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Forbearance Agreements

A Useful Tool for Lenders After Default

By Joseph M. Grant

With a borrower in default and facing the threat of imminent litigation or bankruptcy, both lenders and borrower are increasingly looking to the appealing alternative of forbearance agreements. These are arrangements whereby lenders refrain from exercising their available default remedies in exchange for certain concessions from the borrower. Depending on the circumstances, forbearance agreements give lenders an alternative to the expenses and delays associated with litigation or bankruptcy. Forbearance agreements can also be used to take the place of a more long-term modification of the parties' arrangement. Accordingly, a forbearance usually gives up little on the part of the lender, but allows the lender to secure a number of benefits that will be very helpful in the event of a subsequent default by the borrower.

Parties consider forbearance agreements for a variety of reasons. Lenders seldom immediately shut down a transaction after an initial default and typically give the borrower time to solve its financial problems. If the default is minor or is only temporary, a forbearance agreement may be entered into to give the borrower time to cure the default. In situations where the borrower and the lender are negotiating a broader

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Dealer Protection Statutes Level the Playing Field for Heavy Equipment Dealers

By Bradfute W. Davenport, Jr. and William H. Hurd

Dealers who sell and lease expensive heavy equipment, and therefore those who finance them, are often at the mercy of the manufacturers whose products the dealers sell or lease. Disparities in bargaining power between a local equipment dealership and a national or international manufacturer can force the dealership to accept unfair or oppressive terms. And if the manufacturer arbitrarily terminates the dealership agreement, the thriving business that the equipment dealer built can be totally ruined, often with little or no legal recourse, thereby also putting those who finance the dealer at peril.

Recognizing the need to level the playing field, some states have enacted laws to protect equipment dealers from arbitrary cancellation of dealership agreements. These laws often cover dealers in equipment and machinery used in the construction, forestry, maritime, mining, and other industries. Several states — Virginia, Delaware, Georgia, Maryland, Mississippi, Tennessee, and West Virginia — have laws that prohibit a manufacturer from terminating an equipment dealer without good cause and an opportunity to cure. Garner, *2 Franchise and Distribution Law and Practice*, §16:5 (Thompson/West 2005). These dealer protection statutes take various forms. Some states require manufacturers to repurchase the dealer's inventory after termination; others require the manufacturer to compensate the dealer for the value of its premises. *Id.* In one form or another, "[t]hirty-five states have statutes protecting dealers in farm equipment and similar heavy equipment." *Id.*

THE RECENT VIRGINIA DECISION

One such law — the Virginia Heavy Equipment Dealer Act ("the Act") — was recently the subject of a major court battle. On one side was a Virginia dealer engaged in the business of selling and leasing heavy equipment at retail. On the other side was a Canadian company that manufactures heavy forestry and logging equipment. A written agreement between the two firms had been in effect for nearly 6 years.

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restructuring, the parties may agree to enter into a forbearance agreement to give the lender time to analyze the default situation and determine if it is willing to consider a longer arrangement, as well as give the parties time to negotiate the terms of a possible restructuring and ultimately document the new arrangement. A lender may also consider a forbearance in situations where the borrower may be refinancing its debt or selling the company or its assets. Under these circumstances, a lender may agree to a forbearance simply to allow the 90-day preference period to expire with respect to any new collateral. Finally, lenders can use a forbearance agreement to correct certain deficiencies in the loan documents or with lender's interest in the collateral.

The reason for entering into a forbearance agreement obviously depends on the specific transaction. The forbearance agreement can also take on many forms, such as a letter agreement, additional loan documents, or the preparation of a formal "Forbearance Agreement." However, here are a few issues to consider when agreeing to a forbearance and eventually preparing a forbearance agreement.

OBJECTIVE OF THE FORBEARANCE AGREEMENT

In preparing a forbearance arrangement, the agreement itself should state the reason for the forbearance as well as what must be accomplished during the forbearance period. The agreement may include various representations and warranties associated with the purpose of the forbearance, as well as include specific interim steps that must occur if the goal of the forbearance is to be achieved. The agreement should also clearly state

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exactly what actions the lender is refraining from during the forbearance period, the length of which should be set forth in the agreement.

