

# **Transactional Skills & Professionalism Lab**

## **Course Materials**

Spring, 2011



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## INTRODUCTION

The transactional practice of law is similar to litigation and dispute resolution in many ways. In both settings, lawyers must have a thorough understanding of the applicable legal rules and the policies underlying them. They must be honest, fulfill promises, listen well, communicate clearly, and maintain confidences. It also helps to be creative, courteous, punctual, to admit error, and to accept criticism with grace and an open mind.

This course will help students develop many of these skills, but it will focus on other skills and abilities needed by lawyers involved in transactional practice. These include:

- Ascertaining the parties' true desires through interviews and negotiation;
- Understanding the law applicable to the parties' transaction and to each term thereof;
- Performing due diligence;
- Imagining all the events that might later interfere with the transaction or the parties' relationship and determining which ones to provide for in the transaction documents; and
- Negotiating and drafting the terms of the parties' agreement with precision.<sup>1</sup>

This last one is particularly important. While all lawyers need to be able to use language precisely, this skill is exceptionally critical in drafting transaction documents. A poor word choice, grammatical mistake, or missing comma in a pleading is unlikely to severely impact a client's case. In a contract, any of these errors could lead to disaster. Transactional lawyers must have a painstaking attention to detail.

This course will also cover some substantive material traditionally covered in a course on Contracts or Property. Indeed, to make room for this course in the curriculum, both Contracts and Property were reduced from five credits to four. As a result, this course will explore the distinctions among various types of contract terms, the parol evidence rule, assignment and delegation, and recording systems. You will probably not cover these subjects in any detail – and perhaps not at all – in Contracts or in Property. The coverage of these subjects here will not differ significantly from what you would get in those other courses, but we will approach each from the perspective of a transactional practice. For example, how does the parol evidence rule affect the way a lawyer drafts an agreement? How does the recording system impact the due diligence that a transactional lawyer must perform?

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<sup>1</sup> Another important skill is the ability to creatively structure deals to achieve the parties' desires. This skill requires extensive knowledge of numerous areas of law and for that reason is beyond the scope of this introductory course.

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## THE COMPONENTS OF A WRITTEN AGREEMENT

### THE STRUCTURE OF WRITTEN AGREEMENTS

Most written agreements have the same basic structure:

1. Title
2. Preamble
3. Recitals
4. Definitions
5. Contract Body
  - A. Deal-Specific Terms
  - B. General Terms
6. Signature Lines

#### Title

The title usually identifies the type of agreement, such as “Sales Agreement” or “Lease.” It is useful for locating the document in a file drawer filled with other documents, but usually lacks any independent significance. In those few circumstances where the nature of the parties’ arrangement is both unclear from the language used and yet important to determining their rights, the label the parties attach to their relationship may signify their intent but is unlikely to be determinative and may not even be relevant. Instead, the economic realities of their transaction often governs what type of agreement the parties have formed.<sup>2</sup>

#### Preamble

The preamble identifies the parties and the date (although the date is sometimes placed instead or in addition on the signature page).

**This Agreement (“Agreement”) is made this fifth day of April, 2009, by and between Franklin Properties, LLC, a Washington limited liability company (“Landlord”) and Office Supply Store, Inc., a California corporation (“Tenant”).**

Notice the three parenthetical phrases, each in quotes. This is a manner of creating a defined term. Thus, in the example above, all further references in the written document to Landlord will mean Franklin Properties, LLC. Similarly, all further references to Tenant mean Office Supply Store, Inc. It is of course not necessary to define the parties in such a manner. The agreement could use the

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<sup>2</sup> See, e.g., U.C.C. §§ 1-203, 9-109(a)(1).

parties' full names throughout the document. Alternatively, it could define them using an abbreviated name for each party (e.g., "Franklin," and "OSS"). However, it is customary to use terms that illustrate the parties' relationship to each other, such as landlord and tenant, buyer and seller, or lender and borrower. This practice makes it easier to read the document and helps third parties not get confused about the role each party has in the transaction.

### Recitals

Recitals are often used to explain the background to the agreement: why the parties are entering into the agreement and what they hope to achieve. For example, a written guaranty agreement might contain recitals such as:

**Whereas, Child wants a loan from Bank to start a new business,  
Whereas, Bank is willing to lend funds to Child to start the new  
business only if Parent guarantees the debt, and  
Whereas Parent is willing to guaranty Bank's loan to Child.**

Recitals may also be used to identify the consideration for the agreement. Consideration is a legal concept that you will study in your Contracts course. In general, agreements without consideration are not enforceable contracts. For example, the recitals in that same guaranty agreement might continue in either of the following ways:

**In consideration of the foregoing, Parent and Bank agree as follows:**

**In consideration of \$10.00, receipt of which is hereby acknowledged,  
and other good and valuable consideration, the parties hereby agree as  
follows:**

These types of recitals (all the text in blue in the three blocks above; not the text in red) have no legal relevance. They are not enforceable provisions.<sup>3</sup> They do not provide rights or detail remedies. In most states, even the recital of consideration is immaterial. A mere recital that consideration exists or has been provided will not prevent either party from proving that consideration is in fact lacking.<sup>4</sup>

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<sup>3</sup> See, e.g., *Abraham Zion Corp. v. Lebow*, 761 F.2d 93, 103 (2d Cir. 1985) (quoting *Genovese Drug Stores v. Connecticut Packing Co.*, 732 F.2d 286, 291 (2d Cir. 1984)) ("Although a statement in a 'whereas' clause may be useful in interpreting an ambiguous operative clause in a contract, it cannot 'create any right beyond those arising from the operative terms of the document'"); *Paloian v. Grupo Serla S.A. de C.V.*, 433 B.R. 19, 32 (N.D. Ill. 2010) (recitals are not binding unless referred to the operative portions of the agreement); *Trafton v. Rocketplane Kistler, Inc.*, 2010 WL 771511, \*4 (E.D. Wis. 2010) ("The fact that one of the 'whereas' recitals sets forth both sides' expectations does not create some kind of condition precedent. It is well-established, moreover, that 'whereas' clauses exist merely to provide context and are not themselves part of the agreement").

<sup>4</sup> See Restatement (Second) of Contracts § 218 & cmt. e.

Given this, you may be wondering why contracting parties – and their lawyers – use recitals. The most common answer is tradition. Another reason is that, particularly in complex transactions, they provide context to help the reader (possibly a judge) understand the terms that follow. That context can occasionally be useful in construing terms that are unclear or ambiguous. The fact remains, however, that recitals are generally unnecessary. In some cases they are even worse than that. Sometimes the recitals contain terms that should be representations, warranties, or both.<sup>5</sup> We will discuss representations and warranties in just another page or so. For now, just remember that such terms should be clearly identified for what they are, not buried in the recitals and thereby perhaps stripped of their meaning.

The blocked text above in red are words of agreement. They are not recitals; they are instead the foundation of the document. Such words, or others to the same effect, are essential and should appear in every written agreement.

### Definitions

Brief written agreements may not need definitions. However, if a written agreement will be referring to the same concept many times, it may be useful to create a short term as a substitute for the concept, particularly if the concept itself takes many words to express. For example, if the owner of a business is agreeing to sell all the equipment and inventory of the business to a buyer, it would be very cumbersome to identify all the property to be sold in every place that the agreement needs to refer to that property. Instead, the parties could simply define a single term to mean all the property that will be sold. For example:

**“Property” means all equipment, inventory and other goods of the Seller located at 123 Main Street on July 1, 2009.**

This technique is particularly useful when describing real property because legal descriptions of realty are notoriously long and complex. Instead of repeating the entire description in every place the agreement refers to the property, it is far simpler to state the legal description just once and use it to define a term that the written agreement will then use throughout.

Using definitions and defined terms does more than save space and make written agreements more readable. It also helps prevent error, such as might occur if the writing used slightly different words in different places to refer to the same concept. Lawyers and judges typically assume that different words mean different things, and they often struggle to force a different meaning into terms with only a slight variation in language. Therefore, wherever you mean the same thing, use the same words. Defined terms and their definitions help you do that.

