Fixtures: A Healthy Fixation with Special Priority Rules

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In a rough economy, lessors are more frequently faced with competing claims against equipment on lease to defaulted customers. Some of these claims come from landlords or mortgagees who have an interest in the premises on which the leased equipment is located. Such claims can be particularly troublesome if the leased equipment may be considered fixtures under state law.

Both Article 2A of the Uniform Commercial Code ("UCC"), applicable to true leases, and Article 9 of the UCC, applicable, to dollar out leases or other leases intended as security, define fixtures to be goods that "become so related to particular real estate that an interest in them arises under real estate law". *See* UCC §§2A-309(1)(a) and 9-102(a)(41).

Unfortunately, this definition is merely a legal conclusion and isn't of much use in day to day practice. As a result, case law on this topic varies state by state. Many courts look at the following criteria, although not all are uniformly applied: (1) the degree of the equipment's physical affixation to the real property; (2) the ease of removing the equipment; (3) the intention of the parties; (4) the reasonable expectations of a third party landlord or mortgagee of the real estate; and (5) the extent to which the presence of the fixtures is critical to the functioning of the real estate.

At the end of the day, if goods have any possibility of being fixtures under state law, prudent lessors should understand the following UCC priority rules.

Dollar-Out Leases and Other Leases Intended as Security

The rules applicable to fixtures in the context of dollar-out leases or other leases intended as security are set forth in §9-334 of the UCC. The general rule, found in §9-334(c), is that a security interest in fixtures is subordinate to a conflicting interest of an encumbrancer or owner of the real property (a "real estate claimant"). As such, a lessor or lender must point to one of the following exceptions in order to obtain priority. Some of these exceptions require the filing of a "fixture filing". It should be noted that a security interest in fixtures may be perfected by a regular UCC filing as to the goods, usually filed with the secretary of state in the applicable jurisdiction, or by a fixture filing filed at the office in the jurisdiction where real estate mortgages are recorded, and which provides that it is being filed in the real estate records. *See* §§§9-102(a)(40), 9-334(e)(3) and 9-501(a)(1) and (2). It should also be noted that, although non-consensual, statutory landlord's liens are technically excluded from Article 9 pursuant to §9-109(d)(1), courts in some states rely on the follow rules when analyzing the rights of a lessor of fixtures.

First to File or Record

The first exception which could give a lessor priority over a real estate claimant is the "first to file or record" rule. This rule, which is not frequently useful to equipment lessors, provides that a fixture filing made before a real estate claimant files its interest of record results in the lessor having priority of such real estate claimant if the lessor would also have prevailed over the real estate claimant's predecessor in interest. §9-334(e)(1). The condition that the security interest must have had priority over any conflicting interest of a predecessor in title is simply an expression of the usual rule that a person must be entitled to transfer what he or she has. The official comments explain that "if the fixture security interest is subordinate to a mortgage, it is subordinate to an interest of an assignee of the mortgage, even though the assignment is a later recorded instrument."

It should also be noted that there is a construction mortgage exception to the priority which a lessor may otherwise obtain by this rule. Section 9-334(h) provides that a mortgage which secures an obligation for the construction of improvements to land, including a refinancing of such a mortgage, has priority over a security interest in goods which become fixtures before completion of the construction. The lesson for lessors is to be very weary of leasing fixtures to a lessee who is in the midst of a build out of the premises where the fixtures will be installed.

Purchase Money Security Interest

A more useful exception for equipment lessors is that of purchase money priority. In order to benefit from purchase money priority: (a) the lessee must have an interest of record in the real property or be in possession of the real property; (b) the financing must be "purchase money"—generally meaning that the lessor's funds enabled the lessee to acquire its interest in the fixtures; and (c) the security interest must be perfected by a fixture filing before the goods become fixtures or within twenty (20) days thereafter. Note that perfection must be accomplished with a fixture filing to benefit from this purchase priority rule.

It should also be noted that, unlike with purchase money security interests in equipment, a lessor's purchase money priority interest in fixtures only has priority over a real property claim whose interest *"arises before the goods become fixtures."* §9-334(d)(2). The official comments explain that:

this purchase-money priority with the 20-day grace period for filing is limited to rights against real property interests that arise *before* the goods become fixtures [and t]here is no such priority with the 20-day grace period as against real property interests that arise subsequently[, meaning that t]he fixture security interest can defeat subsequent real property interests only if it is filed first and prevails under the [first to file or perfect rule]." Official Comments No. 7.

This nuance means that a lessor can only assure itself of first priority if it files its fixture filing before the goods become fixtures. Consider, for example, the results which would occur if a mortgage covering fixtures was filed *after* the leased goods became fixtures but before the expiration of the twenty day grace period. In that situation, a lessor's security interest which was perfected by a fixture filing within the twenty day grace period but after the mortgage was recorded would be subordinate. It could not rely on the purchase money priority rules because the real estate claimant did not have an interest which arose prior to the goods becoming fixtures. It would also not have priority over the first to file or record priority rules.

