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Your Eye On The Future

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JOURNAL OF EQUIPMENT LEASE FINANCING

Puncturing the 15 Myths of Software Leasing

By Mark S. Bazrod

One would think that by now most lessors, software vendors, and users would be aware of software leasing: that they would understand it, appreciate its utility, and be familiar with its structures. Not so. Here are 15 ways software leasing is often misunderstood and some thoughts about why a lessor should consider entering the software leasing marketplace.

Avoiding Class Action Lawsuits Concerning Lease Insurance Programs

By James C. Donnelly Jr.

Equipment lease insurance is an important protection. But beware of hidden and excessive profits or penalties. When abuses creep in, the cost and risk of class action lawsuits become more real. Here are some ways leasing companies can protect themselves by modifying their standard lease forms.

New 8-K Reporting Requirements on Public Leasing Companies: Another Reason to Remain Private?

By James M. Johnson, PhD, and Natalie Tatiana Churyk, PhD

The Sarbanes-Oxley Act of 2002 has led to new SEC Form 8-K requirements. They have a very short lead time period for reporting events. This study of public leasing companies suggests some concern that this shortened reporting window will prove expensive and the improvement in timeliness will perhaps not be cost effective.

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Avoiding Class Action Lawsuits Concerning Lease Insurance Programs

By James C. Donnelly Jr.

Standard lease agreements in the equipment leasing industry generally require lessees to insure the leased equipment and its use as a condition of the lease. The required coverage typically includes property and liability insurance. The lease typically states that if the lessee fails to provide proof that it has obtained the required insurance within a specified time, the lessor can purchase insurance to protect its own interests and bill the lessee for any charges related to the insurance.

Equipment lease insurance serves a vitally important purpose. It would not make sense to lease equipment without the protection it provides. However, within the past few years, several prominent and reputable equipment leasing companies have been targeted by class action lawsuits focused on alleged problems in their lease insurance programs.

Typically, the class action lawsuits allege that such programs include hidden and excessive profits or penalties that are not related to the stated purpose of protecting leased equipment with lease insurance. The amount of damages claimed by the named plaintiff that actually brings the lawsuit is usually quite small, but the exposure for the leasing company can be immense if the plaintiff represents a large class of lessees with similar interests.

There is little judicial guidance as to exactly what is or is not permissible, or whether courts would even certify class action status if the matter were contested. Nevertheless, prominent and reputable leasing companies have elected to settle rather than face the cost and risk of class action lawsuits. The settlements usually deny any wrongdoing or liability. However, each settlement typically includes a payment of at least several million dollars. In addition to making large payments, the settling companies often agree, either as part of the settlement agreement or in a consent decree approved by the court, to make changes in their lease insurance programs.

The settlements have generated multimillion dollar fees for the class action law firms that represent the plaintiffs. The lawyers have developed a sharp edge of expertise and insight. They remain active and interested in pursuing similar claims against other leasing companies. They continue to develop new theories, or new applications of existing theories, to support their clients' claims. They are undoubtedly looking for new targets in the form of lease insurance programs that are vulnerable to challenge.

The purpose of this analysis is to educate equipment leasing companies about the types of claims that are asserted in the class actions, and to suggest strategies to avoid them.

OVERVIEW OF CLASS ACTIONS AGAINST EQUIPMENT LEASING COMPANIES

Background of Lease Insurance Programs

Most equipment leases require the lessee to provide evidence of property and liability insurance on the leased equipment. This required insurance protects the lessor from loss, if the equipment is damaged or destroyed, or liability, if the equipment causes harm to third parties. The lease typically states that if a lessee fails to provide evidence that it has obtained the required insurance within a reasonable time, the lessor may purchase such insurance and charge the lessee. The lessee is not named as an insured on the lessor's policy, but the lessee does receive certain indirect benefits such as replacement of the equipment or paying off the lease if the equipment is lost or destroyed.

Equipment lease insurance serves a vitally important purpose. However, abuses have led to costly class action lawsuits, and some have not concluded in the favor of lessors. When it comes to class action lawsuits, in the absence of judicial guidance, an ounce of prevention is worth the proverbial pound of cure.

Some lessors have adopted so called "risk management" or "loss damage waiver" programs that charge lessees that fail to provide the required evidence of insurance.

Such programs don't just involve insurance. They require administrative services such as tracking lessees' compliance, procuring the required coverage, billing and collecting insurance charges, and accounting for payments that are integral to the administration of such programs.