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<sup>5</sup> Although recitals are not themselves representations, and therefore do not help establish the underlying facts necessary to support a claim for misrepresentation, they can be useful as an acknowledgment that helps head off a claim of misrepresentation. *See FSL Acquisition Corp. v. Freedland Systems, LLC*, 686 F. Supp. 2d 921(D. Minn. 2010) (dealing with a disclaimer of reliance in an asset-purchase agreement).

## The Body of the Written Agreement

This is where the operative portions of the agreement will appear. It contains such deal-specific terms as the quantity of goods to be sold, the price to be paid for real estate, and the duration of an employment agreement. It will include everything that either party promises to do or to refrain from doing, every right either party has, and every representation that either party makes. The contract body will usually also include other, more general provisions. These may include a choice of governing law, perhaps a choice of forum, information on where notices are to be sent, rules on assignment and delegation, or a statement about whether headings in the written agreement are relevant to its interpretation.

Although not required, it is usually a good idea to present the terms in the body of the document in some logical sequence. For example, you could list all of the duties of one party followed by all of the duties of the other party. Or, you could list their rights and responsibilities in roughly the chronological order that you expect them to arise. A logical structure helps the drafter keep track of everything, and thus not omit something important. It also helps make sure there are no duplications or internal conflicts.

## Signature Lines

The last portion of a written agreement will be a place for all parties to affix their signatures. It is imperative that parties signing in a representative capacity indicate that.<sup>6</sup> Thus, if a party to an agreement is a corporation, then the signature line should clearly indicate that the individual signing is in fact doing so on behalf of the corporation. For example:

<p><b>Office Supply Store, Inc.,</b></p> <p><b>by: _____</b></p> <p><b>Pat Smith, President</b></p>
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For the same reasons, if an individual is entering into an agreement both in an individual capacity and in a representative capacity, the individual should sign multiple times, once in each capacity.

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<sup>6</sup> See, e.g., *Credit Suisse Securities (USA) LLC v. West Coast Opportunity Fund, LLC*, 2009 WL 2356881 (Del. Ch. Ct. 2009) (individual who signed in his individual capacity an agreement promising not to pledge “directly or indirectly” certain corporate stock for one year did not thereby prevent a limited liability company which he owned and controlled from pledging its own stock to its broker).

## THE TYPES OF CONTRACT TERMS

Within the body of a written agreement will be several different types of terms. Some terms impose duties (creating a correlative right in the other party), some grant authority or discretion (a different type of right), some create a condition, and some do other things. To fully understand the parties' rights and responsibilities under a written agreement, it is essential to appreciate the different types of terms, how each type is used, and what its consequences are. The reader must also be able to identify what type of term each written provision is.

The following is a brief description of the different types of terms. Although terminology differs, the classification below is what we will use for the remainder of this course.

Type of Term	Definition	Effect/Purpose
Representation	A statement of fact made by one party to the other.	Creates potential tort liability if untrue and may be grounds for rescission.
Warranty	A promise that a fact is true.	Creates contract liability if not fulfilled.
Covenant	A promise to do or refrain from doing something.	Creates contract liability if not fulfilled.
Discretionary Authority	A right to choose what action to take.	Creates permission for one party to choose between stated actions or pursuant to a specified standard.
Condition to an Obligation	A predicate to a duty.	Establishes the circumstances that must exist (or not exist) before a party must perform. Failure of a condition is not a breach.
Condition to Discretionary Authority	A predicate to a right.	A fact or circumstance that must exist before a party may exercise discretionary authority.
Present Transfer of Rights	A transfer of rights to property.	Constitutes all or part of one party's performance.
Declaration	A statement as to which the parties agree.	Defines terms or establishes rules applicable to the transaction or to the parties' relationship.

### The Significance of the Distinctions

In many cases, it is possible to draft a portion of an agreement as more than one type of term. Suppose, for example, that Driver decided to sell a used car and agreed to give Friend the option to buy it for \$8,000 within the next week. That agreement could be expressed as discretionary authority:

**Friend may purchase the car by delivering \$8,000 to Driver before the end of the week.**

Alternatively, it could be phrased as covenant subject to a condition:

**Driver shall sell and deliver the car to Friend if Friend tenders \$8,000 to Driver before the end of the week.**

or

**If Friend tenders \$8,000 to Driver before the end of the week, Driver shall sell and deliver the car to Friend.**

On the whole, it may not matter which of these variations the parties use. In some cases, however, the type of term used can make a huge difference. The distinction between a representation and a warranty, for example, is the difference between tort and contract. Imposing liability for a misrepresentation is much more difficult than imposing liability for a breached warranty, but the remedies for the former are often substantially greater than for the latter.<sup>7</sup> Sometimes, the type of clause used for a particular term can affect a party's rights in surprising ways. Consider the case that follows.

***HOOSIER ENERGY RURAL ELECTRIC COOP. V. JOHN HANCOCK LIFE INS. CO.***  
**582 F.3d 721 (7th Cir. 2009)**

Easterbrook, Chief Judge.

Hoosier Energy, a co-op, had depreciation deductions that it could not use. John Hancock Life Insurance Co. had income exceeding its available deductions. The two engaged in a transaction designed to move Hoosier Energy's deductions to John Hancock. They entered into a leveraged lease: John Hancock paid Hoosier Energy \$300 million for a 63-year lease of an undivided  $\frac{2}{3}$  interest in Hoosier Energy's Merom generation plant. Hoosier Energy agreed to lease the plant back

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<sup>7</sup> See, e.g., *Quality Wash Group V, Ltd. v. Hallak*, 58 Cal. Rptr. 2d 592 (Cal. Ct. App. 1996) (ruling that a seller was liable for breach of a warranty but not for misrepresentation).

from John Hancock for 30 years, making periodic payments with a present value of \$279 million. The \$21 million difference, Hoosier Energy's profit, represents some of the value to John Hancock of the deductions that John Hancock could take as the long-term lessee of the power plant.

The transaction exposed John Hancock to several risks. The power station might become uneconomic before the parties' estimate of its remaining useful life (roughly 30 years). Or Hoosier Energy might encounter financial difficulties in its business as a whole. As a debtor in bankruptcy, Hoosier Energy would be entitled to repudiate the lease, leaving John Hancock with a power station that it had no interest in operating. Hoosier Energy's obligation as a repudiating debtor would be considerably less than the present value of the rentals. *See* 11 U.S.C. § 502(b)(6). So Hoosier Energy agreed to provide John Hancock with additional security, in the form of both a credit-default swap and a surety bond. Ambac Assurance Corporation and three affiliates agreed to pay John Hancock approximately \$120 million if certain events occurred. (For its part, Hoosier Energy posted substantial liquid assets to Ambac's credit, in order to protect Ambac should it be required to pay John Hancock; this was part of the transaction's swap feature.) A credit-default swap, like a letter of credit, is a means to assure payment when contingencies come to pass, without proof of loss (as a surety bond would require). One of the contingencies in this transaction is a reduction in Ambac's own credit rating. If that rating falls below a prescribed threshold, Hoosier Energy has 60 days to find a replacement that satisfies the contractual standards.

During 2008 Ambac's credit rating slipped below the threshold. John Hancock then demanded that Hoosier Energy find a replacement, and it extended the deadline from 60 days to more than 120 days when Hoosier Energy reported trouble. Whether replacing Ambac was "impossible" at the time, as Hoosier Energy maintains, or just would have cost Hoosier Energy more than it was willing to pay, as John Hancock believes, is a subject that remains in dispute. When the extended deadline arrived, Hoosier Energy told John Hancock that it was in negotiations with Berkshire Hathaway to replace Ambac. John Hancock concluded that "in negotiations" was not good enough (perhaps it suspected Hoosier Energy of stalling) and called on Ambac to perform. Ambac is ready, willing, and able to meet its obligations. But before Ambac could pay, Hoosier Energy filed this suit under the diversity jurisdiction, and the district court issued a temporary restraining order. The justification for that order, since replaced by a preliminary injunction, is that if Ambac pays, it will demand that Hoosier Energy cover the outlay, and that this will drive Hoosier Energy into bankruptcy – a step that the district court called an irreparable injury.

