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Tactical Drafting of Attorney’s Fees Clauses

Lars E. Lundberg

Contracting parties frequently include in their agreements a clause making one party responsible for the attorney’s fees incurred by the other party in any action on or relating to the contract. Loan agreements, for example, typically make the borrower responsible for all of the lender’s attorney’s fees incurred in connection with enforcing the agreement. Because of the perceived unfairness associated from such one-sided attorney’s fees provisions, several states have enacted reciprocity statutes that impose mutuality on such provisions. See [Cal. Civ. Code § 1717](#); [Fla. Stat. § 57.105\(7\)](#); [Mont. Code § 28-3-704](#); [Or. Rev. Stat. § 20.096](#); [Utah Code § 78B-5-826](#); [Wash. Rev. Code § 4.84.330](#). In other words, these statutes obligate the losing party to pay the winner’s attorney’s fees, even if the agreement purports to make one party responsible for the other party’s attorney’s fees, regardless of who wins.

One tactic transactional attorneys occasionally use in dealing with a reciprocity statute is to limit the scope of the attorney’s fees clause to only those types of contract actions that the client is likely to win. For example, an attorney drafting a lease of real property on behalf of the landlord might, instead of including a clause obligating the tenant to pay the landlord’s attorney’s fees in connection with any action on the lease, draft the clause so that it applies only to eviction actions for nonpayment of rent.

In at least two states – Florida and Utah – this tactic works. See *Florida Hurricane Protection and Awning, Inc. v. Pastina*, [43 So. 3d 893](#) (Fla. Dist. Ct. App. 2010) (reciprocity statute did not make applicable

to homeowner’s successful breach-of-contract action against contractor a clause in the parties’ agreement obligating the homeowner to pay attorney’s fees incurred by contractor in collecting); *Inland Dredging Co. v. Panama City Port*, [406 F. Supp. 2d 1277](#) (N.D. Fla. 2005) (clause providing for recovery of attorney’s fees incurred in enforcing specified contractual provisions was made reciprocal by Florida statute only with respect to litigation concerning those provisions); *Giusti v. Sterling Wentworth Corp.*, [201 P.3d 966](#) (Utah 2009) (reciprocity statute did not extend to a case involving an employee’s unsuccessful tort and contract claims in connection with his termination a clause in the employment agreement making a defaulting party liable for the non-defaulting party’s attorney’s fees); *PC Crane Service, LLC v. McQueen Masonry, Inc.*, [273 P.3d 396](#) (Utah Ct. App. 2012) (reciprocity statute gives to the party not benefitted by a contractual clause on attorney’s fee the same access to attorney’s fees that the provision explicitly gives to the benefitted party).

In contrast, in at least two states, the tactic apparently does not work. In California, the legislature amended the state’s reciprocity statute in 1983 to overturn a court decision ruling that Civil Code § 1717 made reciprocal only the types of claims expressly covered by the contractual clause addressing attorney’s fees. See *Sciarrotta v. Teaford Custom Remodeling, Inc.*, [167 Cal. Rptr. 889](#) (Cal. Ct. App. 1980). The statute now provides: “[w]here a contract provides for attorney’s fees, . . . that provision shall be construed as applying to the entire contract , unless each party was represented by counsel in the negotiation and execution of the contract, and the fact of that representation is specified in the contract.” [Cal. Civ. Code § 1717](#). As a result, parties may not limit recovery of attorney’s fees to a particular type of claim or to actions on specific provisions of the contract. *Kissen v. Runyon*, [2012 WL 639444](#) (Cal. Ct. App. 2012); *Harbor View Hills Cmty. Ass’n v. Torley*, [7 Cal. Rptr. 2d 96](#) (Cal. Ct. App. 1992). In Oregon, the same result has been achieved through judicial decision. See *Jewell v. Triple B. Enterprises, Inc.*, [626 P.2d 1383](#) (Or. 1981) (contractual provision obligating student to pay school’s attorney’s fees in a collection action was broadened by reciprocity statute to cover successful action by student for improper dismissal); *Awbrey Towers , LLC v. Western Radio Servs.*, [278 P.3d 44](#) (Or. Ct. App. 2012) (clause in LLC operating agreement providing for attorney’s fees in an action

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brought by a member was made by the reciprocity statute applicable to actions brought by the LLC against a member).

A drafter would be wise to note the split in authority regarding the effect of a reciprocity statute before addressing the scope of an attorney’s fees clause.