However, some leasing companies use their lease insurance programs as an opportunity to generate additional profits. There are three typical strategies. First, the lessor may bill the lessee for administrative services that it performs in connection with the program, charging rates that generate a profit. Second, the lessor may seek to generate underwriting profits by "reinsuring" the primary insurer through a lessor-owned reinsurance company, or by charging lessees for the risk associated with self-insured retentions. Third, in lieu of actually providing insurance, the lessor may establish a "risk management" or "loss damage waiver" program that charges lessees for the risk and cost of an uninsured loss in exchange for a waiver of the lessor's claim to indemnification from the lessee.

Legal Theories of Class Action Lawsuits

The class action lawsuits typically allege that (1) the lessor violated a duty to disclose material information, (2) the program evades insurance regulations, (3) the lease insurance charges include contractually imposed penalties that violate public policy, or (4) the program's fundamental purpose is to generate "excessive profits" rather than protect the lessor's legitimate property interest in the leased equipment.

The fourth factor alone doesn't necessarily supply an independent basis for liability. But the size of the profit margin is often relevant to the application of the other three liability theories and, in any event, is usually a factor in determining damages. This section analyzes these four factors.

1. Failing to Disclose Material Facts

Most of the class action cases allege the violation of a duty to disclose. There are at least three different sources of that duty. First, Article 2A of the Uniform Commercial Code (UCC) imposes an implied covenant of good faith in every lease, whether or not such a duty is actually mentioned. The covenant of good faith requires "honesty in fact and the observance of reasonable commercial standards of fair dealing" in all lease transactions.[1] This includes the duty to disclose facts that are "material" in the sense that they would influence the decision of an ordinarily prudent person.

Second, Section 5(a)(1) of the Federal Trade Commission (FTC) Act, 15 U.S.C. 45(a)(1), forbids "unfair or deceptive acts or practices in or affecting commerce." The FTC Act does not itself provide for private enforcement actions. However, many states have adopted "baby FTC acts" that authorize private actions to recover damages – and sometimes awards of enhanced damages and attorneys' fees – for unfair or deceptive acts or practices.

Third, the common law imposes its own covenant of good faith, whose precise definition may vary from one state to the next, and provides business tort theories such as "fraudulent suppression" of relevant information and conspiracy.

2. Evading Insurance Regulations

Some lessors have adopted so-called "risk management" or "loss damage waiver" programs that charge lessees that fail to provide the required evidence of insurance.[2] Instead of providing substitute insurance, they charge a fee that supposedly compensates the lessor for the risk of uninsured loss. Such programs usually provide that the lessor will replace the equipment or waive the balance due in case of loss, but they rarely consider loss experience – as would be typical with insurance. The same principle would apply if the lessor retains a large deductible and charges the lessee for the resulting risk.

Class action lawsuits typically allege that risk management and loss damage waiver programs are merely an artifice to avoid insurance regulation. In other words, the lawsuits allege that these are really just an illegal form of insurance. The National Association of Insurance Commissioners (NAIC) Creditor-Placed Insurance Model Act, which has been adopted in four states and whose policies are reflected in the regulations of many

others, requires that the premiums of creditor placed insurance be reasonable in relation to the risk. Risk damage or loss waiver programs that have not been approved by insurance regulators are likely to be seen as schemes to evade insurance regulations, especially if the fees cannot be justified under relevant underwriting standards.

3. Charging Penalties That Violate Public Policy

Charges that bear no relation to a reasonably anticipated loss or expense may run afoul of the public policy against liquidated damage provisions that include disguised penalties. According to this analysis, the risk management and loss damage waiver fee (or any other charges imposed on lessees that violate the obligation to provide insurance) is essentially a form of liquidated damages to compensate the lessor for the resulting risk and inconvenience.

However, the amount of the fee is often set without regard to reasonably anticipated loss experience or costs. The relevant legal principle is summarized in *Restatement (Second) of Contracts*, Section 356(1) (1981)[3]:

> Damages for breach by either party may be liquidated in the agreement *but only at an amount that is reasonable in the light of the anticipated or actual loss* caused by the breach and the difficulties of proof of loss. *A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty* [emphasis added].

If challenged with a class action, the lessor would have the burden to show that the fee was reasonable in relation to the economic risk. It would likely be a difficult and complicated burden.

4. Charging Fees That Generate "Excessive Profits"

Many class action complaints allege that the lessor's true purpose was to generate "excessive profits." This phrase, however, is a red herring. There is nothing inherently wrong with making large profits. But even a modest profit can become improper if it violates one or more of the theories discussed above.

In most cases, class action plaintiffs will be able to discover how much profit the program produces. Profits that seem unreasonably large provide circumstantial evidence that any violation both was intentional and reflected selfish motives.

In addition, the size of the profit will often be part of the lessees' damage calculation. If the overall size of the lease insurance charge seems unrelated to actual costs, risks, or damages, it will increase the risk that courts will view the charge as an improper penalty.

