Uniform Commercial Code: Article 2A--Leases: Structuring Priorities of Competing Claimants to Leased Property

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Uniform Commercial Code: Article 2A—Leases: Structuring Priorities of Competing Claimants to Leased Property

Despite the tremendous growth of personal property leasing in the United States, the statutory and case law related to leasing has failed to provide a comprehensive and consistent framework for dealing with the legal issues arising within the leasing context. Commentators and practicing lawyers have urged some form of uniform statutory treatment of personal property leasing. In response to this perceived need to codify leasing law, Article 2A, entitled "Leases," recently was promulgated as an amendment to the Uniform Commercial Code.
Article 2A has been approved by the National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute (ALI). The proposed statute recently has been presented for enactment to the legislatures of several states. If adopted, the statute will affect many common commercial transactions that create a "true" lease of personal property. In a true lease transaction, the lessee obtains the right to use property owned by the lessor for a period of time in exchange for rent.

4. U.C.C. § 2A-101 comment. All citations and references to Article 2A of the U.C.C. are to 1A U.L.A. (Supp. 1988). Unless otherwise indicated, all citations and references to the U.C.C., other than to Article 2A, are to the 1978 Official Text and Comment.


7. Much litigation and commentary have questioned whether a transaction labeled a "lease" is a true lease rather than either a conditional sale or a lease intended as a security interest. See, e.g., DeKoven, Proceedings After Default by the Lessee Under a True Lease of Equipment, in 1C P. COOGAN, W. HOGAN, D. VAGTS & J. MCDONNELL, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE §§ 29B.03-04 (1988) (discussing distinctions between a true lease, a security lease, and a sale of goods); Reisman & Mooney, supra note 2, at 15-29 (reviewing approaches courts have used to determine whether a lease is actually a disguised security interest); Leary, Leasing and Other Techniques of Financing Equipment Under the U.C.C., 42 Temp. L.Q. 217 (1969) (examining "shibboleths" courts use to distinguish true lease from "lease intended as security" in borderline cases).

Courts have distinguished between leases and security agreements in order to determine whether specific transactions are subject to Article 9 of the U.C.C. See, e.g., Towe Farms, Inc. v. Central Iowa Prod. Credit Ass'n, 528 F. Supp. 500, 503-04 (S.D. Iowa 1981) (finding transaction to be true lease and thus not subject to Article 9). The U.C.C. excludes leases from its definition of security interest:

Unless a lease...is intended as security, reservation of title thereunder is not a "security interest".... Whether a lease is intended as security is to be determined by the facts of each case; however, (a) the inclusion of an option to purchase does not of itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended for security.

U.C.C. § 1-201(37).

Article 2A also distinguishes a true lease from other transactions. "[A] sale, including a sale on approval or a sale or return, or retention or creation of a security interest is not a lease." U.C.C. § 2A-103(j). The U.C.C. Article 2A
This Note focuses on Part 3 of Article 2A, “Effect of Lease Contract,” which governs conflicting claims to leased personal property. Part I of this Note describes the leasing industry and the role of leasing in commercial financing. Part II discusses conflicts arising when a lessor or lessee exposes the other party’s interest to third-party claims and reviews the common-law treatment of competing claims to leased goods. Part III focuses on the application of the priority provisions of part 3 of Article 2A and the policy choices underlying those provisions. Finally, Part IV suggests amendments to further the objectives of the statute.

I. THE LEASE TRANSACTION

Long-term leasing has become a popular alternative to the installment purchase and chattel mortgage, two forms of secured transactions, as a means of financing the acquisition of equipment. A secured transaction is one in which a creditor

Committee also drafted a suggested revision of the definition of security interest for inclusion in U.C.C. § 1-201(37). See 1 U.L.A. 23-24 (Supp. 1988). The effort attempted to draw a clearer line between a true lease and a disguised security interest. U.C.C. § 2A-101 comment.

A comprehensive treatment of whether a transaction is a true lease or a security interest is beyond the scope of this Note. For purposes of discussion, this Note will assume a true lease transaction unless otherwise noted.

8. Part 3 covers third-party rights as well as priority disputes between creditors and the lessee or lessor. Given the expanding role of personal property leasing in our economy, a system of ordering the relative priorities of the various parties asserting claims against the property is crucial.

9. In an installment purchase, or conditional sale, the buyer acquires ownership of the equipment by making an initial down payment and signing a contract to pay the balance in installments over a period of time. The seller takes a security interest in the equipment to secure payment of the unpaid balance. The installment purchase is embodied in the Code’s purchase-money security interest and is governed by Article 9. U.C.C. §§ 9-107, 9-102.

10. The chattel mortgage is a device that allows a lender (mortgagee) to take a security interest in personal property to secure repayment of a loan. The chattel mortgage is an example of a traditional security device governed by Article 9. U.C.C. § 9-102.

11. U.C.C. § 9-102(2). Article 9 substitutes the term “security interest” for the various common-law and statutory terms used to denote forms of secured financing. U.C.C. § 9-101 comment. “Security interest” applies to any interest in personal property that secures payment of an obligation. U.C.C. § 9-201(37).

12. This Note focuses on long-term leasing of equipment. “Equipment” is a category of goods used or bought primarily for use in business. U.C.C. § 9-109. In a long-term lease, the lessee acquires use of equipment for a substantial portion of its life. In contrast, a short-term lease may range from a few hours to several months. A party requiring use of expensive equipment for only a short time probably would not consider purchasing, because it would be cheaper to lease than to purchase outright. A party expecting to use equip-
contractually obtains an interest in personal property owned by a debtor to secure repayment of the debt.\textsuperscript{13} Leasing differs from a secured transaction in that a lessor, the party analogous to a creditor in a secured transaction, retains ownership of the leased property.\textsuperscript{14} A lessee, similar to the debtor, acquires possession of needed equipment, but the lessee has no interest in the property once the lease terminates.\textsuperscript{15} For the lessor, ownership of equipment affords certain benefits. Unlike the creditor, the lessor can take advantage of tax benefits such as depreciation and applicable tax credits.\textsuperscript{16} In addition, once the


14. The touchstone of a true lease is the retention of both a meaningful residual interest in the leased property and any accompanying economic risks of ownership at the end of the lease term. Reisman & Mooney, supra note 2, at 27.

Although the lessor retains ownership of the equipment, most lease agreements stipulate that the lessee assume all the costs normally associated with ownership. These costs include maintenance, insurance, taxes, and other incidental expenses arising during the term of the lease. See id. at 30.

15. Under the lease contract, the lessee acquires only the right to possess and use the property for a period of time. See McDonald's Chevrolet, Inc. v. Johnson, 176 Ind. App. 399, 402, 375 N.E.2d 106, 109 (1978) (noting "[a] bailment involves no transfer of ownership; the bailee acquires only a possessory interest continuing for the period of bailment"); Towe Farms, Inc. v. Central Iowa Prod. Credit Ass'n, 528 F. Supp. 500, 505 (S.D. Iowa 1981) (finding that "true lease is not a transaction of purchase and does not confer even voidable title upon the lessee"); Shosid v. Hughes Tool Co., 258 S.W.2d 945, 948 (Tex. Civ. App. 1953) (holding that title does not pass to lessee in bailor-bailee relationship).

In most modern lease transactions the lessor has no independent use for the equipment. See Hawkland, The Impact of the Uniform Commercial Code on Equipment Leasing, 1972 U. ILL. L.F. 446, 449 [hereinafter Hawkland, Impact] ("The lessor usually never sees the item and has no desire ever to own it in the sense of having the use of it."). Consequently, although the lessor regains possession of the equipment at the end of the lease, the lessor typically will offer to sell or lease it to the lessee at its fair market value. See Reisman & Mooney, supra note 2, at 30.

16. For a discussion of the specific tax advantages obtained through leas-
lessor regains possession of equipment at the termination of the lease, the lessor is free to re-lease or to sell the equipment for additional profit.\textsuperscript{17}

Whether leasing is more desirable than secured financing depends on a variety of factors. For example, a potential lessee may need to conserve working capital\textsuperscript{18} or wish to reduce the risk of equipment obsolescence.\textsuperscript{19} A lessor can expect certain

\begin{itemize}
\item \textbf{Tax Considerations:}
\begin{itemize}
\item \textit{In a true lease, the lessor is entitled to all proceeds upon disposition of the equipment. See Reisman & Mooney, supra note 2, at 37-38.} In a secured transaction, however, the creditor must remit any surplus over the secured debt to the debtor/owner. U.C.C. § 9-504(2).
\item \textit{From the lessee's standpoint, a major advantage of leasing over other forms of financing is that a lease generally requires no down payment.} The sophisticated lessee may acquire the use of income-producing equipment, cover the lease payments out of pre-tax income generated by use of the equipment, and generate a margin of profit with no capital investment. Thus, leasing allows companies to retain existing cash reserves or lines of bank credit for other uses. See R. Contino, supra note 1, at 33-34.
\end{itemize}
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\item \textbf{Other nontax-based incentives to the lessee include:}
\begin{itemize}
\item the ability to maintain debt capacity by excluding lease payments in calculating present debt (although sophisticated lenders ask debtors to disclose such contingent liabilities and to certify the extent of these obligations); the ability to include maintenance and servicing in the lease contract at favorable rates; and the ability to design a contract that allocates rights and obligations advantageously between parties (nonetheless, the lessee should consider the costs of constructing a lease contract). See Int'l Trade Admin., U.S. Dep't of Commerce, A Competitive Assessment of the U.S. Equipment Leasing Industry 12-20 (1985) (discussing types of leased equipment, corresponding finance advantages, and industry pitfalls); Outlook, supra note 1, at 53-2.
\item \textit{Highly technical equipment, such as a computer, may become obsolete before the end of its useful life.} Through leasing, the lessee may be able to negotiate a provision for upgrading equipment as technology improves. The lessor, however, likely will build in a substantial premium to compensate for assuming this risk. See R. Contino, supra note 1, at 32-33.
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\item \textit{Various risks are associated with acquiring untested equipment.} The lessee may prefer leasing to avoid the risk of purchasing equipment that may not perform as predicted. Predicting the residual value of the equipment at the end of the lease term presents another risk. If the lessee can negotiate favorable rental payments based on the lessor's expectation of a large residual value, the lessee may avoid the risk of acquiring a "lemon." For other advantages to the lessee, see supra note 18.
\end{itemize}

\begin{itemize}
\item \textit{Leasing also presents certain disadvantages to the lessee.} The major disadvantage is that the lessee does not acquire an ownership interest in the equipment even though rental payments may equal or exceed the full purchase price. At the end of the lease term, the lessee must return the equipment and has no claim to any residual value. See R. Contino, supra note 1, at
advantages over a secured creditor when competing claims to the equipment arise from creditors of, or transferees from, the lessee.\textsuperscript{20} When a lessee declares bankruptcy, for instance, a lessor's right to reclaim equipment is protected against claims of the lessee's creditors or trustees without filing a financing statement, while a secured creditor's right may be defeated if the security interest is not perfected by filing.\textsuperscript{21}

Notwithstanding differences between leasing and secured transactions, long-term leasing closely resembles secured financing.\textsuperscript{22} A consensual agreement governs each by defining the rights and obligations of the contracting parties.\textsuperscript{23} In addition, each transaction typically involves three parties. Parties to a leasing transaction include a lessee, an equipment supplier, and a lessor.\textsuperscript{24} In many instances, the lessor, like the creditor,
is not involved in the transaction until after the prospective lessee selects specific equipment and negotiates the price with the supplier. 25 The lessee, like a purchaser seeking financing, then contacts potential lessors 26 to find the most favorable terms. 27 Once the lessor approves the lessee 28 and the parties finalize the lease agreement, the lessor purchases the preselected equipment from the supplier and directs delivery to the lessee. 29

In addition to the lessee, supplier, and lessor, other parties may claim interests in the leased property through independent transactions with the lessor or lessee. 30 These parties usually fall within one of four categories. 31 One third party typically claiming an interest in leased goods is the holder of a lien created under the Uniform Commercial Code § 29A.03 [hereinafter Mooney, Lease].


