

# The Transactional Lawyer

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## Don't be Duped by a Duplicate Original

**Bradley N. Gibson**

Now that real estate mezzanine financing has returned to prominence in the real estate capital stack, a troubling trend is emerging. Borrowers are executing duplicate original security certificates representing the equity pledged as collateral. Given the free transferability of security certificates, these duplicate original certificates can cause big headaches for borrowers and their counsel.

### A True Story

This past winter, associates of a large well-known law firm were feverishly scurrying about their office trying to close on a \$105 million mezzanine loan which was secured solely by the pledge of 100% of the membership interests in a real-property-owning limited liability company. They were confirming final versions of executed loan documents and delivering them to escrow in rapid fire, hoping to satisfy all of the closing requirements before the day's wire transfer cut off. As the escrow company's in-house counsel meticulously reviewed all of the submitted documents, he noticed that borrower's counsel had delivered several security certificates, each representing the same 100% membership interest in the LLC. All the certificates were signed in blue ink, appeared to be signed by the same person, and none of the certificates or signatures was a photocopy. Counsel for the escrow company immediately phoned borrower's counsel to alert him of the oversight. Borrower's counsel nonchalantly explained that his firm always had borrowers execute five or six "duplicate original" security certificates to facilitate a smooth closing.

Counsel for the escrow company asked what happened to the "duplicate original" security certificates once the deal closed. Borrower's counsel did not know and assumed that the escrow company either put them in its file or delivered all of them to lender after closing. He did not think that they were ever returned to his firm though.

### Background

In typical real estate mezzanine financing, the loan is secured by a pledge of the ownership interests in an entity that owns real property, rather than by a lien on the real property itself. Thus, the collateral for a mezzanine loan is personal property, such as interests in a limited liability company, partnership, or corporation.

Such pledged equity collateral can be either a general intangible or investment property under Article 9 of the Uniform Commercial Code. Absent the affirmative act of "opting in" to Article 8 of the U.C.C., equity in an LLC or limited partnership is classified as a general intangible. See U.C.C. § 9-102(a)(42); *In re Brown*, [479 B.R. 112](#) (Bankr. D. Kan. 2012) (interest in LLC is a general intangible); *In re McKenzie*, [2011 WL 6140516](#) (Bankr. E.D. Tenn. 2011) (partnership interests and some LLC interests are general intangibles); *In re Dreiling*, [2007 WL 172364](#) (Bankr. W.D. Mo. 2007) (debtor's interest in a limited liability company was a general intangible, not a security, because the LLC interest was not traded on an exchange and the LLC agreement did not provide that the interests were securities). A security interest in general intangibles can be perfected only by filing a financing statement in the appropriate office. § 9-310(a).

However, members of LLCs and partners of limited partnerships can draft or amend their operating agreements or partnership agreements to include language electing that the interests in the entity constitute securities governed by Article 8. This is referred to as "opting in to Article 8." Once equity in an LLC or limited partnership becomes a security, the security can be represented by a security certificate. A lender can then perfect its security interest in the security either by filing a financing statement or through "control." Control is typically obtained by taking possession of the security certificate after it has

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been indorsed in blank or indorsed to the secured party. §§ 8-106(b), 9-106(a).

### Protected Purchaser Status

Once a mezzanine lender perfects its security interest via control, the lender can qualify as a “protected purchaser” pursuant to § 8-303(a).

As a protected purchaser, the mezzanine lender acquires its interest in the security “free of any adverse claim.” § 8-303(b). This cuts off all prior adverse claims and allows the lender to acquire rights in the security even if the debtor did not have the ability to transfer such rights. 17 Williston on Contracts § 51:56 (4th ed.); *Reynolds v. Reynolds*, [355 P.2d 481](#) (Cal. 1960); *American Sur. Co. of NY v. Cunningham*, [275 N.W. 1](#) (Minn. 1937).

While these benefits of protected purchaser status help insulate the mezzanine lender from certain risks, they are also the source of problems when a security certificate indorsed in blank is lost. A third party could come into possession of and satisfy the relatively minimal requirements to become a protected purchaser of such a certificate. Such a protected purchaser would take the security free of adverse claims. Clearly, security certificates are valuable and should be safeguarded. See <http://www.sec.gov/answers/lostcert.htm>.

