

NorVergence Trustee Looks to Lessors for Damages for Failing to Kick the Tires and Look Under the Hood

By Irwin M. Wittlin



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Much has been written about NorVergence since it filed for bankruptcy protection in 2004. The NorVergence saga has spurred litigation by the Federal Trade Commission, drawn the attention of numerous state attorney general offices, and caused the filing of numerous civil lawsuits, including a class action lawsuit by NorVergence leasees. The majority of this litigation focused on the enforcement of the NorVergence Equipment Rental Agreements ("ERA" or "NorVergence leases"). However, this latest adversary action, now seeks extraordinary damages from lessors, accusing the industry of ignoring red flags.

In July, 2006, the Chapter 7 trustee for the estate of NorVergence filed an adversary action against 26 leasing companies/banks seeking in range of \$100 million in actual and punitive damages based upon various theories, including that the leasing companies knew or should have known of the ongoing scam, and upon an emerging theory known as "Deepening Insolvency". "Deepening Insolvency" is a tort governed by state law, meaning that each state is free to make its own determinations. The different court interpretations to date demonstrate its difficulty in application; with differing opinions on whether the tort even exists, who are potential defendants, and what the plaintiff must establish to prevail. But, this attempted expansion against leasing companies, whether or not successful, presents a warning to all those in the leasing industry that it is being looked to as a watchdog for fraud.

Trustee's Allegations Against NorVergence

The trustee's complaint specifically alleges that NorVergence sold telecommunications targeting unsophisticated small businesses. NorVergence staff used formulaic sales scripts, which included statements known to be false, in soliciting new customers to buy the NorVergence package, primarily the "Matrix Box". NorVergence falsely represented that the Matrix Box was a high tech device that would produce great cost saving and eliminate permanent charges on calls, when in reality the Matrix Box was primarily a router, purchased for \$1,278.00 each, which still required an ultimate wholesale carrier. NorVergence represented that the savings would continue even if NorVergence went out of existence, which was false as it was necessary for NorVergence to reimburse the carriers for per minute charges; otherwise, all custom service would cease. NorVergence leased these boxes for up to \$100,000.00.

The lease terms were based upon the lessee's existing fee structure for internet and voice usage. Customers were told that NorVergence would engineer a solution through a "webulator" in its engineering department. NorVergence actually simply applied a discount of 20-30% of the potential customer's current costs. NorVergence's solution would split the customer's invoices into two separate bills; one, a service contract for telecommunications charges and, two, a sixty (60) month lease. Approximately 80% of the overall cost was put into the lease. The lease was promptly transferred to a leasing company.

At its peak the service contracts were generating revenue of \$2.5 million per month with provider bills necessary to deliver the service of approximately \$4.4 million. Total monthly expenses were \$18.5 million. This cash flow shortage was solved by use of the cash flow from the sale of the leases. Thus, the trustee concluded that NorVergence's business plan was doomed to failure from the outset as:

(1) NorVergence was selling unlimited telecommunication services at a fixed rate when it was actually liable on a per minute

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Welcome to Lease Enforcement Analysis & News

LEAN, the only national network of law firms dedicated to providing collection, enforcement and recovery services for leasing companies, welcomes you to the inaugural issue of Lease Enforcement Analysis & News. This quarterly newsletter is provided free of charge to leasing professionals engaged in the legal, credit, collections and operations aspects of leasing firms. LEAN consists of experienced attorneys who assist leasing companies and lease funding entities. What sets LEAN law firms apart is that in addition to being experts in the enforcement of lease obligations including collections, asset recovery, and bankruptcy representation, LEAN members know leasing.

Each issue of the newsletter will feature an article that gives you practical tactics and tips about collection, bankruptcy or other lease enforcement issues. In addition, we will provide a calendar of events of interest to the leasing community. Updates about LEAN members and a useful directory of LEAN law firms are included.

We are anxious to receive your feedback. Visit the LEAN website at www.leasecollect.org or complete the response form on the back of this newsletter to receive your complimentary unique LEAN coffee mug.

