

# **THE EXECUTIVE'S GUIDE TO REMEDIES**

EQUIPMENT LEASING AND FINANCE ASSOCIATION

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## INTRODUCTION

The Legal Committee of the Equipment Leasing and Finance Association (ELFA) first published the Executive's Guide to Remedies along with a companion Executive's Guide to Lease Documentation in 1994. The Guides provide leasing executives and others involved in the commercial equipment finance industry in the United States with a comprehensive overview of the major issues specific to leasing and ranging from documentation through administration and enforcement. The Guides are a general overview and do not provide information about specialized equipment leasing (i.e. railcars, aircraft, and vehicles) or about international transactions or practices.

Business practices and the law applicable to commercial equipment leasing have evolved since the original publication of the Guides in 1994. Accordingly, the Legal Committee has updated and revised the Guides with the assistance of experienced and knowledgeable leasing industry attorneys. Nevertheless, it is impossible to discuss in adequate detail the many issues that may arise during negotiation, drafting, administration, or enforcement of equipment lease agreements and related documents. The Guides are not intended to be an exhaustive review of all issues arising in equipment leasing. The Guides should be consulted only for a general explanation of terms and practices used in the equipment leasing industry. A careful leasing executive will confer with in-house or outside counsel for expert advice on specific issues arising in equipment lease transactions. There is no substitute for sound legal advice on the specifics of any given transaction and the reader is encouraged to seek such advice.

ELFA, the Legal Committee, and the editors and authors of these Guides hope you find them useful and accessible tools, and that they prove to be a benefit to the equipment finance industry at large.

**Teresa D. Davidson**  
Chairman, 2007 Legal Committee  
July 2, 2007

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**Teresa D. Davidson**  
Chairman, 2007 Legal Committee  
July 2, 2007

## **DISCLAIMER**

This publication is intended to provide general information regarding commercial equipment leasing in the United States. The Guide does not address consumer or international transactions. Neither the Equipment Leasing and Finance Association nor the various authors or editors intend for this publication to be construed as offering any legal advice or a legal opinion on any specific laws, transactions, facts, circumstances, practices, or documents. As leasing transactions vary dramatically depending on a number of factors, including the type of equipment, the negotiated economics of the transaction, and applicable state laws this publication is not intended to serve as a definitive or exhaustive authority. The readers of this publication should consult with their own attorneys regarding any questions.

## **1. LEASE AGREEMENTS AND VARIOUS LEGAL DOCTRINES**

### **I. LESSOR'S QUALIFICATION TO CONDUCT BUSINESS IN APPLICABLE JURISDICTIONS**

A lessor is automatically qualified to transact business in the jurisdiction in which it was organized but may need to take additional steps to qualify to conduct business in other states. Such steps often include appointing a local (or “**resident**”) agent to accept service of process and filing certain corporate and tax reports with the relevant governmental authorities on a periodic basis.

A lessor may be subject to various fines and penalties if it fails to qualify to conduct business in a foreign state when required. In addition, the lessor may be prohibited from using the court system of that jurisdiction to commence an action against the lessee, any guarantors or other third-party obligors, and their respective assets until the lessor qualifies to do business in that jurisdiction.

Most states will permit a lessor that has failed to qualify to transact business in their jurisdictions to rectify that problem after the fact by completing the required forms and paying a fee or penalty. Some states may prohibit a lessor from enforcing any lease documents that were executed prior to the date on which the lessor became qualified to transact business in their jurisdictions.

A lessor also may wish to ensure that the lessee is qualified to transact business in all appropriate states. Such actions may be necessary to permit the lessor to enforce its rights under any sublease or other arrangements made by the lessee with respect to the leased equipment.

The general test for ascertaining whether a lessor or lessee is required to qualify to conduct business in a foreign jurisdiction is whether the applicable party repeatedly transacts business in that state. However, the requirements for qualification may vary in different jurisdictions, and lessors should consult with legal counsel regarding the qualification requirements of a particular state.

### **II. AUTHORITY OF LESSEE AND OTHER PARTIES TO ENTER INTO TRANSACTIONS**

A lessee, guarantor, or other third-party obligor may seek to avoid performing its obligations by asserting that: (a) the execution and performance of the party's actions under the lease documents were not authorized by its organizational documents; or (b) the individual who executed the lease documents on behalf of the party was not authorized to do so. These objections may be rejected by a court using a variety of legal doctrines such as apparent authority, estoppel, ratification, and waiver.

Many lessors take certain steps prior to the execution of the lease documents to anticipate and prevent the assertion of such defenses. These steps may include conducting a thorough review of the organizational documents of the lessee, guarantor, or other third-party obligor and obtaining various certificates from the owners or agents

of those entities.

A review of the organizational documents for a corporation includes an examination of its filed articles of incorporation, bylaws, any amendments, modifications, replacements, or substitutions to the articles of incorporation or bylaws, and the corporate stock records.

The lessor may require the secretary (or assistant secretary or other officer) for the obligor to execute a certificate which confirms that a specific resolution authorizing the relevant transactions was approved by the board of directors for that entity and identifies the individuals authorized to execute the lease agreement and related documents on behalf of that party. The certificate from the secretary or assistant secretary also may contain specimen signatures for the persons who have been approved to sign the lease documents and other information pertinent to the transaction.

Depending on state law and/or the organizational documents, the shareholders as well as the board of directors may be required to approve a corporation's guaranty or collateralization of an obligation owed by a shareholder, director, or officer of that entity. Depending on the circumstances, enforceability issues may arise whenever a lease agreement is guaranteed or secured by a third party, including a sister company or subsidiary of the lessee. A prudent lessor may wish to review the laws of the applicable state and consult with legal counsel whenever a lease transaction involves two or more other parties.

A review of the organizational documents for a partnership includes an examination of the filed certificate of limited partnership (only for limited partnerships), the partnership agreement, if any, and any amendments, modifications, replacements or substitutions to those documents. Lessors also may require the partners of a general partnership or the general partners of a limited partnership to execute a certificate which addresses the same types of issues as the secretary's certificate for a corporation.

Lessors may perform similar due diligence with respect to a limited liability company. A review of the organizational documents for a limited liability company includes an examination of the filed certificate of authority, the operating agreement, if any, and any amendments, modifications, replacements, or substitutions to those documents. In addition, the lessor may require the members (or the managers or other authorized person) of the limited liability company to execute a certificate similar to the type of document provided by the partners of a general or limited partnership.

Depending on the type of transaction, a lessor may require that an opinion letter be issued by the attorneys for the lessee, guarantor, or other third-party obligors. The opinion would, among other things, confirm that those parties were duly organized, are validly existing, are authorized to enter into the proposed transactions with the lessor, and are authorized to execute and will be bound by the terms and conditions set forth in the lease documents under applicable law. However, the economics of small-ticket transactions may prevent the lessor from even reviewing the organizational documents

of the various parties, much less obtaining an opinion letter.

### III. TRUE LEASES VS. LEASES INTENDED AS SECURITY

To a great extent, the rights and remedies available to an equipment lessor are dependent upon whether the lease agreement is construed to be a “*true lease*” or a “*lease intended as security*” (which also may be referred to as a “*dirty lease*,” “*dollar-out lease*,” “*security lease*” or “*financing lease*”). While true leases are governed by a version of Article 2A of the Uniform Commercial Code (the “**UCC**”) in forty-nine states, the District of Columbia, and the U.S. Virgin Islands (Louisiana and the Commonwealth of Puerto Rico have not adopted Article 2A), leases intended as security are merely disguised security agreements and are governed by Article 9 of the UCC. Unless noted otherwise when the term “lease” is used in this Guide, it refers to a “true lease” under Article 2A.<sup>1</sup>

Whether a transaction creates a true lease or a lease intended as security is determined by the facts of each transaction. Courts turn to the applicable state’s version of the UCC and the definition of “security interest” under UCC §§ 1-201(35) and 1-203 (lease distinguished from security interest). Some courts have interpreted these sections as establishing a two-part test for determining whether a transaction creates a lease or a security interest. The first part of the analysis is a bright-line test, sometimes referred to as a “*per se*” rule. The second part, which usually is performed by a court only if the bright-line test does not support the re-characterization of a purported lease, compels a court to look to the particular facts to determine whether the economics of the transaction suggest that the transaction is more fairly characterized as a lease or a secured financing arrangement.

#### 1. The First Level of Analysis: The Bright-Line Test.

Under the bright-line test, a transaction creates a security interest if (i) the lessee does not have the right to terminate the lease prior to the end of its term **AND** (ii) any one of the following four factors is present:

- a. the original term of the lease is equal to or greater than the remaining economic life of the leased equipment;
- b. the lessee is bound to renew the lease for the remaining economic life of the leased equipment or is bound to become the owner of such equipment;

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<sup>1</sup> Article 2A of the UCC is the legal framework for equipment leasing. Article 2A was completed by the National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute (ALI) in 1987 and amended by these bodies in 1990. As of November 2014, South Dakota had enacted the 1987 version and all of the remaining jurisdictions (except Louisiana and Puerto Rico) had adopted the 1990 version (with whatever variations each state made to conform with other laws). Substantial amendments to Article 2A were approved by NCCUSL and ALI in 2003, but were not adopted by any state. The 2003 amendments were withdrawn in 2011.

- c. the lessee has an option to renew the lease for the remaining economic life of the equipment for no additional consideration or nominal additional consideration upon compliance with the lease agreement; or
- d. the lessee has an option to become the owner of the equipment for no additional consideration or nominal additional consideration upon compliance with the lease agreement.

These factors are termed as “*residual value factors*” because they determine whether any meaningful residual value/risk remains for a lessor at the end of the lease term.

## **2. The Second Level of Analysis: The Economic Realities.**

The second part of the test requires a court to analyze the specific facts of the case and determine the “*economic reality*” of the transaction. The court must determine whether the only economically sensible action for the lessee is to exercise the option to purchase the property. If the answer is “yes,” then the conclusion under this test would be that the lease is, in fact, a disguised security agreement. Courts have enumerated various factors to be used in the determination, including:

- a. Whether the lessee has acquired equity in the equipment by making payments under the lease so that, at the end of the lease term, it can reasonably be anticipated that the lessee will exercise the option to pay the nominal consideration necessary to purchase the equipment;
- b. Whether the lessee may terminate the agreement without paying a sum certain or without any further obligation to the lessor;
- c. Whether the lease obligates the lessee to maintain and repair the equipment and/or be responsible for taxes, insurance, maintenance, repairs, and other expenses normally associated with ownership;
- d. Whether the total amount of the payments to be made under the lease exceed the value of the equipment;
- e. Whether the equipment has a useful life in excess of the lease term; and
- f. Whether the lessor is in the business of leasing equipment.

The law in this area continually evolves and varies by jurisdiction. Some courts consider the first listed factor, lessee’s equity, to be the most important factor in analyzing the true lease vs. security agreement issue. Courts have also disagreed with or criticized various parts of the test.

## **IV. UCC ARTICLE 2A FINANCE LEASES**

One of the great contributions of UCC Article 2A to the commercial leasing

industry was the creation of the “finance lease.” The authors of Article 2A recognized that it was not fair to hold lessors liable for any problems associated with the leased equipment if the lessors did not manufacture or sell the leased equipment, but only provided lessees with an alternative source of financing for equipment that was selected by the lessees.

If a lease satisfies the requirements for a “finance lease” as defined in Article 2A, the lessor automatically will be provided with certain benefits that, prior to the enactment of UCC Article 2A, needed to be specifically described in the lease. Such benefits include the protections of a “*hell and high water*” clause and the disclaimer of any implied warranties of freedom from infringement, merchantability, or fitness for a particular purpose. These provisions eliminate many of the defenses that might be raised by a lessee seeking release from its obligations under the lease and will be discussed in greater detail later in this *Guide*.

