Troubled Lessors: Implications of Lessor Insolvency on Vendors, Assignees, and Lessees

By Susan G. Rosenthal

As the equipment leasing industry navigates the recent tightening of the credit markets and lenders appear less likely to offer financing to financially troubled lessors, the vendors, lessees, and assignees or purchasers of equipment leases will need to ask themselves just how the insolvency of a lessor might affect them. This article will explore the implications for each of these parties of recent court rulings and suggest possible courses of action both to preserve financial interests and to avoid contentious litigation.

The real fear for a vendor is being unable to collect the purchase price of the equipment sold to a lessor, when the lessor has entered into a lease for that equipment and assigned the lease or its right to collect the lease payments to a third party and then finds that the original lessor has become insolvent or files for bankruptcy. Most vendors do not retain a security interest in the equipment, or if they do, they do not perfect such interest and, in most cases, the obligation to pay the vendor for the equipment is retained by the lessor and not passed on to the lessee.

In the wake of recent court rulings, a lessor's insolvency will have certain effects on other parties. Vendors, assignees, and lessees have various options and strategies to preserve their financial interests and avoid litigation.

A body of case law has developed holding that a vendor generally has no right to collect payments from a lessee of equipment where the lessor has failed to pay the vendor. Some contracts between the lessor and the vendor include a provision that allows the vendor to perfect a security interest in the equipment. However, when a lessor files for bankruptcy protection and such a provision is absent from the contract, courts have held that a vendor's only claim against any party to the leasing transaction would be as a general unsecured creditor of the lessor and against the lessor's bankruptcy estate.[1]

Upstream holders of commercial paper have fears of their own stemming from a lessor's insolvency. One concern is whether the right to collect the lease payments under an assignment or securitization will be enforced by the courts, where a lessor failed to pay a vendor for equipment or sold less-than-perfect merchandise. Assignees' fears have been exacerbated by the NorVergence cases and their offspring. NorVergence, a telecommunications vendor, leased "matrix" boxes to various corporations, claiming that these boxes would reduce telephone, Internet, and wireless communications costs.[2] However, these boxes turned out to be simple routers and were functionally valueless to lessees.

In a myriad of lawsuits, courts sought to bail out fraud victims by allowing them to terminate payment on seemingly valid leases. Clearly, the question of enforceability of hell-or-high-water and waiver-of-defenses provisions that arose from the aggressive positions taken by some of the attorneys general and plaintiffs' attorneys in the NorVergence cases has created a lingering uncertainty for those in the leasing industry. However, the reality is that courts continue to routinely enforce such provisions.

From a lessee's perspective, a lessor's insolvency or its failure to pay for the equipment can lead to lawsuits from vendors seeking payment or, worse yet, a failure of the vendor to continue servicing its equipment or providing required supplies. Often, where a lessor files for bankruptcy, the lessee may be pressured for payment by both the assignee of the lease and the vendor of the equipment. In that situation, it is not surprising that a lessee might decide to stop paying on the lease until a court determines the rights of all the players involved.

While there are many cases involving the respective rights of the parties in a typical equipment leasing transaction—the lessee, the assignee, and the vendor—there are not many reported decisions on how a lessor's insolvency or bankruptcy affects each of the parties.

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VENDORS' RIGHTS

For vendors that are party to a leasing program with a lessor that becomes insolvent or files for bankruptcy, there is a risk that payment for any equipment will not be recoverable. Both the Uniform Commercial Code (UCC) and case law provide that when a lessor fails to pay a vendor and subsequently files for bankruptcy protection, the vendor is left holding the (empty) bag—with only a general unsecured claim against the lessor's bankruptcy estate as its recourse. In a rare opinion discussing a vendor's rights against a bankrupt lessor, the U.S. Bankruptcy Court for the District of New Jersey held that the vendor was left with exactly and only that.[3] First Interregional Advisors Corp. (FIAC) was in the business of financing equipment leases to government entities. Through master agreements with Warnock, a vendor of automobiles, it provided financing to customers of Warnock.

The master agreements between Warnock and FIAC provided that once FIAC received the executed lease, tax documentation, and a purchase order, FIAC would send the documents to Warnock with a vehicle release authorization form outlining the necessary documentation needed before payment would be made. Warnock would then deliver the vehicle to the lessee with a certificate of origin and title to the vehicle listing FIAC as secured creditor. FIAC was then required to wire transfer the purchase price within five days of delivery of the documents, but FIAC often did not make wire transfers for several weeks.

At the time of FIAC's bankruptcy filing, several vehicles had been delivered to lessees by Warnock for which FIAC had not yet made payment. The bankruptcy court held that Warnock took the risk of insolvency when it entered into the master agreements, was not entitled to lease payments from the lessee, and held only an unsecured general claim for breach of contract against the lessor's bankruptcy estate.[4]

In *Wells Fargo v. Levin,*[5] Levin, a Maryland corporation, sold equipment to Terminal Marketing Co., which in turn leased the equipment to Henninger Media Services Inc. Terminal contributed the lease to a special-purpose entity, which pledged the lease to Wells Fargo as trustee for investors under certain securitizations. Terminal subsequently failed to pay its invoice and Levin received an order from a magistrate judge allowing it to garnish lease payments made by Henninger to Wells Fargo. Wells Fargo brought suit in the district court for the Eastern District of Virginia, and the district court granted summary judgment holding that Levin's garnishment of the lease payments was improper. The circuit court affirmed the district court's order in favor of Wells Fargo permitting recovery of garnished lease payments and holding that Wells Fargo was a bona fide purchaser for value which took possession of the lease prior to the vendor's garnishment action.

