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Casenotes

PURPORTED LEASE WITH OPTION TO PURCHASE HELD TO CONSTITUTE A CONDITIONAL SALE

*Beckwith Machinery Co. v. Matthews*¹

Plaintiff-appellant filed a petition in the receivership proceedings of the Burnwell Coal Co. praying for the return of certain machinery then in the possession of defendant-appellee, the receiver for the Company. Plaintiff alleged that it had rented the machinery to the Company for a specified time according to the provisions of a written agreement signed by the parties, and that the lessee was in default in payment of the rent.

The written agreement was captioned "Agreement for Rental of Machinery." The rental term was to run for eight months, during which the lessee agreed to pay a total rental of \$4,632, payable in regular monthly installments of \$579 each.² According to the agreement, the lessee might extend the term by electing to retain the machinery after the expiration of the lease and paying additional rent of \$579 each month thereafter. The lessee also was given the option to purchase the machinery outright at any time during the term for a total sum of \$8,244.64, in which case all prior payments of rent were to be applied to the purchase price. The lessee further agreed to insure the machinery for the benefit of the plaintiff-lessor, and to preserve it in good operating condition. The contract contained the usual provision giving the lessor the right to repossess upon default in payment of the rent by the lessee. It was also provided that title to the machinery shall at all times "be and remain with the Owner unless transferred by separate written instrument."

It was found that the life of the greater part of the machinery was approximately eight years. Testimony revealed that the parties had intended originally to enter into an ordinary conditional sales contract for the sale of the machinery, but that the Coal Company was unable to make the 20% down payment required under wartime Federal regulations. They, therefore, entered into the con-

¹ 57 A. 2d 796, 175 A. L. R. 1360 (Md. 1948).

² It is clear that the Maryland Retail Installment Sales Act, Md. Code Supp. (1947), Art. 83, Secs. 116-140, does not apply to the contract since Section 139 limits the provisions of the Act to goods having a cash price of \$2,000 or less.

tract in question in the form of a lease with an option in the lessee to purchase. It was conceded that the contract had never been recorded, and that credit by third persons had been extended to the Company after it had taken possession of the machinery.

The Court of Appeals, in affirming the decision of the lower court, held that the agreement constituted a conditional sale, and that the reservation of title in the plaintiff was void as against the defendant, under Code, Article 21, Section 71,³ which provided in part, as follows:

"Every note, sale or contract for the sale of goods and chattels, wherein the title thereto, or a lien thereon, is reserved until the same be paid in whole or in part, or the transfer of title is made to depend upon any condition therein expressed and possession is to be delivered to the vendee, shall, in respect to such reservation and condition, be void as to third parties without notice until such note, sale or contract be in writing, signed by the vendee, and be recorded . . ."⁴

The Court stated that in deciding whether a particular transaction is or is not a conditional sale, it would look to the substance of the agreement, and disregard, if necessary, the external form with which the parties had clothed it.⁵ The Court thus points out that:

"In determining whether or not a given instrument is a conditional sales contract, we must find what the intention of the parties was at the time it was entered into. The situation of the parties, their purpose, the thing they sought to accomplish, and the method employed, are all important. Once the intention of the

³ Md. Code (1939) ; since amended, see *infra*, n. 4.

⁴ This section was amended in 1949 by Md. Laws 1949, Ch. 430. Instead of "third parties without notice" (as in the former statute), the amended statute specifies that such parties shall include "subsequent purchasers, mortgagees, incumbrancers, landlords with liens, pledgees, receivers, and creditors who acquired a lien by judicial proceedings on such goods and chattels without notice . . ."

⁵ See Arnold, *Conditional Sales of Chattels in Maryland*, 1 Md. L. Rev. 190-193 (1937), for a discussion of Maryland cases distinguishing between conditional sales and other transactions. In *Sturtevant Co. v. Dugan and Co.*, 106 Md. 587, 68 A. 351 (1907), a case involving goods consigned for sale to a factor, (and in which the rights of innocent third parties were not involved), the Court, at page 618 said:

"The distinction between bailment and sale is not difficult of ascertainment, if due regard be had to the elements peculiar to each. In bailment, the identical thing delivered is to be restored, or the proceeds after sale. In a sale there is an agreement express or implied to pay money or its equivalent for the thing delivered and there is no obligation to return." See Arnold, *op. cit.*, *supra*, 192.

