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DISPATCHES FROM THE TRENCHES

One Troublesome Trio…Fraud & the UCC; Quantum Meruit & Oral Modifications; Affiliates & Subsidiaries

By Kenneth P. Weinberg

This issue of Dispatches from the Trenches discusses: (a) the intersection of the Uniform Commercial Code and the common law of fraudulent misrepresentation; (b) New York analysis of quantum meruit claims and oral modifications; and (c) the benefits of including coverage for affiliates and subsidiaries in documents.

Eureka Broadband Corp. v. Wentworth Leasing Corp., 400 F.3d 62 (1st Cir. 2005).

This case involves interesting analysis with respect to "the intersection between the [Uniform Commercial] Code and the common law of fraudulent misrepresentation." Eureka Broadbank Corporation (Lessee) entered into two conventional finance leases with Wentworth Leasing Corp. (Lessor) to obtain the equipment it needed to pursue its business interests. Although not specifically stated by the Court, these leases appear to be Article 2A "finance leases", which are defined in the Uniform Commercial Code to be a type of true lease consisting of an overall three-party transaction where: (1) the lessor does not select, manufacture, or supply the goods, (2) the lessor did not own the goods before the lease was arranged, and (3) the lessee either approves the purchase contract or receives specified warranty and supplier information before signing the lease agreement.

The first lease was for property from a supplier named CopperCom. The second lease covered property sold by both CopperCom and another supplier named Marconi. The lessee identified the necessary equipment and the lessor agreed to purchase it as long as the lessee demonstrated its

creditworthiness, paid an up-front commitment fee equal to one month's rent and paid a security deposit equal to the first and last months' rent. The lessee did so for both leases, accepted delivery of the equipment from the two suppliers, and authorized the lessor to release payment to the two companies. While CopperCom invoiced the lessor directly, Marconi evidently invoiced the lessee.

In any event, the lessor never paid either supplier. The lessee paid rent as required under the leases but began receiving demands from the suppliers for payment. Eventually, Marconi brought suit against the lessee and the lessee settled by returning the goods and paying Marconi approximately $180,000. In order to avoid litigation with CopperCom, the lessee returned the goods and paid another undisclosed fee. The lessee then brought suit against the lessor claiming breach of contract, unjust enrichment, and fraud. The lessor counterclaimed for breach of the lease.

The District Court ultimately found in favor of the lessee, and the lessor appealed. Although the Court of Appeals did not agree with all of the District Court's reasoning, it ultimately affirmed the entire District Court's holding based on the lessee's fraud claim against the lessor. The Appellate Court specifically held that "in the context of a finance lease transaction, a finance lessor implicitly represents both its ability and its intention to pay for the goods to be leased and that if knowingly false, implicit representations may be treated as actionable misrepresentations."

The Appellate Court rebuffed the lessor's argument that Section 2-702 of the UCC preempts the common law fraud claim. That section limits remedies of the aggrieved party and does not explicitly allow the lessee to recover rentals. However, the Appellate Court did not take the bait and noted that Section 2-702 applies to buyers and sellers and that, under a finance lease, the relationship between lessor and lessee is much different. Section 1-103 of the UCC provides that "[u]nless displaced by the particular provisions [of the UCC,] the principles of law and equity, including ... fraud [and] misrepresentation ... shall supplement its provisions." In addition, Section 2A-505(4) provides that the "[r]ights and remedies for material misrepresentation and fraud include all rights and remedies available under [Article 2A] for default" and such rights include, under Section 2A-508, "the right to cancel the lease and recover such much of the rent and security as has been paid and is just under the circumstances."

The Court dismissed arguments by the lessor regarding the lease's hell and high water provisions noting that, "[w]ere this a simple breach of warranty case, [the lessor's] protect might have some bite [but that] there are a few exceptions [to the statutory hell or high water clause in Article 2A,]

including an exception for fraud." According to the Court, by electing its right to cancel the leases, the lessee discharged all remaining obligations including any obligation to pay rent. The case does not clearly outline whether the lease also contained a contractual hell or high water clause (which should be in every lease) or whether the lessor relied solely on the statutory hell or high water clause in Article 2A. In a case with "tough facts" like this one, it likely would not have affected the Court's eventual holding.

Fulcrum Fin. Advisors, Ltd. v. BCI Aircraft Leasing, Inc., 354 F. Supp 2d 817 (N.D. Ill. 2005).

Fulcrum is a New York entity involved in the business of raising financing and trading secondary debt for the airline industry and BCI is an Illinois corporation in the business of financing airplanes. BCI purchased two Boeing 737-200 aircrafts that were being leased by VARIG Airlines.

