

# The Transactional Lawyer

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## Modernizing Your Contracts and Living to Tell the Tale

**Tina L. Stark**

### Introduction

This two-part article suggests down and dirty changes to improve a lawyer’s drafting. Lawyers can pick and choose which changes they make and when.

Part 1 of the article suggests stylistic and formatting changes that facilitate reading a contract. These changes turn labyrinthian provisions into multiple, discrete sections by showing how parts of a provision relate to each other through subsections and white space. Even more basically, sentences are shortened; subjects are kept next to verbs and verbs kept next to objects. Although formatting and style may seem inconsequential, the clarity that results may unearth an ambiguous provision or reveal a provision that inadequately or incompletely memorializes the business deal. Part 2, which will appear in an upcoming issue of this newsletter, will discuss common causes of ambiguity and how to fix them.

I’ve spent considerable time on the remainder of this Introduction. That said, I have always told my students that practitioners have little time and less patience. Don’t hesitate to delve right into the article’s suggestions. They begin immediately after the bolded heading “Suggestions for improved contract drafting.” Come back any time to the remainder of Introduction.

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Kudos to you for implementing any of the changes in either part of this article. All will improve your drafting.

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Many practitioners would profoundly appreciate a magic spell that transformed their contracts into paradigms of modern drafting. Unfortunately, Harry Potter is nowhere to be found. Commentators’ exhortations to change, along with recriminations for failing to do so, are inappropriate. Most practitioners pride themselves on their work product and work diligently to produce a contract that is both well drafted and that achieves their clients’ goals.

Most deal lawyers of a certain age began practicing well before law schools added drafting courses to the law school curriculum. Unfortunately, no law school course introduced them to drafting principles in a systematic, pedagogically sound manner. Instead, these lawyers learned through osmosis and the venerated, but flawed, precedents their mentors bequeathed to them. Stated succinctly, part of the oft-bemoaned “drafting problem” is generational.

I know how I drafted when I first began teaching in 1993. I had been a corporate partner in New York. On reflection, I drafted not badly, but not well by the standards I now apply. Change was uncomfortable and required relinquishing what I had accepted as “truth.”

Over the past 25 years, I have watched veteran lawyers, now adjuncts teaching drafting, grapple with the substantive and stylistic guidelines in my textbook. Frequently, these guidelines differ from the adjuncts’ past practices. These lawyers will not teach the “new” guidelines (and rightly so) until convinced of their merit. Almost without exception, they struggle to reconcile what they “know” with what they are learning. The relearning is arduous. Suggesting that overworked practitioners fully engage in this time-consuming, reflective process while simultaneously practicing full-throttle is fanciful.

Modernizing a contract has no quick fix. It’s not a matter of carving out a day. A contract’s problems reflect not a single, repetitive error, fixable with a click on Replace All. Rather traditional contracts are replete with a plethora of wide-ranging problems.

The following provision shows how many problems a single sentence may have. Each superscript letter in the provision refers to a Comment that follows. A revised version follows the Comments.

## Version 1 – Original

**Liability for Fraud.** Nothing herein<sup>a</sup> shall operate<sup>b</sup> to relieve a Seller Party of any common law liability to Buyer for Fraud in the event<sup>c</sup> such<sup>d</sup> Seller Party is finally determined by a court of competent jurisdiction<sup>e</sup> to have committed Fraud against the Buyer; provided, however,<sup>f</sup> in no event<sup>g</sup> shall<sup>h</sup> a Seller Party incur liability for an act of Fraud committed by another Seller Party.<sup>i</sup>

Comment a – *Nothing herein* is legalese. In addition, it can be ambiguous because *herein* is a pointing word, and the parties could dispute whether it points to a section or the agreement.

Comment b – *Shall operate* misuses *shall*. *Shall* signals a party's obligation, and *nothing herein* is not a party.

Comment c – *In the event* uses three words when the single word *if* expresses the same point.

Comment d – *Such* is legalese. It is also a pointing word with the attendant problems.

Comment e – *Is finally determined by a court of competent jurisdiction* is in the passive voice. Restating it in the active voice puts the actor upfront, shortens the sentence, and conveys the sentence's meaning more quickly and forcefully.

Comment f – *Provided, however* is ambiguous. *Provided* can signal an exception, a condition, or additional material. Here, it signals additional material. The proviso is also problematic because it unnecessarily lengthens the sentence. Creating a second sentence and using the transitional phrase *in addition* makes the entire provision easier to read.

Comment g – *In no event* is surplusage. It adds nothing substantive by being emphatic.

Comment h – *Shall* is again misused. The clause in the exemplar does not memorialize a party's obligation. Instead, it is a *declaration* – a contract concept used to establish a contract policy to which both parties agree.<sup>1</sup> Declarations should be drafted in the present tense. (More in Part 2.)

## Version 2 – Revised

**Liability for Fraud.** Nothing in this Agreement relieves any Seller Party of any common law liability for Fraud if a court of competent jurisdiction finally determines that that Seller Party has committed Fraud against the Buyer. In addition, no Seller Party is liable for an act of Fraud that another Seller Party commits. [In addition, no Seller

Party is liable for another Seller Party's act of Fraud.]<sup>2</sup>

This article cannot address the full scope of problems that afflict modern contracts. Instead, it suggests discrete, practical ways that you can improve your contract drafting, both in style and substance - while concurrently producing timely, cost-efficient contracts.

To improve your contracts and live to tell the tale, you should engage in triage. Pick the suggestions from this article that seem most likely to improve your contracts concretely and quickly – the ones you consider to be most important and the easiest to implement. Trying to implement them all, and at once, is a fool's errand. It would be akin to a crash diet – destined to fail. Making incremental changes over time will eventually transform your contracts. Each time you add a "suggestion" to your drafting "repertoire," it will become part of how you draft. You'll do it reflexively. It becomes your new, ingrained knowledge.

One final comment before turning to this article's suggestions. This article focuses on drafting complex commercial agreements, not consumer agreements. It espouses a style of drafting that I have dubbed *contemporary commercial drafting*. It resembles plain English, but it is not the same. It draws on the principles of plain English and promotes clarity through among other things, simpler language, shorter sentences, and formatting.<sup>3</sup> The two styles of drafting do differ, however, in their approach to substance. Plain English contract provisions are pared down to their essentials, while a business contract's provisions are hefty, retaining all provisions that might add value or protect against risk.<sup>4</sup>

**Suggestions for improved contract drafting**

1. *Use short sentences.* A reader can only digest a certain quantum of information at one time. If a sentence exceeds that quantum, the reader loses the thread and is unable to process a provision's subtleties. Try applying the three-line rule: If a sentence is longer than three lines, it's too long. In a long sentence, you are probably trying to combine multiple ideas into a single sentence. Better to limit a sentence to a single idea, so the reader doesn't unintentionally and inaccurately conflate the ideas. Sentences that include a semi-colon are *de facto* (don't use Latin) problems. Each clause should be its own sentence.

*Problematic*

**Termination on Fire or Casualty.** If a fire or other casualty destroys the Building, the Landlord may terminate the Lease by notifying the Tenant in writing,<sup>5</sup> and then, all Base Rent and Additional Rent due under this Lease ceases as of the date of the casualty, and the Tenant shall remove its trade fixtures and personal property from the Premises no later than 35 calendar days after it receives the Landlord's termination notice, whereupon both parties are released from all further obligations under this Lease, except from any obligations previously incurred.

*Better*

**Termination on Fire or Casualty.** If a fire or other casualty destroys the Building, the Landlord may terminate the Lease by notifying the Tenant in writing. In that event, all Base Rent and Additional Rent due under this Lease ceases as of the date of the [fire or other]<sup>6</sup> casualty. The Tenant shall remove its trade fixtures and personal property from the Premises no later than 35 calendar days after it receives the Landlord's termination notice. On completion of that removal, both parties are released from all further obligations under this Lease, but not from any obligations previously incurred.

2. *Draft in the active voice.* No doubt, your sixth-grade teacher and legal writing professor drilled this rule into you. But you probably violate it as often as you honor it.<sup>7</sup> In contract drafting, it's not just a good writing rule. It can affect substance and be litigation cannon fodder.

*Wrong*

**Distributions.** No later than fifteen (15) days after the closing of any Capital Transaction, all Partnership Capital Event Receipts shall be paid or distributed according to a formula for calculating the amount of the distribution to the Class A Partners.

This provision is based on contract language disputed in a case.<sup>8</sup> The covenant, drafted in the passive voice, left open which party was obligated to pay the Partnership Capital Event Receipts. Was it the Second General Partner or the Limited Partnership? The provision showcases the worst-case scenario of the use of the passive voice: a covenant without even a by clause (shall be paid by X) to tell the reader which party is obligated to pay. The fix is simple: use active voice.

*Correct*

**Distributions.** No later than 15 days after the closing of any Capital Transaction, the Second General Partner shall pay or distribute all Partnership Capital Event Receipts according to a formula for calculating the amount of the distribution to the Class A Partners.

Most word-processing apps make passive voice errors easy to avoid. They can mark grammatical errors as you type. In Word™, click on "File"; scroll to the bottom and choose "Options"; click on "Proofing," check the box "Mark grammar errors as you type;" choose "Grammar and Refinements" from the dropdown menu for "Writing Style;" and then check the boxes associated with the passive voice. While there, also check the box for nominalizations.<sup>9</sup>

While you should generally draft representations in the active voice, that is not always the case. Sometimes the voice used makes a substantive difference: the absence or presence of the actor in a provision can change its meaning. For example, when purchasing a used parachute, most buyers would want to know the total number of times the parachute had been used, not how many times the seller had used it.

*Active voice*

**Prior Use.** The Seller has used the parachute six times.

*Passive voice*

**Prior Use.** The parachute has been used six times.

When the issue is the action rather than the actor, the passive voice is appropriate. The passive voice may also be appropriate for conditions to closing when the issue is the completion of an act, not who completes it.

*Passive voice*

**The Manufacturing Facility.** The Manufacturing Facility must have been demolished and all debris removed on or before the Closing Date.

*Active voice*

**The Manufacturing Facility.** The Seller must have demolished the Manufacturing Facility and removed all debris on or before the Closing Date.

If the Seller intends to hire an outside contractor to demolish and remove the debris, it would prefer a condition drafted in the passive voice. That would preclude a buyer from arguing that the Seller failed to satisfy the condition because it hired an outside contractor, rather than performing the work itself.

3. *Keep the subject, verb, and object close together and in the beginning of the sentence.* Keeping the subject, verb, and object together and in the beginning of the sentence facilitates understanding. The mind needs the information that these core words provide as soon as possible to quickly assimilate the sentence's purpose and meaning.

4. *Turn monolithic provisions into sections and subsections.* Many contemporary contracts include full pages of solid text. These monolithic provisions create MEGO - mine eyes glaze over - inattention, resulting in the reader's inability to readily absorb the substantive business and legal issues. Most MEGO provisions contain multiple ideas. Therefore, a drafter can "chunk" the information; that is, a drafter can separate the ideas as if they were separate paragraphs of a narrative. Each "paragraph" becomes a new section of the agreement. If a paragraph/section has subparts, also use subsections. Add headings to the sections and subsections to signal what's coming, helping to provide context.

This simple formatting technique facilitates reading. Smaller chunks of information are easier to work with. In addition, each time a new section or subsection begins, it slows down the reader and prevents the reader from inadvertently mashing together different concepts. ("Mushing" is a technical term.) Equally as important, the process may unearth an ambiguity or unclear provision.

You can create sections and subsections relatively easily by using the Enter and Tab keys or a word-processing app's built-in formatting program. Assuming you intend not to revise the provision substantively, consider delegating this task to a junior lawyer or even an assistant, thereby minimizing cost to the client and the time you spend.

Please see Exhibit A to this article for an example of a MEGO provision and its redraft.

