

# The Transactional Lawyer

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## Itsy Bitsy Its

**John Francis Hilson**

It is often said that good things come in small packages. In a recent case, *In re Aéropostale, Inc.*,<sup>1</sup> the pronoun “its” turned out to be a very small word that produced a very good outcome for one of the parties to an agreement.

In *Aéropostale*, the court was called upon to consider some of the hot button issues that frequently arise in bankruptcy proceedings, including whether to equitably subordinate a secured creditor’s claim, whether to limit or prohibit credit bidding by the secured creditor, and whether to recharacterize the secured claim as equity. One issue that might not be noticed in that crowd of big issues is the court’s interpretation of language in an agreement that provided one of the parties with broad discretion. That issue is of importance to transactional lawyers.

Two years prior to the filing of *Aéropostale*’s bankruptcy petition, the company and certain of its affiliates entered into a series of agreements with Sycamore Partners and certain Sycamore affiliates. The broad outline of those arrangements is that a Sycamore affiliate provided a \$100 million loan to *Aéropostale*, a different Sycamore affiliate made a \$50 million loan to *Aéropostale*, and those loan arrangements required *Aéropostale* to enter into a Sourcing Agreement with another Sycamore affiliate, named MGF, whereby *Aéropostale* would agree to purchase merchandise procured for it by MGF.

Ordinarily, payment for goods supplied by MGF to *Aéropostale* under the Sourcing Agreement was due on

30 day terms. If, however, *Aéropostale*’s liquidity (a calculation based upon its availability under a revolving loan facility plus available cash) dropped below \$150 million, then under the terms of the Sourcing Agreement a so-called “Credit Review Period” existed. If a Credit Review Period existed, MGF had the right, apparently following notice to *Aéropostale*,<sup>2</sup> to adjust the terms of payment. The relevant language of the Sourcing Agreement was as follows:

Vendor’s standard payment terms will apply (i.e., U.S. Dollars, immediately available funds, net 30 days, or, during a Credit Review Period such other shorter number of days or up-front terms as deemed prudent by [MGF] in the exercise of its<sup>3</sup> reasonable credit judgment).<sup>4</sup>

When *Aéropostale*’s performance flagged, MGF declared that a Credit Review Period existed and a war of letters followed. Significantly, in connection with its declaration that a Credit Review Period existed, MGF notified *Aéropostale* that it was adjusting the terms of payment. The revised terms required *Aéropostale* to pay in full for goods at the time it placed an order or to provide MGF with an irrevocable standby letter of credit in the full amount of the order.

In connection with *Aéropostale*’s attempt to equitably subordinate the claims of the lenders under the Sycamore loan facilities, it alleged that MGF breached the Sourcing Agreement because MGF’s adjusted terms were unreasonable and, therefore, a breach of the Sourcing Agreement. The company contended that the provision in the Sourcing Agreement “limited MGF to imposing only payment terms during a Credit Review Period that were *prudent* and an exercise of *reasonable credit judgment*, but that the terms in both the February 24 Letter and the February 29 Letter were neither.”<sup>5</sup> While the court agreed that MGF was limited in its ability to apply payment terms under the Sourcing Agreement, it rejected *Aéropostale*’s attempt to characterize the language as requiring an objective standard of reasonableness as opposed to a subjective one. The words of the court were succinct and direct:

For instance, the Debtors state that “MGF may require different payment terms, but only if such terms are *objectively* ‘prudent’ in the exercise of ‘reasonable credit judgment.’” (emphasis added). But that is not what the Sourcing Agreement says. Instead, it explicitly allows

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MGF to impose “such other shorter number of days or *upfront terms* as deemed prudent by *Vendor* in the exercise of *it[s]* reasonable credit judgment.” (emphasis added). Thus, the Term Lenders correctly note that “MGF had the right to apply *its* reasonable credit judgment in light of *its* determination of what was prudent for it.”<sup>6</sup>

The use of the word “its” influenced the court’s interpretation of the provision as a subjective test rather than an objective one.