The legal outcome of the case is correct in that the lessee should be liable only to the assignee of the original lessor and should not have to face double liability because of the failure of the lessor to pay for the equipment. However, the outcome also identifies the practical problems that a lessee often faces when a vendor is not paid, including threatened or actual litigation or the termination of equipment service from the manufacturer of its equipment.

LESSEE'S PERSPECTIVE

For the lessee of equipment under a finance lease, the insolvency of the lessor is never good news. When a

lessor fails to pay a vendor for the equipment and later becomes insolvent or files a bankruptcy petition, the lessee's ultimate fear is being liable for payments to both the assignee of its lease and the unpaid vendor, who may have control over the servicing of the equipment.

Under the UCC and applicable case law, the lessee's obligation to pay the lessor or its assignee is unconditional regardless of whether the lessor paid the vendor. Moreover, if not for the clear lease provisions that require a lessee to pay all costs of litigating where an assignee sues for nonpayment, there would probably be more cases where lessees stop paying for the equipment when a vendor also demands payment.

An extreme example of a lessee's unconditional obligation to make its lease payments is found in *M & I Equipment Finance Co. v. Lewis County Dairy Corp.*,[6] in an opinion by Judge David N. Hurd of the U.S. District Court for the Northern District of New York. The case concerns a lessee's obligation to make payments under a lease in the midst of a dispute between the lessor and the vendor, which erupted even before the subject equipment was manufactured and delivered.

In the case of M&I Equipment Finance Co., the lessor entered into a lease agreement whereby it agreed to finance Lewis County Dairy Co.'s purchase of biological wastewater treatment equipment, with payments to begin immediately and without any condition that M&I actually deliver the equipment to Lewis County. At the time the lease was entered into, the vendor had not yet manufactured the equipment. Several months later, M&I stopped making payments to the vendor when the vendor failed to provide adequate assurance that it would be able to complete the production of the equipment. When Lewis County learned that M&I had stopped making payments to the vendor, it stopped making its lease payments to M&I. M&I had failed to make payment to the vendor, yet, according to the court, it had not breached the terms of the lease.

Despite the fact that Lewis County had received no equipment from M&I, the court ruled that Lewis County was required to make its payments pursuant to the lease agreement. If courts continue to rule in this manner, the ramifications will likely be felt throughout the leasing industry, as potential lessees pursue other options in order to avoid double liability.

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ASSIGNEES' RIGHTS

Lease agreements between lessors and the lessees of equipment customarily include both hell-or-high-water and waiver-of-defenses provisions that provide for (a) an irrevocable "absolute and unconditional" obligation on the part of the lessee to make lease payments and (b) an agreement not to assert any of the defenses, set-offs, or claims against an assignee of the lease payments, which it may have against the original lessor. These clauses create the foundation upon which lessors are able to obtain financing—effectively separating the credit risk of the leases purchased by the assignee from the credit risk of the lessor.

Although these provisions are routinely held enforceable, assignees should continue to plan for and manage the additional risks caused by lessor insolvency, especially after the uncertainty caused by the NorVergence cases. In addition, some of the difficulties an assignee or holder of a securitized pool of leases may face when the original lessor becomes insolvent arise where the original lessor also remains involved in the servicing and collection of payments from the lessees. The automatic stay provisions of the Bankruptcy Code serve to prevent creditors from further depleting a debtor's estate without first seeking court approval. Assignees seeking payment from insolvent lessors are cautioned not to violate these provisions and should seek relief from the stay before attempting to cash checks in the name of or collect money through a bankrupt lessor.

As a practical matter, in addition to requesting legal opinions that neither the leases nor the lease proceeds would be viewed as part of the original lessor's bankruptcy estate under Section 541 of the Bankruptcy Code, assignees of leases can further protect themselves by (a) performing due diligence on the underlying leases and (b) maintaining recourse and replacement guidelines

that will not risk recharacterization of the leases as a secured debt of the original lessor.