parties becomes clear, it is immaterial what the instrument is called, nor how skillfully the real intention of the parties is disguised."⁶

The intent of the parties to effect a sale, and not a lease, was shown by the fact that the "lessee" was obligated to pay 56% of the purchase price as "rental." A rent so disproportionate to the real rental value of the property during the relatively short term would "virtually compel the lessee to buy. No solvent operators would take such a loss, and the only alternative was to buy."⁷

The writer has been unable to find another case in which the Court of Appeals has been called upon to hold that an instrument which on its face purported to be a lease with an option to purchase was in fact a conditional sale. However, the United States District Court of Maryland had previously been faced with the same contention in *In re Rainey*.⁸ The "lease" in that case provided that machinery, valued at \$812, was to be leased for a term of three months, that the lessee would pay \$325 as "partial security" for the fulfillment of the agreement, and that the \$487 balance was to be paid in two monthly payments of \$243.50 each. The lessee had the option after the expiration of the term to purchase the machinery upon payment to the lessor of the amount deposited as security. The agreement was held to be a conditional sale, the Court, speaking through Judge Coleman, stating:

"In order to determine the true character of the agreement, it is necessary to look through form to substance. In the present case, the rental of the machinery for three months, the full term of the lease amounted to 60% of its entire value. A charge so disproportionate to the term of user in relation to the value of the articles, all of which were secondhand, in and of itself certainly suggests a sale."⁹

A somewhat unusual arrangement was before the United States Circuit Court of Appeals in *Enterprise Fuel*

⁶ *Supra*, n. 1, 801.

⁷ *Ibid.*, 800. Cases cited in the opinion were: *In re Rainey*, 31 F. 2d 197 (D. C. Md., 1929); *In re Munger Fish Co.*, 9 F. 2d 54 (C. C. A. 8th, 1925); *Phelan v. Stockyards Bank*, 134 Okl. 13, 276 P. 175 (1928); *Hervey v. Rhode Island Locomotive Works*, 93 U. S. 664 (1876); *Arter v. Jacobs*, 226 App. Div. 343, 234 N. Y. S. 357 (1929); *Loeb Piano Co. v. Kessler*, 18 La. App. 491, 140 So. 398 (1932).

⁸ 31 F. 2d 197. See discussion in *Arnold, op. cit., supra*, n. 5, 193.

⁹ *Ibid.*, 199.

Co. v. Jones,¹⁰ on appeal from the United States District Court for Maryland. The appellant, in this case, had entered into a contract with the appellee to sell him a certain quantity of coal at a fixed price, and to furnish him with an Iron Fireman Automatic Coal Stoker. At the conclusion of the contract for the purchase of coal, he agreed to convey title to the coal stoker to appellee. The court, in a *per curiam* opinion, held that the arrangement constituted a conditional sale, and not a lease, of the coal stoker.

Almost all of the courts in this country which have considered the question have held that the legal significance of a particular transaction under the conditional sales recording statutes is to be determined by the real intent and purpose of the parties irrespective of the label they place upon it.¹¹ Thus, even though an agreement be called a lease or a bailment, the courts will hold it to be a conditional sale if the parties contemplate that the ultimate owner of the property will be the lessee or the bailee, or where such ownership will, as a practical certainty, result because of the nature of the agreement and the circumstances of the case.¹² Pennsylvania stands practically alone in taking a contrary view.¹³ The Pennsylvania rule, as stated in 17 American Law Reports at page 1441 is as follows:

¹⁰ 99 F. 2d 928 (C. C. A. 4th, 1938), 38 Am. Bankr. Rep. N. S. 10.

¹¹ 6 Am. Jur., Bailments, Sec. 35, 197. See Levin, *The Intention Fallacy in the Construction of Title Retaining Contracts*, 24 Mich. L. Rev. 130-149 (1925), pointing out that the courts have uniformly stated that the intention of the parties controls, but that when the rights of innocent third parties are involved, the courts will in fact ignore the subjective intent of the contracting parties and apply a test of "external" analysis based upon the public policy as expressed in the statute. See also 17 A. L. R. 1421:

"In general it may be said that the character of the contract depends upon the intention of the parties but this general rule is apt to be misleading, since such contracts are frequently construed contrary to the express statement therein as to the character thereof. The court looks to the purpose sought to be attained by the contract and to the surrounding facts and circumstances, and construes it in accordance therewith, as well as in harmony with the general cases applicable to the rights enjoyed and obligations imposed by it."

