

# Finance Lease Hell or High Water Clause and Third Party Beneficiary Theory in Article 2A of the Uniform Commercial Code

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## NOTES

### FINANCE LEASE, HELL OR HIGH WATER CLAUSE, AND THIRD PARTY BENEFICIARY THEORY IN ARTICLE 2A OF THE UNIFORM COMMERCIAL CODE

#### INTRODUCTION

In promulgating Article 2A of the Uniform Commercial Code (U.C.C.) in 1987,<sup>1</sup> the National Conference of Commissioners on Uniform State Laws and the American Law Institute sought to establish a comprehensive statutory regime to govern the formation, performance, and enforcement of leases of personal property in both commercial and consumer settings.<sup>2</sup> Historically the leasing of personal property has been subject to many elements of statutory and common law, including principles drawn by analogy from existing parts of the U.C.C.<sup>3</sup> Specifically, the drafters of Article 2A

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<sup>1</sup> SELECTED COMMERCIAL STATUTES 202-304 (West 1987), as amended by *Amendments to Uniform Commercial Code Articles [sic] 2A Leases* (National Conference of Commissioners on Uniform State Laws 1990). All subsequent references are to the 1991 text of the statute unless indicated otherwise. For background on Article 2A, see generally JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE ARTICLE 2A LEASES OF GOODS 2-4 (3d ed. 1991); Peter A. Alces, *Surreptitious and Not-so-Surreptitious Adjustment of the UCC: An Introductory Essay*, 39 ALA. L. REV. 559 (1988); Amelia H. Boss, *The History of Article 2A: A Lesson for Practitioner and Scholar Alike*, 39 ALA. L. REV. 575 (1988); Edwin E. Huddleston, III, *Old Wine in New Bottles: Article 2A—Leases*, 39 ALA. L. REV. 615 (1988); Homer Kripke, *Some Dissonant Notes about Article 2A*, 39 ALA. L. REV. 791 (1988); Harry C. Sigman & Jeffrey S. Turner, *Preface to the California Report on Article 2A (With Some Thoughts About Participation in the Legislative Process)*, 39 ALA. L. REV. 975 (1988). For discussion concerning finance leases in Article 2A, see Gregory Naples, *A Review and Analysis of the New Article 2A—Leases Amendment to the UCC and Its Impact on Secured Creditors, Equipment and Finance Lessors*, 93 COM. L.J. 342 (1988). For a discussion of the priority of liens under Article 2A, see Linda L. Boss, Note, *Uniform Commercial Code: Article 2A—Leases: Structuring Priorities of Competing Claimants to Leased Property*, 73 MINN. L. REV. 208 (1988).

<sup>2</sup> SELECTED COMMERCIAL STATUTES, *supra* note 1, at 205-06. Article 2A does not address leases of real property, because it defines "lease" as "a transfer of the right to possession and use of goods for a term. . . ." U.C.C. § 2A-103(1)(j) (1991) (emphasis added). "Goods" are

all things that are movable at the time of identification to the lease contract, or are fixtures (Section 2A-309), but the term does not include money, documents, instruments, accounts, chattel paper, general intangibles, or minerals or the like, including oil and gas, before extraction.

The term also includes the unborn young of animals.

*Id.* § 2A-103(1)(h).

<sup>3</sup> As of this writing, Article 2A has been enacted in 12 states: California, Florida, Hawaii, Kentucky, Minnesota, Montana, Nevada, Oklahoma, Oregon, South Dakota, Utah, and Wyoming.

relied heavily on Articles 2 and 9,<sup>4</sup> which had close application to leasing transactions; and the great majority of Article 2A's provisions are based on these sections.<sup>5</sup>

There is, however, an important type of leasing transaction that resists codification under principles derived from the U.C.C.: the "finance lease."<sup>6</sup> A finance lease differs fundamentally from the bilateral transactions which form the basic subject matter of both Articles 2 and 2A. A finance lease involves three parties: a lessor, a lessee, and a supplier,<sup>7</sup> each of whom must meet certain specific conditions.<sup>8</sup> With three parties present, and two contracts (one between supplier and lessor, denominated the "supply contract,"<sup>9</sup> and

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<sup>4</sup> These Articles address sales and secured transactions respectively. In addition, one of the basic provisions concerning finance leases, § 2A-209, draws on §§ 302-315 of the RESTATEMENT (SECOND) OF CONTRACTS (1981). U.C.C. § 2A-209 official cmt. (1991). See *infra* notes 81-83 and accompanying text. The official comments state that, owing to the greater similarity of the lease transaction to a sale of goods, rather than a secured transaction, Article 2 of the U.C.C. provided the main analogue for Article 2A. *Id.* § 2A-101 official cmt. The factors in this determination included the fact that parties to a lease, unlike those in a secured transaction, are often not represented by counsel, and that leases, like sales, involve bilateral obligations among the parties. *Id.* Finance leases, however, more closely resemble secured transactions than do "ordinary" bilateral leases. A conforming amendment to § 1-201(37) of the U.C.C., defining security interests, was promulgated along with Article 2A in 1987. Its purpose was to "sharpen[] the distinction between leases and security interests disguised as leases." *Id.* § 1-201(37) official cmt. (1987). The result of the amendment is that the chief characteristic of a "true" lease, as opposed to a security interest, will be the presence of an economically meaningful residual interest held by the lessor at the end of the lease term. An important reason for developing Article 2A was to solidify, on a statutory basis, the distinction between the "true" lease and security interests disguised as leases. *Id.* § 2A-101 official cmt. (discussing differences regarding filing requirements between secured transactions and leases, and also the source of warranty obligations—Article 2 for sales, of uncertain provenance to leases); WHITE & SUMMERS, *supra* note 1, at 5-18. For a discussion of the distinction between leases and security interests before Article 2A, see JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE §§ 21-23 (3d ed. 1988).

<sup>5</sup> This reliance is duly noted in the official comments to these provisions. In addition, the drafters note that "the official comments to those sections of Article 2 whose provisions were carried over [to Article 2A] are incorporated by reference in Article 2A." U.C.C. § 2A-101 official cmt. (1987).

<sup>6</sup> Finance leases are also sometimes known as equipment leases. In addition, the term "finance lease" may have trade meanings not covered by the U.C.C. statutory definition of the term.

<sup>7</sup> U.C.C. § 2A-103(1)(g) (1991).

<sup>8</sup> These are contained in § 2A-103(g). See *infra* notes 19-33 and accompanying text. For the text of § 2A-103(1)(g), see *infra* note 12.

<sup>9</sup> " 'Supply contract' means a contract under which a lessor buys or leases goods to be leased." U.C.C. § 2A-103(1)(y) (1991).

one between lessor and lessee, the "lease contract"<sup>10</sup>), the sequence of events leading to contract formation can be quite varied.<sup>11</sup>

The absence of a structural analogue to finance leases in the U.C.C. prompted Article 2A's drafters to include specific provisions relating to finance leases. This was particularly necessary in the context of warranty and lessee obligations, because the finance leases follow a widely divergent pattern from the typical bilateral lease. In the latter type of transaction, where only a lessor and lessee are present, Article 2 provided a ready model. However, for the finance lease, no comparable model existed.

Article 2A contains three major provisions detailing the characteristics of, and obligations, under a finance lease. First, section 2A-

10 " 'Lease contract' means the total legal obligation that results from the lease agreement as affected by this Article and any other applicable rules of law. Unless the context clearly indicates otherwise, the term includes a sublease contract." *Id.* § 2A-103(1)(l).

11 For example, a finance lease can be created by direct negotiations between the lessee and supplier, with the lessor adopting a limited role in the transaction, or by a "sale-leaseback" arrangement, where the supplier's involvement in the lease becomes more remote.

Typically, the lessee, as a potential user of the goods (say, a moving company interested in some trucks), will approach a supplier directly (this could be a truck manufacturer, for example). The potential lessee will negotiate the terms of a sale, including any warranties or other preferred terms, and will then execute a purchase order with the supplier. The lessee will then seek a finance lessor, typically a bank or financing company, which will assume the purchase order. When the lessee finds a suitable lessor, it assigns the purchase order to the lessor, which in turn executes a lease of the trucks to the lessee. The finance lessor never takes physical possession of the trucks. These are delivered directly to the lessee by the supplier. Thus, the lessor's role is limited to executing the paperwork and supplying the funds necessary to the purchase, and subsequent lease, of the trucks. *Id.* § 2A-103(1)(g) official cmt.

Another method of creating a finance lease—one where the supplier might not be so closely involved during the lease negotiations—is through formation of a so-called sale-leaseback arrangement. See Albert F. Reisman, *Drafting and Negotiating the Equipment Lease*, in *EQUIPMENT LEASING—LEVERAGED LEASING* 24-25 (Bruce E. Fritch & Albert F. Reisman eds., 1977). Here the moving company-lessee already owns the trucks. The mover first sells the trucks to a finance lessor, which in turn leases them "back" to the lessee. See U.C.C. § 2A-103(1)(g) official cmt. (1991). Note that the lessee-mover, in this transaction, is also the supplier. Thus, both the lease and the supply contract run between the lessee and the bank; and, because a finance lease is a "lease," rather than a secured sale, the parties may acquire benefits that would be unavailable in a purchase.

The mover will, of course, want to ensure that it does not lose any warranty benefits that it presently holds from the manufacturer at the time of sale. To protect these benefits, the mover will usually assign its warranty rights to the finance lessor: Article 2A provides that the benefit of such warranties, obtained by the lessor as part of the supply contract (the assignment from the mover-lessee to the finance lessor), will extend to the finance lessee as a beneficiary of the supply contract. *Id.* § 2A-209(1). See *infra* notes 57-67 and accompanying text. For the text of § 2A-209, see *infra* note 16. The bank's function in the transactions is strictly economic; the lessee's motivation is likely to be economic as well, with tax considerations often playing a major role. Finally, other factors, such as insurance, may bear on the choice of transaction type.

