

Key Equipment Finance, Inc.,

Plaintiff

v.

DECISION AND ORDER

Benjamin P. Hawkins, and
Timothy Morse,

Defendants

v.

TD Banknorth, N.A.,

Third-party Defendant

This matter is before the Court on Plaintiff's Motion for Summary Judgment, and Defendant Benjamin Hawkins' Cross-Motion for Summary Judgment. The Court has reviewed and considered the parties' written arguments, and the record evidence.

Evidence of Record

The record evidence can be summarized as follows. Defendant Hawkins owned a 50% stock in, and was the treasurer, chief financial officer and member of the Board of Directors of Morse Brothers, Inc. (Morse Brothers). Morse Brothers was in the business of buying, processing and distributing bark mulch.

On or about January 17, 1995, Plaintiff, as lessor, entered into a Master Equipment Lease with Morse Brothers pursuant to which Morse Brothers leased certain equipment for use in its business (Master Lease). Under the express terms of the Master Lease all future Equipment Schedules executed between Plaintiff and Morse Brothers were to incorporate by reference all the terms and conditions of the Master Lease. The Master Lease further provided that Morse Brothers waived any "right to notice of sale and any defenses

against [Morse Brothers] because of the manner or method of sale or disposition of any Items of Equipment."

In his corporate capacity, Defendant Hawkins signed the Master lease for Morse Brothers. Defendant Hawkins also signed a personal guaranty of Morse Brothers' obligations under the Master Lease and Equipment Schedules (Personal Guaranty). The Personal Guaranty provided that Defendant Hawkins waived any defenses "arising on, out of, under, by virtue of, or in any way relating to the Lease, [the Personal Guaranty], or the transactions contemplated" by the Master Lease or the Personal Guaranty.

Subsequently, Plaintiff and Morse Brothers entered into a series of Equipment Schedule agreements. Specifically, beginning in April 2002, Plaintiff and Morse Brothers executed the following schedules:

1. Schedule No. 8 for the lease of five 2002 Kenworth Tractors with a total value of \$460,182.95 for a term of 48 months.
2. Schedule No. 9 for the lease of five BWS trailers with a total value of \$277,500 for a term of 60 months.
3. Schedule No. 10, for the lease of five 2002 Kenworth Tractors with a total value of \$420,564.60 to Morse Brothers for a period of 48 months.
4. Schedule No. 12 for the lease of five 2003 Pearless trailers with a total value of \$269,175 to Morse Brothers for a term of 48 months.
5. Schedule No. 13 for the lease of five 1999 Manac trailers with a total value of \$150,000 for a term of 36 months.

Schedules 8, 9, 10 and 12 explicitly provide that the schedules are leases and not sales contracts.

On September 28, 2005, Morse Brothers initiated a Chapter 11 bankruptcy proceeding. At that time, Morse Brothers was in default of the Master Lease and its associated Schedules. Thereafter, on January 18, 2006, Morse Brothers and JWA Holdings Corp. (JWA) entered into an agreement by which Morse Brothers would convey all the assets subject of this action to JWA. Plaintiff and JWA subsequently reached an agreement, authorized by the United States Bankruptcy Court for the District of Maine, whereby Plaintiff sold all of the leased equipment subject to the Master Lease and accompanying Schedules to JWA for \$500,000. As of the time of this agreement, Morse Brothers owed

Plaintiff \$845,769.30 under the Schedules. In this action, Plaintiff seeks to recover the amount of the deficiency (\$345,769.30) from Defendant Hawkins based on the Personal Guaranty.

Discussion

I. Applicable Law

Plaintiff and Defendant Hawkins agree that in accordance with the express provisions of the Master Lease and Schedules, New York law applies to this case. The parties, however, disagree as to whether Article 2-A or Article 9 of New York's Uniform Commercial Code is applicable.

Article 2-A "applies to any transaction, regardless of form, that creates a lease", and Article 9 applies to security agreements. *N.Y. U.C.C. Law §§ 2-A-102, 9-109*. Defendant Hawkins argues that the Master Lease and Schedules constitute security agreements subject to Article 9 while Plaintiff argues that the agreements are leases subject to Article 2-A. As the parties acknowledge, the distinction is relevant because the significance of the waiver terms of the Personal Guaranty depends, at least in part, on whether the parties' agreements are considered leases or sales contracts.¹ A personal guarantor of a lease can waive defenses otherwise available to him in accordance with Article 2-A. *N.Y. U.C.C. Law § 2-A-503(1)*. Conversely, Article 9 provides that certain defenses, including notice of sale and a challenge to the commercial reasonableness of the sale, cannot be waived. *N.Y. U.C.C. Law § 9-602(g)*.