ADMISSION OF THE DEFAULT, AND WAIVERS AND RELEASES

In most situations, it is imperative for the borrower to acknowledge the enforceability of the loan documents and lender's right to declare a default and accelerate under them, as well as reaffirm the debt and the outstanding balance. Acknowledgment by the borrower of the outstanding debt will avoid or reconcile any dispute to the balance. The borrower must also acknowledge that it has requested the forbearance in order to establish consideration for the benefits it has received due to the forbearance as well as recognize the validity of the loan documents and the lender's lien on the collateral. Equally as important, a borrower, especially one that stated that it has claims against the lender, must waive all claims and defenses against the lender. Securing a waiver of defenses and a release at this point is crucial if the lender perceives litigation as a probable outcome in the near future.

CONDITIONS TO FORBEARANCE AND EARLY TERMINATION

In addition to providing a "drop dead" or expiration date in the agreement, forbearance agreements can also include events or conditions that would cause the early termination of the forbearance. Typically, termination of the forbearance arrangement will occur as a result of a breach of the forbearance agreement, additional defaults under the other loan or transactions with the borrower, a material adverse change in the borrower's business or financial condition or destruction or damage to the value of collateral, the pledge of any of the collateral to another creditor, the institution of litigation by another creditor or the filing of a bankruptcy petition.

The forbearance agreement may also include provisions terminating the forbearance if certain anticipated events do not occur. These types of provisions are commonly tied to the overall objective of the forbearance

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Post-Petition Enforcement Against the Seller of Contracts for the Sale of Goods

By Grant T. Stein and Jennifer M. Meyerowitz

Generally speaking, after a bankruptcy filing, executory contracts are not enforceable against a debtor that has not yet assumed the contract. *N.L.R.B. v. Bildisco and Bildisco*, 465 U.S. 513, 531 (1984). However, the reverse is not true. During the pre-assumption period the non-debtor party to the contract is presumed to be obligated to perform in accordance with a contract. Howard C. Buschman III, *Benefits and Burdens: Post-Petition Performance of Unassumed Executory Contracts*, 5 Bankr. Dev. J. 341, 346, 359 (1988); *Univ. Med. Ctr. v. Sullivan (In re Univ. Med. Ctr.)*, 973 F.2d 1065, 1075 (3d Cir. 1992); *McLean Indus., Inc. v. Med. Lab. Automation, Inc. (In re McLean Indus., Inc.)*, 96 B.R. 440, 449 (Bankr. S.D.N.Y. 1989). Of course, a debtor who elects to receive the benefits of a contract while deciding whether to assume or reject the contract is expected to pay for the value of the goods and services received in accordance with the contract. As the Supreme Court noted in *Bildisco*, 465 U.S. at 531, "If the debtor-in-possession elects to continue to

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receive benefits from the other party to an executory contract pending a decision to reject or assume the contract, the debtor-in-possession is obligated to pay for the reasonable value of those services ..." See also *Schokbeton Indus., Inc. v. Schokbeton Prods. Corp. (In re Schokbeton Indus., Inc.)*, 466 F.2d 171, 175 (5th Cir. 1972).

There are some limitations, however, on the ability of the debtor in possession to obtain the benefit of a contract after bankruptcy but prior to assumption. Section 365(b)(4) of the Bankruptcy Code, for example, excuses a landlord from providing services and supplies incidental to the lease when there has been a nonmonetary default under the lease, unless the landlord is compensated for the services or supplies. 11 U.S.C. §365(b)(4). With respect to nonresidential realty leases, the debtor in possession must pay the full rent as it accrues post-petition, prior to assumption, even if the premises are not used or occupied. 11 U.S.C. §365(d)(3); *Cukierman v. Uecker (In re Cukierman)*, 265 F.3d 846, 850 (9th Cir. 2001) ("We have held that claims arising under §365(d)(3) are entitled to administrative priority even when they may exceed the reasonable value of the debtor's actual use of the property"); *In re Curry Printers, Inc.*, 135 B.R. 564 (Bankr. N.D. Ind. 1991) (requiring lease payments regardless of actual usage).

With a contract to sell goods, or to provide services, the issue from the perspective of the seller is how to protect itself going forward. Is an administrative expense claim for the provision of post-petition trade credit a sufficient protection? Experience tells us that debtors sometimes do not pay their post-petition administrative obligations. Vendors may prefer cash on delivery or payment in advance of delivery. How, or rather why, would and could such a unilateral change in the contract be effectuated post-petition?