103(1)(g)<sup>12</sup> defines a finance lease and describes the structural relationships between lessor, lessee, and supplier. Second, section 2A-407<sup>13</sup> details the nature of a lessee's obligation to pay rent. This section enacts a standard provision in a finance lease known as a

<sup>12</sup> Section 2A-103(1)(g) reads:

"Finance lease" means a lease with respect to which:

- (i) the lessor does not select, manufacture, or supply the goods;
- (ii) the lessor acquires the goods or the right to possession and use of the goods in connection with the lease; and
- (iii) one of the following occurs:
  - (A) the lessee receives a copy of the contract by which the lessor acquired the goods or the right to possession and use of the goods before signing the lease contract;
  - (B) the lessee's approval of the contract by which the lessor acquired the goods or the right to possession and use of the goods is a condition to effectiveness of the lease contract;
  - (C) the lessee, before signing the lease contract, receives an accurate and complete statement designating the promises and warranties, and any disclaimers of warranties, limitations or modifications of remedies, or liquidated damages, including those of a third party, such as the manufacturer of the goods, provided to the lessor by the person supplying the goods in connection with or as part of the contract by which the lessor acquired the goods or the right to possession and use of the goods; or
  - (D) if the lease is not a consumer lease, the lessor, before the lessee signs the lease contract, informs the lessee in writing (a) of the identity of the person supplying the goods to the lessor, unless the lessee has selected that person and directed the lessor to acquire the goods or the right to possession and use of the goods from that person, (b) that the lessee is entitled under this Article to the promises and warranties, including those of any third party, provided to the lessor by the person supplying the goods in connection with or as part of the contract by which the lessor acquired the goods or the right to possession and use of the goods, and (c) that the lessee may communicate with the person supplying the goods to the lessor and receive an accurate and complete statement of those promises and warranties, including any disclaimers and limitations of them or of remedies.

*Id.* § 2A-103(1)(g).

<sup>13</sup> Section 2A-407 reads:

Irrevocable Promises: Finance Leases

(1) In the case of a finance lease that is not a consumer lease the lessee's promises under the lease contract become irrevocable and independent upon the lessee's acceptance of the goods..

(2) A promise that has become irrevocable and independent under subsection (1):

(a) is effective and enforceable between the parties, and by or against third parties including assignees of the parties; and

(b) is not subject to cancellation, termination, modification, repudiation, excuse, or substitution without the consent of the party to whom the promise runs.

(3) This section does not affect the validity under any other law of a covenant in any lease contract making the lessee's promises irrevocable and independent upon the lessee's acceptance of the goods.

*Id.* § 2A-407.

"hell or high water clause,"<sup>14</sup> which makes the lessee's obligation to pay rent "irrevocable and independent."<sup>15</sup> This assurance of payment is a major incentive to the lessor to provide the funds necessary for a finance lease transaction.

Finally, section 2A-209<sup>16</sup> is the source of the most important warranties extended to the lessee. Article 2A greatly restricts the scope of potential warranties provided by the lessor to the lessee, unlike those provided under the typical bilateral lease.<sup>17</sup> This restriction follows from the finance lessor's limited role in the overall set of transactions—a role inconsistent with the assumption of extensive warranty obligations. Section 2A-209, however, balances this restricted scope by providing that a lessee's warranties under a finance lease stem from the supplier of the goods rather than the lessor. This is accomplished by making the lessee a *beneficiary* of any promises and warranties the supplier has made to the lessor in the supply contract.<sup>18</sup> As a result, the lessee assumes a position close to that of a buyer, looking directly to the *supplier* in matters of warranty rather than to the lessor.

<sup>14</sup> *Id.* § 2A-407 official cmt.

<sup>15</sup> *Id.*

<sup>16</sup> Section 2A-209 reads:

(1) The benefit of a supplier's promises to the lessor under the supply contract and of all warranties, whether express or implied, including those of any third party provided in connection with or as part of the supply contract, extends to the lessee to the extent of the lessee's leasehold interest under a finance lease related to the supply contract, but is subject to the terms of the warranty [*sic*] and of the supply contract and all defenses or claims arising therefrom.

(2) The extension of the benefit of a supplier's promises and of warranties to the lessee (Section 2A-209(1)) does not: (i) modify the rights and obligations of the parties to the supply contract, whether arising therefrom or otherwise, or (ii) impose any duty or liability under the supply contract on the lessee.

(3) Any modification or rescission of the supply contract by the supplier and the lessor is effective between the supplier and the lessee unless, before the modification or rescission, the supplier has received notice that the lessee has entered into a finance lease related to the supply contract. If the modification or rescission is effective between the supplier and the lessee, the lessor is deemed to have assumed, in addition to the obligations of the lessor to the lessee under the lease contract, promises of the supplier to the lessor and warranties that were so modified or rescinded as they existed and were available to the lessee before modification or rescission.

(4) In addition to the extension of the benefit of the supplier's promises and of warranties to the lessee under subsection (1), the lessee retains all rights that the lessee may have against the supplier which arise from an agreement between the lessee and the supplier or under other law.

*Id.* § 2A-209.

<sup>17</sup> In a bilateral lease warranties generally follow the model of Article 2.

<sup>18</sup> *Id.* § 2A-209 official cmt.

This Note will first set out, in Part I, the attributes of the statutory finance lease of Article 2A, illustrating how they combine in a unified structure. Part II will consider the relationship of the supplier and lessee in light of the third party beneficiary and contract assignment theories relied on by the Article. Part III will treat, through the framing of three hypothetical cases, the interaction of the hell or high water provision with the third party beneficiary aspect of the supply contract. Finally, this Note will propose ways to avoid and remedy ambiguities and uncertainties in the statutory language which could potentially upset the expectations of the parties.

## I

### THE STATUTORY FINANCE LEASE UNDER ARTICLE 2A

Building on existing leasing practices,<sup>19</sup> the finance lease structure of Article 2A carefully balances several complementary rights and duties among the parties.<sup>20</sup> There are three basic requirements for the creation of a finance lease: (1) the lessor must not select, manufacture, or supply the goods;<sup>21</sup> (2) the lessor must not lease the goods from inventory;<sup>22</sup> and (3) the lessee must have access to the supply contract, or to information concerning warranties contained in the supply contract.<sup>23</sup> The first two requirements sharply restrict the lessor's relationship to the leased goods, specifically with respect to their selection, manufacture, supply, and prior ownership. The third requirement concerns the notice that a finance lease lessee must receive with respect to the benefit of warranties established by Article 2A between the supplier and the lessee. Once the statutory requirements are met, the finance lease becomes effective, with Article 2A relieving the lessor of many duties it would otherwise bear under a "normal" bilateral lease. This section will identify the three statutory requirements for the establishment of a finance

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<sup>19</sup> The finance lease provisions in Article 2A start from the presumption of a set of "arms-length" commercial transactions, involving parties of equal bargaining power; exceptions are made for settings involving "consumer leases." See, e.g., *id.* § 2A-407(1) (rendering ineffective, in a consumer lease, the statutory "hell or high water" clause otherwise making lessee's obligations "irrevocable and independent upon the lessee's acceptance of the goods"). Article 2A is intended to govern all leases of personal property; thus, the range of transactions—from brief rentals of a chain saw to long-term leases of truck fleets—will be enormous, as will the variety of parties entering into the leases. The variety of goods leased and parties involved in finance leases, will also be large, the only difference being that the lessors will be predominantly financial institutions. On the scope of the leasing business, see generally Reisman, *supra* note 11, at 1-3.

<sup>20</sup> This is notable in the relationship of §§ 2A-209 and 2A-407.

<sup>21</sup> U.C.C. § 2A-103(1)(g)(i) (1991).

<sup>22</sup> *Id.* § 2A-103(1)(g)(ii).

<sup>23</sup> *Id.* § 2A-103(1)(g)(iii).

lease under Article 2A, and discuss their implications on the rights and duties among the three parties.

A. U.C.C. § 2A-103(g): Requirements of Statutory Finance Lease

The statutory finance lease of Article 2A is in itself a bilateral lease—that is, a contract between lessor and lessee—but it stands in a close and specially defined relationship to a second, related contract—the “supply contract”<sup>24</sup>—between the supplier and lessor. In order for a lease<sup>25</sup> to qualify as a “finance lease” under Article 2A, three requirements must be met, each consistent with the limitation on the role played by the lessor in financing the lessee’s activities.

First, the lessor must “not select, manufacture, or supply the goods.”<sup>26</sup> Selection and specification of goods is normally performed by the lessee, who, as user of the goods, is most familiar with its own requirements and best positioned to ensure that the goods selected are suitable for the intended purpose. Prohibiting the lessor from “select[ion], manufacture, or supply”<sup>27</sup> is consistent with relieving it of any statutory obligation to extend implied warranties of merchantability or fitness for a particular purpose.<sup>28</sup> Such warranties are not ordinarily extended by the lessor in a finance lease.

Second, the lessor must not lease the goods out of inventory. Its ownership of the goods, or, in the alternative, its right to possess and use the goods,<sup>29</sup> only arises “in connection with the [finance] lease.”<sup>30</sup> Again, this is consistent with the limited role of the lessor in the overall transaction.

Finally, section 2A-103(1)(g)(iii) makes the effectiveness of the finance lease conditioned upon the lessee’s access to the supply contract or to certain related information. Section 2A-103(1)(g)(iii) delineates four conditions, only one of which must be satisfied, in

<sup>24</sup> See *supra* note 9.

<sup>25</sup> A finance lease is a species of lease under Article 2A. Section 2A-103(1)(j) treats “lease” generally, defining it as:

a transfer of the right to possession and use of goods for a term in return for consideration, but a sale, including a sale on approval or a sale or return, or retention or creation of a security interest is not a lease. Unless the context clearly indicates otherwise, the term includes a sublease.

*Id.* § 2A-103(1)(j).

<sup>26</sup> *Id.* § 2A-103(1)(g)(i).

<sup>27</sup> *Id.*

<sup>28</sup> *Id.* §§ 2A-212(1), 2A-213.

<sup>29</sup> The lessor may itself obtain the goods by lease, rather than by taking an ownership interest in them. *Id.* § 2A-103(1)(y).

<sup>30</sup> *Id.* § 2A-103(1)(g)(ii). The meaning of “in connection with the lease” is not further defined. The official comment states that “[t]he scope of the phrase ‘in connection with’ is to be developed by the courts.” *Id.* § 2A-103 official cmt.



order to have an effective lease.<sup>31</sup> If one of these conditions is met and the parties satisfy the other two requirements of section 2A-103(1)(g),<sup>32</sup> lessor and lessee have effectively entered into a finance lease as defined by Article 2A.<sup>33</sup>

The restricted role played by the lessor in a finance lease—essentially the provision of funds for the purchase or lease of goods from the supplier—has implications on each of the parties' obligations under the two contracts. The lessor's obligations differ significantly from those found in the "usual" bilateral lease transaction, and in view of the lessor's role, Article 2A seeks to ensure that the lessor receives its payments due from the lessee. This is accomplished by the "hell or high water" clause of section 2A-407, which makes the lessee's payment obligation "irrevocable and independent" upon the lessee's acceptance of the goods.

