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Legal Issues Pertaining to Taking Assignment of Bundled Contracts From Equipment Vendors – And Suggested Changes in Practices

By Bob Ihne

Introduction

Vendors ("V") of equipment often enter into agreements with their customers ("C") for the customers' use of that equipment over a period of time. The type of agreement can be a simple lease in which C is paying only for the use of the equipment or an agreement (sometimes containing the word "lease" in the title and sometimes not) for the use of the equipment that also includes the provision of services, supplies and/or other obligations) (collectively, "services") to be provided by V such as for maintenance of the equipment – a "bundled contract". In many cases, these bundled contracts do not disclose to C the break-down between that portion of the periodic rental payment attributable to the use of the equipment and that portion attributable to the cost of services by V.

In order to finance such agreements, V may enter into a relationship with a finance company ("FC") according to which FC will pay V in return for taking assignment of the rights (but not obligations) under the agreement – which often, though not necessarily, includes a purchase of the equipment along with an assignment of the payment stream due from C.

In most cases, FC is paying V only for the equipment and that part of the payment stream that is for the use of the equipment – not the part of the payment stream compensating V for its services. In such cases, FC often collects (in the name of V if the arrangement is to be non-notification to C – i.e., "private label") the entire amount paid by C and then remits the service portion to V.

Perfection of FC's Assignment from V

If the agreement that FC is purchasing from V were a simple lease agreement, there would be two ways to perfect that assignment (protecting FC against competing creditors of V or a trustee in V's bankruptcy). Because a simple written lease is "chattel paper" under the UCC, FC can perfect either by taking possession of the lease (the best way to perfect – providing more protection against competing creditors) and also by filing against V (which at least protects against a trustee in bankruptcy).

A bundled contract, however, includes payments not only for the lease of equipment, but also for the provision of services. It is not entirely clear that such an agreement qualifies as chattel paper under the UCC. While there is a reasonable argument that it does qualify – based on an analogy with the explicit permission given in the UCC for encompassing within the definition of "chattel paper" leases that include not only equipment but also the software used in the equipment – it can also reasonably be argued that a mixture of services and equipment turns the contract into something else – perhaps an account or some combination of chattel paper and an account.

If a bundled agreement is not chattel paper, the only way to perfect an assignment would be to file against V – e.g., by using the names of the agreements being assigned as the collateral and perhaps adding " whether such agreements may qualify as chattel paper, accounts or some combination of both under the UCC." If FC is only taking possession of the agreements and not making such a filing, a trustee in bankruptcy for V could argue that FC had not perfected its interest and thus that any remaining payments under such agreements should flow into the bankruptcy rather than to FC. There is also a risk that FC will not have priority over competing secured creditors with security interests in V's agreements and accounts unless FC does a UCC search (and obtains any necessary subordinations) on V before beginning to finance.

Legal Consequences of V Being the Supplier of the Equipment and/or Services

Many forms of lease on which V is the lessor/owner contain the same kind of "hell or high water" language and/or Article 2A finance lease provisions that are commonly found on lease forms where FC is the lessor. The hope, evidently, is that C will have no choice but to keep making its payments notwithstanding any unhappiness it may have with the equipment or with V's services, if those are included with the lease payments as well.

Notwithstanding such a hope, Article 2A states that a lease will not qualify as a statutory finance lease (under which the lessee has an irrevocable obligation to make all payments) if the lessor is the supplier of the equipment. To the extent that a lease including services to be provided by the lessor is governed by Article 2A, this is even more true.

Article 2A's provisions regarding finance leases were written to codify the idea that if the lessor is merely a financing source (i.e., playing the same role as a bank in making a loan so that a customer can obtain the use of equipment) it should be entitled to receive a lessee's "hell or high water" obligation to make all payments. Even though Article 2A indicates that such an obligation may be created under a lease that does not qualify as a statutory finance lease in all respects, it seems doubtful that a court would enforce such unconditional obligations in favor of a lessor that is actually supplying the equipment – and even less likely to enforce such obligations where the lessor is also supplying services.

The extent to which some lease forms with V as the lessor go to achieve "hell or high water" status can be comical. Some of these forms list V as both the lessor and the supplier of the equipment, but also contain the statement (probably taken from forms in which the lessor is only a financing source) that the lessor is not an agent of the supplier – as if the same entity could wear two hats and take advantage of all the rights of a finance lessor while also supplying equipment and/or services.

