NorVergence Calamity:
Challenging "Hell or High Water" and the Enforcement of Assigned Leases

By Stan Goldberg and Steven Karlin

The NorVergence situation has spawned extensive civil litigation for dozens of prominent leasing companies that acquired leases originated by the failed communications company. Moreover, the practical ramifications of regulatory action have thus far challenged, but not undermined, the basic concepts of "hell or high water" and enforcement of waiver of defenses clauses with respect to assignees.

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 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 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), which provides that an agreement by an account debtor (lessee) with an assignor (lessor) not to assert any claims or defenses the lessee may have against the lessor as against the assignee 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 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.

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A Background on NorVergence

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

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 and various state's attorneys general 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 non-payment, many of the assignees-lessors commenced individual actions in state courts to enforce the rental agreements. Moreover, as more fully discussed below, 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 subpoena and, in some cases, commenced their own court actions or sought to intervene in existing actions against the leasing companies.

Multiple Forums, Multiple Strategies

Along with the usual tactics employed by litigating lessees, the sheer enormity of the number of rental agreements involved in the NorVergence bankruptcy proceeding has resulted in litigation strategies seldom, if ever, seen before.

Among the "usual," of course, are defenses of fraudulent inducement, breach of contract and unconscionability interposed by a single lessee-defendant in a lawsuit by a single lessor-plaintiff. These defenses, while ultimately dependent upon the specific facts of each case, are almost always unsuccessful because of, among other things, the protections afforded under the lease-created, or statute-created, "hell or high water" clauses. Similar strategies have been employed by the less common — but no less unusual — pre-emptive

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suit by a single lessee seeking to have a court void its obligations to, or award damages against, the lessor based upon the same defenses, though now couched as affirmative claims.

The more fanciful and creative actions spawned by NorVergence can, however, be generally grouped into four categories.

The first is the mass class action. In this action, exemplified by a case pending in the U.S. District Court of New Jersey, a few plaintiff-lessees have asserted that they are acting on behalf of every single person or entity in the United States that has a NorVergence lease, against every single leasing company that is an assignee of a NorVergence lease, in seeking to void the leases and recover damages for the same reasons generally asserted in the more typical prevalent pre-emptive suit. While this action poses less financial risk for each potential plaintiff and a much greater financial reward for the attorneys for the "class" (as compared to attorney fees in a single pre-emptive suit by a plaintiff), it suffers the same infirmities as the pre-emptive suit regarding the merits of the claims. Further, it is doubtful it can stand on its own as a "class action." Indeed, to date this mass class action has not been certified as a class and the district court judge, in formally denying the request of this "class" for an injunction preventing the leasing companies from seeking to enforce the leases against lessees in other courts, expressed significant doubts as to whether a class action is an appropriate vehicle.

The second type of action is the "single defendant class action" in which a lessee under a lease assigned to a single leasing company proposes to represent a class of plaintiffs whose leases were also assigned to that single defendant leasing company. This action too has the same difficulty on the merits as the mass class action. And although it may ultimately have a better chance of being certified as a class action because it entails claims against a single defendant, the very nature of the claims — such as fraudulent inducement — lend themselves to individual adjudication, rather than class actions.

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In an attempt to avoid class certification issues, at least one law firm has apparently obtained hundreds — if not thousands — of individual plaintiffs as clients and brought mass lawsuits on behalf of hundreds of individually, named plaintiffs against each individual leasing company. While avoiding the class certification quandary, these individual mass actions may eventually be severed by the courts into hundreds of separate actions by individual plaintiff-lessees, thus placing them in the same posture as the single pre-emptive suits previously described.

Finally, the NorVergence bankruptcy has brought forth numerous actions by the attorneys general of several states. These are probably the actions of greatest concern to the leasing industry. This is not because the AGs have better facts or claims under the law; they don't. But the AGs are not constrained by litigation budgets and, often, are motivated by an internal agenda to champion the rights of the "consumer" against perceived offending business or financial institutions.[1] Thus, the AGs appear to be seeking not only relief under the NorVergence leases but to effect a fundamental change in the way leasing companies operate in the future.

The AGs are, in essence, seeking to change laws governing lease financing, not through elected representatives of the state legislatures, but by the threat of costly and protracted — even if unwarranted and legally unsupported — litigation.

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 the leasing industry is advised to follow all developments carefully as the ultimate impact of NorVergence has not yet been determined. It is imperative that the leasing industry protect and defend the basic principles that it has thrived under, including "hell or high water" provisions and the safeguard of waiver of defenses remaining enforceable by assignees. ■

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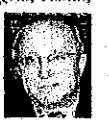

ENDNOTES:

1 The equipment leasing industry accurately and steadfastly maintains that the rental agreements are not "consumer" leases since the Motor Rates are clearly intended for business usage and since, among other factors, the form rental agreement states clearly on its face that the lessee agrees that the equipment "...will not be used for personal, family or household purposes." Nonetheless, the AGs and private plaintiffs contend otherwise.