

## Know When to Hold Them, Know When to Fold Them

### *Determining Whether the Equipment is Worth the Cost of Litigation*

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Is the equipment really worth the cost of litigation? Before advising clients to pursue problem accounts legally, it pays to determine the true market value of the equipment in question.

This article discusses asset valuation, recovery, resale and legal strategies that attorneys should know before filing in court. It concludes with a recent case study that illustrates how careful attention to the “commercially reasonable sale” can determine if a deficiency balance defense will be successful.

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#### KEY STRATEGIES

Some financial institutions rely completely on in-house counsel and asset managers to provide legal services, equipment appraisals, and sales. Some outsource all or part of these responsibilities to outside law firms and asset management professionals. Regardless of the approach, it's important that the following steps are taken to help bullet-proof deficiency balances.

**Weigh the Costs.** Accurate valuations conducted early in the process can help lawyers determine whether or not to file orders of replevin to seize the equipment in question. If the costs of litigation and removal exceed the equipment's value in the marketplace, the answer sometimes may be “no.”

An early evaluation of the equipment to be seized may also indicate where to bring suit. For example, if the equipment value exceeds the costs of litigation and removal, in order to seize the equipment, an action must be brought where the equipment is located. If early in the process, however, a determination is made that the costs exceed the equipment value, suit may be brought in a venue inconvenient to the lessee, but consistent with a forum selection clause contained in the lease. This choice of forum — inconvenient

and costly to the lessee — may lead to settlement negotiations between the parties early in the process.

There are some courts that have inappropriately imposed upon the lessor the requirement to “mitigate its damages” before seeking remedies for breach of lease. While those decisions represent a minority view, obtaining an accurate valuation that demonstrates that the costs of removal exceed the equipment's value will support a lessor's decision not to mitigate damages through repossession and sale.

**Seeking Equipment from a Bankrupt Lessee.** Equipment valuations are often critical to adversary proceedings in bankruptcy courts where the lessor is seeking to compel payment or to repossess equipment. In many cases, debtors claim that the “lease” is really a security interest and, therefore, the debtor (not the lessor) has title to the equipment. The “bright-line test” to determine whether a transaction is a security agreement consists of two components: 1) the obligation to pay rent cannot be subject to termination by the lessee; and 2) the lease must give the lessee either the use of the goods for its remaining economic life, or the option to acquire that right for nominal, or no additional, consideration.

In order to demonstrate that an option is not “nominal” (and, therefore, the lease is a “true lease”), courts will examine *not* the actual fair market value of the leased goods at the time that the option arises, but their fair market value at that time *as anticipated by the parties when the lease is signed*.

It is very difficult to obtain an appraisal today that reflects the value of equipment at the expiration of a lease *as anticipated by parties at the inception of the lease*. Often, because of market changes and conditions as well as equipment obsolescence, there is a significant difference between an appraisal obtained at the inception of a lease which projects value at the end, and an appraisal issued at lease end.

In order to support the lessor's claims that a transaction is a true lease, it is prudent for the lessor to obtain an appraisal at the outset of the transaction. Such appraisal could well serve as just the evidence that makes all the difference in bankruptcy court.

**Use Multiple Valuation Sources.** One common problem with typical valuations is an over reliance on data from published sources such as auction guides and trade books. These sources are important, but they only provide a snapshot of equipment values in the past. The data in some annual guides are up to a year old. Published sources cannot take into consideration the condition of the actual equipment in question nor current market conditions. It is better to use a live, historical sale database to have access to true current market value.

A recent example of this occurred in Ohio when the State Highway Department auctioned off a portion of its construction equipment, including a large number of Case W14C rubber tired loaders. Due to their worn-out

condition, winning bids for the loaders ranged between \$6,000-\$7,000 a piece. Equipment like this under normal use and wear would typically command \$20,000 to \$30,000. The low prices in Ohio will have an impact on published values for the next year when, in fact, the equipment may be worth far more in the marketplace.

A more accurate way to determine value is to tap into databases of remarketers that actively sell daily to large numbers of international buyers. Web sites that remarket equipment for orderly liquidations are effective tools for obtaining a wide range of competitive bids internationally. These sites differ from online auctions because they allow sellers flexibility in setting their own timeframe and conditions for gathering bids. Because of this, Web sites that remarket machinery and business equipment for orderly liquidations tend to attract higher bids than do absolute auctions. This can maximize the plaintiff's potential return on assets plus diminish opportunities for the defense to argue that equipment was undervalued in the first place.

**Beware of Short Cuts.** Asset managers sometimes make the mistake of selling equipment too quickly, to the first or second potential buyer that they contact. They do not follow the necessary steps that constitute a commercially reasonable sale. This can backfire in several ways.