The bottom line is that such "hell or high water" and Article 2A finance lease provisions cannot be relied upon to legally force C to make all payments to V regardless of how unhappy it is with the equipment and/or services supplied by V. To the extent FC, as an assignee of such an agreement, attempts to rely on such provisions, courts may be less likely to entertain better arguments FC may have (e.g., as set forth in the next section) to get paid.

Problems in Relying on a Waiver of Defenses Provision – Especially in View of Non-Disclosure of Apportionment Between Payment Components and Non-Disclosure of Assignment to a Finance Company

When taking assignment from V of a simple lease (or installment sale agreement), if that document contains a waiver of defenses by C, FC is in a very good position to collect all payments owing under that document – as long as FC has taken the assignment in good faith, for value, and without knowledge of defenses that C may have to making all payments. C has agreed that if V's rights are assigned, C will not assert against FC any defenses – such as its unhappiness with the equipment being leased or sold by V – it may have against V to making its payments under the agreement.

Such clauses have long been enforced by courts – but primarily in the context of simple leases or sales of equipment. Of course, unhappy C's may claim that FC did not take the assignment in good faith and without knowledge of defenses (e.g., that FC is somehow an agent of V), but unless C can supply some credible evidence, in many cases FC has been able to win summary judgment motions to collect all payments. On the other hand, some courts have been willing to deny FC summary judgment and require further proceedings to investigate C's various allegations [see the case summaries referenced below].

The application of waiver of defense clauses, however, has not been well tested in the context of bundled agreements involving services. Consider first an agreement for nothing but services (i.e., a simple service contract not involving the sale or lease of equipment) that contains a waiver of defenses. It is not at all clear that if C – as an "account debtor" that has signed a contract containing such a waiver – stops receiving services from V, FC would entitled to collect all payments owing under that contract after the cessation of services by V. On the one hand, the definition of "account" in the UCC includes a monetary obligation for services performed or *to be performed*. Since waivers of defenses apply to such an obligation, FC could attempt to argue that even if C will not be receiving the services it bargained for, since it agreed to waive defenses against V, it must continue to pay FC. On the other hand, it seems likely that many (if not most) courts would find some way around that argument to conclude that the waiver is not enforceable in such a context. Forcing C to continue paying FC when it is receiving no services from V seems materially different than forcing C to continue paying FC even though it is unhappy with the equipment it is leasing (or has purchased) from V. It could be argued, for example, that C simply has no obligation to make a payment if it has not received the service corresponding to that obligation – and therefore there is no obligation for FC as assignee to collect.

If FC has not ventured to take assignment of pure service contracts or even to finance the entire payment under bundled contracts – i.e., FC has only purchased the right to the equipment lease portion of a bundled contract (leaving the service portion to V) – FC appears to be in a safer position. If C is not happy with the service it is receiving from V or is not receiving V's services at all, FC can stop invoicing C for the entire amount and begin collecting only the equipment lease portion of the payments. This may enable FC to prevail against C if C were to cease making any payments on its bundled lease, but it is not clear that all courts will agree. The case summaries below, for example, illustrate that C's have had some success in avoiding summary judgment by alleging that there was an agency relationship between either FC or the original lessor and the provider of promised services such that FC or the original lessor did not deserve to collect all of the remaining payments it was requesting.

To the extent that courts are sympathetic with C's that are receiving no more service, those courts might be tempted to adopt a point of view that C was buying into an inseparable mixed bag of equipment and services when C decided to enter into the bundled contract with V. If V's failure to provide services means that C is effectively unable to use the equipment (which could be the case unless FC is able to find a substitute servicer promptly), some courts may be tempted to ignore FC's claims to receive that portion of the future payments relating to equipment use. Such a sympathetic attitude in favor of C is only made more likely by facts such as (i) the agreement does not break down the equipment use and servicing components of the payments to be made by C, (ii) C had no idea that FC had been assigned a portion of the payments (i.e., the arrangement was non-notification to C), or (iii) unlike a simple lease, the charges payable under some agreements increase each year (all of the increases being payable to V under the program with FC – an arrangement likewise unknown to C). With FC's role being effectively hidden from a bewildered C, courts might not be as likely to consider FC's legal arguments as compared with the sympathies in respect of C's inability to use its equipment while having FC demand all payments that FC claims are owed to it under FC's program with V. Since FC clearly understood these possibilities when it entered into its arrangement with V, C's claims of FC's lack of good faith and knowledge of defenses may sound more plausible to a court.

Cases

Attached as Schedule A are summaries of relatively recent cases that illustrate a variety of issues (which are highlighted within the summaries) that have caused difficulties when finance companies have attempted to collect payments from equipment users when those users are also receiving services from a third party related to that equipment. The structure of the transactions discussed in these cases are not necessarily the structure discussed above – i.e., an assignment of a bundled service contract by a vendor to the finance company. But the issues raised are all issues that could arise in the context of such a structure.

