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Financing Payment Obligations for Services

Are 'Hell or High Water' and 'Waiver of Defenses' Clauses Enforceable in Contracts for Future Services?

By Raymond W. Dusch and Marc L. Frohman

The primordial cornerstone of financing equipment lease receivables has been the ability of funding sources to rely on the enforceability of two related provisions contained in the underlying lease documentation:

1) "Hell or high water" clauses, where the lessee agrees that its payment obligations under the lease are "absolute and unconditional" and are not subject to any defense, setoff, or counterclaim that the lessee may have against the lessor, its assignee, the manufacturer or seller of the equipment, or against any person for any reason whatsoever — essentially, it agrees to pay "come hell or high water."

2) "Waiver of defense" clauses, where the lessee "agrees not to assert against an *assignee*" of the lease payments, any defenses, setoffs, or claims it may have against the lessor, as the original payee under the lease.

What happens, then, if the underlying contract is not principally a lease of equipment, but involves primarily (or exclusively) an arrangement by a service-provider (the "service vendor") to provide future services (for training, maintenance, or software services, etc.) over an extended period of time? To the extent that services payment contracts require periodic payments by the recipient of the services (the "customer"), the service vendor may seek to either: 1) sell the payment stream to a third-party funding source/assignee (the "funding source") or 2) pledge these payments to (and borrow against them from) a funding source. If so, the funding source will need to know that the "hell or high water" and "waiver of defenses" provisions built into the services payment contract are enforceable.

This article examines the support under the Uniform Commercial Code ("UCC") and case law for the enforceability of "hell or high water" and "waiver of defenses" clauses in connection with the financing of payments for future services, and it suggests some due diligence and contractual protections that may be employed to

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Information Security Obligations

Part One of a Three-Part Series

By Melissa J. Krasnow

One of the most pressing issues faced by any business, but especially those in the financial services industry, is the privacy and security of financial and other nonpublic information. This is the first in a series of three articles addressing some of the key issues surrounding corporate responsibility with respect to the privacy of information and security breaches. Whether public or private, small company or large, if you or your client are in possession of the personal information described below, the following series of articles is essential reading.

As business information — particularly in electronic format — continues to proliferate, the need to maintain the security of this information is increasing. There are privacy and corporate governance laws that govern the obligation of a company to keep information secure. According to the Global State of Information Security 2006, a worldwide study by *CIO* magazine, *CSO* magazine, and PricewaterhouseCoopers representing the responses of almost 7800 senior executives, "Noncompliance runs broad and deep in all industries, and ignorance of applicable law is a big factor." This article provides an

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overview of two important information security obligations — security procedures and practices, and document destruction — under privacy and corporate governance laws.

SECURITY PROCEDURES AND PRACTICES

State Security Procedures and Practices Laws

A few states have enacted laws regarding a company's duty to maintain reasonable security procedures and practices. Arkansas, California, Nevada, Rhode Island, Texas, and Utah enacted security procedures and practices laws. California was the first state to enact a security procedures law. Under the California law, a company that owns or licenses personal information about a California resident must implement and maintain reasonable security procedures and practices appropriate to the nature of the information to protect the personal information from unauthorized access, destruction, use, modification, or disclosure.

Personal information means an individual's first name or first initial and last name in combination with any of the following data elements, when either the name or data elements are not encrypted: 1) Social Security number; 2) driver's license number or state identification card number; 3) account number, credit card number, or debit card number in combination with any required security code, access code, or password (*e.g.,* a PIN) that would permit access to an individual's financial account, or 4) medical information.

Federal Trade Commission Security Procedures Standards

Although there is no specific federal security procedures law for all companies, the Federal Trade Commission ("FTC") has described standards for security procedures in a number of recent cases. By way of example, in the BJ's Wholesale Club case in 2005, the FTC charged that BJ's failure to provide reasonable security for sensitive customer information was an unfair act or practice in violation of §5 of the Federal Trade Commission Act because it caused substantial injury that was not reasonably avoidable by consumers and not outweighed by offsetting benefits to consumers or competition. The FTC alleged that BJ's: 1) failed to encrypt consumer information when it was transmitted or stored; 2) stored the information longer than it had a need to do so; 3) stored the information in files that could be accessed using commonly known default user IDs and passwords; 4) failed to use readily available security measures to prevent unauthorized wireless connections to its networks; and 5) failed to use measures sufficient to detect unauthorized access to the networks. The settlement order for this case requires BJ's to establish and maintain a comprehensive information security program that includes administrative, technical, and physical safeguards and to obtain regular third-party professional audits of this program for compliance with the FTC Order and with bookkeeping and record-keeping requirements. The FTC Order is in effect for a 20-year period.

