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DECISION OF NOTE

Court Refuses To Rewrite 'Front-End Loaded' Leases

By Jeffrey N. Rich

If an equipment lessor believes that a bankruptcy filing by a prospective lessee is imminent, it must consider all the implications in the event that a bankruptcy case is filed.

This point was the focus of a recent decision by the U.S. Bankruptcy Court for the Northern District of Ohio, which in *In re Republic Technologies Int'l, LLC*, 267 B.R. 548 (Bankr. N.D.Ohio 2001), held that Bankruptcy Code § 365(d)(10) does not require a debtor to make postpetition lease payments where all the lease payments are "front-end loaded" and due prepetition under the terms of the lease.

The *Republic Technologies* decision is a good example of the varying factors that a lessor must consider when negotiating lease terms with companies in financial distress. The facts of this case are an example of how an equipment lessor can outsmart itself by seeking to front load the payments without closely monitoring the situation.

In *Republic*, the debtor had entered into two lease extensions with its equipment lessor prior to the commencement of its bankruptcy case. Each lease extension provided for four "front-end loaded" payments to be paid by the debtor during the first four months of the extended term, with no lease payments due during the remainder of the term. The debtor

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PRACTICE TIPS

Effect of Revised UCC Article 9 On the Small-Ticket Lessor

By Anthony L. Lamm and Michael J. Witt

Remember suffering through Article 9 of the Uniform Commercial Code in law school? It was dry, technical, tedious and replete with cross-references and complex phraseology. You therefore probably shuddered when you learned earlier this year that Article 9 was being substantially revamped, requiring the education process to begin anew.

If you are counsel to secured creditors, though, you can draw at least some measure of solace from the fact that the revisions, for the most part, are helpful to your clients. The expressed hope of the drafters, at least, was to simplify and clarify the rules governing the creation, perfection, priority and enforcement of security interests.

The revised Article 9, which has been enacted into law in all states and the District of Columbia, will affect commercial equipment lessors in a variety of important ways. Although many of the changes will be of help to the lessor, others present potential pitfalls to the unwary and to lessors who do not make appropriate revisions to their lease documents. This article will discuss some of the major revisions that have been made to Article 9 and then suggest a few key changes that small-ticket lessors should consider making to their standard lease documentation. Of course, the following should not be relied on as a substitute for independent review of the full text of the revisions by the lessor's counsel.

Threshhold Question: Is It a 'True' Lease or a Secured Transaction?

As a preliminary matter, it's important to recognize that Article 9 does not apply to "true" leases. True leases are governed instead by Article 2A of the UCC. It is beyond the scope of this article to discuss all the technical differences between a true lease and an Article 9 "lease" (sometimes also referred to as a "lease intended as security" or a "conditional sale disguised as a lease")[1]. As a general matter, though, most "leases" in which the lessee has the option to purchase the equipment for $1 or another nominal consideration at the end of a noncancelable term will be subject to Article 9 and not Article 2A, while most transactions in which the lessee has no purchase option, a fair- market-value purchase option, or a purchase option in an amount representing a substantial portion of the original equipment cost will be governed by Article 2A and not Article 9.

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For most small-ticket lessors, it is not feasible to have two separate sets of lease documents—one for Article 2A leases, the other for Article 9 leases. Moreover, there would be a certain amount of risk involved in having two different document sets, as some transactions will fall in the "gray" area between true and nontrue lease status and it is not practical to have the documents reviewed by counsel prior to funding. With few exceptions, small-ticket lease forms that are intended to be completed by sales representatives or other nonlawyers should be drafted sufficiently broad to cover either type of transaction. In this regard, the lessor should consider including a "catch all" provision similar to the following:

> Lessor and Lessee agree that this is a true lease and a statutory "finance lease" and shall be governed by Article 2A of the Uniform Commercial Code as enacted in the State of [lessor's principal place of business]. However, in the event this is determined to be other than a true lease and a statutory finance lease, then Lessee shall be deemed to have granted, and does hereby grant, to Lessor a first priority security interest in the equipment, including, without limitation, all fixtures and other property comprising the same, all software embedded therein, all attachments, accessories, additions, accessions, substitutions and replacements relating thereto, all permitted subleases, accounts, chattel paper, security deposits and other collateral relating thereto, and any and all insurance and other proceeds of the foregoing (collectively, the "collateral").