5. *Tabulate.* Some sentences in an agreement call out to be separated into subparts to facilitate reading. They may already have imbedded subsections that are identified through letters and numbers. That's helpful. But a ten-line monolithic sentence with multiple subsections running together remains, at best, difficult to parse and understand. The cure is tabulation, reformatting the sentence using the identifying letters and numbers, indentation, and white space to show the relationship of a sentence's parts. (Tabulation takes its name from the use of the Tab key to create the indents that reflect the relationship between varying levels of subsections.) If the identifying numbers and letters already appear in a draft, it's another perfect task to delegate.

Tabulating has an additional use beyond subdividing the sentence into introductory language and subsections. You can also use it to join together sentences with related ideas, thereby shortening a provision while enhancing readability.

Rumor has it that some lawyers dislike tabulation because it makes a contract longer. It's true that a tabulated contract sometimes takes more paper to print. Arguably, the clarity counterbalances the extra length. But even if your client nixes the tabulation in the final agreement, that shouldn't dissuade you from using tabulation as an analytical technique. If the other side sends a MEGO sentence that you're having trouble parsing, you can't successfully negotiate its substance: you don't fully understand it. If you don't negotiate the sentence, you've lost any points embedded in the sentence before the negotiation has even started. Tabulating the sentence first may reveal its traps, a valuable and justifiable endeavor -- even if you have to "mush" it back together after having unpacked it.

Here are some examples.

Version 1 consists of two sentences on the same topic. Version 2 creates a unified provision by drafting introductory language that grammatically introduces the substantive information from each sentence. That information then becomes an enumerated item (a subsection). When a reader sees this formatting, it signals that the subsections are related, thereby facilitating an understanding of the business deal.

*Version 1 – Untabulated sentences*

**Noncompetition.** For a one-year period after the Term, the Executive shall not employ any person who was an employee during the Term. In addition, during that period, the Executive shall not interfere with the relationship between the Company and any of its employees.

*Version 2 – Tabulated sentence*

**Noncompetition.** For a one-year period after the Term, the Executive  
 (a) shall not employ any person who was an employee during the Term; and  
 (b) shall not interfere with the relationship between the Company and any of its employees.<sup>10</sup>

The style of tabulation used in Version 2 is known as the *sentence format* because the introductory language and each enumerated item would create a complete sentence if they were joined together.

*Version 3 – Tabulated provision recast as separate sentences but using the same introductory language***Sentence 1**

For a one-year period after the Term, the Executive shall not employ any person who was an employee during the Term.

**Sentence 2**

For a one-year period after the Term, the Executive shall not interfere with the relationship between the Company and any of its employees.

Despite rumors to the contrary, there are punctuation rules that apply to the sentence format of tabulation.

- The grammar of the sentence determines the punctuation to be used (or not used) at the end of the introductory language. So, in Version 2, no punctuation follows “the Executive” because if the introductory language were joined with subsection (a) to create a stand-alone sentence (as in Version 3), no punctuation would follow “the Executive.” Some drafters would insert a colon after “Executive.” Why? The untabulated sentences as in Version 3 have no colon; neither should the tabulated sentence.
- A semi-colon punctuates all but the final enumerated item. The semi-colon reflects the use of the sentence format: that each enumerated item ends a “sentence.”
- An *and* or *or* (as appropriate) follows the semi-colon of the penultimate enumerated item.
- A period ends the tabulated sentence.

The following example demonstrates when a comma should end the introductory language of a tabulated sentence. For example, if an untabulated sentence begins with a prepositional phrase that ends with a comma, then that same introductory language retains the comma in the

tabulated version. The comma is grammatically correct in both versions.

*Version 1 – Untabulated sentence*

**Contractor’s Obligations after a Force Majeure Event.** If a Force Majeure Event occurs, the Contractor shall advise the Owner of its existence as soon as possible after its occurrence, and the Contractor’s obligation to perform is suspended until the Force Majeure Event ends.

*Version 2 – Tabulated sentence*

**Contractor’s Obligations after a Force Majeure Event.** If a Force Majeure Event occurs,  
 (a) the Contractor shall advise the Owner of its existence as soon as possible after its occurrence; and  
 (b) the Contractor’s obligation to perform is suspended until the Force Majeure Event ends.

Drafters often use an alternative tabulation format: the *list format*. The introductory language of this type of tabulation uses *follows* or one of its variations and ends with colon. In addition, each enumerated item begins with a capital letter and ends with a period.

The first couple of times you use the list format punctuation, especially when the enumerated item is a single word, the sentence will seem weird and wrong. You may even viscerally recoil. But the punctuation is correct.

Almost all sentences tabulated in the sentence format can be redrafted using the list format. Here’s a provision in the list format that the article first presented in the sentence format.

*Version 1*

**Noncompetition.** For a one-year period after the Term, the Executive shall not do the following:  
 (a) Employ any person who was an employee during the Term.  
 (b) Interfere with the relationship between the Company and any of its employees.

Although you can generally cast a sentence in either format, the introductory language of the list format has an advantage. It can signal clearly whether the enumerated items in the list are cumulative or alternative. In Version 1 immediately preceding this paragraph, litigators would happily dispute whether the covenant was enforceable against the Executive only if the Executive violated both subsections (a) and (b). But adding a few

words to the introductory language immediately clarifies any ambiguity.

#### Version 2

**Noncompetition.** For a one-year period after the Term, the Executive shall not do either or both of the following:

Here are three additional examples of language you can use to clarify the relationship of enumerated items.

#### Example 1

**Termination.** The Company may terminate the Executive for any one or more of the following reasons:

#### Example 2

**Duties.** During the Term, the Executive shall perform all of the following duties:

#### Example 3

**Notice.** When the Company sends a notice, it shall use one of the following methods, but it may choose which one:

6. *Replace legalese with clear, modern language.* Delete *herein, hereof, Witnesseth, hereinbefore, wheresoever*, etc. Instead, use contemporary equivalents. Also, avoid meaningless couplets, such as *null and void*. The history of the phrase may provide comfort when abandoning the couplet. After the Normans invaded England in 1066, French slowly became the language in which the English wrote statutes and conducted their legal proceedings; hence *nul*. But as English reasserted itself as the country's primary language, English lawyers had to translate French concepts into English. As would any lawyer, they worried that *void* was not synonymous with *nul*. They chose the obvious fix: use both. That's not a problem so much anymore.

7. *Modernize the introductory provisions.* The introductory provisions of a contract consist of the preamble, recitals, and statement of a consideration. They are replete with legalese. Revising these provisions may well be one of the easiest ways to begin transforming your documents. Each time you draft a contract, part of what you must do is to draft these provisions. If nothing else, the names of the parties and the date need to be changed. By modernizing these provisions in a precedent that you regularly use, you and your colleagues have

cleaned up a portion of the contract the client always reads. Here are some details.

(a) The *preamble*. The preamble consists of the name of the contract, the date, and the parties. Versions 1 and 2 show both the traditional way to draft a preamble and a more contemporary version.

#### Version 1 – Traditional drafting

THIS NONCOMPETITION AGREEMENT, made the 16th day of March, 20XX, by and between ATTORNEY STAFFING ACQUISITION CO., a corporation organized under the laws of Delaware (hereinafter, the "Company"), and RODRIGUEZ LLC, a limited liability company organized under the laws of South Carolina (hereinafter "the Executive").

(42 words)

#### Version 2 – Contemporary drafting

This Noncompetition Agreement, dated March 16, 20XX, between Attorney Staffing Acquisition Co., a Delaware corporation ("Staffing"), and Rodriguez LLC, a South Carolina limited liability company ("Rodriguez").

(26 words)

Although contemporary Version 2 is 38% more concise than Version 1, the two versions are substantively the same.

#### Drafting tips:

- Don't create two defined terms for a party (or in connection with any definition). It opens the door to confusion and litigation.
- Draft the signature lines at the same time you draft the preamble. It will decrease the possibility of the signature block names differing from those in the preamble.

(b) The *recitals* follow the preamble. Use them to explain a transaction's background; that is, the parties' relationship and why they are entering into the agreement that follows.

Recitals are part of a contract in that the entire contract consists of the introductory language, the parties' agreement, and the signature lines. That said, courts generally do not consider them part of the contract that binds the parties.<sup>11</sup> They precede the language of agreement. Because of this, they cannot create enforceable, operative provisions of a contract. Therefore, save representations and warranties,

covenants, and conditions for the body of the agreement. That said, courts regularly use recitals to help determine the parties' intent when an agreement's provisions are unclear or ambiguous. Accordingly, draft the recitals with care, making sure that everything they state is true and cannot be construed to your client's detriment.

Fixing the recitals is easy. If you use *Recitals* as a title to precede the recitals, replace it with the more modern *Background*. Next change each *whereas* clause to a full sentence, ending each sentence, of course, with a period. Know this: *Whereas* is legalese and is completely, utterly, totally superfluous (as were all those adjectives). *Whereas* has no place in contemporary commercial drafting. Banish it from your lexicon.

No need for semicolons after each recital or an and at the end of the penultimate sentence. Sentences end with periods. Enumerating the sentences is a good idea. Those negotiating can more easily find the recital under discussion. Finally, if you decide that you could compose a nifty paragraph from the three or four sentences in the recitals, it's fine to draft a paragraph.

(c) The last part of the introductory provisions is the *statement of consideration*, fondly known in today's law schools as the *words of agreement*. No statement of consideration can create consideration,<sup>12</sup> but in some states it can create a rebuttable presumption of consideration.<sup>13</sup> It can state for the record that the parties' exchange of promises in the agreement is the contract's consideration.

*Example 1 – Traditional statement of consideration*

NOW, THEREFORE, in consideration of the premises<sup>14</sup> stated, \$10 paid in hand, and other good and valuable consideration the receipt of which is hereby acknowledged, the parties agree as follows:

*Example 2 – Contemporary statement of consideration*

Accordingly, in consideration of the promises exchanged in this Agreement, the parties agree as follows:

Some commentators have suggested that only a statement of the parties' agreement is necessary ("Accordingly, the parties agree:")<sup>15</sup> That is generally true. But stating the consideration has more benefits than that gained by minimizing the number of words in the contract. Cases that focus on whether consideration existed do not crowd the courts' dockets. Nonetheless, when these cases do arise, a simple statement of consideration often carries disproportionate weight.<sup>16</sup>

Therefore, for many lawyers, the risk/benefit analysis weighs in favor of the extra words.

\* \* \*

As noted earlier, Part 2 of this article will discuss common ambiguities and how to cure them. It will appear in an upcoming newsletter.

### Exhibit A MEGO Provisions

*Problematic*

**9.3 Officers of the Joint Venture.** The Managing Venturer shall appoint the chief executive officer, chief financial officer, and other officers of the Joint Venture. The officers are to perform those duties and have those responsibilities that the Managing Venturer assigns to them. The Non-Managing Venturer must approve the appointment and replacement of the chief executive officer and shall not unreasonably withhold or delay its approval. The Managing Venturer may appoint one or more officers of either Venturer to be an officer of the Joint Venture, but only if that officer intends to devote substantially full time to the Joint Venture. If that officer fails to devote substantially full time to the Joint Venture, the Managing Venturer shall terminate that officer's employment. The Managing Venturer may determine, in its sole discretion, the benefits to be offered to any officer appointed in accordance with this subsection. The Joint Venture shall indemnify and defend each officer of the Joint Venture against all claims, losses, damages and liabilities, including reasonable attorneys' fees, relating to any act or failure to act by that officer, but only if the officer's act or failure to act was in good faith and, in both cases, in a manner that officer reasonably believed to be in, or not opposed to, the Joint Venture's best interests; or if the officer relied on the opinion or advice of competent legal counsel. Any indemnity under this Section is to be paid from the Joint Venture's assets, and no Venturer has any individual liability on account of the indemnity under this Section 9.3.

