

The Transactional Lawyer

A Publication of the Commercial Law Center



Ancient Hazards for Today's Transactional Lawyer

Stephen L. Sepinuck

Four recent cases, each dealing with a different transaction and raising different legal issues, provide valuable lessons for transactional lawyers. In each case, the court reached a result that is probably inconsistent with the intent – and certainly contrary to the interests – of the party that in all likelihood drafted the agreement. Yet in each case, the trap the drafter fell into was not new; it is instead akin to a hazard of ancient Greek lore. So, break out your *Bulfinch's Mythology*, and let's see what guidance the ancient world can still provide.

Charybdis¹

The first case, *U.S. Bank v. T.D. Bank*,² involved a five-tranche credit facility, totaling approximately \$200 million, to finance an ethanol plant. The lenders composing the top four tranches entered into an intercreditor agreement. One portion of the agreement provided that amounts received from the exercise of remedies were to be applied in the following order:

1. To pay any interest due and payable to the lenders in all four tranches, equally and ratably based upon the outstanding principal balances of the four tranches.
2. To pay principal due to the lenders in the four tranches, in order of priority.

In short, interest was to be distributed ratably to each tranche, *pari passu*, then principal was to be paid in order of priority.

During the borrower's bankruptcy proceedings, approximately \$25 million in cash proceeds was to be released to the collateral agent acting on behalf of all of the lenders. However, a dispute developed among the lenders regarding how the funds were to be disbursed. Because the lenders were collectively undersecured, the borrower would not be paying post-petition interest. If the released funds were nevertheless disbursed first to pay post-petition interest, the lenders in each tranche would share them. If the funds were not used to pay interest – because the borrower would not be paying post-petition interest – the senior lenders would receive the entire amount.

The collateral agent claimed that the intercreditor agreement did not adequately comply with the "Rule of Explicitness." That rule typically applies when the borrower is not paying post-petition interest but the intercreditor agreement purports to require payment of post-petition interest to the senior lender before any payment to a junior lender.³ In such a case, payment of interest to the senior lender (a form of profit on its loan) comes out of the junior lender's return of principal. The Rule of Explicitness protects the junior lender by requiring that such a distribution scheme be "precise, explicit, and unambiguous"; a provision simply providing that junior debt is subordinated until senior debt is "paid in full" is insufficient.⁴

In this case, the collateral agent was attempting to use the Rule of Explicitness to protect the senior lenders, arguably turning the rule on its head. Specifically, the collateral agent, pointing to a term in the intercreditor agreement providing that payment of post-petition interest was allowed "to the fullest extent permitted by law," argued that because post-petition interest was not allowable under bankruptcy law, it could not be permitted under the parties' agreement. The court agreed that the Rule of Explicitness applied but concluded that it had been satisfied. In doing so, the court noted that bankruptcy law was inapplicable to the dispute at hand and that the collateral agent could not "manufacture an ambiguity by importing bankruptcy principles that are inapplicable to the instant litigation."⁵

Regardless of whether the court was correct in its analysis or conclusion, the fact remains that the junior lenders will now receive post-petition interest even though the senior lenders will likely not be paid in full.

Contents

<i>Ancient Hazards for Today's Transactional Lawyer</i>	1
Recent Cases.....	4

That is unusual and probably not what the parties intended.

The problem was in how the intercreditor agreement created the waterfall of payments. Drafting a waterfall takes care. The trick, if there is one, is to make sure that it accurately describes what is intended, which might involve having more than one flow of funds: one for payments prior to default and another for allocating the proceeds of collateral after default. Charting the course by creating a diagram, and then testing the drafted language against the diagram, is often a useful way to prevent error. But unless drafted carefully, instead of creating an orderly stream, the clause can create a whirlpool of confusion and litigation. Avoid Charybdis.⁶

Cassandra⁷

The second case, *In re Syngenta AG MIR 162 Corn Litigation*,⁸ involved hundreds of suits relating to Syngenta's production and distribution of genetically modified corn seed. The plaintiffs did not use Syngenta's products but claimed that Syngenta's commercialization of its products caused the genetically-modified corn to be commingled throughout the U.S. corn supply, leading China to ban importation of all corn from the United States, and thereby depressing the price for U.S. corn. The particular plaintiff in this case, a seed distributor that had contracted with Syngenta, brought various contract and tort claims.

