Leases

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True Lease v. Disguised Security Interest

The characterization of a transaction as either a true "lease" or a secured transaction is likely to impact the putative lessor's rights and remedies both with respect to the calculation of damages recoverable under the transaction documents as well as to the residual value of the subject equipment, especially if the lessee files for bankruptcy.[1] In disputes between the putative lessor and another creditor claiming to have a security interest in the subject equipment, as in *In re Purdy*,[2] the characterization of the transaction will determine which of those parties will be entitled to recover the value of the equipment. The court in *Purdy* was asked to consider the characterization of a purported lease of cattle, so as to determine whether the purported lessor or the secured creditor would be entitled to the disposition proceeds after the cattle were sold. Sunshine Heifers, LLC ("Sunshine") and Lee Purdy, a dairy farmer, entered into several dairy cow leases over three years, in which Sunshine agreed to provide Purdy with dairy cows in exchange for monthly rent. Prior to entering into the dairy cow leases, Purdy entered into a loan arrangement with Citizens First Bank ("Citizens First"), in which "Purdy granted Citizens First a purchase money security interest in 'all . . . Equipment, Farm Products, [and] Livestock . . . currently owned [or] hereafter acquired.'"[3] When Purdy's farm petitioned for bankruptcy protection, Sunshine moved to retake possession of its cattle. Citizens First argued that the leases were "disguised security agreements"[4] and, as a result,

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1. "If one is a lessor as opposed to a secured seller, one has different rights on default, on lessee bankruptcy, in regard to federal, state and local taxes, and under state usury laws, and the difference even extends to the lessor's and lessee's balance sheet." 2 James J. White & Robert S. Summers, Uniform Commercial Code § 13-2, at 4 (5th ed. 2008).

2. Sunshine Heifers, LLC v. Citizens First Bank (*In re* Purdy), 763 F.3d 513 (6th Cir. 2014).

3. *Id.* at 513 (quoting the Agricultural Security Agreement).

4. *Id.* at 516. This was the term used by the court to refer to a transaction documented as a lease but effectively creating a secured transaction. *Id.*

Purdy owned the subsequently acquired cattle, and such ownership was subject to the bank's security interest. The bankruptcy court agreed.[5] The United States Court of Appeals for the Sixth Circuit reversed the bankruptcy court's decision that the dairy cow leases were per se security agreements.

The court applied a two-step factual analysis to consider the appropriate characterization of the transaction. First, the court applied the so-called bright line test under Arizona's version of U.C.C. section 1-203, including a determination both of whether the lease obligation could be terminated early (of which there was no dispute), and whether the original term of the lease was equal to or greater than the remaining economic life of the cattle.[6] If the lease term exceeded the economic life of the cattle, then the leases to Purdy would constitute security agreements, but if not, the court would examine the facts of the case to determine whether the economic realities of the transaction suggested how the transaction should be characterized.[7] Unlike the bankruptcy court, the Sixth Circuit determined that the leased herd included cattle originally leased as well as replacements for cattle that had been culled from that original herd, and that the herd as so comprised had an "economic life far greater than the lease term."[8] Accordingly, the purported leases "flunk[ed] the bright line test," and the court found that the leases were not per se security agreements.[9]

The court then considered the economics of the transaction, specifically, "whether Sunshine kept a meaningful reversionary interest in the herd."[10] In its analysis of this issue, the court considered two factors: "(1) whether the lease contains a purchase option that is nominal; and (2) whether the lessee develops equity in the property, such that the only economically reasonable option for the lessee is to purchase the goods."[11] The court noted that neither of those factors suggested that the agreements were anything "other than true leases because the contracts [did] not contain an option for Purdy to purchase the cattle at any price, let alone at a nominal one."[12]

Last, the court noted that the Uniform Commercial Code "clearly states that the fact that terms of the lease are unfavorable to the lessee, [or] that the lessee assumes the risk of loss of the goods . . . is not alone grounds to find that a contract is a security agreement."[13] For all of these reasons, the court held that Citizens First failed to carry its burden of proving that the actual economics of the transaction demonstrated that the leases were security agreements, reversed the

5. *Id.*
6. *Id.* at 519 (citing ARIZ. REV. STAT. ANN. § 47-1203(B)). The court determined that Arizona law governed the litigation, so it relied on the pertinent sections of the Arizona Commercial Code and related case law. *Id.*
7. *Id.* (citing Duke Energy Royal, LLC v. Pillowtex Corp. (*In re* Pillowtex, Inc.), 349 F.3d 711, 717 (3d Cir. 2003)).
8. *Id.* at 520.
9. *Id.*
10. *Id.*
11. *Id.* (internal quotation omitted).
12. *Id.*
13. *Id.* at 521 (citing ARIZ. REV. STAT. ANN. § 47-1203(C)).

bankruptcy court's decision, and remanded the case to the bankruptcy court for further proceedings consistent with the opinion.[14]