*Better*

**9.3 The Joint Venture's Officers.**

(a) **Appointment of Officers.** The Managing Venturer shall appoint the chief executive officer, chief financial officer, and other officers of the Joint

Venture. The officers are to perform those duties and have those responsibilities that the Managing Venturer assigns to them.

(b) **Approval of Chief Executive Officer's Appointment.** The Non-Managing Venturer must approve the appointment and replacement of the chief executive officer and shall not unreasonably withhold or delay its approval.

(c) **Appointment of a Venturer's Officer.** The Managing Venturer may appoint one or more officers of either Venturer to be an officer of the Joint Venture, but only if that officer intends to devote substantially full time to the Joint Venture. If that officer fails to devote substantially full time to the Joint Venture, the Managing Venturer shall terminate that officer's employment. The Managing Venturer may determine, in its sole discretion, the benefits to be offered to any officer appointed in accordance with this subsection.

(d) **Indemnity of Officers.** The Joint Venture shall indemnify and defend each officer of the Joint Venture against all claims, losses, damages and liabilities, including reasonable attorneys' fees, relating to any act or failure to act by that officer, but only if

(i) the officer's act or failure to act was in good faith and, in both cases, in a manner that the officer reasonably believed to be in, or not opposed to, the Joint Venture's best interests; or

(ii) the officer relied on the opinion or advice of competent legal counsel.

(e) **Source of Funds.** Any indemnity under this Section 9.3 is to be paid from the Joint Venture's assets, and no Venturer has any individual liability on account of the indemnity under this Section.

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### Notes:

1. Many lawyers are unfamiliar with the contract concept of declarations. Of course, they don't know about the concept because they never learned about it in law school. Despite that, declarations pervade contracts.
2. The bracketed language recasts the last sentence using the possessive. It shortens the sentence, deleting superfluous words.
3. This article draws heavily on the author's textbook DRAFTING CONTRACTS: HOW AND WHY LAWYERS DO WHAT THEY DO (2d ed. Wolters Kluwer 2014). In many instances it quotes or paraphrases the textbook, but it has omitted the quotation marks to facilitate reading.
4. Carl Felsenfeld, one of the first proponents of plain English, stated the following: "The plain English movement requires a new drafting approach. Each provision [of a consumer contract] must be analyzed one at a time against the specific transaction and the type of protection required. Many of the traditional legal provisions may well be found essentially unnecessary. . . . The point is that consumer drafting must be regarded as *a separate process from business drafting*. A legal principle derived from this, while perhaps extreme, does lead the way: 'In a business transaction, if a risk can be perceived draft for it. In a consumer transaction, unless a risk seems likely, forget it.'" Carl Felsenfeld, *Language Simplification and Consumer Legal Forms*, remarks made at program on simplified legal drafting, American Bar Association, New York City, Aug. 7, 1978, in F. REED DICKERSON, MATERIALS ON LEGAL DRAFTING 267 (2d ed., Little, Brown & Co. 1986) (emphasis added). See also CARL FELSENFELD & ALAN SIEGEL, WRITING CONTRACTS IN PLAIN ENGLISH 28-29 (West 1981).
5. Stating that the notice must be in writing is superfluous if the contract's notice provision requires all notices to be in writing.
6. The addition of the bracketed language is necessary so that the first and second sentences say the same thing the same way. Without it, an inventive litigator might argue that the Lease ends but rent continues if the casualty is a fire.
7. Yes. Despite what Mrs. Smith told you in sixth grade, you may begin a sentence with a conjunction and not hang your head with shame.
8. ASR 2620-2630 Fountainview, LP v. ASR 2620-2630 Fountainview GP, LLC, [2019 WL 470240](#) (Tex. Ct. App. 2019).
9. *Nominalizing* a word converts it from a verb to a phrase that includes the noun form of the word. Compare the preceding sentence to its alternative: The



*nominalization* of a word is the *conversion* of a verb into a phrase that includes the noun form of the word. With a word-processing app's grammar check, you can easily and quickly catch any nominalizations and improve your writing style.

10. Although the general rule is to include in the introductory language all words common to each enumerated item, the author suggests a stylistic exception with negative covenants. Including *shall not* with each enumerated item reminds the reader that each subsection prohibits an act. It's a personal preference - the exception to the rule.

11. See *Williams v. Barkley*, [58 N.E. 765](#), 767 (N.Y. 1900) ("The promise is what the parties agreed to do, and hence is the operative part of the instrument, while the recital states what led up to the promise and gives the inducement for making it"); see also *Fugate v. Town of Payson*, [791 P.2d 1092](#), 1094 (Ariz. App. 1990) ("A recital . . . is not strictly part of the contract"). But see [Cal. Evid. Code § 622](#) ("[t]he facts recited in a written instrument are conclusively presumed to be true as between the parties thereto, or their successors in interest"); [Or. Rev. Stat. § 42.300](#) ("Except for the recital of a consideration, the truth of the facts recited from the recital in a written instrument shall not be denied by the parties thereto").

12. See E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS vol. 1, § 2.20 (4th ed., Wolters Kluwer 2019).

13. See, e.g., *Earl v. St. Louis U.*, [875 S.W.2d 234](#), 237 (Mo. App. 1994); *Finegan v. Prudential Ins. Co.*, [14 N.E.2d 172](#), 175-176 (Mass. 1938). In some states, statutes provide that a written instrument is presumptive evidence of consideration. See [Okla. Stat. tit. 15, § 114](#); [Idaho Code § 29-104](#). See also Farnsworth on Contracts, *supra* n.12, vol. 1, 158, and the cases cited therein.

14. *Premises* is not a typo. It means that which came before. Lawyers used it frequently in old (approximately 17th century and later) English contracts.

15. KENNETH A. ADAMS, A MANUAL OF STYLE FOR CONTRACT DRAFTING 35-40 (4th ed. ABA).

16. See NANCY S. KIM, THE FUNDAMENTALS OF CONTRACT LAW AND CLAUSES: A PRACTICAL APPROACH 29-39 (2016 Edward Elgar Publg. Ltd.).



## Persistent Ambiguity in Contracts: Extrinsic Evidence to the Rescue?

*Sue Payne*

Even the most careful contract drafters sometimes draft ambiguous provisions. This is partly due to the slippery nature of language; the meaning of a word is not entirely consistent from person to person and place to place. Although the careful drafter strives to make the language of the contract clearly express what the parties' intend it to mean, ambiguity sometimes creeps in. As the three recent cases discussed below demonstrate, some litigants engaged in ambiguity disputes turn to extrinsic evidence for help. Nevertheless, ambiguity often persists.

### *ASARCO, LLC v. Montana Resources, Inc.*<sup>1</sup>

ASARCO involved a Partnership Agreement (the "Agreement") containing a reinstatement provision with two incorrect cross-references in the Agreement: one leading to the wrong section and the other to a non-existing section.<sup>2</sup> In the context of a post-discovery motion for summary judgment, the defendants sought to clarify the Agreement by introducing two pieces of extrinsic evidence: (1) two newly discovered drafts of the Agreement (located by searching through an off-site storage unit); and (2) an affidavit from the lawyer who represented the defendants during the negotiation and drafting.<sup>3</sup> The defendants argued that comparing the earlier drafts to the final version identified the sections to which the "dead-end" cross-references were supposed to refer.<sup>4</sup> Consequently, according to the defendants, the parties' intent was clear: a defaulting partner could cure and be reinstated only if the non-defaulting partner took the specific steps enumerated in the two correctly referenced provisions.<sup>5</sup>

The lawyer's affidavit attested to what has to be one of every contract drafter's worst nightmares: In editing the document, the drafter re-labeled and renumbered the sections, but forgot to update the cross-references.<sup>6</sup> The defendants contended that this explanation of the drafting error – coupled with the newly discovered earlier drafts of the Agreement – resolved the ambiguity of the reinstatement provision.<sup>7</sup>

The ASARCO court acknowledged that the prior drafts and the lawyer's affidavit provided "some insight into the parties' intent."<sup>8</sup> However, while characterizing the defendants' argument as "certainly persuasive," the court concluded that it could not "weigh competing

evidence at this stage of the litigation.”<sup>9</sup> Therefore, the court denied the defendants’ motion for summary judgment.<sup>10</sup>

**DRAFTING LESSON LEARNED:** First, avoid being the lawyer who has to provide the “Whoops, we made a mistake!” affidavit. “Dead-ends” are not merely annoying; they can plunge parties into lengthy and costly court battles with unpredictable outcomes. Second, be aware that, to resolve an ambiguity dispute, some courts will consider extrinsic evidence contained in documents like prior drafts of an agreement and an affidavit from the drafter. If you find yourself in the unenviable position of having drafted an ambiguous contract, your counsel may be able to clarify the parties’ intent by introducing the prior drafts. While not determinative in the summary judgment context of ASARCO, if a court can weigh competing evidence, the prior drafts might be persuasive. With any luck, you will not have to search through an off-site storage unit to find them.

### *Smith v. Bank of Hawaii*<sup>11</sup>

In this putative class action, Smith challenged the Bank of Hawaii’s custom of using an “available balance method” rather than a “ledger balance method” to determine when a customer’s account funds are insufficient to cover a transaction (*i.e.*, when an “overdraft” has occurred).<sup>12</sup> The available balance method takes into account “authorized but unsettled” transactions and “holds” on deposits that have not yet cleared.<sup>13</sup> According to Smith, by using the available balance method (as opposed to the ledger balance method) to determine when an overdraft has occurred, the Bank breached its own overdraft program documents and charged its customers unwarranted overdraft fees.<sup>14</sup>

As established in two prior decisions in the case (*Smith I* and *Smith II*),<sup>15</sup> the Bank’s overdraft program documents included an account agreement, fee schedule, and opt-in agreement (collectively, the “Agreements”).<sup>16</sup> In the instant case (*Smith III*) the Bank posited that a change-in-terms notice (“CIT”) distributed to customers should be considered an additional agreement in the Bank’s overdraft protection program.<sup>17</sup> On reviewing the CIT, the court found that the Bank used the words “available balance” but failed to define them.<sup>18</sup> Observing that the CIT suffered from the “same flaws *Smith I* identified in the Agreements,” the court then quoted the *Smith I* court’s rationale for finding the Agreements ambiguous:

At no point in . . . the Agreements does [the Bank] define the meaning of “available” when describing balances. [The Bank] apparently assumes that the customer will read the word

“available” in six scattered sections spanning the thirty-six-page Account Agreement and come to a conclusion – [the Bank] will use the available balance method when determining overdraft fees. But this assumes too much. The word “available” simply cannot shoulder the weight of all the assumptions [the Bank] seeks to place on it.<sup>19</sup>

The *Smith III* court then found that, even if the court were to read the CIT along with the Agreements, the ambiguity about the Bank’s overdraft calculation method persisted.<sup>20</sup>

The Bank also offered a variety of extrinsic evidence to establish a course of dealing between the parties and demonstrate that the Agreements were not ambiguous.<sup>21</sup> The court reviewed: a “Frequently Asked Questions” document delivered to Smith by hand and by mail; an “Understanding Overdrafts” page appearing on the Bank’s website; a mobile app displaying Smith’s “current” and “available” balances; overdraft notices and monthly account statements displaying Smith’s balance; and Bank employees’ conversations with Smith regarding the Bank’s overdraft program.<sup>22</sup>

The court also reviewed Smith’s testimony about the extrinsic evidence offered by the Bank. For example, Smith said that he looked at the Bank’s website several times but never saw the page about overdraft fees.<sup>23</sup> He also said that, while he sometimes used the Bank’s mobile app to check his balance, he never paid attention to the difference between current and available balances.<sup>24</sup> Though a bank employee once mentioned “holds” to him, Smith claimed that no one had ever explained “available balance.”<sup>25</sup> And, finally, he related that he had called the Bank five or six times to complain about an incorrect balance resulting in a mistakenly charged overdraft fee.<sup>26</sup> In sum, Smith testified that he never understood the difference between available balance and ledger balance.<sup>27</sup>