A key inquiry is to examine the trade credit provisions of the contract. The reason for this is that as a practical matter, the issue when the case is before the bankruptcy court is whether the bankruptcy judge will make a trade vendor provide post-petition trade credit. There are no

reported cases where the debtor was able to require a trade vendor to provide trade credit. There are cases where the vendor has been required to sell to the debtor, but not on credit in a bankruptcy context. See e.g. *Blackwelder Furniture Co. v. Seilig Mfg. Co.*, 550 F.2d 189 (4th Cir. 1977) (injunction to reinstitute franchise agreement and thus duty to sell, but not in a bankruptcy context); cf., *In re Coserv, LLC*, 273 B.R. 487, 494 (Bankr. N.D. Tex. 2002) (in dicta, stating that a vendor's refusal to supply to a debtor absent payment of a pre-petition claim is in violation of the automatic stay of §362(a)(6) and equating it to "economic blackmail"). The presence of trade credit terms can provide a basis on which a vendor can stop selling to a debtor and thus cease performance under the contract.

Section 365(c)(2) provides that a debtor "may not assume ... any executory contract ... if ... such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor ..." 11 U.S.C. §365(c)(2). Section 365(c)(2) is designed "to protect a party to a contract from being forced to extend cash or a line of credit to one who is a debtor under the Bankruptcy Code." *Tully Constr. Co. v. Cannonsburg Environmental Assocs., Ltd. (In re Cannonsburg Environmental Assocs., Ltd.)*, 72 F.3d 1260 (6th Cir. 1996) (in dicta quoting 1 Collier Bankruptcy Manual ¶365.02[2], at 14-15 (3d ed.1995)).

While the terms "loan," "debt financing," or "financial accommodations" are not defined in the Bankruptcy Code, courts have reviewed the legislative history and held that the terms are to be "strictly construed so as not to extend to an ordinary contract to provide goods and services that has incidental financial accommodations or extensions of credit." *Gill v. Easebe Enters., Inc. (In re Easebe Enters., Inc.)*, 900 F.2d 1417, 1419 (9th Cir. 1990) (rev'd on other grounds); *In re Whiteprize, LLC*, 275 B.R. 868, 873 (Bankr. D. Ariz. 2002). For example, in *In re Emerald Forest Constr., Inc.*, 226 B.R. 659 (Bankr. D. Mont. 1998), an equipment lease was

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found not to be a financial accommodation contract since the primary purpose of the lease was the leasing of the equipment and any extension of credit that occurred was incidental to the primary purpose. Of course, with a lease the goods being leased are already in possession of the debtor and the statute contains an obligation to pay equipment lease payments after the first 60 days (unless the court orders otherwise based on the equities) and the right to seek an administrative expense payment for the use during the first 60 days. 11 U.S.C. §365(d)(5) (former §365(d)(10)); *Guttman v. Xtra Lease, Inc.* (In re *Furley's Trans., Inc.*), 263 B.R. 733, 742 (Bankr. D. Md. 2001) (“Section 365(d)(10) does not preclude Xtra Lease from applying under Section 503(b)(1) for administrative expenses that arose during the first fifty-nine days of the Debtor’s Chapter 11 case.”); *In re Pan Am. Airways Corp.*, 245 B.R. 897, 899 (Bankr. S.D. Fla. 2000) (the court can order lease payments under §365(d)(1) during the first 60 days of the case “based on the equities of the case” and can award an administrative expense claim for such period where the standards of §503(b)(1)(A) are met); *In re Continental Airlines*, 146 B.R. 520, 525 (Bankr. D. Del. 1992) (allowing an administrative expense claim for the post-petition, pre-rejection use of an aircraft where aircraft was used in ordinary course of the debtor’s business). Similarly, the 11th Circuit in *Citizens and S. Nat’l Bank v. Thomas B. Hamilton Co.* (In re *Thomas B. Hamilton Co.*), 969 F.2d 1013 (11th Cir. 1992) determined that a credit card merchant processing agreement was not a contract to make a loan or extend debt financing and cited to the legislative history to §365 that “characterization of contracts to make a loan, or extend other debt financing or financial accommodations, is limited to the extension of cash or a line of credit and is not intended to embrace ordinary leases or contracts to provide goods or services with payments to be made over time.” Accordingly, the court held that merchant credit card

processing was not a “financial accommodation.” 969 F.2d at 1018. Of course, the contract being assumed enabled the merchant processor to require a security deposit to protect itself from chargebacks on credit card slips it purchased. The point is that the law and the cases are usually practical in their analysis.