¹² See: 2 WILLISTON, SALES (Rev. Ed., 1948), Sec. 336; 6 Am. Jur. (Rev. Ed., 1950), Bailments, Secs. 35-8, 197-201; 47 Am. Jur., Sales, Sec. 836, 23-6. Cases annotated in 17 A. L. R. 1434, 1435; 43 A. L. R. 1257; 92 A. L. R. 321, 323; 175 A. L. R. 1382, 1384. See also note to *Purity Creamery Co. v. Hays*, 4 S. W. 2d 1056 (Texas Civ. App., 1928), in 7 Texas L. Rev. 329 (1929); and *Dalzell, Lease — Contracts as a Means of Conveying Title to Chattels*, 1 Ore. L. Rev. 9-21 (1921), (reviewing Oregon cases).

¹³ Pennsylvania early held that a conditional sale was valid only as between the parties. *Martin v. Mathiot*, 14 S. & R. 214 (Pa., 1826). This holding led to the adoption of the Pennsylvania "bailment-lease" device, which was upheld as against innocent third parties although it was in substance nothing but a conditional sale. The Pennsylvania cases are separately annotated in 17 A. L. R. 1441, 43 A. L. R. 1259, 92 A. L. R. 330, and 175 A. L. R. 1387.

"In Pennsylvania the rule obtains that if a party receives the possession of goods under an agreement that he is to retain them for a definite period of time, and if, at or before the expiration of that period, he pays for them, he is to become the owner,—otherwise to pay for the use of them,— this constitutes a bailment, and the title to the property, even as against creditors, remains in the bailor."¹⁴

The Court of Appeals in *Beckwith Machinery Co. v. Matthews*¹⁵ expressly repudiated and refused to follow the Pennsylvania rule.

All the authorities agree that a bailment or lease of personal property with an option in the lessee or bailee to purchase is not *ipso facto* to be regarded as a conditional sale.¹⁶ However, the facts of a particular case may be such that the court is warranted in holding that such a lease or bailment is merely an attempt to disguise what the parties really intend to be a conditional sale. If the so-called lessee or bailee is bound to pay as "rent" an amount substantially equal to the full purchase price, and if, after payment of the last installment, or upon the exercise of an option to purchase for a purely nominal sum, title is to vest in him, the courts (except for Pennsylvania) uniformly view the agreement to be a conditional sale.¹⁷ Of course, an agreement will not be construed as a conditional sale if the total purchase price far exceeds the rent which the lessee is bound to pay,¹⁸ even though he has the option to purchase the property and apply all prior payments to the purchase price.

And although an agreement provides that the lessee or bailee will pay an amount equal to the full purchase price, and that title will vest in him after the last installment is paid, the agreement will *not* be held to constitute a condi-

¹⁴ Judge Coleman in *In re Rainey*, *supra*, n. 8, termed the Pennsylvania rule "an anomaly in the law". Pennsylvania in 1925 adopted the Uniform Conditional Sales Act, so that conditional sales in Pennsylvania are no longer void as to all third parties. However, the "bailment-lease" device still persists. See *infra*, n. 26.

¹⁵ 57 A. 2d 796, *supra*, n. 1.

¹⁶ WILLISTON, *loc. cit. supra*, n. 12; 6 Am. Jur. (Rev. Ed., 1950), Bailments, Sec. 36, 197-8; 8 C. J. S., Bailments, Sec. 42, 325.

¹⁷ 17 A. L. R. 1435, 43 A. L. R. 1257, and other authorities cited, *supra*, n. 12. See also Commissioner's Note to Sec. 1 of the Uniform Conditional Sales Act, 2 Uniform Laws Ann., 2-4.

¹⁸ See, as examples: *Lambert Engine Co. v. Carmody*, 79 Conn. 419, 65 A. 141 (1906); *Cutler Mail Chute Co. v. Crawford*, 167 App. Div. 246, 152 N. Y. S. 750 (1915); *In re National Engineering and Equipment Co.*, 256 F. 985 (D. C., W. D. Wash., N. D. 1918).

tional sale if he can terminate the transaction at any time by returning the property.¹⁹ The lessee-bailee, in such a "hire-purchase"²⁰ contract, is not really bound to make any payments at all, and the transfer of title to him is not a probable or necessary consequence of the contract.