For instance, equipment users will often assert that the finance company is in some way an agent of the service provider (or the service provider is an agent of the finance company) such that the failure of the service provider (whether due to its fraudulent conduct or simply inability to provide the service) should disentitle the finance company from collecting payments under the equipment financing agreement. Sorting through a relationship between a finance company and

a vendor providing services to determine whether the finance company has "clean hands" and should be entitled to collect is often something that courts are unwilling to do on a summary judgment motion.

Other cases illustrate that equipment vendors who have the initial (or only) contact with the customer when the deal is being originated may either (i) mislead the customer regarding the services to be provided or the relationship between the services and the equipment financing or (ii) have the customer sign documents of which the finance company is unaware. Or, even if the finance company is aware of the existence of other documents (such as a separate service contract), the court may be unsure whether the financing document should be read together with the other vendor document.

Even the listed case that appears most favorable – De Lage Landen Financial Services, Inc. v. Rasa Floors – is not exactly on point with the topic of this article inasmuch as it involves a "hell or high water" lease entered into by the finance company *directly* with the customer, rather than a purported "hell and high water" lease with a waiver of defenses entered into by the vendor with the customer before being assigned (often on a non-notification basis) to the finance company. The customer knew of the separate existence and nature of the finance company as distinguished from the services to be provided. It is also possible that the customer could have raised (but did not in this particular case) more issues concerning the relationship between the finance company and the service providers such that this or another court would have been less willing to grant summary judgment.

Some Recommendations

Realizing that not all V's may agree with everything that FC believes will put FC in the best position, the foregoing discussion indicates that certain changes would be advisable in lease forms with bundled services to be assigned by V's to FC's.

First of all, it makes little legal sense – and may only prejudice the courts – to pretend that V is entitled to "hell or high water" or Article 2A finance lease treatment with respect to C's obligations. V is entitled to disclaim as many warranties as is legally acceptable and as the market will permit, but most courts will not treat V as if it were a finance company whose only role is to finance the use of the equipment. **Therefore, many of these provisions should be eliminated.**

FC's main reliance after being assigned a bundled lease must be on the waiver of defenses provision. To best ensure that FC has a chance of enforcing this with respect to collecting the payments that FC has financed, this provision should be (1) made conspicuous enough so that C cannot argue that the provision was in some way "buried" in the document, and (2) drafted to explain very clearly what FC's role is as contrasted with V's, so that C has less of a chance of convincing a court that more facts are required to be discovered following FC's summary judgment motion. Something like the following, made conspicuous in some manner such as italics or bold face print, could be employed (with V being identified in the lease as "Lessor" and C as "Lessee"):

Lessor may assign its interests in the Equipment and that portion of the rental payments owing hereunder related to the use of the Equipment (but not including the portion related to Lessor's servicing of the Equipment) to a financing source ("Assignee") without either notice to or consent of Lessee. **[If the vendor does not object, it would be best also to include the following disclosure in some manner:** ***The amount of each rental payment attributable to use of the Equipment being assigned to Assignee is equal to $ ____.]*** ***Assignee is not an agent of Lessor and Lessor is not an agent of Assignee. Lessee agrees that Assignee shall have all of the rights but none of the obligations of Lessor hereunder including, without limitation, any obligations with respect to either warranties concerning the Equipment and/or the servicing and maintenance of the Equipment. Lessee further agrees to waive as against Assignee any defenses which it might have against Lessor to making all payments hereunder with respect to Lessee's use of the Equipment.***

V's may need to be educated as the reasons for these recommended changes, but once so educated, they should have few justifiable objections to them.

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SCHEDULE A – CASES

Simington v. Lease Finance Group, LLC, 2012 WL 651130 (U.S.Dist.Ct. S.D.N.Y. Feb. 28, 2012)

A pair of small businesses brought a class action suit against a group of defendants in the business of processing electronic payments (for credit and debit cards) which involved the leasing of electronic point-of-sale equipment by plaintiffs. At this early stage in the suit, the court grants some of the defendants' motions to dismiss certain of the plaintiffs' claims but denies other defendant motions with regard to other plaintiff claims. While not at the stage where the court might have discussed lessor/defendant arguments based on "hell or high water" leases, **the case illustrates examples of purported outrageous conduct by the defendants such as, for example, hiding most of the provisions on relatively expensive leases for inexpensive equipment which plaintiffs were talked into signing in return for unfulfilled promises of huge savings on the costs of the payment processing services.**