In other instances, where the debt financing was an integral part of the contract, courts have found that an extension of debt financing renders the contract unassumable and thus unenforceable. In *John Deere Co. v. Cole Bros., Inc.* (In re *Cole Bros., Inc.*), 154 B.R. 689 (W.D. Mich. 1992), for example, the court found that the debt financing was not incidental but rather an integral part of a dealership agreement which included a floor plan financing component. Likewise, in *TransAmerica Commercial Finance Corp. v. Citibank, N.A.* (In re *Sun Runner Marine, Inc.*), 945 F.2d 1089 (9th Cir. 1991), the Ninth Circuit affirmed the reversal of the bankruptcy court and held that even with consent, a floor plan financing agreement through which a party would lend money to retail boat dealers so they could buy boats from the debtor and resell them to customers was not assumable under §365(c)(2).

In addition to the limitations on being able to require a vendor to provide post-petition trade credit under §365(c)(2), the Uniform Commercial Code (“UCC”) is also an area that merits analysis in considering what a seller should do when its buyer files for bankruptcy. The UCC contains provisions authorizing the seller to suspend performance and refuse to deliver goods or stop delivery of goods in transit when there is an insolvent buyer, when there is anticipatory repudiation, or where there are reasonable grounds for insecurity of performance. UCC §§2-609, 2-702, 2-705; *Montello Oil Corp. v. Marin Motor Oil, Inc.* (In re *Marin Motor Oil, Inc.*), 740 F.2d 220, 225 (3d Cir. 1984). Generally, a buyer’s filing of bankruptcy has no effect on a seller’s ability under the UCC and state law to stop goods in transit. *Haywin Textile Prods., Inc. v. Bill’s Dollar Stores, Inc.*,

(In re *Bill’s Dollar Stores, Inc.*), 164 B.R. 471, 475 (Bankr. D. Del. 1994); *In re Fabric Buys*, 34 B.R. 471, 473-75 (Bankr. S.D.N.Y. 1983); *B. Berger Co. v. Contract Interiors, Inc.* (In re *Contract Interiors, Inc.*), 14 B.R. 670, 675 (Bankr. E.D. Mich. 1981). Further, stoppage of goods in transit has been held not to violate the automatic stay of §362 of the Bankruptcy Code. See *Nat’l Sugar Refining Co. v. C. Czarinkow, Inc.* (In re *Nat’l Sugar Refining Co.*), 27 B.R. 565 (S.D.N.Y. 1983). Accordingly, an argument can be made that if the UCC provides that a seller need not sell to an insolvent debtor and can stop goods in transit, and because the Bankruptcy Code does not do anything to limit a seller’s rights under the UCC, then a seller cannot be required to ship post-petition to a debtor in bankruptcy if it could not be required to do so under the UCC. See Thomas Moers Mayer, *Developments in Executory Contracts — 2005*, Thirty Second Annual Southeastern Bankruptcy Law Institute, April 2006, pp. 18-21.

The hard question is the scope of the alternatives available to a seller and how it should act to protect its economic interests. The teachings of the Supreme Court in *Citizens Bank v. Strumpf*, 516 U.S. 16 (1995), are a good example of what a prudent seller should do when faced with the prospect of dealing with a threat of a motion for violating the automatic stay and for sanctions, or for a temporary restraining order, as a response to not doing business with a debtor on credit post-bankruptcy. Under *Strumpf*, the seller should promptly move for relief from the automatic stay or seek other judicial direction recognizing that the seller is relieved of its duty to sell to the debtor, under credit, post-petition.

The practical result of the preceding discussion is that this fight is usually resolved by a compromise of some sort between the vendor and the debtor. At the end of the day, of course, that is what is supposed to happen in bankruptcy cases.