It is interesting to analyze exactly what the language provided. The provision allowed MGF to change payment terms to other terms that are “deemed prudent by [MGF]” so long as doing so was “in the exercise of its reasonable credit judgment.” It could be that the drafter intended to create a completely subjective standard. If that were the intent, then it is unclear why the drafter included the clause “its reasonable credit judgment.” There would be a much stronger case for a totally subjective test if the language allowed MGF to change the terms of payment “as deemed prudent by [MGF]” and did not include the additional language regarding reasonable credit judgment. If the language had been so truncated, MGF would have had an easier time arguing that whatever it deemed prudent would be the revised terms of sale.<sup>7</sup>

It is also possible that a completely subjective standard was a bridge too far for Aéropostale and that it was insisting upon an objective standard. If that were what the parties were seeking to express, then the language would have accomplished the goal of objectivity if it merely eliminated that pesky little word “its.” Thus, the language would have been “such . . . terms as deemed prudent by [MGF] in the exercise of reasonable credit judgment.” If the drafter had eliminated the word “its,” the provision would have called for an objective determination as to whether the revised payment terms imposed by MGF met the standard of the marketplace.

Lastly, perhaps the goal of the drafting was to require reasonable credit judgement (*i.e.*, an objective standard) as applied to the circumstances that this creditor was experiencing (*i.e.*, a subjective gloss). Indeed, the court noted that MGF was concerned that defaults by Aéropostale might result in it breaching financial covenants contained in its own loan documents.<sup>8</sup> If the goal were to have such a bifurcated approach, then the drafting would be much more challenging. Perhaps such a provision would read “such . . . terms as deemed prudent by [MGF] in the exercise of reasonable credit judgment considering the particular facts and circumstances then applicable to MGF.”

Thus, the various alternatives that the drafter could use would be as follows:

Original Version:

as deemed prudent by Vendor in the exercise of its reasonable credit judgment.

Purely Objective Version:

as deemed prudent by Vendor in the exercise of reasonable credit judgment.

Purely Subjective Version:

as deemed prudent by Vendor.

Hybrid Version:

as deemed prudent by Vendor in the exercise of reasonable credit judgment considering the particular facts and circumstances then applicable to Vendor.

It is unclear whether the drafter of the Sourcing Agreement spent time laboring over the operative language and the different alternatives, but one lesson is clear – small differences in the language of a provision can have major repercussions.

*John Francis Hilson is an adjunct faculty member at UCLA Law School.*

**Notes:**

1. [2016 WL 4506712](#) (Bankr. S.D.N.Y. 2016).
2. The court never stated that notice was required and did not quote any provision of the Sourcing Agreement that required notice, but the opinion does refer to the ability of MGF to “declare” a Credit Review Period to exist and, in fact, MGF did send a letter to Aéropostale indicating that MGF believed that a Credit Review Period existed.
3. The actual provision of the Sourcing Agreement referred to “it reasonable credit judgment,” a mistake that the court identified with a “[sic].” The provision has been corrected in this article to make it easier to read.
4. [2016 WL 4506712 at \\*5](#).
5. *Id.* at \*22 (emphasis in original).
6. Citations omitted.
7. This argument ignores and, somewhat surprisingly, the decision does not address whether the discretion of MGF had to be exercised in good faith. See [RESTATEMENT \(SECOND\) OF CONTRACTS § 205](#) (“Every contract imposes upon each party a duty of good faith and

fair dealing in its performance and its enforcement.”) and New York’s – the Sourcing Agreement was governed by New York law – [U.C.C. § 1-304](#) (“Every contract or duty within this Act imposes an obligation of good faith in its performance and enforcement.”). The duty of good faith requires that the party with discretion must exercise that discretion in a manner that is consistent with the reasonable expectations of the other party. *See* *Interim Health Care of N. Ill., Inc. v. Interim Health Care, Inc.*, [225 F.3d 876](#), 884 (7th Cir. 2000) (“When one party to a contract is vested with contractual discretion, it must exercise that discretion reasonably and with proper motive, and may not do so arbitrarily, capriciously or in a manner inconsistent with the reasonable expectations of the parties.”).

8. As stated by the court, “[t]his \$34.9 million in existing exposure was already approaching the amount of MGF’s EBITDA cushion for maintaining compliance with the covenants in its credit agreements (although the amounts of its leverage ratio and fixed charge coverage ratio are confidential), so that non-payment by the Debtors could wipe out the liquidity that MGF needed to avoid defaulting on its own loans.” [2016 WL 4506712 at \\*8](#) (citations omitted).



## Avoiding Ambiguity: Part Three – Semantic Ambiguity

*Stephen L. Sepinuck*

Part One of this Article, which appeared in the June issue of this newsletter, offered advice on how to avoid contextual ambiguity.<sup>1</sup> Part Two, published in the August issue, offered advice on how to avoid syntactic ambiguity.<sup>2</sup> This final part offers advice on how to avoid semantic ambiguity.