To qualify as a “finance lease” under UCC Article 2A, the lease first must be a true lease and not a lease intended as security. The transaction also must satisfy the following conditions:

- a. the lessor may not select, manufacture, or supply the lessee with the equipment;
- b. the lessor must acquire the equipment or the right to possession and use of such equipment only in connection with the lease; and
- c. ***Either***
  - i. the lessee must receive a copy of the contract by which the lessor acquired the equipment or the right to possession of and use of such equipment before signing the lease; **OR**
  - ii. the lessee’s approval of the contract by which the lessor acquired the equipment or the right to possession and use of such equipment must be a condition to the effectiveness of the lease; **OR**
  - iii. before signing, the lessee must receive an accurate and complete statement designating the promises and warranties and any disclaimers of warranties, limitations or modifications of remedies, or liquidated damages, including those of a third party (such as the manufacturer of the equipment) that were provided to the lessor by the person supplying the equipment; **OR**
  - iv. if the lease was not executed for consumer purposes, the lessor must inform the lessee in writing before the lessee signs the lease:

1. of the identity of the person supplying the equipment to the lessor unless the lessee had selected that person and directed the lessor to acquire the equipment,
2. that the lessee is entitled under UCC Article 2A to the promises and warranties, including those of any third party, provided to the lessor by the person supplying the equipment to the lessor, and
3. that the lessee may communicate with the person supplying the equipment to the lessor and receive an accurate and complete statement of those promises and warranties including any disclaimers and limitations of them or of any related remedies.

Parties may contractually agree to treat a lease transaction as a “*finance lease*” even if the lease does not satisfy all the definitional components of Article 2A. Courts vary in enforcing this designation and the decision is usually based on all of the specific facts of the transaction.

## **V. KEY PROVISIONS IN LEASE AGREEMENTS**

### **1. Description of Initial Term and Renewal Periods, Acceptance of Equipment, Amounts Owed, Payment Terms, and the Equipment.**

A well-drafted lease includes a detailed and complete description of the commencement and expiration of the initial lease term and any renewal periods, the amounts owed by the lessee, the payment terms for those obligations, and the leased equipment. Such information is essential to the enforcement of the lessor’s rights against the lessee, any guarantors, and other third-party obligors.

A lease may provide the lessor with the right to insert any missing information to correct any clerical errors in the lease documents. These provisions are very important if items such as dollar amounts, serial numbers for the leased equipment, or other pertinent data were unknown or incorrectly described in the documents on the closing date.

The commencement of the initial lease term may be a date that is specified in the lease (or a separate certificate of acceptance), selected by the parties, or related to a particular event, such as the date of shipment or delivery of the leased equipment to the lessee, the date the lessee accepts the leased equipment, or the date the lessor accepts the lease agreement. Regardless of method, the lessor should seek to avoid any confusion regarding the exact commencement date. Similar care should be taken by the lessor in describing the expiration of the initial term of the lease agreement, the availability of any renewal options, and the commencement and expiration dates for such renewal periods.

Either within the text of the lease or in a separate certificate, a lessee should

acknowledge the delivery and acceptance of the leased equipment. Article 2A of the UCC provides that the obligations of the lessee under the lease become irrevocable after the lessee has accepted the equipment. After acceptance, the lessee usually cannot reject the accepted equipment subject to a finance lease, even if the lessee has knowledge of a defect in the equipment at the time of acceptance. Lessors typically obtain a separate acceptance certificate if the lease is executed prior in time to the physical delivery and/or acceptance of the equipment to the lessee.

Leases commonly contain very detailed descriptions of the amounts (rent) to be paid by the lessee and the terms and conditions upon which the lessee is obligated to pay rent. A complete description of such terms and conditions often will address:

- a. the number, amount, frequency, and due dates of the rental payments;
- b. the amounts to be paid by the lessee to the lessor at the inception of the lease (including any security deposits or advance rent);
- c. the nature and amount of any taxes, assessments, maintenance costs, and other amounts to be paid by the lessee to or for the benefit of the lessor;
- d. the stipulated value or other amounts that will be paid by the lessee to the lessor upon any loss or damage to the leased equipment (may be referred to as "*stip loss*" or "*casualty*" or "*termination*" value);
- e. the damages that will be paid by the lessee upon a default including the mathematical factor that will be used to present value the unaccrued damages owing to the lessor and any credits that will be provided to the lessee upon the sale or re-lease of the equipment; and
- f. the amount of or method for determining any late charges, interest, default interest, attorneys' fees, and other costs that the lessee will be assessed.

Equipment descriptions often will include the name of the manufacturer, model, serial number, and other information necessary to distinguish each item from similar equipment belonging to or used by the lessee or other parties. Small-ticket transactions sometimes suffer from either inadequate or overly-general descriptions of leased equipment. Inadequate descriptions of equipment may create issues in bankruptcy or repossession if the lessee possesses equipment similar to the leased equipment.

## **2. Disclaimers of Warranties, "Hell and High Water" Clauses, and Waivers of Defenses**

A lessor may seek to limit arguments that can be raised by a defaulting lessee when the lessor exercises its rights and remedies. This is accomplished by inserting various disclaimers, a "hell and high water" clause, and waivers of certain defenses in the lease. These provisions often are expressly stated in a lease even though the lease will be entitled to the statutory protections of a finance lease.

a. Disclaimers of Warranties

A lessor often disclaims any express or implied representations or warranties to the lessee with respect to the leased equipment if the lessor is not the manufacturer or supplier of the leased equipment. Many leases contain both a general disclaimer and a laundry list of the specific representations and warranties that are being disavowed by the lessor.

Article 2A requires a lessor to take certain actions to disclaim the implied warranties of merchantability and fitness for a particular purpose in an effective manner. Such warranties may be waived with specific disclaimers or the language “**AS IS**” or “**WITH ALL FAULTS.**” The disclaiming language must be conspicuous to the various parties. Many lessors capitalize and boldface the disclaimers of these warranties in lease documents.

b. “*Hell and High Water*” Clauses

A “*hell and high water*” clause requires the lessee to perform its obligations under the lease notwithstanding any problems with the equipment or the existence of other mitigating circumstances. Such clauses usually contain both broad disclaimers and a list of specific issues that will not affect the enforceability of the lease.

Article 2A provides a finance lease with an implied hell and high water provision. Many lessors include express hell and high water clauses in leases in the event the transactions are determined not to be finance leases.

c. Waiver of Defenses

A waiver of defenses clause provides that if a lessor assigns its rights under a lease to a third party, the lessee will not be entitled to assert any claims, defenses, setoffs, or counterclaims against the assignee that may be raised against the lessor. This clause is specifically enforceable under both UCC Articles 2A and 9 in commercial (not consumer) transactions. UCC provisions concerning enforcement of waiver of defenses do not prevent lessees from raising certain defenses enumerated in the UCC.

### 3. Casualty and Liability Insurance

Lease agreements often require the lessee, at its expense, to provide casualty and liability insurance with respect to its business and/or the leased equipment and to name the lessor as an additional insured and/or loss payee under those policies. The lessor may require that the amount and form of the insurance policies and related endorsements be acceptable to the lessor in its discretion.

Many lease agreements require that the lessor be paid any insurance proceeds pertaining to the leased equipment. Others permit the lessee to be paid the insurance proceeds to repair or replace lost or damaged equipment or require the lessor to reimburse the lessee for such actions from the insurance proceeds.

Lease agreements may also contain a power of attorney clause which enables the lessor to endorse the lessee's name on insurance drafts and other documents. These clauses seek to avoid the difficulties that may be encountered by the lessor in obtaining the lessee's endorsement of any insurance draft if the relationship has become adversarial. Lessors may require the loss-payable endorsement from the lessee's insurance company to contain "waiver of warranty" and "waiver or subordination of subrogated rights" clauses. A waiver of warranty clause provides that the lessor's entitlement to the insurance proceeds will not be affected by the lessee's breach of its representations, warranties, or other agreements that are contained in the insurance policy. A waiver or subordination of subrogated rights clause prohibits the insurance company from being subrogated to the lessor's rights upon the payment of the insurance proceeds to the lessor or, if the insurance company is subrogated to the lessor's rights, subordinates the insurance company's subrogated rights to the satisfaction of the lessor's remaining rights against the lessee, any guarantor, or other third-party obligor.

A lessee's failure to maintain the insurance coverage required by the lease usually constitutes a default. A lease may permit the lessor to obtain substitute insurance at the lessee's cost. Such insurance should be available even though the lessor has not obtained possession of the leased equipment. Many states have so-called "*forced-placed*" insurance laws which create procedural and substantive limitations on a lessor's rights to obtain and charge a lessee for insurance.

#### **4. Choice of Law Clauses**

A lease may contain a "*choice of law*" clause which specifies the state law that will be used to interpret the terms and conditions of the lease. A choice of law provision has become increasingly common in recent years as more lessors conduct business on a regional or national basis and prefer to have their transactions governed by one state's laws.

The primary purpose of a choice of law clause is to provide the lessor with a uniform interpretation of its lease documents. Without such provisions, lessors would be required to acquire and maintain an intimate knowledge of and be subject to different (and, possibly, less favorable) laws of a number of different states.

Most courts will enforce a choice of law clause contained in a lease so long as the controlling law possesses a reasonable relationship to the lessee or lessor and/or the leased equipment. Some states view the importation of foreign laws as presumptively contrary to public policy and will not enforce the provision, especially in a consumer transaction.

A choice of law clause will govern only the substantive issues pertaining to the lease. The rules of the jurisdiction in which an action or suit is commenced by or against the lessor will control procedures to be followed in any litigation.

#### **5. Forum Selection Clauses**

Some lease documents contain forum selection clauses. Such clauses can be permissive or mandatory and usually: (a) provide the lessor with the ability to commence an action against the lessee, any guarantor, or other third-party obligor in a favorable location (such as the jurisdiction containing the lessor's chief executive or regional office); or (b) seek to prevent the lessee, guarantor, or other third-party obligor from commencing an action against the lessor in an inconvenient venue (which may be any jurisdiction not containing the lessor's chief executive or regional office).

The usefulness of forum selection clauses will be limited by the lessor's need to obtain an order for the physical turnover or seizure of the leased equipment in the jurisdiction containing such equipment. Such clauses may be useful if the lessor is seeking only to collect the unpaid amounts owing under the lease documents.

"Floating" forum selection clauses provide that an assignee of the original lessor may bring an action against the lessee in the assignee's jurisdiction without regard to the lessee's or original lessor/assignor's jurisdiction. A bankruptcy court may not enforce a floating forum selection clause and the enforcing assignee's jurisdiction itself may not enforce the floating forum selection clause. A lessor may be required to commence an action against obligated parties only in certain jurisdictions if the legal proceeding involves a consumer lease. Courts are split on whether to enforce floating forum selection clauses in the commercial context. Those refusing to enforce have stated that floating forum clauses are against public policy, especially if the transaction involves a non-profit, small business, or individual lessee.

## **6. Recovery of Attorneys' Fees and Other Costs and Expenses**

Many jurisdictions adhere to the so-called "*American Rule*" regarding attorneys' fees and costs of litigation: the parties must bear their own expenses unless they previously agreed otherwise in writing. A lease may contain a provision awarding the lessor its attorneys' fees and other costs and expenses in the event of any litigation or dispute. Such clauses are necessary to ensure that the lessor possesses the potential to recover all of its damages following a default.

Most well-drafted attorneys' fees clauses are relatively broad in their scope. Nevertheless, certain limitations may be placed on the award of attorneys' fees by the courts in various jurisdictions, especially in consumer transactions.

## **7. Waiver of Jury Trial Clauses**

A lease may contain a waiver of jury trial clause. This provision is designed to avoid erroneous verdicts and excessive awards of damages that have been entered by juries in different cases. The underlying rationale may include the beliefs that: a) judges are more likely to have commercial experience than the average juror; b) judges are dispassionate and less likely to impose disproportionate penalties or ignore evidence; and c) jury trials are more complicated, risky, and expensive than bench trials.

Some states will not enforce a waiver of jury trial clause. Others permit the waiver of jury trial clause so long as the waiver is conspicuous and was entered into

knowingly and voluntarily by the waiving party. Many lessors seek to satisfy these requirements by boldfacing and capitalizing the waiver of jury trial clause and placing that provision immediately above the signature areas in the lease.