Risk Presented by Class Action Lawsuits

None of the class action lawsuits concerning lease insurance has gone to trial. Few have even passed the hurdle of class certification, except with the lessor's agreement as part of a settlement.

There are even some decisions rejecting the class action allegations on motions for summary judgment. For example, *Chris Albritton Construction Co. Inc. v. Pitney Bowes Inc.*[4] upheld summary judgment dismissing a class action lawsuit challenging an arrangement to charge a quarterly fee for a "risk management program" called ValueMax. Value Max did not include insurance, but in exchange for the ValueMax fee, the lessor provided benefits that resemble insurance.

Even under the summary judgment standard, where the court must draw all reasonable inferences against the moving party, the Fifth Circuit dismissed the allegations of fraud and misrepresentation because it found insufficient evidence of any material omission, affirmative concealment, or misrepresentation. It dismissed the claims for breach of contract under Mississippi state law's "voluntary payment" doctrine. It applied the principle that if lessees are given enough information to make a choice, they cannot later complain that they overpaid.

According to the court's interpretation:

> If the Plaintiffs voluntarily paid for something they did not owe, the voluntary payments cannot be recovered. … The general principle is that, where the party with full knowledge, actual or imputed,

Charges that bear no relation to a reasonably anticipated loss or expense may run afoul of the public policy against liquidated damage provisions that include disguised penalties.

At the most basic level, class actions concerning lease insurance programs involve the same basic issue: whether the defendant's conduct has interfered with the dynamics of the market so that lessees are effectively denied access to low-cost alternatives.

of the facts, there being no duress, fraud or extortion, voluntarily pays money on a demand, although not enforceable against him, he cannot recover it back.[5]

If *Chris Albritton* were the last word on the subject, class actions over lease insurance would be just a footnote in history. But as experienced trial lawyers know, victory in one forum doesn't guarantee victory anywhere else. In March 2005, almost three years after that decision, Pitney Bowes agreed to pay a settlement that is nominally valued at $51.8 million in a case called *Harbin v. Pitney Bowes Inc.*,[6] in the Circuit Court of Montgomery County, Alabama.

The allegations were substantially similar to *Chris Albritton*, but the Alabama court rejected a motion for summary judgment. Pitney Bowes faced a trial by jury. The 2005 settlement includes a statement that Pitney Bowes denied liability and points to other victories in similar cases including *Chris Albritton*. But the decision to pay $51.8 million undoubtedly reflects a thoughtful conclusion that a trial could result in even greater liability.

The Class Action Fairness Act of 2005 and Likely Implications of Federal Court Jurisdiction

The Class Action Fairness Act of 2005 (CAFA)[7] has changed the landscape for class action lawsuits to some extent. It amends 28 U.S.C. Section 1332 to provide federal district courts with original jurisdiction of class actions where the aggregate amount in controversy exceeds $5 million and any member of the plaintiff class is a citizen of a different state from any defendant. However, the federal court may decline to exercise jurisdiction in certain circumstances – mainly where the interests of the state that hosts the lawsuit predominate over federal interests.

CAFA also amends 28 U.S.C. Section 446 to permit removal of class actions for which there is jurisdiction under Section 1332. It imposes certain restrictions on "coupon settlements," whereby class members receive coupons as part of the settlement, but the class action attorneys are paid large sums in cash.

However, it would be easy to overestimate the effect of CAFA. Federal courts exercising CAFA jurisdiction will still apply state law. To be sure, the federal courts have more resources. They will likely devote more attention to deciding dispositive motions. Many defense lawyers prefer to avoid state court based on a perception that federal judges are more hospitable to defendants' motions for summary judgment – as may have been the case in *Chris Albritton*. But at the end of the day, federal judges will apply the same fundamental legal principles to the same underlying facts. They will apply substantially the same standard in determining whether a genuine issue of disputed fact precludes summary judgment so as to require a trial.

The now famous antitrust decision in 2001 in *United States v. Microsoft Corp.*[8] is a reminder that federal courts can be at least as vigilant as any other forum in addressing conduct that reduces the efficiency of the marketplace by withholding information that should be the basis of competition. The analogy to antitrust may at first seem far-fetched, but *Microsoft* involves a high-profile application of the same general principle: that it is illegal to manipulate facts to deceive consumers so as to prevent selection of lower cost alternatives.[9]

At the most basic level, class actions concerning lease insurance programs involve the same basic issue: whether the defendant's conduct has interfered with the dynamics of the market so that lessees are effectively denied access to low-cost alternatives. There is no reason to suppose that federal courts or juries would reach materially different conclusions than state court counterparts concerning the propriety of lease insurance programs.