You can refer to the enclosed directory to find a LEAN attorney to assist you anywhere in the United States or use our searchable database on the LEAN web site at www.leasecollect.org. Contact LEAN directly by email at info@leasecollect.org or by calling its toll free number at 877-LEASELAW or 877-532-7352.

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toll basis that greatly exceeded that fixed amount; and

(2) NorVergence had promised the lessee by term (i.e., 5 years) service without long term contracts or the financial ability to provide the promised service.

The trustee alleged NorVergence's balance sheet reflected the following level of insolvency:

<u>Date</u>	<u>Insolvency (Mil)</u>
6/30/2002	3.0
6/30/2003	33.3
3/31/2004	134.3

Trustee's Allegations Against Leasing Companies

The trustee contends that based upon the information within its knowledge the leasing companies "knew or should have known" of the fraud in October, 2003.

A leasing company would enter into a Master Program Agreement ("MPA") with NorVergence establishing a program of non recourse lease assignments subject to repurchase for first payment defaults. The trustee draws adverse inferences from the following:

- (1) the MPA precluded the lease company from communicating with the lessee prior to lease assignment;
- (2) the leasing companies took no response to the significant divergence in the lease terms for the Matrix Box, which the trustee views as putting the leasing companies on notice of the fraudulent activity and
- (3) beginning in October, 2003, the

number of first payment defaults and customer complaints began to increase dramatically. Rather than refusing to fund future leases as the trustee claims would have been a more appropriate response, certain lease companies negotiated more favorable repurchase obligations and hold back provisions, while continuing to fund future leases.

The adversary action also alleged that the Attorney General's Office from 26 states and for the District of Columbia brought action or, otherwise challenged the conduct of the leasing companies, which the majority of the leasing companies settled by waiving all or a major portion of their claim¹.

The Leasing companies are accused of enabling the NorVergence scheme to continue, allowing insiders and key employees to take millions of dollars out of the business to support lavish lifestyles.

The Adversary Complaint asserted various claims against the lessors, including a claim for "Deepening Insolvency."

The Tort of "Deepening Insolvency".

The most astute judicial comment on this tort comes from the Ninth Circuit, which very recently stated "We need not make any general pronouncements on the "Deepening Insolvency" theory, not least because it is difficult to grasp exactly what the theory entails.² There is no clear definition nor specific elements which constitute the tort of "Deepening Insolvency".³

"Deepening Insolvency" is a tort belonging to a corporation against a third party for conduct that deepens the

insolvency on an already insolvent company. The potentially culpable third parties include corporate insiders, professionals providing services, and lenders, such as lessors. The damage to the corporation is ending up in an even worse position by being further insolvent than before the tortious conduct.

This theory had its infancy in language in a 1980 court opinion, which led to Lafferty, a 2001 landmark decision from the Third Circuit interpreting Pennsylvania law as recognizing "Deepening Insolvency" as a viable tort.⁴ The court justified its affirmation of "Deepening Insolvency" on the necessity of remedying certain harms, and focused on two specific harms: (1) the harms associated with causing a corporation to petition for bankruptcy, thereby inflicting legal and administrative costs on the corporation, as well as undermining the corporation's relationships with its customers, suppliers and employees; and (2) the dissipation of corporate assets arising from not dissolving the corporation in a timely manner."

Other courts have also recognized this cause of action,⁵ with differing standards needed to be shown by the plaintiff. A 2004 New York opinion defined "Deepening Insolvency" as a fraudulent prolongation of the corporate life beyond insolvency. It found a lender was not liable for "Deepening Insolvency" merely because it made a bad loan to a troubled company. The court required a further showing that defendant, which prolonged the company's life breached a separate duty, or committed an actionable tort contributing to the continued operation of the corporation and its increased debt⁶. Other courts have imposed

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LEAN Members In The News

Matthew J. Richburg of Kohn Law Firm in Milwaukee, Wisc. was recently certified as a Creditors' Rights Specialist by the American Board of Certification. Mr. Richburg is the Senior Associate and Litigation Manager at the law firm. He can be reached at 800.451.1791 or mattr@kohnlaw.com.

