A Hidden Danger in Master Agreements

Stephen L. Sepinuck

A recent case illustrates a subtle danger that can lurk in master agreements. Fortunately, it is a danger that can easily be avoided with a bit of simple drafting.

The case, Nostrum Laboratories, Inc. v. Balboa Capital Corp., involved a manufacturer that contracted with a financing company for equipment financing. The parties executed a master lease agreement to govern subsequent transactions between them. The master agreement contained no purchase option but twice made reference to a possible purchase option:

16. ENCUMBRANCES AND TAXES. ** Lessee shall also pay all taxes arising out of Lessee’s exercise of any purchase option relating to any Lease (including sales tax).

18. RETURN OF EQUIPMENT. Upon expiration of the term of any Lease, (unless Lessee shall have duly exercised any purchase option with respect to such Lease), Lessee will at its sole cost and expense deliver the Equipment *** to Lessor’s premises ***.

The master agreement also contained the following merger clause:

30. MISCELLANEOUS. *** This Master Lease constitutes the entire agreement between the parties hereto with respect to the leasing of the Equipment.

The parties executed seven lease schedules pursuant to the master agreement, covering various items of equipment. Before the end of the lease terms, the manufacturer sent notification that it intended to exercise its right to purchase each item for $1. The financing company responded with a payoff quote in excess of $250,000, representing the residual value of the equipment plus sales tax.

Litigation ensued and the financing company sought to exclude evidence of any alleged purchase option under the parol evidence rule. The court refused, concluding that the references in the master agreement to “any purchase option” rendered the agreement ambiguous, so that the manufacturer’s parol evidence of a purchase option was admissible.

The court’s analysis is dubious. The mere fact that the master agreement included references to a “purchase option” does not create an ambiguity. That is, those references do not suggest that the master agreement itself provides for a purchase option that the agreement fails to describe, so as to create doubt about whether such an option exists. Instead, the language merely recognizes that a subsequent lease between the parties and governed by the master agreement might include such an option. That said, the master agreement’s references to a “purchase option” might be enough to indicate that, despite the merger clause, the master agreement was not fully integrated, so that parol evidence would still be admissible to supplement its terms.

Regardless of whether the court’s reasoning – or conclusion – was sound, the fact remains that the decision sets a sobering precedent: that any reference in a master agreement to a term that might be included in a subsequent transaction opens the door to parol evidence that such a term applies to all transactions. That possibility should be of concern to any transactional lawyer who drafts a master agreement.

There is, however, a fairly simple way to sidestep this problem. The ambiguity (if indeed there is one) results from confusion about whether the phrase “any purchase option” refers to an option granted in the master agreement or in a later lease. The rather clear intent of the financing company was that it referred to an option in a later lease, but the court seemed to think it might refer to an unwritten term of the master agreement. No ambiguity would exist, however, if the master agreement used a few additional words to make clear that it was
referring to an option in a later lease. For example, the following rephrasing of the terms at issue in the case would likely have avoided the problem.

16. ENCUMBRANCES AND TAXES. ***
Lessee shall also pay all taxes arising out of Lessee’s exercise of a purchase option expressly granted in a Lease (including sales tax).

***

18. RETURN OF EQUIPMENT. Upon expiration of the term of any Lease, unless a Lease expressly grants Lessee a purchase option and Lessee duly exercises that option, Lessee will at its sole cost and expense deliver the Equipment *** to Lessor’s premises ***.