In any event, well-advised leasing companies will probably prefer not to spend the resources that are required to test the idea that federal jurisdiction will dramatically reduce the risk of class action lawsuits. The more prudent course is to modify or eliminate the practices that have been most vulnerable to challenge. The following examples illustrate the range of allegations that have recently produced substantial class action settlements.

EXAMPLES OF CLASS ACTION LAWSUITS AND SETTLEMENTS

Class action lawsuits concerning lease insurance do not fit a single mold. Class action attorneys are alert and inventive. They are likely to challenge any practice that is "opportunistic" in the sense of using lease insurance or risk management programs either to secretly supplement ordinary leasing income or to secretly penalize lessees that rely on the lessor to provide insurance for them. Specific allegations will vary as the class action plaintiffs' attorneys develop new theories and apply them to new situations. The common denominators are allegations that the lessor (1) failed to disclose material facts, (2) interfered with lessees' ability to evaluate less expensive alternatives, (3) violated state insurance regulations, or (4) imposed illegal penalties.

Please note that each of the settlements discussed below included a denial that the leasing company had done anything improper. Nothing in this analysis is intended to suggest otherwise. The leasing companies might have prevailed if the cases had gone to trial. However, the settlements undoubtedly reflect a thoughtful analysis of the risk. The point of this analysis is simply to identify the risk and suggest strategies to reduce it. This presentation will focus on the following five examples.

A. Failing to Disclose That Lease Insurance Charges Will Generate Profits for the Lessor

The case of *Mike Foote Oil & Gas Properties LLC v. Tokai Financial Services Inc., et. al.* in the Circuit Court of Baldwin County, Alabama, targeted the lease insurance program of De Lage Landen Financial Services Inc. (DLL), as successor to Tokai Financial Services Inc., on the straightforward theory that the program was structured to generate profits that were neither authorized nor disclosed in the lease. Although other parties were named as defendants, the complaint was aimed at DLL.

DLL's standard form lease required the lessee to provide property and liability insurance for the leased equipment with coverage satisfactory to DLL. It concluded that: "If you do not provide such insurance, you agree that we have the right, but not the obligation, to obtain such insurance and charge you *for all costs* [emphasis added]."

The class action plaintiff alleged that DLL engaged a lease insurance administrator to conduct the lease insurance program for a fee of $7.25 per month but then subcontracted with the administrator to perform the same exact services for the same exact monthly fee. In other words, according to the theory of this complaint, the lease insurance administrator was a shell whose only function was to funnel the fees for administrative services back to the lessor. Furthermore, the complaint alleged, the $7.25 fee was not the "cost" of the insurance administration but rather a ruse to generate added profits for DLL.

The settlement included a substantial monetary payment (reportedly $7.5 million) from DLL and a permanent injunction that the lease insurance provision would be amended to state: "If you do not provide such insurance, you agree that we have the right, but not the obligation, to obtain such insurance and charge you *an insurance fee on which we may make a profit* [emphasis added]."

The DLL class action teaches two lessons. First, avoid arrangements that class action plaintiffs can portray as a sham. The lease insurance administrator should be a legitimate service provider, not a conduit to generate undisclosed profits for the lessor. Second, the lease should affirmatively disclose that lease insurance charges may include a profit for the lessor.

B. Failing to Provide a Reasonable Chance for the Lessee to Avoid Lease Insurance Charges by Providing Proof of Insurance

The case of *Slocum Properties Inc. v. Kyocera Mita America Inc.*,[11] in the Circuit Court of Mobile County, Alabama, targeted the lease insurance program of General Electric Capital Corp. (GECC). GECC's standard form lease was generally similar to that of DLL. It authorized GECC to procure the required insurance if the lessee failed to provide evidence that insurance had been obtained from other sources, and required the lessee to bear the "cost."

Class action attorneys are alert and inventive. They are likely to challenge any practice that is "opportunistic" in the sense of using lease insurance or risk management programs either to secretly supplement ordinary leasing income or to secretly penalize lessees that rely on the lessor to provide insurance for them.

The GECC class action teaches two additional lessons. First, provide a reasonably clear procedure for lessees to submit proof of insurance. Second, maintain a reasonably efficient tracking system.

The complaint alleged that the insurance charges "greatly exceed the cost of insurance and any cost associated with procuring the same," but also added an important new element. It alleged that GECC billed for insurance charges without a sufficient opportunity to submit the required proof of insurance. It accused GECC of "forcing insurance charges when none were called for by the agreement."

The settlement included an agreement that GECC would pay $11.8 million, to be distributed to the class and their attorneys. It also included an agreement to reduce all future fees by 10% and an agreement to modify disclosures "in such a manner so as to disclose the existence of a profit." The agreement to reduce future fees probably added significant value, from the perspective of class action plaintiffs, and undoubtedly reduced GECC's future profits.