Irreparable injury is not enough to support equitable relief. There also must be a plausible claim on the merits, and the injunction must do more good than harm (which is to say that the "balance of equities" favors the plaintiff). How strong a claim on the merits is enough depends on the balance of harms: the more net harm an injunction can prevent, the weaker the plaintiff's claim on the merits can be while still supporting some preliminary relief. The district court concluded that an injunction would have net benefits, because John Hancock would remain well secured in its absence (it remains the lessee of a power station that is essential to Hoosier Energy's business, so Hoosier Energy will not abandon the lease), and that Hoosier Energy's position on the merits is strong enough to support relief while litigation continues. The district court also directed Hoosier Energy to post \$2 million in cash, a \$20 million injunction bond with sureties, and an unsecured

bond of \$130 million, to ensure that John Hancock would be made whole should it prevail in the litigation.

As for the merits: The district court thought that Hoosier Energy has two arguments with enough punch to justify interlocutory relief. The first is that the transaction is an abusive tax shelter. The district court observed that the Internal Revenue Service has declined to allow similar transactions to transfer deductions from one corporation to another and concluded that this transaction probably should be unwound. The second is that, under New York law (which the parties agree supplies the rule of decision), “temporary commercial impracticability” permits Hoosier Energy to defer coming up with another swap partner until the economy has improved.

John Hancock disputes both of these conclusions \* \* \*. On the subject of irreparable injury, appellate review is deferential at the preliminary injunction stage, and we lack an adequate basis on which to disagree with the district court’s assessment. That leaves the question whether Hoosier Energy has a plausible theory on the merits – not necessarily a winning one, but a claim strong enough to justify exposing John Hancock to financial risks until the district court can decide the merits. We do not agree with all of the district judge’s reasoning, but we do not think that the court erred in thinking Hoosier Energy’s claim sufficient for this limited purpose, given Ambac’s continuing ability to perform and the injunction bonds posted under Fed. R. Civ. P. 65(c).

Let us start with the question whether the transaction is an illegal tax shelter that must be unwound rather than enforced. The district court’s approach has two steps: First, the court concluded that the transaction lacks economic substance and therefore cannot be employed to transfer tax benefits from Hoosier Energy to John Hancock. Second, the court believed that a tax shelter that the Internal Revenue Code does not allow is “illegal” as a matter of contract law. The first of these steps may or may not be right; the tax treatment of leveraged leases, and related transactions such as the sale and leaseback, can be difficult. The second is wrong. A leveraged lease is a perfectly enforceable contract. Whether or not the contract lawfully transfers tax benefits, there is nothing wrong with, or illegal about, the contract itself; only the claim of tax benefits *from* the contract would be problematic. \* \* \*

This leaves the doctrine of “temporary commercial impracticability.” John Hancock’s principal argument on this front is that New York law does not recognize any such doctrine. Like other states, New York recognizes the doctrine of impossibility – but even then only the kind of impossibility that the parties could not have anticipated. As John Hancock describes things, the parties anticipated the possibility that Hoosier Energy, Ambac, or both might get into financial distress and provided what was to happen: if Hoosier Energy did not come up with better security in 60 days, John Hancock could draw on the credit default swap to protect itself. When the economy turned sour, and the risk materialized, John Hancock tried to take advantage of this extra security. Yet the district court deemed the risk’s coming to pass as a reason why John Hancock could not draw on the security. John Hancock sees this as perverse, an order that defeats the parties bargained-for allocation of risks. The district court may have thought that economy-wide conditions justified this reallocation, but it is hard to see how an economic downturn can be alleviated by making contracts less reliable. Enforceable contracts are vital to economic productivity.

Whether Hoosier Energy's performance was "impossible" in the strong sense that contract law requires depends on what its obligations were. John Hancock urges on us the perspective that, when Ambac's credit rating slipped, Hoosier Energy had an option: find a new surety in 60 days, or pay Ambac the sums to which Ambac would become entitled once it paid John Hancock. The holder of an option may not be able to take advantage, but that differs from impossibility. Suppose that Hoosier Energy had an in-the-money option to purchase the Indianapolis Colts by the end of December 2008, and that as a result of the reduced availability of credit it was unable to find a lender to finance the transaction. That would not make performance "impossible" and extend the option's expiration, effectively giving Hoosier Energy a new option (for 2009) for free. Likewise if Hoosier Energy had borrowed \$100 million and was obliged to pay the money back on October 1, 2008. That Hoosier Energy found itself unable to borrow money to roll over the loan would not excuse repayment; the "impossibility" doctrine never justifies failure to make a payment, because financial distress differs from impossibility. *See* Restatement (Second) of Contracts § 261 & comment d.

\* \* \* Downturns \* \* \* are types of things that happen, and against which contracts can be designed. When they do happen, the contractual risk allocation must be enforced rather than set aside. The district court called the credit crunch of 2008 a "once-in-a-century" event. That's an overstatement (the Great Depression occurred within the last 100 years, and the 20th Century also saw financial crunches in 1973 and 1987), and also irrelevant. An insurer that sells hurricane or flood insurance against a "once in a century" catastrophe, or earthquake insurance in a city that rarely experiences tremblors, can't refuse to pay on the ground that, when a natural event devastates a city, its very improbability makes the contract unenforceable.

We postponed discussing New York law until the general points of contract doctrine had been set out. New York law is consistent with what we have said; indeed, New York takes a very dim view of "impossibility" defenses and has never suggested that, when an impossibility defense is unavailable, a "temporary commercial impracticability" defense might serve instead. New York courts refuse to excuse performance where difficulty "is occasioned only by financial difficulty or economic hardship, even to the extent of insolvency or bankruptcy." *407 East 61st Garage, Inc. v. Savoy Fifth Avenue Corp.*, 244 N.E.2d 37, 41 (N.Y.1968). This applies to financial instruments – and, although impossibility might allow a party to suspend its obligations under a financial swap contract, this means more than a short-term inability to pay money. \* \* \*

All of this assumes, however, that John Hancock is right to characterize Hoosier Energy as having an option to find a better surety. As Hoosier Energy understands the contract, however, it had a duty to find a better surety, and failure to perform this duty was the default allowing John Hancock to draw on the swap. Then it might be possible to make out a real impossibility defense, meaning that (a) all parties to the transaction assumed, when they negotiated the terms, that it would be possible to find some other intermediary with adequate credit standing, and (b) as a result of a financial crisis, no such intermediary existed in late 2008, no matter how much Hoosier Energy offered to post in liquid assets to secure its obligations.

Even this would be a difficult defense to make out under New York law. The leading New York case on impossibility, *Kel Kim Corp. v. Central Markets, Inc.*, 519 N.E.2d 295 (N.Y.1987), says that the defense works only if some unexpected event upsets all parties' expectations; it is not

enough that the unexpected event puts one side in a bind. The lessee of a roller skating rink was required by contract to obtain liability insurance, which it got and maintained six years before the insurer declined to renew. When the policy expired, the lessor asserted default, and the lessee sought a declaration that performance was excused by impossibility, because no insurer would underwrite a liability policy for a roller rink at any price. Rejecting the lessee's argument, the Court of Appeals stated that impossibility can excuse performance only if the new event "could not have been foreseen or guarded against" in the contract. Financial distress could be and was foreseen; that's what the credit-default swap is all about. But if no one could have foreseen the extent of the credit crunch in 2008 – and if it really made performance impossible, a subject on which the parties profoundly disagree – then the sort of argument that Hoosier Energy makes could satisfy the requirements of *Kel Kim*.

We have said enough to show that there is uncertainty about how this suit comes out under New York law. It is uncertain whether Hoosier Energy had a duty to replace Ambac, or just an option; the impossibility defense is unavailable if the option characterization is correct. (We have avoided quoting the documents; some portions of these lengthy contracts support each side's characterization of them.) It is uncertain whether the extent of the 2008 credit crunch, which extended into 2009, was foreseeable. It is uncertain whether Hoosier Energy could have replaced Ambac by offering more, or better, security to another intermediary. Hoosier Energy undermined its own position in the litigation by telling John Hancock that it was negotiating with Berkshire Hathaway and could strike a deal with just a little more time, which implies that replacing Ambac was not impossible, but John Hancock returned the favor by suggesting that this deal was just pie in the sky and that Hoosier Energy would not or could not ever replace Ambac – and, if "could not" is the right understanding, perhaps performance was impossible after all.