### Sources of Semantic Ambiguity

Semantic ambiguity exists when a word or phrase has multiple meanings and more than one of those meanings could reasonably apply given the context in which the word or phrase appears.

### *Multiple Meanings*

Some words have obvious multiple meanings. An agreement calling for payment of 10,000 “dollars” could mean U.S. dollars, Canadian dollars, Australian dollars, or the similarly named currency of numerous other nations. The words “ounce” and “ton” – each commonly used in written agreements as a measure of goods to be bought and sold – also suffer from semantic ambiguity. The former might refer to an avoirdupois ounce (437.5 grains) or a troy ounce (480 grains). The latter might mean a long ton (2,240 lbs.), a short ton (2,000 lbs.), or a metric ton (2,204.6 lbs.).

For two reasons, these words rarely present a problem for a transactional lawyer. First, because their semantic ambiguity is obvious, a lawyer should be able to spot the ambiguity and add a qualifier to avoid it. Second, usage of trade or context will often solve the problem.<sup>3</sup> For example, an agreement to buy and sell a specified number of ounces of a precious metal will almost assuredly mean troy ounces, because that is the usage in the precious metal trade. An agreement between two U.S. parties that calls for payment in dollars will no doubt, in that context, require payment in U.S. currency.

Unfortunately, the semantic ambiguity of some other words and phrases is less obvious. A transactional lawyer with no experience in the poultry business might not know that the word “chicken” in an agreement between a domestic seller and foreign buyer could mean only young birds suitable for broiling and frying or might also include older – and cheaper – fowl best suited for stewing.<sup>4</sup> Similarly, it might not occur to the transactional lawyer that there are multiple ways to calculate “sales area,”<sup>5</sup> determine where a document is “executed,”<sup>6</sup> measure distance on land (*i.e.*, by direct measure or by driving route),<sup>7</sup> or interpret whether a student is “matriculated.”<sup>8</sup>

### *Unknown Usage of Trade*

While usage of trade can frequently resolve a semantic ambiguity, on rare occasions it can create it. For example, one seller of rodent traps submitted a winning bid to the City of Chicago in response to an announcement calling for the following specifications for the traps:

150 cases of 5½" x 11"; 24/case

75 cases of 11" x 11"; 12/case.

A dispute arose when the City later claimed – successfully – that usage of trade required delivery of 24 and 12 *pair*/case: double the amount the seller thought the contract required.<sup>9</sup>

### *A Reference to an Unspecified Portion*

A description of property or debt as a portion, fraction, or amount of a larger group, mass, or total can be ambiguous and, in some cases, render an agreement too indefinite to be enforceable. Thus, for example, consider a purchase agreement for “some of Blackacre” or “some of my widgets.” The amount or quantity in each case is so vague – the language merely indicates that less than all is to be transferred – that the agreement would be unenforceable. Similarly, a security agreement covering “some equipment” fails to reasonably describe the collateral.<sup>10</sup> Even a specified fraction or portion of a larger mass might not be an adequate description. While fungible goods undoubtedly can be sold by a reference to a specified share of a larger bulk,<sup>11</sup> a description of real property in that manner – e.g., “half of Blackacre” or “20 acres of Blackacre” – would probably not be sufficient. Note, in these examples the description has arguably gone from vague (“some,” which could be almost any amount) to ambiguous (“half,” which indicates a quantity but fails to explain how the whole is to be divided) but the result is the same.

In short, a reference to a portion of a larger whole can be ambiguous even when the whole is clear and the portion is expressly identified by a percentage or number. This problem probably occurs most commonly when a guarantor promises to guaranty a specified percentage or dollar amount of a larger debt.<sup>12</sup> If, as commonly occurs, the debtor pays a portion of the debt before defaulting, do those payments reduce the guaranteed portion of the debt or the non-guaranteed portion?<sup>13</sup> Put another way, if a guarantor promises to be responsible for half the debt, is it the first half, the last half, or a portion of both?

### *An Unspecified Time*

Many contractual terms operate in present time. For example, the implied warranty of merchantability speaks to the condition of the goods only at the time of tender. While a problem with the goods that becomes manifest shortly after the sale might indicate that the goods were in fact defective when tendered, the problem might be attributable to other factors, such as misuse. A finding of breach requires a determination that the goods were nonconforming at tender.