Apparently, only three ways exist by which the lessee may avoid this obligation: (1) if the lessor breaches the general obligation of good faith; (2) if the lessee justifiably revokes acceptance under section 2A-517; and (3) if the lessor breaches either express warranties made under section 2A-210 or warranties against claims of third parties under section 2A-211(1). While section 2A-407 would appear to put the lessee in a weak position, Article 2A balances it with section 2A-209, which makes the lessee the beneficiary of the promises and warranties made to the lessor in the supply contract. In so doing, Article 2A erects a unified structure of rights and obligations extending over both contracts.

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<sup>31</sup> See *supra* note 12 for the requirements of an Article 2A finance lease.

<sup>32</sup> These relate respectively to the "select[ion], manufacture, or supply" of the goods and to the requirement that the lessor "acquires the goods or the right to possession and use of the goods in connection with the lease." U.C.C. § 2A-103(1)(g)(i)-(ii) (1991).

<sup>33</sup> The rationale behind § 2A-103(1)(g)(iii) becomes clear when one understands the real dimensions of the lessor's role in the transactions. Since the lessor is only a financing party, has played no part in the selection, manufacture, or supply of the goods, *id.* § 2A-103(1)(g)(i), and is prohibited from even possessing the goods before negotiation of the finance lease, *id.* § 2A-103(1)(g)(ii), the lessor is relieved of the necessity of extending *any* warranties to the lessee. *Id.* § 2A-211 official cmt. (1987). However, whatever warranties the supplier makes to the lessor in the supply contract also extend from the supplier to the lessee; this notwithstanding the lack of privity between lessee and supplier. See *infra* notes 68-84 and accompanying text. The drafters of Article 2A ensured that, before entering into the finance lease, the lessee would be given notice of all such warranties (or at least the means to obtain notice), *id.* § 2A-103(1)(g)(iii), that the supplier makes to the lessor. Section 2A-103(1)(g)(iii) serves this purpose. Only if the finance lease is a consumer lease (as defined in § 2A-103(1)(e)) must there be *actual* notice of warranties to the lessee (or the right to condition the finance lease on approval of, or viewing of, the supply contract). In the typical commercial (nonconsumer) setting, the lessee must only be given the identity of the supplier, and notification that it is entitled to a statement from the supplier of the "promises and warranties" made to the lessor. *Id.* § 2A-103(1)(g)(iii)(D).

These provisions—the hell or high water clause of section 2A-407 and the beneficiary aspect of section 2A-209, respectively—will be discussed in the following sections.

#### B. U.C.C. § 2A-407: Lessee's Obligations Under the Statutory Hell or High Water Clause

As discussed above, the lessor may not itself select, manufacture or supply the goods.<sup>34</sup> It may, however, negotiate the price to be paid to the supplier. Indeed, the statute provides a method by which this information—which could be important should the lessee later seek damages for breach of either the lease or the supply contract—may be kept out of the hands of the lessee.<sup>35</sup>

The interaction of supplier and lessee, prior to the actual negotiation of the terms of sale, typically resembles that of a seller and buyer (or, perhaps, lessor and lessee in a bilateral lease) to a greater extent than the interaction of the supplier and lessor. The lessee knows its own requirements and will negotiate directly with the supplier as to the specifications of the goods.<sup>36</sup> The lessor, while formally taking ownership of the goods, will actually only be transferring the funds necessary to their purchase; delivery will be directly from supplier to lessee, in a manner similar to that if the lessee were a buyer.

With the lessor's remote involvement with the leased goods and close focus on the financing aspects of the transaction, Article 2A provides the lessor with a high level of assurance that, in a finance lease, the stream of payments constituting the lessee's consideration will be uninterrupted. Section 2A-407(1) states that "[i]n the case of a finance lease that is not a consumer lease the lessee's promises under the lease contract become irrevocable and independent upon

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<sup>34</sup> See *supra* notes 26-28 and accompanying text.

<sup>35</sup> The lessee may also negotiate over the price paid to the supplier. For example, the lessee's negotiations with the supplier may culminate in a purchase order, which the lessee then assigns to the lessor, or, in a sale-leaseback arrangement, the lessee may purchase the goods from the supplier, sell them to the lessor, and then lease them back through the finance lease contract. In both cases, the lessee negotiates the price in the supply contract. *Id.* § 2A-103(g) official cmt. (1987). See *supra* note 11 and accompanying text. Obtaining warranty information can be achieved at the time of formation of the finance lease by conforming the transaction to either §§ 2A-103(1)(g)(iii)(C) or (D). These sections allow the lessee to obtain either a statement of promises and warranties running from supplier to lessor, or the identity of the supplier, and also grant the lessee the right to receive from the supplier a statement of the promises and warranties. This would appear to give the lessor greater freedom to bargain for the best terms obtainable from the supplier than might be the case were the lessee, when negotiating the lease, always privy to the price the lessor is paying the supplier.

<sup>36</sup> Even if the lessor does know the requirements of the lessee, it cannot participate at the selection stage. U.C.C. § 2A-103(1)(g)(i) (1991).

the lessee's acceptance of the goods."<sup>37</sup> In pre-Article 2A finance leases, a lease provision which created an irrevocable promise to pay rent was very common,<sup>38</sup> and often referred to as a "hell or high water clause."<sup>39</sup> Simply put, the lessee must pay rent "come hell or high water"; no excuse will be available to relieve the lessee of its obligation.<sup>40</sup> Once the lessee accepts the goods,<sup>41</sup> payment may not be interrupted without the lessor's consent,<sup>42</sup> even if the lessor's performance is deficient.<sup>43</sup>

The hell or high water clause is a critical part of the finance lease structure. This is evident from the fact that if a lease qualifies as a finance lease under section 2A-103(1)(g), then the hell or high water clause of section 2A-407 becomes a statutory term of the lease.<sup>44</sup> No separate drafting is required.<sup>45</sup>

### C. Avoidance by Lessee of the Hell or High Water Clause

The hell or high water clause is not, however, watertight. The official comment to section 2A-407 indicates that there are three ways in which a lessee might avoid a hell or high water clause after accepting the goods. First, "[t]he provisions of [section 2A-407] remain subject to the obligation of good faith (Sections 2A-103(4) and 1-203)."<sup>46</sup> A breach of this obligation, which is applicable to all conduct governed by the U.C.C.,<sup>47</sup> would presumably enable the lessee to avoid its obligation to pay under section 2A-407.<sup>48</sup>

<sup>37</sup> *Id.* § 2A-407(1).

<sup>38</sup> WHITE & SUMMERS, *supra* note 1, at 24-27.

<sup>39</sup> *Id.*

<sup>40</sup> The only exceptions are lessor's breach of good faith, lessee's revocation of acceptance under § 2A-517, and lessee's legal action against lessor for breach of warranty. See *infra* notes 46-56 and accompanying text.

<sup>41</sup> See U.C.C. § 2A-515 (1991) (acceptance of goods); *id.* § 2A-516 (effect of acceptance).

<sup>42</sup> *Id.* § 2A-407(2)(b).

<sup>43</sup> Courts have almost invariably upheld such obligations. See, e.g., *In re O.P.M. Leasing Serv., Inc. v. West Virginia*, 21 Bankr. S.D.N.Y. 993 (1982); *National Equipment Rental, Ltd. v. J & I Carting, Inc.*, 73 A.D.2d 666 (N.Y. App. Div. 1979); *Dixie Groceries, Inc. v. Albany Business Mach., Inc.*, 274 S.E.2d 81 (Ga. Ct. App. 1980); *Citicorp Indus. Credit Inc. v. Rountree*, 364 S.E.2d 65 (Ga. Ct. App. 1987).

<sup>44</sup> U.C.C. § 2A-407 official cmt. (1991) ("This section is self-executing; no special provision need be added to the contract."). Note, however, that a consumer lease has no statutory hell or high water clause. *Id.* § 2A-407(1). Whether the parties to a finance lease that is also a consumer lease may agree to an enforceable hell or high water clause "will continue to be determined by the facts of each case." *Id.* § 2A-407 official cmt.

<sup>45</sup> The parties, of course, are free to tailor a more, or less, restrictive clause, or even dispense with its obligations altogether by separate drafting.

<sup>46</sup> U.C.C. § 2A-407 official cmt. (1991).

<sup>47</sup> *Id.* § 1-203.

<sup>48</sup> Avoidance of hell or high water obligations in commercial settings is virtually unknown. For a rare (and old) example, see *U.S. Leasing Corp v. Franklin Plaza Apartments, Inc.*, 319 N.Y.S.2d 531 (C.C.N.Y. 1971) (summary judgment for plaintiff-lessor

Second, the official comment explicitly states that the lessee's obligations under section 2A-407 are also "subject to . . . the lessee's revocation of acceptance (Section 2A-517)."<sup>49</sup> This possibility requires further discussion. Revocation of acceptance under section 2A-517<sup>50</sup> occurs *after* acceptance of the goods—the event which triggers the effect of section 2A-407's hell or high water provisions. Section 2A-517 is carefully drafted to ensure that the lessee may revoke acceptance and be released from its obligation in very few circumstances. A finance lessee may only revoke acceptance where the nonconformity of the goods "substantially impairs its value to the lessee if the lessee has accepted [them] . . . without discovery of the nonconformity [and] if the lessee's acceptance was reasonably induced . . . by the lessor's assurances."<sup>51</sup> Thus, only if the lessor bears some degree of responsibility for the lessee's previous acceptance of inadequate goods, will the lessee be able to revoke acceptance, "turn back the clock," and avoid its obligations under section 2A-407.<sup>52</sup>

Finally, the official comment to section 2A-407 provides the lessee with a cause of action should the lessor breach warranty obli-

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denied, and trial ordered over issue of unconscionability of finance lessor's hell or high water obligation to pay rent on unusable Pitney-Bowes machine); *see also* Angelle v. Energy Builders Co., 496 So.2d 509 (La. App. 1986) (hell or high water clause avoided because goods not delivered by supplier, on grounds of denial of "peaceable possession").