All of these uncertainties collectively support the district court's conclusion that Hoosier Energy has some prospect of prevailing on the merits. Because appellate review is deferential, the district court's understanding must prevail at the interlocutory stage. \* \* \*

Affirmed.

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### ***Questions***

1. What type of contract term was Hoosier Energy claiming had been rendered impossible? What type of term did John Hancock claim was at issue?
2. What is the most unusual or ironic aspect of the arguments in this case?

### ***Problem 1-1***

Your client, Outing For All, Inc. is a non-profit corporation dedicated to providing underprivileged boys and girls from urban areas with camping, hiking,

boating, and similar opportunities. Outing has been searching for a new chief financial officer. Last week, it reached a preliminary oral agreement with Administrator. Review the deal terms identified below and determine for each how it should be translated into contract language. Specifically, for each term, determine which type of term (from the list below) it should be. Note, it may be appropriate for some terms of the deal to be expressed as more than one type of term.

- Representation
  - Covenant
  - Condition to an obligation
  - Declaration
  - Warranty
  - Discretionary authority
  - Condition to discretionary authority
  - Present transfer of property rights
- A. Outing will employ Administrator, and Administrator will work for Outing.
  - B. The term of employment will be for two years, beginning on March 1, 2011.
  - C. Outing may terminate Administrator's employment for "cause."
  - D. Outing will pay Administrator \$5,000 on the last business day of each month.
  - E. Administrator received a B.A. in accounting from Gonzaga University in 1999 and a masters in education from the University of Washington in 2003.
  - F. Administrator is a citizen of the United States and has never been convicted of a criminal offense.
  - G. If contributions to Outing do not exceed \$300,000 in any calendar year, Outing may terminate the agreement.
  - H. In the event of any dispute between the parties, all litigation will occur in the State of Washington.
  - I. Outing is to employ Friend as Administrator's personal assistant.

### ***Drafting Exercise 1-A***

Draft an example of each type of contract term that might appear in a lease of a residential apartment.

### ***Drafting Exercise 1-B***

Your client, Tiant, has reached a tentative oral agreement to buy a 2005 Ford Focus from Doerr for \$9,000, with delivery and payment to take place in two weeks. For each of the following statements, draft appropriate language for inclusion in a written agreement. Before doing so, determine which type or types of clause each statement should become.

- A. Doerr owns the car and it is not subject to any liens.
- B. The car has not been involved in an accident.
- C. The car is in good operating condition.
- D. Prior to delivery, Doerr will not drive the car more than 500 miles, will not paint it, will garage it at night, and will maintain it.

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## THE PROPER USE OF FORMS

Both lawyers and non-lawyers frequently use forms in preparing written agreements. Forms for this purpose are available from many different sources. Some fairly simple forms are available for sale at office supply stores. More complex forms are included in forms books available in most law libraries. Law firms that regularly negotiate and document transactions for the same client – or that frequently represent different clients engaging in similar transactions – often use a written agreement from a prior deal as a model for a new transaction, thereby turning the old agreement into a sort of form.

Regardless of the type or source of a form, competent attorneys must be very careful in how they use a form. This is true for several reasons. First, unless you are using a form that you or your law firm created – and perhaps even then as well – you cannot be certain that the form is well drafted. Is the language clear? Are there latent ambiguities? Is it premised on a correct understanding of applicable law? Has the law changed since the form was created? The mere fact that the form exists does not absolve the lawyer from thinking carefully about these questions.

Second, a form may have been written to favor a particular party or side to a transaction: for example, the buyer, the landlord, or the lender. Using such a form when you represent the other side can be quite problematic. Third, rarely are all the clauses in a form relevant to or appropriate for a particular transaction. In other words, forms are usually over-inclusive. Similarly, forms rarely contain all the terms that should be included in the written agreement for a particular transaction. Thus, they are also usually under-inclusive.

Despite these potential problems, attorneys can save a lot of time by using a form. The trick in using forms is not to treat them as templates with blanks to be blindly filled in. Using a form in such a manner is an invitation to malpractice. Instead, they should be models that serve as a guideline on structure and format, a source of issues that the attorney should consider, and only after the exercise of independent judgment, a possible source of contract language. Above all, never include in an agreement a term that you do not understand. If you do not know why a particular term is included in a form you are using, find out.

### *Problem 2-1*

- A. Below is the beginning of a form commercial lease. Review it closely. For each paragraph of the introduction and for each numbered section, determine what type or types of contract term it contains, what it means, and why it is included. Consult whatever sources or resources you need to thoroughly understand each provision.
- B. As you complete Part A, consider how reading a written agreement is different from reading a judicial opinion or a statute. What should a person do when reading a written agreement that need not be done when reading other legal sources?

## Commercial Lease Agreement

This Commercial Lease Agreement (“Lease”) is made and effective \_\_\_\_\_ **[Date]**, by and between \_\_\_\_\_ **[Landlord]** (“Landlord”) and \_\_\_\_\_ **[Tenant]** (“Tenant”).

Landlord is the owner of land and improvements commonly known and numbered as \_\_\_\_\_ **[Address of Building]** and legally described as follows (the “Building”):

\_\_\_\_\_ **[Legal Description of Building]**

Landlord makes available for lease a portion of the Building designated as \_\_\_\_\_ **[Suite or other portion of Leased Building]** (the “Leased Premises”).

Landlord desires to lease the Leased Premises to Tenant, and Tenant desires to lease the Leased Premises from Landlord for the term, at the rental and upon the covenants, conditions and provisions herein set forth.

THEREFORE, in consideration of the mutual promises herein contained and other good and valuable consideration, it is agreed:

### 1. Term.

A. Landlord hereby leases the Leased Premises to Tenant, and Tenant hereby leases the same from Landlord, for an “Initial Term” beginning \_\_\_\_\_ **[Start Date]** and ending \_\_\_\_\_ **[End Date]**. Landlord shall use its best efforts to give Tenant possession as nearly as possible at the beginning of the Lease term. If Landlord is unable to timely provide the Leased Premises, rent shall abate for the period of delay. Tenant shall make no other claim against Landlord for any such delay.

B. Tenant may renew the Lease for one extended term of \_\_\_\_\_ **[Renewal Term]**. Tenant shall exercise such renewal option, if at all, by giving written notice to Landlord not less than ninety (90) days prior to the expiration of the Initial Term. The renewal term shall be at the rental set forth below and otherwise upon the same covenants, conditions and provisions as provided in this Lease.

### 2. Rental.

A. Tenant shall pay to Landlord during the Initial Term rental of \_\_\_\_\_ **[Annual Rent]** per year, payable in installments of \_\_\_\_\_ **[Monthly Rental Amount]** per month. Each installment payment shall be due in advance on the first day of each calendar month during the lease term to Landlord at \_\_\_\_\_

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**[Landlord's Designated Payment Address]** or at such other place designated by written notice from Landlord to Tenant. The rental payment amount for any partial calendar months included in the lease term shall be prorated on a daily basis. Tenant shall also pay to Landlord a "Security Deposit" in the amount of \_\_\_\_\_ **[Security Deposit]**.

B. The rental for any renewal lease term, if created as permitted under this Lease, shall be \_\_\_\_\_ **[Annual Rent in Renewal Term]** per year payable in installments of \_\_\_\_\_ **[Monthly Rental Amount]** per month.

### 3. Use

Notwithstanding the forgoing, Tenant shall not use the Leased Premises for the purposes of storing, manufacturing or selling any explosives, flammables or other inherently dangerous substance, chemical, thing or device.

### 4. Sublease and Assignment.

Tenant shall have the right without Landlord's consent, to assign this Lease to a corporation with which Tenant may merge or consolidate, to any subsidiary of Tenant, to any corporation under common control with Tenant, or to a purchaser of substantially all of Tenant's assets. Except as set forth above, Tenant shall not sublease all or any part of the Leased Premises, or assign this Lease in whole or in part without Landlord's consent, such consent not to be unreasonably withheld or delayed.

### 5. Repairs.

During the Lease term, Tenant shall make, at Tenant's expense, all necessary repairs to the Leased Premises. Repairs shall include such items as routine repairs of floors, walls, ceilings, and other parts of the Leased Premises damaged or worn through normal occupancy, except for major mechanical systems or the roof, subject to the obligations of the parties otherwise set forth in this Lease.