26. See id. at 1380 (noting customer is essentially inquiring about the "availability of credit"). The leasing industry consists of four basic categories of professional lessors. The first group comprises independent leasing companies that have no direct affiliation with banks or manufacturers and that depend on leasing as a major source of revenue. There are two basic types of independent leasing companies. The lease finance company purchases equipment for lease to specific clients. These companies typically offer only finance leases. The second type of independent leasing company, specialized or service lessors, usually supplies specific kinds of equipment and offers finance or operating leases.

The second category of lessors includes lease brokers who package lease transactions for prospective lessees and prospective lessor-investors. The third category consists of captive leasing companies, the leasing subsidiaries of manufacturers or dealers created as a marketing device for a parent company's products. The fourth category consists of banks and other financial institutions that use leasing as an alternative means of customer financing. See R. CONTINO, supra note 1, at 21-25; OUTLOOK, supra note 1, at 53-1 to 53-2.

27. See R. CONTINO, supra note 1, at 19.

28. The bank, or other potential lessor, will assess "the credit-worthiness of the lessee before accepting the lease." M & M Leasing, 563 F.2d at 1380. "If it is determined that a prospective lessee is not financially strong enough to support a particular lease financing, some form of credit support will be necessary." R. CONTINO, supra note 1, at 53. Credit support generally takes the form of a "full and unconditional guarantee of all the lease obligations from a creditworthy entity." Id. (emphasis in original).

29. See Mooney, Lease, supra note 24, § 29A.03.

30. See infra Part II.

31. The lessee may expose the lessor's interest to third-party claims other than those in the four categories. Other third-party claimants may include the state, owners of real property to which leased goods are affixed, and bankruptcy trustees. In some states, for example, statutes may authorize seizure of property used in illegal activity. See, e.g., FLA. STAT. ANN. § 932.703 (West Supp. 1988); N.C. GEN. STAT. 18B-504 (1983); see also Calero-Toledo v. Pearson
ated by law. A lessee may take leased equipment to a service center for repair and fail to pay the charges. The repairer has a lien on the equipment and typically holds the equipment until the debt is paid. A second category of third-party claimants consists of general creditors of the lessor or lessee who acquire liens on leased property through the judicial process by judgment, execution, or attachment. Secured creditors of either party compose a third category of claimants. For example, a lessee who borrows all or part of the purchase price of equipment may give the lender a security interest in the equipment. In the alternative, the lessor may either sell the lease and the residual interest in the equipment.


If leased property is affixed to real property, special recording statutes or other real property laws may bear on the lessor's rights. See Western Mach. Co. v. Graetz, 42 Cal. App. 2d 296, 299, 108 P.2d 711, 713 (1940). Western Machinery involved leased mining machinery that would become part of realty. Because the court found the transaction to be a true lease, it determined that the statute requiring the recording of mining equipment sales did not apply. Id. Because the machinery was affixed to land, however, it was subject to real property recording statutes. The court therefore held that the lessor's title was subject to the lien of the mortgagee made in good faith and without constructive or actual notice of the lease. Id. at 300, 108 P.2d at 713. See also Reisman & Mooney, supra note 2, at 40 (recording notice may be condition precedent to lessor's superior rights).

If the lessee undergoes bankruptcy, the Bankruptcy Code determines the lessor's rights. Under a reorganization plan, a lease may be affirmed or rejected. Until that decision is made, the debtor-in-possession or the trustee may be able to use the equipment for the benefit of the estate. Rejection of the lease constitutes abandonment of the property to the lessor. In a liquidating bankruptcy, the lessor generally can regain the equipment. The lessee-hold interest, however, may be assigned to a third party without the lessor's consent if the estate will benefit. See Reisman & Mooney, supra note 2, at 184-85 for a detailed discussion of the effect of bankruptcy on the lessor's rights.

32. Examples of common-law and statutory liens include artisan's liens, materialman's liens, and mechanic's liens. See BLACK'S LAW DICTIONARY 832, 104, 881, 885 (5th ed. 1979).


34. Id. at 766, 186 N.W.2d at 721-22 (artisan with valid lien "has a right to retain the [equipment] until the charges are paid").


37. See, e.g., In re Leasing Consultants, Inc., 486 F.2d 367, 369 (2d Cir. 1973) (bank financed purchase of equipment to be leased and took security interest in property leased as collateral); see also Reisman & Mooney, supra note
or use it as collateral to acquire funds for additional lease transactions.\textsuperscript{38} Transferees who purchase or lease the equipment from either the lessor or lessee constitute a fourth category of third-party claimants.\textsuperscript{39} For example, a lessee who no longer needs the equipment may sublease it for all or part of the lease term.\textsuperscript{40}

II. COMMON-LAW RESOLUTION OF COMPETING CLAIMS TO LEASED GOODS

Disputes may result over the priority of conflicting interests in the property when a lessor or lessee enters into separate transactions with these third parties.\textsuperscript{41} In seeking to resolve such priority disputes, courts have found no guidance in the lease agreement and few answers in the U.C.C. or in other statutes. As a contract, the lease agreement governs issues between the lessor and lessee,\textsuperscript{42} but cannot address the competing claims of third parties. Before Article 2A was proposed, the

\textsuperscript{2} at 34 ("lessor may leverage its equity by borrowing ... a substantial portion of the cost of the equipment").

\textsuperscript{38} See, e.g., Reisman, \textit{Assignment of Equipment Leases by Sale or as Collateral}, in \textbf{EQUIPMENT LEASING—LEVERAGED LEASING} 883, 885 (B. Fritch & A. Reisman 2d ed. 1980) ("manufacturers and vendors convert their long-term equipment [leases] into a source of operating cash through chattel paper financing"). A lease transferred by the lessor to a lender as collateral for a loan or in a sale constitutes chattel paper, U.C.C. § 9-105(1)(b), and is governed by Article 9.

\textsuperscript{39} See, e.g., Shosid v. Hughes Tool Co., 258 S.W.2d 945, 946-47 (Tex. Ct. App. 1953) (scrap dealer purchased leased metal bits from lessees); DeSilvio v. Restauire, 264 Pa. Super. 528, 530-31, 400 A.2d 211, 212 (1979) (lessee sold leased car to third party through used car dealer).

\textsuperscript{40} See, e.g., \textit{R. CONTINO}, supra note 1, at 120 ("lessee with the right to sublease equipment is in the best position to lessen or eliminate the impact of having to pay rent on assets which become unproductive because of changes in use needs during the lease term"). Unauthorized transfer of equipment is generally an event of default. \textit{Id.} at 113. Thus, there is potential for competing claims.

\textsuperscript{41} See \textit{supra} text accompanying notes 30-40.

\textsuperscript{42} The agreement usually includes specific provisions regarding title and location of equipment, use, assignment, and subleasing designed to protect the lessor's ownership interests. See, e.g., \textbf{EQUIPMENT LEASING—LEVERAGED LEASING} 1110-43 apps. (B. Fritch & A. Reisman 2d ed. 1980) (examples of lease agreements).

The lessee also can take steps to protect rights of use and possession. For example, the lessee could include a provision in the agreement requiring that all assignments of the lease be subject to the terms of the lease, thus protecting the lessee's right to continued use of the equipment. The lessee also might include a provision allowing the lessee to approve potential purchasers of the lease and equipment or a provision defining acceptable purchasers. See \textit{R. CONTINO}, \textit{supra} note 1, at 97, 119-20.
had few provisions directly applicable to true leases.\footnote{33}{See Hawkland, The Proposed Amendments to Article 9 of the U.C.C.—Part 5: Consignments and Equipment Leases, 77 COM. L.J. 108, 113 (1972) [hereinafter Hawkland, Amendments] ("[T]rue leases are mainly outside the scope of the Code."); Hawkland, Impact, supra note 15, at 446 ("[F]ew U.C.C. rules were made specifically applicable to leasing.").}

In rare instances courts analogized to other Code provisions to resolve priority disputes.\footnote{34}{In the absence of statutory solutions, courts generally have relied on the common-law principle of derivative title\footnote{5}{See Hawkland, The Proposed Amendments to Article 9 of the U.C.C.—Part 5: Consignments and Equipment Leases, 77 COM. L.J. 108, 113 (1972) [hereinafter Hawkland, Amendments] ("[T]rue leases are mainly outside the scope of the Code."); Hawkland, Impact, supra note 15, at 446 ("[F]ew U.C.C. rules were made specifically applicable to leasing.").} to resolve disputes arising when third par-

**43. See Hawkland, The Proposed Amendments to Article 9 of the U.C.C.—Part 5: Consignments and Equipment Leases, 77 COM. L.J. 108, 113 (1972) [hereinafter Hawkland, Amendments] ("[T]rue leases are mainly outside the scope of the Code."); Hawkland, Impact, supra note 15, at 446 ("[F]ew U.C.C. rules were made specifically applicable to leasing.").**

Although true leases are outside the scope of the U.C.C., certain aspects may be controlled by the Code. Subsection 9-206(1), for instance, governs agreements by the lessee not to assert available defenses against an assignee, "whether or not the lease is intended as security." U.C.C. § 9-206 comment 1. Although Article 9 of the U.C.C. requires the filing of a financing statement to protect a security interest in collateral, U.C.C. § 9-302, there is no filing requirement for a true lease. Section 9-408, however, authorizes precautionary filing. Such filing is not determinative of a true lease. "If the lease is a true lease, none of the provisions of the Article is applicable . . . ." U.C.C. § 9-408 comment 2.

Although the transaction creating a true lease is not within the scope of Article 9, prior or subsequent transactions involving the leasehold interest may come under Article 9. Article 9 provides that the right to rental payments for leased goods not evidenced by a writing creates an "account," U.C.C. § 9-106; a lease related to specific goods transferred by the lessor to a lender as collateral for a loan or in a sale constitutes "chattel paper," U.C.C. § 9-105(1)(b) and comment 4; and goods held for lease may be "inventory," U.C.C. § 9-109(4). Transactions intended to create a security interest in accounts, chattel paper, or inventory associated with the lease and sale of accounts or chattel paper are subject to Article 9. U.C.C. § 9-102(1). Such transactions are not within the scope of this Note.

**44. See, e.g., First Nat'l Bank & Trust Co. v. Smithloff, 119 Ga. App. 284, 290-92, 167 S.E.2d 190, 197-98 (1969).** In dicta, the court in Smithloff indicated that under some circumstances U.C.C. § 9-307(1) might protect the lessee as a "buyer in the ordinary course" against the creditor with a prior security interest. Id. at 290-91, 167 S.E.2d at 197. The court found § 9-307 inapplicable, however, because a state certificate of title statute made prior recording of a security interest essential to validity of the interest against a transferee of the debtor. Id. at 291-92, 167 S.E.2d at 197-98. Reisman and Mooney suggest that the prior perfected secured party would have priority over the lessee's possessory rights unless the lessee qualified as a "buyer in the ordinary course of business" and U.C.C. § 9-307 applied by analogy to leases. Reisman & Mooney, supra note 2, at 63-64. Under U.C.C. § 9-307(1), a buyer in the ordinary course of business takes free of a seller's security interest even if it has been perfected. Under § 9-307(2) a buyer of consumer goods for personal use takes free of a seller's security interest unless a financing statement has been filed. See also Reisman & Mooney, supra note 2, at 38-41 (discussing statutes and common law applicable to leases).

