

1980

Arnold Machinery Company v. David M. Balls and Richard S. Johns II, Co-Partners, Dba Utah Excavating : Appellant'S Brief

Utah Supreme Court

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IN THE SUPREME COURT
OF THE STATE OF UTAH

ARNOLD MACHINERY COMPANY, :
Plaintiff-Appellant, :
vs. : No. 16934
DAVID M. BALLS and RICHARD :
S. JOHNS II, co-partners, :
dba UTAH EXCAVATING, :
Defendant-Respondents. :

APPELLANT'S BRIEF

Appeal from a Judgment
of the Third District Court of Salt Lake County
The Honorable Homer F. Wilkinson, Judge

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Clerk, Supreme Court, Utah

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ARNOLD MACHINERY COMPANY, :
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S. JOHNS II, co-partners, :
dba UTAH EXCAVATING, :
Defendant-Respondents. :

STATEMENT OF THE KIND OF CASE

This is an action wherein plaintiff seeks to recover unpaid rentals, pursuant to an equipment rental agreement, in the amount of \$13,889.64, together with interest and attorney's fees and to recover the sum of \$127.35 for repair work.

DISPOSITION IN LOWER COURT

The court, sitting without a jury, ruled that the equipment lease was as a matter of law a security instrument and that the Uniform Commercial Code transformed the lease into a conditional sales contract and that since there was no compliance with the terms of the Uniform Commercial Code relating to conditional sales contracts, plaintiff could not recover unpaid rentals. The court only allowed recovery of \$127.35 for repair costs on the second claim.

RELIEF SOUGHT ON APPEAL

Appellant seeks reversal of the judgment relating to rentals and a remand of the action to the District Court

with the direction to enter judgment in the amount of \$13,889.64 together with interest, and together with such reasonable attorney's fees as the lower court shall determine.

STATEMENT OF FACTS

Plaintiff-appellant Arnold Machinery Company (Arnold) is and was in the business of both selling and leasing equipment (T. 108). Defendant-respondent Utah Excavating, a partnership, was in the excavating business. It had a job on which a backhoe was needed. Arnold had one in inventory and representatives of Arnold and Utah Excavating discussed the alternatives of purchasing or renting one (T. 110). A lease agreement instead of a purchase agreement is often entered into if the contractor is not sure how long his work will last (T. 123), even though financially able to purchase. For those in the position of Utah Excavating, of not being financially able to purchase, entering into a lease is a common transaction (T. 134-135).

If the backhoe were to be purchased, a twenty-percent down payment, or approximately \$20,000 would have been required (T. 111). Utah Excavating did not have the funds for a down payment, nor were they sure if their work would last long enough to warrant purchasing the equipment. The evidence was;

Q. Did you express to their salesman what your objective was in coming to them?

- A. Yes
Q. What was that?
A. That we were interested in obtaining a backhoe so that we could use it to perform work that we had more or less had committed to us if we had that type of equipment.

(Johns of Utah Excavating T. 169)

- A. We wanted a piece of equipment similar to this because we had work to do with it. And because of our financial condition, not having sufficient money to make a down payment and being aware that these kinds of alternatives to purchase were available, we elected to use that kind of an arrangement rather than have to come up with that much capital at that time in order to get the equipment to put it to use.

(Johns of Utah Excavating T. 195)

In lieu of buying the backhoe, it was decided that it would be rented for a long enough period to determine whether or not the work would last and to permit them to acquire from the work sufficient funds to make a down payment. If the work lasted and if they acquired funds for a down payment, it was then the intent of the parties that a conditional sales contract would be substituted for a rental agreement.

* * *They then, of course, decided they did not have the money for a down payment, nor were they sure if the type of work they had was going to last for this two or three-year period. So in lieu of buying the piece of equipment we then elected to rent it to them until they found out if the work was going to hold out, and also they could use the rental payments by which to acquire a down payment and then put it on to a conditional sales contract.