Other contractual terms relate to the past or future. Unfortunately, the past and future are indefinite (and infinite). Unless the precise time is stated or implicit, it is not always clear to how far in the past or future a statement refers. In short, references to the past and future can suffer from semantic ambiguity.

As an example, consider this statement, overheard in December 1996: “Atlanta Braves pitchers have won the last six National League Cy Young awards.” At that time, the last six awards had been won by Tom Glavine (1991), Greg Maddux (1992-1995), and John Smoltz (1996). In 1996, all of them indeed pitched for the Braves. However, when Maddux won his first award, he was a pitcher for the Cubs. Thus, to the extent that the statement meant that the winners of the last six awards *now* pitch for the Braves, it was accurate; to the extent that it meant that the last six winners were pitching for the Braves *when they won*, it was wrong.

Compounding the problem of the indefiniteness of the past and future is the fact that many agreements contain a clause that is ambiguous with respect to whether it is referring to the present or future. Consider a traditional choice-of-law clause, such as “New York law governs this agreement and the relationship of the parties hereto,” or some other reference to “applicable law.” Is that law as of the date the parties entered into the agreement, as of the date or dates the parties are to perform, or as of the date that a court is called upon to resolve a dispute?<sup>14</sup> Or consider an agreement that prohibits assignment or delegation except to an “affiliate” of one of the parties, and which defines “affiliate” in reference to common ownership or control. Does that term refer to entities that were so affiliated when the agreement was executed or to entities affiliated when the assignment or delegation is later made?<sup>15</sup>

### **Techniques for Dealing with Semantic Ambiguity**

When a semantic ambiguity is detected, it is usually a fairly straightforward task for a transactional lawyer to incorporate in an agreement the words necessary to avoid it. For example, the words in blue in each of the phrases below would remove a semantic ambiguity arising from the fact that a word or phrase has multiple meanings:

1000 **troy** ounces.

U.S. Fresh Frozen Chicken, Grade A, 2½-3 lbs., each chicken individually wrapped in cryovac **and suitable for broiling**.

within **a radius of** 50 miles of any Company office.<sup>16</sup>

The same approach can be used to draft around a known and undesired trade usage.<sup>17</sup> To detect such a trade usage, the lawyer should confer with the client.<sup>18</sup>



To deal with the ambiguity arising from an unspecified portion, a transactional lawyer should consider using a completely different approach. For example, instead of drafting a guaranty agreement so that the guarantor promises to guaranty “half” or \$500,000 of a \$1 million debt – so that it is ambiguous what portion is guaranteed – instead have the guaranty cover the entire indebtedness but cap the guarantor’s liability at a specified amount. That approach avoids the problem of determining when to calculate the “half” and makes it unnecessary to allocate payments to the guaranteed and non-guaranteed portions of the debt.

To deal with ambiguity arising from an unspecified time, simply incorporate language that specifies the time desired. For example, a choice-of-law clause could be phrased in either of the following manners, depending on what the parties intend:

New York law, **as in effect on the date of the this agreement**, governs this agreement and the relationship of the parties hereto.

New York law, **as in effect from time to time**, governs this agreement and the relationship of the parties hereto.

Of course, all of these technique work only if the transactional lawyer is aware of the semantic ambiguity. Consequently, the best advice is, as noted in Parts One and Two of this series, to be aware of the different types of ambiguity, understand the common sources of each, and be on constant vigil.

*Stephen L. Sepinuck is the Frederick N. & Barbara T. Curley Professor and Associate Dean for Administration at Gonzaga University School of Law and director of the Commercial Law Center.*