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Deconstructing the Constructive Trust

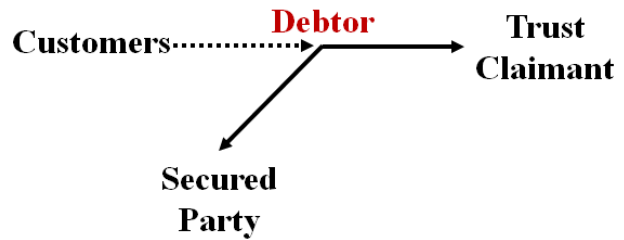
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Most lenders’ counsel are aware of the importance of ascertaining whether the collateral offered by the borrower is truly owned by the borrower. Occasionally, the intended collateral is owned by a related entity, in which case that related entity needs to authenticate the security agreement. *See, e.g., Miko Enters., Inc. v. Allegan Nursing Home, LLC*, [2010 WL 148659](#) (W.D. Mich. 2010) (lenders to owner of nursing home facility that was operated by related entity did not have a security interest in the accounts of the operator because the operator was not a party to the security agreement and the owner of the facility did not own the accounts). *See also* § 9-203(b).

A less common – but more difficult problem – arises when a third party can claim that the debtor is holding the collateral in trust for the third party. While § 9-201(a) states that, except as otherwise provided, a security interest is effective against *creditors*, it does not purport to make a security agreement effective against third-party *owners* of the collateral. This vulnerability applies not only to legal claims of ownership but also to equitable claims of ownership. Specifically, a claim that the collateral is subject to a constructive trust in favor of a third party can defeat the rights of a putative secured party. *See Restatement (Third) of Restitution and Unjust Enrichment (“Restatement”) §§ 66, 69* (2011).

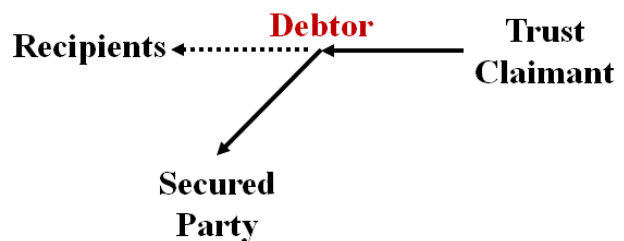
Constructive trust claims typically arise in either of two ways. In one set of cases, the debtor’s income from customers is to be used to pay suppliers,

employees, or independent contractors, and one or more of those people argue that the debtor’s receipts are held in trust for them:



See, e.g., Parker Motor Freight v Fifth Third Bank, [116 F.3d 1137](#) (9th Cir. 1997); *In re Union City Contractors, Inc.*, [2010 WL 1226882](#) (Bankr. N.D.N.Y. 2010).

In the other set of cases, the trust claimant has provided funds (or other property) to the debtor for processing, with the expectation that the debtor will distribute the funds (or property) to third parties:



See, e.g., In re Coupon Clearing Serv., Inc., [113 F.3d 1091](#) (9th Cir. 1997); *Lonely Maiden Prods., LLC v. Goldentree Asset Mgmt., LP*, [135 Cal. Rptr. 3d 69](#) (Cal. Ct. App. 2011) *See also In re AE Liquidation, Inc.*, [426 B.R. 511](#) (Bankr. D. Del. 2010) (debtors’ customers alleged sufficient facts that their deposits toward the purchase of aircraft should be deemed to be held in constructive trust for them – and thus not subject to the debtors’ secured creditors – despite the absence of language of trust in the agreements). In both sets of cases, the trust claimant then argues that the debtor cannot grant a security interest in those funds to a secured party.

The challenges for lenders’ counsel are: (i) to identify the potential bases for imposing a constructive trust; and (ii) to draft appropriate language to minimize the risk. Doing these tasks competently requires knowledge of the law relating to constructive trusts. That law distinguishes between two related things. First, whether the facts entitle the claimant to a constructive trust against *the debtor*. Second, if so, whether *the lender* has a defense to the imposition of a constructive trust.

Imposition of Trust

In the context of the first category of disputes, and probably the second category as well, the three most critical factors are: (i) whether the debtor has – or is required to – segregate the funds received for the benefit of the trust claimant from other funds; (ii) whether the debtor is obligated to pay interest on the funds; and (iii) whether the debtor is liable to the trust claimant even if not paid by the customers. Collectively, these factors seek to distinguish situations in which the debtor is merely a conduit – in which case it is appropriate to impose a constructive trust – from situations in which the debtor’s contractual relationship with the trust claimant is that of debtor-creditor.