GECC reserved the right to discontinue the lease insurance program. In early 2004, shortly after the settlement, GECC reportedly discontinued its lease insurance program entirely. If true, this would seem to be an overreaction. Prudent modifications to the program and supplemental disclosures would enable GECC and its lessees to achieve the benefits of lease insurance without unacceptable risk.

The GECC class action teaches two additional lessons. First, provide a reasonably clear procedure for lessees to submit proof of insurance. Second, maintain a reasonably efficient tracking system that limits lease insurance charges to those lessees that have failed to provide insurance and avoids billing lessees that are in compliance. The tracking system should also monitor expirations and cancellations throughout the term of the lease. Such services can be obtained from qualified third-party program administrators on an extremely cost-efficient basis.

C. Failing to Disclose That the Lessor Will Participate in the Underwriting Profits of the Lease Insurance Program by Providing Reinsurance

The case of *General Resource Corp. v. Citicorp Vendor Finance Inc., et al.,*[12] Circuit Court of Mobile County Alabama, targeted the lease insurance program of Citicorp. Citicorp's standard form lease was generally similar to those of DLL and GECC in the prior two examples. It authorized Citicorp to purchase insurance and bill the "cost" to the lessee if the lessee fails to provide proof of insurance.

Similar to the prior examples, the complaint alleged that Citicorp received improper payments from the insurance program administrator, failed to provide a deadline or procedure for providing the proof of insurance, and improperly billed for lease insurance where such evidence had already been submitted. However, it also added a significant new element: that Citicorp required the primary insurer to purchase "reinsurance" through offshore companies that are part of the Citicorp organization.

"Reinsurance" refers to an arrangement in which a primary insurer can reduce its risk of a large or catastrophic loss by reinsuring a portion of its own exposure. According to the complaint, however, the reinsurance from Citicorp affiliates was highly profitable, and the premiums for such reinsurance were unregulated so that the amount of the premium would not necessarily reflect any actual loss experience or risk. The lessee would usually have no way of knowing whether premiums were inflated by high reinsurance premiums. The class action plaintiffs alleged that Citicorp's reinsurance program was merely a scheme or artifice that was "designed to artificially manufacture a basis for Citicorp's 'costs' of insurance so that amounts far in excess of actual costs could be charged to Citicorp lessees."

The settlement included an agreement that Citicorp would pay $13.36 million to the class and the class attorneys. It also included a provision that Citicorp would reduce all future fees from $1 to $2 per month depending on the category of lease, thereby reducing future profits. Finally, it required Citicorp to modify disclosures by adding a provision that:

> Defendant and/or its Affiliates may receive a portion of any Insurance Charge paid, including without limitation, a profit from

such Insurance Charges, and/or a portion of any premiums, and that a finance charge may accrue on amounts advanced by Defendant or its Affiliates in connection with the placement or procurement of insurance.

The Citicorp class action adds another lesson. If the leasing company chooses to participate in underwriting profits – through reinsurance or by any other means – that fact should be disclosed in the lease. The leasing company must be prepared to justify the reinsurance premiums as reasonable and not excessive. Otherwise, class action plaintiffs can argue that the reinsurance is either a sham that creates a false appearance of costs to improperly justify higher fees and profits or it is a contractually imposed penalty that violates public policy – as discussed below.

D. Charging "Risk Management" or Loss Damage Waiver Fees for a Lessor-Sponsored Risk Management Program That Is Not Approved by State Insurance Regulators

The case of *Harbin v. Pitney Bowes Inc.*, Circuit Court of Mobile County Alabama, involved a different issue. Pitney Bowes' standard lease provided that if the lessee failed to provide evidence of the required insurance, the equipment would be included in the "ValueMax" risk management program, for which the lessee would pay the "then applicable periodic fee." The lease expressly stated that the ValueMax program did not constitute insurance.

The complaint alleged that ValueMax was not a bona fide risk management program because Pitney Bowes "has never undertaken to quantify any risk" and ValueMax fees were not rationally related to any actual risk. It asserted that ValueMax violated state insurance regulations because it had not been qualified by any state department of insurance, and was falsely described as a risk management program in order to conceal the violation. Finally, the complaint alleged more pointedly than any of the prior examples that ValueMax charges are placed on the invoices of lessees that have not been notified to provide evidence of insurance "so that the charges will be paid without their conscious permission."

The settlement, nominally valued at $51.8 million, included an agreement that Pitney Bowes will pay $31.56 million in the form of product certificates to the settlement class less any amounts paid for attorneys' fees to the plaintiffs' class action attorneys, provided that attorneys' fees would not exceed $8.75 million. The product certificates were to be freely negotiable and could be used to make purchases from the Pitney Bowes Supply Line (also called the Pitney Bowes Online Store).