Sarbanes-Oxley Act

Pursuant to §404 of the Sarbanes-Oxley Act of 2002 ("SOX"), management of a public company is responsible for establishing and maintaining adequate internal control over its financial reporting. Management must evaluate and report on the effectiveness of internal control over financial reporting in the annual report filed by a public company with the Securities and Exchange Commission. This management report is accompanied by an attestation from the independent auditor of the public company. Management also must evaluate and disclose changes that have materially affected or are reasonably likely to materially affect a public company's internal control over financial reporting in the quarterly and annual reports. Moreover, the Chief Executive Officer and Chief

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What Leasing Counsel Need to Know About Arbitration

Part Two of a Two-Part Series

By Charles F. Forer

Part One of this series analyzed the consideration that leasing counsel should give to discovery, locale selection, confidentiality, and expediting the arbitration process. This month's installment discusses issues relating to arbitrator-selection.

Good Corp. and Bad Corp. are locked in a dispute regarding a lease for medical imaging equipment. The lease agreement says that Good Corp. and Bad Corp. must arbitrate their dispute. However, the lease agreement does not provide any details about the arbitration resolution process.

After Bad Corp. stopped making monthly lease payments (because the equipment is "no good"), Good Corp.'s general counsel ("GC") asked Good Corp.'s outside counsel ("Outside Counsel") to bring an arbitration claim against Bad Corp. and "wrap it up quickly."

Arbitrators: One or Three

Outside Counsel suggests having three arbitrators so that Good Corp. and Bad Corp. each can choose a "party-arbitrator," and so the two "party-arbitrators" then can pick the third arbitrator who would be neutral.

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GC is befuddled. "Why three arbitrators? Isn't one arbitrator enough?" Outside Counsel's response: "A three-arbitrator panel is better. Why not have one of the arbitrators in my back pocket? During the hearings, I can talk to 'our' arbitrator and fill in gaps in our presentation. I even can find out what is taking place while the three arbitrators deliberate and decide the case!" Good Corp.'s attorney is salivating over the prospects of discussing each day's testimony with Good Corp.'s party-arbitrator and, when the hearings are over, learning the status of deliberations.

Outside Counsel has several party-appointed arbitrators in mind. Outside Counsel hopes that "his" arbitrator will find some way to have side conversations with the neutral arbitrator to ensure that the neutral arbitrator is "on track."

Outside Counsel got one thing right: Although the law varies from state to state, parties generally are permitted to select "friendly" arbitrators, so long as the appointing parties a) disclose their past or present relationship with the selected arbitrator; and b) do not select an arbitrator who has a fiduciary relationship with the appointing party. However, a close relative, employee, or agent of one of the parties to the controversy generally may not act as a party-arbitrator.

Unfortunately, Outside Counsel's advice to GC is wide off the mark in several other respects — practical and otherwise — that will undermine Good Corp.'s strategy of "wrapping it up quickly."

To begin with, Outside Counsel neglected to tell GC that a three-arbitrator panel would complicate scheduling the four-day arbitration hearing. How easy will it be to accommodate the schedules of the attorneys, the parties, and the three arbitrators? If three arbitrators hear the dispute, the proceeding probably will take longer to complete because it will be difficult to schedule hearing dates that are acceptable to all of the parties and to all of the arbitrators. When the hearing is over, moreover, three arbitrators will take longer than one arbitrator to reach a final decision.

Outside Counsel also should have factored in the time that the two party-arbitrators spend in choosing the third neutral arbitrator. Selecting one arbitrator is time-consuming enough as the parties fight over qualifications and potential conflicts of interest. These problems only multiply if the parties, their respective counsel, and their respective party-selected arbitrators all throw in their two cents about the choice of the neutral arbitrator. Does Outside Counsel really think that the process of picking the third arbitrator will happen in the blink of an eye with all of these participants involved in the selection?