<sup>49</sup> *Id.* Section 2A-407 is itself silent about the effect of revocation of acceptance on the "irrevocable" nature of the lessee's promises. *Id.* § 2A-407(1). *See* WHITE & SUMMERS, *supra* note 1, at 32-34. Section 2A-517(5) states that "[a] lessee who so revokes [acceptance] has the same rights and duties with regard to the goods involved as if the lessee had rejected them." *Id.* § 2A-517(5). It is only in the official comment to § 2A-407 that one learns that this can "undo" the hell or high water obligation. On such use of the official comments, *see generally* Donald J. Rapson, *Deficiencies and Ambiguities in Lessor's Remedies under Article 2A: Using Official Comments to Cure Problems in the Statute*, 39 ALA. L. REV. 875 (1988).

<sup>50</sup> The statutory analogue in Article 2 is § 2-608.

<sup>51</sup> U.C.C. § 2A-517(1)(b) (1991). *See* Michael I. Tsai, Comment, *A Unified Treatment of Finance Lessees' Revocation of Acceptance under the Uniform Commercial Code*, 137 U. PA. L. REV. 967, 983 (1989). Section 2A-517 provides for more liberal rights to revoke acceptance in the case of a finance lease that is a consumer lease. U.C.C. § 2A-517(2) (1991). In addition, the lease parties may independently agree to allow for revocation "because of other defaults of the lessor." *Id.* § 2A-517(3).

<sup>52</sup> The statute, in contrast, to the official comment, is less than forthcoming on this point. However, it is arguable that the last part of § 2A-517(5) establishes the ability of the lessee to avoid the hell or high water clause through revocation. Though § 2A-517(5)'s citation of "rights . . . with regard to the goods involved," *id.*, appears to refer to the right to dispose of the goods described in § 2A-512(1)(b), one might argue that, because rightful rejection of goods precludes triggering of the hell or high water obligation, the lessee gains through an effective *revocation* the "right" not to pay rent. Section 2A-509 governs rejection, which is allowed "if the goods or the tender or delivery fail in any respect to conform to the lease contract." *Id.* § 2A-509(1) (Section 2A-509(1) is modeled on § 2-601.). *Id.* § 2A-509 official cmt. Following rejection, the lessee's duties are spelled out in § 2A-512, which reads:

gations to the lessee established under sections 2A-210 and 2A-211(1).<sup>53</sup> Though section 2A-210 concerns express warranties of the lessor to the lessee, in the finance lease setting, because of the lessor's limited role in choosing the goods, such warranties are rarely made.<sup>54</sup> Similarly, though section 2A-211(1) requires the lessor to warrant against claims of third parties to the goods caused by "an act or omission of the lessor,"<sup>55</sup> the lessor's limited involvement with the goods themselves suggests that such situations seldom will arise.<sup>56</sup>

#### D. U.C.C. § 2A-209: Lessee as Beneficiary of Supply Contract

In building a unified structure, Article 2A balances the lessee's weak position under the hell or high water clause with section 2A-209's provision that the lessee shall be the beneficiary of the promises and warranties made to the lessor in the supply contract. Before Article 2A, courts frequently inferred the relationship be-

##### Lessee's Duties as to Rightfully Rejected Goods.

(1) Except as otherwise provided with respect to goods that threaten to decline in value speedily (Section 2A-511) and subject to any security interest of a lessee (Section 2A-508(5)):

(a) the lessee, after rejection of goods in the lessee's possession, shall hold them with reasonable care at the lessor's or the supplier's disposition for a reasonable time after the lessee's seasonable notification of rejection;

(b) if the lessor or the supplier gives no instructions within a reasonable time after notification of rejection, the lessee may store the rejected goods for the lessor's or the supplier's account or ship them to the lessor or the supplier or dispose of them for the lessor's or the supplier's account with reimbursement in the manner provided in Section 2A-511; but

(c) the lessee has no further obligations with regard to goods rightfully rejected.

(2) Action by the lessee pursuant to subsection (1) is not acceptance or conversion.

*Id.* § 2A-512.

Section 2A-512 charges the lessee who has rejected goods with the duty to hold them with reasonable care; § 2A-517(3) charges a lessee who revokes acceptance with the same duty.

<sup>53</sup> U.C.C. § 2A-407 official cmt. (1991). These warranties are (1) express warranties created by the lessor (§ 2A-210), and (2):

a warranty that for the lease term no person holds a claim to or interest in the goods that arose from an act or omission of the lessor, other than a claim by way of infringement or the like, which will interfere with the lessee's enjoyment of its leasehold interest.

*Id.* § 2A-211(1). Section 2A-211(1) thus "reinstates the warranty of quiet possession with respect to leases." *Id.* § 2A-211 official cmt. This was abandoned in Article 2.

<sup>54</sup> *But see infra* notes 110-14 and accompanying text.

<sup>55</sup> U.C.C. § 2A-211(1) (1991).

<sup>56</sup> Still, such situations can be imagined. For example, the lessor might want to sell or lease the goods to a party other than the lessee, or might fail to pay the supplier for the goods.

tween supplier and lessee from the overall pattern of activities and obligations established in the two contracts. Courts found it necessary to engage in such an inquiry because they faced a situation in which there was no privity of contract between the supplier and the lessee.<sup>57</sup> Given that the lessor's role is basically restricted to financing the purchase or lease of the goods from the supplier, the relationship between the lessee and supplier closely resembles that of buyer and seller in a sales contract. Article 2A puts this relationship between supplier and lessee on a statutory footing.

### E. Analogy of Supplier-Lessee Relationship to Sales Law

In recognizing this similarity,<sup>58</sup> the statute provides that, despite the absence of contractual privity between the supplier and the lessee, the lessee gains the "benefit" of whatever promises and warranties the supplier, in the supply contract, has made to the lessor.<sup>59</sup> The effect of this provision is very broad; section 2A-209 seeks to put the lessee, insofar as the promises and warranties of the supply contract are concerned, in the same position as the lessor (i.e., the

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<sup>57</sup> Prior to Article 2A, courts sometimes analogized leases to sales, and brought certain aspects of lease transactions under the control of principles drawn from Article 2. At least one commentator has considered the utility of characterizing a finance lease as essentially a sale between supplier and lessee, with the lessee and lessor entering into a separate contract to finance the purchase. See Amelia H. Boss, *Panacea or Nightmare? Leases in Article 2*, 64 B.U. L. REV. 39, 57-78 (1984).

Frequently, however, courts have granted the lessee buyer-like rights against the supplier through employment of third party beneficiary doctrine. Following the doctrine of *Restatement (Second) of Contracts*, the lessee would be an "intended" beneficiary of the supplier-lessor relationship (as opposed to being an "incidental" beneficiary). As such, the lessee would gain the right to bring an independent action against the supplier for enforcement of the promises and warranties under the supply contract. RESTATEMENT (SECOND) OF CONTRACTS § 302 (1981). Several pre-Article 2A cases have viewed the lessee in this way. See, e.g., *Earman Oil Co. v. Burroughs*, 625 F.2d 1291 (5th Cir. 1980); *Abco Metals Corp. v. J.W. Imports Co.*, 560 F. Supp. 125 (N.D. Ill. 1982); *In re O.P.M. Leasing Serv., Inc. v. West Virginia*, 21 Bankr. S.D.N.Y. 993 (1982); *Bay General Indus., Inc. v. Johnson*, 418 A.2d 1050 (D.C. 1980). But see *Professional Lens Plan, Inc. v. Polaris Leasing Corp.*, 675 P.2d 887 (Kan. 1984) (lack of privity between remote seller of component part and lessee precludes award of purely economic consequential damages).

One case recognizing third party beneficiary rights in the lessee distinguished the nature of the underlying transactions from the single bilateral contract model of the *Restatement*. See *Freeman v. Hubco Leasing, Inc.*, 324 S.E.2d 462, 467 (Ga. 1985):

[L]essee Freeman under automobile lease is "not the typical third party beneficiary; . . . [lessee] is not a stranger to the transaction at hand; [he] is a lessee-purchaser of . . . a manufacturer's warranty transmitted by Hub Motor [lessor], a DeLorean [supplier] dealer, which provides that DeLorean dealers will repair manufacturer's defects without charge. Freeman paid a consideration for this warranty and hence . . . is more than merely a third party beneficiary of the DeLorean-Hub Motor dealer-ship contract.

<sup>58</sup> See, e.g., U.C.C. § 2A-209 official cmt. (1991).

<sup>59</sup> *Id.* § 2A-209. For the text of section 2A-209, see *supra* note 16.

lessee gains the benefit of *any* warranties the supply contract gives the finance lessor as a buyer or lessee itself, "to the extent of the lessee's leasehold interest").<sup>60</sup> Though the lessee's obligation to pay rent continues,<sup>61</sup> the lessee gains a right of action in return, independent of any claims the lessor might assert against the supplier, should the supplier breach any promises extended to the finance lessor. Section 2A-209 works in concert with the definition of a finance lease in section 2A-103(1)(g), which guarantees the finance lessee the knowledge, or the ability to obtain knowledge,<sup>62</sup> of those promises and warranties.

In addition, section 2A-209 ensures that, should the supplier and lessor modify or rescind the supply contract, the lessee's position as beneficiary of the supply contract will not be eroded.<sup>63</sup> Section 2A-209(3) allows "modification or rescission" of the supply contract, made *before* the supplier has notice that the lessee is part of a finance lease, to be "effective against the lessee."<sup>64</sup> In such cases, however, section 2A-209(3) requires that the lessor step in and extend to the lessee the promises and warranties "as they existed and were available to the lessee before modification or rescission."<sup>65</sup> This is potentially strong medicine for a lessor. By discouraging modification of the supply contract, it provides an incentive for the lessor to ensure that the supplier is locked into its obligations to the lessee-beneficiary.<sup>66</sup> Note that a lessor who presumptively assumes such a promise or warranty would still have a right to payment

<sup>60</sup> U.C.C. § 2A-209(1) (1991).

<sup>61</sup> Except in limited circumstances, i.e., where there is a rightful revocation of acceptance under § 2A-517, and if the lessor breaches, as prescribed by §§ 2A-210 or 2A-211(1). See *supra* notes 50-56 and accompanying text.