The settlement further provides that Pitney Bowes will not raise ValueMax rates for a period of two years, and that class action plaintiffs' counsel could assign to this provision an additional value of $20 million beyond the product certificates. It also provided for payment of litigation expenses and costs of $240,000.

Finally, the settlement requires an additional disclosure to be inserted in Pitney Bowes' standard form lease in the line immediately preceding the customer's signature. The additional disclosure will state: "This lease contains a risk of loss provision in paragraph ___ that requires you either to provide proof of insurance or instead participate in a Pitney Bowes program, currently called ValueMax, for an additional fee."

It is hard to judge the exact value of the product certificates and the agreement not to increase ValueMax rates, but taken at face value, the combined total value would be $51.8 million. Regardless of how it is calculated, the value is substantial. The attorneys' fees alone were approximately $8.75 million, payable in cash, not to mention the out-of-pocket cost reimbursement of $240,000.[13]

The *Harbin* settlement didn't consist only of the Alabama lawsuit. It consolidated claims in other class actions in West Virginia, Texas, Mississippi, and California. Although Alabama has hosted many of the class action lawsuits, this illustrates that the problems are not confined to Alabama. The risk is generally present in all 50 states.

To be sure, the settlement agreement included strong assertions that Pitney Bowes did not

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The principal lesson of the Pitney Bowes settlement is that lessor sponsored risk management programs such as ValueMax are inherently more risky than other forms of lease insurance.

engage in wrongdoing. However, this settlement came three years after what might have seemed a conclusive victory in *Chris Albritton*, discussed above. The settlement undoubtedly reflects a thoughtful judgment by the company and its professional advisers that trial by jury posed substantial risk.

The principal lesson of the Pitney Bowes settlement is that lessor sponsored risk management programs such as ValueMax are inherently more risky than other forms of lease insurance. They purport to fulfill the role of lease insurance but are unregulated. Consequently, they give class action plaintiffs an argument that the programs are intended as a subterfuge to avoid insurance regulation. They also forgo the protection that is implicit in a regulated program, given that compliance with regulatory requirements – including any applicable rate setting procedures – may provide a defense to claims of profiteering.

E. "Penalizing" Lessees That Fail to Comply With the Lease

The measure of damages for breach of contract is the amount of money sufficient to put the other party in the same position as if the contract had been performed. In the case of a lessee that fails to provide lease insurance, this includes not just the premium but all the costs that are reasonably incurred obtaining substitute insurance. In cases where the precise amount of damages may be difficult to establish, parties can agree that the defaulter will pay a "liquidated" sum that is specified in the contract, provided that the amount is "reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss."[14] If the liquidated sum is unreasonably large in relation to the actual harm, it violates public policy. This is significant because the public policy violation cannot be cured by merely disclosing the amount or existence of the penalty.

The case of *New York Career Guidance Services v. Wells Fargo Financial Leasing*, in Bergen County, New Jersey Superior Court,[15] concerned a late charge rather than insurance. However, the reasoning applies to any charge that might be viewed as a penalty for noncompliance – including failure to obtain required insurance. The lease in *New York Career Guidance* provided a late charge "at a rate of ten percent (10%) of the late payment or up to $50.00, at Lessor's discretion." The lessor routinely charged the $50 maximum. The lessee alleged that the late fees were disguised penalties because they almost equaled the basic monthly payment of $53.64.

The superior court rejected claims for breach of contract and other consumer violations based on a theory of nondisclosure. The disclosures, according to the court, were perfectly adequate. However, it refused to grant summary judgment on the claim that the late charge was really a disguised penalty. Instead, the court held that items such as late fees, default interest rates, and prepayment provisions are forms of liquidated damage that potentially violate public policy unless they are "reasonable under the totality of the circumstances." The court granted class certification and ordered the case to trial.

Within days of that order, Wells Fargo agreed to settle. Because the scope of the class was limited to leases that contained a New Jersey choice of law and a New Jersey forum selection clause, the amounts were small in comparison to other settlements discussed in this article. Wells Fargo agreed to pay damages of $15 cash for every $50 late fee plus attorneys' fees of $175,000 and expenses of $69,942. Because the class had only 2,023 members, the total settlement cost including attorneys' fees was about $449,977.

But the implications are immense. Had the class been larger, the cash payment of $15 per member would have been far more costly. For example, there were about 600,000 class members in *Harbin v. Pitney Bowes*. A similar sized class in *New York Career Guidance* would translate to a liability of $9 million that would be payable in cash – not in product certificates of indeterminate value.