The analysis of whether a transaction creates a lease or a security interest begins with *N.Y. U.C.C. Law § 1-201(37)*, which provides in pertinent part:

"(a) Whether a transaction creates a lease or security interest is determined by the facts of each case; however, a transaction creates a security interest if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee, and:

¹ As explained above, in the Personal Guaranty, Defendant Hawkins waived certain defenses that would potentially be available to him as a guarantor.

- (i) the original term of the lease is equal to or greater than the remaining economic life of the goods,
- (ii) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods,
- (iii) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement, or
- (iv) the lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement."

Because Morse Brothers had no right to terminate its obligations under the Master Lease and Schedules prior to expiration of the terms established in each Schedule, the initial assessment of whether the parties' agreement is a lease or a security agreement requires an analysis of subsections (i) through (iv).

The factors set forth in subsections (i) through (iv) establish a "bright line test" for determining whether a transaction creates a lease or a security interest. See *Duke Energy Royal, LLC v. Pillowtex Corp. (In re Pillowtex, Inc.)*, 349 F.3d 711, 718 (3rd Cir. 2003) (applying New York law); See also *In re WorldCom, Inc.*, 339 B.R. 56 (Bankr. S.D.N.Y. 2006) (applying California's version of the U.C.C. and giving a detailed comparison of the "Bright-Line Test" versus a "Contextual Analysis"). If any of the four §1-201(37) factors is present, a transaction is considered to have created a *per se* security interest. *Duke Energy Royal, LLC*, 349 F.3d at 717. If none of the factors is present, however, the Court must engage in what has been referred to as a "Contextual Analysis." *In re WorldCom, Inc.*, 339 B.R. at 70.

A. Application of Bright-Line Test

1. Is the term of the agreement equal to or greater than the remaining economic life of equipment (§ 1-201(37)(a)(i))?

The undisputed facts demonstrate that the equipment that is the subject of Schedule 13 will have no remaining economic life at the conclusion of the term of the agreement. In fact, the record evidence establishes that the Schedule No. 13 equipment would have \$1 in economic value at the conclusion of the term. As a result, Schedule No. 13 granted a

security interest in the five 1999 Manac trailers it covers, and Article 9 applies to the transaction involving the trailers.

Unlike Schedule 13, the terms of Schedules 8, 9, 10 and 12 are shorter than the expected useful life of the subject equipment. A review of the record reveals that the projected residual value of the equipment subject to Schedules 8, 9, 10 and 12 is 35% of the original value. Because the equipment retains value after the expiration of the term of the agreement, § 1-201(37)(a)(i) does not mandate a finding that Defendant Hawkins acquired a security interest in the equipment.

2. Was Morse Brothers Bound to Renew the Agreements or to Purchase the Equipment (1-201(37)(a)(ii))?

Schedule No. 13 requires Morse Brothers to purchase the equipment in consideration for the payment of \$1. The transaction memorialized in Schedule No. 13 is, therefore, a secured transaction. The remaining schedules, however, have no such mandatory buyout provision. Although Morse Brothers had an option under to purchase the equipment,² it was not obligated to do so.

Despite the lack of explicit language requiring Morse Brothers to purchase the equipment described in Schedules 8, 9, 10 and 12, Defendant Hawkins argues that because various conditions of the Schedules render it economically unfeasible for Morse Brothers not to purchase the equipment at the conclusion of the term of the agreements, the Schedules effectively require Morse Brothers to purchase the equipment. In other words, Defendant Hawkins contends that Morse Brothers in effect had to purchase the equipment even though it was not technically required to do so by the language of the agreements.

² Paragraph 5 of the Schedules granted to Morse Brothers the *option* of purchasing the equipment.