None of these factors is conclusive. While courts frequently state that the first is the most important, they just as frequently disregard the absence of segregation, particularly if the debtor is receiving funds for numerous potential claimants and segregation for each would be impractical. *See, e.g., In re Columbia Gas Systems Inc.*, [997 F.2d 1039](#), 1061 (3d Cir. 1993).

The third factor is also very important because liability is not consistent with the debtor’s status as a mere conduit. For example, in *In re Coupon Clearing Serv., Inc.*, the debtor operated a clearinghouse that redeemed manufacturers’ coupons for retailers. The Ninth Circuit ruled that the funds the debtor received from the manufacturers were not held in trust for the retailers in part because the clearing house paid retailers on a fixed schedule, regardless of when and if the coupon proceeds were received from the manufacturers. Although the court referred to the risk of loss as a “secondary factor,” it nevertheless ruled that, because the risk was shared – *i.e.*, because the debtor had some of the risk – a debtor-creditor relationship, not a trust relationship, existed. [113 F.3d at 1101-02](#). *See also United States v. Lequire*, [672 F.3d 724](#) (9th Cir. 2012) (insurance agency that employed defendant did not hold funds received for insurance premiums in trust for insurers because the agreement allowed for commingling, required premium payments to made regardless whether the agency had collected them, and required the agency to pay interest on late payments).

One word of caution is in order. What has been written above relates to the imposition of a *constructive* trust, which is a creature of equity used to protect a claim for restitution or unjust enrichment. None of the factors identified is necessarily relevant to the existence of a *statutory trust*, such as the one provided for by the Perishable Agricultural Commodities Act, [7 U.S.C. § 499e\(c\)](#). *See also In re Arctic Express, Inc.*,

[636 F.3d 781](#) (6th Cir. 2011) (maintenance escrow deposits provided by owner-operators of trucking equipment were imbued with a statutory trust by [49 C.F.R. § 376.12\(k\)](#) and thus lender’s sweep of the deposit accounts containing those funds – even though not segregated – violated the owner-operators’ rights).

Secured Party’s Defenses

Even if a constructive trust is imposed, that does not resolve the question of whether a security interest can attach to the trust res. In general, a “purchaser for value and without notice” acquires the rights that a transferor purports to convey, free of any equitable interests of a restitution claimant. *See Restatement § 66*. Because a secured party qualifies as a purchaser for value, *see* U.C.C. §§ 1-204, 9-102(a)(28); [Restatement § 66 cmt. c](#), [§ 68 cmt. b](#), as long as a secured party acts without notice of the facts giving rise to the restitution claim, its security interest will attach and defeat the rights of the trust claimant.

Unfortunately, for this purpose “notice” means knowledge or having reason to know. [Restatement § 69\(2\)](#). *See also Parker Motor Freight*, [116 F.3d at 1142](#) (referring to “inquiry notice”). This means that the more due diligence the lender or its counsel performs, and the more it understands about the debtor’s business and contractual relationships, the more likely it will take subject to the rights of the trust claimant. For example, in *Variety Wholesalers, Inc. v. Salem Logistics Traffic Servs., LLC*, [723 S.E.2d 744](#) (N.C. 2012), the lender to a freight bill processor claimed a security interest in the funds that Variety Wholesalers had provided to the processor and which the processor was to use to pay Variety’s carriers. The court reversed a summary judgment in favor of the lender, ruling that whether the lender had constructive notice of Variety’s ownership of the funds was a question of fact). Similarly, in *Safeco Ins. Co. v. Wheaton Bank and Trust Co.*, [2009 WL 2407740](#) (N.D. Ill. 2009), the court concluded that a contractor’s surety might have priority in the contractor’s deposit accounts over the perfected security interest of the depository bank – and therefore stated a claim against the bank for conversion of the deposits – because the surety had a basis for a constructive trust on the deposits and had alleged that the bank knew the source of the deposits. *Cf. Pair A Dice Farms, Inc. v. InSouth Bank of Covington*, [2012 WL 6119847](#) (Miss. Ct. App. 2012) (bank that had a perfected a security interest in the borrower’s rights to future payments under governmental agricultural assistance programs had priority over lessors of farm land who had an

unperfected agricultural lien; the bank did not hold the government payments in constructive trust for the lessors because there was no evidence that the bank had a confidential relationship with the lessors or that it abused the lessor's confidence; the bank was not unjustly enriched by receipt of the payments).

Drafting Advice

It is doubtful that lender's counsel can put language in their loan agreements to help avoid this problem. Indeed, the more language they add – such as representations and warranties of sole ownership and no valid claims to a constructive trust – the more it may appear they have inquiry notice of the facts giving rise to the trust claimant's rights.