### 6. Alterations and Improvements.

Tenant, at Tenant's expense, shall have the right following Landlord's consent to remodel, redecorate, and make additions, improvements and replacements of and to all or any part of the Leased Premises from time to time as Tenant may deem desirable, provided the same are made in a workmanlike manner and utilizing good quality materials. Tenant shall have the right to place and install personal property, trade fixtures, equipment and other temporary installations in and upon the Leased Premises, and fasten the same to the premises. All personal property, equipment, machinery, trade fixtures and temporary installations, whether acquired by Tenant at the commencement of the Lease term or placed or installed on the Leased Premises by Tenant thereafter, shall remain Tenant's property free and clear of any claim by Landlord. Tenant shall have the right to remove the same at any time during the term of this Lease provided that all damage to the Leased Premises caused by such removal shall be repaired by Tenant at Tenant's expense.

**7. Property Taxes.**

Landlord shall pay, prior to delinquency, all general real estate taxes and installments of special assessments coming due during the Lease term on the Leased Premises, and all personal property taxes with respect to Landlord's personal property, if any, on the Leased Premises. Tenant shall be responsible for paying all personal property taxes with respect to Tenant's personal property at the Leased Premises.

**8. Insurance.**

A. If the Leased Premises or any other part of the Building is damaged by fire or other casualty resulting from any act or negligence of Tenant or any of Tenant's agents, employees or invitees, rent shall not be diminished or abated while such damages are under repair, and Tenant shall be responsible for the costs of repair not covered by insurance.

B. Landlord shall maintain fire and extended coverage insurance on the Building and the Leased Premises in such amounts as Landlord shall deem appropriate. Tenant shall be responsible, at its expense, for fire and extended coverage insurance on all of its personal property, including removable trade fixtures, located in the Leased Premises.

C. Tenant and Landlord shall, each at its own expense, maintain a policy or policies of comprehensive general liability insurance with respect to the respective activities of each in the Building with the premiums thereon fully paid on or before the due date, issued by and binding upon some insurance company approved by Landlord, such insurance to afford minimum protection of not less than \$1,000,000 combined single limit coverage of bodily injury, property damage or combination thereof. Landlord shall be listed as an additional insured on Tenant's policy or policies of comprehensive general liability insurance, and Tenant shall provide Landlord with current Certificates of Insurance evidencing Tenant's compliance with this Paragraph. Tenant shall obtain the agreement of Tenant's insurers to notify Landlord that a policy is due to expire at least (10) days prior to such expiration. Landlord shall not be required to maintain insurance against thefts within the Leased Premises or the Building.

**9. Utilities.**

Tenant shall pay all charges for water, sewer, gas, electricity, telephone and other services and utilities used by Tenant on the Leased Premises during the term of this Lease unless otherwise expressly agreed in writing by Landlord. In the event that any utility or service provided to the Leased Premises is not separately metered, Landlord shall pay the amount due and separately invoice Tenant for Tenant's pro rata share of the charges. Tenant shall pay such amounts within fifteen (15) days of invoice. Tenant acknowledges that the Leased Premises are designed to provide standard office use electrical facilities and standard office lighting. Tenant shall not use any equipment or devices that utilizes excessive electrical energy or which may, in Landlord's reasonable opinion, overload the wiring or interfere with electrical services to other tenants.

#### 10. **Signs.**

Following Landlord's consent, Tenant shall have the right to place on the Leased Premises, at locations selected by Tenant, any signs which are permitted by applicable zoning ordinances and private restrictions. Landlord may refuse consent to any proposed signage that is in Landlord's opinion too large, deceptive, unattractive or otherwise inconsistent with or inappropriate to the Leased Premises or use of any other tenant. Landlord shall assist and cooperate with Tenant in obtaining any necessary permission from governmental authorities or adjoining owners and occupants for Tenant to place or construct the foregoing signs. Tenant shall repair all damage to the Leased Premises resulting from the removal of signs installed by Tenant.

#### 11. **Entry.**

Landlord shall have the right to enter upon the Leased Premises at reasonable hours to inspect the same, provided Landlord shall not thereby unreasonably interfere with Tenant's business on the Leased Premises.

#### 12. **Parking.**

During the term of this Lease, Tenant shall have the non-exclusive use in common with Landlord, other tenants of the Building, their guests and invitees, of the non-reserved common automobile parking areas, driveways, and footways, subject to rules and regulations for the use thereof as prescribed from time to time by Landlord. Landlord reserves the right to designate parking areas within the Building or in reasonable proximity thereto, for Tenant and Tenant's agents and employees. Tenant shall provide Landlord with a list of all license numbers for the cars owned by Tenant, its agents and employees. Separated structured parking, if any, located about the Building is reserved for tenants of the Building who rent such parking spaces. Tenant hereby leases from Landlord \_\_\_\_\_ **[Number of Parking Spaces]** spaces in such structural parking area, such spaces to be on a first come-first served basis. In consideration of the leasing to Tenant of such spaces, Tenant shall pay a monthly rental of \_\_\_\_\_ **[Parking Space Rental]** per space throughout the term of the Lease. Such rental shall be due and payable each month without demand at the time herein set for the payment of other monthly rentals, in addition to such other rentals.

#### 13. **Building Rules.**

Tenant will comply with the rules of the Building adopted and altered by Landlord from time to time and will cause all of its agents, employees, invitees and visitors to do so; all changes to such rules will be sent by Landlord to Tenant in writing. The initial rules for the Building are attached hereto as Exhibit "A" and incorporated herein for all purposes.

#### 14. **Damage and Destruction.**

Subject to Section 8 A. above, if the Leased Premises or any part thereof or any appurtenance thereto is so damaged by fire, casualty or structural defects that the same cannot be used for Tenant's purposes, then Tenant shall have the right within ninety (90) days following damage to elect by notice to Landlord to terminate this Lease as of the date of such damage. In the event of minor

damage to any part of the Leased Premises, and if such damage does not render the Leased Premises unusable for Tenant's purposes, Landlord shall promptly repair such damage at the cost of the Landlord. In making the repairs called for in this paragraph, Landlord shall not be liable for any delays resulting from strikes, governmental restrictions, inability to obtain necessary materials or labor or other matters which are beyond the reasonable control of Landlord. Tenant shall be relieved from paying rent and other charges during any portion of the Lease term that the Leased Premises are inoperable or unfit for occupancy, or use, in whole or in part, for Tenant's purposes. Rentals and other charges paid in advance for any such periods shall be credited on the next ensuing payments, if any, but if no further payments are to be made, any such advance payments shall be refunded to Tenant. The provisions of this paragraph extend not only to the matters aforesaid, but also to any occurrence which is beyond Tenant's reasonable control and which renders the Leased Premises, or any appurtenance thereto, inoperable or unfit for occupancy or use, in whole or in part, for Tenant's purposes.

#### 15. **Default.**

If default shall at any time be made by Tenant in the payment of rent when due to Landlord as herein provided, and if said default shall continue for fifteen (15) days after written notice thereof shall have been given to Tenant by Landlord, or if default shall be made in any of the other covenants or conditions to be kept, observed and performed by Tenant, and such default shall continue for thirty (30) days after notice thereof in writing to Tenant by Landlord without correction thereof then having been commenced and thereafter diligently prosecuted, Landlord may declare the term of this Lease ended and terminated by giving Tenant written notice of such intention, and if possession of the Leased Premises is not surrendered, Landlord may reenter said premises. Landlord shall have, in addition to the remedy above provided, any other right or remedy available to Landlord on account of any Tenant default, either in law or equity. Landlord shall use reasonable efforts to mitigate its damages.

#### 16. **Quiet Possession.**

Landlord covenants and warrants that upon performance by Tenant of its obligations hereunder, Landlord will keep and maintain Tenant in exclusive, quiet, peaceable and undisturbed and uninterrupted possession of the Leased Premises during the term of this Lease.

### ***Questions***

1. The two sentences in ¶ 7 are phrased very differently. The same is true of the two sentences in ¶ 8(b). Is this appropriate or is it poor drafting, and why?
2. Compare ¶ 6 with ¶ 10. Do the provisions overlap and, if so, are they consistent? How might the language in both provisions be inadequate to protect Landlord's interests?