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Notes:
2. The court also indicated that the agreement was ambiguous as to the requirements for terminating a lease (particularly with regard to whether the equipment must be returned), and what “residual value” means. Id. at *8.
3. See, e.g., Bena v. Schleicher, 2017 WL 1907741 (Wash. Ct. App. 2017) (using parol evidence to conclude that a writing with a merger clause was not fully integrated); Kanno v. Marwit Capital Partners II, L.P., 227 Cal. Rptr. 3d 334 (Cal. Ct. App. 2017) (although each of the three agreements executed in connection with the purchase of a business contained a merger clause, none was fully integrated; the fact there were three agreements for the same transaction demonstrated that the parties did not intend for any one agreement to be a complete integration); Rota-McLarty v. Santander Consumer USA, Inc., 2011 WL 2133698 (D. Md. 2011) (despite a merger clause, a retail installment sales contract was not fully integrated), rev’d on other grounds, 700 F.3d 690 (4th Cir. 2012).
4. A written agreement is integrated – either partially or fully – if it constitutes “a final expression of one or more terms of the agreement.” Restatement (Second) of Contracts § 209(1). In other words, an agreement is integrated if one or more of the agreed terms is recorded in (i.e., integrated into) a writing. A fully integrated agreement is one adopted by the parties as “a complete and exclusive statement of the terms of the agreement.” Restatement (Second) of Contracts § 210(1). Thus, a partially integrated agreement is a final expression of some, but not all, of the terms to which the parties have agreed; a fully integrated agreement is a final expression of all of the terms of the agreement. In general, a partially integrated agreement cannot be contradicted by parol evidence; a fully integrated agreement cannot be contradicted or supplemented by parol evidence. See Restatement (Second) of Contracts §§ 215, 216.

Buyers of Some Receivables Need Specialized Terms

Stephen L. Sepinuck

In a recent decision, the Bankruptcy Court for the District of Delaware struggled with how to apply to a sale of promissory notes the rules in U.C.C. Article 9 that override contractual restrictions on assignment. The Spotlight column in the upcoming issue of the Commercial Law Newsletter will explain the court’s various errors in analysis. The point of this column is to explain how the buyers of promissory notes and some other types of receivables that, in either case, purport to restrict assignment are at risk even if Article 9 does override that restriction, and what terms the buyers should include in their purchase agreements to better protect themselves.

Before proceeding further, it is useful to understand how Article 9 applies to transactions in receivables.

First, § 9-109(a)(3) provides that Article 9 applies to a sale of accounts, chattel paper, payment intangibles, or promissory notes. So, regardless of whether any of those types of receivables are sold or used as collateral for a loan – that is, regardless of whether the original creditor assigns the receivables outright or merely assigns them as security for an obligation – Article 9 applies to that transaction and treats the assignee as a “secured party.”

Second, Article 9 contains several sections dealing with contractual restrictions on assignment. The two most important are § 9-406 and § 9-408. The scopes of these two sections do not overlap – that is, to no single transaction will both sections apply – but to determine which section applies to a transaction, one needs to know both the type of collateral and the type of transaction involved. The following chart illustrates the different scopes of the two sections:
It matters which of the two sections applies. When § 9-406 applies, it both overrides a contractual restriction on assignment, thereby making the assignment effective, and requires the obligor on the receivable to render performance to the assignee. In contrast, when § 9-408 applies, it overrides the restriction, again rendering the assignment effective, but does not require the obligor “to recognize the security interest [or to], pay or render performance to the secured party.” § 9-408(d)(3).

This distinction can be important in bankruptcy. Assume first that we have a receivable created by contract that includes both a prohibition on assignment and a statement that any attempted assignment is void. Assume next that we have a sale of the receivable, and that the sale is covered by § 9-408(a). In other words, the transaction is a sale of one or more promissory notes, payment intangibles, or health-care-insurance receivables. Finally, assume that the person obligated on the sold receivable files for bankruptcy protection. Under Article 9, the assignment to the buyer is valid despite the contractual restriction on transfer, but the person obligated on the receivable – now the bankruptcy debtor – has no duty to “pay or render performance to the secured party.” The question becomes, who has standing to file a proof of claim in connection with the receivable?

Because the assignment is valid, the original creditor (the assignor) retains no right to payment and, therefore, would seem to lack standing to file a proof of claim. However, because the bankruptcy debtor owes no duty to the buyer, the buyer also appears not to have standing. It is important to emphasize, however, that by overriding the contractual restriction on sale of the receivable, Article 9 did not intend to – and does not – discharge the obligation of the person obligated on the receivable. Indeed, such a conclusion would be completely at odds with the fact that Article 9 makes the assignment effective. Put another way, the purpose of Article 9’s anti-assignment rules is to enhance the alienability of assets generally and of receivables in particular. If, instead, the rules had the effect of discharging the obligor on the receivable by denying both the original creditor and the buyer standing to assert a claim based on the receivable, thereby rendering the receivable valueless, the whole purpose of these rules would be frustrated.

