Lessor Liability: EFAs and the New Federal Leased Vehicle Act

By Barry S. Marks

Third-party liability is a recurrent nightmare for equipment lessors, especially those who lease motor vehicles. With jury awards and insurance costs climbing, motor vehicle lessors have resorted to the use of equipment finance agreements (EFAs) to avoid holding title in their own name.

This article will examine EFAs, their creation and use for various types of equipment and situations, and whether they remain beneficial in light of a newly enacted federal law designed to insulate motor vehicle lessors from liability.[1]

LESSOR LIABILITY GENERALLY

There are many sources for lessor liability for third-party injuries caused by leased equipment.[2] These include lessor negligence, alleged breach of warranty, and so-called strict (no-fault) liability labeled variously "products liability," "hazardous instrumentality," and "vicarious liability" leases.

Negligence claims may arise from a showing that the lessor knew or should have known that the operator of the equipment was unqualified or that the equipment was defective.[3] Most practitioners advise that lessor negligence is difficult to prove, particularly in the case of long-term financing lessors such as banks and other third-party leasing companies, as opposed to short-term equipment renters. State legislatures, plaintiff's attorneys, and creative jurists, however, have devised other means of extending liability to lessors.

Plaintiffs have claimed that lessors have breached an actual or implied warranty. These cases are also difficult to win, however, as most courts require some direct contact between the maker of a warranty and the injured party. The Uniform Commercial Code also insulates "finance lessors" (lessors merely providing financing as opposed to vendor lessors),[4] and standard forms of equipment leases include warranty disclaimers that may further protect the lessor.

Strict liability laws are much more troubling. These laws impose liability without any finding of "fault," merely because the financed item is defective and causes injury. The Model Uniform Products Liability Act, a consumer protection law enacted in several states, imposes liability on a "product seller." In some states, product sellers include those engaged "in the business of leasing."[5]

Even where a state has not enacted a specific products liability statute, some courts will impose liability on a lessor on a finding, however tenuous, that the lessor is within "the product's distributive chain" and profited from the sale or distribution of the product to the public.[6]

Probably the most common battleground for lessor strict liability is in the area of motor vehicle vicarious liability. Under a long string of statutory and case precedents, those who are injured by defective or improperly operated motor vehicles have found a means to recover from persons other than the operators. In addition to court cases imposing liability on those who are negligent in entrusting motor vehicles to unqualified users, state legislatures have adopted laws imposing liability on motor vehicle renters and, in some cases, finance lessors. These statutes, which came to the attention of the national press[7] in 2003, resulted in a number of cases in which lessors were held liable for injuries caused by leased vehicles.[8]

Because a motor vehicle is deemed to be an inherently dangerous item of equipment, special laws were enacted in some states to require a lessor to maintain, or cause the lessee to maintain, insurance coverage on paying of liability. One such statute[9] was interpreted to apply to a lease with a $1 purchase option over the lessor's objection that the transaction was a mere financing and not actually intended as a lease within the meaning of the statute.[10] Faced with these laws, several motor vehicle leasing companies announced that they would withdraw

Motor vehicle lessors are resorting to equipment finance ageements, or EFAs, to avoid holding title in their own name, and thus also avoid third-party liability. It is too soon to tell whether a newly enacted federal statute will provide more safeguards.

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from New York, Connecticut, Rhode Island, or other states having unfriendly vehicle vicarious liability laws.

LEASES VERSUS LOANS

Before delving further into the issue of lessor liability and the federal government's response, we should point out that lenders, unlike lessors, are generally insulated from potential liability for damage or injury caused by their collateral.[11]

This is for a number of reasons, including judicial recognition of that lenders are not placing items in the "stream of commerce" for products liability purposes and the fact that most vicarious liability laws seek to impose liability on the "owner" of equipment rather than a lender holding a security interest.