Robert S. Bernstein of the Pittsburgh, Penn. based **Bernstein Law Firm** was named Pennsylvania Super Lawyer for the third year in a row. The designation is awarded to the top 5% of Pennsylvania lawyers. **Kirk B. Burkley**, a partner in the firm was named a Pennsylvania Rising Star by Philadelphia Magazine. Only 2.5% of Pennsylvania attorneys are honored with this designation. Bob and Kirk can be reached at 412.456.8100 or through the firm's Web site- www.bernsteinlaw.com.

Hemar, Rousso & Heald LLP of Los Angeles, Calif., announces the addition of four new associates: **Paul N. Andonian, Ninette**

R. Wasseff, Meighan A. McHugh Rowe and David Hadek.

The firm's phone is 818.501.3800 and the Web site is www.hemarrousso.com.

Steven L. Higgs of **Steven L. Higgs, P.C.** located in Roanoke, Va. has been named a Virginia "Super Lawyer" in the area of General Litigation. Only 5% of Virginia attorneys are selected as Super Lawyers. His e-mail is higgs@higgslawfirm.com and his Web site is www.higgslawfirm.com. He can be reached by phone at 540.400.7991.

Jay Welford of the Southfield, Mich. office of **Jaffe Raitt Heuer & Weiss PC** was appointed to the legal committee of the Equipment Leasing Association. Jay can be reached at 248.351.3000 or jwelford@jaffelaw.com.

Robert S. Bernstein of the Pittsburgh, Penn. based **Bernstein Law Firm** was elected President of the American Board of Certification ("ABC"). Bob can be reached at 412.456.8101 or by e-mail at rbernstein@bernsteinlaw.com. The firm's Web site is www.bernsteinlaw.com.

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a more plaintiff friendly standard of negligence, such as in a New Jersey case, where the NorVergence adversary proceeding is pending.⁷

Predicting the legal ruling in this matter will be difficult given the uncertainties in this body of law, notwithstanding the extreme nature of the claims. Does the trustee truly believe that the leasing companies funded these transactions, knowingly participating in a Ponzi scheme? The more important lesson to the industry is that the risk of this potential liability and the need to be prepared to defend against similar future claims is upon us.

In Pari Delicto-A Viable Defense to “Deepening Insolvency”?

A lessor sued on a “Deepening Insolvency”, should assert the affirmative defense of “*in pari delicto*” against a claim of “Deepening Insolvency.” The theory of this doctrine is that “a plaintiff who has participated in wrongdoing may not recover damages resulting from the wrongdoing.” This doctrine has been applied by various courts to defeat the claims of a bankruptcy trustee⁸, which is bound by the actions of the bankrupt debtor and burdened with the defenses created by those actions.⁹ Whether *in pari delicto* will be a successful defense in a particular case will depend upon a variety of factors including the location of the court and the specific facts of the case.

Illustrative of this defense is Lafferty, discussed above, which affirmatively held the tort was viable. The Lafferty court also analyzed a defendant’s claimed defense of *in pari delicto*. By a 2-1 decision, the court ruled that the defense did apply preventing the Plaintiff from recovering. However both the majority opinion and the dissent provides sound reasoning for their opposite conclusions on whether or not this defense is applicable.¹⁰ Future courts will likely be divided on the issue.

Future Impact Upon Leasing and Collections

It is important to be aware of this most recent development in the NorVergence saga, as it provides clear notice that any fact which is an indicia of fraud or any impropriety must be fully investigated to minimize future liabilities. Those facts may be developed after a lease is in collections, as in the NorVergence situation. That investigation should be fully documented and maintained so that it can be favorably presented to rebut any future allegations against the

LEAN Industry Calendar of Events

October 5 - 8 (UAEL)

Annual Conference and Exposition
Albuquerque, New Mexico

October 22 - 24 (ELA)

45th Annual Convention
JW Marriott Desert Springs Resort & Spa
Palm Desert, California

November 3 - 4, 2006 (NAELB)

NAELB Eastern Regional Meeting
Renaissance Concourse Hotel
Atlanta, Georgia

November 7 - 8, 2006 (ELA)

