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REPRINTED FROM THE 2020 MONITOR 100 ISSUE, VOL 47, N0 4

TIPPING THE SCALES

DOUBLE TROUBLE:
NEW YORK AND CALIFORNIA THREATEN MANY BUSINESS PRACTICES

BY **STEPHEN T. WHELAN**

Many equipment finance companies work with third-party sales organizations or originators. But what happens if one of those third parties is accused of fraud? Stephen Whelan examines two cases that may cause equipment finance professionals to question their business practices.

In 2016, the New York State attorney general sued Northern Leasing Systems (NLS), its officers and outside counsel for allegedly conducting business in a "persistently fraudulent or illegal manner." The action was prompted by complaints from more than 800 equipment lessees as well as from the deputy chief administrative judge for the New York City courts.

NLS objected and requested a trial at which both sides could present evidence supporting or refuting the charges. On June 8, 2020, the court — without conducting a trial — ruled in favor of the attorney general and ordered the following relief:

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- Vacating all of the New York default judgments obtained by NLS
- Ordering restitution to all lessees (and their guarantors) harmed by NLS's fraudulent acts from April 11, 2013 to the present, with a hearing on the amount likely to occur in Q4/20
- Terminating every NLS equipment lease — even with lessees that did not complain — entered on and after April 11, 2013
- Permanently enjoining NLS and its co-defendants from the business of conducting equipment finance leasing
- Ordering NLS to dissolve within 60 days after the foregoing relief had been accomplished

WHAT HAPPENED?

The trial court summarized NLS' business model as using independent sales organizations (ISO) to market to merchants the opportunity to acquire the use of point of sale credit card equipment and check reading machines by leasing them from NLS. Each ISO would solicit applications from the lessee and any guarantor and acquire, deliver and install the equipment

after NLS had accepted and countersigned the lease application. NLS would purchase the related equipment from the ISO. Each lessee was required to sign a customary delivery and acceptance receipt. NLS sent a "welcome letter" to each new lessee and made verification phone calls to approximately 15% of its lessees during the period commencing 2010.

The court dismissed these procedures, asserting that the verification phone calls and welcome letters "lack any foundation for authenticity" and that NLS had produced no witnesses to attest to NLS' regular mailing procedures. Even more devastating, the court rejected the D&A receipts signed by the complaining lessees because they were not notarized or otherwise authenticated on the personal knowledge, such as via a sworn affidavit (presumably by an employee of either the ISO or NLS).

The court's decision found that the ISOs were not agents of NLS and had no authority to bind NLS. Yet, paradoxically, the decision announced that NLS' "very hands-off attitude towards the ISOs" was sufficient cause for any misdeeds of the ISOs to be attributed to NLS. According to affidavits from 873 lessees, those misdeeds consisted of 1) signing a one-page document and later receiving a lease "with terms different than the salespersons described," 2) receiving the complete document "only after requesting a copy from [NLS] or…after the renegotiation or cancellation period expired" and 3) "equipment that was inoperative or obsolete, or that the lessees never received, never used or returned."

THE EXECUTIVE LAW

New York Executive Law section 63(12) is an unfamiliar statute, which provides in relevant part that whenever a person persistently engages in fraudulent or illegal business activity, the attorney general may seek an order enjoining the activity and directing restitution and damages. The threshold for invoking the law's protections is very low but at least requires proof that fraudulent or illegal activity occurred.

Yet the court accepted the affidavits of the complaining lessees (which, according to papers filed by counsel for NLS, constitute "fewer than six one-hundredths of one percent of [NLS's] 1.4 million lessees") without permitting NLS to examine the complainants under oath and confront them with tape recordings of the welcome calls which NLS asserted had been made. And the court expanded the customary definition of fraud to include any act that "tends to deceive or *creates an environment conducive to fraud*" (emphasis added). Having expanded the basis under which liability could be found, the court provided no opportunity for the defendants to demonstrate that they were not running such a fraudulent enterprise.

"SENTENCE FIRST — VERDICT AFTERWARDS"

The above quotation from *Alice in Wonderland* illustrates the consternation which observers have exhibited toward the court's decision. It is unsettling for any court to order — without benefit of a full-fledged trial at which evidence can be produced and witnesses cross-examined — not only restitution for the 873 complaining lessees, but also the remedies mentioned at the top of this article. The casual observer might shrug and think that this is a one-off situation. But an informed observer might well echo the line from a 1967 song: "It happened to me and it can happen to you," and fret about the need to have D&A certificates notarized. At some point, the New York State Appellate Division is likely to hear the NLS appeal of the court's judgment, but in the meantime, equipment professionals have much to ponder:

- Will D&A certificates have to be notarized — even if they are electronic documents?
- If a lessor buys contracts and related equipment from a third-party originator, will that broker have to provide an affidavit that its employee witnessed the lessee signing the D&A certificate?
- If a lessor uses brokers to originate a significant portion of its leases and loans, how will it identify the "sweet spot" between having too much oversight of the broker, and being held responsible for the broker's misdeeds, and having too little oversight, and being held liable for having a "very hands-off attitude"?

BREAKING NEWS

On Aug. 6, 2020, the same attorney general sued the National Rifle Association and its top officers, alleging fraud, mismanagement and self-dealing. Echoing its charges against NLS, the attorney general alleged that NRA management was inadequate to control employees' wrongdoing, claimed an expansive reading of fraud by NRA and sought a court order dissolving the NRA. The NLS litigation may have been the first step in a pattern of aggressive lawsuits.

CALIFORNIA, HERE WE COME

Long before the NLS decision in New York, attention had been riveted on a 2019 decision in California which also threatens to derail a customary aspect of equipment lease and loan agreements: consent to trial in the lessor's home state.

In *Handoush v. Lease Finance Group, LLC*, the California Court of Appeals invalidated a jury trial waiver provision in an equipment lease agreement between a New York lessor (LFG) and a California lessee. The lease was governed by New York law and included a consent to jurisdiction in New York as well as a jury trial waiver. When the lessee breached the lease, the lessor sued for damages and performance, and when the lessee failed to appear in the New York courtroom, a default judgment was entered against them.

When the lessor brought an action in California to enforce the default judgment, the lessee sued LFG in a California court on the basis that the mandatory forum selection clause violated their rights under California law because it compelled them to appear in a New York court. The trial judge dismissed the lessee's complaint as having been brought in the improper venue.

But the appeals court concluded that such a forum selection clause would be enforced only if the lessor could demonstrate that a New York court would provide the same or greater rights than California would, or that the New York court would apply California law — which would contradict the choice of New York law in the contract.

The Court of Appeals concluded that the right to a jury trial is a right which the California constitution "zealously guards" and therefore both the forum selection clause and the jury trial waiver violated California public policy. Given this decision, the challenge confronting the equipment finance business is threefold:

1. Whether to use optional forum selection clauses, which have been upheld in other states
2. Whether jury trial waivers will be enforceable if the lessee is a California entity
3. Whether to provide for a judicial reference in lieu of a jury trial waiver if the lessee is a California entity

Both situations erupted before the age of COVID-19, but there is no reason to believe that the pandemic will reduce the impact of the decisions on equipment finance. •

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