<sup>62</sup> U.C.C. § 2A-103(1)(g)(iii)(D) (1991). See *supra* note 12 and accompanying text.

<sup>63</sup> *Id.* § 2A-209(3). For the text of § 2A-209(3) see *supra* note 16.

<sup>64</sup> *Id.* § 2A-209(3).

<sup>65</sup> *Id.* Section 2A-209(3) literally requires that the lessor in such a situation assume the *entire* extent of the promise or warranty that was modified—that is, the promise or warranty as it existed prior to the modification—and not just the extent of the modification. For example, assume that a supply contract originally specified that the supplier was to provide repairs for five years, and that the supplier and lessor subsequently agreed to change this to four years. If this modification was made prior to the supplier receiving notice of the lessee entering into a related finance lease, the language of § 2A-209(3) would have the lessor take on responsibility for all *five* years of repairs. Arguably, this is the plain meaning of the phrase:

the lessor is deemed to have assumed, in addition to the obligations of the lessor to the lessee under the lease contract, promises of the supplier to the lessor and warranties that were so modified or rescinded as they existed and were available to the lessee before modification or rescission.

*Id.* (emphasis added). This interpretation seems to go too far, in that after the modification the supplier still agrees to four years of repairs. The statute should be interpreted to require the lessor to guarantee only the year of repairs that the modification of the supply contract has eliminated, not to apply a penalty against the lessor.

<sup>66</sup> But see *infra* notes 106-14 and accompanying text.

under the hell or high water provision of section 2A-407. However, though the lessee's cause of action against the supplier regarding the modification or rescission would be lost, the lessee could still proceed directly against the lessor for any breach of the promises and warranties as they were originally extended to the lessee.<sup>67</sup>

## II

### THEORIES OF THE SUPPLIER AND LESSEE RELATIONSHIP

Section 2A-209 makes the lessee the beneficiary of the promises and warranties made by the supplier to the lessor in the lease contract, despite the absence of privity of contract between supplier and lessee. The official comment to section 2A-209 explicitly addresses the means by which the absence of privity between supplier and lessee is overcome. One can infer from the comment that there are two competing theories for overcoming the lack of privity: one grounded in the rights of a third party beneficiary and the other in the rights of an assignee of a contract.

As with the operation of the hell or high water provision of section 2A-407, Article 2A makes this "beneficiary" aspect of the supplier's promises and warranties mandatory: the official comment to section 2A-209 states that "[a]s a matter of policy, this provision may not be excluded, modified, or limited."<sup>68</sup> However, section 2A-209 does not adopt the assignment or third party beneficiary theory completely, perhaps because neither theory conforms exactly to the supplier-lessee relationship established by Article 2A. Comparison of each theory with the provisions of section 2A-209 illustrates the effect each has on finance lease transactions.

Section 2A-209 focuses on two distinct topics, each concerned with the relationship of supplier to lessee. Sections 2A-209(1)-(2) address the status of the lessee with respect to the supply contract, along with the defenses available to the supplier against the lessee. Section 2A-209(3) concerns the effect, as against the lessee, of modification and rescission of the supply contract by the supplier and lessor. According to the official comment, section 2A-209 is "modeled on Section 9-318, the *Restatement (Second) of Contracts* §§ 302-315 (1981), and leasing practices."<sup>69</sup> Section 9-318 of the

<sup>67</sup> U.C.C. § 2A-209 official cmt. (1991) ("Enforcement of this benefit is by action.").

<sup>68</sup> *Id.* Section 2A-209 thus codifies the practice, common in the leasing business, of putting the lessee in the shoes of the lessor with respect to the supplier's promises and warranties. Note that in addition to the supplier's promises and warranties, § 2A-209 also makes the lessee the beneficiary of any express or implied warranties "including those of any third party provided in connection with or as part of the supply contract." *Id.* § 2A-209(1).

<sup>69</sup> *Id.* § 2A-209 official cmt. (emphasis added). In citing U.C.C. § 9-318 and §§ 302-315 of the *Restatement (Second)*, the official comment explicitly recognizes the



U.C.C. points to the contract assignment theory as a means of overcoming the lack of privity; sections 302-315 of the *Restatement (Second) of Contracts* point to third party beneficiary theory. Each of this section's two main topics—(1) the lessee's status under the supply contract and the supplier's defenses against the lessee, and (2) the effectiveness of modifications of the supply contract—will be considered in light of these two theories. Through this examination, the primary reliance of section 2A-209 on third party beneficiary theory will be demonstrated.

## A. Lessee's Status Under the Supply Contract and Supplier's Defenses Against the Lessee

### 1. *Assignment Theory*

Section 9-318 of the U.C.C. concerns the respective rights of account debtors and assignees, before and after assignment of a contract between an account debtor and an assignor. The section establishes rules governing the rights of an assignee under an assigned contract.<sup>70</sup> Section 9-318(2) deals with the effectiveness of modifications of the assigned contract after notification of assignment to the account debtor.<sup>71</sup>

A comparison of sections 9-318 and 2A-209 indicates the extent to which the lessee has been given "assignee-like" rights against the supplier. Such rights are subject, according to section 9-318(1)(a), to "all the terms of the contract between the account debtor and assignor and any defense or claim arising therefrom."<sup>72</sup> Section 2A-

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sources of Article 2A's lessee beneficiary status in assignment and third party beneficiary theories.

<sup>70</sup> Section 9-318(1) reads:

(1) Unless an account debtor has made an enforceable agreement not to assert defenses or claims arising out of a sale as provided in Section 9-206 the rights of an assignee are subject to

(a) all the terms of the contract between the account debtor and assignor and any defense or claim arising therefrom; and

(b) any other defense or claim of the account debtor against the assignor which accrues before the account debtor receives notification of the assignment.

*Id.* § 9-318(1).

<sup>71</sup> Section 9-318(2) reads:

(2) So far as the right to payment or a part thereof under an assigned contract has not been fully earned by performance, and notwithstanding notification of the assignment, any modification of or substitution for the contract made in good faith and in accordance with reasonable commercial standards is effective against an assignee unless the account debtor has otherwise agreed but the assignee acquires corresponding rights under the modified or substituted contract. The assignment may provide that such modification or substitution is a breach by the assignor.

*Id.* § 9-318(2).

<sup>72</sup> *Id.* § 9-318(1)(a).

209(1) closely tracks this language and states that the rights of the lessee are "subject to the terms of the warranty [*sic*] and of the supply contract and all defenses or claims arising therefrom."<sup>73</sup> Both sections 9-318(1) and 2A-209(1), therefore, would permit the obligor (account debtor or supplier) to recoup losses suffered in connection with the obligee (assignor or lessor), by a claim or defense against the assignee or lessee. For example, suppose that a finance lessee, as beneficiary of a supply contract, was entitled to repairs on equipment leased under a related lease contract, but that the lessor had fallen behind in payments to the supplier. The supplier, asserting against the lessee its losses arising from the lessor's conduct under the supply contract, could recoup those losses through the denial of repairs (or a reduction in their extent) to the lessee.

Sections 9-318(1) and 2A-209(1) differ, however, over claims and defenses arising *outside* of the transaction. For example, in a finance lease setting, the above claim could arise if the supplier and lessor had engaged in prior dealings and the lessor failed to perform fully. The supplier might seek to avoid some warranty obligations to the lessee as a means of satisfying its claim against the lessor.

Here section 2A-209 gives the lessee greater protection than an assignee receives under Article 9. Section 9-318(1)(b) only allows claims and defenses of the account debtor against the assignor, independent of the contract, to be asserted against the lessee in some circumstances.<sup>74</sup> In contrast, a finance lessee is protected against such claims. If the supplier were able to assert a set-off (arising out of an independent transaction between supplier and lessor) against the lessee, the supplier would, in effect, be able to modify the lessee's rights under the supply contract. This would clearly violate section 2A-209(2), which provides that "[t]he extension of the benefit of a supplier's promises and of warranties to the lessee (Section 2A-209(1)) does not . . . modify the rights and obligations of the parties to the supply contract, whether arising therefrom *or otherwise*."<sup>75</sup> By protecting the lessee against a modification of its rights under the supply contract, section 2A-209 indirectly prevents the supplier from holding the lessee responsible for the lessor's independent obligations to the supplier.

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<sup>73</sup> *Id.* § 2A-209(1).

<sup>74</sup> The account debtor can assert claims that are independent of the contract only where the claims arise before the account creditor receives notice of the assignment. *Id.* § 9-318(1)(b).

<sup>75</sup> U.C.C. § 2A-209(2) (1991) (emphasis added).

## 2. *Third-Party Beneficiary Theory*

Sections 302 to 315 of the *Restatement (Second) of Contracts* provide a different model for overcoming the absence of privity between supplier and lessee—that of the third party beneficiary theory. Section 309 addresses the defenses that are available against the beneficiary. Though the “fit” of this section of the *Restatement*<sup>76</sup> to section 2A-209(1) is not exact, it is much closer than that of section 9-318.

Section 309(2) of the *Restatement* lists four defenses available to an obligor to avoid an obligation to a beneficiary: impracticability, public policy, nonoccurrence of a condition, or present or prospective failure of performance.<sup>77</sup> Though section 2A-209(1) does not employ identical language, it is difficult to imagine that such defenses could not be asserted against the beneficiary in a finance lease setting. Both impracticability and public policy presumably are available as defenses, under general principles of contract law, arising from the supply contract. Also, the defenses of nonoccurrence of a condition and present or prospective failure of performance would arise directly from the lessor’s conduct under the supply contract. Hence, as discussed in the previous section, the supplier would be able to recoup losses caused by the lessor’s conduct, through a reduction in what was due the lessee as beneficiary of the supply contract.

In contrast to U.C.C. § 9-318, section 309(3) of the *Restatement* denies the promisor (supplier) a set-off against the beneficiary (lessee) arising from an agreement separate from that under which the beneficiary gains his rights. Thus section 2A-209 conforms quite closely to the *Restatement*’s rules concerning defenses against a beneficiary. Especially regarding the matter of set-offs asserted

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<sup>76</sup> Section 309 of the *Restatement* reads in full:

Defenses Against the Beneficiary

(1) A promise creates no duty to a beneficiary unless a contract is formed between the promisor and the promisee; and if a contract is voidable or unenforceable at the time of its formation the right of any beneficiary is subject to the infirmity.