(Byerline of Arnold T. 110, 111)

- A. The other option is the so-called lease where we would make an established payment for a given period of time, hopefully with the end result being that we would then acquire sufficient equity in that machine to allow us to obtain financing.* * *
- A. We could convert to a purchase. We could actually purchase that machine. We would have acquired a down payment through the money that we had paid over the period of six months, so that we would then be able to actually purchase that machine.* * *
- A. Not that I recall. He indicated that there would be a six-month minimum. We would have to pay the six-month payments, and if we desired to continue longer we could, but it was to our advantage to convert to a purchase as quickly as we possibly could because of the finance charges, and we were also making payments that were really quite high, * * *

(Johns of Utah Excavating T. 171)

* * * But we knew we didn't have the 20 percent, or ten percent required down payment, so we could see that this was a viable way for us to obtain the equipment we wanted, to get it right to work, and have it earn for us the money we needed to make the down payment so that we could eventually finance it.

(Johns of Utah Excavating T. 172)

Thus, a rental agreement was entered into (Ex. 1-P, T. 112) instead of a conditional sales contract. The rental agreement was accompanied by an option to purchase which provided that rental payments could be applied against the purchase price. (Ex. 2-P) Arnold's experience in rentals such as this was that only twenty to twenty-five percent of those renting

equipment exercised their option to purchase (T. 114). The parties treated the transaction as a lease. Arnold paid its supplier-manufacturer Drott only upon a subsequent sale of the backhoe to Salt Lake County, whereas it would have had to pay Drott upon execution of the rental agreement, had the rental been a sale. (T. 161). Arnold took the depreciation of the backhoe on its corporate books for the rental period. (T. 114). Arnold made major repairs at its expense during the rental period and, in fact, acquired and paid for parts needed for such repairs (T. 299). Utah Excavating, instead of depreciating the backhoe as if it owned it, expensed rental payments (T. 211).

The parties contemplated that a six-month period was a long enough one for Utah Excavating both to determine whether or not their work warranted the purchase of the equipment and to pay rentals in a sufficient amount to enable Utah Excavating to terminate the lease and enter into a conditional sales contract applying the rental payments as a down payment on the conditional sales contract. Utah Excavating's testimony relating thereto is as follows:

- A. As we discussed this option with Arnold Machinery, the kind of language that was used was to the effect that we would go on accruing our down payment as we were making these payments towards this so-called lease, so that we would be able to then at the end of the six months have sufficient money to make the down payment.
* * *

Q. And the lease would have been terminated and the conditional sales contract would have then been entered into, right?

A. That is correct.

(Johns of Utah Excavating T. 208)

Q. The option not to buy presently, but to buy six months later, right?

A. The option to have this piece of Equipment to use and to accrue money during the time we were using it so that we would be able to eventually make this other arrangement, this purchase.

(Johns of Utah Excavating T. 209)

Q. That may be. Did you feel that you were bound to * * * do anything more than pay the six-month rental? * * *

A. That is correct.

(Johns of Utah Excavating T. 210)

A. * * * But we knew we didn't have the 20 percent, or ten percent required down payment, so we could see that this was a viable way for us to obtain the equipment we wanted, to get it right to work, and have it earn for us the money we needed to make the down payment so that we could eventually finance it.

(Balls of Utah Excavating T. 172)

Q. You didn't have an intention at the time you entered into the rental agreement, and the option agreement, to continue with that type of agree-

ment for an indefinite period of time, did you?

- A. No. We wanted to purchase the machine as quickly as possible. * * *
- A. But we were going to do it for the six months and then we were going to pay Arnold Machinery the balance.

(Balls of Utah Excavating T. 268, 269)

Utah Excavating's excavation work did not develop as it had anticipated, and it became delinquent in rental payments (T. 204). Arnold requested payment, and its salesman testified as to collection efforts:

- A. Basically just requests for payment, and of course they would keep promising us they would have money coming in off of their jobs, and we went along and worked with them as best we possibly could and left the machine out so they could still work it. But this went on several times.

(Welch of Arnold T. 317)

When the collection efforts failed, Mr. Johns of Utah Excavating concluded that Utah Excavating was unable to finance the purchase of the backhoe, and so Utah Excavating did not attempt to purchase the machine. He testified:

- Q. * * * When did you wish to exercise the option, at the end of the six months?
- A. We had intended to do that. However at the end of the six months we had not made six payments. We didn't feel like we could obtain the finan-

cing at that time with the little amount that we had accrued, so we didn't even attempt to finance the machine at the end of six months.