## AVOIDING AMBIGUITY (AND OTHER DRAFTING TIPS)

Ambiguity exists when a word, phrase, or provision can be interpreted in two or more mutually exclusive ways.<sup>1</sup> It is a matter of choice among different alternative meanings. Vagueness, in contrast, is a matter of degree, a shading of meaning.

For example, an offer to purchase “10 red shirts” is vague. The requested color could fall along a wide spectrum from dark pink to crimson. An offer to purchase “10 red pens” is similarly vague but also ambiguous: it could mean pens that are red in color or that contain red ink. By the same token, an agreement that calls for payment of \$10,000 is ambiguous. It could mean U.S. dollars, Canadian dollars, Australian dollars, or the similarly named currency of numerous island nations. In most cases, the context would prevent any confusion. But imagine if the agreement were between one party in Toronto and another in Detroit. Presumably the agreement would require payment either in U.S. dollars or in Canadian dollars, but how are the parties – or a court – to know which is the correct currency?

Vagueness can be acceptable, at least where one or both parties wants it. Thus, it is not uncommon to find written agreements with phrases such as “best efforts,” “workmanlike manner,” “good faith,” “just cause,” and “reasonable [fill in the blank].” Proving that such a vague standard has been breached can be extremely difficult. Nevertheless, parties often outline their obligations and rights in such terms. Sometimes they rely on the prevailing practices in their trade or industry to provide context and meaning to a vague standard. Other times they simply prefer to trust each other rather than incur the time and expense involved in trying to negotiate and draft something more specific.<sup>2</sup>

Ambiguity is never acceptable. It is the enemy of every drafter.<sup>3</sup> Unfortunately, it is also very common, perhaps because it arises in three different ways. Semantic ambiguity exists when a word used has multiple meanings and more than one of those meanings could reasonably apply. The word “dollar” in the illustration above is an example of semantic ambiguity. Contextual ambiguity

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<sup>1</sup> Although not etymologically true, it may be helpful to think of the “bi” in “ambiguous” as meaning “two.”

<sup>2</sup> See, e.g., D. Douglas Bernheim & Michael D. Whinston, *Incomplete Contracts and Strategic Ambiguity*, 88 AM. ECON. REV. 902, 903 (1998) (noting that transactions costs require many agreements to be somewhat incomplete).

<sup>3</sup> One might be tempted to think that only unintentional ambiguity is bad. But intentional ambiguity borders on deceit and can also cause problems for the drafter or the drafter’s client. For an interesting decision showing why this is true, see *United Rentals, Inc. v. RAM Holdings, Inc.*, 937 A.2d 810 (Del. Ch. Ct. 2007) (ruling that two clauses in an agreement were in conflict, and because one party knew during negotiations of the interpretation placed on them by the other party but said nothing, the forthright negotiator principle was applicable and the court would construe the contract to mean what the other party understood). One scholar has suggested that the underlying messages of the case are that lawyers may have a professional and ethical obligation to draft contracts clearly and that “conscious ambiguity” undermines those obligations. Gregory M. Duhl, *Conscious Ambiguity: Slaying Cerberus in the Interpretation of Contractual Inconsistencies*, 71 U. PITT. L. REV. — (2009).

is created when two or more clauses are inconsistent. Consider a residential lease that contains the following two provisions:

**Tenant shall maintain the apartment.**

\* \* \*

**Landlord shall maintain the entire building.**

How are they to be reconciled?

Finally, syntactic ambiguity arises when it is unclear what word or phrase a modifying word or phrase is referring to. This is probably the most common type of ambiguity. Sometimes it is the result of misplaced modifiers. Other times it results from the careless use of articles, plurals, or conjunctions. For example, an offer to buy “six black and white horses” could refer to: (i) six mulatto horses (each colored both black and white), (ii) six horses, some of which are black and some of which are white, or (iii) twelve horses, six of each color.

Spotting ambiguity can be difficult, especially because it is occasionally more latent than patent. Consider the following sentence from late fall 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 were indeed pitching 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. As a result, the statement was at best misleading. This ambiguity may be a function of the indefinite nature of the past tense – it is not always clear to how far in the past a statement refers. However, it illustrates the challenge the drafter faces in trying to avoid ambiguity.

### ***Problem 3-1***

The following provision has an ambiguity. Identify and explain what the ambiguity is and how it arose. Then rewrite the provision to remove the ambiguity.

**Allocation of Losses.** Losses shall be borne by the General Partner and the Limited Partners in equal shares.

### ***Problem 3-2***

The following provision has an ambiguity. Identify and explain what the ambiguity is and how it arose. Then rewrite the provision to remove the ambiguity.

**Delivery of Bids.** All bids must be delivered to Seller's office between April 3, 2010 and April 16, 2010.

***Problem 3-3***

The following provision has an ambiguity. Identify and explain what the ambiguity is and how it arose. Then rewrite the provision to remove the ambiguity.

**Insulation.** Contractor shall insulate all domestic water piping and rainwater piping installed above finished ceilings.

***Problem 3-4***

The following provision has an ambiguity. Identify and explain what the ambiguity is and how it arose. Then rewrite the provision to remove the ambiguity.

**Use of Collateral.** Borrower shall not sell, lease, license, pledge or encumber, without Lender's prior written permission, all or any part of the Collateral.

***Problem 3-5***

The following provision has multiple ambiguities. Identify and explain what the ambiguities are and how they arose. Then rewrite the provision to remove them.

**Assignment.** Purchaser may assign its rights under this Agreement to any Affiliate of Purchaser that has a Net Worth of at least \$1,000,000.

***Drafting Exercise 3-A***

Rewrite the following clause to remove the ambiguities and other drafting errors.

**Non-competition.** For one year after Manager's employment with Company ends, Manager shall not be employed by or provide services to any firm that was a client of Company within the one year prior to the termination of Manager's employment or with whom Company may have been negotiating during Manager's employment with Company if Manager participated in such negotiations or had contact with that firm in course of Manager's employment.

## OTHER DRAFTING TIPS

### Use the Appropriate Verb

Contract terms are like a wizard’s spells: if the proper words are not invoked, the whole thing may come to naught . . . or worse. This is not to say that rigid formalism is required. It means merely that, after determining what type of term each clause of an agreement should be, the drafter should be careful to use the word or words necessary in each case to create the type of term intended.

This may sound fairly simple and, indeed, it is. Nevertheless, errors abound. In particular, you are likely to see errant uses of the word “will.” Drafters frequently says things such as “the seller will delivery the goods,” or “the buyer will pay each installment on the first business day of each month.” Presumably, each of these sentences was intended to impose a duty. That is, each was to be a covenant, a promise to perform. However, “will” is merely a prediction of future events, not a promise or a duty. To impose a duty, the draft of these sentences should have used “shall.” For further guidance, consult the following chart.

Type of Term	Purpose	Proper Word(s)
Representation	To create a representation	“represents”
Warranty	To create a warranty	“warrants”
Covenant	To create a duty	“shall” (or “shall not”)
Discretionary Authority	To create discretionary authority	“may” (or “need not”)
Condition to an Obligation	To create a condition	“if”

### *Drafting Exercise 3-B*

Review the sample lease on pages 14-18. Print out those pages and circle every improper use of the words “shall” and “will.”

### Use Active Voice

Imagine the following clause in a residential lease:

**The premises shall be kept in good repair.**

Does this impose an obligation on the landlord or on the tenant? Passive voice can on occasion be proper – particularly in the phrasing of a condition – but do not use it by accident.

## Use Consistent Wording

Ralph Waldo Emerson famously observed that “[a] foolish consistency is the hobgoblin of little minds.”<sup>4</sup> But for the drafter of written agreements, consistency is not foolish, it is essential. Lawyers and judges are trained to assume that the same word or phrase carries with it the same meaning throughout a single document. A corollary to this principle is that different words and phrases presumably mean different things. Accordingly, if you mean the same thing, use the same words. Variation in language may make for appealing prose, but at the cost of creating ambiguity. In short, follow the following two maxims:

Never change your language unless you wish to change your meaning.<sup>5</sup>

Always change your language if you wish to change your meaning.