As might be expected, courts are often confused and decisions split over whether liability should be imposed on the "lessor" under leases intended as security.[12] In an apparent effort to escape the notice of plaintiff's counsel, some lessors prefer to be listed as "lienholders" on certificates of title, even in a true lease or a TRAC lease.[13] Unfortunately, many state motor vehicle departments insist on listing as the owner the party holding the manufacturer's statement of origin or the party shown on the invoice. Some concern also exists as to whether being listed as a lienholder is effective notice for bankruptcy purposes[14] or could have adverse impact on various tax determinations.

THE NEW FEDERAL STATUTE

Faced with this uncertainty and under pressure from motor vehicle renting and lease financing organizations, Congress enacted 49 USC Sec. 30106. The new law is expressly designed to supersede state laws (presumably including both statutory and case law) imposing liability on the owners of motor vehicles (see sidebar). We do not yet have case law interpreting this statute, but several observations seem clear from its plain language.

49 USC Sec. 30106. Rented or Leased Motor Vehicle Safety and Responsibility

(Redacted)

(a) In General. An owner of a motor vehicle that rents or leases the vehicle to a person (or an affiliate of the owner) shall not be liable under the law of any State or political subdivision thereof, by reason of being the owner of the vehicle (or an affiliate of the owner), for harm to persons or property that results or arises out of the use, operation, or possession of the vehicle during the period of the rental or lease, if –

(1) the owner (or an affiliate of the owner) is engaged in the trade or business of renting or leasing motor vehicles; and

(2) there is no negligence or criminal wrongdoing on the part of the owner (or an affiliate of the owner).

(b) Financial Responsibility Laws. Nothing in this section supersedes the law of any State or political subdivision thereof –

(1) imposing financial responsibility or insurance standards on the owner of a motor vehicle for the privilege of registering and operating a motor vehicle; or

(2) imposing liability on business entities engaged in the trade or business of renting or leasing motor vehicles for failure to meet the financial responsibility or liability insurance requirements under State law….

(d) Definitions. In this section, the following definitions apply: …

(2) Owner. The term "owner" means a person who is

(A) a record or beneficial owner, holder of title, lessor, or lessee of a motor vehicle;

(B) entitled to the use and possession of a motor vehicle subject to a security interest in another person; or

(C) a lessor, lessee, or a bailee of a motor vehicle, in the trade or business of renting or leasing motor vehicles, having the use or possession thereof, under a lease, bailment, or otherwise …

- The statue insulates "owners," including not only the title holders but beneficial owners (such as trust beneficiaries and equity participants) and lessees (such as rental companies who lease equipment from a financing lessor and rent it to the public). The statute also covers broadly both short-term renters and lessors as well as users who have financed vehicles by granting a security interest to another party. Affiliates of owners are included, which would appear to insulate leasing subsidiaries and owners that lease to their own affiliates for tax or other reasons.

- The law does not change existing law regarding negligence or criminal wrongdoing. This means that a leasing company might still be subject to liability if it knew or should have known that the lessee would drive irresponsibly or that the vehicle was defective.

- Liability insurance requirements still apply. This might preserve liability under state laws requiring motor vehicle leasing companies to maintain (or require their lessees to maintain) adequate liability insurance coverage.[15] For this reason, lessors would be well advised to continue to monitor carefully their lessee's liability insurance programs and provide insurance coverage if there is any risk that the lessee's coverage will lapse.[16]

In addition to these observations, the overall scope of the federal law remains uncertain. Although the law would appear to address all or most types of strict liability for motor vehicle lessors, one could imagine a judge refusing to extend it to general product liability laws or claimed breaches of warranty. This limitation, together with the remaining potential exposure for alleged lessor negligence or failure to require or provide liability insurance coverage, causes the new federal law to fall just short of a panacea for motor vehicle lessors' concerns.

EQUIPMENT FINANCE AGREEMENTS

Prior to an enactment of the new federal law, many lessors shifted their motor vehicle finance activities to EFAs.[17] EFAs are also sometimes used to finance aircraft and other potentially dangerous equipment, to be clear that lessees have title to preserve tax exemptions available only to the lessees and in other situations where leases intended as security might create an ambiguity as to the lessee's title or the lessor's security interest. An EFA is simply a loan and security agreement by another name. Unlike a lease, the equipment user and not the financer clearly holds title. The transaction is stated to be in the nature of a loan or financing rather than a lease of personal property.

