

# MARKS & WEINBERG, P.C.

## DISPATCHES FROM THE TRENCHES

### Friend and Foe: Liens which Survive Transfer of the Equipment

This issue of Dispatches From the Trenches addresses Uniform Commercial Code provisions which protect a lessee when a lessor sells equipment leased pursuant to a dollar-out lease, mandatory purchase lease, dirty lease, financing lease, lease intended as security, disguised security interest, non-tax lease, ALIAS or whatever other term you use to refer to a lease which is essentially a secured loan. Although the rest of this article uses the terms lessor and lessee, the same rules apply to equipment finance agreements and other straight loans secured by equipment.

Unfortunately, these provisions do not fully protect lessors and it is important to monitor transactions to make sure equipment isn't sold out of trust. In addition, the same provisions which protect lessors can also turn around and bite those who are not careful with leases involving used equipment or leases where funds are not provided directly to the vendor.

#### Lien Survives Transfer but Lessor may need to File Against Transferee

Section 9-315(a)(1) of the Uniform Commercial Code states that "a security interest or agricultural lien continues in collateral notwithstanding the sale, lease, license, exchange, or other disposition thereof *unless the [lessor] authorizes the disposition free of the security interest or agricultural lien.*" This provision comforts a lessor when the lessee sells equipment out of trust by assuring that the lessor's security interest in the equipment survives the transfer.

However, the applicable provisions sometimes still place a burden on the lessor to discover the transfer within the first year. This is because the usefulness of a security interest depends in large part on whether it is a "perfected" security interest. The applicable code provisions provide that any security interest which survives a transfer remains perfected with respect to the collateral *for at least one year* even if the lessor does not file a new financing statement. See UCC §9-507(a) ("a filed financing statement remains effective with respect to collateral that is sold, exchanged, leased, licensed, or otherwise disposed of and in which a security interest or agricultural lien continues, even if the secured party knows of or consent to disposition.")

The one year limitation comes into play only if the transferee is "located" (for Article 9 purposes) in a different state than the original lessee. Recall that, under Revised Article 9, the location of the registered entity is where it is incorporated or otherwise formed. The example in Official Comment No. 3 to UCC §9-507 is helpful:

Dee Corp. is an Illinois corporation. It creates a security interest in its equipment in favor of Secured Party. Secured Party files a proper financing statement in Illinois. Dee Corp. sells an item of equipment to Bee Corp., a Pennsylvania corporation, subject to the security interest. The security interest continues, see Section 9-315(a), and remains perfected, see Section 9-507(a), notwithstanding that the financing statement is filed under "D" (for Dee Corp.) and not under "B." However, because Bee Corp. is located in Pennsylvania and not Illinois, see Section 9-307, unless Secured Party perfects under Pennsylvania law within one year after the transfer, its security interest will become unperfected and will be deemed to have been unperfected against purchasers of the collateral. See Section 9-316. See also UCC §§1-201(30) and (31)(the definitions of "purchase" and "purchaser" are broad enough to include lenders who take security interests in collateral).

Because of this risk, if the transferee is located in a different state than the original lessee, the lessor must file a new financing statement against the transferee in the state where the transferee is located within one year or it will become unperfected with respect to the collateral that has been transferred. It should be noted that the lessor is specifically authorized to file against transferee with respect to the existing collateral. *See* UCC §9-509(c) (by acquiring collateral in which security interest or agricultural liens continues under UCC §9-315(a)(1), the debtor authorizes the filing of an initial financing statement, and an amendment, covering the collateral). However, the lessor must be careful to describe only the collateral transferred and proceeds of it. Any security interest granted by the original lessee in after acquired collateral would not be "existing collateral" covered by UCC §9-509(c) and lessor would not be authorized to file a financing statement against such collateral unless the transferee had assumed all obligations under the lease contractually or by operation of law. *See* UCC §§9-203(d) and 9-509(b).

### **Extra Burden when no Funding Vendor or When Leasing Used Equipment**

The fact that a lien can survive a transfer means lessors who do not fund directly to the vendor need to be extra diligent in tracing title back to a vendor. Lien searches are always a good idea when lessors do not fund the vendor directly since such transactions call into question whether the lessor's funds have "enabled" the lessee to acquire rights in the leased equipment. Remember, by definition, a purchase-money security interest requires that the loan proceeds "enable the debtor to acquire rights in or the use of the collateral." UCC §9-103(a)(2).

However, a lien search alone is not sufficient since, as noted above, a valid perfected lien may exist with respect to collateral even if a financing statement has not been filed against the lessee in question. Indeed, if the lessee acquired equipment from a previous owner/lessee that was located in the same state, it's possible that no filing will ever be made. As such, a new lessor can only assure itself that it has a first lien (or clear title in the case of a true lease) if it traces ownership all the way back to a vendor and makes sure no intervening owners have unreleased liens covering the equipment which survived its transfer.

Bear in mind that tracing title back to a vendor may not be sufficient with respect to used equipment. Lessors normally feel comfortable tracing title back to a vendor since a vendor which sells goods in the ordinary course of business has the ability to clear liens that have attached to the equipment. However, a closer look at the relevant provision reveals that only certain liens are cleared. The applicable provision states "a buyer in ordinary course of business. . . takes free of a security interest *created by the buyer's seller*, even if security interest is perfected and the

buyer knows of its existence.ö UCC §9-320 This rule is used to invalidate a perfected security interest in a debtor's inventory when that inventory is sold in a manner that "comports with the usual or customary practices in the kind of business in which the seller is engaged or with the seller's own usual or customary practices." See UCC §1-201(9).

