

DISPATCHES FROM THE TRENCHES

A Little Something about Lessee Assignments and Assumptions: Is your Collateral Protected?

In these difficult times, lessors are more frequently willing to allow an existing lessee to assign its rights and interest in leased or financed equipment to a new lessee so long as the new lessee assumes all obligations under the lease. If the original lessee's credit is in rough enough shape, the amount of due diligence conducted by the lessor with respect to the new lessee is often fairly limited. This is particularly the case if the assignment and assumption is structured in such a manner as to keep the original lessee on the hook for the obligations under the lease even after assignment to the new lessee. Quite frankly, many lessors view such a transaction as simply adding another obligor and thereby increasing their chance of recovery without much risk. As long as the new lessee is in better financial health than the original lessee, lessors also receive some comfort in having the collateral transferred out of what may eventually become the bankruptcy estate of the original lessee to a company which theoretically is less likely, due to its increased financial health, to file for bankruptcy protection.

However, in situations where the leased or financed equipment has value as collateral, lessors should take precautions to assure that the assignment and assumption does not negatively affect the lessor's security interest in the collateral in the event a court determines that the underlying lease is really a secured loan.

This issue of Dispatches from the Trenches discusses additional due diligence which should be conducted for lessee assignments and assumptions. The remainder of this edition refers to the original lessee as "OldCo" and the new lessee as "NewCo". Although this edition uses terms like lease, lessor and lessee, the discussion is equally applicable to an equipment finance agreement or other loan in which a lender is granted a security interest in equipment or other collateral as security for the borrower's obligations to the lender.

Several provisions within Article 9 of the Uniform Commercial Code are applicable to this situation and they draw a distinction between two different classes of collateral. The first group of collateral is existing collateral that is transferred. This group includes the leased or financed equipment that is transferred from OldCo to NewCo. The second group of collateral is hereinafter acquired or arising collateral. This group includes all collateral not existing at the time of the transfer such as, for example, accounts receivable or rentals to be received after the transfer as a result of OldCo's or NewCo's sublease of the equipment.

Existing Collateral

With respect to existing collateral that was owned by OldCo and sold or otherwise assigned to NewCo, the lessor generally retains its security interest. Section 9-315(a)(1) of the Uniform

Commercial Code states that "a security interest or agricultural lien continues in collateral notwithstanding sale, lease, license, exchange, or other disposition thereof unless the secured party authorizes the disposition free of the security interest or agricultural lien." Assignment and Assumption Agreements by their terms satisfy this criteria by providing that the sale from OldCo to NewCo is subject to the same security interest and other rights in the leased or financed equipment that the lessor had against OldCo.

Lessors need to be mindful, however, that the retention of a security interest against NewCo does not necessarily mean that the security interest remains superior to those of other lenders, good faith purchasers for value or a trustee in bankruptcy. The priority status of the lessor's security interest, or the lack thereof, depends upon whether the lessor remains "perfected" in the leased or financed equipment. The Uniform Commercial Code provides that, unless NewCo is "located" in a different state than OldCo, the lessor remains perfected with respect to the collateral even if it does not file a new financing statement. Section 9-507(a) of the Uniform Commercial Code addresses this issue, stating that "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 risk with respect to this existing collateral occurs when NewCo is located in a different jurisdiction than OldCo. Recall that, under Article 9 of the Uniform Commercial Code, the location of the registered entity is where it is incorporated or otherwise formed. The example in Official Comment No. 3 to Section 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 perfect, 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 [for value] of the collateral [including secured parties]. *See also* Official Comment No. 3 to Section 9-316.

Because of this risk, if NewCo is located in a different state than OldCo, the Lessor must file a new financing statement against NewCo in the state where NewCo is located within one year or it will become partially unperfected with respect to the collateral that has been transferred against all purchasers for value (which includes a secured party). Lessor would still beat a trustee in bankruptcy.

It should be noted that the lessor is specifically authorized to file against NewCo with respect to the existing collateral. This authorization can be found in Section 9-509(c) which states that "by acquiring collateral in which security interest or agricultural liens continues under Section 9-315(a)(1), the debtor authorizes the filing of an initial financing statement, and an amendment, covering the collateral."