(2) If a contract ceases to be binding in whole or in part because of impracticability, public policy, non-occurrence of a condition, or present or prospective failure of performance, the right of any beneficiary is to that extent discharged or modified.

(3) Except as stated in Subsections (1) and (2) and in § 311 or as provided by the contract, the right of any beneficiary against the promisor is not subject to the promisor’s claims or defenses against the promisee or to the promisee’s claims or defenses against the beneficiary.

(4) A beneficiary’s right against the promisor is subject to any claim or defense arising from his own conduct or agreement.

RESTATEMENT (SECOND) OF CONTRACTS § 309 (1981).

<sup>77</sup> *Id.*

against the lessee by the supplier, the drafters appear to have adopted the position that a lessee, with no knowledge of the details of the lessor's performance of independent obligations to the supplier, should not be subject to claims of the supplier arising out of such conduct.

## B. Effectiveness of Modifications of the Supply Contract

### 1. *Assignment Theory*

Section 2A-209(1) concerns the lessee's rights as beneficiary of the supply contract and the supplier's defenses against the lessee. In contrast, section 2A-209(3) addresses the effectiveness of modifications of the supply contract by the supplier and lessor. Again, Article 2A provides greater protection to a lessee than an assignee receives under section 9-318. Specifically, section 9-318(2) allows good faith contract modifications or substitutions to be effective against the assignee even *after* an account debtor has notice of an assignment.<sup>78</sup> The official comment to section 9-318 points to the commercial necessity for allowing this, but acknowledges that this "may do some violence to accepted doctrines of contract law."<sup>79</sup> Section 2A-209(3), in contrast, "locks in" the lessee's benefits under the supply contract *before* the supplier has notice of the lessee's entry into a related finance lease.<sup>80</sup> The supplier's obligations to the lessee remain unaffected by modification or rescission of the supply contract, regardless of when the supplier receives notice. Thus, section 2A-209(3), considered with the analysis of defenses against the lessee-assignee, gives clear evidence that the drafters only partially drew analogies from the assignment provisions of Article 9 when designating the lessee's rights in Article 2A. The lessee, after all, is not an assignee of the lessor's rights; specifically, the lessor's rights against the supplier are not modified by the operation of section 2A-209(1).<sup>81</sup>

### 2. *Third Party Beneficiary Theory*

In general, section 311 of the *Restatement*<sup>82</sup> conforms closely with section 2A-209(3)'s provisions concerning the effect of contract

<sup>78</sup> See *supra* note 71.

<sup>79</sup> U.C.C. § 9-318 official cmt. (1991).

<sup>80</sup> See *supra* notes 62-65 and accompanying text.

<sup>81</sup> For the text of § 2A-209(2), see *supra* note 16.

<sup>82</sup> Section 311 of the *Restatement* reads:

#### Variation of a Duty to a Beneficiary

(1) Discharge or modification of a duty to an intended beneficiary by conduct of the promisee or by a subsequent agreement between promisor and promisee is ineffective if a term of the promise creating the duty so provides.

modifications on the beneficiary; however, there are some significant differences.

The *Restatement* differs from Article 2A primarily in sections 311(3) and (4). The *Restatement* would terminate the power to discharge or modify the duty to the beneficiary upon any of three events: the beneficiary's material reliance, its bringing of suit on the promise, or its requested assent to the promise.<sup>83</sup> This differs significantly from the termination event in section 2A-209(3), which is receipt of notice of the finance lease by the supplier. Under the *Restatement*, entry into the finance lease—a material change in position by the lessee, in reliance on the extension to the lessee of the supply contract's promises and warranties—is itself sufficient to trigger termination of the power to discharge or rescind the beneficiary's rights.

Section 311(4) of the *Restatement* also allows a beneficiary to claim any consideration received by the promisee, after the promisor attempts to discharge or modify the promisor's duty to the beneficiary. As a result, the promisor's duty would be discharged in the amount received by the beneficiary.

Section 2A-209(3), however, strikes a different balance between the parties. In the case of an *effective* modification or rescission of the supply contract,<sup>84</sup> the lessor assumes the original warranties extended to lessee. Conversely, in the case of an ineffective (i.e., attempted) modification or rescission, the beneficiary's right to the consideration received by the promisee, recognized by section 311(4) of the *Restatement*, is absent.

In sum, with respect to the lessee's rights under the supply contract, section 2A-209 relies to a greater extent on third party beneficiary theory than on assignment theory. Article 2A gives the lessee greater protection than an assignee receives under section 9-318, especially in vulnerable areas such as set-off and contract modification. The only differences between section 2A-209 and the *Restate-*

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(2) In the absence of such a term, the promisor and promisee retain power to discharge or modify the duty by subsequent agreement.

(3) Such a power terminates when the beneficiary, before he receives notification of the discharge or modification, materially changes his position in justifiable reliance on the promise or brings suit on it or manifests assent to it at the request of the promisor or promisee.

(4) If the promisee receives consideration for an attempted discharge or modification of the promisor's duty which is ineffective against the beneficiary, the beneficiary can assert a right to the consideration so received. The promisor's duty is discharged to the extent of the amount received by the beneficiary.

RESTATEMENT (SECOND) OF CONTRACTS § 311 (1981).

<sup>83</sup> *Id.* § 311(3).

<sup>84</sup> That is, one before the supplier receives notice that the lessee has entered into a finance lease. *Id.* § 2A-209(3).

ment appear primarily in the area of contract modification, and here there is no clearly "higher" level of protection. The *Restatement would* insulate a beneficiary against modifications, establishing its position as a beneficiary earlier than under Article 2A. However, this is balanced by the provision that, under section 2A-209(3), an effective modification or rescission triggers the lessor's assumption of the promises and warranties as they previously existed. Thus, in the window between the time of material reliance (which, for purposes of argument, may be viewed as the time when the lessee enters the finance lease) and the time of the promisor's (supplier's) receipt of notice that the lessee entered into the lease, the lessee's rights may not be modified by the supplier and the lessor: even before this time, section 2A-209(3) shifted to the lessor any obligations to the lessee which the supplier could succeed in shaking off. However, as I will argue below, the lessee might not be indifferent to the identity of the party charged with the promises and warranties; interchangeability of the supplier and lessor for these purposes might be at odds with both the lessee's expectations and the realities of the commercial environment surrounding the lease.

### C. Conformity of Third Party Beneficiary Theory to the Finance Lease

The preceding discussion demonstrates that section 2A-209 closely implements traditional third party beneficiary theory as set out in the *Restatement (Second) of Contracts*. Clearly, this theory, as opposed to the assignment principles of section 9-318, was used as a model. Indeed, the position of the lessee as a beneficiary initially appears strong: the benefit of *all* of the supplier's promises and warranties to the lessor under the supply contract extends to the lessee by operation of law—that is, the parties to the supply contract cannot choose which of the supplier's obligations to the lessor will extend to the lessee—all of them must.<sup>85</sup>

However, in specifying that the "benefit" of the supplier's promises to the lessor extends to the lessee, section 2A-209(1) fails to give the lessee *rights*, with respect to the supplier, that are identical with those held by the lessor. The official comment to section 2A-209(1) points out that "[e]nforcement of this benefit is by action";<sup>86</sup> thus, a lessee is restricted to suits on the terms of the supply contract. A lessee, as a result, will have fewer alternative methods to

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<sup>85</sup> Thus, the official comment to § 2A-209 makes clear that "selective discrimination against the beneficiaries [lessees] designated under this section is precluded, *i.e.*, exclusion of the supplier's liability to the lessee with respect to warranties made to the lessor." U.C.C. § 2A-209 official cmt. (1991).

<sup>86</sup> *Id.*

obtain the "benefit" of the supply contract than the lessor. This can have important ramifications in at least three areas. First, the restriction to enforcement "by action" bears closely on the scope of the lessee's right to reject, or to revoke acceptance of the leased goods.<sup>87</sup> Second, the preclusion of "selective discrimination against the lessee,"<sup>88</sup> intended to safeguard the lessee's benefit under the supply contract, may lead to unfortunate limitations on the lessee's right to damages after a breach by the supplier. This could occur when a lessee, failing to recognize the statutory equivalence of benefit to lessor and lessee, fails to ensure that the benefits given the lessor under the supply contract include those that the lessee, as beneficiary, wants for itself.<sup>89</sup> Finally, difficulties remain in section 2A-209(3) whereby the lessor is required, after modification of the supply contract, to assume the promises and warranties to the lessee as they stood before modification. Because the lessor might be reluctant, or even unable, to duplicate the supplier's level of expertise or service, the lessee may be denied the benefit of its bargain. However, the lessee might have a remedy in such a situation, through a suit against the lessor for breach of an *express* warranty under section 2A-210(1)(a). As will be discussed in Part III, the promises or warranties assumed by the lessor after modification become express warranties through operation of law. In each of these problematic areas, the parties would be well-advised to contract around the default provisions of Article 2A, in order to ensure that their expectations are not later defeated.

### III

#### THREE HYPOTHETICAL CASES

##### A. Scope of Lessee's Rights: Rejection

The interaction of section 2A-209 with the lessor's rights under the hell or high water clause is an area of considerable uncertainty in Article 2A. The statutory hell or high water clause of section 2A-407 makes the lessee's promises under the lease "irrevocable and independent upon the lessee's acceptance of the goods." The hell

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<sup>87</sup> See *infra* notes 90-98 and accompanying text.

<sup>88</sup> See *supra* note 85.

<sup>89</sup> See *infra* notes 99-105 and accompanying text. The lessee's and lessor's interests, as opposed to their "benefit" under the supply contract, will usually be very different. Consider, for example, the limited role played by the lessor in a finance lease. Serving primarily as a source of funds, the lessor has little interest in what the lessee does with the goods, as long as it (the lessor) gets paid, and the lessee preserves the value of the lessor's residual interest. The lessee, on the other hand, has a strong interest in knowing that the "promises and warranties" of the supplier in the supply contract extend to it. This aspect of the supply contract may have been negotiated by the lessee, and § 2A-209(3) takes steps to prevent the lessee's expectations from being upset.

or high water clause creates a strong obligation for the lessee, because limited circumstances exist under which this obligation can be avoided.<sup>90</sup> Aside from breaches of the general obligation of good faith,<sup>91</sup> the warranties against infringement of quiet enjoyment, or an express provision of the lease agreement,<sup>92</sup> revocation of acceptance<sup>93</sup> appears to be the only means by which the hell of high water clause can be "undone." Revocation, however, is only available under the most limited circumstances. This follows from the restricted scope of the warranties made by the lessor under the finance lease: since the lessor has few warranty obligations, the lessee properly has only limited defenses against the obligation to pay rent.