Syngenta sought to dismiss the claims based on the fourth sentence (in blue) of the following paragraph in the parties' agreement (the entire paragraph was printed in all capital letters and in bold in the agreement):

Warranties. Seller warrants that all products sold have been labeled as required under applicable state and federal seed laws and conform to description on the label within standard tolerances or variations. This warranty is in lieu of all other warranties, express or implied, including any warranty of merchantability or fitness for a particular purpose which are hereby expressly disclaimed. No claim shall be asserted against Seller unless Buyer reports to Seller, promptly after discovery (not to exceed thirty days), any condition that might lead to a complaint. **All claims must be asserted within one year from the date of acceptance of the product.** Buyer's exclusive remedy for any claim or loss, including, without limitation, claims resulting from breach of warranty, breach of contract, tort, strict liability or negligence, shall be limited to repayment of the amount of the purchase price.

The issue was whether the fourth sentence was really as broad as its language, in isolation, would suggest. The sentence refers to "all claims," implying that it covers both contract and tort claims. Moreover, the final sentence expressly refers to both warranty and tort claims. However, the paragraph heading refers to "warranties," the first two sentences deal only with warranties, and the third sentence refers to claims relating to the condition of the seed. This creates contextual ambiguity.⁹ The court, somewhat summarily, ruled that the fourth sentence applied only to claims relating to the condition of the goods received from the seller, and it did not bar the plaintiff's tort claims.¹⁰

The case therefore serves as a reminder that words are affected by the company they keep. To minimize the risk that creates, paragraphs should be limited to one topic. The paragraph at issue attempts to do four different things: (i) create an express warranty; (ii) disclaim other warranties; (iii) impose a time limit on claims; and (iv) limit remedies. That is far too much and, as this case demonstrates, can lead to interpretive problems.

There is a second, perhaps greater, problem with the quoted paragraph, albeit one not discussed by the court: the second sentence might be ineffective. The second sentence purports to disclaim implied warranties. To be effective, such a disclaimer must be "conspicuous."¹¹ Unfortunately, instead of having a caption suggestive of a disclaimer, this paragraph has a caption – "warranties" – suggestive of the reverse. Several courts have ruled that such a caption makes a disclaimer underneath it inconspicuous and, therefore, ineffective.¹²

In sum, the drafter of the fourth sentence referred to "all claims," but the court did not believe that the sentence meant what it said. Moreover, by screaming "warranty" before whispering a disclaimer, the drafter arguably rendered the disclaimer of the second sentence ineffective. Like the princess Cassandra, who could foresee the future but was cursed to have no one believe her prophecies, the drafter invited no one to take heed.

Hydra¹³

The third case, *In re Poole*,¹⁴ involved the debtors' right to modify three home mortgage loans in their Chapter 13 bankruptcy. The saga began in 2005 when the debtors borrowed about \$61,000 from First National Bank and granted the bank a lien on their house. The deed of trust expressly referenced the original promissory note but also indicated that it secured all future indebtedness of either or both debtors to the bank.

In June 2015, the debtors modified the original note and also executed two new promissory notes, one for about \$5,700 and the other for about \$6,400. A year later, the debtors filed for Chapter 13 bankruptcy relief. At that time, the value of their house was less than the amount remaining due on the original promissory note.

A Chapter 13 debtor is generally not permitted to modify a claim secured by the debtor's principal residence.¹⁵ This is true even if the claim is undersecured. However, if the claim is fully underwater – that is, if there is no equity in the property to secure the debt – the claim can be treated as unsecured and modified.¹⁶ Applying this distinction, the debtors' plan proposed to treat the two later notes as unsecured, and pay only a small fraction of each of them. The bank objected.

The court concluded that because there were three promissory notes, there were three separate liens. Consequently, the debtors could modify the obligations represented by the two more recent notes. The court's reasoning is suspect. The notion that there were three separate liens, even though there was only one deed of trust covering contemporaneous and future advances, seems dubious. A single lien can secure multiple debts. However, this error appears to be irrelevant. After all, the Bankruptcy Code authorizes debtors to modify "the rights of holders of secured claims," not to modify "liens," and the three notes would seem to suggest that there were three separate claims.

In any event, the result would likely have been different if, instead of having the debtors execute new notes, the bank had simply had the debtors execute one note to replace the original. With one note (and one deed of trust), it is hard to see how there could be more than one claim (or more than one lien). That the bank did not do so is all the more perplexing given that it had the debtors modify the original note on the same day that the debtors executed the new notes.¹⁷

Mortgage lenders should think of the mortgage debt as the Hydra: many heads but only one beast. Having the debtor issue a new note is like cutting off a head: new heads take its place and the beast becomes even more deadly. Instead, lenders should take efforts to ensure that there is only one note, and thus only one head to confront at a time.