### Duplicate Original Certificates

Although the reason for having duplicate original certificates is not entirely clear, the most plausible reason issuers issue them and borrowers indorse them is to provide lenders with backup assurance of control. If one indorsed certificate is lost or destroyed, another (or several more) remain in the lender’s control. Unfortunately, duplicate original certificates can easily become lost or missing certificates if their whereabouts are not persistently accounted for, and one or more of them could end up in the possession of a protected purchaser. In the resulting priority battle between such a protected purchaser and the mezzanine lender, the purchaser could argue that the mezzanine lender did not have control of the security because the lender was relying on a certificate that was void as an overissue. See §§ 8-210, 8-405. Admittedly, the risk of a duplicate original certificate falling into the hands of a third party may be slight. However, even this small risk can, and commonly does, become a big headache when the mezzanine loan is refinanced. On more than one occasion, the underwriters of UCC Insurance policies have stumbled upon the existence of prior

duplicate original security certificates when asked to issue new UCC policies for a refinancing. For example, as part of the underwriting of these new policies, the UCC insurers will typically request a copy of the security certificate in the possession of the prior mezzanine lender. Counsel will submit a copy of the security certificate in the possession of the current mezzanine lender. If the title insurer issued a UCC policy for the original mezzanine loan, it has a copy of the security certificate that was executed at the closing of the original mezzanine loan and can compare its copy of the security certificate in its file with the one submitted by counsel. Unfortunately, on more than one occasion, the signatures on the two security certificates were not identical, indicating the existence of duplicate originals.

The biggest challenge at this point is to determine how many duplicate original certificates were previously issued and where each is now located. This may be nearly impossible for borrower’s current counsel, who were likely not involved with the original mezzanine loan. Even if borrower’s current counsel were involved in the original mezzanine loan, they probably did not appreciate the significance of having duplicate original certificates and likely have no record or memory of what happened to all the certificates.

If the total number of duplicate originals cannot be determined with certainty or all the known duplicate originals cannot be located, the underwriting of a UCC policy for a mezzanine loan becomes much more challenging. In such a case, the UCC insurer must assume for the purposes of its risk analysis that there are missing certificates. Under § 8-405, the issuer can request a surety bond indemnifying it against losses arising from the issuance of a replacement for each missing certificate. This can be a very costly solution given that commercial surety companies can charge a premium of as much as 15% of the bond amount. In addition to the premium, a commercial surety will also require indemnity from a credit-worthy indemnitor and, in some cases, may even require the posting of collateral to secure the indemnity.

With the UCC providing only expensive solutions, the parties to a mezzanine loan will surely look for other less expensive solutions. The title company can always issue its UCC policy with a narrowly tailored exception for any losses arising from the lost/duplicate original certificates. Alternatively, the title company can insure perfection of the security interest by filing a financing statement but this does not provide assurance of priority over third parties who perfect their security

interest via control. Both of these options shift the risk of the missing/duplicate original certificate to the new lender who may not be willing to take on such risk.

Another option is for the title company to issue the UCC policy without exception and essentially accept the risk of these duplicate original certificates. For this, the title company will almost always require the indemnity of a credit-worthy indemnitor to indemnify the title company for all losses arising from the duplicate original certificates. The proposed indemnitor will have to have sufficient net worth separate and apart from the equity represented by the duplicate original certificate. In other words, the single purpose entity direct parent of the issuer of the duplicate original certificate is not going to be sufficient unless it holds other assets.

### Conclusion

The lesson in all of this is – at least for borrower’s counsel – to never, ever, have the your client indorse duplicate original security certificates for a real estate mezzanine loan. If the borrower does indorse duplicate original certificates, be sure to note the number of duplicate originals executed as well as their disposition (*i.e.*, marked “void” or shredded) in the stock book or books and records of the issuer. Failure to comply with these rules can cause serious headaches down the road for borrowers and their counsel.