Forbearance

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and should list events that are necessary if the borrower is going to accomplish the goal of the forbearance. For instance, a lender can require the borrower to obtain a workout consultant who will provide regular updates to the lender or require the borrower to sell the business, a division of the business, or company assets with the goal of paying off the lender with the proceeds. A lender can also use the forbearance to secure additional guarantees or collateral, or collect additional fees and interest. Finally, a lender can impose requirements on the borrower's use of its own funds to repay the loan.

REPORTING AND DISCLOSURE

Nowadays, frequent and detailed financial disclosure is commonplace. The forbearance arrangement should require periodic reports regarding any interim steps and the borrower's progress toward accomplishing the overall purpose, and provide copies of any related third-party correspondence and documentation. The agreement may also provide for the examination of the borrower's books and records by the lender's own auditors or consultants.

'PRE-WORKOUT' PROVISIONS

If the forbearance's objective is to explore a possible restructuring or long-term arrangement, the lender can use the forbearance to set the rules that will govern those discussions and negotiations. For instance, the borrower and lender can agree that the lender is not obligated to enter into or continue negotiations, that the negotiations constitute settlement discussions and are inadmissible in any later proceedings, and that the discussions will not be binding until final documents are executed and delivered.

SALE OF ASSETS

The forbearance agreement can permit the borrower to sell business assets, including all or part of the collateral. However, such provisions must require the borrower to procure and maintain adequate insurance on the equipment prior to sale and can mandate how the sale must be con-

ducted and how the proceeds will be applied to the debt.

PERMISSIBLE ACTIONS

BY THE LENDER

A lender may be permitted to take specified enforcement actions notwithstanding the forbearance. Many times, litigation may already be pending at the time the arrangement is entered into. In these situations, the lender should secure the borrower's consent to taking actions necessary to preserve the status quo, prevent dismissal or default, and extend deadlines. Conversely, the borrower itself may be required to take or refrain from certain actions in the litigation.

EXPIRATION AND

'MELTDOWN' PROVISIONS

Eventually, the forbearance expires or is terminated due to a breach or the borrower's successful completion of the forbearance goals. On the one hand, if the objective of the forbearance was to allow the borrower time to cure the existing defaults or otherwise improve its business or financial condition and the borrower meets the goals set forth in the agreement, the defaults may be waived and the loan returned to its original terms, or an agreed-upon long-term modification may take effect. However, if the agreement terminates as a result of a breach, the agreement itself should specify that the lender can immediately proceed to enforce or continue to enforce all of its rights and remedies to collect the obligation.

Even if the lender has not instituted litigation, the forbearance agreement should have a provision whereby the lender is entitled immediately to proceed toward judgment, especially due to the borrower's acknowledgment in the forbearance agreement of its default and the amount of the debt, in addition the borrower's waiver of its defenses and claims against the lender. Obtaining such acknowledgments in the agreement will obviate the need to prove default, liability, and damages in litigation. If any action has been filed, the lender should take steps to obtain the court's approval of the agreement, rendering the forbearance a settlement, enforceable in the event of default.

Although a borrower's waiver of its right to file a bankruptcy petition is against public policy, the lender should insist upon provisions in a forbearance agreement to secure its rights in the event of a bankruptcy proceeding. Lenders have some ability to protect themselves. The lender can require provisions in the forbearance agreement regarding indemnity against funds disgorged in connection with avoidance actions and the use of cash collateral. Another important provision may be to obtain the borrower's consent to relief from the automatic stay so that the lender can proceed outside the bankruptcy court to obtain its remedies. Alternatively, a lender can seek to dismiss the bankruptcy case of a borrower if the borrower represented that it did not intend on filing a bankruptcy petition, if the lender acts to its detriment in agreeing to the forbearance, and the borrower commences the bankruptcy proceeding shortly thereafter.

Finally, the lender should include a forum selection clause or "consent to jurisdiction" provision in the agreement, in the event of disputes, thus avoiding unfriendly jurisdictions. To appear fair to both parties, the chosen forum does not need to be the home state of either the lender or borrower. However, the forum selection clause must be mandatory or some courts may not enforce the provision. The lender should also retain the right to bring an action to secure its collateral in any jurisdiction where the collateral may be located. In addition to a forum selection clause, a lender should include a jury trial waiver provision. Although the underlying loan documents may contain a jury trial waiver clause, the forbearance agreement should contain such waiver as well to ensure that if any dispute arises between the parties and a lawsuit is filed, the lender can enforce the contractual jury trial waiver.

