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NEW YORK APPEALS COURT TREATS CAPTIVE LESSOR AS FINANCE LESSOR AND VALIDATES DEEMED ACCEPTANCE LANGUAGE

In what is believed to be a case of first impression in the State of New York, the Appellate Division, First Department ruled on December 10, 2002 in the case of Canon Financial Services, Inc. v. Medico Stationary Service, Inc., et. al. that an "affiliated" Lessor may fully enjoy the benefits of a "finance lease" under UCC Article 2A. The official comments to UCC Article 2A specifically state that there are no special rules for the affiliated or closely held lessor -- often known as *captive lessors*. However, the commentators left the door open for interpretation and indicated that whether a lease made by an affiliate of the manufacturer qualifies as a finance lease would be decided on a case by case basis. This standard also became relevant in so-called "private label" or "program" transactions where the lessor was not an affiliate of the supplier/manufacturer but rather worked closely with the manufacturer or was the sole finance source of the supplier. A lessee would often argue that under a "close-connection" theory, the lessor should be subject to the same claims and defenses as is the supplier. Surely, if the captive was not subject to any of the claims or defenses asserted against the supplier, the unaffiliated lessor operating under an exclusive program with the supplier should enjoy, at least, the same benefit.

The facts in Canon Financial v. Medico Stationary are common. The lessee Medico Stationary Service, Inc. ("Medico") entered into a lease (the "Lease") with Canon Financial Services, Inc. ("CFS") as lessor for a new photocopier which included a three hole punch feature (the "Equipment"). The Equipment was manufactured by Canon USA ("CUSA") and sold to CFS by MCS Canon Business Solutions, Inc. ("MCS") to be leased to Medico. The Equipment was delivered to Medico and installed five (5) days later.

Medico claimed it was unsatisfied with the three hole punch feature of the Equipment and contacted MCS to complain about this feature from the date of installation forward. Medico worked with MCS and to some extent the manufacturer, CUSA, for approximately eight (8) months in an effort remedy the problems with the three hole punch. Notwithstanding Medico's attempts, the lessee continued to claim that the three hole punch feature could not be adequately repaired.

Medico never made a payment under the Lease. Although Medico never executed a delivery and acceptance certificate, the Lease provided that the Equipment is accepted if the Lessee fails to deliver written notice to CFS of its non-acceptance (and reason therefore) within ten (10) days of delivery of the Equipment. Medico never sent CFS a written notice within the aforesaid ten (10) day period that it was rejecting the Equipment. Thereafter, CFS commenced an action against Medico for breach of the Lease and was awarded summary judgment by the Trial Court for the accelerated lease balance. Medico commenced a third-party action against MCS and CUSA for breach of various representations and warranties concerning the Equipment.

On appeal, Medico argued that CFS, MCS and CUSA were inter-related and acted as one entity which it referred to as the "Canon Group". Medico further argued that CFS should be held to the representations and warranties made by MCS' sales representative as well as the warranties of CUSA because CFS and MCS were wholly owned subsidiaries of the parent company, CUSA. Medico then reasoned that the Lease could not be a finance lease under UCC Article 2A because the inter-relationship between CFS, MCS and CUSA violated that portion of the definition of a "finance lease" which requires that the "Lessor does not select, manufacture or supply the goods".

The Appellate Division rejected each of Medico's arguments and held that summary judgment was properly awarded to CFS. In its analysis, the Court noted that the Lease provided for all the customary and appropriate warranty disclaimers and statements distancing CFS from the supplier. The Appellate Court went on to state that these provisions were typical of a "finance lease" under UCC Article 2A and that the subject lease agreement was intended to be just that.

Once the Appellate Court established that the Lease was a "finance lease", it held that the mere fact that CFS and MCS were wholly owned subsidiaries of CUSA *did not deprive CFS of its finance lessor status unless sufficient facts were present to pierce the corporate veil of CFS or MCS*. No such facts were present. The Court further stated that the Lease term which provided Medico with a limited period (measured from delivery of the Equipment) to give written notice of rejection-- a so-called "deemed acceptance" provision -- was not unreasonable. This fact was crucial in the absence of a delivery and acceptance certificate and prevented the lessee from avoiding the "hell or high water" clause in the Lease. The Court then concluded that, as a matter of law, keeping the Equipment and using it for approximately eight (8) months was more time then was reasonably needed to decide whether Medico wished to reject the Equipment.

Significance

The Appellate Court's decision in CFS v. Medico is important to both the captive and non-captive community. Few courts that have dealt with the closely held or affiliated lessor in connection with a finance lease under UCC Article 2A and even fewer have dealt with the similar issues arising under private label or similar vendor program agreements. It would appear that from this decision, the New York Courts have decided that if an affiliated or closely held lessor is truly a separate entity and adheres to the corporate form, its common ownership with a vendor or manufacturer is irrelevant to the Court's analysis. Significantly, the Court applied the standards required to pierce the "corporate veil" in order to "link" the affiliated lessor, vendor and/or manufacturer. Under New York Law the grounds necessary to pierce the corporate veil include: (a) a parent's domination of the affiliate regarding the transaction coupled with such domination used to complete a fraud upon the lessee; (b) absence of corporate formalities by the affiliate; (c) inadequate capitalization, or (d) absence of assets, liabilities or income. In utilizing such a rigorous standard to void "hell or high water" rights, the Court dealt a strong blow to lessee's attempts to avoid their obligations under finance leases.

With respect to cases where the lessee neither executes a delivery and acceptance certificate nor rejects a lease, this decision also seems to suggest that the automatic acceptance provision contained in a lease agreement is enforceable. Although the Court was not clear as to what time frame would be an acceptable rejection period, this type of provision was enforced by the Court. Finally, this decision is also noteworthy in that it is a first payment default case which traditionally has been one of the more difficult cases when the lessee is complaining about the condition of the Equipment.

All in all, CFS v. Medico provides good news to closely held and affiliated lessors in the State of New York and will prove to be a valuable resource to all finance lessors in implementing a successful litigation strategy.

Morrit Hock Hamroff & Horowitz, LLP was counsel to Canon Financial on this appeal.

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