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## When to Contract for Remedies

*Stephen L. Sepinuck*

Contracting parties often include in their written agreement provisions on remedies for breach. Occasionally, these provisions simply restate what the law already provides. For example, it is not unusual for a security agreement to authorize the secured party to repossess and sell the collateral after default, rights that Article 9 expressly grants. *See* U.C.C. §§ 9-609(a)(1), 9-610(a). While superfluity alone is not reason to omit or excise such provisions from written agreements – after all, careful transactional lawyers seek comfort in the safety blanket of

redundancy – there are reasons to avoid this practice. Expressly providing for remedies obviously available under the law lengthens the written agreement. More important, it creates a negative implication that other remedies not mentioned in the agreement, but which the law would normally additionally or alternatively provide, are not to be available.

So, when should an agreement expressly provide for a remedy? When any of the following six reasons applies.

### 1. To Comply with the Law

Some transactions, particularly those involving a consumer, may require that a remedy be expressly stated to be available. If so, then obviously the agreement should expressly provide for the remedy.

### 2. To Create or Expand a Remedy

Some statutory remedies are expressly made available only in limited situations but the law allows parties to make those remedies available in other situations. U.C.C. Article 9, for example, provides for certain basic remedies after default but permits the parties to provide for additional remedies. § 9-601(a). As a result, a well-drafted security agreement will, depending on the type of collateral involved, cover the following:

**Disabling Non-equipment.** Section 9-609(a)(2) authorizes a secured party after default to disable equipment. The agreement should expand this authorization to cover non-equipment collateral, such as inventory, consumer goods, and software. Of course, the secured party should be aware that some state and federal laws might limit a secured party’s rights in this regard. *See, e.g.*, [18 U.S.C. § 1030](#); [Conn. Gen. Stat. § 42a-9-609\(d\)](#) (requiring 15 days advance notification of any electronic self-help, prohibiting electronic self-help entirely if the secured party has reason to know it will result in grave harm to the public interest, and providing for nonwaivable consequential damages for its wrongful use).

**Voting Collateral.** Authorize the secured party to exercise the voting rights of the debtor with respect to collateralized stock, partnership interests, and LLC interests. Bear in mind, however, it remains unclear whether such a clause will in fact work, particularly with respect to LLC membership interests. *See, e.g.*, *In re Crossover Fin. I, LLC*, [477 B.R. 196](#) (Bankr. D. Colo. 2012) (clause in security agreement providing

that, upon default, the debtor's rights as the sole member of LLC to vote and give consents shall cease and that the secured party may vote any or all of the pledged interest did not operate automatically; Colorado law requires a secured party to enforce the security agreement and become admitted as a member before the secured party may exercise voting rights associated with a membership interest pledged as collateral); *In re Lake County Grapevine Nursery Operations*, [2010 WL 4928488](#) (Bankr. N.D. Cal. 2010) (despite language in pledge agreement to the contrary, under California law neither the pledging of membership rights in an LLC nor the declaration of a breach by the secured party is sufficient to divest the pledging member of the right to vote). Moreover, there may be liability concerns that impel a secured party to either not include such a clause in the security agreement or not exercise the authority such a clause grants.

**Entering Premises.** Expressly authorize the secured party and its representatives to enter the debtor's property after default to repossess collateral. Section 9-609 grants a secured party the right to take possession of collateral after default, provided it acts without a breach of the peace. One factor relevant to whether a breach of the peace occurs is the existence and extent of a trespass. While a secured party probably has a license to enter the debtor's driveway or carport even without express authorization, *see Ford Motor Credit Co. v. Ryan*, [939 N.E.2d 891](#), 908-09 (Ohio Ct. App. 2010), entering a garage or other structure is more problematic, *see Osborne v. Minnesota Recovery Bureau, Inc.*, [2006 WL 1314420](#) (D. Minn. 2006). If the security agreement authorizes the secured party to enter the debtor's premises, it may help avoid any trespass claim. This authorization will not, by itself, be sufficient to prevent a breach of the peace and will be irrelevant if the debtor does not own or rent the premises where the collateral is located, but may nevertheless be helpful.