## **8. Modification Clauses**

A modification clause usually prohibits the amendment or waiver of the terms and conditions set forth in the lease unless a writing to such effect is executed by the relevant parties. Under UCC Article 2A some modification clauses must be separately signed or initialed by the lessee and lessor.

Courts have disregarded modification clauses and determined that a lessor's actions or omissions have served to amend or waive its rights under the lease documents. As with any other contract provision, the specific facts of a case will impact the enforceability of a lease provision.

## **9. Integration Clauses**

An integration clause ("*entire agreement*") provides that the lease contains the complete and entire understanding between the lessee and lessor with respect to the terms and conditions set forth in the lease. Integration clauses also may expressly state that the lessee and lessor have not entered into any oral agreements and that the lease supersedes all prior negotiations, discussions and agreements between the lessor and lessee with respect to the equipment.

Many courts will uphold integration clauses. Under certain circumstances, some courts may permit evidence to be introduced that contradicts the terms and conditions contained in the lease.

## 2. DEFAULTS

### I. DEFINITION OF DEFAULT

A default under a lease may consist of the lessee's breach of a representation or warranty, failure to perform an obligation in the lease, or a breach of a covenant contained in the lease. Defaults can be monetary or non-monetary, substantial or non-substantial, and material or non-material, and actual or anticipatory in nature.

A lease contains a detailed list of conditions that constitute monetary or non-monetary defaults. It will indicate whether any notice of default must be given to the defaulting party and whether a grace or cure period will be provided to that person or entity.

A lessor must be familiar with the events that may constitute a default by the lessee under the lease and any other party under any of the lease documents. A lessor should be aware that the default described in a lease document may be altered by a course of dealing between the parties or waived by the lessor's statements or actions.

#### 1. Monetary and Non-Monetary Defaults

The most common form of a monetary default under a lease agreement is the lessee's failure to pay one or more of the rental payments when due. A monetary default may also consist of the lessee's failure to pay personal property or other taxes, insurance premiums, or any other monetary obligations described in the lease.

A lessee typically makes various representations and warranties pertaining to the lessee's business and the leased equipment. The lessee also is typically required to perform a variety of non-monetary obligations including:

- a. maintaining the equipment in good condition;
- b. keeping, storing or using the equipment in a certain location or locations;
- c. preventing any liens, security interests, encumbrances, and other claims from being asserted against the equipment except for those arising from the lessor and other permitted parties;
- d. obtaining and maintaining casualty and liability insurance policies in the amounts and forms and from such companies as may be specified in the lease; and
- e. providing financial and other information to the lessor on a periodic basis.

A lease may contain an "*insecurity clause*" which enables the lessor to declare the lessee in default as a result of the lessor's belief that the prospect of the lessee's payment or performance of its obligations has been impaired in a material fashion. Article 2A requires such actions to be taken only in good faith and many lessors are

hesitant to rely solely upon an “*insecurity*” clause to declare a default under a lease.

## **2. Substantial and Non-Substantial Defaults**

Substantial and non-substantial defaults are Article 2A concepts. Article 2A permits the lessee and lessor to define the actions or omissions that will constitute a substantial default under a true lease and the remedies that may be exercised by the lessor under those circumstances. In the absence of a written understanding between the parties Article 2A provides that a substantial default will consist of a wrongful rejection or attempted revocation of acceptance of the leased equipment, repudiation of the lease agreement, failure to make a payment when due, or any other default which “*substantially impairs the value of the lease contract to the lessor.*”

A “*substantial default*” enables a lessor to exercise a variety of statutory remedies. The lessor also will be entitled to exercise any other remedies described in the lease so long as those remedies are not unconscionable or do not violate applicable law. Lessors may exercise a more limited set of statutory remedies upon the occurrence of a “*non-substantial default*” unless otherwise provided in the lease.

## **II. GRACE PERIODS**

Many lease agreements require a payment to be made or an obligation to be performed by a certain date but provide that a default will not occur unless the payment or obligation remains unsatisfied for an additional amount of time after the due date or notice or both. These periods of time are called “*grace periods.*” Most grace periods are intended to prevent the lessee from inadvertently defaulting upon its obligations to the lessor under the lease. However, such provisions are optional, and many lease agreements do not contain any grace periods.

It is common for leases to provide for relatively short grace periods, if any, for monetary obligations and non-monetary obligations which, if not performed, may cause substantial harm to the lessor or the leased equipment (such as the lessee’s obligation to maintain casualty and liability insurance). Lessees may have longer grace periods for actions which, if not taken, may constitute defaults but will result only in an inconvenience to the lessor (such as the lessee’s obligation to provide the lessor with certain information or reports).

Most lessors do not wish the lessee to repeatedly use the grace periods contained in a lease. Such action can be deterred by inserting language in the lease which limits the number of times that the lessee can take advantage of the grace periods. These provisions are particularly useful in post-default workout or forbearance agreements. Some courts have imposed implied grace periods under a variety of legal doctrines. To avoid such results, many lessors insert a clause in their lease agreements which specifies that “*time is of the essence*” with respect to the performance of the lessee’s obligations.

Even with a “*time is of the essence*” clause, a lessor may be deemed to have waived its right to insist upon the punctual performance of the lessee’s obligations if the

lessor has repeatedly permitted the lessee to delinquently perform its obligations. Accordingly, many lessors diligently monitor and enforce the lessee's performance of its obligations and, if an obligation is waived, may provide the lessee with written notice that the waiver will only apply to the current obligation and not to any future obligations.

### **III. NOTICES OF DEFAULT AND CURE RIGHTS**

Article 2A does not require a lessor to provide the lessee with either notice of the occurrence of a default under the lease or the right to cure such default. Many lessors do provide for notices of default and cure provisions in their leases. The purpose of a notice of default provision, like a grace period, is to prevent the lessee from inadvertently defaulting upon its obligations. To be effective, the notice given to the lessee should be sent in the method specified by the lease.

A cure period is simply a grace period that is provided to the lessee after a notice of default is given. Most lease agreements contain relatively short cure periods, if any, for the lessee's failure to pay a monetary obligation or to perform a non-monetary obligation which could cause substantial harm to the lessor or the leased equipment. However, the lessee may be granted a longer amount of time to cure a non-monetary default which does not expose the equipment to potential substantial harm.

As with grace periods, lessors do not want to provide lessees with unlimited notices of default or cure periods. Lease agreements that contain notice of default and cure provisions often restrict the number of times that such provisions can be exercised.

A lessor may be deemed to have waived the lessee's obligation to cure a default within the amount of time specified in the lease if such requirements are not enforced in a consistent manner. Accordingly, many lessors diligently monitor and enforce the lessee's exercise of its cure rights and, if the lessee's obligation to cure a default has been modified or waived, provide the lessee with written notice that such actions will not be permitted in the future.

### **IV. WAIVER OF DEFAULT**

A waiver is the relinquishment of a right. For a lessor to be deemed to have waived a default by a lessee, two requirements must usually be satisfied. First, the lessor must be aware of the default by the lessee. Second, the lessor must give up or forego a right or remedy that the lessor would otherwise be entitled to exercise under the lease documents.

A lessor may expressly waive the lessee's failure to comply with the terms and conditions described in a lease. Courts will also find that a lessor has waived certain rights from the lessor's actions or omissions. For example a lessor may be found to have waived the lessee's obligation to pay certain amounts on a timely basis when a number of delinquent payments were accepted by the lessor without an express reservation of its right to declare a default for the lessee's future failure to make timely payments.

Many well-drafted lease agreements provide that the terms and conditions set forth in those documents may not be amended or waived except in a writing signed by the relevant parties. Such provisions may need to be separately signed or initialed by the lessee under Article 2A. The presence of a signed modification or waiver clause in the lease may not be determinative, depending on the specific facts. Some courts, in the attempt to achieve a result that they deem "equitable" to the parties, may determine that the lessor's actions or inactions result in a waiver of certain rights under the lease. Lessors, therefore, attempt to avoid inadvertent waiver of their rights and remedies against the lessee by taking the precautions described above.

### **3. AVAILABLE REMEDIES**

#### **I. FORMULATING A STRATEGY**

A lessor should formulate a strategy before reacting to a lease default. The first step may consist of a review of the lease documents and other materials in the lessor's files. This review should consider whether:

- a. the lease documents have been properly dated, completed, and executed by the appropriate parties, and all relevant UCC and other filings have been recorded and maintained with the appropriate governmental authorities;
- b. no material changes have been made to the standard forms used by the lessor except for those changes that are indicated in the credit file;
- c. one or more substantial defaults have occurred;
- d. notices of default have been sent to the lessee and other necessary parties and all other conditions precedent to the exercise of the lessor's remedies have been satisfied in a complete manner;
- e. the defaults have not been cured by the lessee;
- f. the defaults have not been waived by the statements, actions, or omissions of the lessor; and
- g. the lessor possesses current financial and other information on the lessee, third-party obligors, and the leased equipment.

The next step may be to decide upon the remedies to be exercised by the lessor. The nature of such remedies will depend to a certain degree upon whether the lease agreement is a true lease or a lease intended as security.

#### **II. REMEDIES AVAILABLE TO A LESSOR UNDER A TRUE LEASE**

Article 2A allows the parties to establish the remedies available to a lessor by the written contract. In the absence of, or in addition to, contractually specified remedies, Article 2A also provides a lessor with a number of specific remedies following the occurrence of a substantial default under a true lease. Such remedies include:

- a. canceling the lease;
- b. seeking the payment of the accrued but unpaid obligations and the present value of the future obligations together with any incidental costs and expenses;

- c. identifying the undelivered equipment to the lease and completing the manufacture of such equipment if such action is commercially reasonable under the circumstances;
- d. stopping delivery of the leased equipment if not yet delivered to the lessee;
- e. retaining the leased equipment in the possession of the lessor or its agent;
- f. taking possession of the leased equipment without judicial process so long as such repossession may be accomplished without a breach of the peace;
- g. obtaining possession of the leased equipment with a writ of replevin; and
- h. disposing of the leased equipment through sale, lease, or other means

Article 2A also permits the lease to contain additional remedies so long as such remedies are not unconscionable or otherwise inconsistent with applicable law. One often added important remedy is a requirement that the lessee assemble and make the leased equipment available to the lessor at a reasonably convenient location. Such a provision is particularly useful to a lessor seeking to recover leased equipment that is in transit or located in several states or consists of mobile equipment.

A lessor also may possess various remedies against guarantors, other third-party obligors, and/or their respective property. In many situations, the terms and conditions set forth in the lessor's agreements with such third parties may influence the actions that will be taken by the lessor to recover the amounts owed.

Article 2A specifies that the remedies available to a lessor are cumulative in nature but most courts will ensure that a lessor's exercise of its rights under a lease or Article 2A does not provide the lessor with a windfall or otherwise place the lessor in a better position than it would have enjoyed if the lessee had fully performed its lease obligations in a timely manner.

### **III. REMEDIES AVAILABLE TO A LESSOR UNDER A LEASE INTENDED AS SECURITY**

The remedies available to a lessor under a lease intended as security are controlled by Article 9 of the UCC and the terms and conditions set forth in the documents.

Article 9 does not define the actions that may constitute a default under a lease intended as security. Article 9 permits a lessor under a lease intended as security to:

- a. seek the payment of the lessee's or the guarantor's obligations as well as certain incidental costs and expenses;

- b. obtain possession of the collateral without judicial process so long as such repossession may be accomplished without a breach of the peace;
- c. obtain possession of the collateral with a writ of replevin or other judicial process;
- d. dispose of the collateral through sale, lease, or otherwise; and
- e. seek to retain the collateral in satisfaction (or partial satisfaction) of the lessee's obligations that are secured by the equipment.

