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DISPATCHES FROM THE TRENCHES

LEGAL AUDITS: AN OUNCE OF PREVENTION

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Equipment leasing lawyers are routinely lumped into two categories. *Litigation* lawyers, including bankruptcy counsel, clean up the mistakes made by *transactional* lawyers, including those who draft documents and those who close transactions.

The continuing growth of leasing litigation argues for the creation of a third category, or at least a willingness on the part of lawyers who generally litigate disputes or close transaction to add a service: legal auditing.

This article will address some of the benefits and potential pitfalls of legal audits.

Legal Audits: An Overview

Briefly, a legal audit consists of a review of the client's transaction closing files. The files may be selected at random, as is the case for most traditional accounting audits, or with specific emphasis on potential problem areas. One of the most successful types of audit requires senior management of the client to randomly select recently-closed transactions from each of several lease categories such as true leases, financing leases, TRAC's, or leases of specific types of equipment, such as vessels or aircraft.

Ideally, the auditor will have previously reviewed the client's basic documentation to gain familiarity with the client's routine procedures. This can avoid the situation where the file reveals actions that are entirely consistent with good practices in the leasing industry, but are not

supported by the client's documentation. For example, consider the situation where the lease states that late fees will be assessed only after a payment remains due and unpaid for five days, but the file indicates that the late fees were assessed from the first day. The client faces potential litigation exposure (and possibly a class action) that will only be discovered if the auditor is familiar with the client's lease documentation prior to the audit.

Most legal audits take one-half to one full day, depending on the number of files to be reviewed. In most cases, a review of 10-25 files will be sufficient to ferret out significant issues. Of course, the number of files depends on the transaction size (small ticket or middle market), the equipment types, and the volume of transactions.

It is also generally advisable to go back several years to identify problems that may not surface until the equipment comes off-lease or even later, but are still within the statute of limitations.

Following the legal audit, it is essential to prepare a written report for the client, but if possible, a half to full day training session immediately after the audit will permit the auditor to address specific issues found and field questions and explanations from staff.

Scope and Common Audit Issues

A good legal audit works primarily from the client's files and basic form documentation, but also works off of the lawyer's checklist of necessary documentation. The auditor should look for, among other things:

- * Completeness of the basic documents, with all forms contained in the file, executed by both parties, and ready to be presented in court if necessary.
- * Evidence of the lessee's corporate authority, such as secretary certificates and board resolutions, good standing/existence certificates, if any are required.
- * An executed acceptance certificate and, if utilized by the client, evidence of telephone confirmation.
- * All tables (casualty value, termination) properly prepared and attached.
- * Compliance with UCC filing requirements and other filing issues under applicable laws.
- * Completeness of insurance certificates and conformity of the insurance with the lease requirements (the amount of insurance to be discussed with the client if appropriate).

- * Original invoices and payment instructions.
- * Additional documentation, required for some transactions, such as guaranties (and evidence of the guarantor's authority) landlord's waiver, and documentation providing special lessee option, such as renewal and early termination options.

Likely problems will occur not merely with the paperwork itself but the staff's understanding of its use. For example, it is not uncommon to find a properly filed insurance certificate which does not provide that the insurance company will notify the lessor in the event of cancellation, or even that the lessor is not actually covered as an additional insured or loss payee. The distinctions between merely obtaining certification that the lessee has insurance and obtaining the sort of insurance required by most lease documentation and best industry practices need to be explained to staff who will be the people in contact with the lessee and its insurance agent from time to time. Additional documentation can be provided to assist the staff in this regard and to provide more consistent results with respect to insurance.

Common Uniform Commercial Code issues include filing in the wrong place (very common under Revised Article 9), improperly naming the lessee or describing the equipment, failing to file UCC financing statements within the period permitted for purchase money security interests, and failing to check for competing liens where a sale/leaseback transaction is closed.

Landlord waivers present special problems as they are often obtained post-closing, if at all. Again, rather than merely noting the presence or absence of this documentation, the auditor should discuss the importance of landlord waivers as part of the follow-up training session. A better understanding of landlord waivers, such as whether or not they are necessary, does more than assist in the closing. It is not uncommon for the auditor to find that a lessee itself has signed the landlord's waiver form, rendering it useless.

Special Deals, Special Audits

Various special transaction types create additional requirements. For example, in municipal transactions, an essential use letter, opinion of counsel, certificate of appropriation, and other additional documentation are often required though commonly ignored.

For assigned/broker transactions, a spate of additional documentation must be reviewed, including

- * The originator/funder agreement
- * Properly executed assignment documentation complying with the funder's policies
- * Proper UCC filings, including lender-lessor filings, if appropriate, and an assignment of any UCC filed by the original lessor
- * The presence of the sole original counterpart of the lease
- * Evidence of the originator's authority to enter into the transaction and, if desired, a UCC search against the originator
- * The lessee's acknowledgement of the transaction (unless it is a blind assignment)

Progress payment situations add additional complexities as these documents must be reviewed and are often misunderstood by the very people who draft and use them.

Finally, documentation for specific types of equipment must be carefully reviewed. Motor vehicle titles and MSOs, FAA recordings for aircraft, Coast Guard filings for maritime transactions and other special documentation may be necessary; and it is the owner's responsibility to locate this paperwork.

Potential Audit Problems

While legal audits would certainly seem to make sense, and the authors have had good experiences for the most part, auditors and clients should bear in mind that problems can arise.

First, the prospect of an audit can be demoralizing to operations staff. Management must assure staff that the auditor is not there simply to find problems and that punitive action will not necessarily follow. If possible, the entire audit process should be couched in terms of a training session and effort to promote best practices within the company.

It is not uncommon for staff to interfere with the audit by attempting to sway the auditor or explain away problems before they are fully examined.

Selection of the auditor is another issue. In most instances, counsel who routinely works for the leasing company is fully qualified to act as an auditor and is already familiar with the company's documents and procedures. In some instances, however, it makes sense for a new lawyer to lend his or her eyes to the audit. Clients should be reminded, however, that any lawyer can find fault

with another's documentation or approved procedures, and it is the responsibility of the auditor to justify any proposed changes both in terms of necessity and cost-effectiveness.

Cost is the final issue. At normal hourly rates, the one to three days necessary for a proper audit and training session may be cost-prohibitive. Qualified counsel should be approached with the prospect for additional transactional or litigation work or, if already representing the client, continue good relations as a means of negotiating a reasonable flat fee for the entire session.

We can all understand why clients balk at the cost, in dollars and time, of a legal audit. Committing resources to "overhead" rather than income-producing deals is never easy. Experience shows, however, that an ounce of legal prevention, planning and risk management is worth a ton of legal fees, lost revenues and even payments to class action plaintiffs.

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