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DISPATCHES FROM THE TRENCHES

Liquidated Damages; Broad Collateral Descriptions; Term Sheets; All Risk Insurance and De-facto Lessees

By Kenneth P. Weinberg

This edition of Dispatches From the Trenches discusses: (1) an improperly decided liquidated damages case; (2) broad descriptions of collateral on financing statements; (3) types of term sheets; (4) all risk insurance and wear and tear exclusions; and (5) de-facto lessees and perfection risks.

Raymond Leasing Corporation vs. Callico Distributors, Inc., 820 N.E.2d 267 (Mass. App. Ct. 2005)

Raymond is a somewhat scary damages case where the lessor is unable to obtain the residual value for his equipment as measure of damages despite the fact that the underlying lease provided for a fair market value purchase option and the fact the equipment is sold during enforcement.

Summary judgment as to the issue of default was granted in favor of the lessor when the lessee stopped making payments two years into a five-year lease. A different judge then heard the issue of damages and awarded the lessor damages in the amount of \$36,659.54. The formula to arrive at that figure consisted of the following: Total payments due under the lease (\$110,209.80) minus the payments made by the lessee (\$46,839.17) minus the amount recovered when the lessor sold the equipment (\$28,000) plus repossession costs (\$1,288.81) for a total of \$36,659.54. Attorney's fees were also awarded.

The lessor appealed the calculation of damages, arguing that the judge erred by not including the residual value of the equipment in the calculation. The appeals court disagreed with the lessor and affirmed judgment. The court commented that "residual value" was not used at all in the contract and the lessor failed to demonstrate why a figure used at the end of the lease to determine the option price should be included in the remedy for default.

The only amendment the appeals court made to the judgment was to include sales and use taxes in the damages award. Other issues such as attorney's fees and interest were appealed, but the court affirmed the original award, which included these amounts.

In re Management By Innovation, Inc., 321 B.R. 742 (Bankr. M.D. Fla. 2005)

This adversary proceeding arose as a contest between secured creditors. In June of 1999, Orix filed a financing statement to secure a lease on a printing press. The description of the collateral in the financing statement covered the leased equipment but also referenced an attached agreement, which extended to virtually all assets. In 2000, another of these leases and financing statements was executed.

Subsequently, SouthTrust acquired a security interest as well. SouthTrust did not dispute Orix's priority as to the equipment because it was plainly described in the financing statements. SouthTrust did, however, dispute the existence of a blanket lien because it argued that the financing statements were misleading and did not sufficiently describe the other collateral.

The bankruptcy judge, applying Florida law, held that the description in the financing statements was sufficient in regard to the other collateral and granted Orix's motion for summary judgment. The court found it irrelevant that the description was contained in an attached document and stated that creditors have an obligation to read the entire document.

This holding stems from the fact that Section 9-108 allows the collateral to be described by any method that allows for it to be objectively determinable and the commentary notes that "the test of sufficiency of a description under [Section 9-108], is that the description do the job assigned to it: make possible the identification of the collateral described." Some secured parties

aggressively make use of the breadth of this provision by referencing documents not even attached to the financing statement but copies of which could be obtained by written request made by the searcher to the secured party. Under current law, there is clearly precedent that such an approach technically comply with Article 9 requirements. However, one would expect such practices to continue to be challenged through the courts by secured parties who find themselves in a subordinate position at the wrong time.

Fairbrook Leasing, Inc. vs. Mesaba Aviation, Inc., 408 F. 3d 460 (8th Cir. 2005)

Fairbrook Leasing, Inc. (FLI) brought a declaratory judgment action against Mesaba Aviation to bind Mesaba to a contract that required Mesaba to execute long-term aircraft leases with FLI. Mesaba and FLI executed a Term Sheet Proposal that contemplated long-term subleases of twenty used aircraft and the purchase of twelve new aircraft from FLI. As negotiations between the parties regarding the final documents continued during the next two years, Mesaba accepted delivery of aircraft from FLI on short-term leases of two to three months as opposed to the long-term leases of 72 to 96 months specified in the Term Sheet.

After nearly five years of leasing from FLI, Mesaba decided to return some of the aircraft to FLI arguing that it was bound only by the short-term leases and not the long-term leases stipulated in the Term Sheet. FLI protested the return of the aircraft and brought this action to enforce the terms of the Term Sheet under New York law.

