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Article 2A v. Article 9

Consequences in Equipment Recovery

By Anthony L. Lamm

OF THE MANY tasks counsel are called on to perform, some of the most frequent and pressing involve recovering a lessor's equipment. While the process of equipment recovery can be complicated enough, when the equipment in question has come into the possession of a third party with whom the lessor has no contract, entirely new issues present themselves. This article will explore some of the consequences of a "true lease" versus a "disguised security agreement" in cases where the lessor is seeking to recover equipment from a third party.

In the day-to-day operation of an equipment leasing company, potentially hundreds or thousands of checks arrive from numerous lessees all over the country and are typically processed by the accounts receivable department of the company. As the checks are posted to the respective accounts of the lessees, an alert accounts payable clerk notices that the name on one of the checks is different than the name of the company's lessee. The experienced receivables person makes a copy of the check and brings it to the attention of the collection manager or, in other

cases, puts a copy of the check bearing the name of the different entity or individual into the credit file. In either event, during the course of the term of that particular lease, the account becomes delinquent or a bankruptcy petition filed on behalf of the lessee is received by the company. Now, the credit or collection manager reviewing the account is confronted with several dilemmas:

- Should he or she repossess the equipment from the third party who is not the company's lessee?
- Should he or she request the third party to assume the lease contract?
- What procedural and documentation steps have to be taken by the company, to ensure the collection of the balance of the lease payments and protect the company's rights in the equipment?

The collection manager knows a good collection attorney who represents leasing companies, and contacts the attorney to explain the situation and ask for advice. When the collection manager explains to the attorney

that a check from a third party was received by the company, and the actual lessee filed for bankruptcy, the attorney knows that there are initially two important issues to examine with the company representative, which will determine the eventual outcome of the circumstances involving the third party's possession of the equipment. The first issue is whether the lease contract of the company is really a "true lease" or a lease intended as security, sometimes referred to as a "disguised security agreement."

The second issue is whether the company properly and adequately described their ownership interest and right to possession of the equipment in the lease contract itself, as well as on the UCC-1 financing statements that were filed at the inception of the lease. The analysis of these issues impacts the attorney's recommendation to the company, since available remedies are dependent on an initial determination as to whether the lease contract is a "true lease" or a lease intended as security.

If the lease contract is, in reality, a "disguised security agreement" regardless of the contract's heading or marketing artifices, the Uniform Commercial Code will govern the leasing company's right to file an action in replevin and, if it chooses, to accelerate the replevin process with a motion for writ of seizure.

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The UCC provides that, "unless otherwise agreed, a secured party has, on default, the right to take possession of the collateral." UCC § 9-503(a). Specifically, the Code also authorizes the filing of an action in replevin: "If a secured party elects to proceed by process of law, he may proceed by Writ of Replevin or otherwise." § 9-503(b).

In reviewing the company's "lease contract," the attorney should first review the language of the contract providing who the owner of the equipment is and whether title to the equipment passes to the lessee upon the exercise of a purchase option, after the last payment is made or, at the outset, as in certain cases, such as with a lease for an item of equipment (which is also a motor vehicle) where the equipment is titled in the "lessor's" name. The attorney should also try to determine whether the lease

contract provides for the exclusive right of possession of the equipment to the lessor and/or the lessee until termination or default. To be successful in a replevin action, a plaintiff must show, not only title, but also an exclusive right of immediate possession of property in question as against the defendant. *Ford Motor Credit v. Caizzo*, 387 Pa. Super. 561, 564 A.2d 931 (Pa. Super. 1989).

If the contract was prepared as a lease intended for security, the attorney should look for a provision in the company's contract requiring that, on default, "lessor shall have such rights and remedies in respect of the equipment or any part thereof as are provided by the Uniform Commercial Code and such other rights and remedies in respect thereof which it may have at law or in equity." The attorney may even find, in some better-drafted contracts, a provision for confession of judgment for possession (more typically found in commercial real estate leases but supported by local state rules). These provisions are meaningful in the case of a lease intended as security, because documenting the UCC's application

to the lease intended as security is one of the factors that will entitle the company to prevail against the third party in possession in a contest over priorities, should the third party in possession try to assert a superior lien by virtue of a purchase money security interest in the equipment.