The construction mortgage exception discussed above is also noteworthy and applies in the context of a purchase money priority in fixtures. In other words, a construction mortgagee has priority over a lessor who claims a purchase money priority in fixtures if the goods become fixtures prior to completion of the construction.

Readily Removable Factory or Office Machines or Certain other Equipment

The final common exception useful to lessors is for readily removable factory or office machines or equipment that is not primarily used or leased for use in operation of the real property. Section 9-334(e)(2) provides that a lessor has priority in such property as long as it perfects its security interest in them before the goods become fixtures. As the official comments explain:

This rule is made necessary by the confusion in the law as to whether certain machinery, equipment, and appliances become fixtures. It protects a [lessor] who, perhaps in the mistaken belief that the readily removable goods will not become fixtures, makes a UCC filing (or otherwise perfects under this article) rather than making a fixture filing. Frequently, under applicable law, goods of [this type] will not be considered to have become part of the real property. In those cases, the fixture security interest does not conflict with a real property interest, and resort to this section is unnecessary. However, if the goods have become part of the real property, [this exception] enables a [lessor of fixtures] to take priority over a conflicting real-property interest if the fixture security interest is perfected by a fixture filing or by any other method permitted by this article. . . . . See Official Comment No. 8.

It should be noted that a lessor does not need to make a fixture filing to be afforded the priority under this Section but that the lessor's interest must be perfected before the goods become fixtures. In other words, the normal twenty (20) day window applicable on purchase money security interest does not apply. It should also be noted that the construction mortgage exception is not applicable either and a lessor who triumphs under this section will also have a prior interest to that of a construction mortgagee. However, in order to benefit from this rule, the lessor must be able to show that the fixtures are: (a) readily removable; and (b) are factory or office machines or other equipment which is not primarily used or leased for use in the operation of real property.

True Leases

As one would expect, a lessor of fixtures has priority over a real estate claimant if such a claimant has consented in writing to the equipment lease or has disclaimed an interest in the goods as fixtures. §2A-309(5)(c).

The same result also is reached if there is language in the underlying lease between the owner of the real property or the mortgagee that gives the lessee the right to remove the goods. In that case even upon termination of lessee's right to remove the goods, “the priority of the interest of the lessor continues for a reasonable time.” §2A-309(5)(d). Relying on this provision requires a careful reading of the documents between the lessee and the landlord or mortgagee and prudent lessors would also require the real estate claimant to notify the lessor in writing upon any termination of lessee's right (including any amendment to the contract which results in such a termination) and make receipt of such a notice a default under the equipment lease (thereby giving lessor the ability to remove the equipment).

The other rights of a true lessor in fixtures is governed by §2A-309 of the UCC and are similar to those discussed above with respect to dollar-out leases or other leases intended as security.

Section 2A-309(5) provides a lessor with a priority in fixtures if they constitute “readily removable factory or office machines [or] readily removable equipment that is not primarily used or leased for use in the operation of the real estate … and before the goods become fixtures the lease contract is enforceable”. This provision is similar to the Article 9 provision discussed above except, in the true leases scenario, the lessor must only have an enforceable lease contract before the goods become fixtures (rather than having a made a UCC filing as is required by Article 9 of the UCC for leases intended as security).

A frequently unknown fact is that if, if a lessor under a true lease, is not able to have a priority interest in fixtures that it owns and leases to a lessee pursuant to any of the rules discussed above, the lessor can only protect its interest in such fixtures from a real estate claiming by making a fixture filing and by relying on one of the following two situations. First, a lessor who makes a fixture filing before the goods become fixtures or within twenty (20) days thereafter will have priority over real estate claimants if: (a) the lessee has an interest of record in the real estate or is in possession of the real estate; and (b) the lessee does not have the right to use the goods or to possess the goods prior to the time the lease is enforceable. This is the true lease equivalent of the Article 9 purchase money rules for fixtures. Alternatively, a lessor who makes a fixture filing before a real estate claimant is of record will have priority over such real estate claimant if the lessee has an interest of record in the real estate or is in possession of the real estate. This is the true lease equivalent of the Article 9 first to file or perfect rule for fixtures.

Note, §2A-309(9) makes the Article 9 filing rules effective for true leases of fixtures by providing "[e]ven though the lease agreement does not create a security interest, the interest of a lessor of fixtures, including the lessor's residual interest, is perfected by filing a financing statement as a fixture filing for leased goods that are or are to become fixtures in accordance with the relevant provisions of the Uniform Commercial Code on Secured Transactions."