The great majority of the courts have also held that an agreement in the form of a lease or bailment with an option to purchase is to be construed as a conditional sale if the "rental" is greatly in excess of the fair rental value of the property for the term of the lease.²¹ In such cases, the length of the term, the total purchase price, and the probable "life expectancy" of the property are of especial importance. If the court finds that the lessee will as a matter of sound business practice be virtually compelled to exercise the option to purchase, the transaction will be held to constitute a conditional sale, even though it may not be found that the lessee was bound in the first instance to pay an amount equal or substantially equal to the purchase price.²² In the *Beckwith* case,²³ the Court clearly recognized this principle, and, it is submitted, properly applied it to the facts of the case. Although the sum that the Coal Co. was bound to pay amounted to but 56% of the total price (and was *not* therefore "substantially equal" to the price of the machinery), the Court found that it was nevertheless so much greater than the fair rental value as to practically compel the lessee to exercise his option to purchase the property.

The Uniform Conditional Sales Act,²⁴ (enacted in ten states, but not in Maryland),²⁵ clearly recognizes that certain leases and bailments like those discussed above are nothing more than conditional sales in disguise. In Section One of the Act, a conditional sale is defined as follows:

"In this Act 'Conditional sale' means (1) any contract for the sale of goods under which possession is delivered to the buyer and the property in the goods is to vest in the buyer at a subsequent time upon the payment of part or all of the price, or upon the per-

¹⁹ *Helby v. Matthews*, 1895 A. C. 471; *Southern Music House v. Dusenbury*, 27 S. C. 464, 4 S. E. 60 (1887); *Ludden and Bates Southern Music House v. Hornsby*, 45 S. C. 111, 22 S. E. 781 (1895); *In re Ignelzi*, 48 F. 2d 297 (D. C., W. D. Pa. 1930); *McCall v. Powell*, 64 Ala. 254 (1879).

²⁰ 6 Am. Jur. (Rev. Ed., 1950), Bailments, Sec. 35, 197.

²¹ Authorities cited, *supra*, n. 12.

²² *In re Rainey*, *supra*, n. 8, is a good example.

²³ 57 A. 2d 796, *supra*, n. 1.

²⁴ 2 Uniform Laws Ann., Cond. Sales, 1-2.

²⁵ *Ariz.* (1919), *Del.* (1919), *Ind.* (1935), *N. H.* (1945), *N. J.* (1919), *N. Y.* (1922), *Pa.* (1925), *S. D.* (1919), *W. Va.* (1925), *Wisc.* (1919).

formance of any other condition or the happening of any contingency; or (2) any contract for the bailments or leasing of goods by which the bailee or lessee contracts to pay as compensation a sum substantially equivalent to the value of the goods, and by which it is agreed that the bailee or lessee is bound to become, or has the option of becoming the owner of such goods upon full compliance with the terms of the contract."²⁶

The conditional sales recording statutes in seven other states²⁷ classify, as conditional sales, leases and bailments substantially like those defined in subsection (2) above of the Uniform Act.

In this connection, it might also be noted that the Maryland Retail Installment Sales Act²⁸ includes within its definition of installment sales agreements

“. . . any contract for the bailment or leasing of goods under which the bailee or lessee contracts to pay as compensation a sum substantially equivalent to or in excess of the value of the goods . . .”²⁹

The Beckwith case,³⁰ definitely aligns Maryland with the great weight of judicial authority in this country. Moreover, the decision appears to reach a desirable result from the standpoint of sound public policy. The recording statutes are designed to protect innocent third parties who may justifiably rely on another's apparent ownership of property when the records fail to disclose the true ownership. The conditional vendor, who delivers possession of valuable personal property to another can always protect himself by a prompt recording of the contract. Where the rights of innocent third persons are involved, public policy can best be served by looking to the substance of the agreement, and by refusing to uphold any attempted circumvention of the recording statutes.

²⁶ In Pennsylvania subsection two was omitted for the purpose of preserving the validity of the Pennsylvania "bailment-lease" device as against third parties.

²⁷ Ala., Iowa, Me., Mo., Ohio, Wash., and Wyo.

²⁸ *Supra*, n. 2.

²⁹ *Ibid.*, Sec. 139(b). See also a like definition in Section 151(c) of Article 83 (1947 Supp.).

³⁰ 57 A. 2d 796, *supra*, n. 1.