Duke Energy Royal, LLC, v. Pillowtex Corp., infra., upon which Defendant Hawkins relies in part, refutes the argument that a de facto requirement to purchase, even if present, is enough to satisfy the section 1-201(37)(a) analysis. Addressing the de facto argument that Defendant Hawkins urges in this case, the court in *Duke Energy Royal, LLC*, wrote:

Pillowtex provides no authority for the proposition that a de facto arrangement is enough to satisfy the requirements of section 1-201(37)(a)(ii) and (iv). If anything, the relevant caselaw points us to the opposite conclusion. See *Edison Bros.*, 207 B.R. at 810 ("If the lease agreement *explicitly* provides that the lessee has an option to purchase the leased goods for nominal consideration (e.g., for \$ 1), the agreement is presumed to be a disguised security agreement").

Duke Energy Royal, LLC, 349 F.3d at 719. Like Pillowtex, Defendant Hawkins provides no authority to support the proposition that a de facto arrangement is sufficient to satisfy the requirements of § 1-201(37)(a)(ii). Because this is a "bright line test", the insistence on an explicit obligation to purchase the property in order to qualify as a security agreement is sound. Given the absence of an explicit obligation to purchase the property in Schedules 8, 9, 10 and 12, they do not constitute security agreements under N.Y. U.C.C. § 1-207(37)(a)(ii).

3. Did Morse Brothers Have the Option to Renew Leases For the Remaining Economic Life of Equipment for No or Nominal Consideration Upon Compliance with Lease Provisions (1-201(37)(a)(iii))?

Defendant Hawkins does not maintain, nor does the record establish, that any of the Schedules contain a renewal provision that would satisfy the requirements of N.Y. U.C.C. Law § 1-207(37)(a)(iii).

4. Did Morse Brothers Have the Option to Become Owner of the Equipment for No or Nominal Consideration Upon Compliance with Lease Provisions (1-201(37)(a)(iv))?

As discussed above, Morse Brothers could purchase the equipment covered by Schedule No. 13 for \$1 at the conclusion of the lease term. This further supports the conclusion that the transaction memorialized by Schedule No. 13 constitutes a secured transaction.

The remaining Schedules, however, do not grant to Defendant Hawkins an option to purchase the equipment for no or nominal consideration. Accordingly, the remaining Schedules are not, under N.Y. U.C.C. § 1-207(37)(a)(iv), security agreements.

B. Contextual Analysis

Because Schedules 8, 9, 10 and 12 do not constitute security agreements under the "bright-line test", the Court must next conduct what has been referred to as a "Contextual Analysis" to determine the nature of the parties' agreements. *Id.* This analysis requires that the Court "consider the economic reality of the transaction in order to determine, based on the particular facts of the case, whether the transaction is more fairly characterized as a lease or a secured financing arrangement." *Id.* In making this determination, the factors to consider include but are not limited to "(a) whether the purchase option is nominal; (b) whether the lessee is required to make aggregate rental payments having a present value equaling or exceeding the original cost of the leased property; and (c) whether the lease term covers the total useful life of the equipment." *Id.* (quoting, *In re Edison Bros. Stores*, 207 B.R. 801, 809-10 (Bankr. D. Del. 1997)). In this analysis, the relevant factors are the intent of the parties and the facts as they existed at the time of the transaction. *Id.* at 809.

In the present case, on this record, the Court cannot conclude that application of the factors definitively demonstrates that the agreements are secured transactions. However, the factors confirm that a court should examine the essence of a transaction to determine whether it should fairly be construed as a sale or a lease. Indeed, one court noted that the objective of the Contextual Analysis is whether at the conclusion of a purported lease,

the lessor has no interest in the economic value or remaining useful life of the goods, and therefore the lessor transferred title to the goods, in substance if not in form. In other words, the parties did not create a lease where the putative lessor does not have the interest, the entrepreneurial stake, in the goods that a true lessor would have.

Examination of Schedules No. 8, 9, 10 and 12, and consideration of the undisputed facts of record in this context reveals that the agreements are more like sales contracts than traditional leases. Specifically, at the conclusion of the agreements, Morse Brothers had limited realistic options. For instance, as discussed above, Morse Brothers could purchase the equipment at fair market as determined initially through negotiations with the Plaintiff, and if the negotiations are unsuccessful, pursuant to an appraisal process. If the sale generated a payment in excess of the anticipated residual value of the equipment that was established at the time of the agreement, Plaintiff would receive the excess. If the determined sale price of the equipment is less than the anticipated residual value, Morse Brothers would be required to remit the deficiency to the Plaintiff. Under the circumstances, it is clear that Plaintiff did not have a true "entrepreneurial stake" in the equipment at the conclusion of the agreement. The agreement plainly did not contemplate Plaintiff's ownership of the equipment at the conclusion of the agreement. Furthermore, Plaintiff would receive a guaranteed minimum payment (i.e., the established residual value) regardless of the fair market value of the equipment. In other words, Plaintiff had no risk and, therefore, had no real interest in the economic value or useful life of the equipment.

