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DISPATCHES FROM THE TRENCHES

A Lessor's Legal Smorgashbord—

Five Issues to Chew On

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This issue of Dispatches from the Trenches discusses: (1) the effect of a standard UCC waiver with respect to the statute of limitations provided by Article 2A; (2) a lessor consent to an assignment by subsequently accepting payments from an assignee; (3) true lease analysis; (4) sales tax implications of mixed goods and services transactions; and (5) a hell or high water structure surviving an attack from software laws and business models surrounding beta test sites and evaluation licenses.

ESP Financial Services, LLP vs. Vielot, 794 N.Y.S.2d 337 (May 3, 2005)

This case addresses whether a waiver of UCC rights prohibits a party from claiming the statute of limitations as a defense.

ESP Financial Services (öLessorö) filed suit against Erick Vielot (öLesseeö) in September 2003, for breach of a leasing agreement. AT&T Capital Leasing Services leased auto emissions testing equipment to Lessee in November 1997. Several months later, AT&T assigned its rights in the lease to Lessor. In September 1999, Lessee defaulted on the lease and Lessor repossessed the equipment in February 2000. However, Lessor did not file suit until September 2003. Lessee

moved to dismiss the complaint on the grounds that it was filed beyond the four-year statute of limitations period under UCC 2A-506. In response, Lessor argued that the lease agreement included a waiver clause, in which Lessee waived "all rights and remedies conferred upon a lessee by Article 2A." Lessor, therefore, claimed that the action should be examined under Massachusetts's non-UCC six-year statute of limitations period.

The Court dismissed Lessor's claim, holding that the contract did not exclude all aspects of Article 2A. Rather, it was only a waiver of "rights and remedies." The statute of limitations alone is neither a right nor a remedy, since it does not confer a clear benefit on any one party. As a result, the Court held that a four-year statute of limitations period was not included under this waiver. The Court held that the lease agreement did not constitute a waiver and the plaintiff's claim was dismissed as untimely.

Telerent Leasing Corp. vs. Morgan Inn, LLC, No. 565197, 2005 WL 429253 Conn. Super. (Jan. 24, 2005).

This case involves a lessor/licensor who arguably consented to its lessee's/licensee's assignment of its rights under an agreement by accepting payments from the assignee. It should be noted, however, that the court was a little "question of fact happy" as it found many issues to be worthy of additional analysis.

Telerent entered into a leasing and licensing agreement for television satellite equipment and television programming services with Morgan Inn for a period of 60 months. Morgan Inn was to pay \$312.70 per month under the lease agreement and \$300 under the license agreement. Telerent alleged that Morgan Inn and its individual owner Joe Morgan failed to make these payments.

Morgan Inn maintains that the duties were assigned to Gurukrupa LLC, when Morgan Inn was sold to that entity in March of 2000. Telerent claimed to have no knowledge of the sale/assignment, arguing that it was done without Telerent's approval and thus was in violation of the underlying leasing and licensing agreement. Morgan Inn countered that even if the assignment was in violation of the agreement initially, Telerent has since accepted payments

from Gurukrupa and had thus waived the right to bring action against Morgan Inn. In addition, Morgan Inn claimed that the equipment leased by Telerent was defective. Telerent moved for summary judgments on all of its claims.

With regards to the assignment, the court also held that a genuine issue of material fact existed despite a provision in the original agreement forbidding assignments without express approval. The court reasoned that the anti-assignment clause may have been waived by the conduct of Telerent if it did in fact accept payments from Gurukrupa in lieu of payments from Morgan Inn.

The court held that there was a genuine issue of material fact surrounding Joe Morgan's personal liability since he contends that he intended to sign, and was led to believe that he was signing, as a member of the LLC only. The court held that a genuine issue of material fact existed with regard to whether or not the equipment was defective despite the fact that there was a Completion Certificate filled out by Morgan Inn stating that the equipment was acceptable. Thus, the court denied all motions for summary judgment filed by Telerent.

In re Buehne Farms, Inc., 321 B.R. 239 (Bankr. S.D. Ill. 2005).

Where is the beef? It is in the Lessee's estate if lessee has an option to purchase it at a significant discount.

AG Lease or Loan LLC (Lessor) entered into two agreements with a dairy farmer, each titled "Dairy Cattle Lease." The leases were virtually identical, for 122 head and 90 head of cattle respectively. The leases provided that the cattle would be returned to Lessor upon termination of the agreements at a guaranteed minimum value, with any shortcomings being paid by the farmer. The leases did, however, give the farmer the option to purchase the cattle for that minimum value.

The leases contained clauses stating that the farmer could not cancel each agreement at any time and that Lessor retained all right, title and interest in the cattle. The farmer could not sell any of the cattle without prior permission and had to replace any cow injured or lost while in his possession. The farmer filed for bankruptcy and Lessor and its assignees moved to compel the

farmer to assume or reject the two agreements that they contended were leases. The farmer argued that the leases were better characterized as disguised security agreements.

The court applied the Illinois UCC test and resolved the issue under the bright-line-test it provides. Under that bright line test, an agreement is a security agreement, despite language purporting it to be a lease, if the lessee cannot terminate the lease and one of four other factors are present. Those factors are: (1) the original term of the lease is equal to or greater than the remaining economic life of the goods, (2) the lessee is bound to renew the lease for the remaining economic life, (3) the lessee has an option to renew the lease for the remaining economic life of the goods for no new consideration or nominal consideration, or (4) the lessee has an option to purchase the goods for no new consideration or for nominal consideration.