The better analysis is that, despite the contractual restriction on assignment, the buyer acquires rights in the receivable and becomes the beneficial owner of it. However, the sale does not affect the duties of the person obligated on the receivable. In short, the law dissociates ownership of the receivable from the right to enforce it. The obligor may, therefore, continue to discharge its obligations by tendering payment to the original creditor. If it does so, the buyer would presumably have a claim in unjust enrichment against the original creditor.

What this means in the bankruptcy of the obligor is not entirely clear. But because the person obligated on the receivable continues to owe payment to the original creditor, and the original creditor presumably retains the right to enforce the receivable, the original creditor apparently also has standing to file a proof of claim if the obligor becomes the debtor in a bankruptcy proceeding. In contrast, the buyer, despite being the beneficial owner of the receivable, apparently lacks standing to file a proof of claim (i.e., lacks an allowable claim) due to the lack of enforcement rights.

From the buyer’s perspective, this situation is far from ideal. After all, the original creditor has no financial incentive to file the proof of claim. Fortunately, the sale agreement for the receivable can address this problem in either of two ways. First, the agreement could include a covenant by the original creditor to file such a claim on the request of the buyer. Second, the agreement could irrevocably appoint the buyer as the original creditor’s agent for the purpose of enforcing the receivable, including the filing of a proof of claim. The latter option is preferable from the buyer’s perspective because: (i) the buyer might have difficulty tracking down the original creditor; (ii) the original creditor might cease to exist after the transaction with the buyer; or (iii) the original creditor might be uncooperative.

Armed with such agency authority, the buyer could file a proof of claim on both its own behalf and as agent of the original creditor. Because acting in one of those capacities must be proper and effective, acting in both should avoid any issue about who the proper claimant is.
providing that one party “shall not assign this contract, or
assignment ineffective); Rother-Gallagher v. Montana
any portion thereof, . . . without the written consent” of the other party was effective to prevent assignment).

5. The same dissociation occurs under U.C.C. Article 3 if the holder of an instrument is not the beneficial owner of it. The holder is the one with the right to enforce, even though the beneficial owner is the one entitled to be paid.

6. Article 9 does not specify what happens if the obligor, despite being under no obligation to do so, pays the buyer. Presumably, because the buyer is the beneficial owner of the receivable, that payment too discharges the obligation. Thus, the obligor apparently has the option of whom to pay, and paying either the original creditor or the buyer discharges the obligation.

7. With negotiable mortgage notes, which are often securitized, courts uniformly recognize that the party entitled to file a proof of claim in bankruptcy “is the party entitled to enforce the note.” In re Smoak, 461 B.R. 510, 517 (Bankr. S.D. Ohio 2011). See also In re Benyamin, 2018 WL 3219628 (Bankr. S.D.N.Y. 2018). This means, among other things, that even after a note is assigned, if the originating lender retains possession of the note as servicing agent, the originating lender has standing to file a proof of claim for the debt in the note maker’s bankruptcy. E.g., In re Soriano, 2018 WL 3046905 (Bankr. W.D. Okla. 2018).

8. Because there is only one debt on the receivable, only one of the two creditors – the original creditor or the buyer – should have an allowable claim. In this sense, the situation is roughly analogous to a debtor who has promised to pay a debt guaranteed by a third party. Both the creditor and the guarantor have a claim in the debtor’s bankruptcy – the guarantor’s claim is a contingent claim for reimbursement or contribution – but the guarantor’s claim is disallowed as long as it remains contingent. See 11 U.S.C. § 502(e).