Taking all of the extrinsic and other evidence into account, the *Smith III* court held that, even if it were to find the Bank’s extrinsic evidence “somewhat persuasive,” a genuine question of fact still existed regarding Smith’s knowledge about what method the Bank used to identify an overdraft, and thus whether Smith had acquiesced to the claimed course of dealing.<sup>28</sup> Therefore, the court denied the Bank’s motion for summary judgment on Smith’s breach of contract claim.<sup>29</sup>

Significantly, the court also ruled that a genuine issue of fact existed regarding whether the Bank’s practices violated Hawaii’s Unfair or Deceptive Trade Practices Act (“UDAP”).<sup>30</sup> *Smith I* held that a trier of fact could reasonably find that the Agreements contained a “deceptive representation” or that omitting the applicable

balance calculation method from the Agreements constituted a “deceptive act or practice” under the UDAP.<sup>31</sup> Finding that none of the Bank’s evidence had “meaningfully challenged this reasoning,” the *Smith III* court denied the Bank’s motion for summary judgment on the UDAP claim.<sup>32</sup>

**DRAFTING LESSON LEARNED:** The Bank and its attorneys made a big mistake by failing to define “available balance” and failing to communicate precisely how the overdraft program worked. The resulting ambiguity left the Bank open to a putative class action brought on behalf of every Bank customer like Smith, who did not understand the difference between an available balance and a ledger balance. The Bank now faces potential liability to Smith and similarly situated Bank customers for breach of contract and UDAP violations.<sup>33</sup>

*Smith III* demonstrates how important it is to draft explicit, clear definitions of key terms and use those terms, as defined, consistently throughout the agreement (or “Agreements,” as the case may be). In addition, *Smith III* shows that extrinsic evidence, though profuse and somewhat persuasive, may still not save the day. Ambiguity is tough. It can survive multiple attempts at clarification, which may serve only to strengthen it. Don’t expect your reader to figure out what a term means if you don’t define the term but nevertheless use it in multiple places in multiple documents. That’s expecting the reader to do too much work.

#### ***Cadence Education, LLC v. Vore***<sup>34</sup>

As part of an asset purchase transaction, the defendants’ holding company, FHD, sublet from Cadence a portion of a building housing a childhood educational facility.<sup>35</sup> Although the sublease referred to an attached diagram of the space, the parties did not attach the diagram to the sublease.<sup>36</sup> Moreover, the sublease did not contain a description of the subleased premises other than to state that the space consisted of approximately 11,500 square feet.<sup>37</sup> According to Cadence, the subleased square footage referred to “the non-tuition generating classrooms capable of being licensed for enrolled students.”<sup>38</sup> Defendants, on the other hand, claimed that the sublease covered a roughly 10,400 square foot area in “the back half” of the building behind a set of fire doors.<sup>39</sup> Oddly, the parties did not discuss the square footage of the subleased space before entering into the sublease.<sup>40</sup>

Pursuant to the sublease, FHD was to pay rent to Cadence for the subleased premises and FHD’s rent amount was to shrink proportionately as Cadence expanded into the subleased premises.<sup>41</sup> When FHD – which was not occupying the subleased premises at all –

failed to pay rent, Cadence alleged that FHD had breached the terms of the sublease. However, FHD claimed that no rent was due because Cadence had expanded fully into and now occupied all of the subleased premises, thereby reducing FHD’s rent to zero.<sup>42</sup>

The court in *Cadence* found that the words “subleased premises” and “occupancy” were not adequately defined in the sublease.<sup>43</sup> While Cadence argued that the parties understood “subleased premises” to mean certain classrooms, the court found “equally reasonable” the defendants’ belief that “subleased premises” meant the back half of the building.<sup>44</sup> Regarding “occupancy,” the court found that both Cadence’s interpretation (use of rooms for licensed classrooms) and the defendants’ interpretation (use of rooms for other education-related purposes) were credible.<sup>45</sup>

Unable to resolve these ambiguities in the sublease, the *Cadence* court considered extrinsic evidence in order to determine the parties’ intent. The court reviewed the meaning of “occupancy” in the early childhood education business.<sup>46</sup> Although Cadence argued that “occupancy” typically means the use of space as classrooms, the court rejected this construction because Cadence failed to produce evidence supporting it.<sup>47</sup> The court also considered how the space had been used before the sublease (for storage), concluding that it would be reasonable to assume that the parties considered storage use to be a “baseline.”<sup>48</sup> The court found that Cadence’s “occupancy” of the subleased premises would likely require some use beyond the baseline.<sup>49</sup> Ultimately, however, the court held that the parties’ intentions could not be ascertained.<sup>50</sup> Therefore, the court denied the defendants’ motion for summary judgment on Cadence’s breach of contract claim.<sup>51</sup>

**DRAFTING LESSON LEARNED:** Carefully identify what needs to be defined (not just “subleased premises,” but “occupancy” as well) and assure that those defined terms work well together and with other provisions in the contract (like a rent reduction provision with the amount of the reduction tied to one party’s “occupancy” of the “subleased premises”). And, perhaps it goes without saying, but it’s important to know what the parties’ intend before you choose words to embody that intent. Learn about your client’s business. Find out what the client hopes to accomplish through the transaction and explore how your client’s objectives mesh with the other party’s objectives. Discover all you can about the parties’ relationship and prior course of dealing. And, monitor that relationship as it develops during the negotiation and drafting process. In short, do your best to assure that the parties are on the same page when they sign the contract you have drafted.

## Conclusion

Since even careful contract drafters cannot eradicate ambiguity, courts will continue to spend much of their time interpreting ambiguous contracts. Litigants will continue to introduce extrinsic evidence to take advantage of persistent ambiguity or to vanquish it. The careful contract drafter will continue to draft carefully but will also be mindful of how extrinsic evidence could inform the meaning of the words in the contract. Contract drafters sometimes say that their work “memorializes” the transaction. “Memorialize” makes the contract seem like it needs a tombstone. Don’t let your epitaph be “Here lies the contract drafter: Felled by persistent ambiguity when extrinsic evidence failed to rescue him.”

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## Notes:

1. [2019 WL 195059](#) (S.D. Tex. 2019).
2. [Id. at \\*2](#).
3. [Id. at \\*18, 20](#).
4. [Id. at \\*18-19](#).
5. [Id. at \\*19](#).
6. [Id. at \\*18](#).
7. [Id. at \\*19](#).
8. [Id.](#)
9. [Id. at \\*19-20](#).
10. [Id. at \\*20](#).
11. [2019 WL 404423](#) (D. Haw. 2019).
12. [Id. at \\*1](#).
13. [Id.](#)
14. [Id.](#)
15. See *Smith v. Bank of Hawaii*, [2017 WL 3597522](#) (D. Haw. April 13, 2017) (“*Smith I*”) (denying the Bank’s motion to dismiss); *Smith v. Bank of Hawaii*, [2018 WL 1662107](#) (D. Haw. April 5, 2018) (“*Smith II*”) (granting in part and denying in part the Bank’s first motion for summary judgment).
16. [Smith III at \\*1](#).
17. [Id. at 3-4](#).
18. [Id. at \\*6](#).
19. [Id.](#), citing [Smith I at \\*7](#).
20. [Id. at \\*5](#).
21. [Id. at \\*6-8](#).
22. [Id.](#)
23. [Id. at \\*3, 7](#).
24. [Id. at \\*3, 8](#).
25. [Id.](#)
26. [Id. at \\*3, 9](#).
27. [Id. at \\*8](#).
28. [Id. at \\*9](#).
29. [Id.](#)
30. [Id. at 11](#). [Haw. Rev. Stat. § 480-2](#).
31. [Smith I at \\*9](#).
32. [Smith III at \\*11](#).
33. *Smith* also alleged that the Bank violated the Electronic Funds Transfer Act, known as “Regulation E” (15 U.S.C. §§ 1693 -1693(r)) by failing to provide a “clear and readily understandable description of the overdraft service.” [Smith I at \\*7-8](#). Holding that genuine issues of material fact existed regarding the Regulation E claim, the *Smith III* court denied the Bank’s motion for summary judgment. [Id. at \\*13](#).
34. [2019 WL 917020](#) (D. Kan. 2019).
35. [Id. at \\*1-3](#).
36. [Id. at \\*2](#).
37. [Id. at \\*4](#).
38. [Id.](#)
39. [Id.](#)
40. [Id.](#)
41. [Id. \\*1](#).
42. [Id. at \\*10](#).
43. [Id. at \\*10-11](#).
44. [Id. at \\*10](#).
45. [Id. at \\*11](#).
46. [Id.](#)
47. [Id.](#)
48. [Id.](#)
49. [Id.](#)

50. *Id.*

51. *Id.*

52. Thank you to my valued Research Assistant, Jasmine Bell (Emory Law 3L), for the assistance she gave me as I prepared to write this article.



## Zombie Documents: A Dissenting View

*Scott Burnham*

In a recent article,<sup>1</sup> the authors warned of “zombie documents” that might come back to infect a more recent transaction. The article was prompted by the case of *Jipping v. First National Bank Alaska*.<sup>2</sup> In *Jipping*, the parties entered into a security agreement in 2009 in which the collateral included deposit accounts; the agreement contained a future advances clause. The loan was then paid off in 2011 and in 2013 the parties entered into another security agreement that did not include deposit accounts as collateral. On default, the creditor foreclosed on the deposit accounts over the protests of the debtor, who claimed that the 2009 agreement was no longer binding on the parties. The Ninth Circuit ultimately held that the court was barred from looking to the 2009 agreement because the merger clause in the 2013 agreement rendered that agreement fully integrated, thus barring terms that would vary or contradict it under the parol evidence rule.

The authors hypothesize that the parties may have forgotten about the 2009 agreement and use the case as an object lesson to warn practitioners that past agreements they thought were dead may rise up and infect present agreements. Fair enough. But *Jipping* is a dangerous precedent because there is nothing in the opinion to indicate that the holding would be confined only to a future advances clause that the parties had forgotten about. Therefore, it would bar the application not only of zombie documents but living documents as well.

The authors suggest that the decision might be correct. I disagree, for the court misunderstood the role of the parol evidence rule and made the merger clause do too much work.<sup>3</sup> The parol evidence rule is easy to state and hard to apply (which is to say, easy for courts to manipulate). The court stated the parol evidence rule as

found in an earlier Alaska case: “Under the terms of the parol evidence rule an integrated written contract cannot be varied or contradicted by prior negotiations or agreements.”<sup>4</sup> The court correctly concluded that the 2013 transaction was an integrated agreement, as evidenced by the merger clause.<sup>5</sup>

But let’s go back a step. Some time ago I wrote an article on the parol evidence rule.<sup>6</sup> Mortified by cases in which courts discussed the admissibility of extrinsic evidence without telling us what that evidence was, I suggested that the first step in analyzing a parol evidence problem is to ask, “What evidence are you offering?”<sup>7</sup> That is, what is the understanding that a party wishes to have incorporated into this agreement? For example, if the parties’ written security agreement stated that the collateral was equipment and the creditor claimed that the parties had agreed that the collateral was not only equipment but deposit accounts, then “we agreed that the collateral would be deposit accounts” would be the parol evidence. If the court found that the written agreement was fully integrated, then the court would exclude that understanding.<sup>8</sup>

What is the parol evidence that was offered in *Jipping*? That is, what is the understanding that the creditor wished to incorporate into the 2013 writing as fully as if it had been typed in before the parties signed it? The answer is – there isn’t any! For the creditor to prevail, it does not have to offer any evidence to “vary or contradict” the written agreement. Since extrinsic evidence is not being offered to vary anything in the 2013 agreement, the parol evidence rule is not relevant. Of course, the parties were free to provide that the 2013 loan was not to be considered a future advance. This would best be accomplished by inserting an affirmative statement to that effect rather than relying on the merger clause to do the heavy lifting.