Here the court found the leases to be a disguised security agreements because the farmer could not terminate the agreement and the farmer had an option to purchase the cattle for nominal consideration at the expiration of the agreement. The court based this conclusion on the fact that the purchase price if the farmer exercised that option came to roughly \$160 per head, while the cattle could be sold for slaughter at that stage for \$600 to \$800 per head. The court also cited the fact that the purchase price amounted to only 6% of the total rent expenditures the farmer would have incurred at that point.

It should also be noted that the Court described the test more broadly as the economic realities test and stated that since the farmer was basically left with no rational choice but to exercise his option to purchase the cattle, the agreements had to be disguised security agreements.

LZM, Inc. vs. Va. Department of Taxation, 606 S.E.2d 797 (Va. 2005).

LZM is in the business of leasing portable toilets and offering a pumping service to customers who lease LZM toilets. The pumping service appears as a separate charge on LZM invoices. The Virginia Dept. of Taxation found that LZM neglected to collect and remit sales tax for some period of time for the amounts charged for pumping services. LZM contends that the pumping is a distinct service and therefore not subject to the tax.

The lower court applied the true object test to determine the dominant purpose of the mixed sale and service transaction and found against LZM. LZM argues that the true object test is only to be applied to true sales, not leases or rentals as in this situation. The Supreme Court looked to another portion of Virginia code, which defines "sale" to include "lease or rental" and found that the true object test was appropriately applied to this case.

LZM alternatively argued that even if the test is applied, the pumping services should be found to be a distinct from the sale since customers who lease toilets do not have to employ the pumping service. The Supreme Court did not agree with this argument, determining that the pumping services provided by LZM produce the true object of the transaction, a functioning portable toilet. Without the pumping services, the customer would have nothing of value. The record showed that LZM did not provide this pumping service to anyone who had not leased the toilet from LZM. In addition, LZM charges for the pumping service based on the number of toilets leased, not the amount of waste pumped. The Court affirmed the decision that the true objects test can be applied to a lease and that, in this instance, the services provided were essential to the true object of the transaction, and thus not distinct from the sale and taxable.

Sony Fin. Serv. vs. Multi Video Group, No. 03 Civ.1730 LAK GWG, 2005 WL 91310 (S.D.N.Y Jan. 18, 2005).

In this case, lessor's hell or high water structure survived an attack from software laws and business models surrounding beta test sites and evaluation licenses.

Multi Video is in the business of video and film postproductions. Sony Electronics approached Multi Video about purchasing state-of-the-art video equipment. The equipment was still in the developmental stage, and Sony expressed to Multi Video that it would like Multi Video to be a "beta test site" for the product. This entailed Multi Video taking the equipment on somewhat of a trial basis and not being bound to keep the equipment until it gave its final approval in a written Delivery and Acceptance Certificate. This arrangement allowed both parties to determine what, if any, improvements needed to be made to the equipment. Multi Video entered into a System Sale Agreement with Sony Electronics for the equipment. Multi Video had the option to seek

other financing resources, but it chose to use Sony Financial to finance a lease of the equipment. Multi Video would have the option to purchase at the end of the lease period. The equipment was delivered and, on two separate occasions following delivery, Multi Video signed confirmations that the delivery had been complete and the equipment had been inspected and was satisfactory. Shortly thereafter, Multi Video began experiencing performance problems with the equipment. Sony was unable to fix the problem. Multi Video ceased payments to Sony Financial on the lease. Multi Video then brought a breach of contract action against Sony Electronics. Sony Financial filed a claim for breach of lease agreement against Multi Video. These actions were consolidated for pretrial purposes. Sony Electronics and Sony Financial both moved for summary judgments.

Multi Video contended that there was a Beta Test Site Agreement that trumped the System Sale Agreement. Multi Video argued that it was only taking the equipment on a trial basis and that if it was not satisfied with the equipment at some point, it was not bound by the System Sale Agreement. Oral representations from Sony Electronics representatives did indicate that such an arrangement was considered, but there was no written, signed agreement between the parties articulating such an arrangement. The System Sale Agreement contained merger and integration clauses barring the agreement from being modified orally and discounting any previous agreements. Therefore, the court determined, when Multi Video signed the Delivery and Acceptance Certificates, it acknowledged that the equipment had been inspected and was satisfactory. That was the extent of the obligations of Sony Electronic under the System Sale Agreement, thus there was no breach of contract and Sony Electronics motion for a summary judgment was granted.

Similarly, Multi Video felt it was not obligated to continue to make lease payments because Sony Electronic had breached the overall Beta Test Site Agreement to make sure the equipment was in working order. Since there was no real proof that any such firm agreement existed between the parties, this argument failed as well. Further, the Lease contained a clause specifying that any breach by the vendor (Sony Electronics) did not affect Multi Video's obligation to pay on the Lease to Sony Financial. The two Sony entities were designated as entirely separate for the purpose of the lease, and any actions by Sony Electronic were stipulated as having no effect on Multi Video's obligation to pay. Multi Video was found to be in breach of

the lease and Sony Financial's motion for a summary judgment was granted. Sony Financial was granted a judgment for \$2,936,887, which included missed payments and prejudgment interest under New York state law.

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.lease lawyer.com or contact Weinberg at 205-251-8307.



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