Liquidated Damages

Equipment finance transactions structured as leases afford customers various advantages when compared to acquisition financings structured as secured loans. Among those advantages to the lessee are 100 percent financing of the acquisition cost, reduced payments reflecting the federal income tax benefits and residual value proceeds anticipated by the lessor, and an opportunity to avoid technological obsolescence and other customer-specific or market risks relating to the equipment. When offering a financing product with these structural advantages to its customers, lessors must be willing to accept a significantly greater risk that it might not recover the entire amount of its investment, anticipated yield, and enforcement costs.[15]

Accordingly, certainty of payment is essential to equipment financing providers, especially any accelerated payments, when determining the exit strategy in a distressed transaction. The remedies available to a lessor after a true "lease" default are set out in Article 2A.[16] Although lessors and lessees typically rely on the lease recitation of default triggers and remedies, the scope or enforcement of these remedies may be supported or constrained by Article 2A or other applicable law.[17]

Among the critical remedies is the right to demand that the lessee pay damages in a stipulated amount sufficient to compensate the lessor for the loss of its bargain as anticipated at lease inception.[18] Section 2A-504(1) recognizes the enforceability of a liquidated damages remedy in a lease, by which a lessor may demand payment of a specified amount or an amount determined by a formula after the occurrence of a default or other act or omission.[19] However, a liquidated damages provision will be enforceable only if the stipulated damages amount or formula is "reasonable in light of the then anticipated harm caused

14. *Id.*

15. By way of example, secured lenders can limit collection risks by financing a measured percentage of the collateral value of the financed equipment, and by requiring principal reduction payments if the collateral suffers an unanticipated decline in value during the repayment term. Neither of these protections is practical in a lease because the lessor is intended to be the owner of the equipment for federal income tax, commercial law, and accounting purposes.

16. *See* U.C.C. § 2A-523 (2011) (setting forth various statutory defaults and remedies available to a lessor with respect to such defaults).

17. Lessors and lessees "can agree to modify the rights and remedies available under the Article, . . . [including by] provid[ing] . . . for defaults other than those specified in subsection (1), ... [and] whether or not the default would otherwise be held to substantially impair the value of the lease contract to the lessor . . . [and] can also create a new scheme of rights and remedies triggered by the occurrence of the default." *Id.* § 2A-523 cmt. 2.

18. *See id.* § 2A-523(1)(f) ("[T]he lessor may . . . pursue any other remedies provided in the lease contract.").

19. *Id.* § 2A-504(1). This flexibility to stipulate as to the appropriate amount of damages or formula for damages in the event of a default or other act or omission is a predicate for many leasing transactions. *Id.* § 2A-504 cmt.

by the default or other act or omission."[20] Discussed below are three of the noteworthy 2014 cases involving the enforceability of a lessor's claim for liquidated and other damages relating to a defaulted lease. Only one of the three lessors was able to establish to the court's satisfaction that the lease documents and other evidence and submissions supported the lessor's demand for the amount claimed.

In *PNC Equipment Finance, LLC v. MDM Golf, LLC*,[21] the court granted the damages, interest, attorney's fees, and costs requested by the lessor in connection with the lessee's default under two equipment lease agreements because the lessor established the facts supporting the specific calculations set forth in the filings. The lessee defaulted under the leases, and in accordance with the terms, the lessor was entitled upon default by the lessee to declare the Stipulated Loss Value, as defined in of each of the leases, to be immediately due and owing.[22] After the lessor issued notices of default, it repossessed and sold the equipment, and applied the net sales proceeds to the amounts due under each lease. The court relied upon the lessor's exhibits and affidavits as sufficient evidence for a default judgment in favor of the lessor against the lessee and various guarantors for an amount equal to the unrecovered lease obligations,[23] and for the lessee to reimburse the lessor for its attorney's fees and costs incurred in connection with its enforcement actions (which costs were recoverable pursuant to the provisions of the leases because the court determined that the lessor's calculation of those fees and costs were reasonable).[24]

In *Balboa Capital Corp. v. WCS Lending LLC*,[25] the court denied the lessor's motion for default judgment with respect to damages, interest, attorney's fees, and costs because the amounts asserted by the lessor as being payable under the lease could not be determined by mathematical calculation, rationalization, or itemization by reference to the pleadings and supporting documents. According to the lease, in the event of the lessee's breach, the lessor could "recover the entire outstanding balance of the lease, past and then-remaining," and that "in the event of a default, [the lessee] would be credited for amounts already paid, if any."[26] Although the lessor asserted that a "sum certain" of $82,515 was due under the lease, the court was "unable to trace the computation of such amount due to the lack of explanations and evidence in [the lessor]'s supporting documents," and it denied the lessor's motion for the requested sum "pending supplementation of the record at a hearing."[27] The court also denied

20. *Id.* § 2A-504(1).
21. No. 1:14-cv-509, 2014 WL 5219582 (S.D. Ohio Oct. 14, 2014).
22. *Id.* at *2.
23. *Id.*
24. *Id.* at *3.
25. No. 3:14-CV-108-B, 2014 WL 4956459 (N.D. Tex. Sept. 29, 2014).
26. *Id.* at *4.
27. *Id.* at *5. The court noted that the full thirty-six monthly payments of $2,034.25 would total $73,233.00, and yet no explanation was given for the discrepancy between this figure and the $82,515.00 claimed by the lessor. *Id.* at *4.