The discussion will now turn to the major revisions to Article 9 and related drafting considerations. Again, it is perfectly acceptable for small-ticket lessors to include "Article 9" clauses in lease forms that are also used for true-lease transactions.

Place for Filing UCC Statements

Under the new Article 9, security interests in equipment are still perfected by filing UCC statements, but the place for filing is now the "location" of the lessee rather than of the equipment. If the lessee is an individual (including owners of sole proprietorships), the location is his or her principal residence. § 9-307(b)(i). If the lessee is an entity that was created by filing a formal document with a state, such as a corporation, limited liability company or registered partnership, the location is that state. § 9-307(e). If the lessee is an entity that was not created by a filing, such as a nonregistered partnership or association,

Anthony L. Lamm is a partner with Groen, Laveson, Goldberg & Rubenstone, LLC, with offices in Bensalem and Jenkintown, Pa., and Cherry Hill, N.J. He chairs the creditors rights and leasing department. Telephone: (215) 638-9330. **Michael J. Witt** was formerly senior vice president and general counsel of Advanta Business Services, a small-ticket lessor, and is now associated with Groen Laveson.

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Telephone: (800) 537-2128
Editorial e-mail: *mbopkins@amlaw.com*
Circulation e-mail: *circ@amlaw.com*

the location will be the state of its chief executive office. § 9-307(b).

Lessors should understand that these new filing rules can lead to counterintuitive results. For example, take the case of a corporation that has its one and only office in California and all the leased equipment is located there. Assume it was incorporated in Delaware but has no "physical" contacts there. Nevertheless, Delaware would be the only proper place to file.

Note also that except for fixture filings, which must be filed in the office for recording of a mortgage on the related real property, filings are to be made in a single, central office in the state. The "dual filing" system that existed in some states under former Article 9 (under which financing statements were filed both centrally and in the county or parish in which the equipment was located) no longer exists.

Lessors should consider including in their lease form a representation and warranty relating to the lessee's "location," such as the following:

> Each of Lessee and the people signing this Lease on behalf of Lessee hereby represents and warrants to Lessor that: (i) if Lessee is an individual (including the owner of a sole proprietorship), the location of his or her principal residence is correctly stated on page one of this Lease; (ii) if Lessee is a registered entity and not an individual, it is duly organized, validly existing and in good standing under the laws of the State identified on page one of this Lease and its organizational number assigned to Lessee by such State is correctly stated there; and (iii) if Lessee is neither a registered entity nor an individual, its chief executive office is correctly stated on page one of this Lease.

Requiring the person signing the lease to join in this representation/warranty provides an added level of assurance to the lessor that its filing will be made in the proper jurisdiction. (In larger-ticket transactions, representations made by officials within the lessee's organization are typically made in an ancillary document, such as an officer's certificate, but in smaller transactions this is usually not feasible.)

Of course, there is no substitute for independent, pre-transaction due diligence. Wherever possible, the person responsible for documenting the transaction should ask the lessee to provide documentary proof of its "location." In the case of an individual, this might be a copy of a recent real estate tax bill or driver's license. In the case of a corporation or limited liability company, it might be a certified or file-stamped copy of its certificate of organization or other registration papers. This information is also available by contacting the department of the state government in charge of business filings. Many states have web sites where this information can be obtained for a small fee.

Lessee's Name on UCC Statement

Under revised Article 9, it is critical that the lessee's name be correctly stated on the financing statement. Unless the filing office's computer or other searching system is capable of picking up the name in a search, the filing will be ineffective. §§ 9-503(a) and 9-506(c). Lessors should consider adding the following clause to the representation/warranty suggested herein:

> (iv) Lessee's true, correct and complete legal name is stated on page one of this Lease.