#### Notes:

1. See Stephen L. Sepinuck, *Avoiding Ambiguity: Part One – Contextual Ambiguity*, [6 THE TRANSACTIONAL LAWYER 1](#) (June 2016).
2. See Stephen L. Sepinuck, *Avoiding Ambiguity: Part Two – Syntactic Ambiguity*, [6 THE TRANSACTIONAL LAWYER 4](#) (Aug. 2016).
3. See U.C.C. § 1-303(c), (d); Restatement (Second) of Contracts §§ 219–222.
4. See *Frigalim Imp. Co. v. B.N.S. Int’l Sales Corp.*, [190 F. Supp. 116](#) (S.D.N.Y. 1960).
5. See *Winn-Dixie Stores, Inc. v. Dolgencorp, LLC*, [746 F.3d 1008](#) (11th Cir. 2014) (involving a commercial lease that prohibited the landlord from allowing other tenants to sell food items but contained an exception if such items do not exceed “500 square feet of sales area” within the shopping center).
6. See *CresCom Bank v. Terry*, [610 F. App’x 221](#) (4th Cir. 2015) (involving a guaranty signed by the guarantor in Georgia but delivered to the creditor in South Carolina).
7. See *Vantage Technology v. Cross*, [17 S.W.3d 637](#) (Tenn. Ct. App. 1999). The case involved a covenant not to compete in an employment agreement. The court ruled that “because we are to construe covenants not to compete favorably to the employee,” the 50-mile limit would be interpreted as the “shortest driving distance,” not the radius. Cf. Restatement (Second) of Contracts § 207 (preferring interpretation that favors the public interest).
8. See *In re Woodcock*, [45 F.3d 363](#) (10th Cir. 1995) (involving student loans that provided for payment to become due at “the end of the ninth month following the month in which Student ceases to be matriculated”; the student, after receiving a degree, continued to take graduate-level classes part time but not in a degree program).
9. See *Ragus Company v. City of Chicago*, [628 N.E.2d 999](#) (Ill. Ct. App. 1993). The City submitted uncontroverted evidence that: (i) the sole manufacturer of the traps packaged and sold the traps in pairs; (ii) middlemen purchased and resold the traps in pairs; and (iii) the City bought and received the traps in pairs. To the extent that this evidence dealt with how the traps were packaged – rather than how parties communicated about and described the traps – it is not clear that it should have been relevant to the meaning of the parties’ agreement.
10. See U.C.C. § 9-108(a), (b). See also *In re Eyerman*, [517 B.R. 800](#) (Bankr. S.D. Ohio 2014) (suggesting that “certain business assets” was not a reasonable description of the collateral for several reasons, including that the word “certain” did not necessarily mean “all”). The result might be different if a court were willing to apply a tracing or allocation principle of one kind or another to deal with a collateral description based on a number or amount of a larger group of items. See *In re Taylor*, 2011 WL 841511 (Bankr. E.D. Ky. 2011) (security agreement that described the collateral as “155 head of mixed breed cows and calves” without specifying which particular cattle, would be deemed, in the absence of any other reasonable approach, to cover the last 155 cattle sold by the debtor and the proceeds thereof).

In contrast, a financing statement covering “some equipment” would probably be effective to perfect a security interest in whatever equipment was described properly in the security agreement.

11. *See* U.C.C. § 2-501 cmt. 5 (“Undivided shares in an identified fungible bulk, such as grain in an elevator or oil in a storage tank, can be sold.”).

12. *See* Haggard v. Bank of Ozarks, Inc., [668 F.3d 196](#) (5th Cir. 2012). *Cf.* Broadbent v. Fifth Third Bank, [2016 WL 4536686](#) (Ind. Ct. App. 2016), which involved a guaranty that made the guarantor liable for 50% of the outstanding principal and interest on the loan and further providing that any payments were to be allocated first to non-guaranteed portion of the debt. What neither the court nor the parties focused on was that the language did not specify when – or how often – the computation was to be made. Thus, consider a situation in which the debt is \$7 million on day 100. On day 120, the borrower pays \$1 million. On day 140, the borrower defaults. If the computation is made on day 101, before the payment, the guarantor owes \$3.5 million (ignoring interest). If the computation is made on day 121, after the payment, the guarantor owes \$3 million (again, ignoring interest). Similarly, if subsequently, on day 160, the creditor collects \$2 million from the borrower or the collateral, it is unclear how that affects the guarantor’s liability. The language on the allocation of payment suggests that the guarantor’s liability is unaffected. However, if the 50% computation is performed again, the guarantor’s liability would be reduced by \$1 million.

13. Somewhat similarly, if a loan agreement requires the lender to release a “pro rata” portion of the collateral upon payment of principal, it is ambiguous whether the “pro rata” portion is to be determined by acreage, value, or some other measure. *See* West Ridge Group, LLC v. First Trust Co. of Onaga, [414 F. App’x 112](#) (10th Cir. 2011).