De Lage Landen Financial Services, Inc. v. Rasa Floors, LP, 792 F.Supp.2d 812 (E.D.Pa. 2011)

A lessor entered into lease agreements with two lessees in connection with a program operated by certain vendors (Capital 4 and 3Com) who offered customers telephone and internet services requiring networking and telephone equipment, the financing of which took the form of the subject lease agreements. After the service provider failed, the lessees ceased making lease payments and the lessor filed suit. This court grants summary judgment in favor of the lessor – both on it claims against the lessees and on the counterclaims asserted by the lessees. The lease agreements made clear that although the rental payments might include the cost of services being provided (which the lessor would forward to the service provider) in addition to the amount for equipment rental, the lessor was not responsible for providing the services or maintaining the equipment. **The court notes that after the failure of the service provider, the lessor decreased the amount of the rental payments to eliminate the portion for the services. The decision strongly supports the enforceability of lease provisions placing a "hell or high water" obligation on lessees to make all payments (both under Article 2A and under contract law), and finds no evidence that the lessor was in any agency relationship with the vendors such that alleged fraudulent conduct on their part could be attributed to the lessor.**

Artists & Framers, Inc. v. Lease Finance Group, LLC, 2011 WL 345883 (U.S.Dist. Ct. D.Md. Feb.2, 2011)(slip copy)

This decision denies a lessor's motion to dismiss a lessee's suit claiming that the lessee had no obligation to make payments under what was stated to be a non-cancellable lease. **The court is clearly sympathetic to the lessee's claims that an alleged agent for the lessor grossly misled the lessee regarding the nature – in particular, the possibility of cancellation – of a possibly illegible lease of equipment for processing credit cards. The lessee's allegations, if ultimately proven to be true, provide an example of how lessors ought not to induce customers to sign leases.**

Gaia Leasing LLC v. Wendelta, Inc., 2010 WL 5421324 (U.S. Dist Ct. D.Minn. Dec. 23, 2010)

This case should motivate the assignees of equipment lessors to be sure they obtain and understand all of the documents related to the lease transaction being assigned. Although the lease in this case was not an Article 2A finance lease (the lessor had supplied

the goods), it did contain a waiver of defenses (which the court confusingly refers to as a "hell-or-high water" clause). Nevertheless, the transaction also included a document called the Condition Precedent – the satisfaction of which was to be the trigger for the lessee's obligations to the lessor. Since the lessor was not able to satisfy the terms of the Condition Precedent, the lessee was never obligated to begin making payments under the lease to the assignee, against whom the court grants summary judgment.

Faust Printing, Inc. v. Man Capital Corp., 2009 WL 5210847 (U.S.Dist.Ct. N.D.Ill. December 23, 2009)

After the lessee executed a lease with a financing company affiliate of a manufacturer of printing presses (there apparently was some confusion on the part of the lessee as to which company was to sign the lease as lessor) and received a printing press that allegedly did not function as expected, the lessee brought a fraud action against both the manufacturer and its finance company claiming that it had been fraudulently induced to sign the lease with representations that the lessee would have recourse against the manufacturer in the event of problems with the press. This court denies a summary judgment motion by the defendants, which motion argued that the hell or high water clause in the lease precluded a fraudulent inducement claim. Without any explanation, the court mentions a previous summary judgment opinion holding that the hell or high water clause was preceded by "ambiguous" language. In the "Net Lease" language quoted in the opinion, the only such language seems to be "Except as otherwise specifically provided herein or in any Schedule hereto," but the court fails to point to any provision elsewhere which might modify the lessee's absolute and unconditional obligations.

De Lage Landen Financial Services, Inc. v. Viewpoint Computer Animation, Inc., 2009 WL 678635 (U.S.Dist.Ct. E.D.Pa. March 11, 2009) and 2009 WL 902365 (U.S.Dist.Ct. E.D.Pa. April 1, 2009)

These two cases (the later of which does not involve the lessor/plaintiff directly) illustrate issues that can arise when a lessor becomes part of a program involving not only the leasing of equipment, but also the provision of services by third parties. Notwithstanding a rental agreement that clearly disclaimed responsibility on the part of the lessor for the performance of services related to the equipment being leased, the court refuses to decide many of the legal issues facing the lessor without further factual investigation regarding the lessor's role in the program and the possible connection of other program documents (to which the lessor was not a party) to the rental agreement. The customer had signed the rental agreement as part of a program devised by the service provider (with help from the equipment manufacturer) to enable the customer to achieve promised substantial savings on its telephone and internet costs. When the service provider became insolvent and stopped providing those services, the customer stopped making payments on the rental agreement, claiming that it had a right to do so under its agreement with the service provider and claiming that the lessor was part of a conspiracy to commit fraud on it and other similarly situated customers. Indicating, among other things, that it could not determine yet what law to apply (the rental agreement was to be governed by Pennsylvania law while the customer's agreement with the service provider was to be governed by Texas law), the court states, "…**this Court cannot conclude at this stage without discovery whether the [a]greements should be construed together and therefore which law should apply."**

