

Credit Protection in Today's Precarious Economy

When advising equipment lessors, legal professionals are frequently asked the question, "How can I do this deal, but tie it up so that the lessee has no way to get out of its obligation?" The answer to this question often lies in the terms and conditions of the lease documents, which require the lessee to provide industry specific information along with financial data.

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Frequently in precarious economic times or with a marginal credit, credit managers come to their legal departments or outside counsel and pose this question, "How can I do this deal, but tie it up so that the lessee has no way to get out of its obligation?" Many of us in the legal profession have been asked this question. To provide guidance in these circumstances, one of the most helpful ways to respond is to inquire of the credit manager, what are the particular terms of the deal and how are they expressed in the proposed lease contract such as:

- What is the collateral?
- What is the nature of the lessee's business — is there any other equipment or other assets that could serve as additional collateral for the deal?
- Are there guarantors?
- Is there a purchase option? If so, what are its terms? Is it a guaranteed purchase option at a negotiated purchase price, fair market value or nominal purchase option price? Is there a program agreement or assignment between the initiating lessor? Is there an agreement between the vendor or supplier and lessor (that might provide for recourse in the event of the default by the lessee)?
- Is there an escalating rent payment clause for the period commencing as of the expiration date of the original lease term?
- Does the jurisdiction clause of the lease provide for commencing a lawsuit for the repayment of the lease or the recovery of the equipment in lessor's local jurisdiction?
- To the extent that the lessor's jurisdiction permits consent to judgment or confession of judgment clause, would the lessee agree to include this type of provision in the lease?

These type of questions and a discussion involving documenting in advance how to provide for a remedy in circumstances that are not anticipated is beneficial because the lessor may learn that there is a means of recourse or remedies available to it that can be used as additional protection in a difficult economic climate or with a struggling lessee. Common sense compels the lessor to understand that if the lessee is a marginal credit risk, then it is likely that other financial sources will also require additional precautionary remedies. Therefore, asking for provisions such as the ones listed above should not offend or surprise a lessee under these circumstances.

Some perspective in providing for additional credit protection must be given to the business deal itself. If the term of the lease or the structure of the residual does not meet accounting principals and guidelines, your lessee may determine that the lease structure while attractive, does not meet its business purposes. One of the methods, therefore, to introduce credit support in a deal without altering or making the business terms too restrictive is to include additional protections through the language of the lease or loan document and expanding the default section of the contract.

There are numerous occasions that I can recount providing counsel to credit managers and collection professionals who were experiencing "forty-five day remorse" where a lessee, whose credit caused the manager or other professional serious concern at the outset, defaulted on the first payment or leaked some piece of information that suggested serious trouble. When faced with a problem like this, I first ask the credit manager or credit professional to see the default provisions of their lease. Sometimes it is possible to declare a default under the lease if a particular event has occurred that was addressed in this section of the lease. A strong argument in court can always be made that specific events of default (rather than broad and general language) were subject to negotiation by their particular nature and, therefore, are enforceable. Some of the provisions I like to use include:

- A provision making it a breach of the lease if the ownership of a company changes in whole or in part.
- A provision that makes it an event of default where a breach of any other agreement between the lessee and lessor has occurred.
- A provision, that any representation, warranty or signature to the lease made by any guarantor of lessee's obligation or given in any document or delivered to lessor in connection with the lease which turns out to be false or misleading in any material respect when made.
- A provision that any breach by or the insolvency of any guarantor to the lease constitutes an event of default.
- A provision making it an event of default if the lessee suffers a material adverse change in its financial condition, business, operations or assets and, as a result, lessor deems itself or any of its equipment to be insecure.

The above-listed provisions are a few examples of literally dozens of specific events of default that become useful when the credit manager or other risk professional arrives at your office and requests your advice how to terminate a lease with one of his or her customers and pursue the recovery of the debt and/or equipment.

Many times I counsel clients to include terms and conditions for the lease documentation that require the lessee to provide specific financial information applicable to the lessee's type of business or industry, in addition to, financial statements, balance sheets, income and cash flow statements and tax returns. It is usually recommended that a specific date for when this information should be provided be required in the lease. Moreover, the use of specific financial covenants that allow the lessor an opportunity to periodically evaluate the performance of a lessee in determining whether lessee (in lessor's opinion) is capable of maintaining payments for the equipment is a very effective means of providing an escape clause so long as the covenants are reasonable and consistent with lessee's credit application and other financial information provided to the lessor.

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There are many other customer specific covenants and representations that can be included in the actual lease document or a rider that can benefit the lessor when leverage is required to compel a lessee's performance with the terms and conditions of the agreement. The risk manager or credit professional must spend time with the company lawyer or outside counsel to describe in detail the nature of the lessee's business in order to draft such custom covenants. For example, in learning that the lessee is in the business of re-letting leased equipment to sub-lessee (if this kind of business arrangement is permitted by lessor), a covenant can be prepared which would grant to the lessor the right to collect all of the lessee's payments from its sub-lessees (and requiring the lessee to provide the lessor with its customer locations, telephone numbers and contacts).

Another example of a specific provision that can add leverage for equipment recovery is a clause known as Judgment for Possession. This particular provision is similar to a Confession of Judgment for lease payments, but as its title suggests, entitles the lessor upon a default by the lessee to enter an uncontested judgment for possession of the leased equipment. Even though there may be some practical issues that can arise in implementing this kind of judgment in different jurisdictions, a provision such as this that provides for a consensual seizure of equipment gives the lessor a stranglehold on the lessee.

Also, a Maintenance Rider to a lease, which requires a lessee to permit interim inspection and establishes maintenance criteria for parts and structure of the equipment is a useful provision. Much information can be learned about the lessee's general business situation from an interim inspection and like most of the other terms and conditions that I have suggested, impart at the inception of the lease that, as the lessor you are going to be monitoring the lessee's performance which ultimately can result in the lessee deciding to pay you before someone else. **m**

ANTHONY L. LAMM, Esquire became a named partner in the law firm of Groen, Lamm, Goldberg & Rubenstone, LLC on June 1, 2002. The firm has offices in Montgomery and Bucks County, Pennsylvania and in New Jersey. A significant part of the firm's practice is dedicated to representing equipment lessors and lending institutions in the documentation and enforcement of creditor's rights.