14. *See, e.g.*, Kia Motors Am., Inc. v. Glassman Oldsmobile Saab Hyundai, Inc., [706 F.3d 733](#) (6th Cir. 2013). The case involved an automobile dealership agreement that permitted the manufacturer to establish new dealerships in the dealer’s geographic area “only as permitted by applicable law.” At the time the manufacturer and dealer executed the agreement, state law restricted a manufacturer’s ability to establish new dealerships within six miles of an existing dealership. That law was later amended to expand the restricted area to nine miles. The court ruled that the agreement referred to the law in effect when the agreement was signed.

15. There is some authority for the proposition that a reference to a party’s “affiliates” includes only those affiliates in existence at the time the contract was

executed. *See, e.g.*, Ellington v. EMI Music, Inc., [21 N.E.3d 1000](#), 1004-05 (N.Y. 2014) (*citing* VKK Corp. v. National Football League, [244 F.3d 114](#), 130-31 (2d Cir. 2001); Budget Rent A Car Sys., Inc. v. K & T, Inc., [2008 WL 4416453](#), \*4 (D.N.J. 2008)). However, each of these authorities dealt with a provision phrased in the present tense. The *Ellington* case involved a definition of the “Second Party” to the contract, and was phrased in the present tense. The *VKK Corp.* case involved a present release of claims. The *Budget* case involved an exclusive license to operate a “Budget” car rental business, and the licensee’s claim that the license also covered “Avis” branded businesses after the two companies later became affiliated. When the relevant contractual language speaks to the future – such as a clause dealing with a future assignment or delegation to an affiliate – it is not clear that these authorities’ rationale applies.

16. Defining when a student ceases to be “matriculated,” for the purpose of determining when student loans become due, is rather challenging. Presumably, graduates should not be able to indefinitely delay maturity of the loan simply by taking one graduate class each term. On the other hand, many students take courses part time and their loans should not become due before they complete their studies.

17. *See* U.C.C. § 1-303(e)(1) (express terms prevail over usage of trade).

18. Unfortunately, conferring with the client works only if the client is aware of the undesired trade usage. In the famous chicken case, the domestic seller was, apparently, aware of both meanings of “chicken” but it was not clear that the German-speaking buyer was. Similarly, the seller of rodent traps does not appear to have known of the trade usage regarding quantity. One other classic example of semantic ambiguity involved a contract for the sale of cotton to be transported from Bombay to Liverpool via the ship *Peerless*. *Raffles v. Wichelhaus*, [159 Eng. Rep. 375](#) (Ex. 1864). What neither party apparently knew when they made their agreement was that two ships with that name existed and made that voyage, one departing in October and the other in December.



## Unblocking the Rights of Blocking Members

*Alex M. Wilson*

Two recent bankruptcy court rulings impair a lender's ability to install a roadblock on its borrower's path to bankruptcy protection. However, the rulings seem to allow creative transactional lawyers to impose a speed bump on that path.

In *In re Lake Michigan Beach Pottawattamie Resort LLC*,<sup>1</sup> a lender sought to dismiss the bankruptcy proceedings of an LLC, claiming that the LLC lacked authority to file. Previously, as part of a forbearance agreement, the members of the LLC had amended the LLC's operating agreement to require the unanimous consent of all members to file for bankruptcy.<sup>2</sup> They also made the lender a "special member" of the LLC, with the right to vote on any material action and disclaimed any fiduciary duty of the lender when acting as the special member.<sup>3</sup> The effect of these amendments was to give the lender the ability to block the LLC from filing for bankruptcy.<sup>4</sup> Although the court recognized that the terms in the amended operating agreement were permissible under Michigan law governing LLCs, the court ruled that the terms violated federal public policy and were thus unenforceable.<sup>5</sup>

Importantly, the court did not hold that the installation of a blocking member was inherently against public policy; rather, it was how the lender executed the blocking member strategy that was problematic.<sup>6</sup> The amendments to the operating agreement did not merely install the lender as a special member, they also expressly disclaimed the special member's duty of loyalty:

in exercising its rights under this Section, the Special Member shall be entitled to consider only such interests and factors as it desires, including its own interests, and shall to the fullest extent permitted by applicable law, have no duty or obligation to give any consideration to any interests of or factors affecting the Company or the Members.<sup>7</sup>

This, the court reasoned, was the problem. In the absence of such a disclaimer of fiduciary duties, the lender acting as a special member would still need to vote in favor of bankruptcy if doing so was in the LLC's best interest, even if that would be adverse to the lender's interests. If the lender's discretion was circumscribed in

that manner, the court suggested, federal bankruptcy policy would not have been violated.<sup>8</sup>