Charon¹⁸

The fourth and final case, *G & W Warren's, Inc. v. Dabney*,¹⁹ involved the scope of a guaranty. The case arose out of the sale of a motorcycle dealership. In addition to an asset purchase agreement, the parties entered into a lease of the dealership space, a

non-competition agreement, and two consulting agreements. The buyer had payment obligations under all the agreements, but the agreements provided that he could assign his rights and obligations to a corporation he controlled and that doing so would relieve him of his personal obligations. However, the buyer also signed a guaranty.

The buyer did assign his rights and obligation to a corporation, and the corporation later defaulted on all its obligations. The seller sued and the trial court ruled that the buyer was liable for everything. On appeal, the appellate court reversed. Noting that the buyer had been relieved of his direct contractual obligations under the agreements, the only basis for imposing liability on him was through the guaranty. The guaranty agreement covered the obligations under the purchase agreement and the lease, but did not cover the obligations under the non-competition agreement or the two consulting agreements.

The seller tried to circumvent this by arguing that the guaranteed "Purchase Price" was expressly stated to be in exchange for, in part, goodwill, and that this necessarily included the benefits under the non-competition and consulting agreements. The appellate court disagreed.

The court's decision seems correct given how the transaction was structured and documented. Yet in hindsight it is easy to question that structure. When a small business is sold, often much of the purchase price is attributable to the seller's covenant not to compete. Tax considerations might affect whether and to what extent the purchase price will be allocated to that covenant, and whether the covenant will be in a separate agreement. But if it is in a separate agreement, it is hard to understand why any guaranty of the purchase price would not cover amounts due under the non-competition agreement.

To cross the river Styx, each soul must pay Charon, the ferryman, his due. Transactional lawyers representing sellers should think of their client as Charon and the buyer as the wayward soul needing to pay. There is no free passage on the Styx ferryboat.

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

Notes:

1. Charybdis was a sea monster that thrice daily drank water from the sea, creating a whirlpool that obstructed the Strait of Messina. In some stories, Charybdis was simply a whirlpool instead of a sea monster.

2. [2017 WL 436508](#) (S.D.N.Y. 2017).
 3. For a prior discussion of the Rule of Explicitness in this newsletter, see Stephen L. Sepinuck, *The Dangers of Uni-tranche Loans & the Rule of Explicitness*, [3 THE TRANSACTIONAL LAWYER 3](#) (Oct. 2013).
 4. See *U.S. Bank v. T.D. Bank*, [2017 WL 436508 at *9](#) (S.D.N.Y. 2017) (quoting cases).
 5. [Id. at *10](#).
 6. According to Homer, when forced to choose which peril to confront when passing through the Strait of Messina, Odysseus opted to pass close to Scylla, a monster inhabiting a large rock, to which he lost only a few sailors, rather than risk his entire ship in the whirlpool of Charybdis.
 7. Cassandra was the daughter of King Priam and of Queen Hecuba. To woo her, Apollo gave her the ability to foretell the future. When she nevertheless spurned him, he inflicted the curse that no one would believe her prophecies.
 8. [2017 WL 2080601](#) (D. Kan. 2017).
 9. See Stephen L. Sepinuck, *Avoiding Ambiguity: Part One – Contextual Ambiguity*, [6 THE TRANSACTIONAL LAWYER 1](#) (June 2016).
 10. [2017 WL 2080601 at *2](#).
 11. See U.C.C. § 2-316(2). See also *id.* § 1-201(b)(10) (defining “conspicuous”).
 12. See, e.g., *Blankenship v. Northtown Ford, Inc.*, [420 N.E.2d 167](#) (Ill. App. Ct. 1981), discussed in Scott J. Burnham, *Section Captions in Contracts*, [2 THE TRANSACTIONAL LAWYER 4](#) (Apr. 2012). See also *Latimer v. William Mueller & Son, Inc.*, [386 N.W.2d 618](#) (Mich. Ct. App. 1986); *Seibel v. Layne & Bowler, Inc.*, [641 P.2d 668](#) (Or. Ct. App. 1981).
- The court in *Syngenta* apparently assumed, without discussing the requirement of conspicuousness, that the warranty disclaimer was effective. [2017 WL 2080601 at *7](#).
13. The Hydra was a multi-headed monster that grew back two heads for each one severed.
 14. [2017 WL 401799](#) (Bankr. E.D. Tenn. 2017).
 15. 11 U.S.C. § 1322(b)(2).
 16. See, e.g., *In re Blendheim*, [803 F.3d 477](#) (9th Cir. 2015); *In re Schmidt*, [765 F.3d 877](#) (8th Cir. 2014); *In re Scantling*, [754 F.3d 1323](#) (11th Cir. 2014); *In re Lane*, [280 F.3d 663](#) (6th Cir. 2002); *In re Pond*, [252 F.3d 122](#) (2d Cir. 2001); *In re Bartee*, [212 F.3d 277](#) (5th Cir. 2000); *In re McDonald*, [205 F.3d 606](#) (3d Cir.), cert.

denied, [531 U.S. 822](#) (2000); *In re Griffey*, [335 B.R. 166](#) (10th Cir. BAP 2005); *In re Mann*, [249 B.R. 831](#) (1st Cir. BAP 2000).