Alternatively, section 2A-407 only comes into play upon the lessee's acceptance of the goods. The lessee may only rightfully reject if the "goods or the tender or the delivery fail in any respect to conform to the lease contract."<sup>94</sup> The lessor, therefore, has no incentive to incorporate into the lease contract all of the detailed specifications commonly found in a supply contract, because negotiation over such matters relating to selection of the leased goods is outside the scope of a finance lessor's permissible conduct.<sup>95</sup> In addition, the lessor is unlikely to risk allowing such specifications, because if they are incorporated into the lease, they could be interpreted as express warranties<sup>96</sup> to the lessee. As a result, though the goods might not conform to the supply contract, they may conform with the general language of the lease contract, and the lessee may not be able to revoke effectively.

Consider, for example, a finance lease of equipment in which the equipment specifications are the subject of detailed negotiations between the lessee and the supplier. The specifications, however, are incorporated into the supply contract, not into the lessor's finance lease form. Suppose further that the equipment fails in some important respect to conform to the supply contract, but conforms to the limited description in the lease, and that the lessee informs the lessor of the nonconformity. A reading of section 2A-509 indicates that under Article 2A, the lessee cannot reject on the basis of such nonconformity—it runs to the supply contract, not the lease.<sup>97</sup>

<sup>90</sup> See *supra* notes 46-56 and accompanying text.

<sup>91</sup> U.C.C. § 1-203 (1991) ("Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement.").

<sup>92</sup> *Id.* § 2A-407 official cmt.

<sup>93</sup> See *id.* § 2A-407 official cmt. See also *id.* § 2A-517 and official cmt.

<sup>94</sup> *Id.* § 2A-509 (emphasis added).

<sup>95</sup> *Id.* § 2A-103(1)(g)(i).

<sup>96</sup> See, e.g., Boss, *supra* note 57, at 68-70.

<sup>97</sup> Section 2A-509(1) reads:

(1) Subject to the provisions of Section 2A-510 on default in installment lease contracts, if the goods or the tender or delivery fail in any respect to



As a result, under Article 2A's acceptance provisions, the lessee *must* accept the goods, the statutory hell or high water clause becomes effective, and the lessee must pay all the rentals.

The lessor, however, could reject the goods for the nonconformity with the supply contract. Such rejection by the lessor, if it were a purchaser, would be effected via section 2-601. However, if the lessor were a lessee with respect to the supplier, it would have a right of rejection through section 2A-509. In addition, the lessee can bring an action against the supplier under section 2A-209(1) for the "benefit" due as a beneficiary of the supply contract. Does the lessee's "benefit" include a right to reject similar to the buyer's under section 2-601, in cases where the *lessor* is a buyer under the supply contract? (Or, in the alternative case under section 2A-509, where the lessor itself is a *lessee* under the supply contract?)

The text of section 2A-209 leaves the precise contours of the term "benefit" undefined. However, the official comment to section 2A-209 appears to suggest that the lessee has such a right; it states that "an exclusion . . . or limitation of any term of the supply contract, . . . including any with respect to rights and remedies, . . . effective against the lessor as buyer under the supply contract, is also effective against the lessee as the beneficiary designated under this provision."<sup>98</sup> Provided that the contract does not expressly deny the lessor the right to reject, the implication of the comment is that the lessee, as beneficiary, would have the same right to reject as would the lessor. (Of course, the lessee's right to reject only arises because of the les-

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conform to the lease contract, the lessee may reject or accept the goods or accept any commercial unit or units and reject the rest of the goods.

*Id.* § 2A-509(1) (emphasis added).

This is reinforced by section 2A-515, which reads:

Acceptance of Goods.

(1) Acceptance of goods occurs after the lessee has had a reasonable opportunity to inspect the goods and

(a) the lessee signifies or acts with respect to the goods in a manner that signifies to the lessor or the supplier that the goods are conforming or that the lessee will take or retain them in spite of their nonconformity; or

(b) the lessee fails to make an effective rejection of the goods (Section 2A-509(2)).

(2) Acceptance of a part of any commercial unit is acceptance of that entire unit.

*Id.* § 2A-515.

The critical term in § 2A-515 is "conforming." This is defined in § 2A-103(d): " 'Conforming' goods or performance under a lease contract means goods or performance that are in accordance with the obligations under the lease contract." *Id.* Therefore, the standard for a finance lessee upon rejection, is whether the goods conform to the terms of the lease contract, not the supply contract.

<sup>98</sup> *Id.* § 2A-209 official cmt. (emphasis added).

sor's right to reject, and the lessee cannot use section 2A-509 to reject the lease contract itself.)

This conclusion, however, is by no means certain. The lessee who desires a right to *reject* for nonconformity with the supply contract, in addition to the right of action against the supplier provided by operation of section 2A-209(1), would be well-advised to contract around the ambiguity in section 2A-209(1), and negotiate for rejection rights in the lease contract itself. The lessee should remember, however, that rejection precludes operation of the hell or high water clause of section 2A-407, and the price of obtaining such a right will reflect the lessor's assessment of the risk that the profit anticipated from an uninterrupted stream of rent payments may not be realized.

### B. Scope of Remedies: Consequential Damages

The ambiguity relating to the right of a lessee to reject against the supplier concerns the extent to which rights, accrued to the lessor through operation of Article 2 or 2A, also accrued to the lessee under the "benefit" language of section 2A-209(1). Because Article 2A does not clarify whether the "benefit" under section 2A-209(1) implies the right of a lessee to invoke the lessor's right of rejection, it was suggested that a lessee, in order to ensure this right, should bargain for it as part of the lease contract.

The lessee should be aware of a similar potential problem with respect to damages for breaches of the supply contract. Consider, for example, a situation in which the lessor and lessee have entered into a valid finance lease for a large piece of equipment critical to the lessee's manufacturing operations. The lessee has an ongoing production schedule, and needs to put the leased equipment into operation immediately to ensure its ability to continue to fill orders. The lessor contracts with the supplier for the equipment; the lessee is to take delivery at its factory on a date specified in the supply contract, with payment by the lessor to the supplier upon the lessee's acceptance of the equipment. The equipment, whose specifications were the subject of detailed negotiation between the lessee and the supplier, is delivered late by the supplier. The lessee, urgently needing the equipment for his manufacturing operations, accepts the equipment, which otherwise is as ordered and conforms to the lease. The late delivery causes the lessee to incur large lost profits.

Note that, in contrast to the lessee, the lessor has little loss due to the late delivery. The terms of the supply contract obligate the lessor to pay *only* when the equipment is accepted. Since the lessor

has not yet paid the supplier, the lessor is basically unharmed by the late delivery.

Now suppose that the supply contract between the supplier and the lessor contains a term excluding the payment of any consequential damages, including economic losses, incurred by virtue of the supplier's breach. The lessor, whose interest in the overall finance lease arrangement is primarily concerned with the profits gained from rental payments, and who will part with funds only *after* the hell or high water clause of section 2A-407 is triggered by the lessee's acceptance, has little incentive to object to the supply contract's clause excluding consequential damages. (Absence of such a clause would raise the price of the supply contract without corresponding benefit to the lessor.)

In contrast, a lessee who through the operation of section 2A-209(1) becomes a beneficiary of such a supply contract would be unable to assert a claim for consequential damages. Because of the clause excluding consequential damages, it is unnecessary to inquire whether the scope of "[t]he benefit of a supplier's promises to the lessor under the supply contract"<sup>99</sup> includes consequential damages. With consequential damages unavailable to the lessor, it follows that they are also unavailable to the lessee. This result flows directly from the official comment, which makes clear that "[i]f the supply contract excludes or modifies warranties, limits remedies or liquidates damages with respect to the lessor, such provisions are enforceable against the lessee as beneficiary."<sup>100</sup>

Suppose that no clause existed in the supply contract excluding consequential damages. Thus, rather than being a question of whether the supply contract "excludes or modifies warranties, limits remedies, or liquidates damages with respect to the lessor,"<sup>101</sup> the focus would return to "[t]he benefit of a supplier's promises to the lessor under the supply contract."<sup>102</sup> The lessee could argue that the supplier failed to deliver the equipment by a certain date as promised in the supply contract, and is liable to the lessee for any benefit that the lessee would have gained by timely delivery. Presumably, the supplier should have known of the lessee's needs because of the negotiated specifications on the equipment. Thus, given that the economic damages were foreseeable to the supplier,

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<sup>99</sup> *Id.* § 2A-209(1).

<sup>100</sup> *Id.* § 2A-209 official cmt. In an ordinary bilateral lease, disclaimers of consequential damages are routinely upheld. *See, e.g.,* *Cargile v. Della Coal Serv.*, 786 F.2d 1163 (6th Cir. 1986) (under Tennessee law U.C.C. not applicable to leases; consequential damages disclaimer effective against lessee).

<sup>101</sup> *Id.*

<sup>102</sup> *Id.* § 2A-209(1).

the lessee should not be barred from claiming consequential damages.

The result is that the supplier does not have much of a basis under section 2A-209 to bolster the argument against consequential damages. Perhaps the supplier's best argument would be that, because the supply contract runs between supplier and lessor, the supplier intended its liability for breach to be limited to the amount that the breach harmed lessor, and *not* to the amount the breach harmed lessee. Arguably, the language of the official comment, precluding selective discrimination against the lessee,<sup>103</sup> supports a policy that the damages due a lessee would be of the same magnitude as those due a lessor. If, for example, the supply contract liquidated damages, the amount recoverable by either the lessor as a party to the supply contract, or by the lessee as a beneficiary through section 2A-209(1), would presumably be the same.<sup>104</sup> The supplier might then contend that such parity should exist, whether or not explicit limitations were present: arguably it makes no more sense to adopt a position of parity between lessor and lessee when explicit limitations or stipulations of damages exist than when they do not.