Instead of asking whether the 2013 agreement was integrated, the inquiry should begin with the 2009 agreement. It states that the collateral (which included deposit accounts) is also collateral for any future advances from the creditor to the debtor. Was there a later advance from the creditor to the debtor? Yes – the 2013 agreement. End of inquiry. We do not need to add anything to the 2013 agreement to come to that conclusion. The 2013 agreement does not have to provide that the collateral includes deposit accounts because that work is done by the future advances clause in the 2009 agreement; to require the creditor to provide it in the later agreement would vitiate the future advances clause.

Indeed, vitiating of the future advances clause may have been the court’s intent. As the authors suggest with

their discussion of the much-reviled “relatedness rule,” the court may have been indirectly invoking that rule to keep the future advances clause from applying to what it perceived to be an unrelated transaction.<sup>9</sup> If so, the court might have had the honesty to invoke the relatedness rule instead of torturing the poor parol evidence rule.

I agree with the authors that it is possible another court will follow *Jipping* – though by electing not to publish the opinion in West’s Federal Reporter, the court may have wanted it to quietly disappear. Therefore, the cautious practitioner might want to add to the merger clause the language suggested by the authors that would prevent this outcome.<sup>10</sup> It might also be worth noting that the creditor used a document assembly program to put together this transaction.<sup>11</sup> It is important to remember when generating documents that every transaction must be adapted to a particular client in a particular situation.

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#### Notes:

1. E.H. Geiger and Stephen L. Sepinuck, *Zombie Documents*, [9 THE TRANSACTIONAL LAWYER 1](#) (Feb. 2019).
2. [735 F. App’x 436](#) (9th Cir. 2018).
3. For another discussion of how courts occasionally treat a merger clause as relevant to something other than the parol evidence rule, see Stephen L. Sepinuck, *Drafting a Merger Clause for an Integrated Transaction*, [4 THE TRANSACTIONAL LAWYER 2](#) (Dec. 2014).
4. *Still v. Cunningham*, [94 P.3d 1104](#), 1109 (Alaska 2004).
5. The merger clause stated in full: “This Agreement, together with any Related Documents, constitutes the entire understanding and agreement of the parties as to the matters set forth in this Agreement.” [735 F. App’x at 436](#).
6. Scott J. Burnham, *The Parol Evidence Rule: Don't Be Afraid of the Dark*, [55 MONT. L. REV. 93](#) (1994).
7. *Id.* at 95.
8. *See, e.g.*, In re Doctors Hosp. of Hyde Park, Inc., [474 B.R. 576](#) (Bankr. N.D. Ill. 2012) (other documents executed contemporaneously with security agreement would not be considered in determining scope of collateral covered).
9. *Zombie Documents*, *supra* note 1, at 3.

10. *Id.*

11. In re Omni Enterprises, Inc., [2016 WL 3213562](#) at \*2 (Bankr. D. Alaska 2016), *rev’d*, 735 F. App’x 436 (9th Cir. 2018).



## A “Sale” of Future Receivables: Disguising a Secured Loan as a Purchase of Hope

*John F. Hilson*  
*Stephen L. Sepinuck*

In the last few years, a new type of factoring transaction has emerged that involves what purports to be a present sale of future receivables. This article explores the transaction and explains why it does not achieve what its creators likely intended.

#### A Case Study

In early 2016, Cornerstone Tower Services, Inc. entered into a Merchant Cash Advance agreement with LG Funding. In return for a cash infusion of \$50,690, Cornerstone purported to “sell” to LG all of Cornerstone’s future accounts “until” LG received the “Purchased Amount,” which was specified to be \$65,897.<sup>1</sup> To facilitate collection of the Purchased Amount, the parties established a mechanism for automatic debits from one of Cornerstone’s deposit accounts, and limited the amount thereof to \$500 per day out of the receipts for that day. If, on any day, there were no receipts, LG was to receive nothing but, of course, the Purchased Amount would not be reduced. The agreement gave LG a backup security interest in all of Cornerstone’s existing and after-acquired accounts, but it also expressly provided that the amount LG paid – referred to as the Purchase Price – was in exchange for the interest in future accounts and that “such Purchase Price is not intended to be, nor shall be construed as, a loan.”<sup>2</sup>

Less than three weeks later, apparently still in need of cash, Cornerstone entered into a similar transaction with EBF Partners, LLC. Under this transaction, EBF paid Cornerstone \$75,000 for a “Specified Percentage of the proceeds of each future sale by [Cornerstone] until [\$105,000] has been delivered to EBF by or on behalf of [Cornerstone].”<sup>3</sup> The agreement then specified that EBF

was to receive 15% of Cornerstone's future receipts, up to a daily maximum of \$875. As with the transaction between Cornerstone and LG, there was a backup grant of a security interest and the documents expressly declared that Cornerstone was "selling a portion of a future revenue stream to EBF at a discount, not borrowing money from EBF."<sup>4</sup>

Less than two months later, Cornerstone filed for bankruptcy protection. In part because neither LG nor EBF had filed a financing statement prepetition, the trustee brought a preference action against each of them to recover the amounts they received prepetition. LG and EBF each argued that, as a buyer of accounts, it was not a creditor and thus the funds they received could not be avoidable preferences.

The court, in two separate decisions – *Cornerstone I* and *Cornerstone II* – agreed that each transaction was a sale, not a loan, but nevertheless concluded that because LG and EBF had not filed, Cornerstone retained its right to the accounts and a *prima facie* case for preference avoidance was met.<sup>5</sup> However, in each case, the court declined to decide on summary judgment whether the payments were protected from avoidance under § 547(c)(2) of the Bankruptcy Code as payments made in the ordinary course of business.<sup>6</sup>

The portion of the court's opinions that is relevant to this article is the discussion – arguably dicta – of whether Cornerstone's transactions with these financiers were sales or loans.<sup>7</sup> Before examining the court's analysis, however, it is useful to consider the framework in which that analysis should be conducted.

### *Nemo Dat*

To begin with, the type of transaction at issue in the *Cornerstone* cases – a putative present sale of rights to payment that do not yet exist (or, more accurately, of an undivided share of such nonexistent rights) – is both a metaphysical and legal impossibility. It is metaphysically impossible because the essence of a sale is the transfer to the buyer of that which is being purchased. A transfer of future rights to payment – that is, rights that as yet do not exist<sup>8</sup> – cannot occur unless and until the rights to payment arise.

It is a legal impossibility for much the same reason. The law simply does not comprehend or countenance a present transfer of future property. It might recognize and even enforce a *promise* to transfer property that the promisor hopes later to acquire, but that is something different. As one court put it, "[a]t law one cannot transfer by a present sale what he does not then own, although he expects to acquire it. But, while [such a] contract [is] without effect at law as a contract of sale, it

operate[s] as an executory agreement to sell."<sup>9</sup> Indeed, it is a basic legal maxim that "one cannot give what one does not have" (or, in one of several phrasings in Latin, "*nemo dat qui non habet*").<sup>10</sup>

Thus, "[t]here is no doubt that the assignment of a truly future claim or interest does not work a present transfer of property. It does not because it cannot; no property yet exists."<sup>11</sup> It is simply incoherent to assert that a putative buyer has purchased rights to payment that do not exist at the time of the transaction and that may never exist. The buyer's property interest arises, if at all, when the seller first obtains an interest in the applicable right to payment.<sup>12</sup>

The provisions of the Uniform Commercial Code are consistent with these concepts. Specifically, Article 9 does not allow a party to create a security interest in property that does not yet exist.<sup>13</sup> Under U.C.C. § 9-203(b)(2), a debtor must have "rights in the collateral or the power to transfer rights in the collateral" in order for a security interest (including the security interest of a purchaser of receivables) to attach. As the Official Comments to that section explain, "[a] debtor's limited rights in collateral, short of full ownership, are sufficient for a security interest to attach. However, in accordance with basic personal property conveyancing principles, the baseline rule is that a security interest attaches only to whatever rights a debtor may have, broad or limited as those rights may be."<sup>14</sup>

To be clear, a debtor can authenticate a security agreement purporting to grant a security interest in existing and after-acquired receivables. But the security interest will not attach to receivables that the debtor does not own at the time of authentication until the debtor acquires rights in those receivables.<sup>15</sup> Alternatively, a debtor that has a present right to a stream of future payments<sup>16</sup> – as an annuitant might – can, assuming there are no effective restrictions on alienation, grant a security interest in the payments not yet due. In that case, the debtor has a right that is unmaturing, but a present right nonetheless. People have been selling *rights* to future payments for hundreds of years and they have been borrowing against such rights for almost as long. But it is impossible to grant a security interest in the mere *hope* of future revenue. A hope or dream of future wealth is not property. Without property, there can be no collateral.

### **Sale vs. Secured Financing**

The discussion above does not by itself fully answer the question of whether the *Cornerstone* transactions were sales or loans. It demonstrates only that, at the time the documents were signed, the financiers received no

property rights to either Cornerstone's future accounts or the proceeds of those future accounts. The documents could have, however, at least theoretically, provided for an automatic transfer of each new account (or, more accurately, a fractional share of each new account) the instant Cornerstone generated it. Such an automatic transfer would be similar to what happens when a security interest attaches to after-acquired collateral. It would also be analogous to the doctrine of after-acquired title (also known as estoppel by deed), which applies when a grantor of real property, who did not actually have property rights when the grantor purported to convey them, later acquires such rights.<sup>17</sup> In short, while the transaction documents did not create a present sale of future receivables, they could have created either: (i) a future sale of future receivables; or (ii) a loan that would become secured by future receivables.

Article 9 applies to both of these types of transactions: a sale of accounts or payment intangibles, as well as a transaction in which accounts or payment intangibles secure an indebtedness.<sup>18</sup> One of the reasons that it does so is to limit the circumstances in which it is necessary to determine which type of transaction is involved, in part because the distinction between the two types of transactions is often blurred and occasionally difficult to make.<sup>19</sup> However, the Official Comments expressly indicate that whether a transaction is a true sale or a secured loan is an issue that Article 9 itself does not answer and instead leaves to the courts, presumably to determine under other law.<sup>20</sup> Despite that, the distinction between a sale<sup>21</sup> of receivables and an obligation secured by receivables can be important for a variety of reasons, both inside and outside of Article 9. These reasons include:

- Whether the transaction is subject to the automatic perfection rule of § 9-309(3);<sup>22</sup>
- Whether § 9-406 or § 9-408, which have slightly different rules overriding restrictions on assignment, applies to the transaction;<sup>23</sup>
- Whether the transferor is entitled to any surplus under § 9-608;<sup>24</sup>
- Whether the receivables become property of the bankruptcy estate of the transferor;<sup>25</sup>
- When the transfer occurred, which can affect whether it is an avoidable preference;<sup>26</sup>
- Whether the transaction is subject to statutes on usury;<sup>27</sup> and
- Whether the transferee takes free under PACA of the rights of produce suppliers to the transferor.<sup>28</sup>

For each of these purposes, the analysis is largely the same, although courts have not articulated a precise test or standard for determining whether a transaction structured as a sale of receivables is really a secured obligation. Instead, they have merely identified factors that should be considered. These factors including the following:

- Whether the putative buyer acquires the risk of loss or whether that risk remains on the seller (such as by having to indemnify the buyer for losses or having to repurchase a receivable after the account debtor defaults);<sup>29</sup>
- Whether the putative buyer acquires the opportunity for gain (such as by retaining all collections in excess of the purchase price paid, plus interest);<sup>30</sup>
- Whether the putative seller continues to collect the receivables and, if so, whether it commingles the receipts with its other funds;<sup>31</sup> and
- Whether the putative buyer acquires the other incidents of ownership, such as the authority to determine what collection actions to take, the authority to change the servicer, the authority to enter into a binding settlement with the account debtor, the right to assign, the duty to maintain records relating to the receivables, and the burden of collection costs.<sup>32</sup>

It is worth noting that an approach such as this – a list of factors to consider but no standard to apply – is inherently problematic. It provides courts with little real guidance and can instead be used to mask decisions based on other considerations.<sup>33</sup> This problem is exacerbated by the fact that the list of factors is not exhaustive and courts consider other factors, such as how the transaction documents label the transaction<sup>34</sup> or whether the putative buyer filed a financing statement,<sup>35</sup> which are of dubious relevance.<sup>36</sup> Some courts also state that the issue is one of the parties' intent,<sup>37</sup> but such a statement is at best misleading because the parties' intent is to be determined objectively, rather than subjectively,<sup>38</sup> and thus such a statement is really no more than a shorthand way of referring to all the other factors.