(T. 212)

Utah Excavating concluded it would have to "forget it."

The Arnold representative testified:

Q. All right. State what was said concerning termination, Arnold terminating?

A. Basically it was that we couldn't release the machine back to them unless the back payments were caught up. That was the basis of all of the conversations. And we would work with them the best we possibly could if he would catch his payments up.

(Welch of Arnold T. 320)

A. The last conversation that I finally had with Mr. Balls, I told him it was subject to future rental and that we did have people looking to rent this machine. And he finally told me that he did not have the money. In his words, "I guess I will have to forget it."

(Welch of Arnold T. 318)

The parties all intended that the conversion of the lease to a sale would occur six months after the lease was executed (T. 171, 172, 196, 208, 209, 210).

The parties discussed what would happen if the lease went beyond six months by one or two months. It was decided that it could go on a little longer. Mr. Johns testified:

A. No. This was, it was a six-month agreement, but the way the discussion went at that time if we didn't feel at the end of six months that we had enough money accrued into the thing, or we wanted to pay a few more months and keep the mach-

ine before we converted to the purchase situation, we could have gone on a little longer.

(T. 237)

A. We intended to buy the machine at the end of six months, right.

Q. At the end of six months. Now as I recall you said probably Mr. Byerline indicated that if it went over the six months by one or two months that that would be all right. Was there a conversation to that effect?

A. Yes. * * *

(T. 266)

However, Johns, the partner in Utah Excavating handling its financial affairs did not contemplate at the time the lease was entered into what the machine would be worth after the six-month rental period. He was thinking of conversion to a conditional sales contract at the end of a 6-month's lease. He testified:

Q. Did you form an expectation as to what the equipment, or an anticipation as to what the equipment, would be worth after one year?

A. No. I don't recall having done that.

(T. 190)

Utah Excavating became delinquent. It paid only \$12,823.29 (Ex. D9) of the agreed six months' rentals of \$23,400. Had the rentals been paid and the option to purchase exercised, a conditional sales contract would then have been entered into

and the lease would have been terminated (T. 112). The \$23,400 rental payments would have been shown as a down payment and the remaining \$72,736.50 would have been the unpaid contract balance amount (T. 86, 132). (That remaining contract balance takes into account the cost of repairs and the option charge of 1-1/4% per month, both of which under the option agreement were to be added to the \$92,220 option price, Ex. 2-P)

After Utah Excavating could go no further and had terminated the lease after approximately 8 months (T. 319, 318), Arnold rented the backhoe to Salt Lake County. The rental agreement was accompanied by an option to purchase for \$85,000, plus \$850 per month option charge. (T. 160). The County paid four months rental totaling \$15,600 (T. 154) and then determined that it wanted to purchase the equipment. Under its option agreement it would have had to have paid \$85,000 plus an option charge of \$3,400, less rental payments of \$15,600 or a balance of \$72,800 (T. 121-122). Instead of exercising its option to purchase, the County advertised for bids for supplying a backhoe, and Arnold submitted a bid for \$66,400 (Ex. 6, T. 127). The County accepted this bid as being the lowest bid for a machine of acceptable quality, and the County paid \$66,400 for the machine. There thus was no exercise of the County's option to purchase, which would have entailed the larger sum to purchase the property.

The lease to Utah Excavating provided:

Arnold Machinery Company...hereby leases to Utah Excavating...for a minimum period of six months and, thereafter until the equipment is returned or until the lessor terminates the lease, the equipment hereinafter described, according to the terms and provisions hereinafter stated....(Ex. 1-P)

The Court construed that provision as meaning that the lease continued in effect until there was a breach by either party of the terms and conditions of the lease. The Court said:

THE COURT:

So what my immediate interpretation of that, yet it is a six-month lease but it continued thereafter unless either of the parties terminates it according to the terms of the lease which is stated hereafter in the lease. Or on the back of the lease.

