

# MARKS & WEINBERG, P.C.

## DISPATCHES FROM THE TRENCHES

### Dispatches from the Trenches

#### **Fraudulent Inducement, Mistake and Unconscionability Defenses; and the Importance of Language stating the Leased Equipment is not a Fixture**

This issue of Dispatches from the Trenches discusses: (1) a borrower's attempt to avoid its obligations under an equipment financing agreement by asserting the defenses of fraudulent inducement, mistake and unconscionability; and (2) why lessors should make sure their leases have standard language noting that the equipment does not constitute a fixture and is removable from and not essential to the premises where the equipment is located.

***Lyon Financial Services, Inc. v. Marty Hearyman-M.D.*, 2009 Minn. App. Lexis 580 Ct. App. Minn., (June 2, 2009)**

In this case, the Appellate Court of Minnesota enforces a hell and high water equipment finance agreement, rejecting the borrower's claims of fraudulent inducement, mistake and unconscionability. The agreement in question was executed by Lyon Financial Services ("Lyon") and Marty Hearyman, an Arkansas physician who served as the Medical Director of Northside Healthcare Center. Hearyman signed the agreement in several places as "Marty Hearyman, M.D. d/b/a Northside Healthcare Center." Hearyman also signed a paragraph on the agreement titled Guaranty, making him the unconditional personal Guarantor of obligations under the agreement.

Approximately one and half years into the term of the agreement, the borrower stopped making payments and Lyon sued Hearyman in his individual capacity for damages. The District Court disallowed Lyon's claims under the theory that the vendor of the equipment fraudulently induced Hearyman to sign the agreement without reading any of it. Hearyman also testified that he had only been to the Northside Center once or twice and had no ownership or financial interest in the center. He stated that the agreement was presented to him for signing on a busy day and that he did not have time to read it. He further testified that the agreement had several notes on it, showing him where to sign, which obscured some of the text of the agreement. According to Hearyman, he signed

without noticing any of the language that identified him as an owner or Guarantor or which otherwise indicated that Northside was simply a d/b/a for him personally.

According to the Court of Appeals, the District Court concluded that the equipment vendor made false representations to Hearyman to induce him to sign the agreement without reading it and that Hearyman was justified in relying on those representations. The District Court further held that the agreement was unconscionable as a matter of law. As such, the District Court held that it would not enforce the agreement.

The Court of Appeals reversed, agreeing with the law in other States and noting that:

A third party's negligent misrepresentation cannot form the basis of the defense to performance of the contract without a basis for imputing the third party's action to [the party enforcing the contract]. Quoting *Wells Fargo Fin. Leasing, Inc. v. LMT FETTE, Inc.*, 382 F.3d 852 (8<sup>th</sup> Cir. 2004)

Put another way, the fraud of a party or its agent can be asserted as a defense to that party's enforcement of a contract. However, the fraud of an unrelated party which is not imputable to a party to the contract cannot be asserted as a defense.

The Court of Appeals also rejected Hearyman's assertion of mutual mistake, noting that rescission of a contract for mistake is ordinarily founded upon either mutual mistake of the parties or mistake by one induced or contributed to by the other. Quoting *Minnesota Supreme Court in Gethsemane Luthren Church v. Zacho*, 258 Minn. 438, 443-444 (1960). Although the Minnesota Supreme Court has noted that a court can use its equitable powers to rescind the contract purely for a unilateral mistake of one party not induced or contributed to by the other, the Court of Appeals also noted that it is equally clear that in the interest of preserving some reasonable stability in commercial transaction the courts will not set aside contractual obligations, particularly where they are embodied in written contracts, mainly because one of the parties claims to have been ignorant of or misunderstood the provisions of the contract. *Id.*

Lastly, the Court of Appeals rejected Hearyman's claim that the contract is unconscionable stating that it is unconscionable only if it is such as no man in his senses and not under delusion would make it on the one hand, and as no honest and fair man would accept on the other. According to the Appellate Court, there is nothing objectively unconscionable about acquiring equipment through financing or about Hearyman personally agreeing to purchase the equipment for a clinic for which he was Medical Director or personally guaranteeing an obligation of his close personal friend.