Fortunately, courts generally agree that, although no single factor is controlling, the first factor – which party bears the risk of loss -- is the most important.<sup>39</sup>

### Substance

Applying these factors, the *Cornerstone* court concluded that both transactions were true sales. The court noted that the documents clearly stated that the transactions were sales and that Cornerstone retained the



right and obligation to service the accounts.<sup>40</sup> To its credit, the court spent most of its analysis on the risk of loss. Unfortunately, in doing so it stressed the absence of any obligation by Cornerstone to repurchase the accounts,<sup>41</sup> and failed to appreciate that the structure really did leave Cornerstone with virtually all of the risk. This is evidenced principally by three aspects of the transactions, each of which distinguishes them from true sales of receivables.

First, in a typical sale of receivables, the buyer acquires receivables totaling a specified sum due from known account debtors. In contrast, in the Cornerstone transactions, the transfers were not limited to specific receivables owed by identified account debtors or even to receivables of a specified amount. Instead, the “buyers” received an unlimited amount of receivables until the respective buyer received payment of an amount that was identified in the documents as the “Purchased Amount” (*i.e.*, the amount that must be repaid to the “buyer” from collections on all future receivables of the “seller”).

Second, in true sale transactions, the receivables usually have a face amount that is greater than the purchase consideration, but knowledge of the face amount is necessary to determine the consideration that the buyer is to pay. In other words, the price to be paid is typically determined by the face amount of the receivables, discounted by the risk of delay and nonpayment, and adjusted for prevailing interest rates. In most cases, the adjustment for risk requires some knowledge of the creditworthiness of the account debtors, even if that determination is not made individually, but in the aggregate. Put simply, buyers of receivables rarely pay substantial sums for whatever Monty Hall is hiding behind the curtain. However, the transaction between the putative buyers and the seller in the Cornerstone transactions lacked any such information. It is true that the transactions involved a specified *percentage* of the future receivables, but there was no way for the parties to know – at the time they entered into the transactions – what amount of receivables would have to be generated to pay the buyer the Purchased Amount.

Finally, and perhaps more to the point, each of the transactions encompassed a specified portion of future receivables from the transaction’s inception until the respective Purchased Amount was remitted to the buyer. In other words, the transactions purported to transfer future receivables in perpetuity until a specified amount was received by the buyer. Because of this, the seller retained the risk of loss with respect to each individual account. The buyer was in no way injured if any particular account debtor did not pay; in essence the property purportedly “sold” would shift to ensure that the “buyer” received full value. Thus, while nothing in the

transactions purported to give the buyer recourse against the seller in the event that the receivables were less than anticipated, the structure of the transactions effectively meant that the seller bore the risk of the collectability of the individual receivables. The only risk the putative buyer bore was if seller stopped generating accounts. This characteristic of the transactions strongly suggests that they involved secured obligations rather than an outright sale. That is, the receivables were assigned to the buyer to satisfy the obligation to repay the Purchase Price plus an implied interest rate.

Risk of loss aside, the remedies accorded the putative buyer in the event of a default by the seller also strongly suggest that the transactions were loans. Those remedies included the right of the buyer to accelerate the uncollected portion of the Purchase Price.<sup>42</sup> Of course, if these transactions were truly sales, there should be no concept of making the uncollected portion of the Purchased Amount becoming due and payable; it would simply be collected (or not) from the receivables. What is more, the transaction documents gave the buyers the right to change the Specified Percentage to 100% of the receivables.<sup>43</sup> But the idea that a buyer of a specified percentage of a seller’s receivables could unilaterally change that percentage to another, higher percentage if a default occurs – that is, the buyer could unilaterally increase the property “sold” – is inconsistent with a true sale. That is a remedy far more consistent with a secured loan.

Accordingly, the *Cornerstone* court should have regarded these transactions, and all courts should regard similarly structured deals, as secured loans.<sup>44</sup> The consequences of doing so are potentially quite significant.

### Subject to Usury Statutes

First, and probably foremost, the transaction might be illegally usurious. The stated Purchase Price would actually be the original principal amount of a loan and the Purchased Amount would be the amount that the borrower must repay, consisting of both principal and interest. The interest rate is not a fixed rate because it is impossible to tell, at the outset of the transaction, how long it will take until the daily remittances total the Purchased Amount. Nevertheless, ignoring the complexity of that timing variable, the implicit interest rates in these transactions are extremely high.<sup>45</sup>

In *Cornerstone I*, the Purchase Price was \$50,690, for which the buyer “purchased” 5% (the “Specified Percentage”) of the seller’s future receipts, and the Purchased Amount was \$65,897. Pursuant to the documentation, the buyer agreed to a per-month limit of its right to receive those receipts.<sup>46</sup> If collected on a

timely basis, that amount would repay the Purchased Amount with 6 months' worth of receipts and that would result in an implicit annual rate of interest of approximately 60%.<sup>47</sup>

In *Cornerstone II*, the Purchase Price was \$75,000 for which the buyer "purchased" a Specified Percentage of 15% of the seller's future receipts, and the Purchased Amount was \$105,000. Pursuant to the documentation, the buyer was entitled to receive \$875 per day. Assuming that there are 21 business days per month and collections are made on a timely basis, that amount would repay the Purchased Amount in approximately 5½ months, and would result in an implicit annual rate of interest of approximately 90%.<sup>48</sup>

These high rates of implicit interest – and the desire to avoid applicable usury limitations – is no doubt one of the principal reasons the transactions were structured as they were. Recharacterizing the transactions as loans – which is what they are in economic substance – reveals their predatory nature.

### Perfection

Second, the method for perfecting the transferee's interest might change. If the rights to payment are accounts (as that term is defined in Article 9),<sup>49</sup> then the transferee needs to file a financing statement in order to be perfected irrespective of whether the transaction is a sale or a security interest securing an obligation.<sup>50</sup> If, on the other hand, the transaction involves an interest in payment intangibles (as that term is defined in Article 9),<sup>51</sup> then re-characterizing the transaction as a loan will mean that the transferee needs to file a financing statement. In contrast, if the transaction were a true sale, the buyer's interest would be automatically perfected pursuant to U.C.C. § 9-309(3), without the need to file a financing statement.

### Bankruptcy Code § 552.

The last risk with the *Cornerstone*-type transactions comes from Bankruptcy Code § 552,<sup>52</sup> but this risk probably exists regardless of whether the transaction is a sale or a secured financing, whether the receivable is an account or a payment intangible, or whether the buyer filed an appropriate financing statement.

Subsection (a) of § 552 prevents a security interest from attaching to property acquired by the debtor after the petition is filed. Subsection (b) creates an exception for post-petition property that is proceeds of prepetition collateral. Thus, for example, a security agreement purporting to encumber existing and after-acquired inventory can attach to post-petition proceeds of prepetition inventory collateral. If the inventory existed

when the petition was filed, nothing in § 552 prevents the security interest from attaching to the post-petition proceeds, whether those proceeds be accounts, money, or payment intangibles. However, the security interest will not attach to inventory that the debtor acquires post-petition unless that new inventory is demonstrated to be proceeds of prepetition collateral.<sup>53</sup> Similarly, if a lender has a security agreement covering existing and after-acquired receivables, § 552 will prevent the security interest from attaching to receivables that arise post-petition unless those receivable are proceeds of pre-petition collateral. Stated simply, § 552 does not allow a security interest to attach to the post-petition proceeds of a prepetition hope (*i.e.*, a future receivable).

If a *Cornerstone*-type transaction is re-characterized as a loan, there can be little doubt that § 552(a) will cut off the lender's security interest in post-petition receivables, irrespective of whether they are accounts or payment intangibles. Even in the absence of re-characterization, however, § 552(a) is likely to be a problem. After all, the "sold" rights of payment are not proceeds of collateral or proceeds of the transferee's property.<sup>54</sup>

### Conclusion

Transactional lawyers that represent the financiers engaged in these transactions should be very careful not to rely on the documented structure. While the *Cornerstone* court did conclude that the transactions at issue were true sales, that conclusion was not necessary to the court's decision, and thus was arguably only dicta. More important, the court's analysis was seriously flawed. While several other courts, mostly in New York, have ruled similarly,<sup>55</sup> the fact remains that these types of transactions are better viewed as loans. The financiers therefore need to file to perfect their interests and should be very concerned about violating applicable usury laws and the potential application of Bankruptcy Code § 552.

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### Notes:

1. In re *Cornerstone Tower Services, Inc.*, [2018 WL 6199131](#) (Bankr. D. Neb. 2018) ("Cornerstone I").
2. *Id.* at \*2-3.

3. In re Cornerstone Tower Services, Inc., [2019 WL 127359](#) at \*1-2 (Bankr. D. Neb. 2019) (“Cornerstone II”).

4. *Id.* at \*2, 4.

5. [Cornerstone II at \\*6](#); [Cornerstone I at \\*8](#). The court added that the accounts were therefore “property of the estate,” [Cornerstone II at \\*6](#); [Cornerstone I at \\*8](#), but of course to the extent that the accounts were paid prepetition, the accounts themselves would no longer exist and could not possibly be property of the estate.

6. [Cornerstone II at \\*8-9](#); [Cornerstone I at \\*10-11](#).

7. *See also* In re A Goodnight Sleepstore, Inc., [2019 WL 342577](#) (E.D.N.C. 2019); EBF Partners, LLC v. Burklow Pharmacy, Inc., [2018 WL 6620582](#) (Fla. Cir. Ct. 2018); GTR Source, LLC v. FutureNet Group, Inc., [89 N.Y.S.3d 528](#) (N.Y. Sup. Ct. 2018) (each involving a purported “sale” of future receivables).

8. As the discussion below makes clear, there is a difference between an attempted present sale of a future right to payment, and a present sale of an existing right to payment due in the future.

9. T. B. Harms & Francis, Day & Hunter v. Stern, [229 F.42](#) (2d Cir. 1915), *rev'd on other grounds*, 231 F. 645 (2d Cir. 1916).

10. As the Supreme Court has observed: “a person cannot grant a thing which he has not: *ille non habet, non dat*; . . . equity no more than law can deny it. *The thing itself is an impossibility.*” Pennock v. Coe, [64 U.S. 117](#), 128 (1859) (emphasis added).

11. Stathos v. Murphy, [276 N.Y.S.2d 727](#), 730 (N.Y. App. Div. 1966); *see also* In re Hamilton, [18 B.R. 868](#), 870 (Bankr. D. Colo. 1982) (“[i]t is impossible on the face to have a vested property right in after-acquired property . . . because, by definition, after-acquired property is a mere contingency.”).