**45. See DeKoven, supra note 7, § 29B.03(2)(b) ("On common law theory, the lessor, since he has not parted with title, is entitled to full protection against the lessee's creditors and . . . even against good faith purchasers from the lessee."") (quoting G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 3.6, at 76 (1965))).
ties claim a superior interest in equipment that is subject to a true lease. Derivative title limits a person's ability to transfer or encumber property to the interest which that person possesses. This principle affords the lessor or lessee under a true lease significant protection against third-party claims to the leased goods.

Under common law, courts have held that the lessor's claim of ownership in equipment covered by a true lease is superior to a common-law or statutory lien arising out of work performed at the lessee's request. Applying the principle of derivative title, the lessee has no power to encumber the lessor's interest without the lessor's authorization. Courts have found one exception to this rule. The lien is effective against the lessor if the lienholder can show the lessor's express or implied consent to the work performed at the lessee's request.

46. See R. Brown, The Law of Personal Property 193-94 (3d ed. 1975); 8 C.J.S. Bailment § 95 (1988) ("bailee cannot transfer a greater right or a better title than he himself possesses").

47. See DeKoven, supra note 7, § 29B.03 (discussing priorities of liens, claims, and encumbrances upon lessee's default in true lease); see also infra text accompanying notes 48-58.

48. Typically, a common-law or statutory lien is a claim against personal property for payment of charges arising out of services or materials provided by the lienholder related to that property. A valid lien gives the lienholder the right to retain the property until charges are paid. See, e.g., Gibreal Auto Sales, Inc. v. Missouri Valley Mach. Co., 186 Neb. 763, 766, 186 N.W.2d 719, 721-22 (1971) (indicating that valid lien would give mechanic right to retain vehicle). For examples of liens created by law, see supra note 32.

49. See, e.g., Gibreal Auto Sales, 186 Neb. at 767-69, 186 N.W.2d at 722-23 (statutory artisan lien for repairs made to leased tractor at lessee's request ineffective against owner).

50. In Disch v. Raven Transfer and Storage Co., 17 Wash. App. 73, 561 P.2d 1097 (1977), the court articulated the general common-law rule that a warehouseman's lien is not effective if the bailor (lessee) merely had legal possession of the goods. "In the absence of a statute to the contrary, one who deals with a bailee concerning the bailed property does so at his peril. The bailor, as the general owner of the property, may assert his title as against third parties." Id. at 78, 561 P.2d at 1100 (quoting 8 C.J.S. Bailments § 39 (1962)).

51. See Joy Oil Co. v. Fruehauf Trailer Co., 319 Mich. 277, 282-83, 29
Courts also have enforced a lessor's or lessee's leasehold rights against creditors of the other party, including creditors who acquire a lien by judicial process. The lessor, for example, would have priority over the lessee's creditors to the proceeds from a judicial sale of leased equipment. Based on the concept of derivative title, a secured creditor of either party is entitled only to the interest held by that party at the time the security interest attached. Under a true lease, the interest acquired by the lessee's creditor is limited to the lessee's possessory interest during the term of the lease. Additionally, the

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N.W.2d 691, 693 (1947) (where garage-keeper was unable to prove consent of owner, he had not established statutory lien); Disch, 17 Wash. App. at 75, 561 P.2d at 1098 (warehouseman not entitled to lien for storage of goods without knowledge or consent of lessor).

Courts have found that a lease contract requiring the lessee to provide full maintenance does not reach the level of consent necessary to make the lien enforceable against the true owner. See, e.g., Gibreal Auto Sales, 186 Neb. at 767-69, 186 N.W.2d at 722-23 (court did not construe maintenance provision as constituting implied consent by lessor).

Many leases, particularly net leases, require the lessee to maintain the leased property. Reisman and Mooney recommend that lessors specify that such obligation does not constitute authority to create a mechanic's lien. See Reisman & Mooney, supra note 2, at 30.

52. A judicial lien is a claim against property of the debtor obtained by a general creditor through judicial proceedings against the debtor. Liens obtained through judicial process include attachment, levy, execution, and garnishment liens. See D. Epstein & J. Martin, Basic Uniform Commercial Code 173-75 (2d ed. 1983).

53. See, e.g., United Rental Equip. Co. v. Potts & Callahan Contracting Co., 231 Md. 552, 556-59, 191 A.2d 570, 572-73 (1963) (whether lessor's interest in property sold at judicial sale took priority over lien creditor or purchaser at judicial sale turned on whether agreement was true lease). In United Rental, the court found the lease agreement to be a security interest that required filing in order to protect the "lessor" from the judgment creditor. Id. at 558, 191 A.2d at 573.

Consistent with the concept of derivative title, the common law also protects the lessee against judgment creditors of the lessor. The creditor acquires an interest only to the extent of the debtor's interest. Where the debtor previously has transferred a possessory interest to the lessee in a lease agreement the possessory interest is severed from the ownership interest and does not belong to the debtor. 8 C.J.S. Bailment § 29 (1988) (bailee's right to possession "is paramount to any right of the bailor . . . or his creditors").

54. See Taylor Rental Corp. v. Ted Godwin Leasing, 209 Mont. 124, 136, 681 P.2d 691, 697 (1984) (whether secured creditor of lessee could take possession of cement hopper turned on whether the lease on the hopper was a true lease or a disguised security interest). In Taylor Rental, a foreclosing creditor agreed to make the monthly rent payments if the lessor would allow him to retain possession of a cement hopper to enhance the attractiveness of the business being foreclosed. Id. at 129, 681 P.2d at 694. When the creditor defaulted on the payments, the lessor repossessed. Id. at 129-30, 681 P.2d at 694. Although the court remanded the case for determination of whether the lease
lessor generally need not give public notice of an interest in personal property under a true lease and has no duty to notify the creditors of record of the interest in the property. Thus,

was a true lease or a disguised security interest, the court upheld the rental award. *Id.* at 138-39, 681 P.2d at 698-99. If the lease was found to be a true lease, the lessor was entitled to rental payments based on the creditor assuming the debtor's leasehold rights and obligations. If the lease was found to be a disguised security interest, the purported lessor was entitled to rent based on an oral contract made by the foreclosing creditor. *Id.*

The common law provides similar protection to the lessee against secured creditors of the lessor who acquire security interests subsequent to the lease agreement. See First Nat'l Bank & Trust Co. v. Smithloff, 119 Ga. App. 284, 290-91, 167 S.E.2d 190, 197 (1969) (if lessee acquired his interest before creation of bank's security interest, his interest would receive priority). The principle of derivative title limits the interest acquired by the lessor's creditor to the interest that the lessor held at the time the security interest was granted. Thus, if the lessor previously transferred the right of possession and use to the lessee, the lessor's creditor would not have a good claim to this interest. If the creditor has a prior security interest in the property being leased, however, the lessee may lose possession to the creditor if the lessor defaults. *See id.* at 291-92, 167 S.E.2d at 197-98 (suggesting that if bank had perfected its security interest by complying with statute prior to lease agreement becoming enforceable, bank's interest would have superseded lessee's).


The federal recording requirements for railroad rolling stock and aircraft, as well as state motor vehicle title statutes, are exceptions to this general rule. In addition, some states, such as Florida and South Carolina, have bailment recording statutes. See Reisman & Mooney, *supra* note 2, at 41; Mooney, *supra* note 2, at 1613 n.43 (noting that South Carolina requires public recording of personal property leases).

56. A creditor of record is one who previously filed a financing statement perfecting a security interest in the same collateral. See U.C.C. § 9-312(3)(b).

In *Taylor Rental*, the lessee's creditor had a perfected security interest expressly covering after-acquired property and the rental inventory used in the lessee's business. This security interest applied to the "leased" cement hopper even though the creditor had not financed the "leasing" of that piece of rental inventory. If the "lease" of the cement hopper had been a disguised security interest, the priority question would have been governed by Article 9. Under § 9-312(3), the creditor (purported lessor), in addition to perfecting his security interest, would have had to notify any other secured party who had filed earlier for the same type of inventory (the creditor of record) in order to protect his purchase money security interest. If the "lease" had been a true lease, however, the lessor would have had priority without filing or notifying a secured party with a perfected security interest in the same inventory. See *Taylor Rental*, 209 Mont. at 131, 681 P.2d at 695 (leases not intended as security are not subject to U.C.C. priority rules).

57. *See, e.g.*, Towe Farms, Inc. v. Central Iowa Prod. Credit Ass'n, 528 F. Supp. 500, 506 (S.D. Iowa 1981). In *Towe Farms*, the lessors were not estopped from alleging conversion of cattle that had been leased to a farmer and subsequently sold to satisfy the farmer's creditors even though the lessors had legal
under the common law, the secured creditor has no means to protect his interest against the lessor's claim.

As a general rule, courts have held that a lessor may recover property from any person who purchases the property from the lessee or who otherwise receives the property in transfer from the lessee.\textsuperscript{58} This right includes recovery from a buyer who purchases from the lessee in good faith and without notice of the lessor's ownership.\textsuperscript{59} Notwithstanding the buyer's good faith, derivative title provides that the lessee has no ownership interest to transfer to the buyer. Similarly, derivative title also protects the lessee's leasehold interest against a subsequent lessee of, or purchaser from, the lessor.\textsuperscript{60}

Two exceptions to the rule of derivative title apply in each of these third-party situations. Courts have estopped a lessor from asserting her title against a bona fide purchaser\textsuperscript{61} if the lessor had knowledge of or consented to the sale of the leased

\textsuperscript{58} See, e.g., McDonald's Chevrolet, Inc. v. Johnson, 176 Ind. App. 399, 400-01, 376 N.E.2d 106, 107-08 (1978) (affirming lessor's ownership of mobile home against purchaser from lessee); DeSilvio v. Restaure, 264 Pa. Super. 528, 530, 400 A.2d 211, 212 (1979) (upholding lessor's title to automobile against party purchasing from lessee).

\textsuperscript{59} See, e.g., McDonald's Chevrolet, 176 Ind. App. at 404, 376 N.E.2d at 109-10 (because lessee did not have ownership, purchaser's "status as a good faith purchaser for value is not determinative"); Shosid v. Hughes Tool Co., 258 S.W.2d 945, 948 (Tex. Civ. App. 1953) (holding lessor could recover property from purchaser who had no knowledge of lessor's interest because "the bailee had no title to convey, even to an innocent purchaser"); see also R. Brown, supra note 46, at 193 (given dilemma of choosing between owner and innocent purchaser, common law preferred owner). But see Uniroyal, Inc. v. Ken Brown Leasing Corp., 36 Mich. App. 599, 604, 194 N.W.2d 8, 11 (1971) (purchaser of vehicle with leased tires prevailed over lessor-owner of tires when purchaser had no notice tires were leased). Uniroyal is distinguishable on the grounds that the purchase was subject to a certificate of title statute requiring recording of liens. Id. at 601, 194 N.W.2d at 9. In addition, the court, in a previous case, had held that a car without tires and an engine was not an automobile and noted in Uniroyal that ownership of tires passes at the moment title passes. Id. at 602, 194 N.W.2d at 10. Under these circumstances, the purchaser had no indication that someone other than the lessee had title to the tires.