the lessor's motions for accrued interest, attorney's fees, and court costs for the same reasons.[28]

Perhaps of greater import, the court denied the lessor's motion for declaratory judgment seeking return of the leased equipment despite the express provision in the lease affording the lessor the right to "concurrently seek the outstanding balance of the lease as well as retake possession of the goods."[29] When analyzing whether the lessor was entitled to both the accelerated and other amounts claimed as damages under the lease and to recover the equipment, the court considered both the unambiguous text of the pertinent remedy provisions in the lease, as well as section 2A.529 and section 2A.503(a) of the Texas Business and Commerce Code.[30] Relying upon the comments to section 2A.529, the court noted that, "*absent a lease contract provision to the contrary*, an action for the full unpaid rent . . . is available . . . only if the lessee retains possession of the goods," and that these comments suggest that a lessee may, by contract, effectively waive its right to retain the equipment.[31]

The court then examined whether, pursuant to section 2A.503, the lessee's express agreement to the concurrent remedies under the lease constituted an effective waiver of the lessee's section 2A.529 right to retain the equipment.[32] The court determined that the lessee had not waived its retention right because the lessee's waiver of other Article 2A rights failed to reference section 2A.529.[33] Irrespective of whether the lessee had a retention right under section 2A.529, the court noted that the recovery remedy sought by the lessor "seems to place it in a *better* position than had the contract with [the lessee] been fully performed" because the lessor would receive both the accelerated rent and possession of the equipment prior to lease expiration.[34] So even though the lease expressly provided for these concurrent remedies, the court was "reluctant to issue the requested declaratory judgment because it remains unclear whether this would interfere with [the lessor's] proposed damages recovery for the full lease payments."[35]

In *FLCM ACQ VIII, LLC v. Taos Ventures, LLC*,[36] the lessor failed to establish to the court's satisfaction the basis and calculation of the damages, fees, and costs requested. The lessee defaulted on its lease obligations by failing to make lease payments in accordance with the two equipment lease agreements, and thus the court held that the lessor was entitled to a default finding of liability.[37]

28. *Id.* at *4–6.
29. *Id.* at *7.
30. *Id.* at *7–8 (citing Tex. Bus. & Com. Code Ann. §§ 2A.503(a), 2A.529).
31. *Id.* at *7 (emphasis and ellipses added by the court) (quoting Tex. Bus. & Com. Code Ann. § 2A.529 cmt. 1).
32. *Id.* at *8.
33. *Id.*
34. *Id.* (citing Tex. Bus. & Com. Code Ann. § 1.305(a)).
35. *Id.*
36. No. 513-cv-529-Oc-PRL, 2014 WL 7009872 (M.D. Fla. Dec. 11, 2014).
37. *Id.* at *2 (granting default judgment when lessee failed to respond timely to lessor's motion for same and when lessor sufficiently alleged a breach of contract).

With respect to the amount of damages, however, the court stated that it is "incumbent" on the lessor to prove its damages, and that a lessor seeking "default judgment must show the Court what those damages are, how they are calculated and where they come from."[38] Although the lessor gave a specific sum under each lease and attached the lease and schedules, it did not show "precisely how it calculated the total amounts requested."[39] The court also found that the lessor was entitled to reasonable attorney's fees and costs, but that it failed to provide a basis for the court to determine whether the fees and costs demanded by the lessor were reasonable.[40] Therefore, the court ordered the lessor to file a "supplemental evidentiary submission consisting of detailed documentation" to establish the damages, attorney's fees, and costs.[41]

The cases discussed above involve default judgment motions by the lessors seeking acceleration damages and other amounts pursuant to the remedy provisions in their leases. In each of the cases, the court considered whether the lessor established that the amount demanded had been calculated in a manner consistent with the liquidated damages and other remedy provisions in the lease. The lessors in two of the cases failed to establish by their pleadings and related attachments the basis for the amounts demanded. One of those courts also considered whether permitting the lessor to recover accelerated rent and the leased equipment would entitle the lessor to a windfall.

The drafting guidance that may be taken from these cases is that a well-constructed liquidated damages provision should employ a formula or other methodology that on a forward-looking basis is sufficiently precise, so that the stipulated damages amount may be determined with certainty at all times during the lease term and does not entitle the lessor by reason of a default to recover an amount that is significantly greater than the amounts it would have received had the lease not been accelerated. As to the latter point, if the liquidated damages formula includes amounts attributable to future rentals and residual value, the lessor should consider including as part of that formula a credit against any such future rentals or residual value for the lessor's net recovery of those amounts if and when the leased equipment is returned.

