it had imputed knowledge of the terms of the lease); and (2) the ValueMAX fee was clearly delineated in the invoice with an explanation of the fee and a toll-free number for questions.

Kenneth P. Weinberg is a founding partner of Marks & Weinberg, PC. He and co-founder, Barry Marks, 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. Weinberg has written *Dispatches from the Trenches* since 2002, routinely writes articles in a variety of equipment leasing and financing journals, and has participated in numerous seminars on equipment leasing issues. If you would like more cases or articles on leasing, or have any questions or comments about this column or other leasing issues, please visit www.leaselawyer.com or contact Weinberg at 205-251-8307.

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