Financing the Supply Chain
Ritz Carlton Pentagon City
Arlington, Virginia

November 8 and 29, 2006 (ELA)

December 13 (ELA)

Selling Has Nothing to Do with Selling
Web Seminar

December 4 - 6, 2006 (ELA)

Principles of Leasing Workshop
Renaissance Atlanta Hotel Downtown
Atlanta, Georgia

December 11, 2006 (EAEL)

Holiday Party Dinner and Open Bar
Warwick Hotel
New York City, New York

October 2006 through December 2006

For more information about individual events, visit the LEAN website at www.leasecollect.org

December 11 - 13, 2006 (ELA)

Advanced Principles of Leasing
Workshop
Marriott Fisherman's Wharf
San Francisco, California

EAEL = Eastern Association of
Equipment Leasing

ELA = Equipment Leasing Association

NAELB = National Association of
Equipment Leasing Brokers

UAEL = United Association of
Equipment Leasing

company. The issue is not only maximizing collections but identifying facts within the knowledge of the company so that preventive measures can be taken against potential adverse claims.

For example, among facts from which the trustee draws sinister conclusions is that the NorVergence Matrix Box leases had significantly varying lease amounts, and increasing first payment defaults and customer complaints. The claims now being made are that this knowledge should have led the lessor to investigate this price differential and the product’s performance. That investigation would have led to questions regarding the Matrix Box which would have uncovered the true situation.

Should similar or other types of facts come to the attention of the leasing company which raises questions, they must be identified and investigated. This investigation should be appropriate for the type of product and the dollar amount of the program. Performing this investigation serves two purposes. First, it may genuinely lead to the discovery of important information—such as the true nature of the Matrix Box. Second, by properly investigating and documenting that investigation the company will have substantial evidence to readily defend itself should claims later be made against it. This applies as to investigation performed prior to funding a transaction, or investigation of facts which come to light thereafter.

The duty to investigate should now be considered never ending.

Conclusion

A crystal ball may be needed to predict the outcome to the myriad of legal issues surrounding the “Deepening Insolvency” issue; but, the due diligence requirement now takes on extra importance. With new technology products constantly emerging, leasing companies may want to consider having industry experts analyze new products as lessors now face new exposure for damages based upon the performance. Once a program is in place, facts may come to light during the enforcement process. This process now takes on even greater importance, as in addition to the primary goal of maximizing recovery, the law is imposing a new secondary goal of fraud identification.

Irwin M. Wittlin is with **Hemar, Rouso & Hemar, LLP**, concentrating his practice in creditors’ rights, both pre and post judgment remedies, emphasizing representation of equipment lessors, financial institutions, and other business matters. He also is an experienced bankruptcy practitioner, having represented secured and unsecured creditors in Chapter 7, 11, and 13 proceedings, including issues relating to the recovery of equipment, plan confirmation and in bankruptcy adversary proceedings.

Irwin can be contacted at 818.501.3800 or iwittlin@hemar-rouso.com

¹ The trustee disregards that these settlements contain no adverse admissions, nor are out of court settlements generally evidence of disputed facts or issues. These settlements may have been motivated by reasons other than the merits of the underlying case such as issues of cost

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LEAN Members Speak

Jay Welford of the Southfield, Mich. office of **Jaffe Raitt Heuer & Weiss PC** participated on two programs at the 2006 Legal Forum presented by the Equipment Leasing Association. He was a presenter on "Bankruptcy Update" and a facilitator on "Negotiate or Litigate – An Assessment of Alternatives and Risks in the Collections Process." Jay can be reached at 248.351.3000 or jwelford@jaffelaw.com.

Steven L. Higgs of Steven L. Higgs, P.C. in Roanoke, Va. was a seminar panel moderator for a Virginia State Bar CLE program for attorneys and non-attorneys on "Proofs of Claim" in bankruptcy. In November, he will be a panel member for Virginia CLE on "Foreclosure Basics." He can be reached at 540.400.7991 or higgs@higgslawfirm.com.