Failure to follow these rules can lead to significant interpretive problems, and cause a court to interpret the agreement in a way that the drafter did not intend. For example, consider an agreement that contained the following two clauses:

**Except as otherwise provided in this Agreement, Shareholders may not sell, transfer, assign, pledge, convey or otherwise dispose of (by operation of law or otherwise) shares of the Corporation.**

**If a Shareholder proposes to transfer shares of the Corporation and dies prior to the closing of the transaction . . . .**

Notice that the first clause uses six verbs (in red), each with a slightly different meaning, while the second clause uses only one of them. This suggests that the second clause has a much more narrow scope than the first, yet that may not be what the parties meant.

## Place Modifiers Next to the Word or Phrase They Modify

Many competent writers are a bit too casual in their placement of words and phrases within a sentence. Consider the difference between the following two sentences:

Never include a provision in a contract which you do not understand.

Never include in a contract a provision which you do not understand.

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<sup>4</sup> The line continues, “adored by little statesmen, philosophers and divines.” Essays: First Series. *Self-Reliance* (1841).

<sup>5</sup> There is a rule of statutory construction, presumably analogous to contract interpretation, that says that if different language is used in the same connection in different parts of a statute, presumably it has different meaning and effect. *Quarles v. St. Clair*, 711 F.2d 691, 701 n.31 (5th Cir. 1983); *In re Ramirez*, 204 F.3d 595, 599 (5th Cir. 2000) (Benavides, J., concurring).

These sentences mean very different things. In the former, it is a contract that is not understood; in the latter, it is a provision. Admittedly, this example is unlikely to confuse anyone: a reader of either is likely to understand that the author meant what the second sentence says. That will not always be the case. Improper placement of words or phrases can sometimes create difficult interpretive problems.

### ***Problem 3-6***

Employee quits and then claims severance benefits under an employment agreement that provides for such payments:

**... on termination of Employee's employment by Company.**

Is Employee entitled to the benefits? Rewrite the clause without changing, subtracting or adding any words – merely by reordering the words used – to make it clear that benefits are not available in this situation. Then rewrite the original clause – by changing only one word – to make it clear that Employee is entitled to benefits on these facts.

To further illustrate the point, study the chart below. It shows the different meanings that are created by inserting the word “only” into different places in a sentence.

<b><i>Placement</i></b>	<b><i>Effect</i></b>
<i>Only</i> the attorney sent him the will yesterday.	No one else sent the will ( <i>e.g.</i> , not the testator).
The <i>only</i> attorney sent him the will yesterday.	No other attorney was involved.
The attorney <i>only</i> sent him the will yesterday.	The attorney did nothing else ( <i>e.g.</i> , call or talk).
The attorney sent <i>only</i> him the will yesterday.	The attorney sent the will to nobody else.
The attorney sent him <i>only</i> the will yesterday.	The attorney sent nothing else with the will.
The attorney sent him the <i>only</i> will yesterday.	There were no other wills.
The attorney sent him the will <i>only</i> yesterday.	Emphasizes the timing, implying that the will should have been sent earlier.
The attorney sent him the will yesterday <i>only</i> .	Emphasizes the day, implying that the will was to be sent on multiple days.

Be very careful when using an adverb such as “only,” it is a powerful word that can significantly change the meaning of a sentence when put in the wrong place.

### Punctuation Matters

Compare the two sentences below:

*The assailant was a fat, armed man.*      |      *The assailant was a fat-armed man.*

The one on the left refers to an overweight man with a weapon. The one on the right refers to a man with fat arms. Now compare these two sentences, made famous by a book title:

*The panda eats shoots and leaves.*      |      *The panda eats, shoots, and leaves.*

The sentence on the left identifies two things the animal eats. The sentence on the right refers to three things the animal does, one of which might involve a gun:



The problems of interpretation presented by improper punctuation are not always so fanciful. Numerous cases, including at least one decided by the United States Supreme Court, have rested in whole or in part on the presence or absence of a comma.<sup>6</sup> The most common problem involves a modifying clause that either was or was not set off by commas.

### Problem 3-7

The following two sentences differ only in the comma after the word “terms.” How do the two sentences differ in meaning? *See Application by Rogers Cable Communications, Inc. Regarding Aliant Telecom Inc.’s Termination and Assignment of a Support Structure Agreement*, CRTC 2006-45 (Can. Radio & Tel. Comm’n 2006) (accessible at <http://www.jweinsteinlaw.com/pdfs/dt2006-45.pdf>).

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<sup>6</sup> See, e.g., *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235 (1989) (interpreting the Bankruptcy Code); *Shelby County State Bank v. Van Diest Supply Co.*, 303 F.3d 832 (7th Cir. 2002) (interpreting a security agreement); *Berkshire Aircraft, Inc. v. AEC Leasing Co.*, 84 P.3d 608 (Kan. Ct. App. 2002) (interpreting a contract); *Judson v. Associated Meats & Seafoods*, 651 P.2d 222 (Wash. App. 1982) (interpreting a statute that had been amended to remove a comma); *Reeves v. American Security & Trust Co.*, 115 F.2d 145, 146 (D.C. App. 1940) (interpreting a will) (“There is no difficulty in this case which could not have been forestalled by application of the fundamental rules of punctuation which the testator doubtless learned in grammar school. The litigation arises out of the testator’s fondness for commas and his corresponding aversion to periods. Somewhere in the above-quoted provision a period (or a semi-colon) should have been inserted instead of a comma. The dispute is over where that period belongs.”). *But cf.* *Overhauser v. United States*, 45 F.3d 1085, 1087 (7th Cir. 1995) (expressing skepticism about the grammatical expertise of the drafters of legal documents, and therefore of the relevance of grammatical arguments).

**The contract shall continue in force for a period of five years from the date it is made, and thereafter for successive five-year terms, unless and until terminated by one year prior notice in writing by either party.**

**The contract shall continue in force for a period of five years from the date it is made, and thereafter for successive five-year terms unless and until terminated by one year prior notice in writing by either party.**

### Double-Check . . . Everything

Sometimes a contract term simply does not work the way it was intended. For example, a computational formula may simply be wrong in some way, with the result that it yields a result that neither party intended. Consider an employment contract that provides:

**For the first year of this Agreement, Employee's Base Salary shall be \$100,000. Beginning on the first anniversary of the Agreement and on each subsequent anniversary during the Employment Term, the Base Salary of Executive shall be increased by 7 percent.**

There are at least two potential problems with this language. First, the increases should probably occur on the anniversary of the employment term, not the anniversary of the Agreement. In other words, if the parties signed the Agreement on June 13 for employment to commence on August 1, the increases should occur in subsequent years on August 1st, not June 13th. Second, the parties probably intended that the 7% increase be based on the previous year's salary, not on the first year's salary. The significance of this compounding can be seen over time:

	<b>Percentage Increase Computed from Base Salary</b>	<b>Percentage Increase Computed from Previous Year's Salary</b>
<b>Year 1 (Base Salary)</b>	\$100,000	\$100,000
<b>Year 2</b>	\$107,000	\$107,000
<b>Year 3</b>	\$114,000	\$114,490
<b>Year 4</b>	\$121,000	\$122,504
<b>Year 5</b>	\$128,000	\$131,080
<b>Year 6</b>	\$135,000	\$140,255
<b>Year 7</b>	\$142,000	\$150,073
<b>Year 8</b>	\$149,000	\$160,578

The careful transactional lawyer must double-check computational formulas to make sure they produce the result intended. In other words, input data, follow the contractual language to generate output, and then compare that to what the parties intend. The difficulty in doing this the same difficulty that confronts anyone trying to edit his or her own work: the writer knows what was intended and, unless careful, will read the words as saying the same thing. The careful drafter will fight that tendency and read the drafted language critically and with an open mind.

Another similar problem occurs when subsequent events are not what the drafter anticipated they would be and the language used does not contemplate the situation that has arisen. Yet this is precisely what lawyers are paid to do: to imagine everything that might occur and draft accordingly. Consider this recent example.

Bank's deposit account agreement with Depositor provides that "[a]ny fees or expenses (including attorney's fees and expenses) the Bank incurs in responding to legal process may be charged against any account you maintain with the Bank." Bank responds to legal process, thereby incurring substantial attorney's fees. The fees incurred far exceed the balance credited to Depositor's deposit account. Does the clause limit Bank's recourse to the deposit account or is Depositor personally liable for the portion of the fees in excess of the deposit account balance? Put another way, did the lawyer who drafted the agreement consider the possibility that the deposit account may not have a balance sufficient to cover the fees incurred? See *Gunderson v. Wells Fargo Bank*, 2010 WL 2636162 (Tex. Ct. App. 2010).