Article 9 also permits additional remedies to be provided for in a lease intended as security (such as the requirement for the lessee to assemble and make the collateral available to the lessor at a reasonably convenient location) so long as such remedies are not commercially unreasonable, do not provide the lessor with a windfall, and are not otherwise unconscionable under applicable law. A lessor under a lease intended as security also may possess various remedies against guarantors, other third-party obligors, and/or their respective property. Pursuant to Article 9, such third-party obligors are usually entitled to receive written notice of any intended disposition of the equipment or other collateral and to seek damages against the lessor if such assets are not disposed of in a commercially reasonable manner.

Article 9 specifically provides that the remedies available to a lessor under a lease intended as security are cumulative. Nevertheless a few states possess "one action rules" or other limited election of remedies doctrines which may cause a lessor to carefully select the order or types of remedies that will be exercised against the lessee, any guarantors or other third-party obligors, and the collateral.

#### **IV. DISCUSSION OF SPECIFIC REMEDIES UNDER TRUE LEASES**

The remedies that are available to a lessor following the lessee's default in a true lease often include:

##### **1. Cancellation and Termination**

It is very common for a lease to provide that a lessor will be entitled to "*cancel*" the lease agreement upon the lessee's default. Such rights also are provided to a lessor under Article 2A. Cancellation vacates the lessee's right to continue to possess or use the leased equipment and preserves the lessor's ability to collect from the lessee both the accrued and unaccrued obligations under the lease.

Under Article 2A, the "*termination*" of a lease entitles the lessor to recover only the accrued obligations under the lease as of the date of termination (rent due up to the date of termination). Due to Article 2A's distinction between the "*cancellation*" and the "*termination*" of a lease agreement, many lessors have replaced the word "*terminate*" with "*cancel*" in their lease forms.

##### **2. Acceleration**

Article 2A permits a lessor to accelerate and seek to collect all of its damages following the occurrence of a default under a true lease. It is very common for acceleration rights also to be specified in the lease.

### **3. Recovery of Monetary Damages**

Most lease agreements contain a liquidated damages provision which specifies the damages that will be recoverable by the lessor following the lessee's default. The liquidated damages provision may contain a mathematical formula (often used to calculate the "*net present value*") or refer to the stipulated amounts that are payable to the lessor upon the loss or destruction of the leased equipment.

A liquidated damages provision should be enforceable against the lessee so long as it is intended to compensate the lessor for the damages arising from the lessee's default under the lease and not to penalize the defaulting party. Most liquidated damages provisions enable the lessor to collect from the lessee:

- a. any accrued but unpaid rental payments, late payment charges, and other amounts owed;
- b. the net present value of any unaccrued (future) rental payments and other amounts;
- c. any adverse tax consequences suffered by the lessor as a result of the lessee's default and the premature cancellation of the lease;
- d. if the equipment has not been returned to the lessor, the residual value of the equipment discounted to its present value;
- e. any commissions, fees and other costs incurred in the recovery, storage, and disposition of the equipment; and
- f. attorneys' fees and other expenses incurred in the exercise of the lessor's remedies under the lease documents.

Both Article 2A and the common law in many jurisdictions provide that a lessor may collect only the present value of the future rental payments (unaccrued as of the date of default) and other amounts owing under the lease. Some leases either do not specify the percentage rate or discount factor that will be used to calculate the present value of such unaccrued damages or do not utilize a default damage formula or stipulated loss value schedule that contains an implied discount factor. In such situations, the court may refuse to enforce the liquidated damages provision contained in the lease or apply its own discount factor to the unaccrued damages owed to the lessor. The discount factor selected by the court may or may not fully compensate the lessor for its damages.

#### **4. Mitigation of Monetary Damages**

Besides requiring a lessor to present value the unaccrued damages under a lease, Article 2A and the common law in many jurisdictions require a lessor that has recovered the lease equipment to mitigate its damages by using reasonable efforts to remarket the equipment. Such reasonable efforts do not require selling or leasing the repossessed equipment to the detriment of the lessor's other property. The lessor should be prepared to demonstrate to a court that it took reasonable steps to advertise and market the repossessed equipment and received the prevailing fair market value or fair rental value from the disposition of the equipment.

If the equipment is sold to a third party, the lessee's obligations to the lessor may be decreased by the amount of the net sale proceeds (less the present value of the anticipated residual value of the equipment at the end of the lease). Similarly, if the equipment is released to a third party, the lessee may be entitled to receive a credit for the present value of the net amounts to be paid to the lessor by the replacement lessee during the remaining term of the original lease.

The discount factor used in calculating the credit to be given to the lessee for the unaccrued rental payments and other amounts under the second lease agreement may or may not be equal to the discount factor that was used to present value such amounts under the original lease. However, a court may refuse to apply the discount factors selected by the lessor if it determines that the factor was intended to penalize the lessee and not simply to compensate the lessor for its damages.

The lessee will not be entitled to receive any credit from the remarketing of the repossessed equipment if, despite its reasonable efforts, the lessor was unable to sell or re-lease the equipment. Since the lessor (and not the lessee) is the owner of the equipment, the lessee should not be entitled to receive any compensation for monies that are recovered by the lessor from the disposition of the repossessed equipment which exceed the amount owed under the lease.

#### **5. Repossession of Leased Equipment**

Many leases provide that the lessor will be entitled to repossess equipment following the lessee's default. Such rights are also provided to a lessor by Article 2A and common law.

A lessor's repossession of equipment may be accomplished with or without judicial process. If the lessor elects to repossess the equipment without the assistance of the judicial system, it may not breach the peace to do so. Such a violation may occur if the lessor commences or continues with the repossession of the equipment over the objections of the lessee or if the lessor seeks to remove a lock, fence, or other obstacle to the repossession of the equipment without the lessee's consent.

Lessors often employ third party agents to repossess equipment. A lessor should exercise care in the selection of such agents since a lessor may be liable for damages

caused by the agent in the repossession process. Some states have adopted legislation which absolves lessors from liability for the actions of their repossession agents if such agents have posted required bonds.

The alternative to non-judicially repossessing the leased equipment is the commencement of a legal action by the lessor which seeks the entry of a writ of replevin against the lessee. Writs of Replevin are discussed in detail in the next Chapter of this Guide.

## **6. Requiring the Lessee to Assemble and Make Available the Leased Equipment**

Many leases contain a provision which entitles the lessor to require the lessee to assemble and make the leased equipment available to the lessor at a reasonably convenient location. This provision can be used by the lessor to obtain a court order requiring the lessee to surrender the equipment to the lessor. In extreme cases, if the lessee refuses to surrender the leased equipment, the court may hold the lessee or its controlling officers in contempt and place those parties in confinement until the lessor has received its property.

## **7. Lessor's Rights Against Guarantors and Other Third Party Obligors**

Besides possessing various remedies against the lessee and the equipment, a lessor may possess certain rights against guarantors, third-party obligors, and their assets. Such rights often are subject to a variety of potential setoffs and defenses. Many of these setoffs and defenses can be waived by guarantors and other third-party obligors in well-drafted documents.

The lessor may assign warranties from, and other rights against, the manufacturers or dealers of the leased equipment to the lessee upon the execution of the lease. Such assignments usually are revoked upon the lessee's default.

## **V. SPECIFIC REMEDIES UNDER LEASES INTENDED AS SECURITY**

The pre-bankruptcy rights afforded to a lessor under a lease intended as security are similar to the remedies enjoyed by a lessor under a true lease in many respects. Upon the occurrence of a default under a lease intended as security, a lessor usually is entitled to terminate the lessee's right to use the equipment, accelerate the lessee's obligations, repossess the equipment, require the lessee to assemble and make available the equipment, and sell, lease, or otherwise dispose of the equipment.

The primary differences between the rights afforded to a lessor under a true lease and those granted to a lessor under a lease intended as security are:

- a. the lessor under a lease intended as security may be entitled to recover only its principal and accrued and unpaid interest (and not the present value of unaccrued amounts under the lease);

- b. the lessor under a lease intended as security may not be entitled to recover the residual value of the equipment;
- c. Article 9 requires the lessor under a lease intended as security to provide the debtor and any guarantors or other third-party obligors with written notice of the disposition or intended retention of the equipment in satisfaction of the lessee's obligations;
- d. Article 9 requires the lessor under a lease intended as security to follow certain procedures to conduct a strict foreclosure of the leased equipment collateral or dispose of the equipment in a "*commercially reasonable*" manner; and
- e. if the monies received by the lessor under a lease intended as security from the sale, lease, or other disposition of the equipment exceeds the outstanding balance of the lessee's obligations under the lease, the excess proceeds will be remitted to the lessee or other party entitled to receive such monies under applicable law.

There also are a number of significant differences between the rights that are provided to a lessor under a true lease and those that are afforded to a lessor under a lease intended as security in a bankruptcy proceeding. These differences are largely attributable to the legal distinctions between the rights of a lessor as the "*owner*" of the equipment covered by a true lease vs. the rights of a lessor as only a secured creditor under a lease intended as security. These distinctions are addressed in more detail in Chapter Five of this Guide.

## **VI. PRACTICAL CONSIDERATIONS**

A lease may provide a variety of remedies in the event of a lessee default. Prior to exercising such remedies, the lessor should conduct a cost/benefit analysis to determine which actions, if any, should be taken to collect the amounts owing to the lessor. Among the factors that may be considered by the lessor in assessing the remedies to be exercised against the lessee, guarantors, other third-party obligors, and the equipment are:

- a. Did the review of the lease documents reveal any material problems?
- b. Has the lessor satisfied all of the conditions precedent to the exercise of its remedies under the lease and, if not, what is the amount of time and money that must be expended to satisfy the remaining conditions precedent?
- c. What is the current location, condition, and value of the equipment?
- d. What is the current net worth of the lessee, guarantors, and other third-party obligors?

- e. What is the anticipated cost to repossess, refurbish, advertise, and resell or re-lease the equipment?
- f. Will the lessor be required to commence a legal proceeding to recover the equipment and, if so, will the lessee file bankruptcy to prevent the repossession?
- g. What is the likelihood that the lessee will attempt to recharacterize the true lease as a disguised security agreement?
- h. Will a deficiency balance exist after disposition of the equipment?
- i. What will it cost to obtain a judgment against the lessee, guarantors, and/or other third-party obligors?
- j. What is the likelihood that the lessee, guarantors, or third-party obligors will file a counterclaim against the lessor and, in such event, the possibility that those parties will prevail upon the counterclaim?

After analyzing these and other factors, the lessor may elect to exercise all, some, or none of its remedies against the lessee, guarantors, other third-party obligors, and/or the equipment.

## 4. LITIGATION

When a lessee cannot or will not cure a lease default, cooperate in a work-out, or allow recovery of the equipment after default, the lessor must decide whether to enforce its rights through the legal process.

In the absence of an overriding public policy, upon the lessee's default, the lessor is entitled to recovery of its equipment and to the damages agreed to in the lease and under Article 2A, which frequently include: (1) past due rent; (2) all future rentals due under the lease plus any residual (both amounts discounted to their present value at the time of default or judgment); (3) any unpaid insurance premiums advanced by the lessor; (4) taxes; (5) late fees; and (6) legal fees and costs and other expenses of recovery.

It usually is a good idea to act quickly once a lessee or guarantor has defaulted on its obligation. There generally is a direct correlation between how fast the lessor reacts and the ultimate collectability of the obligation. Lessees and their guarantors almost always will respond first to creditors who act aggressively to recover their losses. The longer a lessor waits to take action against a recalcitrant lessee, the more emboldened the lessee may become. The longer the lessee maintains the possession and use of the equipment without paying, the more likely the lessee will begin believing that the lessor is not serious about pursuing the debt and recovery of the equipment. Nevertheless, as discussed in the prior Chapter of this Guide, much care should be given to the formulation of a strategy for recovery before taking action.