\textsuperscript{60} See, e.g., MacArthur v. Gendron, 312 S.W.2d 146, 149 (Mo. Ct. App. 1958) (per curiam) (bailee has "right of exclusive possession of the property, even against the bailor"). If the lessor interferes with the lessee's right to possession, the lessee may recover the property or damages. See R. Brown, supra note 46, at 300.

\textsuperscript{61} A bona fide purchaser is "[o]ne who has purchased property for value without any notice of any defects in the title of the seller." Black's Law Dictionary 161 (5th ed. 1979).
goods or if the lessor's conduct led the purchaser to believe that title was in the lessee. Merely conveying possession to the lessee, however, is insufficient to preclude the lessor from asserting ownership against an innocent party purchasing goods from the lessee.

The U.C.C. also has been used to diminish some of the lessor's traditional protection. Courts have applied the entrustment doctrine of section 2-403 to further the interests of innocent purchasers. The doctrine of entrustment dictates that if a lessor delivers goods to a lessee who is a merchant dealing in goods of that kind, the lessee has the power to transfer title to a buyer in the ordinary course of business. Unlike


63. See Shosid, 258 S.W.2d at 947-48 (finding no conduct on part of owner-lessee to support estoppel); R. BROWN, supra note 46, at 202-04.

A purchaser asserting estoppel bears the burden of proving reliance upon the owner's express or implied representation that the bailee had authority to convey ownership. See Tom W. Carpenter Equip. Co. v. General Elec. Credit Corp., 417 F.2d 988, 990 (10th Cir. 1969) ("The essential elements of estoppel must be pleaded and proved."); R. BROWN, supra note 46, at 202 (estoppel has two elements: representations by owner that he knew or should have known would be relied on, and actual good-faith reliance).

64. See Carpenter Equip., 417 F.2d at 990 ("mere possession does not create an indicia of ownership"); R. BROWN, supra note 46, at 202-03 (under common law, purchaser "could not rely on the mere possession of his vendor as indicating title and right to sell").

65. See, e.g., Exxon Co., U.S.A. v. TLW Computer Indus., Inc., 37 U.C.C. Rep. Serv. (Callaghan) 1052, 1057-58 (D.C. Mass. 1983) (applying U.C.C. § 2-403, court stated that broker, as lessee under true lease, could transfer good title to leased computer if purchaser was buyer in ordinary course of business, but found that purchaser was not buyer in ordinary course of business).

66. The Code limits the class of protected purchasers to buyers "in the ordinary course of business." U.C.C. § 2-403(2). The buyer in the ordinary course of business is a person who buys: (a) in good faith; (b) without knowingly violating a third party's ownership rights; (c) in the ordinary course; (d) from a merchant dealing in goods of that kind. U.C.C. § 1-201(9).

67. "Any entrusting of possession of goods to a merchant who deals in goods of that kind gives him power to transfer all rights of the entruster to a buyer in the ordinary course of business." U.C.C. § 2-403(2); see, e.g., Sumner v. Fel-Air, Inc., 680 F.2d 1109, 1113 (Alaska 1984). In Sumner, the purchaser of an airplane brought an action against the dealer, who was lessee of the plane. The purchaser claimed breach of warranty of title but did not assert ownership against the lessor. Id. at 1111, 1112. In dicta, the court indicated that the purchaser could have defeated any attempt by the original owner-lessee to regain possession of the airplane because he had purchased from a lessee who was a dealer in the goods without knowledge of the true owner's interest. Id. at 1113 (referring to U.C.C. § 2-403).

Section 2-403 does not protect an innocent buyer who purchases from a
the common-law estoppel exception, protection of the innocent purchaser under section 2-403 does not depend on knowledge by or conduct of the owner.  

III. EFFECT OF ARTICLE 2A ON PRIORITY OF INTERESTS ARISING UNDER TRUE LEASES

To a great extent, Article 2A incorporates the common-law approach to resolving conflicting claims. Under Article 2A, the lessor's and lessee's leasehold interests are, with minor exceptions, protected against third-party claimants. Part 3 of Article 2A sets forth rules governing the rights of various parties asserting claims to equipment subject to a true lease.  

Section 2A-301 codifies the traditional rule that the lease contract is enforceable between the parties and against purchasers of the goods and against all creditors of both the lessor and the lessee. To further shield interests of the lessor and lessee, dealer, however, if the dealer acquires possession through the lessee instead of the lessor-owner. See McDonald's Chevrolet, Inc. v. Johnson, 176 Ind. App. 399, 403, 376 N.E.2d 106, 109 (1978). The McDonald court reasoned that the lessee had purchased only possession for a period of time. Id. at 404, 376 N.E.2d at 109. Applying the principle of derivative title, the court determined that because the lessee did not have title, he could not convey title to the dealer. Consequently, the dealer could not convey good title to any party purchasing from him. Id. This result comports with subsection 2-403(2), which provides that a merchant may transfer only the rights of the person who has entrusted the goods to the merchant. See also Carpenter Equipment, 417 F.2d at 988 (lessor of construction equipment prevailed over secured creditor who had financed purchase of equipment from dealer who had received the equipment from lessee for subleasing).

For a discussion of the applicability of U.C.C. § 2-403 and its effect on priorities, see R. Brown, supra note 46, at 202-06.

68. See Note, Uniform Commercial Code Section 2-403(2): The Authority of a Bailee to Convey Title, 21 U. Fla. L. REV. 241, 244 (1968) [hereinafter Note, Authority of a Bailee].

69. See infra text accompanying notes 77-80, 91, 129-131, 141-143.

70. Section 2A-301 states the general rule that a lease contract is effective "against purchasers of the goods, and against creditors of the parties." Sections 2A-304 through 2A-310 set forth rules for determining the priority of claims asserted by specific classes of purchasers and creditors.

71. Article 2A applies to leases of goods including fixtures. U.C.C. § 2A-103(1)(j) (lease pertains to goods); U.C.C. § 2A-103(1)(h) (goods includes fixtures). In most cases, the lessor with a prior interest in the fixtures will have priority over the real estate interest if the interest is perfected with a fixture filing. The fixture filing must conform to the requirements of § 9-402(5). U.C.C. § 2A-309. Priority issues surrounding goods that become fixtures are beyond the scope of this Note.

72. U.C.C. § 2A-301. The lease contract is enforceable between the parties and against creditors and purchasers "[e]xcept as otherwise provided in [Article 2A]." Id.
Article 2A continues the general practice of not requiring that leases be filed or recorded to be effective or enforceable.\textsuperscript{73} Although Part 3 of Article 2A incorporates many common-law rules protecting the lessor's and lessee's interests\textsuperscript{74} from competing claims,\textsuperscript{75} several provisions create preferences favoring third-party interests.\textsuperscript{76} In effect, part 3 creates a system of priorities designed to provide limited protection to certain creditors and transferees of the lessor and lessee.

A. **Claims of Statutory or Common-Law Lienholders Against a Lessor or Lessee**

Article 2A offers greater protection for the rights of statutory or common-law lienholders than does the common law.\textsuperscript{77} Section 2A-306 gives persons holding possessoriy liens, which secure payment of materials for or repairs to leased equipment, preference over the lessor or lessee unless the statute or rule of law creating the lien provides otherwise.\textsuperscript{78} The party against

\textsuperscript{73} See U.C.C. § 2A-301 comment. Filing of true leases is permissive and does not affect the priorities of the various parties asserting claims to leasethold property. Section 9-408, which provides for optional, precautionary filing, states that such filing is not determinative in characterizing a transaction as a lease or security agreement. U.C.C. § 9-408. Article 2A is subject to state and federal statutes, however, including certificate of title statutes. These laws may include filing or notice requirements for certain leased goods. See, e.g., S.C. CODE ANN. § 27-23-80 (Law. Co-op. 1976) (requiring recording of leases of personal property).

Whether the law should require the filing of true leases has been the topic of much discussion and commentary. See Ayer, *Further Thoughts on Lease and Sale*, 1983 ARIZ. ST. L.J. 341, 345-46; Boss, *Leases and Sales: Ne'er or Where Shall the Twain Meet?*, 1983 ARIZ. ST. L.J. 357, 383 [hereinafter Boss, *Leases*]; Dworkin, *Commercial Law: Developments in Leasing*, 1985 ANN. SURV. AM. L. 95, 100-03; Mooney, supra note 2, at 1626.

\textsuperscript{74} For the lessee, the leasehold interest is the right to possess and to use the equipment according to the terms of the agreement. See Reisman & Mooney, supra note 2, at 10-11. For the lessor, the leasehold interest represents the right to rental payments. Id. at 182-83. The lessor also has a reversionary interest in the goods themselves. Id.

\textsuperscript{75} The lease contract is enforceable against purchasers and creditors. U.C.C. § 2A-301.

\textsuperscript{76} U.C.C. § 2A-304(2) (subsequent lessee from original lessor); U.C.C. § 2A-305 (buyer or sublessee in ordinary course of business from lessee who is merchant); U.C.C. § 2A-306 (holder of common-law or statutory lien); U.C.C. § 2A-307(2)(a) (creditors obtaining lien through judicial process prior to lease becoming enforceable); U.C.C. § 2A-307(2)(b) (certain secured creditors).

\textsuperscript{77} For the common-law approach, see supra notes 48-51 and accompanying text.

\textsuperscript{78} If a person in the ordinary course of his [or her] business furnishes services or materials with respect to goods subject to a lease contract, a lien upon those goods in the possession of that person
whom the lien is enforced need not have consented to the work unless the statute authorizing the lien so requires.\textsuperscript{79} Either the lessee or lessor therefore may encumber the leasehold interest of the other party without express or implied authorization.\textsuperscript{80}

Lessees routinely order repairs of leased equipment and occasionally make major improvements to the equipment.\textsuperscript{81} Whenever the lessee cannot or will not pay for the labor or materials involved, either the lessor or the repairer suffers.\textsuperscript{82} Of the two, Article 2A gives priority to the repairer’s claim, ending a judicial practice of interpreting statutory liens as requiring consent of the party against whom enforcement is sought.\textsuperscript{83} Article 2A’s policy of giving preference to a lien created by law over interests of the lessor or lessee will facilitate commerce by enabling repairers and suppliers to conduct business with the assurance that an undisclosed interest will not unexpectedly defeat the customary procedures available to them to induce payment.\textsuperscript{84} Either injured party, whether lessor or lessee, will have a cause of action against the other party for the amount of the lien.\textsuperscript{85}

\begin{itemize}
\item Given by statute or rule of law for those materials or services takes priority over any interest of the lessor or lessee under the lease contract or this Article unless the lien is created by statute and the statute provides otherwise or unless the lien is created by rule of law and the rule of law provides otherwise.
\item If the lien is created by rule of law, consent may be a factor. See U.C.C. § 2A-306 (lien takes priority “unless the lien is created by rule of law and the rule of law provides otherwise”). Applicable cases have held that common law workman liens are not enforceable against a lessor who has not consented to the repair. See, e.g., Gibreal Auto Sales, Inc. v. Missouri Valley Mach., 186 Neb. 763, 767-68, 186 N.W.2d 719, 722 (1971) (artisan’s lien not effective against lessor who did not consent, even though lease contract required lessee to provide full maintenance).
\item Section 2A-306 creates a presumption in favor of the lienholder that can be overcome when express statutory language or rule of law requires consent.
\item The lease contract itself usually requires that the lessee maintain the leased property in good repair. See supra note 51.
\item The lessor will either have to pay the outstanding debt as a condition of repossessing the equipment, or the repairer will lose the cost of labor and materials.
\item See, e.g., Joy Oil Co. v. Fruehauf Trailer Co., 319 Mich. 277, 282, 29 N.W.2d 691, 693 (1947) (where repairer had failed to prove that repairs were made “at the request of or with the consent of” lessor, he did not sustain the “burden of establishing a statutory garage-keeper’s lien”).
\item “Mechanics lien statutes provide one of the most effective collection procedures available to private litigants.” Hellmuth, Mechanics Lien Claims by Lessee’s Contractors, 1982 J. Mo. B. 408, 408 (footnote omitted).
\item The injured party could have a cause of action for conversion. Conver-
B. CLAIMS OF LIEN CREDITORS OF A LESSOR AGAINST A LESSEE

Under Article 2A, creditors of the lessor who acquire a lien on property covered by a lease normally take subject to the lease contract. Such creditors' liens attach only to the lessor's interest in the leased goods. Subsection 2A-307(2)(a), however, provides an exception for a creditor holding a lien that attached before the lease contract became enforceable.