MR. LOWE:

Is Your Honor construing this lease as going on forever insofar as Arnold Machinery is concerned, and at the whim of the lessee to terminate it otherwise? I don't think could be a reasonable construction, Your Honor.

MR. RICHARDS:

I certainly do, Your Honor.

THE COURT:

Just a minute. Just a minute. My immediate construction right now is that if the parties remain current in their payments that this lease could have gone on indefinitely, under the wording of this particular lease, unless they vio-

lated one of the provisions herein-
after provided for in the lease. And
if they violate those provisions then
they have cause or grounds to set it
aside. I think that was the intent of
the parties. It appears from the testi-
mony that I have heard in this matter
thus far.

MR. LOWE:

The testimony has always been, Your
Honor, that neither of these defendants
thought that it would, expected that it
would go on for more than six months.
At that point they intended to convert it
into a, not a lease but a conditional
sales contract. And the Court, I think,
should look at those circumstances in
construing whether or not this lease was
intended by the parties to go on for-
ever.

THE COURT:

I think you're correct when you state, of
course, that the testimony is that they
expect to convert it. But I think under
the terms of the lease, if that expecta-
tion didn't materialize, they could have
continued to lease it.
So based on that the Court would allow,
would overrule the objection and allow,
the witness to answer the question.

(T. 311, 312)

The Court then felt that it was a waste of Court's
time to consider the intention of the parties at the time
the equipment lease agreement was entered into that the
option should be exercised in six months. The Court said:

MR. DIBBLEE:

Well, I mean I didn't, I thought that
that issue was more or less concluded
and there wasn't any sense of wasting
the Court's time.

THE COURT:

I think it really is myself * * *.

The Court thereupon considered not just the cost of exercising the option to purchase at the expiration of six months when the parties intended that the option should be exercised, which was \$76,473.46, (T. 90), but over objection admitted evidence relating to figures one, two and three years later. Mathematical calculations were carried out to the point at which rental payments - had the lease continued long enough and had rental payments been made - would have exceeded the option purchase price of \$92,220 (T. 90-92). The court considered, also over objection, the value of the machine at the date three years later when rentals would have exceeded the value of the machine (T. 299-314).

ARGUMENT

I. THE LEASE WAS NOT IN PERPETUITY

The lower court concluded that it deemed the lease to be one in which the lessee was bound for only six months and then could terminate at any time without cause, but that the lessor could only terminate the lease for cause, or that both parties could terminate only for cause, and if there were no cause that it would have run forever. Such a result appears to be a most unreasonable one. The pertinent part of the lease is as follows:

Arnold Machinery Company, Inc., a Utah corporation whose address is 2975 West 21st So., Salt Lake City, County of Salt Lake, State of Utah, hereinafter called the lessor, hereby leases to Utah Excavating whose address is 4591 Holly Lane, City of Salt Lake, County of Salt

Lake, State of Utah 84117, hereinafter called the lessee, for a minimum period of six months and thereafter until the equipment is returned or until lessor terminates the lease, the equipment hereinafter described, according to the terms and provisions hereinafter stated. (Ex. 1-P) (Emphasis added).

The lease set forth terms and provisions concerning maintenance, repairs, tire charges, damage to equipment, condition of the equipment on delivery, defects in equipment, compliance with lease, damage by the elements, indemnification against loss, insurance, title, disclosure of location, subletting, acceleration of rentals in event of default, repossession, interest, attorney's fees, etc. These provisions logically apply to the lease during its stated term. The lower court illogically construed the phrase "according to the terms and provisions hereinafter stated" as modifying the verb "terminates." Such a strained construction would, after deleting extraneous words, result in: "Arnold Machinery hereby leases to Utah Excavating until the lessor terminates according to the terms and provisions herein stated." Such a construction would result in the default provisions not being applicable during the stated term of the lease. A logical construction, which would give effect to what any lessor and lessee would have contemplated, is that the phrase "according to the terms and provisions hereinafter stated" modifies the verb "leases." The latter construction would, after deleting extraneous language, result in: "Arnold Machinery Company hereby leases to Utah

Excavating according to the terms hereinafter stated." A reasonable construction of the rental agreement is that the express right to terminate the lease in the various situations of default and remedies provided for in such event are not in limitation of the lessor's right to terminate after the minimum period of time of six months, but rather permit the lessor during the minimum period to terminate in the event of such defaults.