It is important that those individuals in the lessor's organization who are responsible for preparing and filing UCC statements understand the importance of getting the name correct. For example, if the registered name of the lessee is "ABC Corp.," it should not be written as "ABC Corporation." In addition, fictitious trade names or "doing business as" names should not be included in the "Lessee's Name" section of the financing statements.

Lessee Authorization to File UCCs in Its Name as the 'Debtor'

Under former Article 9, it was necessary to secure the lessee's signature on the original UCC-1 financing statement or to obtain a formal power of attorney (which was typically included in the lease agreement itself) authorizing the lessor to sign the statement on the lessee's behalf. The new Article 9 allows this procedure to be significantly streamlined. The term "record" replaces the old term "writing," allowing filings to be done either in a written document or through electronic means. § 9-102(a)(69). In addition, the defined term "authenticate" has been added, allowing for manual or electronic signatures. § 9-102(a)(7). Lessors desiring to take advantage of these liberalized filing rules should consider revising their lease forms by including a provision similar to the following:

> Upon Lessor's request, Lessee shall promptly execute or otherwise authenticate and deliver to Lessor UCC financing statements (including, without limitation, amended and continuation statements, as appropriate in Lessor's sole determination) covering the equipment and any other collateral. In addition, to the extent permitted by law, Lessee hereby authorizes Lessor to file such financing statements without Lessee's signature or authentication.

Note, however, that if the lessor desires to file a financing statement prior to the time the lessee executes the lease, separate written authorization should first be obtained from the lessee (or the lessee may manually sign the financing statement itself).

Financing Statement Amendments

Sometimes an original filing will need to be amended. The most common examples of events requiring an amendment are discussed below.

If the lessee changes its name and such change makes the original filing "seriously misleading," the lessor must file an amended financing statement within four months following the name change or he will be unperfected as to any collateral added or substituted after the four-month period. (However, the lessor will remain perfected as to all equipment actually covered by the original financing statement or acquired during the four-month period.) See § 9-507(c).

If the lessee is a registered entity and, subsequent to the original filing, reorganizes under the laws of a different state, a new financing statement must be filed in the new state within one year following the reorganization. § 9-316(a)(3).

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If a nonregistered entity moves its chief executive office to a new state, the lessor will have up to four months to reperfect by filing in the new state. See § 9-316, Official Comment 2.

In addition, if the lease is assigned or otherwise transferred to (i) a r egistered entity organized under the laws of a different state or (ii) an unregistered entity whose chief executive office is located in a different state, the lessor will have one year to reperfect by filing in the new state. § 9-316(a)(3).

Unless the lessor reperfects within the "safe-harbor" periods discussed previously, it will become unperfected prospectively as to other equipment lienholders, and retroactively as to purchasers-for-value, but not as to lien creditors (for example, a bankruptcy trustee). § 9-316(b). See also Official Comment 3 to § 9-316.

Under the former Article 9, the creation and perfection of a security interest in computer hardware did not automatically extend to the software embedded in the hardware. Under the revised code, all embedded software is automatically included in a filing covering "equipment." §§ 102(a)(44) and (75).

It must be remembered, however, that in most cases, the software "purchased" by the lessor for lease to the lessee is subject to the software developer's license. In many cases, the computer vendor issues the license directly to the lessee. In other cases, lessors will ask the vendor to issue the license in the lessor's name. In either case, following a repossession of the hardware and software, the lessor will need to obtain permission from the licensor (the software developer) before selling or releasing the software to a third party.

Purchase-Money Security Interests

Under the new code, a lessor purchasing equipment for lease to a lessee will automatically have priority over a prior-filed "blanket" security interest covering the lessee's "after acquired" equipment if the lessor files its financing statement within 20 days after the lessee "received possession" of the equipment. § 324(a). Under the prior code as enacted in some states, the lessor only had 10 days to file.