Section is a common-law tort action available against a party who, without authorization, deprives an owner of his property interest permanently or for an indefinite time. See BLACK'S LAW DICTIONARY 300 (5th ed. 1979). The injured party also might have a cause of action for breach of contract, assuming the contract prohibited encumbering the property. The common law supplements Article 2A to provide these remedies. See U.C.C. § 1-103.

86. The U.C.C. definition of creditor includes general creditors, secured creditors, lien creditors, and any representatives of creditors. U.C.C. § 1-201(12).

87. Article 2A defines a lien as "a charge against or interest in goods to secure payment of a debt or performance of an obligation, but the term does not include a security interest." U.C.C. § 2A-103(1)(r). A secured party is not a creditor with a lien for purposes of Article 2A. See infra notes 97-116 and accompanying text (discussing the status of claims made by secured parties).

88. U.C.C. § 2A-307(2). With several important exceptions, § 2A-307(2) provides that a lessee's interest has priority over claims asserted by creditors of the lessor. Creditors who may assert priority include: (1) statutory or common-law lienholders, U.C.C. § 2A-306; (2) creditors of lessors in situations involving fraudulent retention of possession, fraudulent transfers, or voidable preferences, U.C.C. § 2A-308; (3) creditors with liens attaching before the lease becomes enforceable, U.C.C. § 2A-307(2)(a); and (4) secured creditors who would have priority under Article 9 over a creditor holding a security interest perfected by a filing made at the time the lease becomes enforceable, U.C.C. § 2A-307(2)(b). See supra notes 77-80 and accompanying text (discussing statutory or common-law lienholders); infra notes 91, 99-112 and accompanying text (discussing creditors with liens and secured creditors).

89. The lessor's interest includes an interest in the lease contract and the reversionary interest in equipment covered by the lease.

90. A court must look outside Article 2A to determine whether and when a lien attached. See, e.g., MINN. STAT. § 550.37 (1986) (listing categories of property not liable to attachment, garnishment, or execution sale); see also infra notes 93-95 (giving examples of state statutes defining when lien attaches).

91. A creditor of a lessor takes subject to the lease contract, "unless the creditor holds a lien that attached to the goods before the lease contract became enforceable." U.C.C. § 2A-307(2)(a).

This rule and other priority rules set forth in Article 2A depend on when the lease contract becomes enforceable. See, e.g., U.C.C. § 2A-304(2) ("before the interest of the subsequent lessee became enforceable"); U.C.C. § 2A-307(2)(a) ("before the lease contract became enforceable"); U.C.C. § 2A-307(2)(b) ("at the time the lease contract became enforceable"); U.C.C. § 2A-307(4) ("after the lease contract becomes enforceable"). Article 2A does not, however, explicitly define when a lease becomes enforceable. Part 2 of Article 2A sets out the rules regarding the formation and construction of the lease.
A creditor qualifying for this exception takes free of the lease. This rule protects a creditor who obtains a judicial lien on a debtor's property against any attempt by the debtor to place the property beyond the creditor's reach through a leasing arrangement. In most instances, a lessee seeking to lease equipment has notice of the creditor's lien, either because the property is in the possession of the sheriff or because the attachment order is on file in the appropriate government office. Thus, with minimal investigation, a lessee can discover the third-party owner of the property.

In general, Article 2A provides that the lease contract may be made "in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of a lease contract." U.C.C. § 2A-204. To be enforceable, the lease contract must conform to the principles of construction and interpretation contained in U.C.C. Article 1. U.C.C. § 2A-103(4). Enforceability also depends upon the lease contract meeting the requirements of the Statute of Frauds provision of § 2A-201. U.C.C. § 2A-301 comment. Under the U.C.C. Statute of Frauds provision, enforcement of a lease contract worth $1000 or more requires a writing describing the goods and the lease term or, in the absence of a writing, a substantial beginning of manufacture or procurement of specially manufactured goods by the lessor, an admission of enforceability, or receipt and acceptance by the lessee. U.C.C. § 2A-201. Receipt and acceptance of payment on a lease is an insufficient substitute for the writing. U.C.C. § 2A-201 comment. Enforceability is not dependent on filing or recording the lease contract or financing statement. U.C.C. § 2A-301 comment.

Courts therefore have some discretion in determining when a lease became enforceable. Applying general contract principles, a court might determine that the lease contract became enforceable at the time the contract was made. Alternatively, a court might determine that a lease contract is enforceable only when the parties have complied with the requirements of the Statute of Frauds provision. Assuming a court bases enforceability on compliance with the Statute of Frauds provision, there still may be a dispute regarding the specific time a lease contract became enforceable. For example, if enforceability is based on a party's admission in court, the court might apply contract law to determine timing. On the other hand, if enforceability is based on the exception for specially manufactured goods, the court has some discretion in defining what constitutes "a substantial beginning of their manufacture or commitments for their procurement." U.C.C. § 2A-201.

Because Article 2A has no rule expressly defining when a lease contract becomes enforceable, it allows courts some discretion in determining which party has priority. Further discussion of the issue of enforceability of the lease contract is beyond the scope of this Note.

92. Once the lien attaches, it supersedes any subsequent lease agreement. U.C.C. § 2A-307(2)(a).
93. E.g., MINN. STAT. § 570.061 (1986) (providing that "[a]ttachment of personal property shall be a lien on the interest of the [debtor] in the personal property from the time of seizure by the sheriff or subject to the control of the sheriff").
94. E.g., MINN. STAT. § 550.13 (1986) (providing that personal property is attached immediately, because of bulk or other cause, it is sufficient levy if officer files in appropriate office certified copy of execution); MINN. STAT. § 270.69(2) (1986) (providing that notice of tax lien must be filed in office of appropriate county recorder).
party interest and can avoid loss by not leasing the property until the lien has been discharged or has expired. Occasionally, however, property may be subject to a nonpossessory lien that is not publicly recorded. In this circumstance, the lessee has no protection. Subsection 2A-307(2) makes the lessee's interest subordinate to a judicial lien, regardless of whether the lessee had knowledge or notice of the lien.

C. CLAIMS OF SECURED CREDITORS OF A LESSOR AGAINST A LESSEE

Although Article 2A generally protects the lessee against claims of the lessor's secured creditors, the Article provides exceptions when a secured creditor's interest arises before the lease transaction. The secured creditor's interest may have priority over the lessee's subsequently obtained leasehold inter-

95. E.g., CAL. CIV. PROC. CODE § 708.110(d) (West 1987) (providing that service of order on judgment debtor to appear for examination creates lien on debtor's personal property); see also UNIFORM COMMERCIAL CODE COMM. BUSINESS LAW SECTION, STATE BAR CAL., REPORT ON PROPOSED CALIFORNIA COMMERCIAL CODE DIVISION 10 (ARTICLE 2A) 45 (Dec. 1, 1987) [hereinafter CAL. REPORT] (citing CAL. CIV. PROC. CODE § 708.110(d) as an example of a secret lien).

96. The lessee has no easy means of discovering the lien and may lose possession of leased equipment to the lien creditor. In these circumstances, however, the lessee would have a cause of action against the lessor for breach of warranty. See U.C.C. § 2A-211 (providing that lease contract includes implied warranty that "no person holds a claim to or interest in the goods that arose from an act or omission of the lessor . . . which will interfere with the lessee's enjoyment of its leasehold interest").

97. U.C.C. § 2A-307(2) ("a creditor of a lessor takes subject to the lease contract").

Suppliers who offer a leasing option in-house typically sell the lease or use it and the residual interest in the equipment as collateral in a loan. Consider the following example. Lessor leases a computer to Lessee on May 1. On May 2, Finance Agency lends Lessor $50,000 and takes a security interest in the lease contract and the equipment. Finance Agency perfects its security interest by filing on the same day. Two months later Lessor defaults and Finance Agency seeks to recover the computer from Lessee.

Under U.C.C. § 2A-307(2)(b), Lessee's interest is superior to that of Finance Agency because Finance Agency did not file or perfect its interest before the lease contract became enforceable. The special priority given to a purchase money secured creditor does not apply. In this example, Finance Agency knew of the lease transaction involving the collateral and expressly agreed to be satisfied by the stream of rent payments and residual value of the equipment in the event the debtor-lessee defaulted on the loan. Because Finance Agency knew of Lessee's prior leasehold interest in part of the collateral, Finance Agency cannot complain when its interest in the equipment is subordinate to that of Lessee.
To qualify for protection, the secured party must file or perfect the security interest before the lease contract becomes enforceable, or must hold a purchase money security interest that qualifies for special priority under Article 9 of the U.C.C. The lessee can avoid becoming subject to creditors' protection.

Section 307(2)(b) provides:
A creditor of a lessor takes subject to the lease contract, unless the creditor holds a security interest in the goods that under the Article on Secured Transactions (Article 9) would have priority over any other security interest in the goods perfected by a filing covering the goods and made at the time the lease contract became enforceable, whether or not any other security interest existed.

Subsection 9-312 sets forth the rules governing priorities among conflicting security interests. Given that a hypothetical secured party (the stand-in for the lessee) holds a security interest perfected by filing at the time the lease becomes enforceable, the lessor's secured creditor must have filed or perfected before that time, U.C.C. § 9-312(5)(b) ("[c]onflicting security interests rank according to priority in time of filing or perfection"), or qualify for a purchase money super priority under § 9-312(3) or (4).

"A security interest is perfected when it has attached and when all of the applicable steps required for perfection have been taken. Such steps are specified in Sections 9-302, 9-304, 9-305 and 9-306." U.C.C. § 9-303(1). Perfection typically is accomplished when the creditor files a financing statement.

Article 2A is unclear regarding the timing of enforceability. See supra note 91. The following scenario illustrates exactly when a secured creditor qualifies for the § 2A-307(2)(b) exception, allowing his security interest to take free of a lease contract. On February 1, Buyer purchases a tractor from Seller on credit. Seller retains a security interest in the tractor and files a financing statement on February 8 when the tractor is delivered to Buyer. On March 1, Buyer leases the tractor to Lessee. Three months later, Buyer-Lessor defaults and Seller seeks to recover the tractor from Lessee.

Seller's security interest has priority over Lessee's interest because it was perfected before the lease became enforceable. See U.C.C. § 2A-307(2)(b).

A purchase money security interest is one:
(a) taken or retained by the seller of the collateral to secure all or part of its price; or
(b) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.

A purchase money security interest in inventory would have priority over the lessee's interest if (a) it is perfected at the time the debtor receives possession . . . and (b) the purchase money secured party gives notification in writing to the holder of the conflicting security interest if the holder had filed a financing statement covering the same types of inventory (i) before the date of the filing made by the purchase money secured party, or (ii) before the beginning of the 21 day period where the purchase money security interest is temporarily perfected without filing or possession.

