by Stan Goldberg and Steven Karlin

A still-emerging scenario in the equipment-leasing industry arising from the demise of the telecommunications reseller, NorVergence, Inc., may ultimately have legal and practical consequences for the entire banking industry. In particular, the end result of the NorVergence saga may have a bearing upon the reliance by banks upon their holder in due course status in enforcing loans or other commercial paper acquired by assignment. At the very least, the experiences of financial institutions in the companion industry of equipment leasing (one in which many banks operate through affiliates or divisions) should be monitored closely by the banking industry. It may prove instructive on, or serve as a precursor of, legal and regulatory issues affecting the industry. Further, NorVergence may serve notice that state regulatory agencies may be more likely to involve themselves in what have traditionally been private commercial disputes; and that these agencies may use their influence and power to alter the dynamics of the resolution of such disputes.

Not within recent memory has one failed company or the termination of its business had such a negative impact on the equipment leasing industry or caused the level of private litigation and regulatory investigation as has reverberated nationwide since the bankruptcy filing of NorVergence, Inc. in June 2004.

It has long been a basic tenet of the equipment leasing industry that a well-written lease, containing the typical and prevalent "hell or high water" provision is enforceable in a non-consumer lease. Consistent with this principle, the equipment-leasing industry has universally relied upon that contractual provision and the statutory provisions of Section 9-403 of the Uniform Commercial Code (formerly Section 9-206.) This provides that an agreement by an account debtor with an assignor not to assert against the assignee any claims or defenses the account debtor may have against the assignor is enforceable, provided that the assignee takes for value, in good faith and without notice of certain defenses or claims. This latter provision affords an assignee in an equipment lease context rights parallel to those of a "holder in due course" and stands as the legal cornerstone upon which the countless assignments of individual leases, portfolio acquisitions and securitizations proceed in the leasing industry each year.

The NorVergence situation has spawned extensive civil litigation for dozens of prominent leasing companies, many of which are bank-related, which acquired leases originated by NorVergence. Moreover, the practical ramifications of regulatory action have thus far challenged, but not undermined, the basic leasing concept of "hell or high water" as well as the broader precedent regarding enforcement of waiver of defenses' clauses with respect to assignees.

Background on NorVergence

While the conduct and actions of NorVergence, its principals and officers have been vilified by Web sites, disgruntled customers, legal pleadings and regulatory agencies as allegedly fraudulent or in the nature of a "Ponzi" scheme, the fact remains that as yet, none of those allegations have been substantiated in any of the numerous legal forums in which NorVergence-related actions are pending. Significantly, none of the dozens of leasing

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companies embroiled in the NorVergence dilemma have been specifically accused, other than in the broad and conclusory fashion typical of legal pleadings, of wrongdoing themselves or of actual knowledge of fraud or wrongdoing by NorVergence prior to taking assignments of their respective equipment rental agreements. What can be impartially and objectively stated is the following: NorVergence marketed a package of low-cost, long-distance, Internet and cellular services to its customers. In order to deliver the telephone and Internet services, it was allegedly necessary to install a piece of hardware, generically referred to as a "Matrix Box" at the customer's premises. The Matrix Box was rented from NorVergence pursuant to an Equipment Rental Agreement (Rental Agreement) and in many cases, a personal guaranty of the obligations under the Rental Agreement was obtained. Under various scenarios, the individual Rental Agreements were assigned by NorVergence to numerous leasing companies. NorVergence entered into separate agreements with each of its customers regarding the monthly charges for their telecommunication services. Ultimately, NorVergence enrolled in excess of 10,000 business customers in numerous states. In order to deliver the telecommunication services to its customers, NorVergence also entered into relationships with major telecommunication carriers, including Qwest, T-Mobile and Sprint. By the spring of 2004, NorVergence became increasingly unable to pay these vendors, as well as numerous others. On June 30, 2004, an involuntary petition under Chapter 11 of the Bankruptcy Code was filed against NorVergence; on July 14, 2004, the Bankruptcy Court sitting in Newark, New Jersey, converted the involuntary Chapter 11 proceeding into a voluntary Chapter 7 liquidation and a Trustee was appointed. Shortly thereafter, Qwest, T-Mobile and Sprint were authorized by the Bankruptcy Court to terminate T-1 and cellular services to NorVergence customers.

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Following the termination of services, numerous lessees (referred to as "Renters" in the Rental Agreements) refused to make their monthly rental payments for the Matrix Boxes in accordance with their respective Rental Agreements. Upon receipt of late notices and demand letters from the leasing companies, hundreds of lessees and/or their counsel wrote to the leasing companies, NorVergence, the Trustee, the Federal Trade Commission (FTC) and various states' attorneys general (AGs) or other consumer affairs agencies expressing outrage over NorVergence's conduct and claiming that the Rental Agreements were void or otherwise unenforceable. In response to nonpayment, various of the assignees-lessors commenced individual actions in state courts to enforce the Rental Agreements. Moreover, numerous lessees retained private counsel to defend such actions or to commence their own actions to declare the Rental Agreements void and seek damages. In addition, the class action bar solicited potential plaintiffs and the FTC and multiple AGs commenced investigations, issued inquiries or formal subpoenas and, in some cases, commenced their own court actions or sought to intervene in existing actions against the leasing companies.

Although rare in the past, the AGs and the FTC are now frequently joining with small *businesses* in seeking affirmative relief against leasing companies. The AGs and FTC have been arguing, though no decision with any nationwide implications has been rendered, that the small businesses fall under *consumer* protection statutes and regulations. Undoubtedly most, if not all, of the leasing companies will oppose what appears to be an unwarranted interpretation of consumer statutes, but the government resources to carry this battle are substantial. It certainly bears keeping in mind that there are likely to be more attacks upon the free flow of commercial paper and all financial institutions—not just leasing companies—would do well to consider this additional risk when relying on the anticipated unfettered alienability of commercial paper.

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Conclusion

As each day passes, there are practical and procedural developments emanating from the various pending legal actions, each of which has an impact, profound or subtle, on the broad challenge to the leasing industry posed by NorVergence. The NorVergence situation remains dynamic and fluid and carries with it implications for banks and related financial service providers. The banking industry is advised to follow all developments carefully as the ultimate impact of NorVergence has not yet been determined. It is imperative that the banking industry protect and defend the basic principles that it has thrived under, including "holder in due course" status and the safeguard of the enforceability of waiver of defenses clauses by assignees. ▲