Less than two months later, and relying in part on the *Lake Michigan* decision, the Bankruptcy Court for the District of Delaware ruled similarly.<sup>9</sup>

Looking forward, a lender might be able to serve as or install a blocking member provided the blocking member is subject to traditional fiduciary duties. To protect the creditor from a claim of breach of those duties, the LLC should be required to obtain liability insurance that covers the blocking member's breach of fiduciary duties. Section 408(d) of the Revised Uniform Limited Liability Act permits an LLC to purchase and maintain insurance that covers liability arising out of a member's conduct, including intentional misconduct. Delaware law apparently gives LLC members free reign in determining the extent to which the LLC will indemnify and insure its members and managers for any liability resulting from misconduct.<sup>10</sup>

*Alex M. Wilson is a second-year student at Gonzaga University School of Law.*

### Notes:

1. [547 B.R. 899](#), 902 (Bankr. N.D. Ill. 2016).
2. [Id. at 904](#).
3. [Id.](#)
4. [Id. at 910](#).
5. [See id. at 912, 914](#).
6. [See id. at 913](#).
7. [Id. at 914](#). Cf. [Revised Uniform Limited Liability Company Act § 105\(c\)\(5\), \(7\), \(d\)\(2\), \(3\)](#) (expressly permitting an operating agreement to waive a member's duty of loyalty).
8. [547 B.R. at 914](#).
9. *In re Intervention Energy Holdings, LLC*, [553 B.R. 258](#) (Bankr. D. Del. 2016).
10. *See Del. Code. tit. 6, § 18-108*; *In re ALH Holdings LLC*, [675 F. Supp. 2d 462](#) (D. Del. 2009).



## Recent Cases

### SECURED TRANSACTIONS

#### *Attachment Issues*

*In re Johnson,*

[2016 WL 4401609](#) (Bankr. S.D. Ohio 2016)

A security agreement purporting to encumber “the payment, proceeds, and rights under and related to” the debtor’s contract to play hockey for the Columbus Blue Jackets, failed to comply with California Labor Code § 300(b), governing assignments of wages, because the security agreement failed to state that there was no other assignment in connection with the transaction and because there was a pending garnishment order covering the wages. Accordingly, no security interest attached.

*Lakewood Credit Union v. Goodrich,*

[2016 WL 4626480](#) (Wis. Ct. App. 2016)

A bank could and did obtain a security interest in a deposit account containing funds that the debtor originally received as social security benefits. Although 42 U.S.C. § 407(a) prohibits assignment of future benefits, it does not prevent a recipient from using benefits paid to satisfy or secure a preexisting obligation. Although § 407(a) also prohibits the use of “legal process” to obtain social security benefits payable or paid, it does not prevent a secured party from foreclosing non-judicially on its security interest, because that interest was consensual.

#### *Perfection Issues*

*In re Sweeney,*

[2016 WL 4402220](#) (Bankr. E.D.N.C. 2016)

Because the debtor’s manufactured home was not permanently affixed to the real property on which it was located, even though the home’s wheels and axles had been removed, a security interest in the home and the accessions thereto was perfected by having the lien noted on the certificate of title. The home’s vinyl siding, fiberglass tub, garden tub, water heater, furnace, fireplace, shutters, ceiling fans, and central air conditioning system were all accessions and thus the security interest in them was perfected. However, the range, washer, dryer, and refrigerator were not physically united with the home, were therefore not accessions, and thus the security interest in them was not perfected by the notation on the certificate of title. Because no financing statement was filed, the security interest in the appliances was unperfected.

#### *Liability Issues*

*Cooper v. Campbell,*

[2016 WL 4487924](#) (Tex. Ct. App. 2016)

A promissory note that: (i) required the maker to apply all distributions from a specified partnership to payment of the note; (ii) indicated that the payee must look only to such distributions for payment; and (iii) provided for no deficiency judgment against the maker after the application of such distributions, did not prevent the payee from obtaining a judgment against the maker for the amount of distributions the maker received but failed to use to pay the note. The language did not address default and the prohibition on a judgment for deficiency applied only after the application of distributions, which did not occur.