If the company's contract includes provisions that "reserve an exclusive security interest and perfected first lien in the equipment," "prohibit any contracts or subleases" by the lessee or "borrower" and "disclaim the creation of a security interest or a right of possession in third parties by any attempt of such a contract or sublease," there is a strong likelihood of the company's prevailing against the third party, especially if the third-party claims to have a purchase money security interest arising out of a contract with the original lessee or "borrower," because of the existence of the "exclusive right" provision of the contract. "Exclusive right" means a right that excludes the third party from possession, and the clear expression in the contract of the lessor's reserved and exclusive security interest in the equipment, cou-

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Leasing Defeasances Under FAS 25

What You Need to Know About Lease Accounting

By Petter Wendel

IN THE WORLD of leasing, defeasances are becoming more commonplace. Whether through the payment of last month's rent or the establishment of a legal defeasance payment undertaking agreement through an offshore bank, advisers (accounting, financial, legal and others) must have a thorough understanding of defeasance mechanisms. In particular, this article will focus on the accounting aspects of leasing transactions that involve defeasances under Financial Accounting Standard 125 (Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities). A defeasance can be defined simply

as a transaction where a lessee makes a payment to a third party (whether in the form of a deposit or some other sort of agreement, such as a legal defeasance), and that the third party agrees to satisfy the lessee's scheduled payment obligations under the lease (but not the lessee's indemnity obligations). As is the case with most financial concepts, defeasances are best explained through example. As such, this article will focus on three different forms of defeasance, each of which is set forth below.

Leasing transactions are wholly or partially defeased for a number of reasons, including, but not limited to:

(i) Additional lessor security, such

as a security deposit, in case the lessee defaults on its scheduled payment obligations under the lease (or, in some cases, indemnity obligations);

(ii) Avoidance of lessee country withholding taxes in crossborder leases;

(iii) Hedging foreign currency risk when the lease is denominated in a currency other than a currency the lessee has ready access to through its revenue base; or,

(iv) Administrative convenience.

A defeasance of a leasing transaction can take many forms but, for the purposes of this article, the author will discuss the following three types of transactions: (i) a legal defeasance, (ii) an economic defeasance and (iii) a hybrid defeasance. For each transaction, assume that, from the lessee's perspective, the lease will be classified as a capital lease transaction under Financial Accounting Standard 13 (Accounting for Leases) (i.e., for

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pled with the proper filing of a UCC-1 financing statement reflecting that security interest, is evidence of the company's intention to create such an "exclusive right" that should defeat the claim for possession by a third party.

The analysis, however, is not complete at this stage in reaching a determination whether to repossess by legal process or seek an assumption of the contract with the third party in possession. If the third party in possession has moved the company's equipment from the county in which it was originally located and where the UCC-1 financing statements were filed, there may be a problem recovering the equipment by legal process if the third party in possession has filed a UCC-1 financing statement of its own in the county where the equipment has been moved to and the lessor has not refiled its financing statement in that county.

To be sure what the situation is, a UCC search should be conducted in the new county to see if and when a financing statement was filed by the new party, which impairs the lessor's "exclusive right" of possession. In this event, and assuming a number of other facts, including that the account is being paid satisfactorily by the third party who is also otherwise cooperative, and the bankruptcy of the lessee or "borrower" is a liquidation and not a reorganization, assumption of the contract by the third party in possession is, practically speaking, an alternative course of action.

Article 2A of the UCC, governing the rights and remedies of lessors and lessees where the contract is a "true lease," allows for a much easier determination in making a decision whether to repossess by legal process in the case of a third-party possessor than in the case of a lease intended as security, since a lessee under Article

2A does not have any equity in the leased goods and therefore transfers no equity to a third party in possession under the present hypothetical.

Additionally, the defenses to replevin raised by a third party in possession, including breach of warranty and lawful right to possession of the equipment, based on an assumption or transfer of equity, will not survive our company's motion for summary judgment against the third party in possession where the underlying contract is a "true lease" rather than a "disguised security agreement," because Article 2A, and the underlying philosophy of the financial lease transaction embodied in Article 2A, recognize the lessor's ownership and/or title of the equipment, and the lessor's "exclusive right" to possession of the equipment on default, as defined by the lease contract itself and Article 2A. ■