Other Collateral

The foregoing analysis applies only to existing collateral that was transferred by OldCo to NewCo. To the extent the security interest granted to the lessor covers other property, the rules discussed above do not apply. Other property would include, for example: (a) assets that NewCo

has immediately prior to its acquiring of the existing collateral from OldCo; and (b) accounts, equipment, fixtures and other tangible property or intangible property acquired by NewCo after the existing collateral was transferred to it.

In most equipment leasing transactions, this other collateral is present only in the form of proceeds of the leased or financed equipment or additions, accessions or enhancements to it. If the equipment is subleased by lessee to third parties or furnished to third parties under a contract of service, it is common to obtain a security interest in rentals or other payments due from such third parties as well as the subleases or other contracts evidencing those payment obligations. This type of collateral is also the type of after acquired collateral for which this second set of rules applies. Although less standard, lessors dealing in certain markets with weaker and less sophisticated credits may also obtain a security interest in additional collateral which falls in this category, sometimes even an "all assets" security interest.

With respect to this second set of collateral, Article 9 does not focus on whether the security interest survives the transfer of assets from OldCo to NewCo. Rather, it focuses on whether and the extent to which NewCo became bound by the lease or other security agreement entered into by OldCo. Under Section 9-203(d), "the person becomes bound as debtor by a secured agreement entered into by another person only if by *operation of law* other than this article *or by contract* (1) the security agreement becomes effective to create a security interest in the person's property; or (2) the person becomes personally obligated for the obligations for the other person, including the obligations secured under the security agreement, and acquires or succeeds to all or substantially all of the assets of the other person."

If an Assignment and Assumption Agreement is executed by NewCo, it clearly becomes bound by contract to the original lease. Although a digression, it is worth noting that these provisions can also apply and be useful to lessors in situations where NewCo acquires all assets of OldCo (by merger or otherwise).

Under Section 9-508 of the Uniform Commercial Code, the original financing statement is effective with respect to all property of NewCo in existence at the time of the transfer and all after-acquired property of NewCo if the financing statement would have been effective had OldCo been in possession of, or acquired possession of, such collateral. Because the financing statement is only effective if it has been filed in the state where NewCo is "located," this rule of continued perfection will only apply if NewCo is located in the same state as OldCo. *See* §9-316 of the Uniform Commercial Code, Official Comment 2; example 5.

Even if NewCo is located in the same state as OldCo, however, the continued perfection discussed above with respect to after-acquired property lasts for only 4 months if the difference between the name of NewCo and the name of OldCo is such that the filing is "seriously misleading" unless the secured party files an initial financing statement against NewCo before the expiration of the 4-month period. *See* §9-508(b) of the Uniform Commercial Code. The difference would be seriously misleading "if a search of the records of the filing office, under the [new] name, using the filing office's standard search logic, if any, [fails to] disclose [the] financing statement." *See* §9-506(b) and (c) of the Uniform Commercial Code.

It should be noted, however, that any secured party of NewCo with a previously filed financing statement would have priority over this after acquired collateral. It should also be noted that it is possible for a lessor to avoid the complications noted with respect to after acquired collateral consisting of insurance proceeds by being loss payee on the insurance policy and having the insurance company pay lessor directly for any such loss.

Moral

The lesson here with respect to both types of collateral is that the lessor must conduct lien due diligence with respect to NewCo anytime the leased equipment or other collateral has value to the lessor.

With respect to the existing collateral which is transferred, such as the leased or financed equipment, this due diligence consists of verifying the correct legal name and jurisdiction of organization of NewCo and filing a financing statement against NewCo covering such collateral. Although it is not technically necessary to file the financing statement if NewCo is organized/located in the same jurisdiction as OldCo, it is good practice to do so and also serves the practical purpose of putting creditors of NewCo on notice of the lessor's interest.

In situations where after acquired collateral is of significant value, for example rentals due under subleases of the equipment, lessors should conduct the same steps as set forth above for existing collateral and should also obtain necessary subordinations or releases from creditors of NewCo who have filings which also cover the same after acquired collateral.

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Article appeared in the May/June, 2009 issue of the *Monitor*.
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