End-of-Lease Options

In *REWJB Dairy Plant Associates v. Bombardier Capital, Inc.*,[42] the court determined whether a lessee had committed a breach of contract by non-payment of amounts owed under the lease. The lessee claimed that the parties had entered into an accord and satisfaction settlement arrangement, whereby the lessee would make a few final payments in purchase of the leased goods. The court

38. *Id.* at *3 (quoting PNCEF, LLC v. Hendricks Bldg. Supply LLC, 740 F. Supp. 2d 1287, 1294 (S.D. Ala. 2010)).
39. *Id.*
40. *Id.*
41. *Id.*
42. 152 So. 3d 21 (Fla. Dist. Ct. App. 2014).

looked to the language in the lease in evaluating the lessee's claim.[43] The lease provided that the lessee was required to give at least 270 days' notice before the end of the initial term, if it desired to either purchase or return the goods. If the lessee failed to give such notice, the term would automatically renew for a successive term. Using the plain language in the contract, the court determined that the lease could only be terminated by the timely exercise of either (1) the lessee's payment of the purchase option price pursuant to the lease or (2) the lessee's return of the equipment.[44] However, because of uncertainties with the jury's findings on a possible accord and satisfaction, as well as damages calculations, the court remanded for a new trial on both liability and damages.[45]

In *Lance & Linda Neibauer Joint Trust v. Kurgan*,[46] the court determined the validity of an aircraft purchase option after the initial term of the lease had expired. The lessee had the option to purchase the aircraft at the end of the term provided he gave the lessor thirty days' notice before the lease term ended. The parties entered into an addendum to extend the lease term if, by the end of the initial term, the lessee paid the lessor a specified sum of money. At the end of the initial term, the lessee neither paid the sum of money to the lessor nor gave thirty days' notice to purchase the aircraft. The court concluded that, because of the lessee's failure to give such notice or to pay the lessor the sum of money to extend the lease, the lease terminated at the end of the initial term.[47] With the termination of the lease, the court further entered a declaratory judgment that the lessee lost its ability to exercise its purchase option and the lessor was free to contract with a third party for the sale of the aircraft.[48]

"Hell or High Water" Clauses

In a finance lease, where the lessor is providing the financing that allows the lessee to acquire the goods from the supplier, the lessor expects the lessee to seek recourse from the supplier if there are any problems with the goods.[49] A related corollary provides that the lessor expects the lessee to pay the rent and perform all other obligations under the lease regardless of any problems with the goods. In other words, the lessee is to pay come "hell or high water." U.C.C. section 2A-407 codifies this result by making irrevocable and enforceable the lessee's payment and performance obligations in a finance lease that is not a consumer lease upon the lessee's acceptance of the goods.[50] However, leases commonly include a contractual "hell or high water" clause to accomplish the same result, whether or not the contract is a U.C.C. finance lease.

43. *Id.* at 22–23.
44. *Id.* at 23.
45. *Id.* at 28–29.
46. No. 6:14-CV-01192-MC, 2014 WL 7251526 (D. Or. Dec. 16, 2014).
47. *Id.* at *2.
48. *Id.* at *3.
49. *See* U.C.C. § 2A-209 cmt. 1 (2011).
50. *Id.* § 2A-407.

In *Nissan World, LLC v. Market Scan Information Systems, Inc.*,[51] the court had to evaluate the "hell or high water" clause in the lease between Nissan World, LLC ("Nissan World") and Wells Fargo Financial Leasing, Inc. ("Wells Fargo") for equipment supplied to Nissan World by Market Scan Information Systems, Inc. ("Market Scan"), which lease was accompanied by a loyalty agreement between Nissan World and Market Scan. The lease required monthly payments and a balloon payment for the final month of the lease, but the loyalty agreement provided that Market Scan would make such balloon payment if Nissan World "entered into future leases with Market Scan that were of an 'equal or greater value' compared to the prior leases."[52] Wells Fargo sought to have Nissan World make such balloon payment and also have Market Scan pay damages for breaching its General Dealer Agreement with Wells Fargo.[53] Regarding Wells Fargo's first demand, the court denied summary judgment because there were disputed issues of material fact regarding whether the loyalty agreement modified Nissan World's "hell or high water" obligation under the lease, in part because Wells Fargo may have known, or should have known, that Market Scan had agreed to make such balloon payment and because Market Scan may have been acting as an agent of Wells Fargo when entering into the loyalty agreement.[54]

With respect to Wells Fargo's second demand, the court found that Market Scan breached its General Dealer Agreement with Wells Fargo by failing "to perform all of its obligations under the warranties given by [Market Scan relating to the leased goods] . . . and hence that Market Scan breached both the loyalty agreement and the General Dealer Agreement.[55] The court concluded that Market Scan was liable for its breach of warranty but deferred any award of damages pending production of adequate evidence to substantiate calculation of damages.[56]