Given Plaintiff's lack of interest in the economic value or useful life of the equipment covered by Schedules No. 8, 9, 10 and 12, given that Plaintiff would have no continuing ownership in the property, and given that Morse Brothers would, as a practical matter, have to sell or buy the equipment at the conclusion of the agreement, the Court concludes that the parties' agreements as to the equipment covered by Schedules 8, 9, 10, 12, as well as Schedule 13 as previously explained are secured transactions to be governed by N.Y. U.C.C. § 9.

II. Article 9 Analysis

Because the transactions are security agreements under New York law, the waiver terms of the parties' agreements do not operate to foreclose Defendant Hawkins from asserting his two principal defenses to Plaintiff's claim – that the sale of the equipment was not commercially reasonable, and that Defendant Hawkins did not receive adequate notice of the sale. *N.Y. U.C.C. § 9 – 602(g)*. The question for the Court on parties' motions for summary judgment is thus whether there remains a disputed issue of material fact as to either of the defenses asserted by Defendant Hawkins.

A. Commercial Reasonableness of Sale

When a secured party sells property following default of the debtor, “[e]very aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable.” *N.Y. U.C.C. Law § 9-610(b)*. In this case, rather than foreclose on the equipment and sell the equipment at auction, Plaintiff negotiated with and sold the equipment to a third party (JWA Holdings Corp) for \$500,000.

Because Morse Brothers had filed for bankruptcy protection, the bankruptcy court's approval was necessary before the sale could be completed. The United States Bankruptcy Court for the District of Maine approved the sale. The bankruptcy's approval is not insignificant in this case. New York law provides that disposition of collateral is considered commercially reasonable if it is approved “in a judicial proceeding.” *N.Y. U.C.C. Law § 9-627(c)(1)*. The bankruptcy court's approval of the sale plainly occurred in the context of a “judicial proceeding”. Simply stated, Defendant Hawkins' arguments to the contrary, including the suggestion that Plaintiff's efforts to sell the equipment in the bankruptcy proceeding were intentionally orchestrated to impose a personal financial obligation upon Defendant Hawkins, are unsupported by the record and are unavailing. The sale is, therefore, by operation of law, commercially reasonable.

B. Notice of the Sale

Defendant Hawkins maintains that Plaintiff did not provide Defendant Hawkins with sufficient notice of the sale and, therefore, Defendant Hawkins challenges the sale and his obligation to satisfy the deficiency. Plaintiff acknowledges that before a secured party can dispose of collateral, a secondary obligor such as Defendant Hawkins must receive notice of the sale. *N.Y. U.C.C. Law § 9-611(c)(2)*. Whether such notice is reasonable is generally a question of fact. *N.Y. U.C.C. Law § 9-612(a)*. The question for the Court is whether a disputed fact exists as to Defendant Hawkins' notice of the sale.

Plaintiff does not contend that Plaintiff provided Defendant Hawkins with actual personal notice of the sale of equipment prior to the sale to JWA Holdings Corp. Rather, Plaintiff argues that a number of factors support imputing to Defendant Hawkins the actual notice provided Morse Brothers. Under New York law, "[a] person has 'notice' of a fact when . . . from all the facts and circumstances known to him at the time in question he has reason to know that it exists". *N.Y. U.C.C. Law § 1-201(25)*. In support of its contention that Defendant Hawkins had constructive notice of the sale, Plaintiff cites Defendant Hawkins' 50% ownership of Morse Brothers, his position as its chief financial officer, his membership on Morse Brothers' board of directors, his participation in Morse Brothers' decision to file for bankruptcy, and his execution of the bankruptcy petition on behalf of Morse Brothers.