The lesson of *New York Career Guidance* is that even conspicuous disclosure will not prevent liability if the fee is a disguised penalty. The test is whether the charge is reasonable in relation to

An Ounce of Prevention Is Worth a Pound of Cure

Typically, the class action lawsuits concerning lease insurance programs allege that such programs include hidden and excessive profits or penalties that are not related to the stated purpose of protecting leased equipment with lease insurance.

Prominent and reputable leasing companies have elected to settle rather than face the cost and risk of litigation. The settlements usually deny any wrongdoing or liability. However, each settlement typically includes a payment of at least several million dollars.

The following are recommendations for leasing companies in modifying their standard lease forms:

- Avoid any charge that resembles a penalty.
- Avoid risk management programs that do not include real insurance.
- Avoid "reinsurance" arrangements with affiliated companies that do not provide added value to lessees.
- Provide efficient tracking services so that lease insurance charges are only billed to lessees who have failed to provide the required proof of other insurance.
- Disclose that the lease insurance program charges may include a profit to the lessor, its affiliates, and its agents.
- Avoid use of the words "cost" or "expense" in reference to insurance charges.

actual costs, risks, and damage. The penalty analysis applies as much to lease insurance charges as to any other charge in the lease. The implications are important. If lease insurance charges are found to be a penalty, disclosure will not provide a defense.

Risk management or loss damage waiver fees that do not reflect actual loss experience and are not reasonably related to underwriting risk will likely remain a very inviting target for class action lawsuits.

SUGGESTED STRATEGIES TO AVOID CLASS ACTIONS

A. Modify Existing or Proposed Lease Insurance Programs and Lease Formats to Avoid Foreseeable Risks

Prudent equipment leasing companies will review existing or contemplated lease insurance programs with an open mind to determine whether they are appropriately designed to fulfill the stated purpose of protecting the lessor from uninsured loss or liability. Such programs can legitimately include charges for administrative services that are integral to the program. For example, it is often more efficient for lessors to provide billing and cash receipt services related to lease insurance, because they are already billing and collecting lease payments. Lessors can legitimately expect to earn a profit for additional services that improve efficiency.

However, the program should be designed in a way that seems objectively reasonable – and the opportunity to generate additional profit must be fully disclosed. The risk of class action liability will be much greater if the program seems mainly intended to provide a false or artificial justification for charges that dramatically increase the lessor's profits. Prudent leasing companies will modify their standard lease forms to assure that the documents address the issues raised by past class actions. Some basic recommendations are as follows.

• Avoid any charge that resembles a penalty, including any fee or charge that is not reasonably related to actual costs, risks, or damage.

• Avoid risk management programs that do not include real insurance. They are problematic and involve significantly greater risk based on potential allegations that they are just an unregulated and illegal substitute for insurance, or an improper liquidated damage penalty.

• Avoid "reinsurance" arrangements with affiliated companies that do not provide added value to lessees. This includes programs that (1) are not

The risk of class action liability will be much greater if the program seems mainly intended to provide a false or artificial justification for charges that dramatically increase the lessor's profits.

Second, delaying corrective action creates an appearance of willful misconduct. The risk of class action lawsuits is increasingly well known and widely recognized throughout the industry. Strategies to reduce the risk are becoming the industry standard.

actuarially reviewed periodically to ensure competitive pricing, or (2) do not meet the target loss ratios of the Creditor-Placed Insurance Model Acts.

• Provide efficient tracking services so that lease insurance charges are only billed to lessees that have failed to provide the required proof of other insurance. The tracking service should monitor insurance expirations and cancellations throughout the terms of the leases. It should avoid billing for lease insurance where the lessees (1) have not yet been asked for evidence of other insurance, (2) have not been given a reasonable period to comply, or (3) have already produced evidence of insurance that the lessor failed to credit.

• Disclose that the lease insurance program charges may include a profit to the lessor, its affiliates, and its agents. The disclosure should mention any applicable source of profit including charges for administrative services. If the amount of profit seems unreasonable in relation to either the total lease insurance charge or the value of the service, it will increase the risk of a class action lawsuit.

• Avoid use of the words "cost" or "expense" in reference to insurance charges, because they can be interpreted as including only out-of-pocket costs that are directly related to the program or paid to unaffiliated third parties for services that are priced via arm's-length negotiation.

B. Assure That the Relevant Provisions Are Conspicuously Included in the Body of the Lease

The disclosures should be contained in the lease itself. This is because leases typically include an "integration clause" stating that the lease represents the entire agreement between the parties and that any provision not contained in the lease is not part of the agreement. Disclosures in other documents may still be helpful, but the lease itself is the most important document.