And there is the cost issue. Counting Outside Counsel, Good Corp. will have to pay two and one-half professionals during the arbitration hearing. Does the amount in controversy between Good Corp. and Bad Corp. warrant these costs?

Outside Counsel did not only miss these practical realities in his push for three arbitrators, but he also neglected to consider ethical issues. In 1977, a joint committee of the American Arbitration Association and a special committee of the American Bar Association prepared a Code of Ethics for arbitrators in commercial disputes. In 2003, an ABA task force and a special committee of the AAA revised the Code. This Code dashes several of Outside Counsel's dreams.

First, the Code requires all arbitrators — party-appointed or not — to disclose any financial or personal interest in the outcome of the arbitration before accepting appointment. The Code also requires potential arbitrators to disclose past or present financial, business, professional, or personal relationships that "might reasonably affect impartiality or lack of independence in the eyes of any of the parties." Good Corp. may well be able to select Outside Counsel's good friend as a party-arbitrator. Before appointment, however, the friend must make all appropriate disclosures. So much for "slipping something by" Bad Corp. in the arbitrator-selection process.

Second, the Code says that party-appointed arbitrators must disclose, "at the earliest practicable time,"

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whether they intend to communicate with their appointing parties. All parties then will know at the outset what is fair game in terms of arbitrator communications. This means that Outside Counsel must tell Bad Corp.'s counsel that Outside Counsel intends to communicate directly with Good Corp.'s party-appointed arbitrator.

Third, the Code says that party-appointed arbitrators may not disclose any deliberations by the arbitrators; may not communicate with the parties concerning "any matter or issue taken under consideration by the panel after the record is closed or such matter or issue has been submitted for decision"; and may not disclose any decision before it is disclosed to all parties. So much for Outside Counsel's notion of communicating with Good Corp.'s arbitrator during the deliberation process.

Fourth, the Code says that unless the arbitrators and the parties otherwise agree, a party-appointed arbitrator, in the absence of the other party-appointed arbitrator, may not communicate orally with the neutral arbitrator concerning anything arising or expected to arise in the arbitration. Does this mean that the charm and charisma of Good Corp.'s party-appointed arbitrator will be wasted? Not necessarily. Good Corp.'s arbitrator will be free to advance Good Corp.'s side of the case with the neutral arbitrator *so long as Bad Corp's arbitrator is present*. If Good Corp. wants its arbitrator to have *ex parte* communications with the neutral arbitrator, Outside Counsel should get Bad Corp. to agree that the arbitrators for both parties can have *ex parte* communications. This leveling of the playing field will defeat Outside Counsel's strategy of having secret *ex parte* conversations.

Investigating Arbitrators

Outside Counsel's face turned pale when GC asked him how he intends to choose Good Corp.'s "party arbitrator." He turned beet red when GC asked the following:

"Will you make sure that the arbitrator does not have any conflicts?" (Outside Counsel's response: "But he will not be a lawyer for Good Corp.")

"Will you find out anything about the proposed arbitrator through word of mouth?" (Outside Counsel acknowledged that he does not intend to ask anyone about the proposed arbitrator.)

"Will you make the decision based on the proposed arbitrator's experience in arbitrating other cases?" (Outside Counsel said he did not intend to find out how many other cases, if any, the proposed arbitrator has arbitrated.)

"Will you find out whether the proposed arbitrator has subject matter expertise?" (Outside Counsel's response: "What am I supposed to do? Do a background check on every proposed arbitrator?")

Outside Counsel dropped the ball here. Uncovering conflicts of interest is essential to picking an arbitrator. However, a party must do more than merely confirm that the potential arbitrator does not have a conflict.

A party and its counsel initially should determine the type of arbitrator best suited to hear the case. They should consider whether the arbitrator: a) should be a lawyer, a certified public accountant, an architect, an engineer, an appraiser, or other professional; and b) should have training, expertise, knowledge, or experience in the factual or legal issues in dispute. They also should find out if the prospective arbitrator has experience and training in arbitration or other types of alternative dispute resolution. An arbitrator who knows everything about the subject matter would be a disaster if he or she cannot efficiently and expeditiously conduct an arbitration proceeding.

Lawyers rarely get the chance to talk directly to proposed arbitrators. How-ever, lawyers often have the ability — through the Internet, through word of month, or through professional publications, to name just a few sources — to uncover all kinds of information about proposed arbitrators. Lawyers should take full advantage of this information in order to make an informed decision about the abilities in the arbitrator-selection process.