That purchase was financed in part by a bridge loan in the original amount of $3.9 million and when BCI wanted to refinance the bridge loan, it solicited the assistance of Fulcrum to locate a lender and structuring a refinancing. An Engagement Letter named Fulcrum as BCI's non-exclusive advisor and called for a 3% fee to be paid to Fulcrum upon the closing of the refinancing. Fulcrum located a lender in Transamerica Equipment Finance Services and structured the deal.

BCI notified Fulcrum that it had a long-standing relationship with Transamerica and requested a limit to the Engagement Letter. In addition, it appears that BCI performed most of the heavy lifting including certain duties expected of Fulcrum. Prior to accepting Transamerica's final proposal, BCI therefore attempted to renegotiate Fulcrum's fee before proceeding with the closing. BCI misrepresented to Fulcrum that "he had other lenders in the wings" and coerced Fulcrum to accept a $50,000 fee instead of the 3% fee agreed upon earlier. Fulcrum reluctantly agreed to accept the $50,000 only if it received the payment immediately upon closing. The closing was delayed briefly when VARIG Airlines reported a loss of $83 million for 2000. Shortly thereafter, the closing went through without any notification being given to Fulcrum. BCI then refused to pay a fee altogether, claiming the negotiations of Fulcrum did not assist in the closing of the deal.

Fulcrum brought a breach of contract and a quantum meruit claim. For those readers who are neither Latin scholars nor trivial pursuit champions, the term "quantum meruit" means "as much as he deserves" and is a legal concept used when a person employs another (impliedly or expressly) to do work for him, without any agreement as to the compensation to be paid the worker. In such cases, the law implies a promise from the employer to the workman that he will pay him for his

services, "as much as he may deserve or merit." Courts generally do no allow claims for quantum meruit where there is a valid contract.

The court held that the Engagement Letter applied to the closing with Transamerica and that Fulcrum had met its contractual obligations. On the breach of contract claim, the court awarded Fulcrum the 3% fee. Crucial to the Court's holding was the fact that oral modifications to existing contracts are not binding unless there is consideration for (i.e. benefit to) both parties. A written modification is binding even without consideration and BCI introduced evidence of a writing changing Fulcrum's fees. However, the Court held that it would not enforce such a modification because "it was made in bad faith and based upon a blatant misrepresentation by [BCI]."

Like most states, New York generally precludes recovery in quantum meruit cases where there is a valid contract. However, the court stated that a plaintiff in New York may bring a breach of contract claim and a quantum meruit claim jointly when there is a question as to whether the contract covers the dispute. Therefore, the court held that Fulcrum was also entitled to the 3% fee in its quantum meruit claim, holding that 3% was reasonable compensation. In New York, courts are split on whether quantum meruit claims allow for an award of interest. This court used its discretion to award the interest in its alternative quantum meruit analysis.

Sunrise Medical HHG, Inc. v. Health Focus of New York, 2005 WL 357203 (N.D. N.Y. 2005)

This case provides a nice example of the impact of including subsidiaries and affiliates in contracts. A brief reference to such entities made life much easier for Sunrise Medical HHG, Inc. ("Sunrise"). Sunrise manufactures and distributes medical equipment and, when one of its customers was being acquired by Health Focus of New York ("Health Focus"), Sunrise contacted Health Focus in an effort to continued the same deal flow it had with the original customer.

After several telephone discussions, Health Focus authorized the continued sale and leasing of Sunrise's equipment and, over time, executed several agreements including an Account Agreement, a Promissory Note and a Security Agreement. Additional Guaranties were also executed. Some of these documents were with Sunrise and others were with Sunrise's affiliates. Over the next few months, Sunrise shipped over $100,000 of equipment and services to Health Focus, only to receive one $55.16 payment in return.

Sunrise filed a claim in the U.S. District Court for the Northern District of New York to recover the debt owed by Health Focus to the various Sunrise entities which totaled approximately $250,000. Health Focus argued that Sunrise was seeking payment on accounts that it did not own and that certain of the documents were not entered into for the benefit of Sunrise. Sunrise moved for summary judgment noting that: (a) the Account Agreement and Guaranties and Promissory Note included Sunrise as a creditor since it covered " Sunrise Medical Inc. and/or any of its subsidiaries or affiliates now owned or hereafter acquired"; and (b) the Promissory Note was assignable without Health Focus's consent and had been assigned to Sunrise. The court agreed and granted Sunrise's motion for summary judgment.

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