12. The *T.B. Harms* case does include language that “[t]o every contract of sale an actually or potentially existing subject is necessary.” However, “potentially existing” does not simply mean the potential to exist. Rather, in the old common law of sales, something was deemed to “potentially exist” if it was the natural “product or increase” of property already owned by the seller. A mere expectancy could never be the subject of a sale. “Thus, a man has no potential property in a catch of fish which he expects to make, even though he has a ship and nets and all the other appliances necessary for catching fish. He has no property, actual or potential, in any fish until they are actually caught, and hence cannot pass any property right in them until that time.” Modern American Law: A Systematic and Comprehensive Commentary on the Fundamental Principles of American Law and

Procedure, Accompanied by Leading Illustrative Cases and Legal Forms, with a Rev. Ed. of Blackstone’s Commentaries, Volume 4, Eugene Allen Gilmore & William Charles Wermuth, January 1, 1914 (Blackstone Institute).

13. The UCC does permit the parties to create a security interest in after-acquired collateral. *See* § 9-204. This flexibility does not, however, represent a departure from the fundamental principle that the debtor needs to have rights in the collateral for the security interest to attach. Not only does that baseline rule requiring that the debtor have rights in the collateral apply as to original collateral, it applies with equal force to after-acquired collateral. As explained by comment 2 to § 9-204: “This section adopts the principle of a ‘continuing general lien’ or ‘floating lien.’ It validates a security interest in the debtor’s existing and (*upon acquisition*) future assets, even though the debtor has liberty to use or dispose of collateral without being required to account for proceeds or substitute new collateral” (emphasis added). A purported present sale of future receivables may be effective as a contract and may be effective as and when the receivables are created, but until the receivables are created it is an unattached security interest.

14. § 9-102 cmt. 6. *See also* Steven L. Harris and Charles W. Mooney Jr., *Using First Principles of UCC Article 9 to Solve Statutory Puzzles in Receivables Financing*, [46 GONZ. L. REV. 297](#), 302 (2011) “Under section 9-203(b)(2), a security interest does not attach unless the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party. The first quoted phrase reflects *nemo dat. A debtor cannot create a security interest in collateral in which the debtor has no rights, and a debtor who has rights in collateral can create a security interest only in those rights that it has.*” (emphasis added).

15. § 9-203(b)(2) (also indicating that attachment can occur if the debtor has the power to transfer rights in the collateral).

16. In *Cornerstone II*, the financier argued (albeit in a different context) that “under the terms of the agreement, it purchased a ‘stream of payments.’” [Cornerstone II at \\*7](#). This is an echo of a long since discredited “stream” theory of collateral. In some cases decided under the former Bankruptcy Act, courts held that rights to payment could not be avoided as preferential transfers if they were acquired by the debtor in the flow of a payment “stream” originating prior to the commencement of the preference period. *See, e.g.,* DuBay v. Williams, [417 F.2d 1277](#) (9th Cir. 1969); Grain Merchants of Indiana, Inc. v. Union Bank & Savings. Co., [408 F.2d 209](#) (7th Cir. 1969). The theory was that the creditor’s security interest attached to

the entire “stream” of payments when the security interest was granted. Those decisions, which were widely criticized, were legislatively overruled by the Bankruptcy Code. *See* H.R. Rep. No. 95-595, at 373 (1977); S. Rep. No. 95-989, at 88 (1978) (“Paragraph (5) of Bankruptcy Code § 547(c) codifies the improvement in position test, and thereby ‘overrules’ cases such as *DuBay* and *Grain Merchants*”). Just as a security interest cannot attach to a “stream” of payments if the rights to payment have not yet arisen, ownership of future payments cannot be transferred in the present.

17. *See, e.g.*, *BMCL Holding LLC v. Wilmington Trust*, [201 So. 3d 109](#) (Fla. Dist. Ct. App. 2015); *Rabo Agrifinance, Inc. v. Terra XXI, Ltd.*, [336 P.3d 972](#) (N.M. Ct. App. 2014).

18. *See* § 9-109(a)(1), (3). Article 9 also applies to the sale of chattel paper and promissory notes.

19. *See* § 9-109 cmt. 4. Another reason Article 9 applies to sales of receivables is to subject those transactions to the filing system that Article 9 creates for perfection. That filing system is designed principally to deal with the ostensible ownership problem that results from the creation of a lien securing an obligation: both the debtor and the secured party have property rights in the collateral but that fact might not be readily apparent to others who might wish to acquire an interest in such property. When receivables are truly sold there are not multiple owners, but there is often still an ostensible ownership problem: the seller, who created the receivable and might normally be presumed to be the owner, in fact no longer is. By covering sales of receivables, Article 9 impels the buyer to give public notice of its interest, thereby reducing the risk that the seller could purport to sell the receivables to others (or use them as collateral for a loan).

20. § 9-109 cmt. 4 (“Although this Article occasionally distinguishes between outright sales of receivables and sales that secure an obligation, neither this Article nor the definition of ‘security interest’ delineates how a particular transaction is to be classified. That issue is left to the courts.”).

21. Article 9 does incorporate the definition of sale from Article 2 (“A ‘sale’ consists in the passing of title from the seller to the buyer for a price.”). *See* §§ 2-106(1), 9-102(b).

22. *See, e.g.*, *In re Commercial Money Center, Inc.*, [350 B.R. 465](#) (9th Cir. BAP 2006).

23. *See* §§ 9-406(e), 9-408(b). *See also* *Fenway Fin. LLC v. Greater Columbus Realty, LLC*, [995 N.E.2d 1225](#) (Ohio Ct. App. 2013) (dealing with whether a transaction labeled as a sale of accounts by a real estate agent was

really a secured loan, and therefore subject to an Ohio statute that prohibits real estate brokers from paying an agent’s commission to a creditor of the agent).

24. *See* § 9-608(a)(4), (b). *See also* § 9-602(5) (making a borrower’s right to a surplus not subject to variation by agreement); *Major’s Furniture Mart, Inc. v. Castle Credit Corp.*, [602 F.2d 538](#) (3d Cir. 1979).

In addition, a secured party has an obligation to act in a commercially reasonable manner when collecting receivables only if the secured party has a right of recourse against the debtor. *See* § 9-607(c). The existence or absence of such a right of recourse is not the same thing as the distinction between a loan and a sale, but it is a highly relevant factor. *See infra* notes 29-32 and accompanying text.

25. *See, e.g.*, *In re Contractors Equip. Supply Co.*, [861 F.2d 241](#) (9th Cir. 1988); *In re Dryden Advisory Group, LLC*, [534 B.R. 612](#) (Bankr. M.D. Pa. 2015); *In re Siskey Hauling Co.*, [456 B.R. 597](#) (Bankr. N.D. Ga. 2011).

26. *See, e.g.*, *In re Qualia Clinical Serv., Inc.*, [441 B.R. 325](#) (8th Cir. BAP 2011). *See also* 11 U.S.C. § 547(e)(2) (providing that a transfer of a security interest occurs when it is perfected, not when it is attached, if it is perfected more than 30 days after it attaches).

27. *See, e.g.*, *Funding Metrics, LLC v. D&V Hospitality, Inc.*, [2019 WL 138614](#) (N.Y. Sup. Ct. 2019) (vacating a confession of judgment in a *Cornerstone*-type transaction so that a defense of usury could be adjudicated); *In re Hill*, [589 B.R. 614](#), 621-22 (Bankr. N.D. Ill. 2018) (citing numerous earlier decisions that in New York such *Cornerstone*-type transactions are not loans, and hence not usurious); *Express Working Cap., LLC v. Starving Students, Inc.*, [28 F. Supp. 3d 660](#) (N.D. Tex. 2014); *Carter v. Four Seasons Funding Corp.*, [97 S.W.3d 387](#) (Ark. 2003).

28. *See* *S & H Packing & Sales Co. v. Tanimura Distrib., Inc.*, [883 F.3d 797](#) (9th Cir. 2018); *Nickey Gregory Co. v. AgriCap, LLC*, [597 F.3d 591](#) (4th Cir. 2010); *Reaves Brokerage Co. v. Sunbelt Fruit & Vegetable Co.*, [336 F.3d 410](#) (5th Cir. 2003); *Endico Potatoes, Inc. v. CIT Group/Factoring, Inc.*, [67 F.3d 1063](#) (2d Cir. 1995); *Classic Harvest LLC v. Freshworks LLC*, [158 F. Supp. 3d 1317](#) (N.D. Ga. 2015).

29. *See, e.g.*, *Nickey Gregory Co.*, [597 F.3d at 602](#); *Reaves Brokerage*, [336 F.3d at 414](#); *Endico Potatoes*, [67 F.3d at 1068-69](#); *Dryden Advisory Group*, [534 B.R. at 620](#); *Qualia Clinical Serv.*, [441 B.R. at 330](#); *Commercial Money Center*, [350 B.R. at 483-84](#); *Fenway Fin.*, [995 N.E.2d at 1231](#).

30. *See, e.g.*, *Reaves Brokerage Co.* [336 F.3d at 414](#); *Endico Potatoes, Inc.*, [67 F.3d at 1068-69](#). *See also*

Dryden Advisory Group, [534 B.R. at 620](#) (referring to whether the seller has the option to repurchase the receivables).

31. *See, e.g.*, Dryden Advisory Group, [534 B.R. at 620, 622](#).

32. *See, e.g.*, *id.* at 620; Carter, [97 S.W.2d at 655-56](#); Fenway Fin., [995 N.E.2d at 1229-30](#) (discussing whether transactions between the putative seller and its customers required credit approval of the factor and which party had the duty to maintain records relating to the receivables).

33. *See* Stephen L. Sepinuck, *Rethinking Unfair Discrimination in Chapter 13*, [74 AM. J. BANKR. L. 341](#), 356-57 (2000) (discussing cases that have made this point in other contexts).

34. *See, e.g.*, [Cornerstone II at \\*4](#); [Cornerstone I at \\*5](#); Nickey Gregory Co., [597 F.3d at 601-03](#) (but also looking at the language of preliminary transaction documents and other transaction documents, including a financing statement that referred to “advances” under the factoring agreement); Reaves Brokerage, [336 F.3d at 415-16](#) (noting that the agreement referred to “advances” that would be “charge[d]” to the assignor’s account); *In re Jersey Tractor Trailer Training, Inc.*, [2007 WL 2892956](#) at \*7 (Bankr. D.N.J. 2007), *vacated in part on other grounds*, [580 F.3d 147](#) (3d Cir. 2009); Fenway Fin., [995 N.E.2d at 1229](#).

35. *See, e.g.*, Fenway Fin., [995 N.E.2d at 1233-34](#).

36. The labels that the parties use should not matter because the determination is to be based on the substance of the transaction, not its form. *See* U.C.C. § 9-109(a)(1) & cmt. 2. The filing of a financing statement should not matter because the assignee has reason to file regardless of whether the transaction is a sale or a secured loan. *See* U.C.C. § 9-505(b) (“the filing [of a financing statement] is not itself a factor in determining whether the collateral secures an obligation”).

37. Express Working Cap., [28 F. Supp. 3d at 666-67](#); Carter, [97 S.W.2d at 655](#). *See also* Robert D. Aicher & William J. Fellerhoff, *Characterization of a Transfer of Receivables as a Sale or a Secured Loan Upon Bankruptcy of the Transferor*, [65 Am. Bankr. L.J. 181](#), 206 (1991).

38. Article 9 used to expressly state that it applied to any transaction, regardless of its form that was intended to create a security interest in personal property or fixtures. U.C.C. § 9-102 (repealed). Revised Article 9 omits that reference to “intent.” *See* U.C.C. § 9-109(a)(1). The purpose of this revision was not to change the law, but to make it clear that the subjective intent of the parties with respect to the legal characterization was never relevant,

and instead the economic substance of the transaction is what controls. *See id.* at cmt. 2.