**Taking Non-collateral.** Authorize the secured party, when repossessing the collateral, to repossess things in or attached to the collateral. For example, a consumer who has granted a security interest in a motor vehicle will typically keep in the vehicle items of personal property that are not encumbered by the security interest. Indeed, the secured party probably cannot take a security interest in the property the debtor happens to later put in the vehicle. *See* § 9-204(b); [16 C.F.R. § 444.2\(a\)\(4\)](#) (making it an unfair credit practice to take a nonpossessory, non-PMSI in

household goods). While a secured party may not need express authorization to temporarily take such property during a repossession, *see Terra Partners v. Rabo Agrifinance, Inc.*, [2010 WL 3270225](#) (N.D. Tex. 2010), such authorization should help insulate the secured party from conversion and trespass claims with respect to such property. As long as the security agreement does not make such goods collateral for the secured obligation, this authorization should not run afoul of the prohibition in § 9-204(b).

**Retaining Surplus to Cover Unliquidated and Contingent Secured Obligations.** Indicate what the secured party may do with the proceeds of a collection or disposition if there are non-monetary obligations that remain outstanding. For example, the secured party should, after satisfying the monetary secured obligations, be permitted to hold onto additional proceeds until such time as the debtor's non-monetary obligations are satisfied or discharged. While a secured party has nonwaivable duties to account for surplus proceeds of collateral and to remit them to either a junior lienor or the debtor, *see* §§ 9-602(5), 9-608(a); 9-615(a), (d), the security agreement would presumably be relevant to determining whether a surplus exists and should be able to specify – at least with respect to the debtor – how quickly the secured party must act in remitting any surplus.

### 3. To Enhance Availability of a Remedy

Some remedies, particularly equitable remedies, are within the court's discretion. For example, the appointment of a receiver to manage collateral before final judgment is subject to a variety of factors, the most critical of which are whether the creditor is undersecured and whether the debtor is insolvent. *See, e.g., Canada Life Assurance Co. v. Lapeter*, [563 F.3d 837](#) (9th Cir. 2009). To enhance the likelihood that a court will appoint a receiver, the mortgage or security agreement might provide for such an appointment upon the lender's application therefor after the borrower's default. Courts will not be bound by such a contractual provision, but the provision may help. It may also permit such an appointment to occur on an *ex parte* basis. *See, e.g., U.S. Bank v. Gotham King Fee Owner, LLC*, [2013 WL 2149992](#) (Ohio Ct. App. 2013); *Fortress Credit Corp. v. Alarm One, Inc.*, [511 F. Supp. 2d 367](#) (S.D.N.Y. 2007). *Cf. Comerica Bank v. State Petroleum Distribs., Inc.*, [2008 WL 2550553](#) (M.D. Pa. 2008) (secured creditor was not entitled to appointment of receiver in part because the security agreement did not provide for such remedy).

Similarly, an award of specific performance is subject to court discretion and will not be ordered if, among other reasons, an award of damages would be adequate or the remedy would be unfair. *See* Restatement (Second) of Contracts §§ 357(a), 359(1), 364(1). Because courts regularly regard equitable relief as jurisdictional and beyond the competence of private contracting parties, they are unlikely to treat a clause expressly declaring damages to be inadequate or expressly authorizing specific performance as binding or even as relevant. This certainly appears to be the approach taken by federal courts. *See, e.g., Dominion Video Satellite, Inc. v. EchoStar Satellite Corp.*, [356 F.3d 1256](#), 1266 (10th Cir. 2004); *Smith, Bucklin & Associates, Inc. v. Sonntag*, [83 F.3d 476](#), 481 (D.C. Cir. 1996); *Riverside Publishing Co. v. Mercer Publishing LLC*, [2011 WL 3420421](#) (W.D. Wash. 2011). Nevertheless, a contractual clause declaring damages in certain instances to be inadequate – such as for breach of a covenant not to compete – might enhance the prospect that a court would conclude similarly. Moreover, in some states – Delaware, for example – courts regard a clause stipulating to the existence of irreparable harm in the event of breach as binding. *See Martin Marietta Materials, Inc. v. Vulcan Materials Co.*, [2012 WL 2783101](#) (Del. 2012). *See also* Stephen J. Shapiro & Aaron J. Fickes, [Contracting for Irreparable Harm May Not Be as Effective as You Think](#); Kenneth A. Adams, [Redraft This Sentence, MSCD-Style: My Version of an “Irreparable Harm” Provision](#). A clause declaring goods to be sold as “unique” or indicating that the buyer will not be able to cover quickly enough to avoid irreparable injury might also be helpful. *Cf.* U.C.C. § 2-716(1) (authorizing specific performance when the goods are unique or in other proper circumstances).

