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## DISPATCHES FROM THE TRENCHES

### The Increased Legal Risks of Leasing to Individuals, Sole-Proprietors

By Kenneth P. Weinberg

This edition of **Dispatches from the Trenches** discusses the increased legal risks of leasing to individuals, including sole proprietors as sometimes individuals have a personal or tax reason to lease in their own name. These reasons are often incorrectly perceived. Other times, the individuals are small businesses who haven't received sufficient legal counsel to set up a formal business entity such as a partnership or limited liability company. There are several legal risks involved with leasing to individuals, and the remainder of this article outlines these risks.

#### **Risk 1 - Name of Debtor**

A financing statement is not effective to offer the lender/lessor protection if it does not properly identify the Debtor by name. The name to be used for corporations, limited liability companies and other formal business entities created by filings with state agencies, such as the Secretary of State, are generally clear and can be verified online with the applicable state agency or otherwise in an independent manner. The name to be used for individuals is more difficult to obtain accurately. Even driver's licenses or social security cards can obtain outdated information, due to a marriage or other name changes by an individual. Individual names can also raise issues as to what name is the first name and what name is the last name. Official comment number two in **Section 9-503** of Article 9 of the UCC uses the example of the name Perry Mason (which could

be Mason Perry). Local filing agencies are instructed to reject filings with this potential ambiguity.

On the bright side, Revised Article 9 clears up what used to be the hazy issue of what name should be used for sole proprietors — individuals doing business under a trade name of “dba” — since new **Section 9-503(c)** specifically states that a “financing statement that provides only the debtor’s trade name does not sufficiently provide the name of the debtor” and new **Section 9-503(b)** states that a “financing statement that provides the name of the debtor [accurately] is not rendered ineffective by the absence of a trade name or other name of the debtor.”

### **Risk 2- Location of Debtor**

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 upon 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 online 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 “principal residence.” This rule is less clear, especially for wealthier individuals who may have a variety of residences and vacation homes. As a result, prudent lessors/lenders often have no choice but to make multiple filings.

### **Risk 3- Movement of Debtor**

Another 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 principle residence. Even worse, no filings are required in any public record to reflect any such movement.

#### **Risk 4- Transfers of Collateral**

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 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. Various organizations, such as Diligenz, offer monitoring services to help track such information.

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 in mergers, 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.

## **Risk 5 - Consumer Issues**

State and federal law protects consumers in many ways. Many of these laws are drafted to protect business entities as well as individuals, such as the New Jersey Unfair Trade Practice Act, which protects "any natural person or his legal representative, partnership, corporation, company, trust, business entity or association, and any agent, employee, salesman, partner, officer, director, member, stockholder, associate, trustee or cestuis que trustent thereof." Florida, Texas and Connecticut are other states with such statutes.

However, many other of these consumer protection laws generally protect only individuals. For example: (1) the definition of a "consumer lease" under Article 2A of the UCC covers only "a lease that a lessor regularly engaged in the business of leasing or selling makes to a lessee who is an individual;" (2) the definition of a "consumer transaction" under Article 9 of the UCC requires an individual to incur the obligation associated with the transaction; and (3) the Fair Credit Reporting Act covers only individuals. Recall, that the FCRA can apply to commercial transactions when a report regarding the individual's credit worthiness is obtained from a "consumer reporting agency."

In addition, 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 a lessee who is an individual is much more likely to receive the benefit of this blurring of the lines than is a corporate lessee.

## **Risk 6 - Death Incapacity**

All documents used for lending or 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 a lessor/lender certainly does not want to have to deal with a probate court, family issues and other potential entanglements. Requiring the lessee's incapacity (mental or physical) to be an Event of Default is also advisable.

## **Risk 7 - Bank Secrecy/Patriot Act/Anti-Money Laundering**

Due to the presence of identity theft, it is becoming much more difficult to obtain records to verify the accuracy of presented driver's licenses and social security numbers. In addition, using such information on lease forms, UCC's and other documents may also lead to problems later due to privacy protection laws. Lastly, at the present time, there is not sufficiently clear direction from the federal government as to what identification it requires for bank lenders/lessors. Given this uncertainty, the risk of leasing to individuals is increased.

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