9. See Bankr. Rule § 3001(b) (providing that either a creditor or its authorized agent may execute a proof of claim).

10. For additional protection, and to deal with the possibility that a bankruptcy court might reach the erroneous conclusion that no one has standing to file a proof of claim, the secured party might wish to include in the sales agreement a requirement that the original creditor repurchase the receivable after such a ruling. The original creditor is unlikely to agree to such a covenant, however.
Tying up Loose Ends Relating to an Insurance Binder

Edward J. Cassidy

A recent case¹ decided by the Appellate Court of Illinois reveals a hidden danger for lenders who rely on a life insurance policy as collateral for a loan. The facts of the case are as follows. Lender provided a line of credit to an individual’s business and received a security interest in the business’s assets to secure the debt. To provide further protection, the individual was to obtain a $3 million life insurance policy on himself and assign the policy to the lender. The individual applied for a policy and during that period received a “binder” that provided $1 million in coverage for 60 days while the application was under review.

The individual executed a document purporting to assign the policy (which at this point did not yet exist) to the lender and, apparently, sent notification of the assignment to the insurer. However, the insurer rejected the application after learning more about the individual’s health, and instead offered a similar policy with a much higher premium. The individual rejected the counteroffer and shortly thereafter, the binder expired. Two years later, the individual died in a car accident and the lender sought to collect under the insurance policy. The insurer denied coverage and the lender sued, claiming that the insurer breached a duty to notify the lender of the nonpayment of premiums. The lender relied in part on a state statute that prohibits an insurer from declaring a policy lapsed for nonpayment of premiums unless the insurer first notifies a policy assignee of the nonpayment.²

The court ruled for the insurer, concluding that no policy was ever issued and the binder was not cancelled, it simply expired. Moreover, the assignment itself neither created insurance coverage nor estopped the insurer from denying coverage.³

The court ruled for the insurer, concluding that no policy was ever issued and the binder was not cancelled, it simply expired. Moreover, the assignment itself neither created insurance coverage nor estopped the insurer from denying coverage.³

The lender’s problem in this case was that it apparently conflated either the application for an insurance policy or the temporary binder issued in connection with the application with an actual insurance policy. In essence, it relied on collateral that either did not exist or had only a fleeting existence. To avoid this error, transactional lawyers should caution their clients that insurance applications and binders are not policies. If, for business reasons, a loan must be made before the required policy is issued, the lawyer should advise the client to calendar the need to check on the application sometime before the binder is scheduled to expire. The lawyer should also draft the loan agreement so as to make the borrower’s failure to provide proof of insurance by the end of the binder period an event of default.

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Notes:

Recent Cases
SECURED TRANSACTIONS

Scope Issues
In re Johnson,
A renewable one-month lease of a portable storage shed with an option to purchase after 48 months was a true lease, not a sale and a secured transaction, because the Tennessee Rental-Purchase Agreement Act expressly provides that an agreement for the use of personal property for personal, family, or household purposes, for an initial term of four months or less, even if automatically renewable and containing a term that allows the consumer to become the owner of the property, “shall not be construed to [create a] ‘security interest’ ” under U.C.C. § 1-203. Even if the Act did not apply, the transaction would still be a true lease under § 1-203 because the initial lease term was shorter than the remaining economic life of the goods and the lessee had no obligation to renew or purchase.

Attachment Issues
In re Factory Sales & Engineering, Inc.,
Collateral that the debtor provided to sureties that issued performance bonds remained encumbered after some of the bonds were released when the projects related to the bonds were completed because the indemnity agreement provided that the collateral security lasts until the debtor
furnishes written evidence of the termination of past, present and future liability under “any Bond,” not “the Bond.”

**CFPB v. RD Legal Funding, LLC, 2018 WL 3094916 (S.D.N.Y. 2018)**
The assignment by individuals of their rights to payment under a settlement agreement with the NFL were void because the settlement agreements expressly prohibited assignment and stated that any attempted assignment was void. Although the New York version of § 9-408(d) overrides many restrictions on the assignment of general intangibles, it expressly excludes “the right to receive compensation for injuries or sickness as described in 26 U.S.C. § 104(a)(1) and (2),” and the settlement agreement, which was rooted in the physical injuries resulting from repeated brain injuries that retired NFL players experienced while active in professional football, involved such a right.