However, lender's counsel may be able to short circuit constructive trust claims by requiring the debtor to include in its agreements with potential trust claimants a waiver of their rights. Because a constructive trust is a creature of equity, there is no reason to think that the right to it cannot be affected by agreement or waived. For example, to deal with a potential constructive trust on receivables due or funds received from third parties (the first category above), the debtor's agreement with its client might incorporate language such as the following.

Nothing in this agreement gives [Client] any right to, ownership interest in, or claim on either [Debtor's] right to payment from any of [Debtor's] customers or any payment received by [Debtor] from any of [Debtor's] customers. [Client] has no right to a constructive trust or lien on any of [Debtor's] accounts due or receipts from [Debtor's] customers.

Dealing with a potential constructive trust on funds or property provided *by* the potential trust claimant (the second category above), is probably more difficult because language conspicuously addressing the issue might prompt the potential trust claimant to reconsider doing business with the debtor. It may therefore be advisable to deal with the issue a bit more obliquely by not expressly stating either that the debtor becomes the owner of funds or property provided by the potential trust claimant or that the debtor has the right or power to convey a security interest in those assets. In addition to imposing no duty on the debtor to segregate the funds or property provided, include language such as the following.

Nothing in this Agreement in any way restricts [Debtor] from assigning any or all of its rights under, relating to, or arising in connection with this Agreement. Nothing in this Agreement creates a fiduciary relationship or establishes a trust.

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Recent Cases

SECURED TRANSACTIONS

In re Estate of Wheeler,

[2013 WL 3440953](#) (Colo. Ct. App. 2013)

Commercial lease that purported to grant the landlord a security interest in “all property now owned or hereafter acquired by [the tenant] which shall come in or be placed upon the Premises,” was a sufficient description.

T. Gluck & Co., Inc. v Craig Drake Mfg., Inc.,

[2013 N.Y. Misc. LEXIS 2384](#) (N.Y. Sup. 2013)

Consignor with PMSI priority in diamonds consigned to debtor lost that priority after five years when it failed to renew the notification to the debtor's inventory lender. Accordingly, inventory lender had priority in the consigned diamonds as the first to file or perfect. Regardless of the consignors loss of priority in the consigned diamonds, the inventory lender had priority in the debtors accounts. Because the inventory lender had priority, the consignors had no claim for conversion.

Ross v. Rothstein,

[2013 WL 3793585](#) (D. Kan. 2013)

Secured party to whom the debtor had, pursuant to a settlement agreement, delivered a pledged stock certificate with a legend indicating that resale was prohibited by SEC Rule 144 was entitled to an order directing the debtor to do all he could to provide a new certificate without the restrictive legend because the secured obligation was with recourse and thus the six-month holding period began when the debtor acquired the shares and had long expired.

In re Henderson,

[2013 WL 2255170](#) (Bankr. D. Nev. 2013)

Because a newly enacted Nevada law limits default in automobile retail installment contracts to a failure to pay as required by the agreement and situations when “[t]he prospect of payment, performance or realization of collateral is significantly impaired,” a default-on-bankruptcy clause in such a contract is unenforceable.

In re Strata Title, LLC,

[2013 WL 2456399](#) (Bankr. D. Ariz. 2013)

“Self-operative” term in LLC operating agreement between two 50% owners providing that one of them would become the 100% owner if its capital contribution was not repaid by a specified date created a security interest. Although that security interest was unperfected and the date had not yet occurred when the other member filed for bankruptcy protection, the bankruptcy trustee took subject to that term and because Arizona law gives LLC members the authority to adopt provisions in an operating agreement governing the relations between members, changes in classes of members, and the right to acquire other member’s interests. As a result, the debtor’s interest ceased to be property of the estate when the specified date passed without the other member receiving its capital contribution.

Nelson v. Vernco Construction, Inc.,

[2013 WL 3716434](#) (Tex. Ct. App. 2013)

Because bank’s forbearance agreement with debtor recited that the bank “now owns” the debtor’s contract and tort claims in pending lawsuit and further recited that bank “is the owner of all claims (including commercial tort claims) identified in the Litigation,” the bank had accepted the claims in partial satisfaction of the secured obligation, was now the owner of the claims, and the debtor had no standing to prosecute the claims. As a result, the judgment in favor of the debtor had to be vacated.