Another set of remedies is available only following a material breach. Under modern contract law, the contracting parties’ main promises to each other are regarded as dependent – rather than independent – covenants. As a result, one condition to a party’s duty to perform is that there be no “uncured material failure” by the other party to perform. *See* Restatement (Second) of Contracts § 237. In short, any breach gives rise to a claim for damages but only a material breach excuses the non-breaching party from the duty to perform.

Unfortunately, it is not always clear what constitutes a material breach. As a result, after a dispute arises, a game of chicken may ensue. For example, a contractor renovating a home might, in violation of its agreement with the owners, leave them

without running water for several days. The owners might respond by withholding the next installment payment. The contractor might then walk off the job. Who wins in the resulting lawsuit will depend on who was the first to materially breach. If the contractor’s initial breach was material, the owners were permitted to withhold payment. If not, the owners had a duty to pay. If their failure to pay was a material breach, then the contractor was justified in refusing to complete the work. If their failure to pay was not material, then the contractor’s refusal to finish was a further breach, and no doubt a material one. Needless to say, it is difficult to predict in advance how a court or jury will rule. *See, e.g., K & G Constr. Co. v. Harris*, [164 A.2d 451](#) (Md. 1960) (involving a dispute between a general contractor and a subcontractor).

To clarify the parties’ rights, the agreement might expressly provide under what circumstances a breach by one party will excuse the other. Such a clause need not – and probably should not – be exhaustive. That is, it should not purport to identify all the breaches that suspend the other party’s duty to perform, unless the drafter is confident that nothing else should so qualify.

One caveat is in order. Some written agreements purport to do this by simply declaring a particular type of breach to be “material.” For example, one standard purchase agreement for the sale of grapes from a vineyard to a winery provides “[b]uyer’s failure to make payment within sixty (60) days of due dates constitutes material breach of this agreement.” There are at least two problems with this clause. First, outside Louisiana, the contract would be governed by U.C.C. Article 2, which does not use the phrase “material breach.” Thus, it is not clear what purpose such a declaration would serve in an agreement of this type. Second, payment by the buyer was the last act called for under the agreement; the seller would necessarily have shipped the grapes months before and have no duties remaining. As a result, the seller would have no performance to suspend if the buyer failed to pay, and the declaration of materiality would be meaningless.

#### 4. To Negate or Limit a Remedy

Contracting parties often wish to make unavailable a remedy to which one or both of them would otherwise be entitled or limit the extent or duration of a remedy that will remain available. Common examples of this are disclaimers of consequential damages, liquidated damages clauses, limits on the time or grounds for rejecting tendered goods, clauses

shortening the applicable limitations period, and terms conditioning a right to recovery on prompt notice of the claim. Secured lending on a nonrecourse basis can also be viewed as a negation of personal liability for any deficiency. Any intention to negate or limit a remedy must be stated in the parties' agreement.

### 5. To Set Standards

Some remedies are subject to vague standards that the parties cannot waive or disclaim but which they can help clarify. For example, Article 9 requires that every aspect of a disposition of collateral be commercially reasonable. U.C.C. § 9-610(b). The parties cannot by agreement alter this requirement, § 9-602(7), but they can set the standards for what is reasonable, as long as those standards are not themselves "manifestly" unreasonable. *See* §§ 1-302(b), 9-603(a).