As under the prior law, lessors need to pay particular attention to the exact date the equipment is delivered. It is not uncommon for the equipment vendor to deliver the equipment prior to the date on which the lessor funds the transaction. In most small-ticket leasing companies, the lease file does not move to the UCC filing stage until after the vendor is funded and the lease is "booked." The representatives of the leasing company who are dealing with the vendor during the pre-funding stage need to be aware of these timing issues. In addition, it is advisable for the lessor to confirm the exact delivery date during the verbal delivery-and-acceptance confirmation with the lessee.

When does the lessee "receive possession" of equipment that is delivered and installed in stages? The revised code, unlike the former code, provides guidance. In Official Comment 3 to § 9-324, the drafters suggest that the lessee would be considered to have received possession at such time as it would be apparent to a lender that the lessee has acquired an interest in the equipment "taken as a whole." Although this is not a bright-line test, it is an improvement over the prior code.

Under the prior law, some courts held that a purchase-money security interest would lose its purchase-money status if the lease obligations were also secured by nonpurchase money collateral. This was referred to as the "transformation rule." The new law definitively rejects those prior decisions. § 103(f); see also Official Comment 7 to § 9-103.

Disposition of the Equipment Following Default

The new code contains a number of improved provisions relating to lease enforcement, particularly in the area of equipment remarketing. The new law, like the old, requires the lessor to use "commercially reasonable" efforts to remarket the equipment following a repossession. § 9-610(b) (following former § 9-504). Under the prior law, however, some courts held that the lessor was entirely barred from recovering a deficiency judgment if his re-marketing of the equipment was conducted in a commercially unreasonable manner. Probably the most common example was the lessor who sold the equipment for an amount less than its fair market value. Under the new law, on the other hand, the lessor's failure to use commercial reasonableness may reduce the amount of the deficiency but may not be cited as an absolute bar. § 9-626(a)(3). See also §§ 9-627(a) and 9-610(b). (The amount of the reduction will be equal to the additional amount that would have been received had the lessor adhered to the commercial reasonableness standard. See Official Comment 3 to § 9-626.)

Note also, under the new law, that any "noncash" proceeds received from re-marketing, such as a new lease or an installment sale contract, will not have to be applied to the original lessee's deficiency balance until the lessor actually receives cash payments from the new lessee or installment purchaser, unless it is commercially unreasonable not to make an immediate application of such future payments. § 9-615(c).

The new law also addresses some of the pre-revision case law that had held that the lessor had an absolute duty to refurbish or otherwise prepare the collateral for disposition. Under the new code, the lessor need not invest time or money refurbishing unless, considering the costs and probable benefits and the risk of recouping those costs, "it would be commercially unreasonable to dispose of [the collateral] in that condition." §9-610(a).

Another improvement over the old law is that the lessor will now be entitled to a "rebuttable presumption" that the disposition of the equipment was done in a commercially reasonable manner. § 9-626(a). Unless the lessee raises the issue, the lessor will not have the burden of proving commercial reasonableness. This will make it easier, generally, for lessors to obtain summary judgment or default judgment. § 9-626(a)(5).

Note, however, that the new code limits the enforceability of lease clauses that waive certain rights of a lessee or secondary obligor (for example, a personal guarantor) or

waive certain duties of the lessor in exercising his default remedies. § 9-602. Specifically, neither the lessee nor any secondary obligor may waive the lessee's obligation to dispose of the collateral in a commercially reasonable manner (§ 9-610(b)) or to provide notice of a disposition to the lessee and secondary obligor (§ 9-611). In addition, the lessor's duty not to breach the peace when repossessing the collateral is nonwaivable. §§ 9-602(6) and 9-609(b)(2). The parties may, however, stipulate to standards that define "commercial reasonableness" provided only that such standards are not "manifestly unreasonable" or allow a breach of the peace. § 9-603.

