MARKS & WEINBERG, P.C.

# Financial Services, Inc. v. Woodlake Imaging, L.L.C.

2005 WL 331695 (E.D. Pa. Feb. 9, 2005)

The case of **Lyon Financial Services, Inc. v. Woodlake Imaging, L.L.C.**, 2005 WL 331695 (E.D. Pa. Feb. 9, 2005) provides strong language in its analysis of hell and high water clauses contained in Article 2A true leases that should put smiles on the faces of funders of equipment leases. However, it also contains analysis about the potential lack of enforceability of such clauses in Article 9 leases-intended-as-security that may give funders some heartburn.

## *The Case*

This adversarial proceeding arose due to a dispute between Lyon Financial Services (ñLyonò), the assigned successor in bankruptcy to DVI Financial Services, Inc. (ñDVIò), and Woodlake Imaging, L.L.C. (ñLesseeò).

After DVI and Lessee entered into a Master Equipment Lease and Schedule, Lessee received the medical equipment to be leased thereunder and signed a Certificate of Acceptance. DVIôs payments to the vendors under the supply contracts pursuant to which the equipment was purchased for lease by DVI to Lessee were due over time. Approximately one year after entering into the Master Equipment Lease with Lessee, DVI filed for bankruptcy. Until that point, DVI had paid $700,000 of its $983,209 of

total obligations to the vendors under the supply contracts. Lessee, citing DVI's failure to pay the remainder of its obligations to the vendors under the supply contracts, refused to make any further lease payments to DVI. Lyon, DVI's court appointed bankruptcy successor, filed suit against Lessee for the remaining payments due under the lease, relying on the hell and high water provision and related waivers within the lease.

The Master Equipment Lease contained standard language and provided that Lesseeôs obligation to pay rent for the equipment as provided in the lease was "absolute and unconditional, and shall not be subject to any abatement, reduction, setoff, defense, counterclaim, interruption, deferment or recoupment for any reason whatsoever, and that all such payments shall be and continue to be payable in all events.ò In addition, the lease provided that Lessee waived a variety of rights and remedies, including any of those provided under Article 2A of the Uniform Commercial Code in connection with the leased equipment in the event that DVI defaulted on the lease terms.

***Dr. Jekyll***

The court noted that hell or high water provisions in true leases were not only enforceable, but also acknowledged the important role that such clauses play in the industry, particular in the area of lease syndications, stating:

> The essential practical consideration requiring liability as a matter of law in these situations is that these clauses are *essential to the equipment leasing industry.* To deny their effect as a matter of law would seriously chill business in this industry because it is by means of these clauses that a prospective financer-assignee of rental payments is guaranteed a meaningful security for his outright loan to a lessor. Without giving full effect to such clauses, if the equipment were to malfunction, the only

> security for this assignee would be to repossess equipment with a substantially diminished value.

However, the court felt obligated to tie its analysis to Article 2A true leases, stating that ñ[c]ustomarily, Article 2A of the Uniform Commercial Code governs ôhell or high waterô lease provisions [and u]nder Article 2A, such provisions . . . are fully enforceable.ò

Although not specifically mentioned by the Court, it is worth noting that Article 2A highlights the importance of these provisions in the leasing industry by embedding the hell or high water clause into the statute itself. Certain types of Article 2A true leases (defined under the UCC as "finance leases") automatically receive the benefit of a statutory hell or high water clause contained in §§2A-407 and 508 which make lesseesô obligations under Article 2A finance leases (including payment obligations) irrevocable and independent of the lessorsôor suppliersôobligations.

The term "Finance Lease" is defined under Article 2A to be a true lease which "consists of an overall three-party transaction in which: (1) the lessor does not select, manufacture, or supply the goods, (2) the lessor did not own the goods before the lease was arranged, and (3) the lessee either approves the purchase contract or receives specified warranty and supplier information before signing the lease agreement." Ian Shrank and Arnold G. Gough, Equipment Leasing-Leveraged Leasing (PLI 4th ed.,1999), Vol. 1, §3:1.5[C].

***Mr. Hyde***

Lessee noticed (or maybe even influenced through clever briefing) the Courtôs tying of the hell or high water clause to Article 2A leases. As such, Lessee argued that the lease in question constituted a ñlease intended as securityò and that, as such, the hell or high water provision should be governed by UCC Article 9 and was therefore not enforceable. The Court was much more willing to consider this argument than many in the industry

would hope and noted that ñ[i]f the contracts are, in fact, [leases intended as security] rather than [true] leases, then Article 9 would govern the agreements, and the ôhell or high water provisionsô might not be enforceable.ò

Lyon argued that the hell or high water provision is fully enforceable regardless of whether the lease is governed by Article 2A or Article 9. However, the Court noted that ñ[i]n almost all cases cited by Lyon, however, the parties did not dispute that the subject contracts were leases [and that] Lyon has cited only one case in which the court held that it would enforce a ôhell or high waterô provision in favor of an assignee regardless of whether the underlying transaction was a [true] lease or a [lease intended as security.]ò

Since there was not sufficient information before the court at that time to determine whether the lease in question was an Article 2A true lease or an Article 9 lease-intended-as-security, the court refused to rule on the issue at that time.

Many in the industry may be surprised by the Courtôs analysis since the common belief is that lessors can obtain the same sort of hell or high water treatment through contractual provisions located within the lease. Indeed, the UCC provisions are ñmerely codifications of standard commercial leasing practices that previously were achieved by contract rather than by statute." Shrank, *supra* at §3:1.10[A]. However, the only UCC statute which explicitly addresses this issue is found in Article 2A where comment (g) to Section 2A-103 states that ñ[i]f a transaction does not qualify as a finance lease, the parties may achieve the same result by agreement."

One would think that, upon further analysis, the court would reject Lesseeôs contention that hell or high water clauses are unenforceable with respect to Article 9 leases for a variety of reasons. First, commercial entities signing a lease contract should be able to create hell or high water treatment by contract. Second, hell or high water treatment is even more appropriate in the context of an Article 9 leases intended as security since such

contracts essentially operate as straight loans secured by the ñleasedò equipment. No one would argue that a promissory note and security agreement needs a hell or high water provision. Nonetheless, until further analysis by the court, this case evidences a potential willingness by the Mr. Hydes of the justice system to entertain such arguments raised by lessees. Indeed, in this case, the argument cost Lyon the ability to win on summary judgment, thereby resulting in increased legal fees, frustration and heartburn.

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