The purpose of any notice requirement is to provide a party the opportunity to act in response to the notice. The issue is whether "from all the facts and circumstances known to" him, Defendant Hawkins "had reason to know" of the sale. *N.Y. U.C.C. Law § 1-205(25)*". In his deposition, Defendant Hawkins suggested that he was not aware of the bankruptcy court's sale order until after the sale. Plaintiff nevertheless argues that summary judgment is warranted because all of the circumstances (e.g. Defendant

Hawkins' participation in the bankruptcy proceeding) demonstrate that Defendant Hawkins "had reason to know" of the sale.

Although the circumstantial evidence might suggest that Defendant Hawkins "had reason to know" of the sale, viewing the evidence in the light most favorable to the non-moving party,³ the Court cannot conclude as a matter of law that Defendant Hawkins had constructive notice of the sale. Given that Defendant Hawkins asserts that he was not aware of the bankruptcy court's order authorizing the sale until after the sale, whether Defendant Hawkins was sufficiently involved in the bankruptcy proceeding such that notice of the sale can be imputed to him is a disputed issue of fact for trial.⁴

III. Plaintiff's Claim for Attorneys' Fees

Defendant Hawkins argues that Plaintiff is not entitled to recover attorneys' fees because Plaintiff did not specifically request attorneys' fees in its Complaint. While Plaintiff's Complaint did not include an explicit request for attorneys' fees in its final prayer for relief, a fair and objective reading of Plaintiff's Complaint establishes that Defendant is on notice that Plaintiff is seeking to recover for its attorneys' fees and costs of collection. When calculating the amount of the alleged deficiency in paragraph 20 of the Complaint, Plaintiff included its attorneys' fees and collection costs among the expenses for which Defendant was responsible. In other words, Defendant Hawkins was on notice from

³ *Lightfoot v. Sch. Admin. Dist. No. 35*, 2003 ME 24, ¶6, 816 A.2d 63, 65.

⁴ Defendant Hawkins also argues that the notice provided to Morse Brothers was insufficient to satisfy the requirements of § 9-612. The only argument that Defendant Hawkins makes, however, is that N.Y. U.C.C. Law § 9-612(b) requires 10 days notice prior to conducting a sale of collateral. Because Morse Brothers was not afforded 10 days notice, Defendant Hawkins argues that the subsequent sale of the equipment did not comply with Article 9. Contrary to Defendant Hawkins' argument, while providing 10 days notice affords a secured party a "safe harbor" from subsequent complaints of inadequate notice, the failure to provide that much notice does not result in any negative inference regarding a lack of sufficient notice, much less require a finding of insufficient notice. *See N.Y. U.C.C. Law § 9-627(c)(1)*. Nevertheless, whether notice was provided within a reasonable time is a question of fact. *N.Y. U.C.C. § 9-612(a)*. The reasonableness of the notice is, therefore, an issue for trial.

the commencement of this action that Plaintiff was seeking to recover its attorneys' fees and the costs of collection.

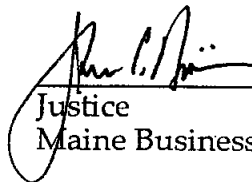
Conclusion

Based on the foregoing analysis, the Court grants in part and denies in part the parties' motions for summary judgment. The Court specifically finds as follows:

1. The agreements between the parties are secured transactions under the applicable New York law.
2. Defendant Hawkins personally guaranteed payment of Morse Brothers' indebtedness to Plaintiff.
3. Plaintiff's sale of the equipment to JWA Holdings Corp. for \$500,000 was commercially reasonable.
4. The amount of the deficiency after the sale of the equipment is \$345,769.30.
5. A material issue of fact remains in dispute as to Defendant Hawkins' assertion that he did not receive notice of the proposed sale. Therefore, the issue for trial is whether under the applicable New York law, Defendant Hawkins had reasonable notice, actual or constructive, of the sale of the equipment prior to the sale.
6. Plaintiff can, under the pleadings in this matter, seek recovery for its attorneys' fees and costs of collection.⁵

Pursuant to M.R. Civ. P. 79(a), the Clerk shall incorporate this Decision and Order into the docket by reference.

Date: 5/13/08



Justice
Maine Business and Consumer Docket

⁵ The Court's conclusion that Plaintiff can seek recovery for its attorneys' fees and costs of collection should not be construed as a comment on the merits of Plaintiff's claim for fees and costs. The Court will address the merit of Plaintiff's claim for fees and costs at the time of and/or following trial.