CONCLUSION

A lender should evaluate a potential forbearance agreement with the goal of increasing the likelihood of repayment while improving its ultimate ability to recover. By including such provisions

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The Canadian manufacturer tried to terminate the agreement in 2005. The Virginia dealer went to court to stop the termination. The manufacturer responded aggressively with a three-point counterattack. As a threshold matter, the manufacturer claimed that the dealer did not carry enough inventory to fall within the statutory definition of “dealer,” and therefore did not qualify for the Act’s protection. It also claimed that the Act violated the state constitution’s prohibition against “special laws.” Finally, in an argument with potential industrywide ramifications, the manufacturer claimed the Act violated the Commerce Clause of the U.S. Constitution.

In an April 2006 decision of the U.S. District Court for the Eastern District of Virginia, the Canadian company lost and the applicability and constitutionality of the Act were upheld. *Atlantic Machinery & Equipment, Inc. v. Tigercat Industries, Inc.*, 419 F.Supp.2d 856 (E.D. Va. 2006) (“*Atlantic Machinery I*”); *Atlantic Machinery & Equipment, Inc. v. Tigercat Industries, Inc.*, 427 F.Supp.2d 657 (E.D. Va. 2006) (“*Atlantic Machinery II*”). This precedent should help equipment dealers defend — or enact — similar statutes in other states.

THE VIRGINIA ACT

Adopted by Virginia in 1988, the Act lists a variety of goals. Among

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them are (i) promoting “a stable business climate for the supply and distribution of heavy equipment ... [thereby encouraging] economic development” as well as (ii) “foster[ing] *fair business relations* between suppliers and dealers of heavy equipment,” and (iii) “prohibit[ing] *unfair treatment* of dealers of heavy equipment.” 1988 Acts of Assembly, ch. 73 (emphasis added). (The Act is found at Virginia Code §59.1-353 *et seq.*)

The Act defines “heavy equipment” as “self-propelled, self-powered or pull-type equipment and machinery, including engines, weighing 5000 pounds or more, primarily employed for construction, industrial, maritime, mining and forestry uses.” Motor vehicles requiring registration and certificates of title, farm machinery, equipment and implements sold or leased pursuant to dealer agreements with suppliers subject to other provisions of Virginia law, and consumer goods are carved out of the definition of “heavy equipment.”

In a nutshell, the Act prohibits a “supplier” of heavy equipment from canceling — or failing to renew — a dealership agreement without “good cause.” The term “good cause” is limited. It means a decision by the supplier to withdraw from selling its products in Virginia or some “performance deficiency” on the part of the dealer. As a general rule, the supplier must give the dealer at least 120 days prior written notice and an opportunity to cure any alleged deficiency. There are exceptions to the notice requirement for certain severe situations, such as dealer bankruptcy, fraud, delinquency in paying the supplier, a felony conviction, etc. Significantly, the Act states that these protections apply “notwithstanding the terms ... of any agreement.” Va. Code §59.1-354. Thus, these are not rights that equipment dealers can be forced to give up when they contract with manufacturers.

There is, however, a limitation on who qualifies for these protections. Occasionally selling or leasing a piece of heavy equipment is not enough. Under the Act, a “dealer” is a person who is “(i) engaged in the business of selling or leasing heavy equipment at retail, (ii) who custom-

arily maintains a total inventory, valued at over \$250,000, of new heavy equipment ... and (iii) who provides repair services for the heavy equipment sold.” Va. Code §59.1-353.

THE DEALERSHIP AGREEMENT

Signed in 1999, the agreement between the Virginia equipment dealer and the Canadian manufacturer in this case was not unusual. The manufacturer designated the dealer as an authorized representative of its equipment for a geographic area of “primary responsibility” that included much of Virginia. The manufacturer had no other direct sales outlets in the state. Its equipment was manufactured in Ontario, Canada, and was shipped to the dealer “free on board” Ontario.