A purchase money security interest in collateral other than
claims by learning whether any previously filed financing statement covers the property to be leased.\textsuperscript{103} If the property is covered, the lessee can request that the lender subordinate\textsuperscript{104} its interest to the lease or the lessee can refuse to complete the lease transaction.

Even if the secured creditor of the lessor qualifies to take free of the lease contract, the creditor's interest can be defeated in two ways.\textsuperscript{105} Article 2A protects the leasehold interest of a lessee in the ordinary course of business\textsuperscript{106} against a security interest in leased goods even if the lessee knows of the security inventory would have priority over the lessee's interest if it were "perfected at the time the debtor receives possession . . . or within ten days thereafter." U.C.C. § 9-312(4).

Consider the following example. Finance Lessor and Lessee execute a lease agreement for a compressor on April 1. The same day, Finance Lessor completes the purchase of the compressor which Lessee had previously selected from Supplier and directs that it be delivered to Lessee. Finance Lessor withholds payment to Supplier pending certification that the compressor has been delivered and installed. Pursuant to the agreement, Supplier takes a purchase money security interest in the compressor that is perfected by filing on April 15, the day of delivery. Finance Lessor does not pay Supplier, however, and three months later Supplier seeks to recover the compressor from Lessee.

Under § 2A-307(2)(b), Supplier's security interest has priority over the lease contract. Supplier has satisfied the requirements of § 9-312(4) by filing the purchase money security interest within 10 days of the debtor receiving possession. Consequently, Supplier would have priority over any conflicting security interest in the collateral perfected by filing made at the time the lease became enforceable and, therefore, would have priority over Lessee. Lessee, in this example, does not qualify for an exception to the rule that the secured party takes free of the lease contract. See infra notes 105-112 and accompanying text. Lessee can acquire protection against default by Finance Lessor, however, by obtaining Supplier's agreement to subordinate its interest to that of Lessee.


\textsuperscript{104} The lender might agree to a lower priority interest in the collateral than that held by the lessee.

\textsuperscript{105} See U.C.C. § 2A-307(3)-(4).

\textsuperscript{106} Section 103(1)(o) provides:

"Lessee in ordinary course of business" means a person who in good faith and without knowledge that the lease to him [or her] is in violation of the ownership rights or security interest or leasehold interest of a third party in the goods, leases in ordinary course from a person in the business of selling or leasing goods of that kind but does not include a pawnbroker.

U.C.C. § 2A-103(1)(o).
To invoke protection, the lessee must act with good faith and without knowledge that the transfer violated a third party's ownership rights, security interest, or leasehold interest. This protection parallels the protection that Article 9 provides to a buyer in the ordinary course of business. Similarly, the leasehold interest of a lessee not in the ordinary course of business is protected against most discretionary future advances made by the secured party to the lessor after the lease contract becomes enforceable. There is one exception to this rule. The secured creditor retains priority if the future advances were made pursuant to a commitment entered into without knowledge of the lease and within forty-five days after the lease became enforceable.

Under Article 2A a lender has no assurance that its interest will have priority if the interest has not been perfected before the lease agreement becomes enforceable. Suppose that a lessor borrowed money from a lender using equipment covered by a lease as collateral, but failed to disclose the existence of a lease contract. The lender in this situation would find, contrary to expectations, that its priority on the equipment is actually subordinate to the lessee's interest under the

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107. "A lessee in the ordinary course of business takes the leasehold interest free of a security interest in the goods created by the lessor even though the security interest is perfected and the lessee knows of its existence." U.C.C. § 2A-307(3).

108. "'Good faith' means honesty in fact in the conduct or transaction concerned." U.C.C. § 1-201(19). "'Good faith' in the case of a merchant means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade." U.C.C. § 2-103(1)(b).

109. "A person 'knows' or has 'knowledge' of a fact when he has actual knowledge of it." U.C.C. § 1-201(25).


111. See U.C.C. § 9-307(1).

112. The lessee is protected after 45 days, or sooner if the secured creditor knows of the lease.

A lessee other than a lessee in the ordinary course of business takes the leasehold interest free of a security interest to the extent that it secures future advances made after the secured party acquires knowledge of the lease or more than 45 days after the lease contract becomes enforceable, whichever first occurs, unless the future advances are made pursuant to a commitment entered into without knowledge of the lease and before the expiration of the 45-day period.


113. Article 2A incorporates the definition of "pursuant to commitment" set forth in § 9-105(1)(k). U.C.C. § 2A-103(3).

114. See supra note 112.

115. Neither the lessor nor the lessee is required to file or to give other public notice of the lease contract. U.C.C. § 2A-301 comment.
lease contract.\textsuperscript{116}

D. CLAIMS OF CREDITORS OF A LESSEE AGAINST A LESSOR

Except to protect holders of possessory liens for materials or repairs provided on leased equipment,\textsuperscript{117} Article 2A gives the lessor priority over all creditors of the lessee who claim an interest in leased goods.\textsuperscript{118} Subsection 2A-307(1) codifies the traditional common-law rule requiring a lessee's creditor to take subject to the lease contract.\textsuperscript{119} A creditor's lien or security interest attaches only to the lessee's interest.\textsuperscript{120} A creditor who proceeds against property ostensibly owned by the lessee therefore acquires only the use of the equipment during the remaining lease term.\textsuperscript{121} Although temporary use of equipment rarely satisfies the creditor's claim against the lessee, Article 2A provides no means for the creditor to assure that the debtor

\textsuperscript{116} Because the lender did not file or perfect its security interest prior to the lease contract becoming enforceable, the lender's interest would not have priority over a security interest in the goods perfected by filing at the time the lease did become enforceable. The lender thus does not qualify for the § 2A-307(2) exception and must take subject to the lease agreement. U.C.C. § 2A-307(2).

If the lessor defaults, the secured creditor may be entitled to the rental payments as proceeds. U.C.C. § 9-306 (security interest continues in any identifiable proceeds unless disposition by debtor was authorized). Suppose, however, that the lessor has used the lease contract as collateral in a separate transaction. Assuming that the second lender perfected his interest in the chattel paper, the first lender may find that he does not have first claim to the rental proceeds and that the residual value of the collateral at the end of the lease contract is minimal.

\textsuperscript{117} See supra text accompanying notes 78-79.

\textsuperscript{118} "Except as otherwise provided in Section 2A-306 (governing priority of liens arising by operation of law), a creditor of a lessee takes subject to the lease contract." U.C.C. § 2A-307(1).

\textsuperscript{119} U.C.C. § 2A-307(1). If the lessee functions in the capacity of the lessor, as in a subleasing contract, this section governs disputes between the sublessor and creditors of the sublessee. Creditors of the sublessee take subject to the lease contract between the sublessor and sublessee. See U.C.C. § 2A-103(1)(p) ("lessor" includes sublessors). The provisions of § 2A-307(2) govern disputes between the sublessor's creditors and the sublessee.

\textsuperscript{120} The lessee's interest includes the interest in the lease contract and the right of possession and use according to the terms of the lease.

\textsuperscript{121} Similarly, the purchaser at an execution or disposition sale acquires only the lessee's interest. Transfer of the lessee's interest to the creditor or purchaser would be deemed involuntary. Under § 2A-303 the transferee therefore would have to make assurances to the lessor to retain use of the leased equipment. If the involuntary transfer "materially changes the duty of or materially increases the burden or risk imposed on the other party," that party may demand that the transferee "cure or provide adequate assurance" of performance under the contract. U.C.C. § 2A-303(1)(b), (2).
has ownership and not simply possessory rights in equipment. Subsection 2A-307(1) makes no specific reference to the rights of those creditors who acquired an interest in the property while it was owned by the present lessee, as in a sale and leaseback situation. Article 9 of the U.C.C. will govern such situations.

E. Claims of Purchasers or Sublessees Against a Lessor

Subsection 2A-305(1) codifies the common-law rule that a purchaser or sublessee "takes subject to the existing lease contract." This provision incorporates the principle of derivative title and limits the interest a transferee may acquire. Under subsection 2A-305(1), the transferee acquires only the leasehold interest held by the lessee at the time of the transfer. Article 2A enumerates two limited exceptions to this rule.

First, a lessee with a voidable leasehold interest can transfer a good leasehold interest to a good faith transferee for value. Because the transferee takes subject to the lease contract, however, the interest acquired is limited to that provided

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122. Article 2A requires neither the lessor nor the lessee to file or to give other public notice of the lease contract. U.C.C. § 2A-301 comment.

123. Because Article 2A recognizes the validity of sale-leaseback transactions, it would seem that the drafters did not intend that § 2A-307(1) be construed to affect the rights of creditors of the lessee acquired while the lessee was owner. U.C.C. § 2A-308(3). Section 9-306(2) provides that a security interest continues in collateral notwithstanding disposition unless the lender authorized the disposition. Thus, the rights of a creditor who acquires a security interest in property that has been sold and subsequently leased back by the original owner should be governed by Article 9.


125. Unless the lease prohibits voluntary transfers, "a buyer or sublessee from the lessee of goods under an existing lease contract obtains, to the extent of the interest transferred, the leasehold interest in the goods that the lessee had or had power to transfer." U.C.C. § 2A-305(1).

A state's certificate of title statute may, however, supersede this rule of priority. A transferee of goods subject to a lease contract and covered by a certificate of title statute "takes no greater rights than those provided both by this section and by the certificate of title statute." U.C.C. § 2A-305(3).

126. Article 2A does not define a "voidable leasehold interest" but sets forth three situations in which the rule would apply. When the lessee has obtained possession of equipment through a lease transaction, a good faith purchaser or sublessee acquires a good leasehold interest even though the lessor was deceived regarding the lessee's identity, the check given on delivery was dishonored, or delivery was procured by fraud. U.C.C. § 2A-305(1).

127. See U.C.C. § 1-201(44).
in the original lease.\textsuperscript{128}

Second, although the general rule of Article 2A protects the lessor's interest against claims arising out of the lessee's transactions with third-party purchasers or sublessees,\textsuperscript{129} subsection 2A-305(2) allows a merchant-lessee to transfer both the lessor's interest and his own interest in the goods free of the lease contract.\textsuperscript{130} This rule draws on the entrustment doctrine of its U.C.C. Article 2 analogue, subsection 2-403(2) and advances the general Code policy of facilitating commerce by protecting consumer expectations in the marketplace.\textsuperscript{131}

Three elements must be present before subsection 2A-305(2) applies: the lessor must entrust the goods to the lessee;\textsuperscript{132} the lessee must be a merchant dealing in goods of that

\textsuperscript{128} "A lessee with a voidable leasehold interest has power to transfer a good leasehold interest to a good faith buyer for value or a good faith sublessee for value, but only to the extent set forth in the preceding sentence." The preceding sentence provides that:

Subject to the provisions of Section 2A-303 [covering transfer of lease contracts, see supra note 121], a buyer or sublessee from the lessor of goods under an existing lease contract obtains, to the extent of the interest transferred, the leasehold interest in the goods that the lessee had or had power to transfer, and except as provided in subsection (2) and Section 2A-511(4), takes subject to the existing lease contract.

U.C.C. § 2A-305(1).

\textsuperscript{129} U.C.C. § 2A-305.

\textsuperscript{130} Section 305(2) provides:

A buyer in the ordinary course of business or a sublessee in the ordinary course of business from a lessee who is a merchant dealing in goods of that kind to whom the goods were entrusted by the lessor obtains, to the extent of the interest transferred, all of the lessor's and lessee's rights to the goods, and takes free of the existing lease contract.

U.C.C. § 2A-305(2).