If such reasonable construction is given the rental agreement, then the Maryland case relied upon by defendants United Rental Equipment Company vs. Potts and Callahan Contracting Company, 231 Maryland 552, 191 Atlantic 2d 570, 574 is neither controlling nor persuasive, because in that case the Court relied upon the fact that:

The only option given the lessor to terminate the lease is for enumerated causes. This is consistent with an extended period of rental payments to be determined solely by the lessee.

That court reasoned that, if the lessor could not terminate the lease prior to the time at which lease payments would exceed the option to purchase price, then the provision of 70A-1-201 (37) would be applicable. That section provides that a transaction is not a lease, but a sale with the creation of a security interest if the lessee has "the option to become the owner of the property for no additional consideration or for a nom-

inal consideration" as set forth in subsection (b):

An agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended for security.

A proper construction of the lease here is that after six months the lessor could terminate without cause. Consequently, Utah Excavating's lease is not such a lease as there involved.

The Maryland case is further distinguishable because the Maryland court, in determining whether or not the lease "is intended as security," as provided by the code, determined that the intent of the parties was that it should continue until the full option price had been paid. The code provides that "whether a lease is intended as security is to be determined by the facts of each case." In the Maryland case there was no expressed intention of the parties that the option was to be exercised at the end of six months. Here, both Johns and Balls of Utah Excavating testified that they intended to exercise the option then. (T. 172, 208, 209). Therefore, there is no reasonable basis for any ruling that the parties intended that the option would be exercised at such later time as the rental payments would have equaled the option price. Defendants here argued that the court could have considered times 10 or 20 years later if such longer period were

needed to make rentals equal the option price (T. 300).

The lower court's determination should have been what the parties intended at the time they entered into the transaction. That intent has been stated by the parties, and no later ruling of law that the lease could have continued forever and the option could have been exercised whenever rentals exceeded option price is any reflection of what the parties intended.

In the event this Court feels that the Maryland case is not distinguishable, then we submit that the Maryland case and this case were erroneously decided, because 1-201 (37) of the code provides that if "upon compliance with the terms of the lease" the lessee may become the owner of the property by paying a nominal consideration, the transaction is one intended for security. Here, even adopting the construction advocated by Utah Excavating that the lessee may terminate after six months but the lessor is bound forever (T. 311), the lessee would only be obligated to make six months' payments. After six months, it would have had no obligation to pay if it wished to terminate. The "compliance with the terms of the lease" by the lessee would reasonably relate to a payment of the rentals the lessee was obligated to make. At the time of entering into the rental agreement that obligation was only to pay the minimum six-month rental, since the lessee could

then terminate the lease. At that point, the option price was \$99,136.50. The agreed rental obligation was \$23,400.00, leaving a balance to exercise the option of \$75,736.50, which is hardly a nominal payment.

There is an exhaustive annotation on "Equipment Leases as Security Interest Within Uniform Commercial Code § 1-201 (37)" in 76 ALR 3d 11. The only case cited relating to a holding over lease situation is the Maryland case, which at the most would be persuasive rather than binding upon this Court. The other cases in the 99-page annotation relate to a fixed option price at the end of a stated term lease. Such was the situation in FMA Financial Corporation vs. Pro-Printers, ___ U. 2d ___, 590 P. 2d 803. A reasonable construction of subsection (b) is that it applies to a situation in which the lessee is bound to make payments which equal or exceed the purchase price, in which event the statute makes the transaction a security interest and subject to the Commercial Code requirements relating to secured transactions. The UCC creation of an artificial situation in which a lease is deemed a sale should not be extended to cover a situation in which the lessee is not obligated to pay a sum substantially equal to the purchase price.

II. THE PARTIES INTENDED THAT THERE NOT BE A SECURITY INTEREST

Section 70A-201 (37) provides:

Whether a lease is intended as security is to be determined by the facts of each case; however (a) the inclusion of an option to purchase does not of itself make the lease one intended for security.

