

DISPATCHES FROM THE TRENCHES

Follow the UCC Road- Searching for a Little Courage

Companies who discount, purchase or otherwise take assignment of equipment leases and the payment streams they evidence (hereinafter referred to as "Funders") sometimes require an executed Notice and Acknowledgment or other similar documentation from the underlying lessees. These Acknowledgments often provide various representations and warranties from the underlying lessees that help confirm the value of the documents being assigned (such as the number of remaining payments and the amount of any purchase option). They also contain a promise from the underlying lessee to pay the Funder instead of the originator directly beginning either on a specified date or immediately after receipt of written notice from the Funder.

In other cases, Funders do not receive any Acknowledgment and the assignment is essentially "blind" to the lessee. There is an increased risk with assignments where the lessee is unaware that the originator has sold the payment stream and/or assigned a lease to a Funder (often called, "blind assignments"). This practice is, however, very common, particularly where reputable originators want to maintain their good lessee relationships or vendors want to keep their private label program hidden from their customers.

This issue of Dispatches from the Trenches analyses some of the statutory framework of the Uniform Commercial Code (the "UCC") which provides some comfort to Funders willing to go blind. It also highlights some of the benefits of Acknowledgments.

Preliminary Definitions and Concepts

Prior to analyzing the applicable UCC provisions, it is helpful for the reader to know a couple of key definitions used in the UCC. First, equipment leases constitute "Chattel Paper" under the UCC, irrespective of whether or not they are true leases or leases intended as security such as a dollar out lease, since Chattel Paper is defined to mean a record or records that evidence both a monetary obligation and a security interest in, or a lease of, specific goods. *See* §9-102(a)(11). An equipment finance agreement or similar documentation is also Chattel Paper.

Next, an "Account Debtor" under the UCC includes any person obligated on Chattel Paper and would therefore include lessees under equipment leases and borrowers under equipment finance agreements. For ease of reference, this edition of Dispatches from the Trenches will generally refer to lessees and borrowers as "Lessees" and to equipment leases and equipment finance agreements as "Leases", although the same general analysis should apply in both cases.

It is also important to understand that many of the provisions of Article 9 of the UCC relating to a Funder's rights in Chattel Paper apply irrespective of whether the assignment constitutes (1) an outright sale of the Lease by the broker or originator to the Funder; (2) a loan from the Funder

to the broker or originator that is secured by the Lease and the underlying equipment on a recourse or non-recourse basis; or (3) a hybrid whether the rent stream is "sold" and a security interest granted only in the equipment (this third option should really exist only in the context of a true lease). See UCC §9-109 and the Official Comments to that Section (noting that Article 9 covers a security interest in Chattel Paper as well as the sale of Chattel Paper); See also UCC §9-102(71)(D)(defining "Secured Party" to include a person to whom Chattel Paper has been sold). The reason for the broad coverage is that it is often very difficult to distinguish a true sale from a grant of security interest in the wacky world of Lease assignments.

Rights of an Funder with respect to the Originator

The UCC provides that a Funder may, after a default by the originator, "notify an account debtor or other person obligated on collateral to make payment or otherwise render performance to or for the benefit of [Funder; and] enforce the obligations of an account debtor or other person obligated on collateral and exercise the rights of the [originator] with respect to the obligation of the account debtor or other person obligated on collateral to make payment or otherwise render performance to the [originator], and with respect to any property that secures the obligations of the account debtor or other person obligated on the collateral." See §9-607.

In other words, Section 9-607 provides a Funder with a statutory right (after default by the originator) to step into the shoes of the originator and enforce the rights that the originator would otherwise have as a lessor or lender under the assigned documents against the underlying Lessee. If the underlying assignment documents specifically provide, a Funder may exercise these rights prior to a default by the originator. *Id.*

The applicable UCC provisions and the related Official Comments make clear that the Funder's rights are broader than the mere right to demand payment and would, for example, allow Funder to enforce a breach-of-warranty claim arising out of a defect in the leased or financed equipment or to bring an injunction against infringement of a patent that constitutes collateral. See Official Comment 3 to §9-607.

It is important to understand that these provisions only relate to the Funder's rights *against the originator*. Different rules create, regulate, or otherwise affect the duties or rights of the actual account debtor (in this case the underlying Lessee) or other person obligated on the collateral. In other words, Section 9-607 prevents an originator from stopping Funder from notifying the Lessee to make payments directly to it after an originator default even if that right has not been granted to Funder within the assignment agreement. However, nothing in that section requires to Lessee to pay the Funder. Those rights are found elsewhere in the UCC and discussed below.

As with any disposition of leased or financed equipment, the concept of "commercial reasonableness" can be intertwined with any collection under a Lease that is assigned. Article 9 specifically notes that, where there is credit recourse to the debtor, the collection must be made in a commercially reasonable manner. The reasoning behind this provision is that: (1) true sales of chattel paper, accounts, payment intangibles, and promissory notes are governed by Article 9; and (2) there is no need to apply the commercial reasonableness standard if the transaction is a true sale without any recourse against the seller/debtor, because the seller/debtor will not be affected by a poor disposition.

Rights of an Funder with respect to the Underlying Lessee

The statutory rights that a Funder relies upon with respect to the underlying Lessee are found in Section 9-406 of Article 9. That provision provides that an account debtor on chattel paper may discharge its obligation by paying the original party entitled to payment (i.e. the originator) until

the account debtor receives proper notification that a different party (i.e. the Funder) should be paid.

Notification is ineffective if it fails to reasonably identify the rights being enforced by the new party. The Account Debtor also has rights to request proof of the Funder's interest. However, once notice and proof of the Funder's rights have been provided to the underlying Lessee, such person may discharge its obligation by paying the [Funder] and may not discharge the obligation by paying the [originator].

Extra Benefits of Acknowledgment

The foregoing provisions should provide courage to Funders who are willing to go blind and discount, purchase or otherwise take assignment of Leases and the payment streams they evidence without receiving an Acknowledgment from the underlying Lessees.

It is still always better to have an Acknowledgment than not. Acknowledgments help confirm key terms of the underlying transaction being assigned. They also serve as extra fraud protection.

Even if a Funder completely trusts the originator's honesty and competency, making the first protections less necessary, the Acknowledgment creates contractual privity between Funder and the Lessee, allowing Funder to sue the Lessee for breach of the Lessee's promises under the Acknowledgment as well as the Lease. Quite simply, it is always easier to waive a piece of paper in front of the Lessee (or the judge for that matter) than to walk people through the applicable Article 9 provisions described above.

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