The lessee-plaintiffs in *In re Brican America LLC Equipment Lease Litigation*[57] purchased advertising display systems from Brican America LLC ("Brican") and financed the purchase through a lease with NCMIC Finance Corporation ("NCMIC"), or with Brican which later assigned the leases to NCMIC. Brican also entered into marketing agreements with the lessees in which Brican agreed to pay plaintiffs a monthly sum (to offset the financing costs under the leases) for advertising Brican services on the display systems. While there were multiple versions of the marketing agreements, each contained cancellation provisions providing that Brican would "buy back," "repurchase" or "assume assignment" of the leases if Brican stopped making payments under such agreements, and some versions further provided that all related agreements could be cancelled. The court

51. No. 05-2839 (MAH), 2014 WL 1716451 (D.N.J. Apr. 30, 2014).
52. *Id.* at *2–3 (quoting a letter from Market Scan's Senior Account Executive).
53. *Id.* at *3.
54. *Id.* at *22–24.
55. *Id.* at *9–11.
56. *See id.* at *12 (stating that "Wells Fargo claims a total of $403,026.99 [in damages] from Market Scan [but] . . . has not offered adequate substantiation").
57. No. 10-md-02183-PAS, 2014 WL 250246 (S.D. Fla. Jan. 22, 2014).

invoked the "hell or high water" clause in ruling that the lessees could not unilaterally cancel the leases, although also holding that Brican had promised to buy back the applicable leases if it stopped providing payments under the marketing agreements.[58] Under the applicable marketing agreements, the court ruled that, although related agreements could be cancelled, the leases could not be, because of the clear enforceability of the "hell or high water" clause.[59]

These decisions illustrate that seemingly ancillary documents pose a threat to enforceability of "hell or high water" clauses. To minimize this risk, practitioners should provide that the obligations of the lessee are absolute and unconditional, notwithstanding nonperformance by other parties of their obligations under any other documents, whether or not lease transaction participants are a party thereunder. Such a covenant may be included in a master lease, an equipment schedule, or the lessee's acknowledgement of, and consent to, assignment.

Whimsical observers sometimes have referred to *General Electric Capital Corp. v. FPL Service Corp.*[60] as a "hell and high water" situation. The lessee's premises were flooded during Hurricane Sandy and the leased equipment was destroyed. The lessee objected that the commercial impracticability doctrine set forth in section 261 of the *Restatement (Second) of Contracts*[61] permitted it to evade its contractual obligations, but the court observed that this doctrine provides that remaining performance is discharged "*unless* the language [of the contract] or the circumstances indicate the contrary."[62] The court also dismissed the lessee's claim that it should be discharged because of the impossibility of insuring the equipment against a calamity such as a hurricane, and it observed that the contract "expressly deals with improbable contingencies by assigning the risk of those contingencies to [the lessee]."[63] Most significantly, the court announced that "hell or high water" clauses would be enforceable "regardless of whether they are found in a lease or a secured transaction"[64] and granted summary judgment in favor of the lessor on the issue of the lessee's liability.[65]

58. *Id.* at *4–6.

59. *Id.*

60. 986 F. Supp. 2d 1029 (N.D. Iowa 2013).

61. RESTATEMENT (SECOND) OF CONTRACTS § 261 (1981) ("Where, after a contract is made, a party's performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged, unless the language or the circumstances indicate the contrary."). The lessee also asserted that section 265 discharged its obligations. *Gen. Elec. Capital Corp.*, 986 F. Supp. 2d at 1034; *see* RESTATEMENT (SECOND) OF CONTRACTS § 265 ("Where, after a contract is made, a party's principal purpose is substantially frustrated without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his remaining duties to render performance are discharged, unless the language or the circumstances indicate the contrary.").

62. *Gen. Elec. Capital Corp.*, 986 F. Supp. 2d at 1034 (emphasis added by court) (quoting RESTATEMENT (SECOND) OF CONTRACTS §§ 261, 265).

63. *Id.* at 1037.

64. *Id.* at 1035.

65. *Id.* at 1037. Though the court, in December 2013, did not determine the damages payable to lessor, *see id.* at 1043, the court ultimately entered judgment against FPL Service Corp. for $258,424.39, plus attorney's fees and costs. Gen. Elec. Capital Corp. v. FPL Serv. Corp., 995 F. Supp. 2d 935, 943 (N.D. Iowa 2014).

Leasing Services LLC v. Machinist AFL-CIO Lodge 6S[66] involved a six-year equipment lease for three copiers and ancillary equipment. The lessee discovered that there were other providers charging lower rentals and sought to terminate the lease on the grounds of unconscionability, notwithstanding its "hell or high water" clause. The Wisconsin Court of Appeals stated that, "[f]or a contract to be found unconscionable, it must exhibit both procedural and substantive unconscionability,"[67] and found that the contract was not procedurally unconscionable, because the terms of the contract were clear and the lessee had the opportunity to "comparison shop" with other lessors.[68] There was no need to analyze the substantive unconscionability requirement, because the agreement was not procedurally unconscionable, and the "hell or high water" clause was upheld.