The agreement said that the manufacturer could terminate the equipment dealer relationship upon 60 days written notice, rather than the 120 days required by the Act. And, unlike the Act, the agreement contained no requirement that there be “good cause,” nor did it require the reason for termination to be explained, nor did it provide for the dealer to be given an opportunity to cure. In July 2005, the manufacturer sent the dealer a termination notice. While the bare bones notice complied with the agreement, it did not comply with the Act. Facing a major blow to its business, the equipment dealer filed suit in state court.

Based on “diversity of citizenship” — Virginian and Canadian — the manufacturer removed the lawsuit to federal court.

THE INVENTORY CLAIM

The manufacturer claimed that the equipment dealer did not meet the Act’s inventory requirement because the dealer did not “customarily maintain a total inventory, valued at over \$250,000, of new heavy equipment” *from this manufacturer*. The court held that “total inventory” means inventory from all suppliers, not just the individual supplier in the case. It also held that “customarily” is flexible and dependent on the facts in a specific case. Applying “customarily” to the case before it, the court decided that the equipment dealer’s total

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inventory should be assessed on a monthly or quarterly basis for the 5 years immediately preceding the supplier's termination of the agreement. *Atlantic Machinery I*, 419 F.Supp.2d at 860-61. With that clarification by the court, the equipment dealer easily established that it customarily maintained total inventory exceeding \$250,000. *Atlantic Machinery II*, 427 F.Supp.2d at 660-61.

THE STATE CONSTITUTIONAL CLAIM

The manufacturer claimed that the Act did not further any legitimate state interest, and that it was “designed to protect a specific group — existing heavy equipment dealers in Virginia to the detriment of other[s].” *Id.* at 662. Thus, it said the Act was “economic favoritism” and invalid under the state constitutional prohibition against “special laws.” *See* Va. Const. Art. IV, §14. Not persuaded, the court noted that an “economic classification” is valid if there is “a reasonable and substantial relation” between the law and a legitimate legislative goal. *Id.* There was nothing on the face of the Act — and nothing in the evidence — to support the manufacturer's claim that the Act was “unreasonable or arbitrary.” *Id.* Thus, the court rejected the state constitutional challenge, saying it would not “second guess” the legislature's judgment on whether the Act promoted its objectives — economic development and fair business relations. *Id.*

THE FEDERAL CONSTITUTIONAL CLAIM

The manufacturer also claimed the Act violated the federal Commerce Clause. The Constitution gives Congress the power to regulate interstate and international commerce. *See* U.S. Const. Art. I, §8, cl. 3. Even where a state enacts economic regulation in the *absence* of congressional action, however, the regulation still must be judged in light of judicially developed constitutional standards known as the “*dormant* Commerce Clause.”

The dormant Commerce Clause involves two tiers of analysis. On the

first tier, a state statute will almost always be struck down if it *discriminates* against interstate commerce. One way for a statute to discriminate is to regulate commerce occurring *wholly outside* the state's borders. This was the theory pressed by the manufacturer. Even though the dealership agreement was executed in Virginia — and governed the retail sale of equipment there — the manufacturer cited the “free on board” provision in the agreement. Noting that formal ownership passed to the dealer while the equipment was still in Canada, the manufacturer claimed the Act was being used to regulate conduct occurring beyond Virginia's borders, and thus was unconstitutional. It was a creative argument, but the court readily rejected it. Where elements of a transaction occur in two states, or here in Virginia and Canada, both have an interest in the terms and performance of the contract. As the court explained, “Virginia has a legitimate interest in regulating contracts entered into within her borders, particularly those affecting the stability of its economy ... [and] involv[ing] conduct between the parties of an ongoing nature ... within the state's borders.” *Id.* at 666. Thus, the manufacturer's attempt to take advantage of a technicality — where title passed — proved unsuccessful.

The manufacturer also argued that the Act discriminated against interstate commerce on the theory that *dealers* are local while *suppliers* of heavy equipment are out of state. It claimed that the Act was a “one-sided attempt” to favor local equipment dealers over foreign suppliers. *See Id.* at 666-67. The court rejected this argument too. Taking issue with its factual assumption, the court then went further and suggested that the actual location of existing suppliers does not affect the outcome. “The Act cannot be considered economic protectionism when it affects both in-state and out-of-state *suppliers* equally.” *Id.* at 666-67 (emphasis added). The focus must be on how the Act affects in-state suppliers *versus* out-of-state suppliers, not on how it affects in-state dealers *versus* out-of-state suppliers. A state law protecting dealers against unfair treat-

ment by suppliers should not be struck down merely because all suppliers are out of state.