Assure that all disclosures concerning lease insurance are written in a style that unsophisticated lessees can easily understand. Be sure that the important disclosures are conspicuous, to avoid claims that they were hidden in fine print. For example, important disclosures can be printed in boldface type for emphasis.

C. Do Not Postpone the Review and Modification of Lease Insurance Program for Fear of Admitting Liability

It would be a mistake to think that changing existing programs as suggested in this analysis would intensify present risks by admitting that the old program is improper. There are at least three aspects to this issue.

First, corrective measures cannot be used to show that the defendant's prior conduct was improper. For example, Rule 407 of the Federal Rules of Evidence (as amended Dec. 1, 1997) states that:

> When, after an injury or harm allegedly caused by an event, measures are taken that, if taken previously, would have made the injury or harm less likely to occur, evidence of the subsequent measures is not admissible to prove negligence, culpable conduct, a defect in a product, a defect in a product's design, or a need for a warning or instruction.

Although the corrective measures may be admitted for other purposes, such as to show the feasibility of precautionary measures, it is not an admission of liability. In any event, the feasibility of precautionary measures is usually not a disputed issue in cases that involve lease insurance.

Second, delaying corrective action creates an appearance of willful misconduct. The risk of class action lawsuits is increasingly well known and widely recognized throughout the industry. Strategies to reduce the risk are becoming the industry standard. Prudent companies are making changes to address the issue, and willingness to improve existing products is usually interpreted as a sign of good faith. Conversely, failing to keep up with the new and evolving standards will now, more than ever before, have an appearance of intentional exploitation. In some cases, delay could be the factor that tips the balance of risk and liability

against the leasing company – forcing a more generous settlement.

Third, as a matter of simple math, damages will grow as time goes by. Each new lease will increase the size of the class. Also, delay will increase the liability for prejudgment interest in cases where prejudgment interest is appropriate.

In this class action environment, an ounce of prevention is worth a pound of cure. Reasonable and comparatively inexpensive changes to conform to the state of the art in lease insurance programs can potentially avoid major liability.

Endnotes

1. UCC Secs. 2-103(a)(b) and 2A-103(2).

2. Other names for such programs include "risk fees" and "property damage surcharges." The same analysis applies to any program that charges a fee for failure to provide evidence of insurance coverage but does not involve a substitution of other insurance – regardless of the label.

3. For the most part, U.S. contract law consists of rules and principles that courts have evolved in response to the facts of particular cases, and contract law dates back to English decisions that precede American independence. Though all states follow the same general principles, often referred to as common law, applications of it may vary from one state to the next. The American Law Institute, which maintains uniformity on American common law issues, publishes various resources including the *Restatement (Second) of Contracts* to summarize the most widely accepted principles. Most courts will treat the Restatement as an authentic source of common law, and it is often cited in court decisions.

4. *Chris Albritton Construction Company Inc. v. Pitney Bowes Inc.*, 304 F.3d 527 (5th Cir. 2002).

5. *Albritton*, at 531.

6. *Harbin v. Pitney Bowes Inc.*, Civil Action No. 2002-769 in the Circuit Court of Montgomery County, Alabama.

7. Class Action Fairness Act of 2005 (CAFA), Public Law 109-2, Feb. 18, 2005.

8. *United States v. Microsoft Corp.*, 253 F.3d 34 (D.C. Cir. 2001). *United States v. Microsoft Corp.*, 253 F.3d 34 (D.C. Cir. 2001).

9. The Microsoft analysis of anticompetitive conduct is relevant in two respects: the U.S. Court of Appeals upheld a finding that Microsoft secretly and deceptively included software features that were intended to protect its monopoly in the platform software market (reference 8 at 76-77) and ruled that

Microsoft might also be liable on remand for bundling software products in a single pricing package that would potentially inhibit competition (at 95-97).

10. *Mike Foote Oil & Gas Properties LLC v. Tokai Financial Services Inc.*, et. al. Case No. CV-00-782 in the Circuit Court of Baldwin County, Alabama.

11. *Slocum Properties Inc. v. Kyocera Mita America Inc.*, Case No. CV-02-1133 in the Circuit Court of Mobile County, Alabama.

12. *General Resource Corp. v. Citicorp Vendor Finance Inc. et al.*, Circuit Court of Mobile County Alabama, Civil Action No. 2001-4204-JSJ.

13. This type of payment, in product certificates rather than cash, is now prohibited in cases that are subject to CAFA. The effect of CAFA may be to reduce the nominal value of settlements, but settlements will now have to be paid in cash.

14. See reference 3.

15. *New York Career Guidance Services v. Wells Fargo Financial Leasing*, in Bergen County, New Jersey Superior Court, Civil Action No. BER-L-1705-03.

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