A discussion of the risks to assignees of finance leases would not be complete without a further and additional brief mention of how the NorVergence cases may have, in a limited sense, muddied the water with respect to (a) the line between consumer and nonconsumer leases under state consumer protection statutes and (b) the enforceability of hell-or-high-water and waiver-of-defenses clauses in cases of fraud. The Federal Trade Commission and plaintiffs' attorneys in a number of the NorVergence cases took the position that NorVergence's customers (many of them churches, nonprofits, charities, and small businesses looking for savings on high-volume calling plans) should be protected by state consumer protection laws and the Federal Trade Commission Act.[7]

Since the decisions in the NorVergence cases, however, both federal and state courts have routinely enforced hell-or-high-water and waiver-of-defenses clauses, providing some comfort to assignees that these provisions will continue to be enforced in most cases. Fraud, however, remains a viable defense to the payment of leases with hell-or-high-water provisions. For example, in *Eureka Broadband Corp. v. Wentworth Leasing Corp.*, the First Circuit held that the equipment lessor's fraud permitted the lessee to cease making lease payments.[8]

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To operate its fiber-optic installation business, Eureka leased equipment in two separate leasing transactions with Wentworth Leasing Corp. Wentworth agreed to purchase the equipment from CopperCom Inc. and Marconi Communications Inc. and delivered the equipment to Eureka. When Wentworth failed to pay either of the two equipment vendors, they began demanding payments directly from the lessee for the equipment. The lessee struck a deal with the vendor, returning the equipment and paying a certain amount to settle the transaction. After returning the equipment, the lessee sued the lessor for the amounts it paid the lessor on the lease.

The court denied the lessor's counterclaim that the hell-or-high-water provision in the lease entitled it to continued payments under the lease, noting the exception to Article 2A–407[9] allowing a lessee to cancel a lease because of fraud on the part of the lessor.[10] The court also noted that in cases of fraud, the victim is entitled to the remedies for default, including cancellation, under Section 2A–508 of the UCC.

The lesson from NorVergence and its litany of cases is this: the uncertainty in the enforceability of hell-or-high-water provisions, choice of law/forum provisions, and waivers of defenses resulting from the combination of governmental intervention and public outcry can be avoided by practicing minimal prudence in the purchase of lease portfolios to avoid the next potential disaster.

BANKRUPTCIES IN GENERAL

In addition to all of the foregoing, vendors and assignees need to be aware that once a lessor with whom they are dealing goes into bankruptcy, vendors and assignees receiving payments or other assets from the lessor prior to the bankruptcy may find themselves the subject of a preference or other avoidance action. In this situation, the lessor or a trustee for the lessor's bankruptcy estate will seek return of payments made to the vendor or assignee, even though such payments may have been made pursuant to valid and otherwise enforceable agreements.

For assignees, issues may also arise regarding the assignee's rights to lease payments at all. The trustee or debtor may allege that the assignment of the original leases was actually a loan by the assignee to the lessor and not a true sale, or that the assignee's rights were not perfected without filing a financing statement for a payment intangible. For a lessee, a trustee or debtor may attempt to characterize the lease as a true lease and engage in tough negotiations, since the troubled lessor may no longer be concerned about repeat business with a lessee.

Although it is difficult to protect against many of these possibilities or to predict whether these issues will arise, there are ways to avoid many of these headaches, namely, carefully performing due diligence prior to the purchase of lease portfolios, creating strict payment schedules and manners of payment to protect vendors and lessees, and, for assignees, crossing the t's and dot-

ting the i's when documenting a purchase of leases to ensure against recharacterizing the transaction as a loan.

CONCLUSION

To summarize the key points of this article:

- In the event of a lessor bankruptcy, the filing of a proof of claim in bankruptcy may be a vendor's only legal recourse for recovery of payments due for equipment already delivered.
- If a lessor has not breached the lease agreement but the vendor has not supplied products due to the lessor's default, a lessee under the lease agreement may still be liable for lease payments.
- In instances of fraud, a court will be more inclined to allow lessees to terminate lease payments, even where the lease is still valid.
- To ensure the right to lease payments when there is a subsequent lessor bankruptcy, assignees should take care that the purchase of leases is documented as a purchase from the lessor and not as a loan.

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Endnotes

1. See, e.g., *Warnock Automotive Group Inc. v. Goldin (In re First Interregional Advisors Corp.)*, 218 B.R. 722 (Bankr. D.N.J. 1997).

2. See, e.g., *State v. Commerce Commercial Leasing, LLC.*, No. 1D05-2743 (Fla. Dist. Ct. App. – 1st Dist. 2007); see also *Leasing Companies Release Customers from NorVergence Leases*, Jan. 13, 2005. www.consumeraffairs.com/news04/2005/fl_norvergence.html.

3. *Warnock*, 218 B.R. 722.

4. *Id.* at 729–730.

5. 2006 WL 1919174 (4th Cir. 2006).

6. 2007 WL 128879 (N.D.N.Y. 2007).

7. For example, the attorney general of Florida brought suit against for violating the Florida Deceptive and Unfair Trade Practices Act, a statute protecting consumers.

8. 400 F.3d 62 (1st Cir. 2005).

9. Section 2A-407 of the UCC is a codification of the hell-or-high-water clause. It states that in a nonconsumer finance lease, the lessee's promises under the lease contract become irrevocable and independent upon the lessee's acceptance of the goods, and is effective and enforceable between the parties, and by third parties including assignees, and is not subject to cancellation, termination, modification, repudiation, excuse, or substitution without the consent of the party to whom the promise runs.

10. See 2A-407, comment 5 (suggesting that the hell-or-high-water clause is not relevant in cases of fraud).

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