First, it is difficult to defend court challenges of deficiency balances if the plaintiff has not followed state guidelines for a commercially reasonable sale. Second, quick sales can undermine the plaintiff's ultimate goal of maximizing return on assets. Equipment with a book value of \$50,000, for example, may fetch only \$5,000 if the potential buyer knows he or she is not bidding against the com-

petition. Asset managers that work the marketplace with comprehensive resources for soliciting bids may attract a buyer willing to pay the full \$50,000. Competitive bidding could bring even more for the same piece of equipment.

**Require Adequate Documentation and Automated Access.** Asset managers should maintain adequate documentation to defend commercially reasonable sales. They also should provide attorneys quick, automated access to this documentation whenever needed by offering them password-protected entry to online systems. Some of the documentation required by courts may include condition reports and photos of the equipment as well as a log detailing all bids and their outcome. Savvy asset managers go beyond the letter of the law in order to strengthen their position, maintaining records on everyone contacted about the equipment. Afterward, records should be kept indefinitely in a handy, automated format.

**Ensure the Credibility of Expert Witnesses.** Can the expert adequately defend his or her position in court? Consider the longevity of the professional and his/her firm, reputation, success in previous court cases, and proven experience in valuing the specific equipment in question. Asset management firms with these attributes sometimes have the edge over in-house professionals because the court may view them as more seasoned and less biased in matters of valuation, in other words, as a disinterested third party.

**Understand UCC codes on public versus private sale.** When faced with determining whether a sale is public or private, courts will rely on a number of factors, including, among other things, competitive bidding, public advertisement, notice, invitation to attend the sale and the location of the sale. There is no uniformity among courts as to

what factor or factors are dispositive and the weight afforded to different factors can vary from court to court.

For example, a court is likely to look at the notice of sale given to the debtor by the secured party. This will often state whether the sale is public or private. Although this may be helpful in determining the type of sale, this intent does not always reflect what actually occurred after notice was given and cannot be relied upon exclusively.

Courts will also weigh the details of the audience targeted by the notice, how the notice was distributed, the number distributed and the format of the notice itself. Was it addressed to the public at large through a widely circulated newspaper or via a widely used Web site? Or was it posted in a trade publication with a limited, specialized readership? Broad circulation may bolster the argument that the sale was public. Placement in a trade publication shifts the evidence toward a private sale, but other factors may influence the courts to determine that the sale was public.

### **CASE STUDY**

The following case illustrates a typical challenge to a deficiency balance and the factors influencing its successful defense. The challenge came near the end of a trial in which the financial institution alleged that the lessee owed a deficiency balance of \$180,000.

In this case, there was a substantial period of time before the 30 trucks in question were recaptured. The financial institution hired an asset management company to inventory the equipment, provide condition reports and appraisals and eventually resell the trucks. Asset managers also provided the financial institution's legal counsel

with password-protected, online access to commercially reasonable sales of the equipment in question, which attorneys used in preparing their case.

Inspection and condition reports revealed that 25 of the 30 units were in poor condition, suffering from neglected maintenance, physical damage, the effects of high mileage and, in some cases, missing components. The other five trucks were in good shape.

Asset managers consulted published sources and their database reflecting recent sales over the company's Web site, a portal for reselling machinery and business equipment via orderly liquidation. When selling equipment that is not of interest to the general public (such as commercial trucks), Internet-based orderly liquidation tends to yield higher prices than public auctions because it exposes the equipment to more potential buyers nationally and internationally over a longer time frame. The process also bypasses the influence of weather and accessibility — common problems with public auctions. Bidders retain the option of personally inspecting the equipment before purchase.

Potential buyers were also notified directly via e-mail, fax, and phone. In all, 1,400 potential end users and dealers were contacted. As required by law, the lessee and personal guarantor were notified about the pending sale should they decide to counter the bids. They did not counter, and the equipment was sold. The proceeds were then applied, less expenses, to determine the deficiency balance.

Near the end of the case, legal counsel for the personal guarantor argued that the trucks had not been sold at commercially reasonable sale prices

and did not follow UCC procedures. An asset management expert was called to testify.

He presented photos of the equipment, condition reports, and a total log of all bids and contacts made on behalf of the equipment. Documentation showed that most of the units were so damaged they were worth only about \$6,000 per unit as opposed to the \$30,000-\$32,000 contended by the defense. The judge questioned the personal guarantor about his figures and the guarantor said a dealer told him the units were worth the higher price. What the dealer may not have realized was that the units were so damaged that they were worth far less than book value. For example, where 400,000 miles a year would be normal mileage for a commercial truck, the lessee in many cases had tripled that.

After viewing the documentation, the judge said he was impressed with the breadth of the sales process and was shocked that the trucks had even sold for the prices they did. The judge granted the plaintiff \$180,000 against the personal guarantor, deeming that the sale had been public, not private, and had followed UCC procedures. Keep in mind that certain Web sites can support both public and private sales.

This case illustrates the point that careful attention to remarketing can be a determining factor when defending deficiency balances. Before rendering a decision, a court may consider whether or not there is adequate documentation relating to the equipment and the sale, the depth and reach of the sales process used, and strict adherence to regulatory guidelines for commercially reasonable sales.