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DISPATCHES FROM THE TRENCHES

Unsafe at Any Speed: Dangerous Practices in Small-Ticket Leasing

By Kenneth P. Weinberg

No one denies that business is moving at faster speeds than ever before. Even the fax machine has given way to e-mails and turnaround/approval times have been cut in half and then halved again in just the past couple of years.

At the same time, competition has heated up and lessors are under increasing pressure to do more deals and do them faster in order to maintain their bottom lines. Lessors now employ streamlined policies and practices to get the work in and out.

Many practices common to small-ticket leasing, however, prove disastrous when tested in court. The fact that "everybody does it" is small comfort when the gavel is dropped. This article will examine some potentially dangerous, though common practices.

Advance Execution of Certificates of Acceptance

Most equipment lease forms require the lessee to execute a separate certificate of acceptance to indicate that (1) the equipment has been delivered, (2) the lessee has inspected the equipment and found it to be the correct make, model and description and in good working order and (3) the equipment is accepted for all purposes under the lease and the lessor is authorized to make payment to the vendor and begin collecting rent. Unfortunately, this practice usually involves a

two-step process with the lessee executing the lease on one day and the acceptance certificate days or weeks later.

To save time, some lessors have taken to having the acceptance certificate executed at the same time as the lease. In fact, some leasing company forms include the acceptance certificate on the face of the lease, saving the õextra piece of paper.ö

The dangers of this practice are indicated in cases such as JAZ, Inc. vs. Foley, 104 Hawaii 148, 85 P.3d 1099 (2004); Colonial Pacific Leasing Corp. vs. JWCJR Corp., 199 P.2d 541(Utah App. 1999); and Tri-Continental Leasing Corp. vs. Law Office of Richard W. Burns, 710 S.W.2d 604 (Tex. App. 1985).

The JAZ case is particularly instructive. In it, the court refused to enforce an acceptance certificate executed prior to the delivery of the equipment because, among other things, the terms of the lease stated that the acceptance certificate was "for the sole purpose of commencing the lessee's rental payment and other obligations to the lessor under [the] lease.ö That language in the lease and other language in the certificate led the court to the conclusion that "JAZ did not make an acceptance for all purposes of the Master Lease" (at JAZ vs. Foley at 153 and 1104).

The second, and more universal, basis for the court's holding was UCC §2A-515, which states that acceptance occurs for UCC purposes only after: (1) "the lessee has had a reasonable opportunity to inspect the goods" and (2) the lessee either (a) signifies or acts in a manner that signifies that the goods are accepted or (b) fails to make an effective rejection. Obviously, noted the court, where an acceptance certificate is executed in advance of delivery, there has been no "reasonable opportunity" to inspect.

Against this line of reasoning, lessors have argued, often successfully in the past, that a number of legal theories apply. Some cases have variously turned on whether the lessee's act in executing an acceptance certificate before delivery constitutes a waiver of its right to inspect and is subject to the parol evidence rule that a written contract may not be varied by oral testimony except in a case of patent ambiguity. (See e.g., CIT Group/Sales Financing, Inc. vs. Lark, 906 S.W.2nd 865 [Mo. App. 1995].) Other cases have held simply that the terms of the contract should be strictly enforced, rendering execution of the acceptance certificate dispositive. (See e.g., Moreland Auto Stop vs. TSC Leasing, 216 Ga. App. 438, 454 S.E.2d 626 [1995].) Where lessees have argued failure of consideration, courts have rightly pointed out that, in a three-party ("finance lease")

transaction, that the consideration is not delivery of the equipment but funding by the lessor. (See e.g., Stewart vs. United States Leasing, 702 S.W.2d 288 [Tex. App. 1985].)

It should be noted that there are circumstances under which the traditional acceptance certificate will not work. Pre-funding transactions are increasingly common. Some lessees will be willing to waive their rights to inspect equipment in order to avoid having the sign a second time. As the JAZ case and others indicate, however, every effort should be made to be specific in the language of the document if either of these is the case. Pre-funding transactions should be carefully drafted so that it is clear that the lessee assumes the risk of non-conforming, defective or undelivered equipment. An acceptance certificate to be signed in advance of delivery should specifically state that the lessee waives its right to inspect and acknowledges that the lessor will rely on the certificate in advancing funds to the vendor.

As a general rule, an acceptance certificate signed in advance may be like the proverbial oral contract in the hands of some judges: not worth the paper itøs written on.

Leases to Individuals

It is not uncommon in small-ticket leasing to lease to a sole proprietor (an individual doing business under a trade name). Sometimes, for a variety of personal and (often incorrectly perceived) tax-related reasons, business owners want to lease equipment in their own names. This is also a tempting alternative to the use of a guaranty.