The idea is that inventory lenders expect for their debtors to sell inventory to make profits and that this rule does not adversely impact the inventory lender since the lender's interest in the inventory is not cut off by this provision until the goods are actually sold by the debtor and since the lender's security interest will continue in identifiable proceeds generated by the sale. This buyer in ordinary course rule also encourages the marketability of goods and protects the interests of buyers who assume that they have clear title to goods they purchase from vendors in the business of selling goods of that kind.

However, the rule only clears liens that are öcreated by the buyerø sellerö such as liens granted by the vendor to lenders providing inventory financing or floor-planning. Any liens which survived a transfer of the equipment from a *prior* owner to the vendor would not be cleansed by this mechanism. Depending on the size and stature of the vendor, it may be reasonable to rely on a vendor warranty of title. However, be wary of fly-by-night vendors selling used equipment.

**RFC Capital Corporation v EarthLink, 55 U.C.C Rep. Serv.2d 617 (Ct. App. 10<sup>th</sup> Cir. 2004)**

The case of RFC Capital Corporation vs. EarthLink, Inc. provides a nice example of some of these provisions in action. In that case, RFC Capital Corporation (öLenderö) provided a working capital line to Internet Commerce and Communications, Inc. (öBorrowerö). In accordance with the loan, RFS took a security interest in, among other things, all of Borrowerø customer base including past, present and future customer contracts, any customer lists relating thereto and any information regarding prospective customers and contracts, goodwill or other intangible assets associated with the foregoing (the öCustomer Baseö).

When Borrower encountered financial difficulty it entered into an arrangement with EarthLink, Inc. (öPurchaserö) pursuant to which Borrower sold the Customer Base to Purchaser. Compensation was based upon the number of customers who actually entered into service agreements with Purchaser and made payments for two months of service.

At the time the agreement was entered into between Borrower and Purchaser, Lender was not aware of Purchaserø reported sale of the Customer Base. It appears that Borrower was less than truthful to Purchaser about Lenderø knowledge and willingness to release its security interest in the assets. In fact, the sale agreement between Borrower and Purchaser stated that Lender öhas agreed to waive any security interest, lien or encumbrance in the [Customer Base] and execute necessary documents in order to allow this Agreement to be executed and performed in full by Borrower.ö However, that agreement was not signed by Lender. Further, Purchaser never obtained any specific written or oral acknowledgment from Lender that it would in fact waive its interest.

Borrower finally contacted Lender for the release and after much pleading, convinced Lender to enter into an amendment which required Lender to release its security interest in the Customer Base after Borrower made sufficient payments bring its outstanding balance on the revolving line of credit to an amount which was 1.75 times the borrowing base. The previous maximum amount

allowed was equal to four times the borrowing base. The anticipated payments due from Purchaser would have resulted in such a reduction.

Neither Borrower nor Lender informed Purchaser of the amendment and Borrower forbade Lender from contacting Purchaser in this regard. At the end of the day, the Customer Base did not yield the anticipated number of switched customers and Purchaser was not required to pay anywhere near the amount originally contemplated. In fact, the amount paid to Borrower was not sufficient to reduce the borrowing base to such a number that required Lender to release its security interest.

Shortly after Borrower filed for bankruptcy, Lender brought suit against Purchaser, alleging conversion, tortious interference with a contractual relationship, unjust enrichment, impairment of Lender's security interest and a right to an accounting. It claimed that as a secured party it was entitled to recovery from Purchaser because Purchaser took and damaged its collateral without obtaining a release.

The court cites §9-315(a)(1) of the applicable jurisdiction, noting that the buyer of collateral takes the collateral subject to a secured party's interest *unless the secured party authorizes its release*. According to the court, the authorization can either be explicit or implicit. Since Purchaser could not provide proof of any explicit authorization, it argued that such authorization should have been implied.

According to the court, to constitute an implied authorization, a secured party's acts must unequivocally demonstrate an intent to waive its security interest since such a waiver cannot be inferred from doubtful or ambiguous factors [and] because [9-315] does not require a secured party to take any action to preserve its interest, inaction alone may not necessarily lead to a finding of implied authorization. The court upheld the lower courts finding that Lender did not implicitly release its security interest, noting that Lender authorized the sale of the customer base but made the collateral subject to its security interest until Borrower performed its contractual obligations (i.e., remitting payments up to a certain amount) to Lender.

Purchaser argued that the conditions which would result in the release of Lender's security interest were outside of Purchaser's control and therefore were ineffective. The court acknowledged that there is a split of authority regarding whether conditional consent cuts off a secured party's interest in the collateral. There is one line of authority which holds that a condition imposed on an authorization to sell is ineffective unless performance of the condition is within the buyer's control. Such courts reason that a condition requiring performance only the seller can provide is not a "real" condition because it makes the buyer insure of acts beyond its control. Under such a view, the third party purchaser who agreed to no condition has superior rights over the secured party who permitted the collateral to be placed on the market.

The opposing line of cases holds that regardless of the nature of the condition, no authorization exists where the debtor fails to satisfy the conditions of the creditor's conditional consent. There courts reason that the Uniform Commercial Code does not prevent a secured party from attaching a condition or limitation to its consent. A buyer can protect itself by searching UCC filings to ascertain whether a security interest exists and then contacting the secured party to determine whether there are any conditions attached to the consent.

The court in this particular case sided with the latter line of authority and held that Lender's secured interest was still valid. The case was remanded with respect to other issues but §9-315 certainly worked to Lender's advantage.

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