The arbitrator-selection process does not stop with conflict-checking and information-gathering. The best selection process and the most thorough background check will mean little if the arbitrator becomes unable to serve because of professional commitments, illness, or death. Accordingly, the parties should think about two other issues in connection with the proposed arbitrator.

First, particularly in an arbitration proceeding that will take several months from arbitrator selection to post-hearing briefing, the parties should consider whether to specify a procedure if one or more arbitrators becomes unable to serve. The parties should agree upon not only the process to select a replacement; they also should consider whether the arbitration proceedings would have to be repeated after the replacement steps in.

Second, to ensure that the arbitration proceeding does not languish, the parties should determine, before arbitrator-appointment, whether the proposed arbitrator has the time to adjudicate the dispute as quickly as the parties want. To assure that the selected arbitrator promptly will decide the dispute, the parties further may agree to select an arbitrator only if he or she expressly represents that he or she has the time to hear and decide the matter by a specified date.

Although Outside Counsel's face is no longer beet red, he reluctantly concludes that arbitrator selection involves more investigation than he ever dreamed. In fact, he muses to himself, the process sure sounds like jury selection.

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Financial Officer of a public company must provide certifications regarding their responsibility for establishing and maintaining internal control over financial reporting, and the design of internal control over financial reporting, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. These certifications are attached as exhibits to a public company's quarterly and annual reports.

Delaware Case Law

The suit against the board of directors of Caremark International Inc. involved claims that the directors breached their fiduciary duty of care to the company in connection with alleged violations by Caremark employees of state and federal laws. *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del.Ch. 1996); *see also*, *Stone v. Ritter*, ___ A.2d ___, 2006 WL 3169168 (Del. Nov. 6, 2006). The plaintiffs sought to recover losses on behalf of the company from the directors. According to the Delaware Chancery Court:

> [I]t is important that the board exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility ... [A] director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.

Document Destruction

State Laws

Close to one-third of states have enacted laws requiring the destruction of documents. Arkansas, California, Hawaii, Indiana, Kansas, Kentucky, Montana, Nevada, New Jersey, North Carolina, Rhode Island, Tennessee, Texas, Utah, Vermont and Washington enacted document destruction laws. Under the California law, a company must take all reasonable steps to destroy or arrange for the destruction of the records of a customer within its custody or control containing personal information which is no longer to be retained by: 1) shredding, 2) erasing, or 3) otherwise modifying the personal information in those records to make it unreadable or undecipherable through any means.

Personal information means any information that identifies, relates to, describes, or is capable of being associated with, a particular individual, including: 1) name; 2) signature; 3) Social Security number; 4) physical characteristics or description; 5) address; 6) telephone number; 7) passport number; 8) driver's license or state identification card number; 9) insurance policy number; 10) education; 11) employment; 12) employment history; 13) bank account number; 14) credit card number; 15) debit card number; or 16) any other financial information. Records refer to any material regardless of the physical form on which information is recorded or preserved by any means (*e.g.,* in written or spoken words, graphically depicted, printed, or electromagnetically transmitted).

Fair and Accurate Credit Transactions Act

The Disposal Rule under the Fair and Accurate Credit Transactions Act of 2003 ("FACTA") requires a company that maintains or otherwise possesses consumer information for a business purpose to properly dispose of consumer information by taking reasonable measures to protect against unauthorized acquisition or use of the information in connection with its disposal. Consumer information means any record about an individual in paper, electronic, or other form that is derived from a consumer report or a compilation of such record. Disposal refers to the discarding or abandonment of consumer information or the sale, donation, or transfer of any medium (including computer equipment) upon which consumer information is stored.

Reasonable measures include establishing and complying with policies to: 1) burn, pulverize, or shred papers containing consumer report information so that the information cannot be read or reconstructed; 2) destroy or erase electronic files or media containing consumer report information so that the information cannot be read or reconstructed; and 3) conduct due diligence and hire a document destruction contractor or dispose of material specifically identified as consumer report information. Although the FACTA Disposal Rule applies to consumer reports and the information derived therefrom, the FTC, which enforces this Rule, encourages those that dispose of any records containing a consumer's personal or financial information to take similar protective measures.