### BANKRUPTCY

#### *Claims & Expenses*

*In re Johnson,*

[2016 WL 4401609](#) (Bankr. S.D. Ohio 2016)

Even if a lender had a valid security interest in the debtor’s right to payment under his contract to play hockey for the Columbus Blue Jackets, the debtor’s postpetition salary under the contract would be after-acquired property, and thus the security interest in that salary would be cut off by § 552(a). The lender’s security agreement did not purport to encumber the contract, merely the rights to payment. Even if the security agreement had encumbered the entire contract, the debtor’s postpetition salary would not be proceeds of the contract.

*In re Reichold Holdings US, Inc.,*

[2016 WL 4479286](#) (Bankr. D. Del. 2016)

Even though the reclamation rights of a prepetition seller of goods are subject to the rights of a prepetition secured party with a perfected security interest, and thus would be extinguished by foreclosure of the security interest, the existence of the security interest does not negate the seller’s reclamation rights under § 546(c). The payment in full of the debtor’s prepetition secured party with funds provided by a DIP lender extinguished the secured party’s security interest, leaving the seller’s reclamation rights intact and enforceable. As a result, the seller had a claim entitled to priority as an administrative expense under § 503(b)(9).



**Avoidance Powers**

*FTI Consulting, Inc. v. Merit Management Group, LP*,  
[2016 WL 4036408](#) (7th Cir. 2016)

The protection from avoidance for settlement payments by or to a financial institution does not protect a transfer that is conducted through a financial institution that is neither the debtor nor the transferee, but merely a conduit. Accordingly, a settlement payment the debtor made for the purchase of securities, which was handled by a bank as an escrow agent, was not protected and could be avoided as a fraudulent transfer to the seller of the securities.

**GUARANTIES & RELATED MATTERS**

*Broadbent v. Fifth Third Bank*,  
[2016 WL 4536686](#) (Ind. Ct. App. 2016)

A guaranty that limited the guarantor's liability to 50% of the outstanding balance of principal and accrued interest on the guarantied note but provided further that "any reduction of the Liabilities whether prior to or after the occurrence of an Event of Default shall be applied first to that portion of the Liabilities not guarantied by Guarantor hereunder," meant that the proceeds the creditor received from foreclosing on the collateral were to be applied first to half of the debt not guarantied, and only the residual proceeds after so doing reduced the guarantor's obligation.

**LENDING & CONTRACTING**

*In re Graves*,  
[2016 WL 4427068](#) (Bankr. W.D. Tex. 2016)

Although a cause of action normally merges into a judgment on the claim, with the result that res judicata would normally prevent a subsequent claim for attorney's fees incurred in pursuing the claim, because a promissory note expressly obligated the maker for the payee's "post-judgment" costs and expenses, the payee's claim for attorney's fees incurred post-judgment survived.

*In re Ky Simoukdalay Sanh Dimoukdalay*,  
[2016 WL 4613346](#) (Bankr. E.D. Tenn. 2016)

An attorney's fees clause in a promissory note, which was written in the passive voice and which did not specify who was responsible for the fees, was unenforceable.

*In re Fair Finance Co.*,  
[2016 WL 4437606](#) (6th Cir. 2016)

Because the debtor and secured party structured their refinancing agreement so that it might have been a novation, which would have extinguished the existing security interest and created a new one, the creation of the new security interest would have involved unencumbered assets and thus constituted a "transfer" under the Uniform Fraudulent Transfer Act. The debtor's trustee therefore stated a claim for avoidance of the security interest and all payments thereafter made on the secured obligation.

*Kirton McConkin PC v. ASC Utah, LLC*,  
[2016 WL 5335426](#) (Utah Ct. App. 2016)

The law firm that represented a lessor of real property and which obtained a security interest in the lessor's right to rent secure the firm's right to fees was not entitled to collect rent from the tenant who later obtained a \$60 million judgment against the lessor and was expressly granted by the court a right to set off its rent obligation against the judgment. Although the lease expressly prohibited set off, it also contained a provision indicating that it was a binding obligation of the lessor "subject to equitable principles." Thus, although the tenant could not withhold rent as a self-help remedy, once the judgment was entered, the court could set off as a matter of equity; because the law firm, as an assignee, stepped into the shoes of the lessor, the law firm's rights were subject to the tenant's set off rights.

**Edited By:**

[Stephen L. Sepinuck](#)

Frederick N. & Barbara T. Curley Professor,  
 Associate Dean for Administration,  
 Director, Commercial Law Center  
 Gonzaga University School of Law

**Scott J. Burnham**

Former Professor  
 Gonzaga University School of Law

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