When a statute survives the first tier of analysis, there is still a second tier that must be considered — the *Pike* balancing test. *See Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970). A statute will survive the *Pike* test unless the burdens the statute imposes on interstate commerce are “clearly excessive” compared with the benefits it provides for the state. *Id.* at 142. The court must identify both the benefits and burdens of the challenged statute and weigh one against the other.

The court easily recognized that the Act provides Virginia with legitimate benefits — “namely, the overarching objective of stimulating economic development by encouraging stability and consistency between suppliers and dealers of heavy equipment ... ” *Atlantic Machinery II*, 427 F.Supp.2d at 667. In trying to overcome these benefits, the manufacturer tried to amass a number of alleged burdens. The court was not impressed. Some of the alleged burdens, such as the scope of the dealer's geographic area, flowed not from the Act but from the agreement. Other alleged burdens were not viewed as burdens at all. For example, the court regarded the length of the notice period — 120 days — as both “relatively short” and necessary to achieve the goals of the Act. *Id.* at 669.

The manufacturer sought to draw an analogy between the Act and Virginia's *motorcycle* dealer protection statute, recently invalidated in another case. *See Yamaha Motor Corp. v. Jim's Motorcycle, Inc.*, 401 F.3d 560 (4th Cir. 2005). The court did not buy the analogy. Under the statute in *Yamaha*, an existing motorcycle dealer could prevent his manufacturer from creating a new dealership *anywhere* in the state, even outside the existing dealer's market area. By contrast, the Virginia Heavy Equipment Dealer Act did not prevent the creation of any new dealerships; it only imposed certain requirements on the termination of an existing one. To the extent the existing equipment dealer enjoyed any territorial control, it was the result of the

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IN THE MARKETPLACE

The **Equipment Leasing Association** of Arlington, VA announced that former U.S. Representative **Kenneth E. Bentsen, Jr.** has assumed leadership of the organization as president effective July 1. He joined ELA from his previous position as a Managing Director at Public Strategies, Inc. of Austin, TX. Bentsen succeeds **Michael Fleming**, who retired as president after serving in that position for the last 27 years. Fleming will continue to remain an active member

of the leasing community and will join the U.S. division of **The Alta Group** as a principal.

Bentsen, only the second president to serve since the association's founding, previously represented the 25th District of Texas in the U.S. House of Representatives from 1995 to 2003. As a senior member of both the House Budget and Financial Services Committees, he helped craft the legislation to modernize the nation's banking and securities laws and the

Sarbanes-Oxley Act. He also authored and co-authored many measures related to health care, thrift savings plans, international trade, and the nation's response to terrorism, particularly with respect to banking and insurance. Prior to serving in Congress, Bentsen was an investment banker in Houston and New York, specializing in municipal and housing finance. He was a senior banker for numerous structured-finance, mortgage-backed, special purpose and general government transactions.



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agreement, not the Act. The Commerce Clause challenge failed.

THE RESULT

Having ruled that the agreement was governed by the Act and that the Act was constitutional, the court then found that the notice given by the manufacturer was invalid.

LESSONS

If you finance lessors or sellers of heavy equipment, you should not necessarily take their contracts with suppliers at face value. The chances are good there is state legislation that provides dealers with valuable protection from termination, cancellation, or non-renewal by their suppliers. Whether the dealer or supplier knows it or not, such legislation may well trump inconsistent

provisions in the supplier's contract, which itself may well be, or appear on its face to be, non-negotiable and a contract of adhesion. The courts will apply and enforce this protective legislation to favor the dealer because doing so is consistent with the broad, remedial purposes of the legislation and is exactly what the state legislature intended when it enacted the law.



Forbearance

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in any forbearance arrangement, a lender secures itself a better position in the event of a subsequent default by the borrower. At the same time, both the lender and the borrower must ensure that the forbearance arrangement provides sufficient time and flex-

ibility to allow the borrower to accomplish the goals of the forbearance.



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