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DISPATCHES FROM THE TRENCHES

Attempting to avoid the Hell or High Water Clause by alleging Fraudulent Inducement

By Kenneth P. Weinberg

As we near the tenth anniversary of the *Colonial Pacific v. McNatt* case out of Georgia, it is very clear that the lessons of that case will continue to pass the tests of time. It is always a pleasure reporting on cases where courts acknowledge the importance of the hell or high water clause in leases and enforce it emphatically. It is, however, quite scary when a case acknowledges a chink in the armor of even the most robust hell or high water clause.

Any lessor ever subject to a lessee claim regarding defective equipment is aware of the various tricks lessee counsel uses to avoid a well crafted hell or high water clause. The most common trick is to claim fraudulent inducement and the *Colonial Pacific* case provides a detailed analysis of such an attack.

Background Information regarding the Hell or High Water Clause

According to one historian, the term Hell and High Water “appears in print around the beginning of the twentieth century [and one of the first examples] is from 1901” Evidently, “[t]he setting of many of the earliest examples strongly point to cattle ranching as the origin, in particular the driving of cattle to railheads in the mid West in the latter part of the nineteenth century. In 1939 Paul Wellman published a book with the title *Trampling Herd: the Story of the Cattle Range in America* in which he wrote: “In spite

of hell and high water is a legacy of the cattle trail when the cowboys drove their horn-spiked masses of longhorns through high water at every river and continuous hell between. <http://www.worldwidewords.org/qa/qa-com1.htm>

In any event, the term is used to refer to both statutory and contractual protection common in the leasing industry pursuant to which the lessee agrees to pay rent to the lessor no matter what happens, even come hell or high water.

Due to the limited role that a lessor plays in an Article 2A finance lease and the important role that lease financings play in our economy, Article 2A of the Uniform Commercial Code (the "UCC") offers special statutory protection to lessors who lease goods in such transactions. As noted in the comments to the UCC, the various sections of Article 2A operate to "substitute the supplier of the goods for the lessor as the party responsible for warranties *and the like*." UCC §2A-101, comments (emphasis added). For example, §2A-209 automatically extends the seller's warranties (and their exclusions) to the lessee and automatically excludes any implied warranties of fitness or merchantability by the lessor. Shrank, *supra* at §3:1.5[B]. In addition, §§2A-516 and 517 state that, once lessee has accepted the property, it has no right to revoke that acceptance. Most importantly, §§2A-407 and 508 create a statutory "hell or high water" clause by making lessee's obligations (including payment obligations) irrevocable and independent of the lessor's or supplier's obligations. *Id.* At §3:1.10[A]. In other words, once the lessee accepts property under a finance lease, that lessee is obligated by statute to perform under that lease "come hell or high water."

Technically, an Article 2A "finance lease" is a lease which:

consists of an overall three-party transaction in which: (1) the lessor does not select, manufacture, or supply the goods, (2) the lessor did not own the goods before the lease was arranged, and (3) the lessee either approves the purchase contract or receives specified warranty and supplier information before signing the lease agreement. Ian Shrank and Arnold G. Gough, *Equipment Leasing-Leveraged Leasing* (PLI 4th ed., 1999), Vol. 1, §3:1.5[C].

Unfortunately, the terminology "finance lease" is sometimes a source of confusion since some people in the industry use the term to refer to a transaction which, although called a "lease", is actually a loan from the lessor to the lessee with the "leased property" serving as collateral for the loan. This type of secured transaction is more accurately referred to as a "Lease Intended as Security" and is covered by Article 9 of the UCC which governs secured transactions rather than Article 2A which covers true leases.

Fortunately, all of the aforementioned protections afforded lessors under finance leases can be obtained through contractual provisions in any equipment lease agreement. The Official Comments to the UCC state that "[i]f a transaction does not qualify as a finance lease, the parties may achieve the same result by agreement." UCC §7-2A-103. comment (g). Indeed, the UCC "provisions are merely codifications of standard commercial leasing practices that previously were achieved by contract rather than by statute." Shrank, *supra* at §3:1.10[A]. Well respected authorities encourage lessors to "include express 'hell or high water' clauses if for no other reason than to avoid arguments about whether a 'finance lease' is involved." *Id.* At §3:1.[D].

The Attack of Fraudulent Inducement

In *Colonial Pacific Leasing Corp. v. McNatt et al.*, McNatt (the "Lessee") entered into negotiations with Itex Systems (the "Vendor") for the acquisition of a computer system (the "Equipment"). 268 Ga. 265, 266 (Ga. 1997). Lessee selected the Equipment that it desired to obtain from Vendor and executed leases with Burnham Leasing Company (the "Lease Financer"), whereby the Lease Financer agreed to purchase the Equipment chosen by Lessee from the Vendor and to then lease the Equipment to Lessee for a monthly rental payment. The leases executed contained provisions stating that the Lessee's obligations to Lease Financer became absolute and irrevocable once Lessee accepted the Equipment.