IFC Credit Corp. v. Burton Industries, Inc., 536 F.3d 610 (7th Cir. 2008)

A NorVergence lessee had signed both NorVergence's standard Equipment Rental Agreement as well as another NorVergence-generated document entitled "Hardware Application." **Notwithstanding the lease's provisions for "hell or high water" payment obligations, a waiver of defenses in favor of assignees, and – of special relevance to this decision – a merger clause stating that the lease terms were the complete and exclusive statement of the agreement and that terms not contained in the lease would not be legally enforced, the Seventh Circuit found that the Hardware Application's provision that the lease was not binding until the equipment was installed was applicable (as a contemporaneous written document whose admission into evidence did not violate Illinois's parol evidence rule) to the facts of this case.** Although the equipment was delivered and the lessee signed a delivery and acceptance receipt, since the equipment was never installed, the lease was held never to have existed, leaving the assignee with no legal right to collect. **Whether or not the facts of this case are common to other NorVergence lease situations, this ruling should give pause to any assignee of any well-drafted lease which has not somehow assured itself that the lessee had not signed some other document simultaneously that could call into question the existence of the lease.**

National City Commerce Capital Corp. v. Blackledge Country Club, Inc., 2008 WL 2797010 (Conn.Super. June 25, 2008)(unpublished opinion)

This brief denial of a lessor's motion for summary judgment illustrates the potential difficulty of enforcing even a "hell or high water" lease when there exists a service agreement to be fulfilled by other parties that is necessary for the proper functioning of the equipment. Although the facts are not entirely clear, the lessor may have taken this lease of GPS equipment to be used at the defendant's golf course by assignment from a company who had relations with other companies responsible for installing and servicing the equipment. **The court denied the lessor's summary judgment motion before a factual examination of the defendant's claims concerning the purported agency relationship between the plaintiff and parties that were alleged to have improperly serviced the equipment and/or alleged to have improperly induced the defendant to sign the lease.**

IFC Credit Corporation v. Specialty Optical Systems, Inc., 252 S.W.3d 761 (Tex.App. 2008)

Although vacating a trial court's order of sanctions (including ordering that letters regarding the assignee's agreements with NorVergence be sent to all other NorVergence lessees against which the assignee had made claims) against this NorVergence assignee, this appellate court affirms the trial court's holdings that (i) the lessee had been fraudulently induced by NorVergence into signing its lease (when NorVergence falsely promised to see that a contract with a competing telecommunications provider would be cancelled before countersigning the lease) – making the lease unenforceable (presumably by NorVergence in particular, though the decision does not make this clear) – and (ii) **IFC was not entitled to holder in due course status with regard to enforcing the lease's waiver of defenses provision because it was aware that, among other things, NorVergence was promising lessees savings in connection with its leases with no intent to deliver.**

IFC Credit Corporation v. Century Realty Funds, Inc., 2006 WL 435695 (U.S.Dist.Ct. M.D.Fla. February 21, 2006)

In a case brought by an assignee of a NorVergence lease, which case had been transferred from a District Court in Illinois (where it had been initially brought by the assignee) to Florida (the defendant's principal place of business), **this court denies the plaintiff's motions to dismiss defendant's counterclaims and to strike defendant's affirmative defenses by stating that all the defendant needed to do was plead a claim for fraud and/or fraudulent misrepresentation under the applicable law. It is not clear whether the court's conclusions rely on the defendant's claims of assignee participation in the fraud or whether allegations of ab initio illegality of the contract as fraudulently induced only by the original lessor would have been sufficient.**

Copelco Capital, Inc. v. Johnson, 2004 WL 1559652 (Cal.App. 2 Dist. July 13, 2004) (not officially published)

Summary judgment in favor of an assignee of a lease of a copier is upheld based upon the "hell or high water" and waiver of defenses provisions found in the lease, notwithstanding the failure of the original lessor to service the copier as required by the lease. **The court commented that the assignee had not sought to collect payment of amounts due on the maintenance agreement, though it was not made clear whether or how the lease distinguished between payments for maintenance and those strictly for the use of the equipment.**

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