Sarbanes-Oxley Act

Two sections under SOX that cover document destruction apply to a company, whether public or private. Section 802 of SOX states:

> [W]hoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under title 11, or in relation to or contemplation of any such matter or case, shall be fined ... imprisoned not more than 20 years, or both.

Section 1102 of SOX states in pertinent part:

> [W]hoever corruptly ... alters, destroys, mutilates, or conceals a record, document, or other object, or attempts to do so, with the intent to impair the object's integrity or availability for use in an official proceeding; or ... otherwise obstructs, influences, or

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reduce risk in financing future service payments.

SUPPORT UNDER THE UCC

The "hell or high water" clause, a creature of the common law of equipment leasing, was given statutory recognition in §2A-407 of the UCC, which provides hell-or-high-water protection to a lessor under a "finance lease" by making the lessee's obligations "*irrevocable* and *independent*" of the lessor's obligations under the lease contract merely upon the lessee's acceptance of the leased goods. UCC §2A-508(6) likewise restricts a lessee's rights of setoff in a hell-or-high-water finance lease. These protections apply, however, only to non-consumer *finance leases*, which require, among other things, that the lessor not also be the supplier of the goods being leased (*See* UCC §2A-103(g)). There is, however, no comparable UCC provision offering hell-or-high water status to original payees in transactions for future *services*, even if the original payee is not directly supplying the services being provided.

Fortunately for service vendors and their funding sources, the enforceability of a "waiver of defenses" clause with respect to the financing of payments for future services by an assignee/funding source of the payee *is* expressly supported by §9-403 of the UCC (enacted as part of Revised Article 9 of the UCC in 2001). This section states that "an agreement between an *account debtor* and an assignor *not to assert against an assignee* any claim or defense that the account debtor may have against the assignor" is generally enforceable, provided that the assignee takes the assignment for value, in good faith, and without knowledge of any claims or defenses. Under revised §9-102 of the UCC, an "account debtor" includes "a person obligated on an *account,*" and an "account" expressly includes "a right to payment of a monetary obligation, *whether or not earned by performance* ... for *services* rendered or *to be rendered* ..." Section 9-403 applies equally whether the "assignment" constitutes an outright *sale* of the underlying account for future services, or the grant of a security interest in the account. Consequently, the UCC expressly anticipates the financing of payment obligations for future services, and the enforceability by assignees of "waiver of defenses" clauses agreed to by account debtors for such services.

CASE LAW SUPPORT

While the enforceability of "hell or high water" and "waiver of defenses" provisions in the context of equipment leasing cannot be quibbled with, there are no published court decisions under Revised Article 9 of the UCC directly addressing the enforceability of either provision in the context of an assignment of payment obligations for future services yet to be performed. Nonetheless, decisions upholding the enforceability of "waiver of defenses" and "hell or high water" provisions in the more traditional context of equipment lease transactions are instructive.

In a 1991 case that involved the assignment of a master lease of a mainframe computer system, for example, the U.S. Court of Appeals for the 10th Circuit in *Colorado Interstate Corp. v. CIT Group/Equipment Financing, Inc.,* 993 F.2d 743 (10th Cir. 1991), enforced a standard "hell or high water" clause, focusing on two important public policy justifications. The clause in question stated: "This Master Lease is a net lease and Lessee agrees that its obligations to pay all Basic Rent and other sums payable hereunder (collectively, Rent), and the rights of Lessor and Assignee in and to such Rent, are absolute and unconditional and are not subject to any abatement, reduction, setoff, defense, counterclaim or recoupment due or alleged to be due to, or by reason of, any past, present or future claims which Lessee may have against Lessor, Assignee, the manufacturer or seller of the equipment, or against any person for any reason whatsoever." 993 F.2d at 745. The two public policy justifications focused on by the court were:

1) Parties' right to freely contract. Absent fraud or deceit committed by or otherwise "known" by the assignee, sophisticated and well-represented parties "are given broad latitude within which to fashion their own remedies for breach of contract ... It follows that contractual limitations upon remedies are generally to be enforced unless unconscionable." *Id.* at 748.

2) The *commercial necessity* of such provisions, finding "hell or high water clauses" essential to the equipment leasing industry. "[I]t is by means of these clauses that a prospective financier-assignee of rental payments is guaranteed meaningful security for his outright loan to the lessor. Without giving full effect to such clauses, if the equipment were to malfunction, the only security for this assignee would be to repossess equipment with substantially diminished value." *Id.* at 748.