\textsuperscript{131} "The many particular situations in which a buyer in ordinary course of business from a dealer has been protected against reservation of property or other hidden interest are gathered . . . into a single principle protecting persons who buy in ordinary course out of inventory." U.C.C. § 2-403 comment.

\textsuperscript{132} It is not clear whether the lessor must be aware that the lessee is a merchant dealing in the same goods as those leased. This question arises in the context of entrustment under goods for sale governed by U.C.C. § 2-403(2). See Note, Authority of a Bailee, supra note 68, at 245. There has been some support for requiring a showing of awareness on the lessor's part. See Atlas Auto Rental Corp. v. Weisberg, 54 Misc. 2d 168, 171, 281 N.Y.S.2d 400, 404 (N.Y. Civ. Ct. 1967). If full weight is to be given to the intent of the provisions, however, a knowledge element should not be required. The provision intends to facilitate commerce by protecting innocent buyers. Under this interpretation, if the lessor intends to deliver goods to the lessee, whether or not the lessor was aware of the lessee's status as a merchant dealing in goods of that kind, the entrustment element is satisfied.
and the buyer or sublessee must acquire the interest in the ordinary course of business. The policy choice that subsection 2A-305(2) embodies is a familiar one. In a transaction

133. A buyer is protected only if the lessee-seller is a person in the business of selling goods of that kind. See U.C.C. § 2A-103(1)(a). A sublessee, however, is protected if the lessee-sublessor is in the business of selling or leasing goods of that kind. U.C.C. § 2A-103(1)(o). Section 2A-305(2) thus would not protect a buyer in the ordinary course if the buyer purchased from a merchant who regularly leased but did not sell the goods of the type in question. To illustrate: if a lessor leased a fleet of vehicles to a company engaged in short-term vehicle leasing, the lessor would have priority over the purchaser because the purchaser would not meet the requirements of a buyer in the ordinary course under § 2A-103(1)(a).

Subsection 2A-305(2) apparently overlaps with § 2-403(2), which protects a buyer in the ordinary course who purchases goods entrusted to a merchant who deals in goods of that kind. Entrusting includes leasing. There is a difference, however, in the definition of buyer in the ordinary course as applied in Article 2 as opposed to Article 2A. U.C.C. § 2A-305 comment. Article 2A requires that the buyer take without knowledge that the sale violated a leasehold interest of a third party.

134. U.C.C. § 2A-103(1)(a). The following example illustrates the application of § 2A-305(2). Red Brown acquires a small plane for use in his business under a five-year lease agreement with a "no cancellation" clause. Three years into the lease, Red's business slows and he subleases the plane to a local aircraft dealer on a three-month term renewable until business revives. The dealer includes the plane in its leasing inventory, but instead of reserving it for short-term leasing as planned, the dealer seizes an opportunity for significant profit and leases the plane to White Bros. Transport on a five-year contract. Six months later, Red acquires several large carrier contracts and notifies the dealer that he will not renew the sublease contract at the end of the current term and will take possession of the leased plane. White Bros., who leased from the dealer, claims that its interest in the leased plane is superior to Red's.

In this example, Red is the lessor and the dealer is the lessee subleasing the equipment. Under the general rule of § 2A-305, the sublessee would take subject to the lease contract between Red and the dealer. U.C.C. § 2A-305(1). Because the dealer had a three-month lease, the sublessee could acquire no more than what remained in that term. Assuming that the lease contract did not prohibit voluntary transfers, see U.C.C. § 2A-303, the sublessee can acquire only a leasehold interest that the "lessee had or had power to transfer." U.C.C. § 2A-305(1).

Ordinarily, then, Red could recover the plane after three months. Red, however, chose to sublease to a merchant dealing in aircraft. Under § 2A-305(2), Red assumed the risk that a buyer in the ordinary course or a sublessee in the ordinary course would acquire not only the dealer's rights but also all of his lease rights to the plane. "[A] lessee who is a merchant dealing in goods of that kind . . . [has] power to transfer" all of the lessor's and lessee's rights to the goods." U.C.C. § 2A-305(2). Under these rules, White Bros.'s interest has priority. Red can protect against this result in the future by refusing to lease to a merchant dealing in goods of that kind.

If White Bros. is a sublessee in the ordinary course, Red will not be able to recover the plane until the end of his own original lease term, approximately one and one-half years later.
between two innocent parties, the one entrusting to a dealer bears the risk. Because a contrary rule would create problems in the market, the buyer or sublessee in the ordinary course of business may rely on the dealer's ostensible ownership. Subsection 2A-305(2) limits the interest a dealer-entrustee can transfer solely to his own and the entrutor's interest. A hypothetical situation illustrates this principle. Suppose a farmer who had leased a tractor subleases it to a merchant dealing in farm equipment for three of the remaining five years of his lease term. The merchant has power to sublease the tractor to a sublessee in the ordinary course of business for the full five years remaining on the entrutor's lease. The merchant does not, however, have power to convey the rights of the owner who originally leased the tractor to the farmer. Thus, as long as the lessor does not lease to a merchant dealing in goods of the kind leased, the interest the sublessee or another transferee of the lessee can acquire is subject to the original lease contract.

F. CLAIMS OF A LESSEE AGAINST ANOTHER LESSEE OF THE SAME LESSOR

Section 2A-304 addresses priority disputes arising between original and subsequent lessees when a lessor leases equipment subject to a previous lease. Subsection 2A-304(1) incorporates the common-law preference for the original lessee's possessory rights and makes the interest of a subsequent lessee subject to the prior lease contract.

135. See U.C.C. § 2A-305 comment.
136. "[T]he need to expedite sales of inventory by protecting buyers in the ordinary course of business is a widely felt commercial reality." R. Brown, supra note 46, at 205.
137. Subject to the voidable interest exception, a person has power to entrust only his own rights. It is important to keep in mind that "lessor" includes "sublessor" unless the context clearly indicates otherwise. U.C.C. § 2A-103(1)(p). Thus, where the original lessee-sublessor delivers the leased goods to a merchant-lessee, the merchant-lessee can freely transfer any rights in the property plus any leasehold rights of the sublessor. Based on the concept of derivative title, however, the merchant-lessee cannot transfer the rights retained by the original lessor. The lessor's ownership interest is protected against transferees unless the lessor leases to a merchant dealing in goods of that kind and the transferee qualifies for the buyer or sublessee in the ordinary course of business exception.
138. The original lessor-owner did not entrust the tractor to a merchant dealing in goods of the kind leased.
139. U.C.C. § 2A-305(1).
140. An exception is made for the buyer or subsequent lessee who takes
Subsection 2A-304(2), however, creates a narrow exception to the general rule that the original lessee has priority. Under this subsection, a subsequent lessee in the ordinary course of business\textsuperscript{141} takes free of the existing lease contract. To invoke the exception, the original lessee must have entrusted the goods to the merchant-lessee before the subsequent lease became enforceable.\textsuperscript{142} Suppose that a dealer executed a lease agreement with A that called for delivery of the equipment to A in six weeks. Prior to delivery, however, the dealer leases the same equipment to B. Because A, the original lessee, entrusted\textsuperscript{143} the equipment before the subsequent lease contract became enforceable, subsection 2A-304(2) would subordinate A’s interest to that of B, the subsequent lessee. To address this situation, the drafters of Article 2A balanced the interests of two innocent parties leasing from the same merchant. By conditioning the subsequent lessee’s priority on the earlier lessee’s entrustment, the drafters provided additional protection for the original lessee and supplied a clear rule to resolve competing claims of the two parties.

IV. PROPOSED AMENDMENTS

Even though Part 3 of Article 2A incorporates some needed protections for innocent purchasers and creditors, additional protections should be added. At least two amendments to Article 2A should be made. First, under certain circumstances, Article 2A should protect bona-fide lessees who do not qualify for protection as lessees in the ordinary course of business. Second, Article 2A should shift the initial burden of identifying the existence of a lease affecting certain property from

\textsuperscript{141} See supra note 106 (defining lessee in the ordinary course of business).

\textsuperscript{142} U.C.C. § 2A-304(2) (goods must have been “entrusted by the existing lessee before the interest of the subsequent lessee became enforceable against the lessor”).

\textsuperscript{143} The definition of \textit{entrustment} includes any delivery or acquiescence in possession. U.C.C. § 2-403(3).
third parties to lessors. Shifting this burden could be accomplished by requiring lessors to file their leasehold interests or to mark their leased goods in order to provide notice to subsequent creditors and transferees. Both amendments would further Article 2A's goal of providing extended protection to innocent creditors, transferees, and similarly situated parties.

Under the first suggested amendment, a good-faith lessee leasing for value and without notice of a prior judicial lien\textsuperscript{144} could take free of that lien. The following situation illustrates the importance of this exception. Pursuant to an examination order,\textsuperscript{145} a judgment creditor acquires a lien attaching to equipment owned by the debtor. While that equipment is still in his possession, the debtor leases it to a lessee. Following the examination proceedings, the sheriff seizes the equipment and sells it to satisfy the judgment.\textsuperscript{146} As currently drafted, subsection 2A-307(2) subordinates the lessee's interest in the leased equipment to the creditor's lien regardless of whether the lessee had knowledge or notice of the lien attaching. This is a deviation from the Code's usual policy of not enforcing "hidden" interests against third-party transferees.\textsuperscript{147} Such a worthy policy should be extended to protect the lessee who leases in good faith, for value, and without knowledge or notice of competing claims to the property. Extending this policy to protect the good-faith lessee would not prevent lien creditors from satisfying any judgment recovered out of the lessor's interest in the leased

\textsuperscript{144} Creditors can obtain attachment liens and other judicial liens prior to judgment. Goods subject to such a lien may remain in the possession of the debtor. \textit{See}, e.g., \textit{supra} note 95.

\textsuperscript{145} An examination order is a court order requiring a judgment debtor to appear and answer questions concerning his property to aid in enforcement of a money judgment. \textit{See} Collins v. Angell, 72 Cal. 513, 514, 14 P. 135, 135 (1887).

\textsuperscript{146} \textit{Cf} Nordstrom v. Corona City Water Co., 155 Cal. 206, 212-13, 100 P. 242, 245 (1909) (stating that when judgment creditor institutes supplemental proceedings to collect on the debt, any recovery relates back to time of levy and cuts off intervening claims).

\textsuperscript{147} \textit{See infra} note 153. Enforcing a nonpossessory lien of which there is no public notice also varies from Article 2A's general emphasis on protecting the interests of the parties to the lease agreement against creditors of the parties. Article 2A creates three exceptions to the general rule that creditors of the lessor take subject to the lease contract. Exempted are: possessor liens created by law, liens that attach prior to the lease becoming enforceable, and perfected security interests. U.C.C. §§ 2A-306-307. In most cases the lessee has actual or constructive notice of the lien. Typically, either the equipment is in the possession of the creditor or there is a public filing on record which the lessee could check to ensure that there are no hidden claims that might take precedence over the lessee's right of possession. In situations in which a nonpossessory lien is unrecorded, the lessee has no means of protecting himself.
goods. The creditor could acquire the flow of rents and any residual interest in the property belonging to the lessor.\footnote{148}

In addition to amending Article 2A to extend protection to good-faith lessees as suggested above, subsection 2A-307(2) also should be amended to provide an exception for lessees in the ordinary course of business.\footnote{149} As currently drafted, Article 2A gives the claim of a creditor with a nonpossessory judicial lien priority over the claim of a lessee in the ordinary course of business who leases from a merchant dealing in goods of the type leased. The proposed amendment would parallel Article 2A's exception for lessees in the ordinary course of business against claims of secured creditors.\footnote{150} The amendment would advance the general Code policy of facilitating commerce by protecting the expectations of innocent purchasers and lessees in the marketplace.