As opposed to a lease intended as security (a financing lease), an EFA is clear on its face as to the parties' intention. The EFA therefore has the following advantages over a financing lease.

- The EFA includes remedies under UCC Article 9 rather than mixing lease (Article 2A) and loan (Article 9) language. Presumably, this will make it easier to enforce in the event of a borrower default.

- The EFA clearly states that the lessee holds title, which may have advantages for state sales tax purposes. Many states assess sales tax on the finance charge component of rent in a true lease. Some will tax financing leases the same way as true leases, assessing the additional tax because it appears that the lessor retains title.

- As the lessee clearly holds title, lessee sales and property tax exemptions are more likely to be preserved.

- The lender will be shown as a lienholder on the certificate of title, avoiding confusion with state titling authorities.

At the same time, because the EFA does not include a promissory note or security agreement as such, many lessors that are under internal restrictions prohibiting the making of traditional loans can close an EFA transaction. The absence of a promissory note eliminates extra paper and, to a large degree, the EFA can be modeled on an existing lease agreement package so as to preserve familiar late fee policies, document modeling, and deal structures.

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Of course, it should be remembered at all times that the EFA is a loan-type transaction document. Because it will not own title, the lessor will not be entitled to depreciation or other state or federal tax benefits arising from ownership of the leased equipment, and the transaction cannot possibly qualify as an operating lease for accounting purposes on the lessee's books. It is absolutely essential that the lessor file UCC financing statements if it wishes to preserve its rights in the collateral.

DRAFTING AN EQUIPMENT FINANCE AGREEMENT

Generally speaking, any standard equipment lease can be converted to an EFA without a great deal of redrafting. Several important points should be considered, however.

General Language – Obviously, terms such as "rent," "lessor," and "lessee" should be changed throughout. The document should clearly state that the parties intend a loan (or financing) and that title will vest in the lessee immediately and not upon payment of a "purchase option" or "final rental."

Defaults and Remedies – The language of these sections should be changed to contemplate a secured lending rather than a lease. The lender will be entitled to remedies under UCC Article 9, rather than UCC Article 2A. Although the result is similar, the language is different and clarity is important.

Purchase Option Language – This language should be deleted or changed to reflect a final or balloon payment.

Interest – In an equipment lease, the rent is stated without generally identifying the implicit interest rate. Under some state motor vehicle laws, the interest rate in a secured financing must be disclosed. While these considerations should (theoretically) apply to a financing lease, some lessors escape scrutiny because of the form of their documents. An EFA would be more likely to be subject to state motor vehicle finance laws, and whether the interest rate must be disclosed should be checked.

Usury – Although usury considerations should (theoretically) apply to financing leases, they generally do not apply to true leases. An EFA is more likely to be subject to state usury limitations than a lease, particularly if the interest rate is stated on the face of the document. Most lessors would be comfortable relying on choice of law and forum selection clauses in the lease bringing any litigation into a state that does not have a restrictive usury ceiling. Usury "savings clauses," under which the interest rate is reduced to the maximum rate permitted by law, should be included in every EFA.

Tax Language – Any federal or state income tax indemnity for loss of tax benefits should be excised. The lessor should consider whether its policy regarding the payment of sales and property taxes should be reconsidered where the lessee will obviously be the owner of the leased equipment.

Grant of Security Interest – The EFA should state clearly that the financing party is granted a first priority security interest.

Purchase Money Security Interest – It will be even more important than in most lease transactions that the lessor file its UCC financing statement within 20 days after delivery (not necessarily acceptance) of the equipment in order to preserve the purchase money security interest status.

Return Provisions – The return provision language should be adjusted so that it is clear that the equipment is not to be returned. Query whether this language should remain as the borrower's responsibility in the event of a default.