Accordingly, the security agreement should contain a clause on how the secured party may dispose of the collateral. Such a clause is particularly important when the parties anticipate no ready market for the collateral, such as closely-held stock. *See, e.g., Gulf Coast Farms, LLC v. Fifth Third Bank*, [2013 WL 1688458](#) (Ky. Ct. App. 2013) (because the security agreement covering equine collateral expressly provided that "any disposition of Collateral at a regularly scheduled auction where similar Collateral is ordinarily sold (*e.g.* Keeneland or Fasig–Tipton sales) with or without reserve . . . is per se commercially reasonable," the bank's sale of the collateral at a Keeneland sale was commercially reasonable and the debtors could not argue, even through expert testimony, that the bank's disposition was commercially unreasonable); *Financial Fed. Credit Inc. v. Boss Transp., Inc.*, [456 F. Supp. 2d 1367](#) (M.D. Ga. 2006) (upholding the standards for notification and disposition set forth in the parties' security agreement). At a minimum, the agreement should disclaim any obligation by the secured party to engage in a public offering of privately held securities. Similarly, the agreement should provide either that the secured party has no responsibility to repair collateral before sale or limit any such duty to a specified dollar amount. *Cf.* § 9-610 cmt. 4. It should also provide standards on whether or when the secured party must apply noncash proceeds to the secured obligation. *Cf.* §§ 9-608(a)(4), 9-615(c).

### 6. To Preserve a Remedy the Law Might Eliminate

After reading heading #6 above, a careful lawyer might respond that there is always a chance that the

law will change. Therefore, it is always desirable to list all remedies. Yet consider what the heading really implies: that the law will change so as to: (i) eliminate a remedy currently available; but (ii) permit parties to contract around that change by agreement. This seems a remarkably unlikely scenario and one probably restricted to consumer transactions for which a legislature may wish to require that the remedy be expressly stated as a form of notice. In general, this is not a sufficient justification for expressly stating remedies that the law currently makes available.

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## Contracting Around *Contra Proferentem*

*Scott J. Burnham*

*Contra proferentem*, one of the age-old maxims of interpretation, means that an ambiguity in a contract will be construed against the one who "proffered" the ambiguous term. The maxim is expressed in § 206 of the Restatement (Second) of Contracts and codified in § 1654 of the California Civil Code:

**Uncertainty; interpretation against person causing.** In cases of uncertainty not removed by the preceding rules, the language of a contract should be interpreted most strongly against the party who caused the uncertainty to exist.

There are a number of approaches to the use of *contra proferentem*. As indicated in the California statute, it is best used as a last resort when all other interpretive devices fail. Judge Posner stated this approach in *Residential Mktg. Group, Inc. v. Granite Inv. Group*, [933 F.2d 546](#), 549 (7th Cir. 1991):

Residential drafted the contract, but the venerable principle of interpretation that ambiguities in written contracts are to be resolved against the draftsman does not bar the use of oral testimony to disambiguate a written

contract. It is a tie-breaker, used to resolve cases in which the written contract remains ambiguous even after oral evidence has been admitted.

This approach makes sense, for if the purpose of contract interpretation is to ascertain the intentions of the parties, *contra proferentem* does not really serve that purpose.

Another approach to *contra proferentem* is to use it as a strict liability principle, holding at fault the party who caused the ambiguity to arise by drafting the contract, and to place the maxim at the head of the line of interpretive devices. This approach may provide an incentive for drafters to take more care to avoid ambiguity, but makes little sense in light of the purpose of interpretation. Some courts nevertheless find it useful when the court is disposed to find in favor of the “little guy,” as in contracts of adhesion between consumers and banks or insurance companies. *See, e.g., State Farm Mut. Auto Ins. Cos. v. Queen*, [685 P.2d 935](#) (Mont. 1984), in which the Montana Supreme Court, ignoring the trial court opinion, held that language in an insurance contract was ambiguous and, rather than treating the intended meaning as a question of fact, held as a matter of law that the ambiguity would be construed against the insurance company.

Some drafters, apparently tired of being punished by judges for their failure to draft ambiguity-free contracts, are fighting back by including in their contracts a provision that attempts to contract around the effect of *contra proferentem*. The language might look like this:

Both parties drafted this agreement and share responsibility for its wording.

No case has been found that addresses a court’s response to such a provision. If we try to anticipate what might happen when a court looks at the provision, I think we will find that parties should be cautious in using it for 1) it might not work to avoid the maxim, and 2) if it does work, the result may be worse than application of the maxim.

Is a court likely to give effect to this provision? I think the answer is: It depends. If it is inserted by the big guy drafting a contract of adhesion for the little guy to sign without negotiation, a court is likely to ask, “Who are you trying to kid?” Possibly, the court will phrase its reaction in the words of another maxim, found at Cal. Civ. Code § 3528:

**Form and substance.** The law respects form less than substance.

In that event, the drafter will be unsuccessful in contracting around the maxim and will only arouse the ire of the court.

