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DISPATCHES FROM THE TRENCHES

Form or Substance?

Impact of an Assignment prior to a Broker's Bankruptcy; and Claims that a Lessor Misrepresented whether a Lease was a Loan

This issue of Dispatches from the Trenches discusses: (1) whether an assigned lease is part of the assignor's bankruptcy estate; and (2) whether a lessee has a valid cause of action if a lessor misrepresents that the "lease" is really a loan. Mixed goods and services transactions and conflicting choice of law provisions are also mentioned.

Gaia Leasing, LLC, v. Wendelta, Inc. 2009 U.S. Dist. Lexis 115690 (U.S. Dist. Ct., Minn., December 11, 2009)

In this case, the District Court determines whether a lease transaction assigned by a broker prior to its involuntary bankruptcy is part of its bankruptcy estate. Gaia Leasing, LLC ("Assignee") sued Wendelta ("Lessee") for failing to make lease payments when due under a lease originated by LGI Energy Solutions, Inc. ("Lessor").

The Master Lease was executed by Lessor and Lessee on November 10, 2008 but the Lease Schedule contemplated a sixty month lease term beginning on April 1, 2009. Shortly after the Master Lease was executed, Lessor and Assignee entered into an "Agreement for Purchase and Sale of Equipment" and a "Bill of Sale and Assignment". Although the effective date specified in these documents differed, the Court held the difference to be a scrivener's error and the assignment was effective as of November 13, 2008.

Less than a month later, on December 11, 2008, Lessor notified its creditors that it had terminated operations and surrendered its assets to its lenders. In February of 2009, Lessor's creditors forced it into involuntary bankruptcy. One month later, on March 30, 2009, the day before the Term of the Lease Schedule commenced, Lessor notified Lessee of the assignment to Assignee. Lessee refused to make payments and Assignee filed this suit.

Lessee's main defense in this particular suit was that the lease was part of Lessor's bankruptcy estate. If that were true, the District Court would not have jurisdiction over the dispute and Assignee would have violated the automatic stay by bringing its claim against Lessee in the District Court.

The Court found for Assignee with respect to this issue, holding that an absolute assignment occurred in November of 2008. The fact that the transaction between Lessor and Assignee was documented as an outright assignment as opposed to a collateral assignment securing a non-recourse note was crucial to the Court's decision. The Court noted that "[the] absolute

language indicates an immediate assignment from [Lessor] to [Assignee], with no control retained by [Lessor]. As such, the Court held that neither the lease nor the equipment was part of Lessor's bankruptcy estate or protected by the automatic stay.

This case may be enlightening for funders considering whether to document transactions as outright assignments or collateral assignments in situations where the lessor/broker/originator is not retaining any residual interest. Some lessors prefer to document such transactions by taking collateral assignment of the lease as security for the assignor's obligations under a non-recourse note. In such cases, the assignee simply structures the note such that all payments made under the underlying lease, including any balloon, are necessary to fully amortize the non-recourse note. Such an approach may help shield the assignee from a variety of lessor liability claims, including, for example, the type that arise from damages which the leased equipment causes to persons, property or the environment. However, a court is much more likely to view an assignor under a collateral assignment as retaining an interest in the lease or the equipment, making it property of the assignor's estate. A sophisticated Court *should* look beyond the form of assignment to the substance of the transaction to determine whether the assignor retains any interest in the transaction. However, as we have seen in too many cases, in the form sometimes governs over substance when unfamiliar judges analyze the somewhat misunderstood world of leasing.

Later holdings in this dispute may also prove relevant for lessors or funders involved in mixed goods and services transactions. Although the Court does not provide much detail, it notes that Lessor and Lessee also entered into various service agreements and it appears that the equipment and servicing were inter-related. The Court describes Lessor as "an energy-services company [that] provides services and equipment for energy management and monitoring to retail customers." It also notes that Lessor agreed in the services agreements "to provide energy information, utility-bill payment, facility monitoring and control and utility-procurement services" and that the equipment being leased was "energy management equipment" intended to demonstrate savings to the Lessee.

Although not crucial to this particular ruling by the Court, it takes the time to quote what appears to be fairly robust assignment provisions within the lease, acknowledging that the lease: (1) provided that "the terms and conditions of this Lease Agreement have been fixed in anticipation of possible assignment of Lessor's rights under the Agreement and to the Equipment. . . ." and (2) contained a hell-or-high water clause that was specifically for the benefit of Assignee, stating that Lessee will pay all amounts due under the Lease "notwithstanding any defense, set off or counter claim . . . that Lessee shall have against Lessor."

Farnam Street Financial, Inc. v. Pump Media, Inc., 2009 US Dist. Lexis 114146 (U.S. Dist. Ct., Minn., November 23, 2009)

The District Court describes Farnam Street Financial, Inc. ("Lessor") as a typical finance lessor, purchasing equipment for the sole purpose of leasing it to the businesses that selected the equipment in the first place. Pump Media ("Lessee") is a company in the business of providing gas stations with televisions intended to set atop gas pumps and transmit various advertising and other messages. When Lessee missed consecutive payments under the Lease, Lessor sued. Lessee asserted in its defense various claims for usury, common law fraud, unfair business practices, breach of contract, rescission, and declaratory relief. One of Lessee's main arguments was that Lessor fraudulently represented that the transaction between it and Lessee would be a "loan" rather than a "lease."

Before addressing this issue, the Court first determines which state's laws govern. Prior to execution of the Lease, which contained a Minnesota governing law provision, the parties executed a confidentiality agreement which was on Lessee's form and stated that California Law applied. The Court held in favor of Lessor and applied Minnesota law, noting that the lease agreement was clear and unambiguous. The Court emphasizes language in the lease which notes that "[this Lease] and associated documents supersede all prior agreements." Since the Confidentiality Agreement was entered into prior to the Lease, the Court held that it was superseded.

Applying Minnesota law, the Court dismissed Lessee's usury claim since corporations are statutorily barred under Minnesota Law from asserting such a claim. The Court also dismissed the fraud, deceit, misrepresentation and unfair business practice claims since they were all based on allegations by Lessee that Lessor falsely represented itself as providing a loan of money when it really "secretly" intended to provide a lease. According to the Court, the document clearly and unambiguously stated it was a lease and it was impossible for Lessee to have believed that the agreement was anything other than a lease. Additionally, the Court notes that the lease contained a merger clause that precludes the Court from reaching outside the four corners of the document to examine extrinsic evidence in the absence of an ambiguity.

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.leaselawyer.com or contact Weinberg at 205-251-8307.



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