### I. NEGOTIATE OR LITIGATE

Even though the lessor initially may wish to compel the lessee to pay damages and return the equipment by seeking relief through the courts, consideration should be given to the decision as to whether to negotiate rather than litigate. As noted in the prior Chapter of this Guide, some factors to consider are the following:

- a. The amount still owed on the lease;
- b. The fair market value of the equipment;
- c. The costs involved in litigation and in recovering the equipment;
- d. The type of assets owned by the lessee, such as cash, significant receivables, real estate, or other assets that the lessor can pursue;
- e. Whether the lessee is solvent;
- f. Whether there are any personal guarantors or other third-party obligors, and their solvency;
- g. Whether the lease documentation is complete;

- h. Whether there are defenses or possible counterclaims that can be asserted by the lessee in the event that a legal action is commenced;
- i. Whether the primary interest of the lessor is the recovery of the equipment or the lessee's ability to pay its obligations;
- j. Whether it might be more advantageous to seek to obtain additional collateral securing the lessee's obligations;
- k. Whether commencement of litigation could trigger a bankruptcy filing by the lessee or any third-party obligor; and
- l. Whether the filing and service of a lawsuit will get the lessee's attention in order to resolve the lease default.

A significant factor often is the importance of the equipment to the lessee's business and the type of effort and manpower that will be required to recover the equipment. If the equipment is vital to the lessee's business, then the lessor's actions seeking to recover the equipment may be enough to force a settlement or even payment in full of the lease.

If the net liquidation value of the equipment is sufficient to satisfy the lessee's obligations, then it may be less desirable to negotiate. If the net liquidation value is not sufficient to satisfy the lease obligations, it may be advantageous to negotiate and require additional collateral.

### **1. Advantages Of A Negotiated Workout**

There are several advantages to a negotiated workout. Frequently, there are problems with the original documentation. The lessor can tailor a resolution that is satisfactory to both the lessee and lessor, perhaps with minimal attorney involvement. The lessor can require updated financial information, which might be helpful in the event of a future default by the lessee under the settlement agreement. A settlement might forestall or prevent a bankruptcy filing. A carefully-drafted settlement agreement can be prepared to allow for immediate entry of judgment for money and possession of the equipment without litigation in the event of a default under the settlement. The settlement agreement also can serve to cure any problems with the original transaction documents.

### **2. Disadvantages Of A Negotiated Workout**

Failure by the lessor to commence litigation immediately may result in unnecessary delay allowing other creditors to gain an advantage by attaching the lessee's assets. The lessee may abuse the opportunity by stalling the lessor in order to hide assets and information. Continued discussions without preserving the assets by seeking an attachment order may result in further deterioration of the lessee's financial condition.

### **3. Advantages of Litigation**

Commencing litigation immediately upon default frequently will get the lessee's attention and allow the lessor to secure the lessee's assets before they are dissipated by the lessee or attached by other creditors. Litigation also may create leverage with the lessee by making it difficult for the lessee to continue with its business affairs without negotiating an early settlement. Furthermore, it may precipitate the lessee's filing of a bankruptcy, which in some cases is more advantageous to the lessor. For example, a Chapter 11 bankruptcy can force the lessee under a true lease either to assume the lease and pay rent to keep the equipment or to reject the lease and return the equipment. A bankruptcy could set the stage for another entity to purchase the equipment or assume the lease, and pay the lessor in full. A bankruptcy also can force the lessee to make adequate protection payments to the lessor in order to keep possession of equipment, as well as force other creditors, who had recently received preferential payments from the lessee, to return those preferential payments to the bankruptcy estate to be distributed equally to all creditors. At minimum, the lessee should be required to make full and complete financial disclosures to the Bankruptcy Court and to its creditors, and must appear for questioning by creditors, which may also be of benefit in locating the equipment. With careful planning and timing, the early attachment or levy of assets as part of litigation may sufficiently precede the filing of an inevitable bankruptcy by the lessee so as to place the lessor's attachment or levy outside of the preference avoidance period.

### **4. Disadvantages of Litigation**

Although litigation ultimately may be the lessor's only option where the lessee remains uncooperative, cost is always a major factor in deciding whether to litigate. There can be much more delay in obtaining and enforcing a judgment than in negotiating a settlement (sometimes many years). This is especially important in jurisdictions where the early attachment of assets is unavailable or where the facts of the case are such that the right to pre-judgment replevin or attachment would be limited. The lessor's flexibility during litigation is limited. The judge and court rules determine the manner and length of the proceedings. Frequently, this process includes multiple expensive court hearings such as status conferences, case management conferences, mediations, hearings related to motions filed by the parties, including the petitions and motions made to enforce discovery rights, and settlement conferences, which the lessor cannot avoid. Moreover, the results of litigation are always unpredictable, even in situations where the rights of the lessor seem very clear. The commencement of litigation may result in the lessee filing cross-complaints against the lessor or third-party complaints. Finally, litigation increases the likelihood of the lessee filing bankruptcy under circumstances where the bankruptcy would be disadvantageous for the lessor. Aside from attorney's fees and related expenses, companies often overlook an additional cost related to litigation which should be taken into consideration: the cost of time spent by executives and/or key employees in working with counsel, responding to discovery related requests and preparing for depositions and/or trial.

## **II. GATHERING INFORMATION**

Weighing the factors in favor of negotiation or litigation is both science and art. The lessor has a number of tools at its disposal to gather information and assess the lessee's financial condition. Before proceeding, the lessor can take the following steps to secure as much information as appropriate under the circumstances of a particular case:

- a. Obtain credit information on the lessee and any guarantors by running current credit bureau reports;
- b. Recheck the lease file for flaws in the documentation and for financial disclosures the lessee and guarantors provided at the time of application. This search should include credit applications, which may contain banks, trade credits, references, etc.;
- c. Review copies of payment drafts for the names of banks holding the lessee's accounts;
- d. Review publicly available records of assets such as real estate ownership;
- e. Hire private investigators to do location and asset searches;
- f. Hire appraisers to value the equipment and any real property or other assets of the lessee or guarantor;
- g. Run UCC searches to identify other creditors and determine their priority; and
- h. Discuss with recovery agents the cost to remove, ship, store, remarket, and/or sell the equipment.

### **III. COMMENCEMENT OF THE ACTION**

Once the decision is made to litigate, the lessor should decide which jurisdiction is the most beneficial. Frequently, the lessor can rely upon the forum selection clause contained in the lease, as more fully discussed in Chapter 1. In the absence of such a clause, the lessor may file the action where the lessee and/or the equipment is located or where the contract was entered into by the parties. Although there are advantages to filing in a court close to the lessor, the lessor may be deprived of certain provisional remedies, such as replevin, unless the action is filed in the state where the equipment and/or the lessee are located. Federal courts may prove to be a good alternative forum, since they are sometimes known for being faster and unbiased towards out-of-state plaintiffs. However, in order to qualify to file in the federal courts (in the absence of a federal issue) all parties to the action must be citizens of different states (e.g., no plaintiff may be from the same state as any defendant in the case) and the amount in controversy must exceed \$75,000, exclusive of interest and costs.

A lawsuit is commenced upon the filing of a "*complaint*" with the court. The complaint can contain a request for money damages, and if applicable, for possession

of the equipment or other collateral. A written demand for payment or performance can and should be made on the lessee and all guarantors prior to filing the legal action. The defendants usually have between 20 and 30 days to respond to the complaint, once served, depending upon the jurisdiction where the complaint is filed. If the lessee or guarantor fails to timely respond, the lessor is usually entitled to enter a default judgment and commence repossession or a levy on assets.

#### **IV. PREJUDGMENT OR PROVISIONAL REMEDIES: POSSESSION OF EQUIPMENT AND ATTACHMENT OF ASSETS**

If the lessor decides to pursue legal action, it may have several prejudgment remedies, also known as provisional remedies, available to it to secure payment and/or return of the equipment, which do not require waiting until the final judgment is rendered at the end of the lawsuit. Two remedies available to lessors are “*replevin*” and “*attachment*”. An “*Order for Replevin*” (sometimes called a “*Writ of Possession*” or similar name) allows the lessor to take possession of its equipment or collateral before actually obtaining a judgment. A “*Right to Attach Order*” allows the lessor to freeze assets of the lessee pending final disposition of the case. Seeking these early orders can create immediate leverage against the lessee or guarantor under some circumstances. These remedies can eliminate delays and force the lessee and guarantors to retain counsel and they may reveal the lessee’s defenses at an early stage. Finally, they may result in early settlement.

##### **1. Replevin**

A lessor is entitled to recover its leased equipment from inside a lessee’s business or other premises without a court order only if doing so would not “*breach the peace*,” which in practicality often means that the lessee must consent to the recovery and permit the lessor or its agent to enter the premises and remove the equipment. Any attempt to force entry into a lessee’s business or other premises or to recover the leased equipment from the lessee’s business or other premises without the lessee’s clear and express permission would constitute a “*breach of the peace*” and subject the lessor to civil liability. If the lessor cannot recover the leased equipment through the lessee’s voluntary relinquishment or from another location without a breach of the peace, the lessor must seek a court’s order for the issuance of a Writ of Possession.

Some states allow the lessor to seek recovery of equipment through an application for replevin or some other quick and summary process. The application frequently requires accompanying affidavits to establish the lessor’s right to possession. The lessee is given an opportunity to receive notice of the application and to defend. In these states, the lessor can quickly obtain a court order allowing the sheriff to enter a business or other premises to recover the leased equipment. Once the equipment is recovered, the lessor can dispose of it according to the requirements of the UCC, without further legal proceedings. The sole point of the replevin action is to provide the sheriff with court-ordered authority to enter the lessee’s premises and recover the equipment. After the equipment is recovered, the replevin action ends.

In other states, in order to seek recovery of equipment, a civil lawsuit must be filed, which must include a cause of action for replevin or some other cause of action for recovery of the equipment. In some states, the replevin is called "*Claim and Delivery*." In states where a civil lawsuit is required, the litigation follows the same time frame as all other regular civil lawsuits. In such situations, the final judgment in the case – the decisional end of the lawsuit – could take from one to five years.

In most states where the lessor must file a regular civil lawsuit for replevin, the lessor is entitled to seek a prejudgment replevin in order to gain quicker access to its equipment. This remedy requires the lessor, either at the same time that it files its civil lawsuit or at any time thereafter, to file a separate application asking the court to issue a "*Writ of Possession*" to allow recovery. The decision granting the prejudgment Writ of Possession does not conclude the lawsuit. The lessor still must prevail at trial and bring the case to a conclusion, even if the equipment already has been recovered or sold.

The application for a prejudgment Writ of Possession must specify the grounds for the lessor's right of possession. The application generally must claim: a) the existence of the lease; b) a description of the leased equipment; and c) the payment or other default that has occurred. Because the lessee has the opportunity to oppose the application and contest the facts set forth in the affidavits, a strong affidavit from the lessor by a custodian of records or person with actual knowledge of the lease must be submitted to the Court.

The application for a prejudgment Writ of Possession may be heard at any time from a few weeks to a month after the lessee is given notice of the hearing, subject to the court's rules and calendar availability. If the judge is satisfied that the lessor has established its right to re-take possession of the equipment and the judge believes that it is more likely than not that the lessor will prevail in the lawsuit, the judge ordinarily will grant a prejudgment Writ of Possession.

Once the Writ of Possession is granted, the sheriff or other governmental officer is empowered immediately to take possession of the equipment at the lessee's business or other premises. The sheriff may ask the lessor's counsel to coordinate who actually will dismantle and move the equipment. The sheriff usually requires an advance payment of its anticipated costs. If the equipment can be moved easily, the sheriff may arrange the repossession. If the equipment is very heavy, bolted to a floor, specialized, or has electrical, gas, or other utility hookups, the lessor will usually be required to hire the proper dismantlers and movers. The hiring of these recovery professionals must be coordinated with the enforcement of the Writ of Possession, so that the professionals will arrive at the business premises along with the sheriff.

After enforcement of the Writ of Possession and before final judgment, the lessor may store or dispose of the equipment according to applicable law. If the equipment is disposed of prior to final judgment, there is a risk that the court or jury could find at trial that the lessor was not entitled to possession and subject the lessor to liability for damages.