Irwin Wittlin, the author of this newsletter's article, of Hemar, Rouso & Heald, LLP located in Los Angeles, Calif. will be a panel participant at the 2006 annual conference of the United Association of Equipment Leasing. He will speak on "NorVergence - Chapter 7 Trustee Comes After Leasing Companies and the Future of Small Ticket Leasing." Irwin can be reached at 818.501.3800 or iwittlin@hemar-rouso.com.

Daniel A. Heald of Hemar, Rouso & Heald, LLP located in Los Angeles, Calif. spoke on "How to be an Effective Collector" and was moderator of the "Litigation Alternatives" panel at the 2006 Credit and Collections Management Conference presented by Equipment Leasing Association. Dan can be reached at 818.501.3800 or dheald@hemar-rouso.com.

David S. Willenzik of the New Orleans office of McGlinchey Stafford PLLC was a panelist on "Fundamental Issues Arising in Motor Vehicle Finance Transactions" at the 2006 Legal Forum presented by the Equipment Leasing Association.

Howard Toland of Haley, Sinagra, Paul & Toland, P.A. of Ft. Lauderdale, Fla. spoke on "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005: What You Need to Know about the Changes in Bankruptcy Law" at the 2006 Credit and Collections Management Conference presented by Equipment Leasing Association. Howard can be reached at 954/467-1300 or by e-mail at htoland@hspatlaw.com.

Matt Richburg of Kohn Law Firm, Milwaukee, Wisc. spoke in July on behalf of Lorman Education Services on "The Magic of Successful Collection Work in Wisconsin."

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effectiveness, collectability, competition, and unique issues of public perception for the particular leasing company and for the industry.

2 *Smith vs. Arthur Andersen* 421 F.3d 989 (2005).

3 A tort is a civil wrong not arising from contract for which the injured party is entitled to recover damages.

4 *Official Comm. of Unsecured Creditors vs. R.F. Lafferty Co., Inc.*, 267 F.3d 340, 351 (3rd Cir 2001). *Lafferty* is a Third Circuit decision and only binding in courts within that Circuit.

5 *E.g.* In re Exide Technologies, 299 B.R. 732 (2003); In re Del-Met Corp. 322 B.R. 781 (2005) {Federal courts interpret existing Delaware and Tennessee laws to predict each state will recognize existence of cause of action}.

6 In re *Global Service Group*, 316 B.R. 451 (NY, 2004) [Relying upon the business judgment rule the court stated that the corporate officers and directors have no duty to shut down and liquidate an insolvent corporation, where in their good faith judgment there is an alternative. Liability would only arise if the action were taken in bad faith, or with fraudulent intent.]

7 *Crowley v. Chait*, No 85-2441, 2006 U.S. Dist. Lexis 8894 (D.N.J.), Mar 7 2006.

8 See, *Dublin Secs.*, 133 F.3d at 380 [applying Ohio law]; *Hirsch v. Arthur Andersen & Co.*, 72 F.

3d 1085, 1093-94 (2d Cir) [applying Connecticut law]; *Shearson Lehman Hutton, Inc. v. Waggoner*, 944 F.2d 114, 120 (2d Cir) [applying New York law]; *Hedged-Investments Assoc.*, 84 Fed 1281 (10th Cir. 1996).

9 This is in the event that the wrongful conduct of the debtors agent can be imputed to the corporation. The law of imputation is strictly a state law issue. *O'Melveny & Myers vs. FDIC*, 512 U.S. 79 (1994). In *Lafferty*, the court set forth the applicable test for imputing the fraud of an officer to a corporation as whether the fraud was (1) in the course of employment, and (2) for the benefit of the corporation. As to the second prong of this test, the court recognized the "adverse interest exception" wherein fraudulent conduct will not be imputed if the officer's interests were adverse to the corporation and not for the benefit of the corporation; however, that exception is subject to its own exception known as the 'sole actor exception' in which the agent who committed the fraud was also the sole shareholder of the corporation.

10 The majority opinion is the ruling of the court, and is binding precedent for that court system. *Lafferty* is a Third Circuit decision and only binding in courts within that Circuit. The dissent is an opinion written by a judge who disagrees with the majority and is not precedent.