On the other side, however, the lessee could point to its "buyer-like" position in the set of transactions: the detailed negotiations entered into between lessee and supplier would have put the supplier on notice as to the nature of the lessee's business, and thus made the consequential damages foreseeable. Moreover, the lessee could argue that the "benefit" of timely delivery *to the lessee* differs from that to the lessor. It is the value of such timely delivery to the lessee, not merely the monetary value of timely delivery to the lessor, that a supplier should consider in setting a price with the lessor, and, which, in turn, would have been reflected in the rental terms of the lease.

Provided the supplier is made aware of the lessee's expectations during negotiation of the equipment specifications, the lessee should prevail on a claim for consequential damages. The lessee, however, would be advised not to leave this matter to chance. Rather than relying on interpretation of the "benefit" language in section 2A-209(1), the lessee should seek to ensure that its potential consequential damages are not cut off. First, the supply contract, under which the lessee is made a beneficiary through the operation of section 2A-209(1), could explicitly provide for protection against consequential damages; this would protect the lessor as well. Alter-

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<sup>103</sup> See *supra* note 85 and accompanying text.

<sup>104</sup> This assumes the liquidated damages clause in the supply contract was not void as a penalty or as unreasonable. See U.C.C. § 2-718(1) (1991) (if supply contract was sale); *id.* § 2A-504(1) (if supply contract was lease).

natively, the lessee could make a separate agreement with the supplier to provide for consequential damages in case of the supplier's breach of the supply contract. The possibility for such an agreement is raised in section 2A-209(4),<sup>105</sup> which states that the operation of section 2A-209(1), making the lessee a beneficiary of the supply contract, would have no effect on the lessee's rights under an independent agreement.

### C. Effect of Supply Contract Modification

Finally, there is the effect of the modification of the supply contract, and the role played by section 2A-209(3) in ensuring that the lessee's rights are not cut off. Recall that section 2A-209(3) denies the effect of "modification or rescission" of the supply contract against the lessee on two occasions. If the supplier has notice that the lessee has entered into a "related" lease contract, the modification or rescission is ineffective against the lessee. However, if the supplier has not yet received such notice, the second sentence of section 2A-209(3) allows the modification or rescission to become "effective." Though section 2A-209(3) allows the lessee's position as beneficiary of the supply contract<sup>106</sup> to be altered by modification or rescission of the supply contract between the supplier and lessor, it requires that the *lessor* extend to the lessee the promises or warranties of the supply contract "that were so modified or rescinded as they existed and were available to the lessee before modification or rescission."<sup>107</sup>

This last sentence protects the lessee's legitimate expectations of its rights as a beneficiary under the supply contract. However, in a finance lease, the lessee is the party responsible for selecting the goods, and the task of negotiating warranties falls on the lessee, not the lessor. The nature of the protection embodied in section 2A-209(3), however, opens the door to a serious defeat of the lessee's expectations.

Consider the following sequence of events. The lessee again negotiates over the specification and selection of a large piece of equipment critical to its manufacturing. The supplier now approaches a finance lessor—perhaps one with which it has had prior dealings—to arrange financing. They enter into a supply contract, one incorporating the specifications and warranties previously negotiated by the supplier and lessee-to-be.

Now recall that in order for a lease to qualify as a statutory finance lease, the lessee must be given the opportunity to learn of the

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<sup>105</sup> For the text of § 2A-209(4), see *supra* note 16.

<sup>106</sup> U.C.C. § 2A-209(1) (1991).

<sup>107</sup> *Id.* § 2A-209(3).

supplier's promises and warranties to the lessor made in the supply contract: one of four events must occur under section 2A-103(1)(g)(iii).<sup>108</sup> Suppose further that of those four possibilities, the parties choose the option whereby the lessee receives a statement from the lessor of the promises and warranties in the supply contract.<sup>109</sup> Suppose further that after the parties furnish this statement to the lessee, the lessor and supplier modify a warranty: this could occur, for example, if the lessor owed the supplier an outstanding debt from a prior transaction, and some warranty protection was exchanged for its discharge. At some point after this modification, the lessee signs the lease and notifies the supplier that it has entered a finance lease.

In this scenario, what are the consequences for the parties? According to section 2A-209(3), the modification is effective against the lessee, having occurred before the supplier received notice of the lessee's entry into the finance lease. However, the lessor must step in and assume the warranty obligation as it existed prior to the modification.

This gives the lessee greater protection than it would have under the *Restatement* which allows the supplier and lessor (as promisor and promisee) to modify the promisor's duty to the beneficiary up to the point of the lessee's material reliance on the promise—that is, when the lessee signs the lease. In giving greater protection to the lessee, Article 2A implicitly recognizes the nature of the lessee's role here as a party paying, through the lease instrument, for the warranty protection.

However, suppose that at the time the lessee signed the lease, the modification has not yet occurred. Here the *Restatement* would terminate the power of the supplier and lessor to modify the supplier's duty, if the lessee's signing is viewed as material reliance. Under section 2A-209(3), however, the supplier and lessor could *still* modify the warranty, up to such time as the supplier is notified of the finance lease; if they did so, the lessor would still have to assume the modified obligation.

Despite the protection given the lessee's warranty rights by forcing the lessor to assume them in case of modification of the supply contract, section 2A-209(3) could still fall short of ensuring the lessee the full benefit of its bargain. First, there is no assurance that the lessee will know of the modification before it attempts to enforce its warranty rights, since section 2A-103(1)(g)(iii) does not require

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<sup>108</sup> See *supra* text accompanying note 12.

<sup>109</sup> Sections 2A-103(1)(g)(iii) and (D) were both added in the 1990 amendments to Article 2A. Formerly, the lessee was required to see the actual supply contract "evidencing the lessor's purchase. . . ." U.C.C. § 2A-103(1)(g)(iii) (1987).

that *modifications* of the supply contract be communicated to the lessee subsequent to its initial receipt of a statement of the promises and warranties. Second, a significant difference may exist in the quality of performance under the modified warranty when, for example, the lessor is called upon to perform, rather than the supplier (which may be a manufacturer with unique expertise).

As with the previous hypothetical cases, the best course for the lessee is to address the problems expressly during negotiations. The lessee should insist on a *current* statement of the supply contract's promises and warranties immediately before entering into the lease, and give notice immediately to the supplier in order to terminate the power of the supplier and lessor to modify the supply contract.

The question remains, however, of what remedy might be available to the lessee should it learn of a subsequent modification in circumstances where the lessor, who by operation of section 2A-209(3) has assumed the modified warranty, is unable to provide adequate service. Would the lessee have rights against the lessor?

Recall that the lessee's obligation to pay rent would be binding under the hell or high water clause of section 2A-407. However, because the lessor, upon agreement to modify the supply contract, is deemed to assume the warranty obligations,<sup>110</sup> the lessee may now have a claim for breach of an *express* warranty against the lessor,<sup>111</sup> one of the limited number of claims to which the hell or high water clause is vulnerable.<sup>112</sup> Since section 2A-210(1)(a) includes in the definition of an express warranty any "promise made by the les-

<sup>110</sup> *Id.* § 2A-209(3).

<sup>111</sup> Express warranties are governed by section 2A-210, which reads in full:  
Express Warranties

(1) Express warranties by the lessor are created as follows:

(a) Any affirmation of fact or promise made by the lessor to the lessee which relates to the goods and becomes part of the basis of the bargain creates an express warranty that the goods will conform to the affirmation or promise.

(b) Any description of the goods which is made part of the basis of the bargain creates an express warranty that the goods will conform to the description.

(c) Any sample or model that is made part of the basis of the bargain creates an express warranty that the whole of the goods will conform to the sample or model.

(2) It is not necessary to the creation of an express warranty that the lessor use formal words, such as "warranty" or "guarantee," or that the lessor have a specific intention to make a warranty, but an affirmation merely of the value of the goods or a statement purporting to be merely the lessor's opinion or commendation of the goods does not create a warranty.

*Id.* § 2A-210.

<sup>112</sup> *Id.* § 2A-209 official cmt.

sor to the lessee which relates to the goods and becomes part of the basis of the bargain,"<sup>113</sup> and since the lessor is now, by operation of law, making to the lessee a promise previously made by the supplier, the lessor has arguably taken on a new, *express* warranty. In addition, an express warranty will be made whether or not the lessor actually "intends" it: following the model of section 2-313(2), section 2A-210(2) explicitly states that "[i]t is not necessary to the creation of an express warranty . . . that the lessor have a specific intention to make a warranty."<sup>114</sup> Under such an express warranty, the lessee, to the extent that the value of the warranty to the lessee has been reduced, would be able to offset its rental obligation, which is no longer "irrevocable and independent" under section 2A-407.

### CONCLUSION

Article 2A goes a long way to bring personal property leasing under a uniform regime. In both general provisions and the many exceptions to the general leasing rules, it addresses several of the most difficult issues in the area of finance leases: the scope of the substantive rights of the lessee as beneficiary of the supply contract, the nature of the lessee's obligation to pay rent, and the issue of modification of the supply contract both before and after the finance lease becomes effective.

In each of these areas there remain unresolved issues—issues which arise because the relationship between the parties in a finance lease arrangement is not completely specified, and the integration of Article 2A with existing remedy provisions of Article 2 is unclear. The nature of the "benefit" extended to the lessee by operation of section 2A-209 is the chief problem that emerges from close analysis of the statute. The scope of rights against a supplier that flow to the lessee as a result of the beneficiary status under the supply contract remains unacceptably confused in a statute whose express purpose is to bring clarity to the limbo-land of personal-property leasing under the common law. Similarly, the apparent equation of lessor and lessee, with respect to the supplier, opens the door to an overly formal reading of 2A-209 in the area of remedies. Finally, the provisions regarding contract modification, and specifically what avenue is open to a lessee who discovers a change in the identity of a warranty provider—potentially after relying on the supplier to be standing ready—is disturbing. Article 2A remains unclear on whether warranties "deemed" to be assumed by a lessor under section 2A-209(3) become express warranties, and thus actionable by a lessee.

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<sup>113</sup> *Id.* § 2A-210(1)(a).

<sup>114</sup> *Id.* § 2A-210(2).



While such matters are ideally dealt with in the statutory text, without further amendment of Article 2A, these problems await resolution by the courts. In the absence of such judicial emendation, parties to finance leases, increasingly subject to Article 2A in future years, would be wise to contract around those areas of the statute where the text lacks the clarity to offer predictive value.

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