Under the new code (and notwithstanding any contrary provision in the lease), the lessee must give notice of "foreclosure" sales not only to the secondary obligors (§ 9-611(c)), but also to other secured parties of record (§ 9-611(b)). A suggested form of notice to other secured parties is set forth in § 9-613(5). Identifying other secured parties requires the lessor to conduct a UCC search in the state of the lessee's "location." Search costs can sometimes be expensive and may not always be feasible for the small-ticket lessor. In such cases, the lessor should weigh the risks of not notifying other secured parties against the benefits of avoiding a search.

There is no doubt that the new Article 9 will afford equipment lessors greater certainty and predictability in nontrue lease financing transactions. It is hoped that the changes will lower administrative and other transaction costs and, thus, reduce the cost of lease credit over time. Lessors who have not already done so should revise their standard lease documents to reflect the new law. Failure to do so not only will expose them to greater risks, but also put them at a competitive disadvantage relative to the rest of the industry.

(1) Sec. 1-201(37) of the UCC sets forth the factors that are considered in determining whether a transaction is a true lease subject to Article 2A or a secured financing subject to Article 9. Note that merely calling a transaction a "lease" in the documents is not sufficient to make the transaction a true lease.

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SECURED CREDITORS

What Does Consent by a Secured Creditor to a Sale of Assets Really Mean?

By Leslie A. Berkoff and Marc L. Hamroff

Chapter 11 filings often take place to facilitate a sale of select assets of a business or to orchestrate an entire sale of a company or business unit. Due to the existence of extensive secured debt or the nature of unsecured payables, buyers often require from sellers a "clean bill of health" in the form of a Bankruptcy Court Order approving the sale of assets free and clear of liens and encumbrances.

The sale of assets in bankruptcy may occur in the first few weeks of a case on motion papers served to all creditors. Vigilance by secured creditors is crucial to ensure that the interest in collateral sought to be sold is protected. For purposes of this article secured creditors include equipment lessors whose leases are leases intended as security as defined in UCC § 1-201(37)(a).

In general, the provisions of the Bankruptcy Code offer debtors an opportunity to facilitate certain transactions more expeditiously and freely in the context of a bankruptcy case than would ordinarily be possible. Among these opportunities is the ability to sell property of the debtor's estate (as defined in § 541 of the Code) free and clear of liens, provided that certain requirements are met and certain facts established. Specifically, § 363(f) allows for the sale of property of a debtor's property free and clear of liens in certain limited circumstances. The Code provides:

> The Trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of any entity other than the estate, only if—
>
> (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
>
> (2) such entity consents;
>
> (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
>
> (4) such interest is in bona fide dispute; or
>
> (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

11 U.S.C. § 363(f). (In the context of a Chapter 11, trustee includes the debtor.)

This article will only focus on Subsection 363(f)(2) and the question of what constitutes "consent" by a secured creditor to sale, and whether silence or inaction by the secured creditor can be deemed consent.

In *In re Roberts*, 249 B.R. 152 (Bankr. W.D. Mich. 2000), it was argued that the failure by the secured parties to object to a proposed sale of property free and clear of liens, claims and encumbrances constituted "implied consent" that was sufficient to satisfy the requirements of § 363(f) in authorizing a sale of assets free and clear of liens, claims and encumbrances.

Several courts have held that the consent required by § 363(f)(2) may be implied by the lienholders' failure to object after notice. See, e.g., *In re James*, 203 B.R. 449, 453-54 (Bankr. W.D. Mo.1997); *Hargrave v. Township of Pemberton (In re Tabone Inc.)*, 175 B.R. 855, 858 (Bankr. D.N.J. 1994); *In re Shary*, 152 B.R. 724, 725-26 (Bankr. N.D. Ohio 1993); *Citicorp Homeowners Services Inc. v. Elliot (In re Elliot)*, 94 B.R. 343, 345-46 (E.D. Pa. 1988); *Pelican Homestead v. Wooten (In re Gabel)*, 61 B.R. 661, 667 (Bankr. W.D. La. 1985).

The court in *Roberts* rejected this analysis, finding a lack of support

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Leslie A. Berkoff and **Marc L. Hamroff** are partners with the firm of Moritt, Hock, Hamroff & Horowitz, LLP, Garden City, N.Y.