

Equipment Lease Alert

Reading Between the Lines

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Entering into an equipment lease for telephone systems, computers or lift trucks usually involves a straight-forward process. First, find the right equipment and compare brands and models. Then negotiate for the most advantageous financial terms. Sign the lease, take delivery, inspect the equipment and get back to work. After all, all equipment leases are standard; they all say the same thing. Unfortunately that may not be a fair assumption.

In order to give the lessor/lender a security interest in the equipment, it must be described in the financing statement (UCC-1). Ordinarily this is done by including the description and serial or part numbers shown on the lease or invoice or bill of lading. The Commercial Code requires that the description be “reasonable.” Commercial Code § 9108 says that any of the following is a sufficient method of description: (1) specific listing; (2) category; (3) as collateral defined in the Code; (4) quantity; (5) computational or allocational formula or procedure; (6) anything objectively determinable. The sufficiency of the description measures the extent to which someone searching the UCC files can determine that the lessor/lender claims a security interest in that specific equipment.

If the lender/lessor says “see attached security agreement” or “IBM computer serial number 12345 and as set forth in the attached security agreement” where the collateral should be described in the UCC-1 financing statement and then attaches the security agreement, anyone searching the record must then read the

security agreement. Otherwise, the person searching the UCC files will not know for certain what property is subject to the claim of the lender/lessor.

Some equipment lessors have started to broaden their rights without much notice being taken by the lessees. A lessee expects to sign a security agreement and have a financing statement filed that gives the lessor a first security interest in the equipment being leased. But some lessors are adding language giving them a “blanket” security interest in ALL of the lessee’s “goods, general intangibles, inventory, machinery, contract rights, accounts, and all proceeds therefrom.” That creates an economic issue and a legal issue. In economic terms, the lessee may be giving security worth far more than the risk undertaken by the lessor. Suppose the computer equipment being leased is worth \$15,000 new but the lessor takes a security interest in the equipment as well as accounts receivable worth \$50,000. That is a lopsided deal and one that a lessee is unlikely to make. In legal terms, it creates a cloud on the ability of the lessee to give other lenders a security interest in those other assets. That will either prevent the lessee from obtaining the other financing or will make it more expensive.

If the lessee has already obtained a line of credit and given such a blanket security interest to that lender, then the equipment lender’s blanket security interest is junior. But if the lessee obtains a new line of credit or redocuments a credit facility so that there is a new UCC filing, the equipment lessor’s blanket security interest may move up to number one giving it priority over the other lender(s).

The other lender would ordinarily search the UCC records to determine what security interests are ahead of it before going ahead with the financing. But if the equipment lessor has filed a UCC-1 that refers generally to the security agreement attached in lieu of a specific description of the security interest that has been conveyed, the scope of the collateral may not be apparent. One doing a UCC search will see an equipment lease and assume, perhaps wrongly, that the collateral is limited to the specific equipment. If the lender doing the search does

read everything and see that a blanket security interest has already been given to the equipment lender, then the credit line may be withdrawn or priced differently or, at the very least, the lessee will have to help the lender negotiate a subordination agreement with the lessor. This will add expense to the credit facility and will certainly delay the funding.

This is not a hypothetical situation that never really occurs. It all happened in *Orix Credit Alliance, Inc. v. Young Express, Inc.*, 43 Fed. Appx. 650, 2002 U.S. App. LEXIS 17602 (4th Cir. 2002) to the sorrow of the lender. Orix leased computer equipment to Young and took back a blanket security interest. It is apparent from the case that Young never realized it had given such a broad security interest in all of its assets. Orix filed a UCC-1. Then Wachovia Bank gave credit to Young and took a blanket security interest and filed its UCC-1. It is also apparent that Wachovia did not focus on the full extent of the prior security interest claimed by Orix. Young defaulted on the lease payments and notified Orix of its plight and that it had transferred some of its accounts receivable to Wachovia. Orix demanded that Wachovia recognize Orix' prior perfected position and give the accounts receivable to it. Because Orix did have a valid prior security interest in all of the lessee's property it was able to state a claim against Wachovia and Young. This expansion of the scope of the security interest taken by equipment lessors has been used by other equipment lessors who are also giving themselves the added protection by broadening the scope of their security interest.

This creates a risk to the equipment lessee in at least two ways. First, it gives the lessor collateral far beyond the industry standard, far beyond what the lessee anticipates it is giving, and probably far more than the lessor needs to be secure. Second, it interferes with the lessee's ability to obtain financing for operating expenses, or other purposes because it cannot give a first security interest in its other assets to another lender. And if the other lender does not realize the scope of the equipment lessor's lien, a belated discovery will undoubtedly occur in the worst possible context. In the Orix case, the equipment lessor sued the borrower's

principals for breach of their fiduciary duty (an insolvent company has a fiduciary duty to its creditors) and for conversion, a tort that often may justify an award of punitive damages.

Avoid the Problem

If you are leasing equipment, **READ THE SECURITY AGREEMENT**. Every careful lessee reads the terms to make sure that the payments are right, the term is right and the residual payment, if any, is right. But beyond that it is necessary to read the “boilerplate.” Read the description of what property secures the obligation. If it describes anything more than the actual equipment itself, think about whether you really want to sign. You may not want to pledge your accounts receivable or your patents to the lessor. Insist that the financing statement accurately describe only the collateral that you intend to give to secure the lease. If the description is unintelligible, insist that it be rewritten in plain English so that there is no doubt as to the nature and scope of the collateral. Do not allow a general description of “collateral as described more particularly in the security agreement attached hereto” be used to obfuscate the scope of the collateral.