

DISPATCHES FROM THE TRENCHES

From Limited Liability Clauses to Forum Selection

By Kenneth P. Weinberg

This issue of Dispatches from the Trenches discusses: (1) the dangers associated with having lessees execute acceptance certificates prior to delivery of the equipment; (2) reasons why broker-funder agreements may need limited liability clauses; and (3) forum selection clauses.

Jaz, Inc. v. B. Foley et. al., 2004 WL 194081 (Hawaii Ct. of App.)

This case provides a nice example of why Lessors should be careful to have Acceptance Certificates signed after the equipment is delivered. The Lessee acquired some photo processing equipment from Environmental First (öVendorö) pursuant to an equipment lease with Hawaiian Leasing, Inc. (öLessorö). Prior to delivery of the equipment, Lessee executed all relevant lease documents, including an Acceptance Certificate that was signed but not dated. Within the next couple of days, Lessor issued a Purchase Order to Vendor and wired the money. At that point, Lessor dated the Certificate of Acceptance. Lo and behold, the equipment was never delivered. Lessee made some lease payments to Lessor before bringing suit against both Lessor and Vendor. Default judgments were entered against Vendor and the majority of the opinion related to the respective rights of Lessee and Lessor.

The court made no analysis as to whether the öLeaseö was a true lease governed by Article 2A of the Uniform Commercial Code or a lease intended as security but used Article 2A in the

analysis. It noted that Article 2A provides default rules for what constitutes acceptance and when a Lessee owes payment under the statutory Hell and High Water Provisions in Article 2A but also noted that the parties are generally free to agree to any terms they wish by contract. As such, the court looked first to the terms of the Lease.

Of course, Lessor referred to: (1) the Acceptance Certificate which states that "all of the equipment has been delivered and installed and the Lessee has accepted the equipment for purposes of commencing Lessee's payment rental obligations under the Lease"; (2) applicable provisions in the Master Lease which stated that "upon completion of its inspection of the equipment, the Lessee shall promptly deliver to the Lessor an executed Acceptance Certificate . . . or reject the equipment . . . "; and (3) the applicable provisions in the Master Lease which required Lessee to make payments under the lease notwithstanding any malfunction, loss or damage to the equipment."

The court analyzed whether or not a signed Acceptance Certificate is sufficient to show acceptance of the goods before delivery, quoting opinions from: (A) Texas-- *Stuart v. United States Leasing Corp.*, 702 S.W. 2d 288 (Tex. App. 1985) (Signed Acceptance Certificate was adequate); (B) Utah-- *Colonial Pacific Leasing Corp. v. J.W.C.J.R.*, 977 P. 2d 541 (Utah Ct. App. 1999) (Accepted Certificate not sufficient); (C) Tennessee-- *Moses v. Newman*, 658 S. W. 2d 119 (10 Ct. App. 1983) (Acceptance Certificate not sufficient); and (D) Ohio-- *Information Leasing Corp. v. GDR Investments, Inc.*, 152 App. 3d 260 (2003) (Acceptance Certificate not sufficient). The general reasoning for the cases which invalidated the Acceptance Certificate was that "[t]he Lessee must have a reasonable time for inspection, which requires that Lessee have actual possession of the goods."

Using this case law and the general wording of the Acceptance Certificate and the Master Lease, the court held that the express agreement of the parties as described in the lease documents did not provide that for an Acceptance Certificate executed prior to delivery to be sufficient to result in acceptance of the equipment. The court noted that the language of the Acceptance Certificate provided that it was *only effective* to commence rental payments and obligations but was not intended to be an actual acceptance of the equipment. On the other hand, the Master Lease provided for the Acceptance Certificate to show actual acceptance but required, by its terms, that Lessee first inspect the equipment which inspection, according to the court, requires possession. The default rules under Article 2A similarly required possession since Section 2A-515 provides that "acceptance of good occurs after Lessee had a reasonable opportunity to inspect the goods."

Having lost on its argument that the equipment had been accepted, Lessor also argued, without success, that Lessee impliedly accepted the equipment. Lessor's first argument was that, since it was required to pay for the equipment prior to delivery, Lessee impliedly accepted the equipment in advance of delivery. Unfortunately for Lessor, the Purchase Order provided that all the equipment would be subject to inspection by the Purchaser (i.e. Lessor) or Lessee and the court therefore held that Lessor gave Lessee the right of inspection even though prepayment was required.

Lessor next argued that the "hell and high water" and "event of loss" sections of the Master Lease shifted all risk of loss to Lessee. However, the court interpreted those clauses as shifting the risk of loss to Lessee only after the risk passed from Vendor. According to Section 2A-219 of the UCC, the risk of loss did not pass from the Vendor until the equipment is delivered. As such, there was no implied acceptance.

The key lesson is that the courts may not honor acceptance certificates executed prior to delivery of the equipment. As an additional note, lessors should use other methods to protect themselves to the extent they are willing to prefund with respect to vendors who require prepayments. For example, lessors can use progress payment agreements or, at the very least, the lessee should explicitly accept all risks relating to the vendor refusal or inability to deliver the goods or otherwise perform its obligations.

Bank of America v. C.D. Smith Motor Company, Inc., 106 S.W.3d 425 (Ark. Sup. Ct. 2003)

This case may be of particular interest to leasing companies involved in broker-funder relationships. In this case, C.D. Smith Motor Co., Inc. ("Originator") was a used-car dealer who established a recourse-financing relationship with Bank of America and its predecessor banks ("Funder"). Originator sold approximately seventy percent of its cars through financing and assigned approximately thirty-five percent of that loan paper, with recourse, to Funder. Under this arrangement, Originator was required to repurchase any loans that were more than ninety days past due.

