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'Braving Tempestuous Times'

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A Postscript

The two-part article, titled "Braving Tempestuous Times — Hell-or-High-Water Obligations Maintain Their Viability Despite Leasing Scams and a Troubled Economy," which appeared in the February and March 2010 editions of this newsletter, discussed several recent court decisions that ruled on the enforceability of hell-or-high-water obligations and waiver-of-defenses provisions in leases and accounts receivable financings. Below is further elaboration of issues raised by two of these cases.

The 'Real Defense' of Fraud in the Factum

In the discussion of "What Are 'Hell-or-High-Water' Obligations?" (and in the discussion of *Popular Leasing USA, Inc. v. Mortgage Sense, Inc.*) in Part One of the article, the references to "fraud in the inducement" (with respect to a lessee's execution of lease forms, without reading or understanding the significance of their impact), should instead have been referred to as "fraud in the factum" as described in Comment 7 to UCC Section 3-305 (*i.e.*, "the defense of 'real' or 'essential' fraud, sometimes called fraud in the essence or fraud in the factum"). The Comment provides that the test of the "real defense" of fraud in the factum with respect to a holder-in-due-course of an instrument (and thus a defense to an Assignee of a lease or accounts receivable obligation under a waiver-of-defenses clause covered by UCC Section 9-403(4)(A)(iii)) is that of "excusable ignorance" of the contents of the document signed on behalf of the Obligor.

The test of excusable ignorance requires that the signing party that is induced to sign the document not only have actual ignorance, but also have no reasonable opportunity, considering "all relevant factors," to obtain knowledge of the character or essential terms of the document. These relevant factors include: the party's intelligence, education, business experience, reading ability, and understanding of English; the representations made to him and his reason to rely on them; the presence or absence of any third person to read or explain the document to him, or any other possibility to obtain independent information; and the apparent necessity (or lack of necessity) to take immediate action. The Comment concludes that "[u]nless the misrepresentation meets this test [of excusable ignorance], the defense is cut off by a holder in due course."

The term "fraud in the inducement" refers not to ignorance of the terms of a specific document, but to ordinary fraud in which the signing party is misled as to the essential facts upon which he will base his decision to act (*e.g.*, that a lease entitles the lessee to communications services, in addition to use of the leased equipment). Fraud in the inducement does not constitute a real defense to an Assignee having the rights of a holder-in-due-course, but might still constitute a defense to the lessor under a hell-or-high-water lease obligation.

Two-Pronged Approach to Assignee Enforcement of Lease Obligations

In the discussion of *Wells Fargo Bank Minnesota, N.A. v. B.C.B.U.*, in Part Two of the article, it was stated that an Assignee can become insulated from an Obligor's claims and defenses against an Obligee/Assignor of a lease obligation in two distinct ways: 1) derivatively, by virtue of the Assignee succeeding to the hell-or-high-water rights of the Assignor, as set forth in the underlying agreement or as otherwise provided for leases covered by UCC Article 2A, and 2) directly, in its own right, by obtaining the rights of a holder-in-due-course to enforce a waiver-of-defenses provision covered by UCC Section 9-403.

To clarify this two-pronged approach to an Assignee's enforcement of a lease obligation, Comment 4 to UCC Section 9-403 states that "other law," and not UCC Article 9, determines the effectiveness of a hell-or-high-water provision against an Obligee/Assignor and, if a hell-or-high-water provision is enforceable by the Assignor of an obligation, it is also enforceable by its Assignee. However, it is important to note that even if other law (such as the common law of fraud) prevents the Assignor from enforcing a

hell-or-high-water provision, a waiver-of-defenses provision covered by UCC Section 9-403 might nonetheless permit its Assignee to do so.

Comment 7 to UCC 9-403 further explains that even if an Assignee takes the assignment of an obligation with notice of a claim or defense by the Obligor against the Obligee/Assignor (and would thus not have the rights of a holder-in-due-course), Section 9-403 does not supersede any "other law" that would otherwise allow enforcement of a hell-or-high-water obligation by an Assignor (and its Assignee), notwithstanding the existence of a claim or defense against the Assignor (such as ordinary failure of performance, or other breach of a representation or warranty).

Accordingly, even though an Assignee takes an assignment of a lease with actual notice of a claim or defense, so long as the lessor would have been able to enforce the lease under a hell-or-high-water provision despite the existence of a contractual defense, by stepping into the shoes of the lessor, the Assignee will still be able to enforce the lease without the need to satisfy the requirements of a holder-in-due-course under UCC Section 9-403(b), including that it take the assignment in good faith and without notice of claim or defense of the Obligor, etc. However, if any law other than UCC Article 9 would prevent the lessor from enforcing a hell-or-high-water lease obligation, then the Assignee may not enforce the lease in its own right under a waiver-of-defenses provision unless it meets the standards of a holder-in-due-course.

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