Although the process of seeking a prejudgment Writ of Possession is a straightforward one, there are a number of important details that must be addressed in the application. These include:

- a. Proof that the lease is authentic and properly assigned, if the equipment lease was originated by a lessor other than the party now seeking the writ;
- b. A clear description of the equipment, including serial numbers or other particular identifying numbers or information. Judges want to be sure that in allowing the sheriff to enter a business to remove equipment, the sheriff takes the correct equipment. The sheriff will not levy, even with an order, unless he is positive that he is taking the correct equipment;
- c. A correct address where the equipment is located. Even if the order is granted based upon a wrong address, the sheriff usually may levy only at the address set forth on the Writ unless the equipment is mobile.

As a condition to granting a prejudgment Writ of Possession, many courts require the lessor to obtain a bond to cover the possible damages to the lessee if it is ultimately determined that the lessor was not entitled to possession. The amount of the bond varies among jurisdictions. Most bonding companies do not require security for the undertaking and the premiums for the bond are fairly insubstantial (1-2% per year).

Most jurisdictions allow the lessee to retain and use the equipment prior to trial despite the existence of the court-ordered prejudgment Writ of Possession, if the lessee posts a “*redelivery*” or other bond. The bond is required to protect the lessor against any damage or loss of value to the equipment while the lessee retains possession. If the lessee disappears with the equipment or damages or destroys the equipment during the interim period, the lessor could collect on the bond for the value of the equipment and damages. It is important that the lessor argue that the court set the redelivery bond in an amount sufficient to compensate the lessor for the loss of possession of the equipment, including the fair market value of the equipment. If the redelivery bond is set high enough, the lessee may find it difficult to post the redelivery bond. Because the lessee is the defeated party at the Writ of Possession hearing, most bonding companies require the lessee to pay a premium as high as 10% of the bond amount and to also fully collateralize the bond.

If the lessor believes or knows that its equipment is in imminent danger of being harmed, destroyed, hidden, or moved out of the jurisdiction, in most states the lessor is entitled to seek a prejudgment Writ of Possession on an ex-parte (immediate and with no or limited notice) basis. The court generally will grant the application in a matter of days, not weeks or months. To succeed in obtaining an immediate Writ of Possession, the lessor must not only prove that it is entitled to the equipment due to the lessee’s breach, but it also must present clear and convincing evidence of the urgency of the situation and the imminent danger of loss of the equipment.

## **2. Attachment**

A “*Right to Attach*” order allows the lessor to seize assets of the lessee after the filing of the lawsuit but prior to the trial. The lessor may record liens on real property, place monitoring personnel in the lessee’s business, instruct the sheriff to hold bank deposits pending trial, or other similar actions. To obtain a Writ of Attachment, the lessor must apply to the court and establish that the contractual obligation arises out of the lessor’s trade, business, or profession and that it is “*more likely than not*” that the lessor will prevail at trial. A Writ of Attachment also is available as against a guarantor if the guarantor is involved in the business of the lessor on a daily basis. Some states limit the right to attachment prior to trial to circumstances where the property to be attached will disappear or be harmed.

As with a Writ of Possession, the application for a Right to Attach Order is made by noticed motion (except where *ex parte* grounds exist), giving the lessee the opportunity to file an opposition and participate at the hearing.

The amount of the attachment order is usually limited to the balance owed on the lease, plus estimated costs and attorney fees (if the lease includes an attorney fee provision), less the fair market value of the leased equipment (if it hasn’t already been recovered and sold before the hearing). As an example, if the balance owed on a lease is \$100,000, and the leased equipment has a fair market value of \$35,000, the court could grant an attachment order in the amount of \$65,000, plus estimated attorney fees and costs of suit. This is because the purpose of a Right to Attach Order is to allow the lessor to freeze the lessee’s assets pre-trial to secure payment of the obligation, only to the extent the obligation is unsecured or undersecured.

Some states allow an attachment against a guarantor for the full amount of the obligation without offsetting the value of the equipment under the theory that the guaranty agreement is a wholly-unsecured obligation separate from the lease. This right exists only where the guarantee contains a clause waiving the guarantor’s right to compel the lessor to first exhaust its security or liquidate the leased equipment.

Once a prejudgment Right to Attach Order is granted, the lessor is entitled to recover from the lessee’s or guarantor’s assets in much the same manner as recovering after a final judgment. The assets recovered must be retained by the sheriff (or other authority) and not liquidated until after judgment. If the lessee successfully levies on bank accounts or collects money directly from the lessee’s business, the money is frozen and turned over to the sheriff pending the final outcome of the case. A lien can be placed on the lessee’s real estate which remains in place, pending conclusion of the trial. One of the benefits to a Writ of Attachment is that any attachment lien on property relates back to the time of the lien. In other words, if the lessor obtains a judgment, the judgment lien will be effective as of the date of the attachment lien and will prevail as against an intervening lien. If the lessee files bankruptcy within 90 days after the final judgment lien, the lien will not be avoided because it relates back to the date of the attaching lien.

## **V. PRETRIAL DISCOVERY**

Once an answer to a lawsuit is filed, the time for conducting discovery begins. The discovery process is controlled by the applicable state and federal rules of the court. Every party in litigation is entitled to conduct discovery before trial to gather evidence for its case. Discovery also is used to narrow the issues in the case and determine what claims or defenses are entirely without merit or so lacking in credible evidence that they should be dismissed. Almost all trial courts allow a wide scope of discovery, the theory being that all parties should go to trial with as much knowledge about the matter as possible, and that the parties should not be able to keep secrets from each other. This broad right can involve the discovery of any material relevant to the case with the exception of privileged information. There are several methods of conducting discovery, including the serving of interrogatories and requests for admission, the taking of depositions, and the inspection of paper and electronic documents and other materials. Through discovery, the lessor can establish the elements of its case and avoid the introduction of surprise at trial. The responses given by the lessee or guarantors may be used to impeach them if inconsistent with testimony at trial. Information obtained through discovery may provide the basis for motions for summary judgment or partial summary judgment. The defendants may also use discovery for the same purposes. The costs associated with the collection, review and production of discovery materials, particularly electronic discovery, can be substantial, and should be considered and thoroughly discussed in the decision making process. The costs of electronic discovery have traditionally been borne by the producing party, and even a party found free of liability could still be stuck with the bill for these costs. A growing number of court decisions however, indicate that a prevailing party may recover some electronic discovery costs. Knowing a jurisdiction's law on recovery of electronic discovery costs is therefore vital.

## **VI. MOTIONS FOR SUMMARY JUDGMENT**

A trial is necessary only when there are disputed issues of fact. After the close of discovery, it may become apparent that the facts in the case are not in dispute, and one or more parties may file a motion for summary judgment. A motion for summary judgment can be filed at any time after the answer to the complaint is filed. Summary judgment motions are used to obtain favorable judgments without going to trial. They provide the courts with a method for determining that there is no merit to a lessee's defenses and that judgment should be awarded to the lessor without the need for a trial. In order to prevail on a motion for summary judgment, the lessor must convince the court, from the evidence presented by all parties, that there is no triable issue as to any material fact and that the lessor is entitled to judgment as a matter of law. A motion for partial summary judgment (sometimes called a motion for summary adjudication) is similar to a motion for summary judgment but is more limited in scope inasmuch as it requests only that the court adjudicate the merits of a particular cause of action, affirmative defense, or claim for damages. Certain jurisdictions provide an expedited process for the determination of claims that have demonstrable prima facie validity by authorizing the commencement of an expedited action based upon either a judgment or an instrument for the payment of money (such as a guaranty or promissory note). These actions, known in some jurisdictions as "motions for summary judgment in lieu of complaint," are commenced by serving a summons with a notice of motion for summary

judgment (instead of a summons and a complaint, with a motion for summary judgment to follow weeks or months later). Even though the action is commenced by summons and motion rather than summons and complaint, the defendant usually has at least the same time within which to appear in court. If the motion for summary judgment is denied, generally the moving and answering papers are then treated as the complaint and answer, unless the court orders otherwise. Motions for summary judgment in lieu of complaint are not available in all jurisdictions, and may not be available in all types of leasing transactions depending upon the transaction structure.

## **VII. ALTERNATIVE DISPUTE RESOLUTION**

Many lease agreements include an Arbitration or Dispute Resolution clause that covers the procedure for the parties to follow if a dispute arises concerning the performance of contractual obligations. An ADR clause is meant to ensure prompt and efficient dispute resolution, thereby increasing the likelihood of resolving a dispute before the parties resort to court proceedings or litigation. Even if no such clause exists in the agreement, most courts encourage settlement by requiring the parties to participate in alternative dispute resolution programs before going to trial. The theory is that better settlement rates can be achieved through consensus-building. The courts require the parties to participate in mediation with specially-trained officers. Judges frequently also require the parties to go through nonbinding arbitration before a neutral third party. Finally, if the parties are still unsuccessful in resolving their issues, the courts will conduct settlement conferences with the parties before trial. These court-directed programs are designed to reduce court congestion by facilitating settlements through third-party assistance.

## **VIII. POST JUDGMENT**

If the lessee refuses to settle and the lessor prevails at trial or wins by summary judgment, the lessor can seek to execute on the lessee or guarantor's bank accounts, receivables, real estate, and other assets. The lessor can also place judgment liens on real and personal property. If the lessor already has attached assets, it can take possession of those assets from the sheriff or execute on and sell the real property. If the lessor has not yet recovered the equipment, it can do so with the aid of the sheriff if the judgment provides for recovery of the equipment.

To locate assets of the lessee or guarantor, the lessor may wish to engage the services of a private investigator or asset locator. The lessor also can seek a court order compelling the judgment debtors to appear and answer questions about their assets. In addition, there now are numerous websites available to a lessor for locating information about, and the assets of, a lessee or guarantor in order to satisfy a judgment.

## 5. BANKRUPTCY ISSUES

The United States Bankruptcy Code (“*Bankruptcy Code*”) was adopted by Congress in 1978 and significantly revised in 1994 and in 2005. The 2005 revisions were designed to provide remedies for perceived abuses of the bankruptcy process by individual consumers. However, certain amendments affect the rights of lessees and lessors in commercial transactions. The Bankruptcy Code uses its own special language. A lessee filing bankruptcy will be referred to as the “*debtor*” and a lessor is the “*claimant*” or “*creditor*.”

### I. TYPES OF BANKRUPTCY PROCEEDINGS

Five types of bankruptcy proceedings are prescribed by the Bankruptcy Code. Each type of bankruptcy proceeding is governed by a different chapter of the Code.

Many lessors are familiar with Chapter 7, 11, and 13 proceedings. Chapter 7 provides for the orderly liquidation of a debtor’s (lessee’s) assets. Chapter 11 involves the reorganization of a lessee’s financial affairs for all persons or entities who are not entitled to, or do not elect to, commence a bankruptcy proceeding under the less-familiar sections of the Bankruptcy Code. Chapter 13 applies to the reorganization of wage earners and other individuals who possess regular incomes and whose obligations do not exceed certain limitations set by the statute.

The more obscure types of bankruptcy proceedings are found in Chapters 9 and 12 of the Bankruptcy Code. Chapter 9 involves the reorganization of municipalities. Chapter 12 controls the bankruptcy proceedings of family farmers and family fishermen.

#### 1. Chapter 7 Proceedings

A “*trustee*” is appointed by the bankruptcy court to administer the lessee debtor’s estate in a Chapter 7 case. The administration involves the liquidation of the debtor’s assets and the disbursement of the proceeds to the creditors of the debtor’s estate.

The trustee has no authority to seek to reorganize the debtor’s financial affairs. In liquidating the bankrupt estate, a trustee may seek to operate the debtor’s business on a temporary basis or take any other actions necessary to preserve the value of the debtor’s assets.

Very few, if any, assets are found in many Chapter 7 cases. In such instances, no distributions will be made to the unsecured creditors of the debtor’s estate. A lessor may be able to recover the leased equipment in a Chapter 7 matter, but past-due rent is an “*unsecured*” claim and, if any distributions are made, typically an equipment lessor receives pennies on the dollars.