17. Of course, it is easier to use multiple notes if the obligations are to have different interest rates or maturity dates. Even in such a case, however, the borrower could execute one note that requires irregular payments or regular payments of different amounts over different periods of time. Why the bank in *Poole* required the debtors to execute two new notes instead of one is particularly unclear, given that the two notes had the same interest rate and maturity date.

18. Charon was the ferryman of Hades who for a coin transported souls of the newly deceased across the river Styx, which divided the world of the living from the world of the dead. Those who could not pay the fee had to wander the shores for one hundred years.

19. [2017 WL 1737668](#) (Cal. Ct. App. 2017).



Recent Cases

SECURED TRANSACTIONS

Santander Consumer USA, Inc. v. Mata, [2017 WL 1208767](#) (Tex. Ct. App. 2017)

A secured party sued by the debtor for actions relating to a repossession, and which moved to compel arbitration pursuant to a clause in the security agreement, could not compel the repossession agent it hired or the agent's subcontractors to arbitrate the secured party's claims against them for indemnification and contribution. There was no arbitration clause in the secured party's agreement with the repossession agent, nor did that agreement incorporate by reference the terms of the security agreement.

Edwards Family Partnership, LP v. Bancorpsouth Bank,
[2017 WL 1732709](#) (S.D. Miss. 2017)

The assignee of the secured party, which had a control agreement with a bank, had no claim against the bank for allegedly permitting the debtor to make 13 transfers from the blocked account to accounts other than the one to which the control agreement permitted transfer. The assignee, through its course of conduct, had waived that restriction in the control agreement because the assignee was aware of numerous transfers to other accounts – including some of its own accounts – yet did not complain and instead relied on the debtor to replenish the blocked account.

BANKRUPTCY

In re Salamon,
[854 F.3d 632](#) (9th Cir. 2017)

A creditor whose claim was secured by a junior deed of trust on real property could not make the § 1111(b) election after the property was sold at a nonjudicial foreclosure sale. After that time, the claim was no longer secured by a lien on property of the estate.

LENDING & CONTRACTING

Bena v. Schleicher,
[2017 WL 1907741](#) (Wash. Ct. App. 2017)

A suit to reinstate a promissory note was not an action “to collect” within the meaning of the contractual clause authorizing an award of attorney’s fees, and therefore the trial court properly declined to award such fees.

FDIC v. FBOP Corp.,
[2017 WL 2021088](#) (N.D. Ill. 2017)

A tax allocation agreement between a bank holding company and its bank subsidiaries (with which it filed a consolidated return) that provided for how a tax refund would be allocated did not clearly alter ownership of the refunds. Consequently, ownership was to be determined based on the default rule, and the FDIC, as the successor to the banks, was entitled to the portion of the refunds attributable to taxes paid by the banks.

Family Security Credit Union v. Etheredge,
[2017 WL 2200364](#) (Ala. 2017)

Even if the trial court correctly concluded that the arbitration provision in vehicle financing contracts was substantively unconscionable because the financier reserved the right to avail itself of the courts while forcing the borrowers to arbitrate every conceivable claim, the provision was nevertheless enforceable because there was no evidence of procedural unconscionability. By referring to “[a]ny controversy or claim arising out of or relating to this Agreement,” the arbitration provision covered the borrowers’ claims that the financier negligently failed to ensure that they obtained good title to the purchased vehicles.

Impression Products, Inc. v. Lexmark International, Inc.,
[2017 WL 2322830](#) (U.S. 2016)

Patent rights in goods are exhausted by the first sale of the goods. Consequently, a buyer that purchased used printer cartridges knowing that the manufacturer/patentee had previously sold them pursuant to agreements that prohibited re-use and resale, did not infringe on the patent by engaging in restricted resale and use.



Edited By:

[Stephen L. Sepinuck](#)

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

Scott J. Burnham

Former Professor
Gonzaga University School of Law

This newsletter is intended to provide accurate information on the subjects covered. The newsletter is provided for informational purposes only; its publication and distribution do not constitute the provision of legal or professional advice or services by either the authors or the publisher. If legal or professional services are required, the services of a competent professional should be sought.