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DISPATCHES FROM THE TRENCHES

Taking Assignments of Leases: Precautionary Measures for Funders

By Kenneth P. Weinberg

A funder must take certain precautions whenever it takes assignments of leases that have been originated in another lessor's name (this party will be referred to as the "assignor" throughout this column). These precautions are necessary regardless of whether the funder is taking an outright assignment of the entire lease (including any residual) or taking an assignment of the rent stream only. This column summarizes some legal issues raised by such assignments, outlines some procedures that funders should follow in acquiring such leases and describes the benefits of complying with these procedures.

I. "CHATTEL PAPER" AND THE RELEVANT UCC RULES

Leases constitute "chattel paper" under the Uniform Commercial Code (the "UCC"). *See* §RA-9-102(11) (defining chattel paper as "a record or records which evidence both a monetary obligation and a security interest in . . . or a lease of specific goods. . ."). Depending on the facts and circumstances of each case and the documentation used by the funder and the assignor, all assignments fall into one of two categories: (1) the transaction can be viewed as an outright sale of the lease by the assignor to the funder; or (2) the transaction can be viewed as a loan from the funder to the assignor that is secured by the lease (often documented with a "promissory note" and a "security agreement and/or collateral assignment of lease"). This distinction is not important for purposes of this column since the intricacies of the chattel paper provisions in the UCC inevitably lead to identical treatment. *See* UCC §§RA-9-109 and comments (noting that Revised Article 9 covers *a security interest in chattel paper* as well as *the sale of chattel paper*);

see also UCC §9A-102(71)(D)(defining "Secured Party" to include a person to whom chattel paper has been sold).

A funder can perfect its security interest in the assigned lease or assure that it has sole ownership of the assigned lease (in the case of an outright sale) by either: (a) filing a UCC-1 financing statement that names the assignor as "debtor" and the funder as "secured party" (UCC §9A-9-312); or (b) taking "possession" of the chattel paper (UCC §9A-9-313).

However, the prudent funder that "chooses" between perfecting by filing and perfection by possession cannot forget about §9A-9-330(b) lurking in the UCC. That section states that:

A purchaser of chattel paper has priority over a security interest in the chattel paper . . . if the purchaser gives new value and takes possession of the chattel paper . . . in the ordinary course of the purchaser's business, and without knowledge that the purchase violates the rights of the secured party.

In other words, possession wins over filing as long as the possessor does not know that the rights of the other secured party have been violated.

II. THE BASIC CONCERN (AN EXAMPLE)

Consider for a moment the following hypothetical:

Bad Broker (who in this case is a crook but could just be just sloppy) approaches First Funder and offers to assign a lease. Bad Broker is designated as the lessor and Larry Lessee is designated as the lessee. Bad Broker agrees to execute an assignment agreement and the UCC's and other documents requested by First Funder.

Unbeknownst to First Funder, Bad Broker has Larry Lessee sign multiple copies of the lease in question and later assigns one copy to Problematic Purchaser for fair market value. First Funder and Problematic Purchaser are the last victims after months of this kind of chicanery by Bad Broker and, as soon as the funds are delivered, Bad Broker absconds.

How do the rules described above affect your answer to the following questions: (1) Does it make a difference whether or not the court views the "assignments" as a loan secured by the lease as collateral, or an outright sale of the lease? (2) Who will own the benefits of the lease

and who will receive payments from Lessee? (3) What would happen if First Funder's UCC filing were incorrect for one reason or another? (4) If First Funder's UCC filing is correct, does it automatically win over Problematic Purchaser's filing?

The answer(s) POSSESSION, POSSESSION, POSSESSION. As noted earlier, it makes no difference whether or not the lease is sold outright to First Funder or serves as collateral for a loan from First Funder to Bad Broker. Either way, possession is crucial. Even if First Funder's filing is proper, §9-330(b) makes it ineffective against Problematic Purchaser to the extent that *Problematic Purchaser* is in "possession" of the chattel paper and is not aware of First Funder's interest. On the other hand and irrespective of whether or not First Funder's UCC filing is proper, First Funder is the clear winner if First Funder is in "possession" of the chattel paper.

III. THE PROBLEM OF POSSESSION

"Possession" can be tricky. Indeed, the drafters of Revised Article 9 address two common practices that can make possession trickier. UCC §9-330, Comment 4. The first situation is when parties create more than one original counterpart of chattel paper. In the aforementioned example, Problematic Purchaser and First Funder are each holding identical versions of the lease (i.e. each bearing original ink signatures as of the same date). Often, matters are complicated even further when Larry Lessee itself is holding a third identical version. In such cases, the drafters of Revised Article 9 recommend solving the problem, as do many practitioners, by having the terms of the agreement designate only one identifiable counterpart as the original. For, example one of the originally executed leases can contain a legend that it is the "sole original counterpart" and others can designate that they are "duplicate original no. ___ of ___."

The second practice to which the drafters of Revised Article 9 referred relates to the use of a single master lease with multiple schedules. In order to assure that a funder possessing the sole original counterpart of a schedule has possession of that schedule even though the funder only has a copy of the master lease (as opposed to the original), the schedules should incorporate the terms of the master lease and not the other way around.

IV. ADDITIONAL PROTECTION

Additional protection is available by way of a Notice and Acknowledgement, executed by the assignor and the lessee. In this document, the *lessee* represents to the funder that the lessee has executed only one version of the lease marked "sole original counterpart" and promises to make payments directly to the funder. When Problematic Purchaser and First Funder both demand payment from Larry Lessee and First Funder waives the additional Notice and Acknowledgement in Larry Lessee' face stating "you promised us that there was only one sole original and that you would make payments directly to us", Larry Lessee is more likely to pay First Funder than Problematic Purchaser.

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