If the situation does not involve a contract of adhesion, what does it mean that both parties drafted the agreement? It is unlikely that the parties hammered the language out together. Generally, one party prepares the document, although this may mean no more than filling in the variables in a form, and sends it to the other, inviting comment. In the case of a form contract, neither party is technically the drafter, though one did proffer the ambiguous language to the other. In this situation, a judge would likely conclude that just as the party offering the contract had a chance to redraft the terms, the party who received it likewise had an opportunity to suggest changes that would have prevented the ambiguity from arising. If *contra proferentem* is based on fault, then it might make sense to hold each party equally at fault for not detecting the problem. In the insurance context, courts have applied a “sophisticated insured” exception to the rule of *contra proferentem*, refusing to apply the rule when the contract was negotiated between sophisticated parties rather than imposed on a consumer. *See Vought Aircraft Indus., Inc. v. Falvey Cargo Underwriting, Ltd.*, [729 F. Supp. 2d 814](#), 824 (N.D. Tex. 2010); *Penford Corp. v. Nat’l Union Fire Ins. Co.*, [662 F.3d 497](#), 505 (8th Cir. 2011).

In a contract between sophisticated parties, therefore, a court might well honor the parties’ agreement not to hold either one liable as the drafter. But honoring that agreement may have an unhappy consequence. If all the other interpretive aids have been exhausted, and *contra proferentem* is not applicable because the parties have drafted around it, then the court may be in the position of being unable to give effect to the ambiguous term. If the term is not material, perhaps it could be dropped out and replaced by a default term. But if the term is material or not severable, then the court may have to declare the entire agreement void.

The situation that arises when a basic term contains an ambiguity that cannot be resolved is called *misunderstanding*. With no way to resolve the problem, the court must declare that there is no contract because of a lack of mutual assent. *See* Restatement § 20. Familiar cases involving misunderstanding are *Raffles v. Wichelhaus*, [159 Eng. Rep. 375](#) (Ex. 1864) and

*Frigalment Importing Co. v. B.N.S. Int'l Sales Corp.*, [190 F. Supp. 116](#) (S.D.N.Y. 1960). In *Frigalment*, Judge Friendly initially ruled in favor of the defendant because the plaintiff did not satisfy the burden of proving that its interpretation should govern, but later realized that he might have better avoided the contract on grounds of misunderstanding. See *Dadourian Export Corp. v. United States*, [291 F.2d 178](#), 187 n.4 (2d Cir. 1961).

Thus, a drafter may wish to think twice about contracting around *contra proferentem*. It might well prevent a term from being construed against the drafter, but at the price of having no contract at all. Perhaps there is a middle ground. Parties sometimes provide that if an event occurs that significantly alters one of the performances, such as an unanticipated event or a market price fluctuation, they will renegotiate the term so that they may continue performance on a modified basis, or they will have an arbitrator determine what is fair in the circumstances. Similarly, parties could provide that a finding that a term is ambiguous is such an unanticipated event. If the ambiguity cannot be resolved through the use of traditional interpretive tools, then they might agree to negotiate a reasonable resolution or to appoint an arbitrator to do it for them.

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## Recent Cases

### SECURED TRANSACTIONS

*Gulf Coast Farms, LLC v. Fifth Third Bank*, [2013 WL 1688458](#) (Ky. Ct. App. 2013)

Although debtor, which was manager and 35.45% owner of LLC, submitted evidence indicating that the secured party knew that the debtor intended to pledge as collateral only 35.45% of the LLC's assets, because the security agreement described the collateral to consist of all of the LLC's interests in specific assets, the LLC's entire interests were encumbered. There was no ambiguity that would permit introduction of parol evidence. Dissent believes that the agreement was ambiguous in part because there was no signature expressly on behalf of the LLC.

*In re Cunningham*,

[2013 WL 1429683](#) (Bankr. D. Kan. 2013)

Signed credit card application in which the debtors purported to grant the card issuer a security interest "in the goods purchased with your Card," combined with sales receipts that identified the goods so purchased was not an adequate description of the collateral, given that a description of consumer goods only by collateral type is insufficient and the receipts were not a component of the security agreement.