39. *See, e.g.*, Nickey Gregory Co., [597 F.3d at 602](#); Endico Potatoes, [67 F.3d at 1068-69](#); Classic Harvest, [158 F. Supp. 3d at 1326-28](#); *In re Qualia Clinical Serv.*, [441 B.R. at 330](#); Carter, [97 S.W.2d at 656-67](#); Fenway Fin., [995 N.E.2d at 1231](#); Siskey Hauling, [456 B.R. at 607](#); *Wiers Farm, Inc. v. Waverly Farms, Inc.*, 2011 WL 1296867 (M.D. Fla. 2011). *But cf.* Major’s Furniture Mart, 602 F.2d at 544 (“the presence of recourse in a sale agreement without more will not automatically convert a sale into a security interest”); Express Working Cap., [28 F. Supp. 3d at 669-70](#) (“the presence of recourse provisions in the Agreements does not transform the arrangement into a loan because recourse provisions vary from contract to contract,” a statement based largely on a nonuniform provision added to the Texas version of § 9-109).

40. *See* [Cornerstone II at \\*5](#); [Cornerstone I at \\*6](#). The court also noted that there was no evidence that LG or EBF had investigated any of Cornerstone’s account debtors, and in doing so implied that this also suggested that the transactions were loans. To the extent that such investigation merits consideration at all, it seems that the court misunderstood why and which way it cuts. A buyer of accounts is much more likely to investigate the creditworthiness of account debtors than is a lender that takes a security interest in accounts because a buyer typically has more at stake from any individual account debtor’s failure to pay. Accordingly, the court misapplied this factor; it should have suggested that the transaction was a loan, not a sale.

41. [Cornerstone II at \\*6](#), [Cornerstone I at \\*8](#).

42. “The full uncollected Purchased Amount plus all fees (including legal fees) due under this Agreement and the attached Security Agreement will become due and payable in full immediately.” [Cornerstone II at \\*6](#).

43. “The Specified Percentage shall equal 100%.” *Id.*

44. If the transaction as structured is determined to be a secured loan, then the collateral would seem to be not all of the borrower’s rights to payment, but merely the identified percentage of those rights to payment. Because that structure might present a problem if the lender ever declares a default and seeks to exercise collection rights, both of the “buyers” in Cornerstone I and II required Cornerstone to grant a blanket security interest in all receivables, not merely a percentage of them.

45. As the trustee in Cornerstone I asserted, “The plaintiff argues that it is a financing agreement with an exorbitant rate of interest.” [Cornerstone I at \\*1](#).

46. “LG Funding agrees not to take more than \$10,982.00 per month.” *Id.* at \*2.

47. The implicit rate of interest is calculated as (\$50,690) times (x%) = \$65,897 or x% = \$65,897/\$50,690. This equation produces a 30% annual interest rate, but the buyer’s anticipation was that the loan would be repaid in a 6-month period and, if it were, the result is an annual rate of interest of approximately 60%.

48. The implicit rate of interest is calculated as (\$75,000) times (x%) = \$105,000 or x% = \$105,000/\$75,000. This equation produces a 40% annual rate of interest, but the buyer’s anticipation was that the loan would be repaid in a 5½-month period and, if it were, the result would be an annual rate of interest of approximately 90%.

49. “Account” is defined to include “a right to payment of a monetary obligation, . . . for property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of.” U.C.C. § 9-102(a)(2).

50. *See* § 9-310(a).

51. A “payment intangible” is defined as “a general intangible under which the account debtor’s principal obligation is a monetary obligation.” § 9-102(a)(42). Although that seems very broad, the term “general intangible” is in turn defined as a catch-all term that excludes the other classifications of property. *See* U.C.C. § 9-102(a)(42). Thus, a payment intangible is defined, at least in part, as a right to payment of a monetary obligation that is not an account.

Analysis of the difference between rights to payment that are accounts versus those that are payment intangibles is beyond the scope of this article. In many cases, the determination is not a simple task. As two examples, courts have found that a right to the return of an overpayment made in connection with the purchase of goods, and a claim for breach of warranty in connection with a sale of goods, to be payment intangibles rather than accounts. *See In re Iroquois Energy Mgmt., LLC*, 284 B.R. 28 (Bankr. W.D.N.Y. 2002) (based on old Article 9); *Millennium Bank v. UPS Cap. Bus. Credit*, 327 P.3d 335 (Colo. Ct. App. 2014).

52. The section provides:

(a) Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.

(b) (1) Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title,

if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, products, offspring, or profits of such property, then such security interest extends to such proceeds, products, offspring, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

53. If the debtor is in a service industry, and therefore generates receivables from the provision of services rather than from the sale of inventory, it is unlikely that receivables generated post-petition will be proceeds of pre-petition collateral.

54. There is a textual obstacle in applying Bankruptcy Code § 552 to a true sale transaction. The section provides that it cuts off a lien as to after-acquired property acquired post-petition where the lien results from a security agreement. The term “security agreement” is defined in Bankruptcy Code § 101(50) as an “agreement that creates or provides for a security interest” and the term “security interest” is, in turn, defined in Bankruptcy Code § 101(51) as a “lien created by an agreement.” Finally, the term “lien” is defined in Bankruptcy Code § 101(37) as a “charge against or interest in property that secures payment of a debt or performance of an obligation.” Note that, unlike the definition of security interest under the U.C.C. (§ 1-201(35)), this definition of lien does not include the interest of a purchaser of accounts or payment intangibles. While the language has clear application to a security interest securing an obligation, the language does not fit nicely with respect to a sale of rights to payment. The policy underlying the section would, however, seem to be equally applicable to both structures. Perhaps an alternative remedy of the bankruptcy trustee with respect to post-petition receivables would be found in Bankruptcy Code § 549, which avoids post-petition transfers.

55. *See* cases cited *supra* n.27.



## Recent Cases

### SECURED TRANSACTIONS

#### *Attachment Issues*

*In re Pettit Oil Co.*,

[2019 WL 1104662](#) (9th Cir. 2019)

A consignor that did not file a financing statement was not the owner of the cash and accounts constituting proceeds of the consigned fuel, but instead had an unperfected security interest in those proceeds, which the consignee's bankruptcy trustee could avoid.

*Church Crop Ins. Servs., Inc. v. GemCap Lending I, LLC*,

[2019 WL 1057095](#) (Iowa Ct. App. 2019)

An intermediary insurance broker, which had a right to receive commissions from an insurance company and an obligation to pay commissions to the agency that solicited applications for the insurance policies issued, could and did grant to an accounts financier a security interest in the right to receive future commissions. The language of the relevant agreements made the broker "solely responsible for all commissions" owed to the agency, indicating that the broker was not a mere conduit and thus had sufficient rights in the future payments from the insurance company for a security interest to attach. Moreover, the insurance company had acknowledged that the grant of the security interest did not constitute a default of the broker's agreement with the insurance company, further indicating that the broker had the right to the payments.

#### *Perfection Issues*

*In re First River Energy, LLC*,

[2019 WL 1103294](#) (Bankr. W.D. Tex. 2019)

The law of the jurisdiction where the debtor is located – Delaware – governs the perfection and priority of security interests in the debtor's inventory of fuel, not the law of Texas, which provides for an automatically perfected PMSI in favor of oil producers. Because the Texas producers did not file a financing statement in Delaware, their security interests in the inventory and its proceeds were unperfected and subordinate to the rights of a secured party that did perfect its security interest. In contrast, Oklahoma law governs the perfection and priority of an Oklahoma statutory lien in favor of oil producers.

#### *Priority Issues*

*Liberty Mutual Insurance Co. v. SBN V FNBC LLC*,

[2019 WL 346707](#) (E.D.N.C. 2019)

A secured party with a perfected security interest in a contractor's accounts, which acknowledged that its interest in the receivables due on any bonded project was subordinate to the rights of the insurer that both issued the performance bond for the project and incurred expenses to complete that project, had superior rights to the net receivables due on each bonded project. The insurer was not entitled to offset losses on some projects against net receivables on other projects, even if the account debtor on the projects was the same.

#### *Liability Issues*

*Kapor v. RJC Investment, Inc.*,

[434 P.3d 869](#) (Mont. 2019)

Although the debtor voluntarily vacated the mobile home serving as collateral, allowed the secured party to take possession of the home, and thereafter signed a document purporting to release all rights in the home, she remained the debtor in a secured transaction and was entitled to the surplus the secured party received upon selling the mobile home. Section 9-602(5) prohibits the debtor from waiving the right to a surplus. The secured party had not conducted a strict foreclosure because the release did not state that the secured party accepted or consented to accept the collateral in full satisfaction of the debt; the released purported to waive the debtor's rights but included no commitment by the secured party.

### GUARANTIES & RELATED MATTERS

*In re Republic Airways Holdings Inc.*,

[2019 WL 630336](#) (Bankr. S.D.N.Y. 2019)

Because the liquidated damages provisions in aircraft leases were unenforceable penalties, they could not be enforced against the guarantors of the leases. Although guarantors are generally permitted to waive affirmative defenses, and the unenforceability of the principal obligation is an affirmative defense, the invalidity of a contract based on illegality or public policy cannot be waived.

*Capital Finance LLC v. Rosenberg*,  
[2019 WL 296706](#) (D. Md. 2019)

The individuals who executed bad boy guarantees for their companies' loans, triggered by (i) an improper involuntary bankruptcy; (ii) an improper voluntary bankruptcy; "and" (iii) fraud or other illegal actions, were personally liable for the debt because the borrower illegally failed to pay payroll taxes, provided false borrowing base certificates, and diverted the proceeds of accounts receivable. The triggers to liability had to be interpreted disjunctively, and thus there was no requirement that all three triggers had to occur.

*Apex Bank v. Thompson*,  
[2019 WL 1090573](#) (Ga. Ct. App. 2019)

Although guarantors can waive the requirement of judicial confirmation of a nonjudicial foreclosure sale of real property that serves as collateral for the debt, none of the transaction documents in this case contained an adequate waiver. The promissory note indicated that a change in terms of the note would not release the guarantors and provided that the lender had discretion over which collateral to foreclose upon first and how to apply the proceeds, but neither of those terms evidenced a waiver of the guarantors' rights under the confirmation statute. A simultaneously executed Assignment of Deposit Account provided that one guarantor would "remain liable under the Note no matter what action Lender takes or fails to take *under this Agreement*" (emphasis added), but that language dealt with the Deposit Account Agreement, not the confirmation statute. Other language in that agreement providing that the guarantor "waives any defenses that may arise because of any action or inaction of Lender" could be interpreted to apply to the failure to seek confirmation of the foreclosure sale, but could also be interpreted to mean that the guarantors were waiving only those defenses relating to enforcement of that agreement, and thus there was no sufficiently clear waiver.

## LENDING & CONTRACTING

*Central Bank of India v. U.S. Bank*,  
[2019 WL 1206489](#) (S.D.N.Y. 2019)

An intercreditor agreement pursuant to which each creditor promised to "not challenge or question in any proceeding" the validity of any secured obligation owed to the others or the attachment, perfections, or priority of each other's lien, but which also provided that nothing in the agreement restricts any creditor's right "to object in any insolvency proceeding," did not prevent one creditor from objecting to another's claim in the debtor's bankruptcy proceeding.

*In re Republic Airways Holdings Inc.*,  
[2019 WL 630336](#) (Bankr. S.D.N.Y. 2019)

The liquidated damages provisions in aircraft leases – which entitled the lessor to unpaid rent plus an amount that compensated the lessor for both the future rent (discounted to present value) and the diminished value of the aircraft – were unenforceable penalties. Because the lessor would bear the risk of diminished value if the lessee had fully performed, providing for recovery of that in the event of default, in addition to the other amounts, was an unenforceable penalty. For example, if the lessee defaulted at the end of the lease term, the lessee would have to pay more than 50 times the total amount of unpaid rent; the total cost of performance when the debtor rejected the leases was \$12.5 million but the liquidated damages were \$52.7 million.



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