#### 2. Chapter 11 Proceedings

The reorganization of the lessee debtor’s financial affairs, and not the liquidation of its assets, is the focus of a Chapter 11 proceeding. Ordinarily, the debtor is entitled to

continue to operate its business as a “*debtor in possession*.” In instances of fraud, dishonesty, and/or gross mismanagement, a trustee may be appointed by the bankruptcy court to operate the business of the Chapter 11 debtor, though in most instances, any fraud, dishonesty, or gross mismanagement occurring prior to the filing of a chapter 11 petition is not grounds for the appointment of a trustee.

In a Chapter 11 proceeding, the debtor’s goal is to formulate and obtain the acceptance of a “*disclosure statement*” and a “*plan of reorganization*.” These documents are intended to provide the creditors with a complete description of the debtor’s financial affairs, its strategy for financial rehabilitation, and its proposed treatment of the various claims by creditors against the debtor’s estate.

Acceptance or rejection of a plan of reorganization is determined via a voting process - creditors are afforded the opportunity to cast a ballot either accepting or rejecting the proposed plan. A plan will divide the creditors into classes based on the type of claim. Examples are administrative, secured, unsecured, and contingent claims. A lessor may possess all of these types of claims from one lease transaction depending on the type and status of the default during the bankruptcy. A bankruptcy court rarely refuses to approve a plan of reorganization (i.e. “*confirm*” a plan) if the plan is accepted by all of the classes of claimants (creditors) and other interested parties. In addition, the bankruptcy court possesses the authority to “*cram down*” a plan of reorganization over the objections of those persons or entities (i.e. confirm a plan notwithstanding any objections or rejecting classes of claimants) so long as one impaired class (type of creditor) has accepted the plan of reorganization and the court finds that:

- a. the plan of reorganization is fair and equitable;
- b. the plan of reorganization will not provide any of the claimants (creditors) or other interested parties with less than they would have received in a Chapter 7 proceeding; and
- c. the plan of reorganization satisfies the other requirements set forth in the Bankruptcy Code.

The approval and implementation of a plan of reorganization usually marks the conclusion of a Chapter 11 proceeding. The bankruptcy court may retain jurisdiction to decide certain issues arising from the debtor’s failure to comply with the terms and conditions set forth in the plan of reorganization.

### **3. Chapter 9 Proceedings**

In a Chapter 9 proceeding, a municipality may seek to reorganize its financial affairs by obtaining the approval of a disclosure statement and plan of reorganization. The requirements for the contents and approval of a disclosure statement and plan of reorganization in a Chapter 9 proceeding are identical to those that are applied by the court in a Chapter 11 proceeding.

#### **4. Chapter 12 Proceedings**

In a Chapter 12 proceeding, the family farmer or fisherman will seek to propose and obtain the court's approval of a plan of reorganization within a relatively short time. Although the creditors will be entitled to file objections to the plan of reorganization, they will not be able to vote for or against the acceptance of that document. The greatest drawback to creditors is that payments are only made annually.

A trustee is appointed by the court to supervise the administration of the debtor's estate in a Chapter 12 proceeding. Such administration will include the collection of monies from the debtor and the payment of various amounts to its creditors and other interested parties.

#### **5. Chapter 13 Proceedings**

A Chapter 13 proceeding is similar to a Chapter 12 proceeding in many ways. However, Chapter 13 proceedings involve the reorganization of the debts of an individual with regular income. A standing Chapter 13 trustee supervises every Chapter 13 proceeding and, like a Chapter 12 trustee, is responsible for collection of monies from the debtor and the distribution of payments to the debtor's creditors in accordance with a Chapter 13 plan.

## **II. BASIC ELEMENTS OF A BANKRUPTCY PROCEEDING**

The Bankruptcy Code contains a number of common elements that apply to all of the various types of bankruptcy proceedings. The most important elements are described below:

### **1. The Automatic Stay**

One of the central features of the Bankruptcy Code is the imposition of the "*automatic stay*" upon the commencement of a bankruptcy. The automatic stay is an injunction that prohibits all creditors, including lessors, from seeking to collect or secure their outstanding obligations from the debtor or taking any action against the debtor's assets without a specific court order.

The purpose of the automatic stay is to prevent aggressive creditors from disrupting the orderly liquidation or reorganization of the debtor's business. Violations of the automatic stay are void and also may render the creditor liable for compensatory and, possibly, punitive damages. Once the bankruptcy case has been filed, the automatic stay prohibits a lessor from taking certain actions including, but not limited to:

- a. canceling or terminating the lease;
- b. commencing an action against the lessee to collect monies or to recover the equipment;

- c. repossessing the equipment; and
- d. disposing of the equipment (unless the lease has expired or been canceled prior to the commencement of the bankruptcy proceeding).

Violations of the automatic stay by a creditor can result in severe penalties.

The automatic stay does not prevent a lessor from canceling the delivery of equipment to the lessee prior to the commencement of the lease or seeking relief against a guarantor or other third-party obligor under the lease documents.

## **2. Notice to Creditors and Other Interested Parties and Entries of Appearances**

The Bankruptcy Code includes mechanisms and procedures intended to provide the debtor and all creditors and other interested parties with adequate notice of any actions that could affect their rights or property. One of a lessor's primary goals usually is to ensure that it receives copies of any notices that are distributed in a bankruptcy proceeding.

This goal can be accomplished in several ways. At the commencement of the bankruptcy proceeding, the debtor is required to provide the court with a list of its priority, secured, and unsecured creditors; the amounts of the obligations owing to those parties; and certain other information that is relevant to the debtor's financial condition. The court will use the information provided by the debtor to prepare an initial mailing list and, if the name and address of a lessor are on that list, the lessor should receive copies of all notices that are sent to the creditors and other interested parties of the debtor's estate.

If a lessor is not described in the list of creditors that is provided by the debtor to the court or, if the lessor's attorneys wish to receive copies of the notices sent to the creditors and other interested parties, the lessor or its attorneys may file an entry of appearance with the court and mail copies of that document to the debtor, its attorney, the trustee, and any parties that are contained in the court's mailing list. These actions will cause the lessor or its attorneys to be added to the mailing list and entitle those parties to receive notice of any significant actions being taken in the debtor's bankruptcy proceeding.

The Bankruptcy Code contains provisions that create a definition of effective notice which could prove particularly helpful to institutional creditors with a large number of locations. Under certain conditions, if a creditor has supplied the debtor with an account number and the address at which the creditor requests delivery of correspondence, any notice required to be sent by the debtor must be sent to that address and include the account number. A creditor also may designate a person or department and notice is not deemed brought to the attention of the creditor until that person or department receives it. Notice other than in accordance with these provisions is not effective. This provision is intended to avoid the common problem of notices and motions being mailed to creditors' payment lock boxes, which often resulted in the entry

of orders against creditors by default, and creditors missing filing deadlines. The U.S. Bankruptcy Courts require parties to use Electronic Bankruptcy Noticing (EBN) where possible, which is a free service that allows court notices and filings to be transmitted electronically immediately upon filing, resulting in their timely delivery to interested parties.

### **3. Proofs of Claims**

In a Chapter 7, 12, or 13 proceeding, a lessor who wishes to participate in distributions from the debtor's estate must file a proof of claim within a certain deadline. A lessor is required to file a proof of claim in a Chapter 9 or 11 proceeding only if its debt has been described as disputed, contingent, or unliquidated in the schedules of assets and liabilities that have been submitted by the debtor's estate or if the lessor wishes to correct an inaccurate description of its debt or the leased equipment that is contained in the schedules of assets and liabilities.

Because a review of the debtor's schedules of assets and liabilities can prove time-consuming (particularly in large cases), many lessors adopt a practice of filing proofs of claims in all bankruptcy proceedings at the very outset of each case. Such a practice minimizes the possibility that the lessor will subsequently fail to file a required proof of claim or dispute the debtor's erroneous description of its claim or the leased goods.

### **4. Adequate Protection**

A debtor is required to provide a lessor under a true lease or a lease intended as security with adequate protection for the continuing possession or use of the leased goods. Although the term "*adequate protection*" is not defined in the Bankruptcy Code, the courts often have found a lessor to be adequately protected if:

- a. the debtor maintains the leased equipment in good condition and does not commit any waste with respect to those goods;
- b. the debtor possesses sufficient insurance to protect the lessor from any loss or damage to the leased equipment; and
- c. the lessor receives payments or otherwise is protected from any diminution in the value of the equipment (i.e., the fair market value of the equipment is greater than the amount of the obligation).

A number of courts have awarded a lessor under a true lease the full amount of its lease payments as compensation for the diminution in the value of the leased equipment. However, lessors under leases intended as security often receive adequate protection payments that are equal only to the depreciation of the leased goods.

Debtors rarely provide lessors with adequate protection for the possession or use of the leased goods on a voluntary basis. If a debtor fails or refuses to provide adequate protection, the lessor is entitled to file a motion seeking such relief from the bankruptcy

court.

## **5. Relief from the Automatic Stay**

The Bankruptcy Code provides that a lessor is entitled to seek the entry of an order vacating the automatic stay “*for cause*.” The term “*cause*” includes, but is not limited to: (a) the debtor’s failure to provide the lessor with adequate protection; or (b) the absence of any equity in the leased equipment covered by a lease intended as security; or (c) in the case of a Chapter 11 or 13 case, a demonstration that such equipment is not necessary for an effective reorganization of the debtor’s estate.

Under the most recent revisions to the Bankruptcy Code in an individual Chapter 7, Chapter 11, or Chapter 13 case, the automatic stay automatically terminates sixty days after a request for release of the equipment by the creditor, unless the court orders otherwise or the parties agree to a longer period.

## **6. Assumption or Rejection of Leases**

The Bankruptcy Code requires a debtor to assume or reject a true lease of equipment within different amounts of time depending upon the type of bankruptcy proceeding. In a Chapter 7 proceeding, a debtor will be deemed to have rejected a lease agreement unless such lease is assumed by the debtor’s estate within sixty days from the commencement of the bankruptcy case (absent a court order extending the foregoing deadline). In Chapter 9, 11, 12, and 13 proceedings, a debtor is required to assume or reject a lease agreement within a reasonable amount of time but, in no event, later than the confirmation of a plan of reorganization.

If a debtor delays in making a decision to accept or reject a true lease, the lessor is entitled to request the court to enter an order requiring the assumption or rejection of the lease agreement within a specified period. In general, to assume a true lease, the debtor must cure defaults (except for the payment of certain penalties) and provide the lessor with adequate assurances of its ability to perform the obligations described in the lease agreement in the future. The debtor’s requirement to cure existing defaults may extend to non-monetary as well as monetary defaults; however, this issue has not been decided by the courts in a conclusive manner. Finally, the assumption is all or nothing - the debtor may not pick and choose which provisions in a lease agreement to assume and which to reject.

Technically, a debtor must perform virtually all of the obligations described in a true lease (for non-consumer goods) that arise on or after the sixtieth day of a Chapter 11 bankruptcy filing. This provision is supposed to prevent lessees from enjoying a free ride of the leased goods while they decide whether to accept or reject the lease in a Chapter 11 proceeding, but as a practical matter, very few Chapter 11 debtors voluntarily make such payments without a demand or motion by the lessor.

The rejection of a true lease is deemed to constitute a breach of the terms and condition set forth in the lease as of the commencement of the bankruptcy proceeding.

If a lease of personal property is rejected, the leased property is no longer property of the bankruptcy estate and the stay is automatically terminated which would permit repossession of the leased equipment. In the event of a lease rejection, the lessor can also assert an unsecured claim against the debtor's estate for the damages arising from the breach of the lease. The lessor also may seek an administrative claim for unpaid rent, against the debtor's estate, for the period that the debtor used the equipment post-petition. Determining whether the lessor's claim (or parts thereof) is administrative, secured, or unsecured determines the priority in which the claim will be paid from the assets of the estate.

A debtor's assumption or rejection of a true lease must be approved by the bankruptcy court, and such approval will be granted if the debtor can demonstrate that the proposed action will benefit the debtor's estate despite any anti-assignment language contained in the lease. A debtor is entitled to assume and assign a true lease to a third party only if the arrearages are cured and the assignee provides the lessor with adequate assurances of its ability to perform the remaining obligations under that lease.