Other courts have held similarly, based in part upon a commercially acceptable "allocation of the risk" of nonperformance to the lessee who selected the equipment, instead of the risk being assumed by a good faith assignee for value that merely provides financing for the benefit of the lessee. For instance, in *Benedictine Coll. Inc. v. Century Office Prods., Inc.*, 853 F. Supp. 1315, 1324 (D. Kan. 1994), the court held that when the lessee agreed to terms of a lease containing a "hell or high water" clause, it agreed to continue making rent payments despite any claim it might have against the lessor or the lessor's assignee, and it expressly *assumed risk of lessor's*

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nonperformance. Moreover, the court in *Philadelphia Savs. Funds Soc. v. Desert Mortgage Corp.*, 632 F. Supp. 129, 136 (E.D. Pa. 1985), held that "[T]hese clauses are essential to the equipment leasing industry. To deny their effect as a matter of law would *seriously chill* business in this industry ..."

Similar public policy concerns apply in the context of financing payment obligations for future services. Funding sources will not purchase or otherwise finance payment obligations for future services without confidence that contractual "hell or high water" and "waiver of defenses" provisions will be enforced against account debtors. Indeed, the argument for enforcing such provisions in the context of financing payment obligations for *future services* is even *stronger* than in the context of equipment leasing since, in a service agreement, absent any special rights granted by the service vendor to the finance company in a separate agreement, upon the customer's default the finance company will have recourse *only* to the customer's general credit and, in contrast to an equipment lease, the finance company will not have a security interest in hard collateral that can be liquidated to mitigate its losses.

The authors are aware of only one case that might cast doubt on the enforceability of waiver of defenses clauses in the specific context of the financing of payment obligations for future services — *Suburban Trust and Savings Bank v. Univ. of Delaware*, 910 F. Supp. 1009 (D. Del. 1995), in which the court denied an assignee's attempt to enforce a "waiver of defenses" clause with respect to the assignment of payments under a computer maintenance services contract. However, there are several reasons why *Suburban Trust* should have no precedential value today:

1) The "waiver of defenses" clause was construed under the *former* UCC §9-206 (which was expressly limited to "buyers and lessees," which the court further limited to the sale of *goods*, and not services), rather than *revised* UCC §9-102 and §9-403, which substantially broadened the applicability of "waiver of defenses" clauses to include "account debtors" with respect to "*services* ... performed or to be performed" in the future.

2) Rather than truly analyzing the enforceability of "waiver of defenses" with respect to services payment contracts, the court relied upon a thinly veiled unconscionability line of reasoning; and

3) No other court has relied on the *Suburban Trust* decision for a similar holding, and at least one case, also construing the pre-revision UCC, has expressly called the holding into question. *See Brookridge Funding Corp. v. Northwestern Human Services*, 175 F.Supp.2d 355, 363 (D. Conn. 2001) (refusing to follow the *Suburban Trust* court's reasoning, and holding that the waiver of defenses clause could be applied to the waiver executed by the lessee in that case).

Conclusions and Recommendations

By following the strictures of revised UCC §9-403, and provided that unconscionability is not at issue, funding sources have good reason to rely on the enforceability of "waiver of defenses" clauses when financing payment obligations under contracts for future services. Nonetheless, especially in high-volume, single-source service relationships with service vendors, there are a number of steps a funding source can take to reduce the risk of litigation and to factually bolster its position should litigation ensue.