New York law recognizes two types of binding preliminary agreements: Type I and Type II. Type I arises when both parties agree on "all the points that require negotiation." Type I is preliminary only as to form and the parties have the right to demand performance of the transaction. Type II "establishes a framework for agreement, and binds the parties to negotiate in good faith within that framework." Once the parties make a "good faith effort to close the deal and have not insisted on conditions that do not conform to the preliminary writing," they may walk away freely. The court determined that the parties in this case entered into a Type II agreement and intended to be bound by the proposal based on the following five factors: (1) the language of the agreement; (2) the existence of open terms; (3) whether there has been partial performance; (4) whether the agreement is of the type usually committed to writing; and (5) the context of the negotiations resulting in the preliminary agreement.

The dissenting judge in this case held that FLI does not have the right to enforce the Term Sheet Proposal as a binding contract between the parties because a breach by Mesaba would not bind the parties to the contractual objective of the Term Sheet. In his opinion, the judge reiterated that a court should rarely find a contractual obligation in a preliminary agreement, unless the agreement "clearly manifests" such an intention. The judge argued, "if a final contract is not agreed upon, the parties may abandon the transaction as long as they have made a good faith effort to close the deal and have not insisted on conditions that do not conform to the preliminary writing." In other words, FLI cannot enforce the Term Sheet as a contract because the agreement lacks the detail and specificity of an aircraft lease and the parties never reached such an agreement. If the parties negotiated in good faith, they may walk away from the deal freely.

***Meridian Leasing, Inc. vs. Associated Aviation Underwriters*, 409 F. 3d 342 (6th Cir. 2005)**

Meridian Leasing, Inc. purchased an aircraft in March 2001, and insured the aircraft with an all-risk insurance policy. In August 2001, the aircraft malfunctioned and caused extensive damage to the engine of the aircraft. Meridian filed a claim that Associated Aviation Underwriters (AAU) denied because the damage allegedly fell within the exclusion for wear and tear.

The lower court found that the Policy did not define wear and tear and, using California law, the court held that wear and tear should be given its "ordinary and popular" meaning. According to the court, wear and tear therefore referred to damage resulting from "normal or ordinary operation of the aircraft."

The Court of Appeals analyzed and upheld the lower court's decision. California law states that a provision in a policy is ambiguous "when it can have two or more reasonable constructions." Additionally, the ambiguities in a contract must be construed against the drafting party. The courts must give effect to the intention of the parties when determining what the ambiguous contract means. In this case, the court determined that terms must be given their "ordinary and popular" meaning unless used in a technical way or given a special meaning by usage. The court interpreted the policy holistically and based on the circumstances of the case.

All-risk insurance policies typically have wear and tear clauses since the insurers do not want to cover inevitable losses. The intent of such clauses is such that the insurance policy only covers

damage caused by accidents. As such, the court held that California law requires limiting language to be exacting. In other words, the insurer cannot fail to insure because the exclusionary clause is ambiguous. The court found it reasonable that Meridian expected the policy to cover the damage caused to the engine.

Furthermore, AAU knew the language was ambiguous and that the wear and tear exclusion might be interpreted to mean ordinary or normal operation of the aircraft since a similar conclusion had been reached by another court interpreting the exact same language in another case and determined. As such, the court held that the parties did not intend wear and tear to have a specialized meaning and never intended the policy to exclude events such as the one that occurred in this case. Based on the whole policy, the phrase wear and tear must be given its ordinary meaning otherwise the limitation is at odds with the purpose of the all-risk insurance.

In re Sho-Me Nutraceuticals, Inc., 319 B.R. 273 (Bankr. MD Fla. 2005)

Sho-Me arose as a motion for relief from automatic stay filed by CIT, a creditor. CIT leased equipment to Matco, a company that was in negotiations with Sho-Me for acquisition or merger. CIT filed a financing statement showing Matco as debtor. Because the companies were in negotiations, the equipment was delivered to Sho-Me, not Matco. At all relevant times the equipment was located at Sho-Me. Additionally, Sho-Me made all the payments, and in 2003, after the merger never materialized, the president of Sho-Me asked CIT about paying off the lease.

CIT argued that it should be relieved from the automatic stay because Sho-Me only had a mere possessory interest in the equipment, which is not protected by the stay. The court disagreed. After calling this a "classic picture of how not to structure an ordinary commercial transaction," the court held that Sho-Me was a de facto lessee. Based on the fact that the equipment was never delivered to Matco and Sho-Me was the only party to make payments on the lease, the court concluded that CIT had acknowledged Sho-Me as a de facto lessee. Therefore, CIT had a duty to protect its interest by filing a financing statement against Sho-Me. CIT chose not to make such a filing and because it did not have a validly perfected security interest, its motion for relief from the automatic stay was denied.

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