## **7. Disclosure Statement and Plans of Reorganization**

A lessor is a creditor of the debtor's estate and is entitled to file objections to disclosure statements and plans of reorganization in all types of bankruptcy proceedings. It also may propose and vote on plans of reorganizations in Chapter 9 and 11 proceedings. And although a creditor cannot vote in a Chapter 12 or 13 plan, a creditor can file an objection to confirmation of a proposed plan.

A plan of reorganization may reduce the amount that a lessor under a lease intended as security is entitled to collect from the debtor's estate by reducing the secured portion of its claim to reflect the fair market value of the leased goods, and making the balance of the claim unsecured. The plan also may lower the rate of interest charged by the lessor to the current rate that would be paid by the debtor under current economic conditions. Such actions cannot be taken with respect to the claim belonging to a lessor under a true lease since such agreements must be accepted or rejected by the debtor's estate in their entirety.

## **8. Objections to Discharge and Motions for Appointment of Receivers or Trustees and Conversion or Dismissal of Bankruptcy Proceedings**

A lessor, in its capacity as a creditor, also is entitled to exercise other rights in a bankruptcy proceeding. These rights include objecting to a discharge of the debtor's obligations described in the lease, seeking the appointment of a receiver or trustee in a Chapter 9 or 11 proceeding, and requesting the dismissal or conversion of a bankruptcy in any chapter.

A bankruptcy court rarely grants a lessor's objections to the discharge of a debtor's obligations under a lease unless the lessor can demonstrate that the debtor fraudulently induced the lessor to enter into the lease, stole the equipment, or otherwise

intentionally harmed the lessor or the equipment. Likewise, most courts will not appoint a receiver or trustee in a Chapter 9 or 11 proceeding, or dismiss or convert a bankruptcy proceeding absent a showing of bad faith, mismanagement, waste, fraud, or the inability to formulate or effectuate a plan of reorganization or file certain pleadings with the court that are required by the Bankruptcy Code. The grounds for dismissal/conversion/appointment of a trustee include failure to maintain appropriate insurance that poses a risk to the estate, which may, under certain circumstances, provide equipment lessors sufficient cause to justify a request for a conversion or dismissal or appointment of a trustee.

### **III. COMPARISON OF THE RIGHTS OF LESSORS UNDER TRUE LEASES AND LEASES INTENDED AS SECURITY IN BANKRUPTCY**

Generally, a lessor under a true lease possesses many advantages over a lessor under a lease intended as security in a bankruptcy proceeding.

First, the Bankruptcy Code provides a lessor under a lease intended as security only with the right to seek relief from stay or adequate protection for the use of its equipment in a Chapter 7 or 11 proceeding and does not establish a deadline for provision of such protection by the debtor's estate. However, if the value of the equipment is less than the balance due under the lease, and the debtor is in default on any payments, lessors can immediately move for relief from stay without waiting for the sixty day period to expire.

Besides seeking adequate protection from the lessee, a lessor under a true lease also may be entitled to have the lease deemed to be rejected by the debtor's estate if: (a) the debtor does not assume the lease within sixty days of the commencement of a Chapter 7 proceeding; or (b) the debtor fails to perform virtually all of the obligations described in a non-consumer lease that arise on or after the sixtieth date of a Chapter 11 proceeding (unless this deadline is extended by the bankruptcy court due to the equities of the case).

Second, the adequate protection that is provided to a lessor under a lease intended as security may consist only of payments equal to the depreciation of the leased equipment. However, a court may require the debtor to remit adequate protection payments that are equal to the full amount of the rental payments and other obligations to a lessor under a true lease.

Third, the secured portion of the claim belonging to a lessor under a lease intended as security may be reduced to the fair market value of the leased goods and, in a plan of reorganization, the interest payable under the prevailing market conditions. However, the debtor is required to assume or reject a true lease in its entirety.

### **IV. MISCELLANEOUS ISSUES AFFECTING RIGHTS IN BANKRUPTCY**

A true lease will not be construed to constitute a portion of the debtor's estate if the lease expires or is cancelled prior to the commencement of the bankruptcy proceeding. If a lessor believes that a lessee may become the subject of a bankruptcy

proceeding, the lessor may wish to ascertain whether a default exists that would justify the pre-petition cancellation of the lease.

The lessor also may wish to obtain possession of the leased equipment (if it is entitled to take such action) before the automatic stay imposed upon the commencement of the bankruptcy proceeding prevents such repossession. Otherwise, substantial amounts of time and money may be expended by the lessor to exercise its post-petition remedies with respect to the equipment.

## 6. FRAUD ISSUES

Fraud can pose a problem for equipment lessors. The consequences of fraud can have a serious financial impact on an equipment lessor. Many lessors have implemented procedures to help eliminate or decrease their susceptibility to fraud and to increase their chances of mitigating any resulting damages.

### I. COMMON TYPES OF FRAUD

One of the first steps to be taken in developing an anti-fraud system is recognizing some of the types of fraud that have been perpetrated against lessors. Types of fraud include:

- a. the equipment vendor, broker, or lessee obtaining financing for the leased equipment from several different sources;
- b. the lessor is sold non-existent goods;
- c. the lessor is sold equipment at inflated prices (this type of fraud poses a particular problem for leases involving custom-made equipment where a recognized market does not exist to corroborate the fair market value of the leased equipment);
- d. the lessor is sold used equipment that is represented to be new equipment;
- e. the lessor is provided with lease documents, financial statements, or tax returns that contain fraudulent information or forged signatures;
- f. the monies from the lessor for the purchase of the leased goods are diverted by the equipment vendor, broker, or lessee;
- g. the leased equipment is used by a third party without the lessor's knowledge or consent; and
- h. employees of the lessor receive "*kickbacks*" or other remuneration from equipment vendors, brokers, or lessees in exchange for providing improper favors to those parties.

Many of the different types of fraud involve the alteration of the invoices and bills of sale for the leased equipment or the fraudulent production of such documents. Lessors often attempt to address this issue by carefully and methodically confirming the ownership of the leased equipment and the nature and fair market value of those goods.

Similarly, members of the leasing industry often seek to prevent or uncover fraudulent information, signatures or documents by:

- i. obtaining certain materials from third parties (such as copies of a lessee's or guarantor's tax returns from the United States Internal Revenue Service and other taxing authorities);
- j. corroborating certain information with other knowledgeable parties (such as the fair market value of the leased equipment with technical experts, other dealers, or appraisers of such goods);
- k. requiring the most important lease documents (such as the lease agreement and guaranties) to be notarized or witnessed by third parties; and
- l. confirming that the financed equipment actually has been delivered to the customer, by written documentation, oral confirmation or on-site inspection.

A lessor also may attempt to prevent the diversion of monies used to purchase the leased goods by insisting upon the direct payment of such monies to the manufacturer or seller of those goods or the employment of a reputable escrow agent.

Many lessors seek to prevent or uncover the improper use of the leased equipment by conducting periodic inspections (including inspections without prior notice being given to the lessee). Lessors may attempt to address the issue of kickbacks and other inappropriate forms of compensation paid to their employees by implementing and enforcing written policies that strictly prohibit their employees from receiving any gifts or other types of remuneration from any third parties and requiring several persons (as opposed to one individual) to be responsible for the approval and documentation of each lease transaction.

## **II. INDICIA OF FRAUD**

There are a number of indicia that often serve as warning signals to lessors of potential fraudulent conditions. Some of these indicia are:

- a. the inability or reluctance of the manufacturer, vendor, broker, or lessee to provide the lessor with direct access to any source of information regarding the lessee's business or the leased equipment. There is seldom a valid reason why the lessor or its agents should be prevented from conducting a reasonable amount of due diligence on a specific transaction or series of lease agreements;
- b. the inability or reluctance of the manufacturer, vendor, broker, or lessee to permit the lessor to inspect the leased equipment or the party's premises. Such actions may indicate that the leased equipment does not exist or is being used by a third party;
- c. the inconsistency of the proposed lease transaction with the size or type of the lessee's business or inconsistency between the terms of the various

lease documents. This condition also may indicate that the lessee is seeking financing for fictitious equipment or that the leased equipment is being used by a third party;

- d. the existence of an inordinate number of UCC filings against the lessee. This condition may suggest that the lessee has obtained duplicate financing, is seeking financing for fictitious equipment or will not be using all of the leased goods;
- e. the lessee's creation and maintenance of an inordinate number of related entities. Affiliate companies and subsidiaries often are used to confuse a lessee's creditors and disguise its liabilities and assets;
- f. the lessee's sharing of its business premises or subleasing of its goods. These conditions may complicate the analysis of the lessee's actual business operations and assets;
- g. the reluctance of the manufacturer, vendor, broker, or lessee to provide the lessor with standard representations or warranties pertaining to a specific lease agreement or series of lease transactions. Such reluctance may indicate that the responsible party possesses knowledge of the breach of the requested representations or warranties;
- h. a flurry of last-minute changes to a prospective lease agreement or an inordinate amount of pressure to close the lease transaction in an inordinately short amount of time. Such actions may indicate that the manufacturer, vendor, broker, or lessee is seeking to prevent the lessor from confirming the absence of any problems with respect to the proposed lease agreement and leased goods; and
- i. the existence of unresolved customer complaints from the users of the equipment. Such complaints may indicate serious issues involving the vendor's ability to properly service the equipment or more fundamental misunderstandings between the vendor and the lessee.

A lessor may wish to use additional caution whenever any of these indicia are found with respect to a proposed lease transaction.

### **III. REMEDIES FOR FRAUD**

Once a fraud is discovered, it is important for a lessor to move quickly to assess the nature and scope of the fraudulent activity and review potential remedies. These remedies may include:

- a. declaring a default with respect to the affected leases;
- b. exercising its remedies against the lessee, guarantors, other third-party obligors, and leased equipment;

- c. making demands upon or commencing civil actions against the manufacturers, vendors, or brokers for any breach of their representations or warranties to the lessor or the performance of their obligations under any repurchase or remarketing agreements;
- d. making demands upon or commencing conversion or replevin actions against any third parties who have obtained the leased equipment without the lessor's consent;
- e. making demands upon or commencing civil actions against any professionals or insurance companies who possess any potential liability to the lessor; and
- f. filing complaints for criminal conduct against the perpetrators of the fraud with the appropriate governmental authorities.

A defrauded lessor often will find that the perpetrators of a fraud also have defrauded other creditors and third parties. If the fraud is widespread and also affects multiple lessees, particularly small businesses, the defrauded lessor may find that one or more regulators or enforcement agencies may become involved with the fraud and commence an investigation that may involve the lessor, or that the lessor itself is subject to a class action brought by similarly situated lessees. The lessor may wish to share information and the cost of pursuing its remedies against the perpetrators with the other victims that are not in an adversarial position against the lessor. In addition, the lessor may wish to report the nature of the fraud to its business associates and various credit rating agencies. All of these actions should be taken only upon the advice of legal counsel and with a full understanding of the lessor's potential liability for libel, slander, tortious interference with contractual relations, and other claims.

A lessor also would be well-advised to enlist the assistance of legal counsel before filing a criminal complaint against the perpetrators of the fraud. However, under certain circumstances, federal law may require the lessor to file a Suspicious Activity Report with the Department of Justice. The fact that such filing may not be disclosed to third parties, possibly including outside counsel, may become problematic during discovery in litigation. Applicable law may prohibit a lessor from using the threat of criminal action to obtain monetary or other concessions from another party under applicable law, so counsel should be consulted.

#### **IV. PREVENTING FRAUDS**

Many lessors will review their internal policies and procedures after discovering a fraud or learning that a competitor has been defrauded by a third party. Even in the absence of a fraud, a lessor should conduct a review of its policies and procedures on a periodic basis. These reviews should include an in-depth examination of a sampling of the lessor's portfolio to ensure that its employees are actually following the written policies and procedures.