Rights of Assignees

The court in *In re Brican America LLC Equipment Lease Litigation*[69] also had to determine whether NCMIC, as the lessor (directly or by assignment from Brican), could be liable for Brican's misrepresentations that it would "buy back" the leases, when Brican knew it was not in a financial position to do so. For the leases where NCMIC was the original lessor, the court found that NCMIC was not liable for Brican's misrepresentations because, while there was an apparent agency relationship between NCMIC and Brican, there was no evidence that NCMIC authorized Brican to make such "buy back" representation, and that NCMIC could not be held liable as an apparent agent.[70] However, for leases assigned from Brican to NCMIC, the court found that there was a fact question precluding summary judgment as to whether NCMIC could enforce the waiver-of-defenses clause in such leases because NCMIC had imputed knowledge of possible fraud by Brican because of the "close connection" between the two entities, and NCMIC's failure to investigate such fraud meant that NCMIC did not receive the assigned leases in good faith and hence was not a holder-in-due-course that could enforce the waivers-of-defenses clause.[71] This decision highlights the wisdom of lessors drafting "hell or high water" and waiver-of-defenses clauses to provide that they apply notwithstanding any existing or future business dealings that the assignee may have with the lessor, the supplier, or any other person or entity.

In *Lyon Financial Services, Inc. v. Illinois Paper & Copier Co.*,[72] the Minnesota Supreme Court upheld the enforceability of a lease assignor's representation and warranty that the underlying lease contract (to an Illinois village) complied

66. 847 N.W.2d 427 (Wis. Ct. App. 2014) (per curiam).
67. *Id.* at para. 7.
68. *Id.* at para. 9.
69. No. 10-md-02183-PAS, 2014 WL 250246 (S.D. Fla. Jan. 22, 2014); *see also supra* notes 72–76 and accompanying text (discussing *In re Brican* in the context of "hell or high water" clauses).
70. *Brican*, 2014 WL 250246, at *1, *6–7.
71. *Id.* at *7–9; *accord In re* Brican Am. LLC Equip. Lease Litig., No. 10-md-02183, 2015 WL 235409, at *23–30 (S.D. Fla. Jan. 16, 2015).
72. 848 N.W.2d 539 (Minn. 2014).

with all applicable law, without the assignee's having to prove that it relied upon the assignor's statements in the vendor agreement.[73] Illinois Paper & Copier Company ("Illinois Paper") warranted that the six-year lease was valid and enforceable, but Illinois law provided that a municipal lease can extend no more than five years. When the lessee stopped making lease payments, Lyon Financial Services, Inc. ("Lyon Financial") sued Illinois Paper for breach of warranty. Although the case began in federal court, the United States Court of Appeals for the Seventh Circuit certified questions of Minnesota law to the Minnesota Supreme Court.[74] The Minnesota decision enables parties to equipment finance agreements to rely upon assignor representations and warranties rather than having to incur the expense of counsel opinions. Equipment lessors and lenders are advised to examine their master program agreements to verify that they contain language that any contracts financed are in reliance upon all of the representations, warranties, covenants, and agreements contained in the program agreement.

Wells Fargo Equipment Finance, Inc. v. Titan Leasing, Inc.[75] involved the leasing of a locomotive that was damaged in transit and underwent lengthy repairs. The lessor assigned the lease to an affiliate, Titan Leasing, Inc., which pledged the lease and the locomotive as security for a loan from Wells Fargo Equipment Finance, Inc. ("WF Equipment"). Upon delivery of the locomotive to the lessee, it was rejected pending further repairs. The loan agreement with WF Equipment stated that, "[a]s of the date a Lease is assigned to [WF Equipment] . . . , the related Equipment has been delivered and accepted by the Lessee and the Lessee has acknowledged receipt and acceptance of such Equipment."[76] Because of the lessee's rejection of the locomotive, WF Equipment claimed breach of this warranty, but the district court granted summary judgment against WF Equipment because the lease provided that shipment of the locomotive established acceptance and the lessee had the opportunity to inspect the locomotive before shipment.[77]

The Seventh Circuit reversed and granted summary judgment in favor of WF Equipment.[78] The court stated that the loan agreement warranty to WF Equipment required both delivery and acceptance, to ensure the lessee was satisfied and therefore more likely to perform its obligations under the lease.[79] Acceptance and acknowledgment of receipt are important indicators of a satisfied

73. *Id.* at 544–45.

74. *Id.* Following the guidance provided by the Minnesota Supreme Court, the Seventh Circuit reversed and remanded to the district court. Lyon Fin. Servs., Inc. v. Ill. Paper & Copier Co., 577 F. App'x 606 (7th Cir. 2014).

75. 768 F.3d 741 (7th Cir. 2014).

76. *Id.*

77. *Id.* at 742–43 (citing Wells Fargo Equip. Fin., Inc. v. Titan Leasing, Inc., No. 10 CV 4804, 2012 WL 6184896 (N.D. Ill. Dec. 7, 2012)); *see also* Robert Downey, Edward K. Gross & Stephen T. Whelan, *Leases*, 68 BUS. LAW. 1191, 1199 (2013).

78. *Wells Fargo Equip. Fin.*, 768 F.3d at 744.