Over the years, Originator and Funder developed various procedures that governed their relationship. One such procedure was that Funder would attempt to collect on accounts that were less than sixty days delinquent. Funder would also: (1) provide a list to Originator of any such accounts so that Originator could assist in collection and could ready itself for any required

repurchase; and (2) provide Originator with a list of any bankruptcy filings by the delinquent debtors so that Originator could file a proof of claim with the bankruptcy court.

Funder notified Originator that it would no longer purchase any accounts from Originator and that it would not longer provide any of the lists mentioned above. Originator was unable to obtain financing from other lenders and eventually went out of business. Originator then sued Funder for breach of contract and the trial court granted it over one million dollars for consequential damages stemming from the breach. It should be noted that nothing in the court's decision indicates whether the underlying agreements required Funder to finance certain of Originator's loans or whether such decisions were discretionary to Funder. If there had been explicit language in the underlying agreement which provided that nothing therein constituted a commitment by Funder to lend any money to, or accept any assignments from, Originator, such language would likely have been very helpful in limiting the type of breach that Originator could claim.

Funder appealed to the Arkansas Supreme Court, arguing three main points: (1) that evidence of the parties previous course of dealing should not have been admitted; (2) that Funder did not agree to be liable for consequential damages caused by a breach; and (3) that Originator did not prove any damages stemmed from the breach.

The Court first held that the evidence that Funder used to provide certain assistance with collection and certain lists to Originator was admissible under sections 1-205 and 2-202 of the Uniform Commercial Code since it constituted a "sequence of conduct" which could "fairly . . . be regarded as establishing a common basis of understanding." It is noteworthy that the Court allowed admission of this evidence notwithstanding a standard merger clause that stated that the written agreement contained all of the terms and that no other statement or agreement shall have any force or effect.

Then, the Court addressed Funder's argument with respect to consequential damages, defining them as "those damages that do not flow directly and immediately from the breach, but only from some of the consequences or results of the breach." In this case, Originator was awarded over one million dollars for lost profits and the loss of its business. The Court articulated a two-prong test that the Originator satisfied in order to recover such damages. First, the Originator produced evidence that Funder had actual knowledge that Originator "would look to [Funder] for compensation if [its] business was destroyed." Next, Originator produced evidence that Funder

tacitly agreed to pay consequential damages by signing the agreement *after* Funder conveyed the foregoing point.

Once again, Funder tried to escape liability by pointing to the merger clause. However, the Court noted that merger clauses only prevent extraneous evidence that alters, varies or contradicts the written contract. In this case, the recourse financing agreement was silent on the issue of consequential damages and the oral evidence with therefore admissible. *Funders should consider adding a limitation of liability clause to their broker agreements whereby the parties to the agreements explicitly waive consequential damages.*

Lastly, the Court reject Funder's third argument, that Originator failed to prove any damages resulted from the default, and held that Originator introduced sufficient evidence indicating that the Originator's profits declined drastically after Funder's breach.

DeLage Landen Financial Services, Inc. v. DeSoto Diagnostic Imaging, LLC, 2002 US. Dist. LEXIS 24744 (E.D. Pa. 2002)

This is another case highlighting the manner in which forum selection should work. The plaintiff, DeLage Landen Financial Services (öDLLö) sued DeSoto Diagnostic, Inc. (öDeSotoö) for breach of a lease agreement in Pennsylvania and Desoto sought to change venue from the U.S. District Court for the Eastern District of Pennsylvania to the U.S. District Court for the Northern District of Mississippi. DeSoto argued that venue should be changed because the equipment DeSoto leased from DLL was located in Mississippi at the time of the breach. Further, most of DeSoto's witnesses and evidence were in Mississippi.

DLL countered that its witnesses and evidence were in Pennsylvania. Most importantly, the lease contract contained a forum selection clause pursuant to which DeSoto consented to personal and subject matter jurisdiction in the U.S. District Court for the Eastern District of Pennsylvania. Further, a choice of law provision in the contract stated that Pennsylvania law would govern disputes arising from the contract. DeSoto countered by claiming that the lease agreement was an adhesion contract (since DLL used form documents and would not negotiate them) and that the forum selection provision was therefore unenforceable.

The district court noted that "a forum selection clause is treated as a manifestation of the parties' preferences as to a convenient forum [and] should be enforced unless enforcement is shown by

the resisting party to be unreasonable under the circumstances. It further rejected DeSoto's claim regarding the lease as an adhesion contract and held that, even if the lease were an adhesion contract, DeSoto would have to show that the forum selection provision in particular was the product of fraud or coercion. DeSoto did not show any sort of fraud or unbalanced bargaining power with DLL. In particular, the court noted that "[d]efendants have not alleged that they were unsophisticated lessees or that they were coerced into signing the agreements because they had less power than did [DLL]."

Other points noted by the court were the fact that: (1) each side had witnesses in its home state, and the Mississippi witnesses could testify via videotaped depositions; (2) the equipment, while located in Mississippi at the time of the breach, was in Tennessee and California during the litigation; and (3) due to the choice of law provision, Pennsylvania was the more appropriate location because federal courts in Pennsylvania were in a better position to interpret Pennsylvania law than Mississippi federal courts. DeSoto's change of venue motion was denied.

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