Lessee stopped making payments when the Equipment did not perform as Vendor's sales agent claimed it would. Lease Financer repossessed the Equipment, in accordance with the lease and Lessee sued Lease Financer and Vendor, claiming fraud and seeking rescission of the lease. *Id.*

The leases in this case were entered into prior to the effective date of Article 2A in Georgia but the case was tried after Article 2A had the law in Georgia for some time. As such, the Court was presented with, and took advantage of, the opportunity to discuss lease financings from both a statutory (UCC) and contractual standpoint.

The Court noted the role of Lease Financer under Article 2A, clearly indicating that, under a UCC statutorily defined "Finance Lease," a Lessee should pay a Lease Financier regardless of whether or not the Equipment performed as represented by the Vendor:

Traditionally, a finance lessor had been thought of as a passive lessor, whose transactions remain functionally the equivalent of an extension of credit. It is typically the lessee, not the lessor, who selects the goods in a "finance lease." Moreover, [because the goods are shipped directly to lessee,] a finance lessor often [does not have] the opportunity to inspect the goods in order to discover defects in them. Given the limited function of the lessor, the lessee relies almost entirely on the supplier for representations, covenants, and warranties. In effect, the [lessee] is relying upon the [supplier] to provide the promised goods and to stand by its promises and warranties; the [lessee] does not look to the [finance lessor] as a seller to the [lessee] with warranty liability [and the finance lessor, like a bank making a loan,] usually expects to be paid, even though the [equipment] might prove to be defective or totally unsuitable for the [lessee's] particular business. *Id.* at 268.

However, the Court noted that, since Article 2A was not in effect at the time the leases were entered into, the case must be decided under general principles of contract law. Of course, the contractual language in the leases was drafted to provide the same type of protection that is now afforded under Article 2A.

The lessee sought to circumvent the hell or high water clause by alleging fraudulent inducement. The legal basis for such claims stems from Section 1-103 of the UCC which states that "the principles of law and equity, including . . . principal and agent [and] fraud . . . shall supplement [the] provisions [of the UCC]." UCC §1-103. As such fraud on the part of the lease financer is not excused by any provision of the UCC.

It is important to note that a claim of fraudulent inducement also erodes protections normally afforded by a contractual hell or high water clause since one who fraudulently

causes another to sign an agreement cannot rely on the terms of the agreement in any respect. The fraud itself, if proven, would render the agreement *void ab initio* (lawyer-speak for void from the beginning).

The Court noted that, in the absence of fraud, it would uphold the bargain struck by the parties but that, since Lessee was alleging fraud, the contractual "hell or high water" clause did not conclusively resolve this case. *Id.* at 269. The Court continued its analysis by noting that Lessee alleged "that the *equipment supplier's employees* fraudulently induced [it] to enter into the equipment lease contracts [and that i]n order for the purported fraud of *the employees of the equipment supplier* to authorize rescission of the finance lease, their actions must somehow ***be imputed*** to the [Finance Lessor]." *Id.* at 270 (emphasis added). The following facts were offered to show an agency relationship sufficient to impute the fraud:

the employees who purportedly made the fraudulent statements to [the Lessee] wanted [the Lessee] to sign a lease and told [the Lessee] the monthly leasing costs. [The Lessee] provided a financing statement to the [Vendor's] employees as part of the effort to secure a finance lease, and the lease documents were presented to the [Lessee] by the [Vendor's] employees. *Id.* at 270.

Despite the foregoing, the Court noted that "the equipment [Vendor's] employees never represented themselves as being agents of the finance lessors, and [it] never discussed being employees of the finance lessors." *Id.*

As such, the Court held as follows:

We conclude from our review of the record that the equipment [vendor's] employees acted only as a conduit of information between the [lessee] and the finance lessor; there is no evidence that the finance lease was negotiated by the [vendor's] employees pursuant to authorization given them by the finance lessor [and that] there is no evidence of a relationship pursuant to which the purported fraud of the [vendor's] employees could be imputed to the finance lessor and vitiate the contracts executed by [Lessee] with the finance Lessor [it]. As there is

no evidence of fraud imputable í the leases are not rescindable í and the hell or high water clauses contained in the lease are viable. *Id.* at 271.

Although the lessor survived the lessee's claim of fraudulent inducement, the success of the result depended upon the courts conclusion after a facts and circumstances analysis of the relationship between the vendors sales persons and the lease financier.

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