79. *See id.* at 743–44.

lessee and allow the lender to advance money with a higher chance of being repaid.[80] Although the lessee acknowledged acceptance, it never acknowledged receipt. This ruling illustrates the importance for the lessor/borrower to coordinate the documentary requirements in the lease and debt documents.

Vicarious Liability of Motor Vehicle Lessors

As noted in last year's survey, a few states, including New York and Florida, impose liability vicariously on the owner of a motor vehicle for accidents relating to the negligence of the end user.[81] In response, in 2005, Congress enacted the Graves Amendment to preempt state laws that hold motor vehicle lessors vicariously liable for damages caused by their lessees while operating the leased vehicle, provided that (1) the lessor is engaged in the business of leasing or renting motor vehicles (and the vehicle at issue was under lease at the time of the accident) and (2) the lessor was neither negligent nor engaged in criminal wrongdoing.[82]

Since last year's survey, there have been no reported decisions successfully challenging the Graves Amendment. Indeed, the Graves Amendment appears to be established law. As a consequence, plaintiffs have concentrated their efforts on the *independent, direct* negligence of lessors and rental companies, such as lack of maintenance or repair or negligent entrustment claims, rather than the *indirect, vicarious* liability of such lessors and rental companies.[83] For example in *DelPrete v. Senibaldi*,[84] in addressing the legal sufficiency of the plaintiff's negligent entrustment claim rather than vicarious liability,[85] the court noted

80. *Id.*

81. *See* Fla. Stat. § 324.021(9) (2013), *invalidated in part by* Vargas v. Enter. Leasing Co., 60 So. 3d 1037, 1039 (Fla. 2011); N.Y. Veh. & Traf. Law § 388 (Consol. 1992 & Supp. 2014), *invalidated in part by* Green v. Toyota Motor Credit Corp., 605 F. Supp. 2d 430, 433–36 (E.D.N.Y. 2009); Robert Downey, Edward K. Gross & Stephen T. Whelan, *Leases*, 69 Bus. Law. 1169, 1174 n.42 (2014).

82. 49 U.S.C. § 30106(a) (2012) ("An owner of a motor vehicle that rents or leases the vehicle to a person (or an affiliate of the owner) shall not be liable under the law of any State or political subdivision thereof, by reason of being the owner of the vehicle (or an affiliate of the owner), for harm to persons or property that results or arises out of the use, operation, or possession of the vehicle during the period of the rental or lease, if—(1) the owner (or an affiliate of the owner) is engaged in the trade or business of renting or leasing motor vehicles; and (2) there is no negligence or criminal wrongdoing on the part of the owner (or an affiliate of the owner)."). Sponsored by Representative Sam Graves of Missouri, the amendment was enacted as part of the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU), Pub. L. No. 109-59, § 10208(a), 119 Stat. 1144, 1935–36 (2005) (codified at 49 U.S.C. § 30106 (2012)); Barry A. Graynor, Teresa Davidson, Edwin E. Huddleson, III & Stephen T. Whelan, *Leases of Goods*, 61 Bus. Law. 1561, 1562 n.7 (2006).

83. *See, e.g.*, Shew v. Hill, No. 4:13-CV-420-VEH, 2013 WL 5290005, at *3 (N.D. Ala. Sept. 18, 2013) (holding that, while the Graves Amendment preempts state vicarious liability laws respecting motor vehicle lessors, it contains a savings clause permitting direct negligence actions); Marble v. Faelle, 89 A.3d 830, 835 (R.I. 2014) (declining to address the constitutionality of the Graves Amendment but holding that, because the defendant owner of the vehicle, Hertz Corporation, attached the rental record/contract of a Toyota Prius, rather than the Dodge Challenger at issue in the case, for purposes of summary judgment, the rental record did not establish the period of the rental because it did not identify the vehicle involved in the accident).

84. No. CV116024795S, 2014 WL 5286741 (Conn. Super. Ct. Sept. 16, 2014).

85. The court noted that, although the defendant made reference to the Graves Amendment, its argument was void of any actual preemption analysis and thus the court elected to treat the preemption argument as abandoned. *Id.* at *3.

that "[t]he essential elements of the tort of negligent entrustment of [a motor vehicle are] that the entrustor knows or ought reasonably to know that one to whom he entrusts it is so incompetent to operate it upon the highways that the former ought to reasonably anticipate the likelihood of injury to others by reasons of that incompetence, and such incompetence does result in injury."[86] The court also made it clear that liability cannot be imposed simply because the defendant permits another person to operate the motor vehicle; instead, "[l]iability can only be imposed if (1) there is actual or constructive knowledge that the person to whom the automobile is loaned is incompetent to operate the motor vehicle; and (2) the injury resulted from that incompetence."[87] By way of illustration, the court noted that there were no allegations that the defendant lessee was not a responsible or safe driver, had a past history of incompetent driving or of subleasing the car to unqualified drivers, or that the defendant owner knew of any such behavior.[88]