FUNimation Entertainment v. A.D. Vision, Inc.,

[2013 WL 2189881](#) (S.D. Tex. 2013)

Debtor had no standing to bring an antitrust claim against competitor that bought collateral from secured party who purchased it at a public sale after the debtor’s default because, even if the competitor encouraged or conspired with the secured party to foreclose on the collateral, the foreclosure was legally permissible, the debtor’s injury resulted from its own default, and the antitrust laws were enacted to protect competition, not competitors, and there was no harm to competition here.

LENDING & COMMERCIAL CONTRACTING

Teed v. Thomas & Betts Power Solutions, L.L.C.,

[711 F.3d 763](#) (7th Cir. 2013)

Company that acquired employer’s assets as a going concern in a sale conducted by a receiver was liable as a successor of the employer for overtime pay under the Fair Labor Standards Act.

Weinreb v. Fannie Mae,

[2013 WL 3670741](#) (Ind. Ct. App. 2013)

Nonrecourse carve-out provisions in note and guaranty that made maker and guarantor liable upon the occurrence of specified events do not constitute liquidated damages provisions because they merely establish the terms and conditions of personal liability and permit the lender to recover the damages actually sustained. As a result, the carve-out provisions were enforceable.

Vargas v. Sai Monrovia B, Inc.,

[2013 WL 2419044](#) (Cal. Ct. App. 2013)

Arbitration provision in automobile retail sales contract satisfied the two elements of procedural unconscionability – oppression and surprise – because: (i) the buyers were presented with the form on a nonnegotiable, take-it-or-leave-it basis; (ii) the form was a single two-sided page; (iii) the arbitration provision, which was printed on the back, was unnoticeable to buyers who were told where to sign on the front side and were not given an opportunity to see that the form had provisions on the back; and (iv) even though the arbitration provision was referenced on the front, that reference was inconspicuous. The provision was drafted to benefit the seller and was substantively unconscionable because: (i) the losing party could appeal an award in excess of \$100,000 or injunctive relief; (ii) the appealing party must pay in advance the filing fee and both parties’ costs while permitting but not requiring the appellate arbitration panel to apportion those costs; and (iii) the provision exempts repossession from arbitration while requiring that other requests for injunctive relief be submitted to arbitration.

Meso Scale Diag., LLC v. Roche Diag. GmbH,

[62 A.3d 62](#) (Del. Ch. 2013)

Reverse triangular merger, which leaves the target intact but under new ownership, does not constitute an assignment “by operation of law or otherwise” prohibited by the target’s patent license.

Tap Holdings, LLC v. Orix Finance Corp.,
[2013 WL 3586688](#) (N.Y. App. Div. 2013)

Subordinated lenders stated claims for piercing corporate veil, successor liability, and fraudulent transfer against entity formed by the senior lenders and which acquired the membership interests in the debtor, reaffirmed the senior debt, and continued the debtor's business at the same location using the same trade names, physical assets, website, and executives. The claims were not barred by a clause in subordination agreement providing that the subordinated lenders "waive any right to . . . challenge the appropriateness of any action the . . . Senior [Lenders] take with respect to the Senior Debt and hereby consent to the . . . Senior [Lenders] exercising . . . rights and remedies as if no other debt existed," because intentional misconduct cannot be waived.

In re Doctors Hosp. of Hyde Park, Inc.,
[2013 WL 3779657](#) (Bankr. N.D. Ill. 2013)

Subsidiary created as bankruptcy-remote entity to facilitate securitization of accounts was a separate entity for fraudulent transfer purposes because corporate formalities were observed and the entity performed the limited purpose for which it was formed, even though the entity did not have a staff, an office, a business or stationary. The transfer of receivables to the entity was a true sale of accounts because the originator did not retain any risk of loss.



Recent SEC Ruling

On May 16, 2013, the SEC issued the following Compliance and Disclosure Interpretation regarding Rule 144, [17 C.F.R. § 230.144](#).

Section 532. Rule 144(d) — Holding Period for Restricted Securities

532.01 A pledgor who is an affiliate defaults on a loan that is secured, either with or without recourse, by a bona fide pledge of company stock acquired in the open market (*i.e.*, these securities are not "restricted securities" in the pledgor's hands). In the pledgee's hands, these securities are "restricted securities" because they have been "acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering." If the pledgee is a non-affiliate and has not been an affiliate during the preceding three months, the pledgee may resell such securities pursuant to Rule 144(b)(1) without regard to the holding period requirement in Rule 144(d) but subject to the current public information requirement in Rule 144(c)(1), as applicable. No other requirements in Rule 144 are applicable to the pledgee's resale.

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