**Perfection Issues**

Because a security interest in a motor vehicle is perfected under Virginia law when the application to note the lien on the certificate of title is delivered to the Department of Motor Vehicles, the lender’s security interest was perfected before the debtor’s bankruptcy petition was filed, even though the certificate noting the lien was issued post-petition.

**Enforcement Issues**

A debtor stated a claim against a repossession agent for taking a tank and sprayer attached to the collateralized vehicle and for initially refusing to return the property despite a demand therefor. The fact that the agent was acting on behalf of the secured party did not insulate the agent for its own tortious acts. Although the debtor granted a security interest in accessions to the vehicle, which the security agreement defined to be “things attached to or installed in” the vehicle, the security agreement also included a disclaimer of the secured party’s responsibility for other property “attached to” the collateral, suggesting that not every item attached to the vehicle became an accession. Accordingly, only property attached permanently became an accession. The tank and sprayer were not accessions and thus no security interest was granted.

The fact that a secured creditor filed continuation statements after entering into forbearance agreement did not show an intent not to forbear and was not relevant to whether the promise to forbear was consideration for the debtor’s reciprocal promise, which it was. The secured party agreed to forbear, not to release its lien.

**Liability Issues**

An account debtor that claimed to have overpaid the debtor and the secured party due to the debtor’s inclusion of unauthorized surcharges in its invoices had no unjust enrichment claim against the secured party because § 9-404(b) expressly denies an account debtor a right to affirmative recovery against a secured party.

A creditor that received an assignment of the debtor’s life insurance policy had no cause of action against the insurer for denying coverage because the policy was never issued; the insurer merely provided a 60-day binder but refused to issue the policy after discovering the debtor’s medical history. Even if the assignment had been delivered to the insurer before the binder expired, the insurer had no duty to notify the assignee of the refusal to issue the policy.

A secured party’s claim against an insurer for denying a claim for theft of collateral due to the debtor’s non-cooperation was not barred by the statute of limitations, as shortened by the insurance contract. Although the contract required actions to be commenced within one year of the “date of loss,” that phrase could mean either the date of the theft or the date that the insurer denied the claim, and insurance contracts are interpreted against the insurer.

A buyer of a corporation’s assets, other than those relating to its medical division, assumed the corporation’s debt incurred to finance the medical division because the purchase agreement disclaimed assumption of liability except for “any executory obligations of [the corporation’s] continued performance arising in the ordinary course of business under any contracts and commitments that become performable or payable on or
after the Closing Date.” The loan was an “executory obligation,” even though it might not be an “executory contract.” The loan, although incurred before the closing, involved “continued performance” due to the corporation’s continuing obligation to pay and the fact that the loan became due eleven days after the closing.

The buyer of shares of stock in a cooperative apartment at a foreclosure sale was obligated to pay the $87,000 in outstanding maintenance fees that accrued both before the sale and after the sale but before the buyer obtained possession of the apartment because the terms of the auction sale expressly so provided. It did not matter that § 9-615(a) provides that the proceeds of the sale are to be used to pay down the secured obligation because that provision may be modified by agreement. The terms of the sale might not have been standard, but the buyer failed to [submit] that the terms made the sale commercially unreasonable and the terms were not unconscionable.

Bankruptcy

An individual who terminated his right to purchase real property in exchange for a right to half the net profit if the property were resold under specified circumstances, who later recorded with the Bureau of Conveyances an Affidavit of Adverse Claim to the property, then released the Affidavit to facilitate a sale of the property and placement of the net proceeds in escrow, and finally received payment of a portion of the escrowed proceeds during the preference period, was liable for the preferential transfer. The transfer occurred when the payment was made, not earlier. The agreement creating the right to proceeds did not create a security interest in the property because the creation of a security interest requires the intent to transfer a lien, and the agreement did not exhibit such an intent. The filing of the affidavit (the equivalent of a lis pendens) did not create a lien because a lis pendens is effective only to give notice of a claim to real property; it is ineffective to secure a claim against the owner of the property. Finally, placing the proceeds in escrow did not terminate the debtor’s rights to the funds or create a security interest in favor of the individual because nothing in the escrow instructions purported to do either of those things.