Here the parties considered whether to have a lease or whether to utilize a conditional sales contract which would create a security interest. The parties consciously chose to enter into a lease instead of a conditional sales contract and later, if available jobs and financial ability developed as anticipated at the end of six months, to terminate the lease and then enter into a conditional sales agreement and then to create a security interest, and if not the lease could be terminated. They therefore did not intend that the transaction was a conditional sale with a security interest reserved.

Utah Excavating and the lower court relied upon FMA Financial Corporation vs. Pro-Printers et al ___ U2d ___, 590 Pacific 2d, 803. That case is distinguishable upon its facts. In that case there was a firm 60-month lease with an option price at the end of the 60 months, which was 10% of the cost of the equipment and 6% of the total lease payments. This case is in no way comparable insofar as the relation of the option price to cost and lease payments is concerned, and, even under the facts in the FMA case, there was a 3 - 2 decision.

Various factors influencing the determination as to whether or not the lease was intended by the parties to be a conditional sale with a security interest reserved are set forth in the annotation in 76 ALR 3d:

Option to Purchase

This alone under the code does not indicate a security interest.

Option to Purchase For No Additional Consideration

This factor is determined as of the date the option was to be exercised. Here that date was six months later when the purchase price was substantial, not 3 years later. Thus no security interest was intended.

Relationship Between Option Price and Value at the Time

Option Was to be Exercised

Here the parties did not consider any value other than the value anticipated six months after execution of the lease, when it was contemplated the option would be exercised, at which point the option price was not disproportionate to the value. Thus no security interest was intended.

Absence of Alternative to Exercise of Option

At the end of the contemplated six-month period there was a viable economic alternative open to Utah Excavating, particularly if it did not have jobs

available, to terminate the lease and not exercise the option to purchase, indicating no security interest.

Nature of Lessor's Business

Arnold was in the business of both selling and leasing equipment and not in the business of financing same as was FMA Financial Corporation, indicating no security interest.

Lessor's Security Anxiety

Whether or not a security deposit was required for performance has been considered by some courts as a factor. Here there was no security deposit which would be indicative of no security interest.

Default or Termination Provisions

The existence of various rights given to the lessor upon default by lessee, as expressly set forth in this lease, is indicative that there is no security interest.

Tax Consequences

The parties here treated the transaction as a true lease and not as a security interest in their tax treatment of the transaction, indicating no security interest.

The above factors reinforce the conclusion that should have been reached from the expressed intention of the parties that a lease and not a security transaction was intended.

CONCLUSION

The lease by its terms was not in perpetuity, nor was it intended to be so. Therefore, 70A-1-201 (37) (b) is inapplicable, which provides that a lease is one intended for security if upon compliance with its terms the lessee has the option to become the owner for no additional consideration.

70A-1-201 (37) (a), which provides that the inclusion of an option to purchase does not of itself make the lease one intended as security, is applicable. The clause in 70A-1-201 (37) that is controlling is "whether a lease is intended as security is to be determined by the facts of each case." Here the expressed intention of the parties that they intended a lease instead of a purchase and that the option was to be exercised six months after the rental agreement was entered into should have been accepted by the lower court in determining "whether a lease is intended as security." That intention was that there should be a lease and not a conditional sale creating a security interest, and that the option was to be exercised at a time when a very substantial rather than nominal consideration would have had to have been paid in order to exercise the option to purchase.

Respectfully submitted,



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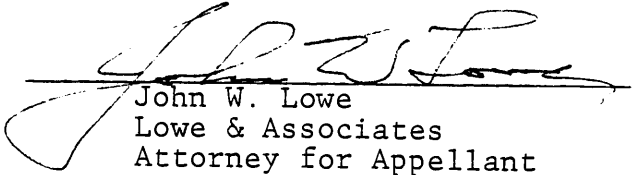
CERTIFICATE OF MAILING

I hereby certify that I mailed, postage prepaid, two copies of the foregoing Appellant's Brief to each of the following counsel for the respondents:

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