***Koch Foods of Alabama, L.L.C. v. General Electric Capital Corporation*, 303 Fed. Appx. 841 (11<sup>th</sup> Cir., December 18, 2008)**

In this case, General Electric Capital Corporation (Lessor) leased a chicken deboning line and spiral freezer to Silvest Farms, Inc. (Lessee). When Lessee went into

bankruptcy, Koch Foods of Alabama (Koch) purchased Lessee's assets at a bankruptcy sale, including the plant in which the equipment was located. At that time, Koch was given the opportunity to assume or reject the equipment lease. Koch chose to reject the lease but continued seamless operation of the processing plant including use of the leased equipment.

When Lessor learned of Koch's use of the equipment, it demanded past and future lease payments and warned that failure to pay would subject Koch to an action for conversion of the equipment. Koch replied with an offer to purchase the equipment. That reply also provided Lessor with permission to enter the plant and remove the equipment if it did not accept Koch's purchase offer so long as Lessor would indemnify Koch for any damage caused by the removal of the equipment. Lessor rejected the offer but never attempted to reclaim the equipment.

After some time, Koch removed the equipment and placed it in an adjacent parking lot in order to install new equipment. Koch then filed a complaint against Lessor asserting that Koch either owned the equipment or, alternatively, that Lessor was liable for storage costs under the doctrine of unjust enrichment.

The Court of Appeals began by analyzing whether or not the equipment constituted a fixture under Alabama Law. The lease contained standard language noting that the equipment shall remain at all times personal property of the Lessor even though it may be attached to real property. The Court notes that under Alabama Law:

the chattel character of a fixture may be retained by an agreement between [two parties] even against third persons purchasing or taking a mortgage upon the land upon which the fixture stands, *bona fide* and without notice of such agreement. *Quoting Mobile Cab and Baggage Co.*, 261 Ala. 242 (Ala. 1954).

According to the Court, the lease between Lessor and Lessee preserved the nature of the equipment as Lessor's personal property under the rule established in the *Mobile Cab* case. As such, Lessor retained ownership and Koch did not acquire ownership in connection with its purchase of the plant.

Koch unsuccessfully attempted to distinguish this line of Alabama precedent by arguing that only a land owner could enter into an agreement preventing chattels from becoming fixtures. However the Court was not forced to address such an argument since, before selling the plant in the bankruptcy sale, Lessee had become the true legal owner of the plant.

The Court ruled against Lessor on its claim for conversion noting that Lessor's failure to repossess the equipment created an implied consent to Koch's retention of it. Lessor asserted that Koch's requirement that it indemnify Koch for any damage caused by a removal was an unreasonable restriction which prevented Lessor from reclaiming the equipment. The Court disagreed, noting that under Alabama Law "if the detachment of

the chattel would occasion some diminution in the value of the freehold, as it would have stood had the detachment not been made, then the depreciation must first be made whole to the land owner, before the right of the chattel owner can be recognized.ö *Quoting Warren v. Liddel*, 110 Ala. 232 (Ala. 1896). As such, the requirement imposed by Koch was already mandated on Lessor as matter of law.

The Court rejected Koch's assertion that it should receive storage costs under a theory of unjust enrichment agreeing with the trial court that: "nothing suggest that [the court] must step in to balance the equities in this case. . . . Unjust enrichment is an old equitable remedy permitting the court in equity in good conscious to disallow one to be unjustly enriched at the expense of another.ö

Since Koch used the deboner without payment for ten months, the Court held that Lessor was not unjustly enriched by Koch's storage of the equipment.

Kenneth P. Weinberg is a founding partner of Marks & Weinberg, PC. He and co-founder, Barry Marks, have significant experience in dealing with virtually every type of equipment and facility lease financing, have participated in leasing financings for more than a billion dollars of equipment and are recognized throughout the industry. Weinberg has written *Dispatches from the Trenches* since 2002, routinely writes articles in a variety of equipment leasing and financing journals, and has participated in numerous seminars on equipment leasing issues. If you would like more cases or articles on leasing, or have any questions or comments about this column or other leasing issues, please visit [www.leaseawyer.com](http://www.leaseawyer.com) or contact Weinberg at 205-251-8307.



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