LENDING & CONTRACTING

A credit union was entitled to summary judgment on its action on a balloon note despite the debtor’s assertion that the loan had regularly been renewed for over 25 years. The note expressly provides that the credit union has no obligation to refinance the loan, and thus the debtor could not have reasonably relied on any alleged oral promise to renew. Similarly, the debtor had no defense based on the credit union’s refusal to renew the loan unless the debtor provided a home mortgage to secure the debt because note expressly provided that the credit union could demand additional collateral even during the term of the loan.

Mellen, Inc. v. Biltmore Loan & Jewelry-Scottsdale LLC, 2018 WL 2978532 (9th Cir. 2018)
The buyer of a four-carat diamond did not take free under the entrustment rule of § 2-403(2) because: (i) the seller’s agent, with whom the buyer contracted, was not a dealer in diamonds; and (ii) the buyer did not purchase in the ordinary course of business because it first acquired only a security interest in the diamond and later when it purchased the diamond at a foreclosure sale it did so in satisfaction of a money debt.

Even though the merger clause in a loan agreement stated that all the related “Loan Documents” comprised the entire agreement of the parties, it did not absorb all the other documents into the loan agreement, so as to make them interdependent, particularly given the existence of a severability clause. Therefore, a subordination agreement, by which an insider promised not to accept payment until the senior loan was fully paid, was not rendered unenforceable by the expiration of the loan agreement and the maturity of the loan.

A seller of real property who warranted he had complied with all applicable environmental laws and who represented that, to his knowledge, no hazardous substance was stored on the property did not have liability under either term even though, unbeknownst to him, a prior owner had buried old tires and other debris on the property.
A note holder’s agreement to extend the maturity date was supported by consideration because the note holder received the benefit of collecting further interest on the loan. Consequently, the extension was enforceable and the note holder’s action was brought within the applicable limitations period.

A term in a nonrecourse promissory note that provided for the obligation to become recourse if the mortgaged property becomes encumbered by a mechanic’s lien that is not discharged within 30 days after its creation was enforceable. The term was not ambiguous and despite the trial court’s statement that this would create a windfall for the lender, parties are free to choose the terms they desire in a contract unless prohibited by statute or public policy. The guaranty of the note maker’s liability similarly became enforceable when the lender acquired recourse against the maker of the note.

A term in a $1.3 million promissory note, issued in connection with a settlement agreement, which provided that an additional $600,000 would become due upon default, was not enforceable. Although the payee argued that she was poised to recover $1.9 million on her claim if the litigation had not been settled, and that the $600,000 was a discount for timely performance, the settlement agreement contained no such term. It called for payment of only $1.3 million. The $600,000 term was therefore a liquidated damages clause and it was invalid as a penalty. It did not provide compensation for anticipated attorney’s fees and costs of collection because those damages were covered by other provisions of the note.

A guaranty that identified the principal obligor only by its trade name nevertheless satisfied the statute of frauds and was enforceable.

In re Altadena Lincoln Crossing LLC, 2018 WL 3244502 (Bankr. C.D. Cal. 2018)
A term in the agreements for two loans totaling $26 million, which provided for a 5% increase in the interest rate after default, was an unenforceable penalty even though there was evidence that a 5% increase was customary in the industry and even though the debtor acknowledged in several forbearance agreements the amount due, including interest calculated using the default rate. The increase could not be liquidated damages designed to compensate for the cost of collection because other provisions in the agreements obligated the borrower to pay such costs, along with a fee for any late or missed payments. Although there was testimony that the increase was designed to compensate the lender for the increased risk of nonpayment, increased loan loss reserves, staff and senior management time devoted to managing and reporting on the loan and dealing with increased regulatory oversight, there was no evidence that the lender considered these things when making the loan and many of these expenses have little or no relationship to the size of the loan.

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