1) Take into consideration the added benefit that comes with being an "assignee" of a service vendor, rather than the original payee under the contract. "Hell or high water" and "waiver of defenses" clauses may be the "belts and suspenders" of receivables financing, but the benefits of "waiver of defenses" clauses are *only* available to assignees of the original payee. The express statutory authority of UCC §9-403 applies *only* to the *assignee* (" ... an agreement between an account debtor and an assignor *not to assert against an assignee* any claim or defense that the account debtor may have against the assignor *is enforceable by an assignee*"). Absent an assignment, if a funding source serves as the original payee under the services payment contract, its sole refuge resides in the enforceability of the "hell or high water" clause — a protection that is statutorily enforceable with respect to non-consumer finance *leases of equipment*, but that may be subject to attack in financing other types of receivables, such as service payment obligations. The success of any attempt to make a service customer's direct payment obligations truly hell-or-high-water by making them completely "independent" of the obligation of the original payee/service vendor to provide the contracted services, would appear to be far less certain under current law than the certainty afforded by indirect financing of service payment obligations by an assignee. Thus, to the extent that a non-assignee funding source may be tainted by the vendor's failure to perform its service obligations, notwithstanding the existence of a "hell-or-high-water" clause, a funding source serving as an original payee under a services contract may have significant exposure to the customer. In a non-assignee context, therefore, funding sources should be mindful of the degree of control or influence they have over the true service provider and its relationship with the customer, whether through a joint venture or a "co-branded" financing arrangement (also known as "semi-private label" or "quasi-private label" finance programs).

2) Undertake reasonable and documented due diligence on the service vendor's historical performance of its service obligations, including: a) creating a written record showing a reasonable basis for concluding that the vendor can and will perform its service obligations as promised under its extended term service agreements, and b) preparing a written appraisal or evaluation of the types of service fees, in order to confirm whether the amounts being charged for such services are commercially reasonable for such

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Financing Payment

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services, given the customer's credit-worthiness (*i.e.*, ensure that the vendor does not set unjustifiably high, off-market rates for one customer, and much lower rates for comparable customers receiving comparable services, as became an issue in the *Norvergence* cases).

3) Obtain an indemnity from the service vendor for claims and defenses raised by customers in connection with the vendor's nonperformance. In order to give the service vendor a continuing financial incentive to perform its service obligations under its contract, consider holding back a portion of each financing, the payment of which is made contingent upon the vendor's satisfactory performance over a specified period. To give the funding source more leverage in its collection efforts, obtain an agreement that the vendor will (upon notice by the funding source) cease providing services to a customer upon the funding source's request, if (and so long as) the customer fails to make any payments to funding sources when due under the services payment agreement, and require the vendor to include its right to withhold services for non-payment in the underlying service agreement.

4) Obtain a notice of assignment (or estoppel certificate) executed by the customer, confirming the key facts of the transaction (or, at the very least, obtain telephonic *oral* confirmation from the customer of such key facts). For example, such notice or confirmation could confirm: a) the amount and timing of payments to be made under the service agreement; b) that the customer has not prepaid for any of the services; and c) that, to date, the customer has received all of the expected services in a satisfactory manner.

5) Consider making the hell-or-high-water, choice of forum, severability, and waiver of defenses clauses "conspicuous" (and/or separately acknowledged or initialed by the customer) in the services payment agreement and/or in a separate notice of assignment.

6) Select a reasonable forum for dispute settlement of small- to middle ticket-agreements, so that a customer cannot validly argue that the service vendor made it so difficult and inconvenient that the customer is, for all practical purposes, deprived of its day in court.

7) Institute a systematic approach to communicate service complaints received by the funding source's collections and customer service staff, to ensure that additional transactions are not funded if an abnormally high number of service-related complaints is received.

Of course, while the foregoing list of actions is far from complete, these actions should, if followed, provide a solid foundation for protecting and enforcing a funding source's interests in financing payments for future services. This will help ensure that funding sources as assignees of service vendors can fully utilize the legal protections under case law and the UCC for enforcing hell-or-high-water payment obligations under contracts for future services.

Security

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> impedes any official proceeding, or attempts to do so ... shall be fined ... or imprisoned not more than 20 years, or both.

Conclusion

As information security obligations are continually changing, the laws governing them are evolving. Laws in different areas such as privacy and corporate governance are both addressing these obligations. As a result, a company must carefully and constantly monitor developments in all of these laws in order to comply with them. According to the Ernst & Young 2006 Global Information Security Survey, compliance requirements in the past year have most significantly impacted and in the next year likely will continue to significantly impact the information security practices of companies.

Next month's installment will address security breach notification.

IN THE MARKETPLACE

AIG Equipment Finance Holdings, Inc. of Dallas has announced the appointment of **Eugene (Gene) Henneberry** as president and CEO of its AIG Rail Services, Inc. subsidiary. He joins AIG after spending 10 years with GE Railcar Services, most recently as executive vice president of operations and quality. Henneberry will be located at the AIG Chicago offices.

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