Article 2A also should be amended to shift the risk of determining whether leased property is encumbered from creditors and purchasers to lessors. This goal could be accomplished by requiring lessors to file long-term commercial leases.\footnote{151} Article

\footnote{148} Section 2A-303 governs alienability of leasehold interests. A lessor's or lessee's leasehold interest can be involuntarily transferred. In the event of an involuntary transfer, Article 2A requires the transferee to provide assurances to the other party to the lease. U.C.C. § 2A-303(2).

\footnote{149} See Cal. Report, supra note 95, at 45-46 (recommending that California amend its Code of Civil Procedure in response to Article 2A in order to provide protection for the lessee in the ordinary course of business against nonpossessory judicial liens).

\footnote{150} U.C.C. § 2A-307(3) (lessee in ordinary course of business takes free of security interest created by lessor even if lessee knows of interest).

\footnote{151} This Note focuses on long-term leasing and its role as an alternative means of financing the acquisition of needed equipment. See supra notes 9-12 and accompanying text. Commentators have discussed the advantages and disadvantages of requiring filing for some categories of true leases and exempting others. See, e.g., Ayer, supra note 73, at 345-354 (raising concerns regarding mandatory filing of true leases); Baird, Notice Filing and the Problem of Ostensible Ownership, 12 J. Legal Stud. 53-55 (1983) (arguing that filing system serves useful function in sorting out and protecting interests of competing property claimants); Boss, Leases, supra note 73, at 382-86 (arguing that public policy behind requirement of filing for security interests should apply to leases as well as sales unless other considerations, such as de minimus leases, make filing inappropriate); Burns, supra note 103, at 454-62 (arguing that because use of public files as disclosure tool has diminished, costs of mandatory filing outweigh benefits); Hawkland, Amendments, supra note 43, at 114-15 (arguing that filing requirement would prevent innocent creditors and purchasers of lessee from being misled); Huddleson, supra note 55, at 22-23 (reviewing factors considered by drafters of Article 2A in determining not to require public filing); Leary, supra note 7, at 252-53 (suggesting that because practical and economic distinctions between leasing and secured financing have narrowed, it would be appropriate to subject most leases to Article 9 rules, including filing).
Article 2A currently adopts the policy that the lessor's ownership interest in equipment possessed by the lessee should have priority over the interests of third-party claimants even if those claimants have no easy means of discovering the lessor's interest. As a practical matter, a creditor, purchaser, or sublessee cannot simply rely on the ostensible ownership of the lessee. These parties instead must investigate to determine the extent of the lessee's interest. Thus, creditors and transferees bear the burden of determining whether property is subject to an ex-
isting lease contract. The policy that this rule manifests deviates from the U.C.C.'s principle that a party's nonpossessory interest in property typically is effective against other parties only if those parties can discover that interest. The same principle should apply to long-term leases.

As discussed earlier, long-term leasing is essentially an alternative means of commercial financing. Lessors and lessees choose leasing over other forms of financing for various reasons. Although leasing may differ from secured transactions in its allocation of property rights and obligations between the parties, the transactions are indistinguishable to a third party. The lessee has ostensible ownership, while the lessor retains a nonpossessory property interest. To the extent that the lessor's or lessee's leasehold interest is enforceable against third parties, creditors or purchasers dealing with either party bear a risk of losing to a "hidden" superior claim. A potential creditor of the lessee seeking security in unencumbered collateral should be able to obtain assurance that no competing interests have priority. Similarly, a potential lender to the lessor should be able to discover the existence of a lease contract covering the collateral the lender intends to take as security.

The easiest means of achieving this goal is to impose a filing requirement parallel to that which Article 9 imposes on secured creditors. The drafters of Article 2A, however, rejected imposing a filing requirement on lessors or lessees that would permit third parties to discover the existence of leasehold claims on property. Thus, third parties must rely on other means to

154. See Baird & Jackson, supra note 153, at 178; see also U.C.C. § 9-302 comment (transactions are exempt when suitable alternative means of giving public notice are available).

155. See supra notes 13-29 and accompanying text.

156. See supra notes 120-123 and accompanying text.

157. See supra notes 115-116 and accompanying text.

158. See supra notes 110-113 and accompanying text.

159. The Committee rejected mandatory U.C.C. filing, determining that the costs outweighed the benefits. It concluded that the burden of adding additional filing requirements to an already overburdened recording system was not justified by the protection that would be achieved. See Nat'l Conf. of Commissioners on Uniform State Laws, Proceedings in Committee of the Whole, Personal Property Leasing Act, 158-60 (Aug. 1984) (available on microfiche) [hereinafter Proceedings] (remarks by Mr. DeKoven). It emphasized that creditors, the group most likely to be concerned by the lack of public notice, were not asking for protection. Id. at 159.

"Costs" of filing include administrative overhead and filing fees as well as an increased risk that the lessor will lose inherent priority in the property to a third-party claimant because of a delay or technical error in filing. Another
guard against purchasing or lending against leased property.  

The drafters rejected mandatory public filing of leases primarily because they believed the costs of mandatory filing outweighed the benefits. This position, however, does not explain why leases, especially long-term leases, should be treated differently from secured transactions when the two are functionally similar and frequently indistinguishable to third parties.

"cost" of mandatory filing is the burden it would place on filing and recording systems currently overburdened with security transactions.

To opponents of filing, these additional costs are not justified by the protection that would be achieved. Opponents contend that modern credit practices, such as financial statement analysis, and the use of credit reports and credit references, have diminished the role of public files in credit financing. These opponents also argue that creditors, both general and secured, make credit decisions with the expectation that earnings, rather than particular assets, will be the source of repayment. Consequently, opponents conclude that because public filing offers little information regarding a debtor's overall financial health and profitability, creditors would derive a very limited benefit from mandatory filing of true leases. Opponents of mandatory filing also question whether third-party purchasers would benefit, postulating that few would actually search the files. See, e.g., Burns, supra note 103, at 429, 457 n.171; Proceedings, supra note 159, at 158, 161-62.

160. See Burns, supra note 103, at 456-59 (creditors can look to "financial statement ratio analyses, make inquiry of other creditors, and request information from . . . Dun & Bradstreet"; buyers can seek "external evidence of title . . . [and] independently verify the title documentation").

161. See supra note 159. Opponents of mandatory filing may have overstated the costs involved. Although lessors would incur additional costs if filing were required, the lessor presumably would pass these "costs" along to the lessee in the form of a higher rental rate. Because most lessors engaged in long-term leasing already file precautionary leasing statements, see U.C.C. § 9-408 and comment, however, it is likely that some of these costs are included in lease rates.

In addition, because precautionary filing of long-term leases is commonplace, the burden on recording systems may not increase as dramatically as feared. Moreover, with computerization, state recording systems will be able to accommodate heavier demands, and at the same time decrease the turn-around time for receiving information requested. But see Burns, supra note 103, at 429 n.25.

This Note addresses only long-term leasing that serves as a device for financing the acquisition of large equipment and advocates filing of these leases. It does not consider whether filing should be required for short-term leases or for leases involving minimal dollar amounts. Exempting short-term and de minimis leases from the filing requirement would reduce the potential burden on state filing systems. See ABC's, supra note 12, at § 4.1.05 (discussing Canadian Personal Property Security Act).

Because "[n]either the acquisition and dissemination of information about competing property claims nor the assumption of the risk of an undiscovered superior property claim is costless," the burdens should initially fall on the holder of the property interest "who can handle them most cheaply." Baird & Jackson, supra note 153, at 188-89.
parties. Unless a more important interest is served by exempting lessors from the general principle that a holder of a nonpossessory property interest has an effective interest only if third parties can discover that interest, lessors should be required to file. Finance lessors, for example, should not have automatic priority over creditors holding a perfected security interest in the lessee-debtor’s property by virtue of an after-acquired property clause when purchase-money secured creditors must file to assure priority over the same creditors. Because the U.C.C. has adopted a notice filing system to sort out the claims of persons asserting an ownership interest in property, this system should encompass all transactions that split the bundle of ownership sticks and create nonpossessory property interests.

As an alternative to requiring public recording, Article 2A could require lessors to permanently mark leased property. Permanent marking, in the form of an engraved or painted label, would specify the rights of the lessor and would protect transferees and creditors of the lessee. Those parties might otherwise be deceived by the lessee’s ostensible ownership of property.

CONCLUSION

Leasing has become a popular device for financing the acquisition of needed equipment. Leasing differs from secured financing because the lessor, the party analogous to the secured creditor, retains ownership of the leased property. The two transactions are similar, however, in that they are designed to

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162. Leary, supra note 7, at 252 (finding “continual narrowing of the practical and economic distinctions between leasing and secured financing, where leasing is for use for a substantial term”).

163. Finance lessors and purchase money secured creditors perform a similar function. Both finance the acquisition of equipment needed by the lessee or purchaser respectively. See supra notes 22-29 and accompanying text.

164. To assure priority over conflicting security interests in the same collateral, such as that which lessors enjoy over security interests of the lessee’s creditors, the purchase money secured creditor must file within the prescribed time and comply with any applicable notice requirements. U.C.C. § 9-312(3), (4).

165. See Baird & Jackson, supra note 153, at 187-89 (arguing that such a rule would enhance the advantages of a system of secured credit).

166. Such labeling is commonly seen on rental trailers and railroad cars. In Shosid v. Hughes Tool Co., 258 S.W.2d 945 (Tex. Civ. App. 1953), the raised trademark of the Hughes Tool Company was relied on to identify leased roller bits as property of Hughes entitled to priority over a subsequent purchaser from the lessee. Id. at 947.
allow both parties to the transaction to have rights in the equipment. This situation creates the potential for conflicting claims to the property when either party or both parties engage in separate transactions with third parties involving the equipment.

In resolving disputes between parties claiming an interest in property covered by a true lease, courts generally have applied the common-law principle of derivative title and have protected the lessor's or lessee's interest against claims arising out of actions of the opposite party. Absent estoppel or statutory exceptions, courts have enforced the lessor's ownership rights against all creditors or transferees of the lessee. Similarly, courts generally have protected the lessee's leasehold interest from claims arising out of activities of the lessor undertaken after the lease transaction. Until Article 2A was proposed, however, there was no comprehensive, uniform framework for addressing the legal issues related to leasing.

This Note discussed several provisions in part 3 of Article 2A that set forth rules ordering the priorities of various parties asserting claims to leased personal property. In its present form, Article 2A conforms for the most part to existing law. Article 2A has departed from traditional common law, however, in its attempts to provide protection to certain creditors and transferees of the lessor and lessee and thus to bring the law of personal property leasing into line with policies reflected in other articles of the U.C.C.. Although Part 3 of Article 2A extends some needed protection to purchasers and creditors, additional protections are worthy of consideration.

This Note suggested two amendments to Part 3 of Article 2A. Article 2A should create an exception to subsection 2A-307(2) allowing a good-faith lessee who leases for value and without notice of a prior nonpossessory judicial lien to take free of that lien. A second amendment should require public recording of long-term leases. As presently drafted, Article 2A provides no easy means for creditors, purchasers, or sublessees to discover a lessor's interest in property ostensibly owned by the lessee. A mandatory filing requirement for long-term leases is consistent with the general U.C.C. principle that a holder of a nonpossessory property interest must make it possible for others to discover that interest if the interest is to be effective against third parties. Finally, mandatory filing advances Article 2A's policy of protecting the legitimate interests of third
parties engaged in independent transactions with the lessor or lessee.

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