Where the lessee is an individual who operates as a sole proprietor with a bona fide business, leasing requires extra care and attention to detail. Where the lessee is an individual acting in his or her own name with no specific business, the practice of leasing to him or her is probably bad business.

A financing statement is not effective to offer the lender/lessor protection if it does not properly identify the debtor by name. While the name to be used for corporations, limited liability companies and even partnerships is clear, the name to be used for sole proprietors is subject to some debate. Section 9-503 indicates that the individual's name must be used and a trade name alone is not sufficient.

Given indexing practices and other revised Article 9 language, we recommend that any financing statement for an individual list the individual and include "d/b/a ____________" only after the

individual's name is listed. In fact, it is safer to file twice, one in the individual's name alone without the trade name (although this may be overkill). The trade name alone, or with the individual's name after it ("____________, a trade name for ________") should never be used.

Until we have case law on this issue, however, there is room for some judicial interpretation and a modest risk of a bad ruling, particularly in the event of an error at the filing office, such as indexing under the trade name or debtor's first name.

Another risk stems from the fact that the UCC provisions under Revised Article 9, which govern where a secured party must file, are often based on the "location of the debtor." If the debtor is an organized entity, it is "located" in the state in which it is created. For example, a Delaware limited liability company is "located" in Delaware and most filings against such a debtor must therefore be made in Delaware. It is easy to order a "certificate of existence" or obtain other proof on-line of where a registered entity was created. This rule is therefore very clear and the risk of filing in the wrong place is lessened.

However, individual debtors are "located" at their "principle residence." This rule is less clear, especially for wealthier individuals.

A third risk relates to the fact that the debtor may change location. If the debtor changes its location to that of a different state, a secured party must file a new financing statement in the new location within four months or it will lose its priority status against other creditors of the debtor or certain purchasers of the collateral.

An organized entity cannot "change its location" from one state to another. For example, if your borrower were a Delaware corporation, it cannot "move" to Alabama. It could create an Alabama corporation with the same (or different) name and transfer the assets to that Alabama entity. However, this is not viewed as a "movement" under Revised Article 9 and the above quoted four-month rule does not apply. On the other hand, individuals can change their principal residence and no filings are required in any public record to reflect any such movement.

If an original debtor transfers the collateral to a new debtor that is "located" in another state, a secured party must file a new financing statement against the new debtor in the state where the new debtor is located within one year or it will lose its priority status against other creditors of the new debtor or certain purchasers of the collateral.

Both individuals and registered entities can transfer collateral. As mentioned earlier, a merger type event is viewed as a transfer of collateral. For example, if your borrower were a Delaware corporation and decided it wanted to be an Alabama corporation, it would merely create the Alabama corporation (the new debtor) and merge into or otherwise transfer the collateral to the new debtor. In many cases, this sort of occurrence requires that the original debtor file some paper work in Delaware (such as "articles of merger") and, if the lessor searches the records annually for its riskier customers, it may receive notice of the transfer in time to make the new filings.

If an individual debtor decides to "incorporate," this will also result in the individual being viewed as "transferring" certain of its assets to the newly incorporated entity. Unlike with merger situations, the lessor would not be able to discover the incorporation since no filings are made against the "original debtor" (the individual) in this case and the new entity could be incorporated in any state and under any name, thereby making searching practically impossible.

More importantly, individuals are, as a practical matter: (1) much more likely to incorporate as their business increases than they are to sell assets to another company and (2) much less likely to realize that incorporating without the lessor's prior written consent is a violation of the agreement.

It is common knowledge that, state and federal law protects consumers in many ways. Unfortunately, several state attorneys general have indicated that they will blur the line between consumer and commercial transactions and try to enforce consumer protection laws against lenders and lessors to small businesses. There have been instances where agencies of the federal government have shown some confusion as to where this line should be drawn and we fear that judges will stretch to find an excuse to grant consumer protection to business borrowers and lessees.

Although a well-drafted lease form makes it clear that the lease is a commercial and not a consumer lease, it is prudent to have any individual lessee sign a side letter acknowledging that the equipment may not be used for consumer purposes.

All documents used for leasing to individuals should also be checked to make sure that the lessee's death is an immediate event of default. This may be a problem for the lessee but the

lessor does not want to have to deal with a probate court, family issues and other potential entanglements. The lessee's incapacity (mental or physical) should also be an event of default.

All the practices described in this article are risky but, for the most part, they can be addressed through careful drafting by qualified counsel. The question is: If the lessor is trying to cut a corner and trying to move quickly, does it make sense to add a lawyer and his or her fees into the process?

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