Similarly, in *Davis v. ELRAC, LLC*,[89] the court concluded that, if a negligent entrustment claim is legally sufficient, the exemption under the Graves Amendment would not apply.[90] The court also emphasized that "the negligence of the incompetent driver is not the determinative factor . . . ; rather, the core of a negligent entrustment action is whether *the entrustor was negligent* in supplying a vehicle to the incompetent driver."[91]

Several recent cases have elaborated on certain types of vehicle owners that are and are not entitled to protection under the Graves Amendment. For example, in *Kindard-Jennings v. Yellow Cab Co.*,[92] the court noted that taxicabs, repair shop owners who provide loaners to their customers, and car dealerships that allow test drives *are not* entitled to protection under the Graves Amendment.[93] Also, as pointed out in last year's survey, membership-based car-sharing companies (such as Zipcars) that permit members to rent cars on an hourly basis *are* entitled to Graves Amendment protection.[94]

Perhaps the most controversial motor vehicle liability case reported since last year's survey, at least with respect to the court's legal analysis, rather than the underlying equities of the case, is *Stratton v. Wallace*,[95] a case that may well

86. *Id.* at *4 (quoting Ellis v. Jarmin, No. CV095010839, 2009 WL 5511268, at *2 (Conn. Super. Ct. 2009)).

87. *Id.* (quoting *Ellis*, 2009 WL 5511268, at *2).

88. *Id.* at *10.

89. No. CV136037866S, 2014 WL 5394924 (Conn. Super. Ct. Sept. 26, 2014).

90. *Id.* at *15.

91. *Id.* at *17 (citations omitted).

92. No. CV126037331, 2013 WL 4046584 (Conn. Super. Ct. July 19, 2013).

93. *Id.* at *2 (citing Hall v. ELRAC, Inc., 859 N.Y.S.2d 641, 642 (App. Div. 2008)) (rejecting the "argument that the Graves Amendment violates equal protection by favoring car rental companies over other vehicle owners, such as *taxi owners*, *repair shops owners who provide loaner vehicles to customers*, *and car dealerships that allow test drivers*, who also allow others to operate their vehicles" (emphasis added)).

94. Moreau v. Josaphat, 975 N.Y.S.2d 851, 853 (N.Y. Sup. Ct. 2013); Downey, Gross & Whelan, *supra* note 81, at 1176–77 (analyzing *Moreau*).

95. No. 11-CV-74-A (HKS), 2014 WL 3809479 (W.D.N.Y. Aug. 1, 2014).

end up being overturned. In *Stratton*, the court held that the requirement of the Graves Amendment that there be "no negligence or criminal wrongdoing on the part of the owner (*or* an affiliate of the owner)"[96] applies only if *both* the lessor and lessee are free from negligence.[97] (In *Stratton*, the lessee was an affiliate of the owner/lessor.) This conclusion, however, seemingly conflicts with the text of the statute, which reads in the disjunctive, rather than conjunctive ("or" not "and").

It is often said that bad facts make bad law. In *Stratton*, the court may have arrived at this strained reading of the statute in light of the sad and somewhat convoluted facts at hand. A commercial truck driver, Thomas Wallace, was employed by the lessee, Millis Transfer, Inc. ("Millis"), and struck and killed a lady while she was sitting in a disabled car at the side of an interstate road.[98] The owner and lessor of the truck was Great River Leasing, LLC ("Great River"). Millis and Great River were found to be "affiliates" under the definitions contained in the Graves Amendment because they were both wholly owned subsidiaries of Midwest Holding Group, Inc.[99] In addition to likely being influenced by the tragic circumstances of the accident at issue, the court was clearly also troubled with the distinction between a more typical lessor that leases vehicles to the general public rather than one that leases to an affiliated company, as was the case in *Stratton*.[100] The court noted that "[t]he Graves Amendment was concerned with the apparent problem that commercial rental and leasing companies have no choice as to whom they rent their vehicles or into what state those vehicles are driven."[101]

The meager legislative history for the Graves Amendment does not support the court's interpretation.[102] The language of the Graves Amendment itself does not seem to require that *both* the lessor and lessee (in this case, owner/lessor and affiliate/lessee) be free from negligence. Until this decision is clarified by an appellate court, vehicle owners in the Western District of New York are advised to carefully consider the risks in leasing vehicles to an affiliate.

96. 49 U.S.C. § 30106(a)(2) (2012) (emphasis added).

97. *Stratton*, 2014 WL 3809479, at *4.

98. *Id.* at *1. Defendant Wallace "was watching pornographic films in the cab of his truck when he struck Ms. Stratton's car . . . , pleaded guilty to second degree manslaughter as a result of the accident and [was] incarcerated in a New York prison." *Id.* at *1 n.1.

99. *Id.* at *3; *see* 49 U.S.C. § 30106(d)(1) (2012) (defining "affiliate" as "a person other than the owner that directly or indirectly controls, is controlled by, or is under common control with the owner").

100. *Stratton,* 2014 WL 3809479, at *6.

101. *Id.*

102. The court concluded that the legislative history, sparse as it was, supported its interpretation of the Graves Amendment. *Id.* at *5–7.