*In re Murphy*,

[2013 WL 1856337](#) (Bankr. D. Kan. 2013)

Signed credit card application in which the debtors purported to grant the card issuer a security interest "in the goods purchased with your Card," was an adequate description of the collateral because it was not a description only by collateral type (court disagreed with *Cunningham*).

*In re Clean Burn Fuels, LLC*,

[2013 WL 2099956](#) (Bankr. M.D.N.C. 2013)

Seller of corn to debtor had only a security interest, not ownership, of corn in storage bin on debtor's property and leased by the seller from the debtor because even though the agreement expressly provided that title remained with the seller until "the [corn] leaves the storage bin and moves across the weighbelt into the plant at [the debtor's] Ethanol Facility," the agreement also provided that delivery is complete when the corn is received at the debtor's facility, and thus delivery occurred when the corn arrived at the storage bin. Retention of title by a seller of goods after delivery is limited in effect to reservation of a security interest. The seller's security interest was not perfected by possession because even though the seller had the right to cut the power needed for the debtor to access to the corn and the agreement obligated the debtor to place signs on the bins or in the debtor's plant to notify third parties that the bins had been designated exclusively to receive and store corn owned by the seller, the debtor never requested permission from the seller to remove the corn from the bins, was never prevented from removing the corn, and never posted signs, and thus the seller's alleged control over the corn did not provide any notice to third parties.

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*Monroe Bank & Trust v. Chie Contractors, Inc.*,  
[2013 WL 1629300](#) (Mich. Ct. App. 2013)

Because bank had contractually agreed to subordinate its security interest in specified equipment to equipment lender – and the lender’s assignees – the finance company that paid off the equipment lender and received an assignment of the equipment lender’s security interest had priority over the bank.

#### LENDING, CONTRACTING & COMMERCIAL LITIGATION

*Speedemissions, Inc. v. Bear Gate, L.P.*,  
[2013 WL 1341308](#) (Tex. Ct. App. 2013)

Action by lessee against lessor, to whom leased realty was transferred one month before the lessee purchased all the stock in the prior owner, was not subject to arbitration clause in the stock purchase agreement because the lease and stock purchase agreements were separate transactions between different parties and did not even reference each other.

*In re Pilgrim’s Pride Corp.*,  
[706 F.3d 636](#) (5th Cir. 2013)

Promissory estoppel claim brought by chicken growers against poultry company for terminating contractual relationship after growers had invested substantial sums to upgrade their own facilities in reliance on statements by the poultry company that it “was committed to [the] growers for the long run” was barred by the existence of a contract between the parties covering the same subject.

*Davis v. Carroll*,  
[2013 WL 1285272](#) (S.D.N.Y. 2013)

Summary judgment granted to consignor of artworks in action against dealer who purchased them from the consignee because the dealer did not qualify as a buyer in ordinary course of business. Despite red flags to the dealer – including mixed signals about ownership of the artworks, pricing at less than one-third of fair market value, and the unusualness of a clearance sale in consigned goods – the dealer’s limited due diligence of inspecting the consignee’s provenance, conducting a physical exam of the artworks, and searching for filed financing statements was not a commercially reasonable response to those red flags.

*CIT Group/Equipment Financing, Inc. v. Shapiro*,  
[2013 WL 1285269](#) (S.D.N.Y. 2013)

Terms in equipment lease that, upon default, allow the lessor to sell the equipment and retain the sale proceeds while also obligating the lessee to pay all future rent and a sum designed to compensate for the drop in value of the equipment was duplicative and unconscionable.

*Middleton v. First National Bank*,  
[2013 WL 1932159](#) (Mo. Ct. App. 2013)

Bank did not have contractual right to setoff certificate of deposit against debt guaranteed by one of the certificate owners because even though the deposit agreement signed by the certificate owners expressly incorporated the terms on Addendum A, and Addendum A expressly provided that the bank had the right to set-off the funds in the CD account against any indebtedness owed by either or both certificate owners, Addendum A was conditioned on the certificate owners “signing this form” which they never did. Because Addendum A expressly referred to the “deposit agreement,” the reference to “this form” must be to something different, and thus was to Addendum A itself.



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