Miscellaneous Boilerplate – Article 2A language should be removed, acceptance language should be adjusted, and other general boilerplate should be discussed with counsel so that both the language in the document and the lessor's policies may evolve appropriately to the new transaction format.

CONCLUSION

Although the new federal law should provide a great deal of comfort to motor vehicle lessors, business considerations and limitations on the new law support the continued use of equipment finance agreements. With careful drafting, these agreements may actually be clearer and more certain in their court treatment than the traditional $1 purchase option financing lease.

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Endnotes

1. 49 USC Sec 30106 (“Rented or leased motor vehicle safety and responsibility”).

2. See generally Barry S. Marks, “Lessor Liability,” Chap. 10 in *Equipment Leasing – Leveraged Leasing*, edited by Ian Shrank and Arnold Gough Jr., 4th ed. (New York: Practicing Law Institute, 2005).

3. One possible source of liability might be an inspection of equipment by a lessor that fails to note that the equipment is not being properly maintained or is otherwise dangerous to third parties.

4. Uniform Commercial Code, Sec. 2A-212, Sec. 2A-213.

5. See, e.g., *Svege v. Mercedes-Benz Credit Corp.*, 329 F. Sup. 2d 272(D. Conn. 2004); *Bostwick v. Ballard Marine Inc.*, 127 Wash. App. 762, 112 P. 3d 571 (2005).

6. *Samuel Friedland Family Enterprises v. Amoroso*, 630 So. 2d 1067 (Fla. 1994).

7. E.g., Karen Lundegaard and Ruth Simon, “Lawsuits Drive Up Car-Lease Prices,” *The Wall Street Journal*, Jan. 22, 2003.

8. *Fu v. Fu*, 160 N.J. 108 (1999) (in which the New York vicarious liability statute was held to apply to a lease entered into in New Jersey); *Hassan v. Montuori*, 1999 N.Y. 2d 348, 786 N.E. 2d 25, 756 N.Y. S. 2d 126 (2003) (in which the plaintiff was, in fact, one of the vehicle’s owners under the meaning of the statute).

9. Fla. Stat. Ann. Sec. 324.021 (9)(v).

10. *Amba-An v. A. Arias-Turecious*, 704 So.2d 1093 (Fla. App. 1997).

11. See, e.g., *Altman v. Morris Plan Co.*, 58 Cal. App. 3d 951, 130 Cal. Rptr. 397 (1976); *Scott v. First Ing Corp.*, 556 F. Supp. 782 (W.D. Pa. 1983).

12. Compare *Peterson v. Ford Motor Credit Co.*, 448 N.W. 2d 316 (Iowa 1989), with *Barksdale v. National* or *National Bank of Detroit*, 186 Mich. App. 286, 463 N.W. 2d 258 (1990). See also *Amba-An v. A. Arias-Turecious*, 704 So.2d 1093 (Fla. App. 1997).

13. TRAC leases are those with terminal rental adjustment clauses which, under the laws of 48 states, are true leases despite providing for an adjustment in rent at the end of the term based on the use or value of the returned motor vehicle.

14. See, e.g., *In re Otasco Inc.*, 111 BR. 976 (Bankr. N.D. Okla 1990), *Rev’d on other grounds*, 196 BR 555 (N.D. Okla. 1991); *In re Nat’l Welding of Mich. Inc.*, 17 BR 624 (Bankr. W.D. Mich. 1982); *In re Charles*, 323 F. 3d 841 (10th Cir. 2003).

15. Query whether the Amba-An case in endnote 10 is still good law. That case relied on the Florida insurance statute, which is itself in response to Florida’s “dangerous instrumentality doctrine.” The doctrine itself might be superseded by the new federal statute. It would appear that the situation in Florida remains unclear.

16. Note, however, that “force-placed insurance” has been the subject of recent litigation in several states including Alabama and California.

17. EFAs may be used for any type of equipment, including vessels and aircraft, although care should be taken in recording these documents as security agreements rather than leases under federal and state recording statutes.

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