### *Drafting Exercise 3-C*

Aside from being a bit awkward, what is wrong with the following choice-of-forum clause? Rewrite the clause to avoid the problem.

**Any legal action may be brought and maintained only in the jurisdiction where Buyer's principal residence is located. For this purpose, the jurisdiction of Buyer's principal residence is located in a state if the Buyer resides longer during a calendar year in that state than in another state.**

## CONTRACT INTERPRETATION

Many old cases dealing with contract formation refer to a requirement that there be a “meeting of the minds.” This traditional view of contract was *subjective* in that it examined what each party intended. Unless the parties’ intent matched, there was no contract. In contrast, modern contract law, embraced by most states and reflected in the Restatement (Second) of Contracts, is premised on an *objective* theory of contract.<sup>1</sup> Instead of asking if the parties intended the same thing, the objective theory of contracts looks at their communications. As Justice Holmes famously observed, “the making of a contract depends . . . not on the parties’ having *meant* the same thing but on their having *said* the same thing.”<sup>2</sup> Thus we look at their “manifestations of assent.”

Nevertheless, remnants of the subjective theory of contract survive. Specifically, if parties attach materially different meanings to their manifestations, and neither party has reason to know of the meaning attached by the other, no contract is formed.<sup>3</sup> The following decision – a classic of contracts law – can be interpreted as an example of this doctrine in operation.

***FRIGALIMENT IMPORTING CO., LTD. v. B.N.S. INTERNATIONAL SALES CORP.***  
**190 F. Supp. (S.D.N.Y. 1960)**

FRIENDLY, Circuit Judge.

The issue is, what is chicken? Plaintiff says “chicken” means a young chicken, suitable for broiling and frying. Defendant says “chicken” means any bird of that genus that meets contract specifications on weight and quality, including what it calls “stewing chicken” and plaintiff pejoratively terms “fowl.” Dictionaries give both meanings, as well as some others not relevant here. To support its, plaintiff sends a number of volleys over the net; defendant essays to return them and adds a few serves of its own. Assuming that both parties were acting in good faith, the case nicely illustrates Holmes’ remark “that the making of a contract depends not on the agreement of two minds in one intention, but on the agreement of two sets of external signs – not on the parties’ having *meant* the same thing but on their having said the *same* thing.” The Path of the Law, in *Collected Legal*

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<sup>1</sup> See Restatement (Second) of Contracts § 3 (defining “agreement” as a manifestation of mutual assent by two or more persons). See also Restatement (Second) of Contracts §§ 18-19 (explaining what constitutes a manifestation of assent).

<sup>2</sup> Oliver W. Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 457, 464 (1897). See also *Navair, Inc. v. IFR Americas, Inc.*, 519 F.3d 1131, 1139 (10th Cir. 2008) (“Put another way, the inquiry will focus not on the question of whether the subjective minds of the parties have met, but on whether their outward expression of assent is sufficient to form a contract”).

<sup>3</sup> See Restatement (Second) of Contracts § 20 (also reaching the same result if both parties have reason to know of the meaning attached by the other). See also Restatement (Second) of Contracts § 201(3) (providing similarly).

Papers, p. 178. I have concluded that plaintiff has not sustained its burden of persuasion that the contract used “chicken” in the narrower sense.

The action is for breach of the warranty that goods sold shall correspond to the description, Two contracts are in suit. In the first, dated May 2, 1957, defendant, a New York sales corporation, confirmed the sale to plaintiff, a Swiss corporation, of

US Fresh Frozen Chicken, Grade A, Government Inspected, Eviscerated 2½-3 lbs. and 1½-2 lbs. each all chicken individually wrapped in cryovac, packed in secured fiber cartons or wooden boxes, suitable for export

75,000 lbs. 2½-3 lbs.....	@\$33.00
25,000 lbs. 1½-2 lbs.....	@\$36.50
per 100 lbs. FAS New York	

scheduled May 10, 1957 pursuant to instructions from Penson & Co., New York.

The second contract, also dated May 2, 1957, was identical save that only 50,000 lbs. of the heavier “chicken” were called for, the price of the smaller birds was \$37 per 100 lbs., and shipment was scheduled for May 30. The initial shipment under the first contract was short but the balance was shipped on May 17. When the initial shipment arrived in Switzerland, plaintiff found, on May 28, that the 2½-3 lbs. birds were not young chicken suitable for broiling and frying but stewing chicken or “fowl”; indeed, many of the cartons and bags plainly so indicated. Protests ensued. Nevertheless, shipment under the second contract was made on May 29, the 2½-3 lbs. birds again being stewing chicken. Defendant stopped the transportation of these at Rotterdam.

This action followed. Plaintiff says that, notwithstanding that its acceptance was in Switzerland, New York law controls \* \* \*, defendant does not dispute this, and relies on New York decisions. I shall follow the apparent agreement of the parties as to the applicable law.

Since the word “chicken” standing alone is ambiguous, I turn first to see whether the contract itself offers any aid to its interpretation. Plaintiff says the 1½-2 lbs. birds necessarily had to be young chicken since the older birds do not come in that size, hence the 2½-3 lbs. birds must likewise be young. This is unpersuasive – a contract for “apples” of two different sizes could be filled with different kinds of apples even though only one species came in both sizes. Defendant notes that the contract called not simply for chicken but for “US Fresh Frozen Chicken, Grade A, Government Inspected.” It says the contract thereby incorporated by reference the Department of Agriculture’s regulations, which favor its interpretation; I shall return to this after reviewing plaintiff’s other contentions.

The first hinges on an exchange of cablegrams which preceded execution of the formal contracts. The negotiations leading up to the contracts were conducted in New York between defendant’s secretary, Ernest R. Bauer, and a Mr. Stovicek, who was in New York for the Czechoslovak government at the World Trade Fair. A few days after meeting Bauer at the fair, Stovicek telephoned and inquired whether defendant would be interested in exporting poultry to

Switzerland. Bauer then met with Stovicek, who showed him a cable from plaintiff dated April 26, 1957, announcing that they “are buyer” of 25,000 lbs. of chicken 2½-3 lbs. weight, Cryovac packed, grade A Government inspected, at a price up to 33¢ per pound, for shipment on May 10, to be confirmed by the following morning, and were interested in further offerings. After testing the market for price, Bauer accepted, and Stovicek sent a confirmation that evening. Plaintiff stresses that, although these and subsequent cables between plaintiff and defendant, which laid the basis for the additional quantities under the first and for all of the second contract, were predominantly in German, they used the English word “chicken”; it claims this was done because it understood “chicken” meant young chicken whereas the German word, “Huhn,” included both “Brathuhn” (broilers) and “Suppenhuhn” (stewing chicken), and that defendant, whose officers were thoroughly conversant with German, should have realized this. Whatever force this argument might otherwise have is largely drained away by Bauer’s testimony that he asked Stovicek what kind of chickens were wanted, received the answer “any kind of chickens,” and then, in German, asked whether the cable meant “Huhn” and received an affirmative response. Plaintiff attacks this as contrary to what Bauer testified on his deposition in March, 1959, and also on the ground that Stovicek had no authority to interpret the meaning of the cable. The first contention would be persuasive if sustained by the record, since Bauer was free at the trial from the threat of contradiction by Stovicek as he was not at the time of the deposition; however, review of the deposition does not convince me of the claimed inconsistency. As to the second contention, it may well be that Stovicek lacked authority to commit plaintiff for prices or delivery dates other than those specified in the cable; but plaintiff cannot at the same time rely on its cable to Stovicek as its dictionary to the meaning of the contract and repudiate the interpretation given the dictionary by the man in whose hands it was put. Plaintiff’s reliance on the fact that the contract forms contain the words “through the intermediary of:,” with the blank not filled, as negating agency, is wholly unpersuasive; the purpose of this clause was to permit filling in the name of an intermediary to whom a commission would be payable, not to blot out what had been the fact.

Plaintiff’s next contention is that there was a definite trade usage that “chicken” meant “young chicken.” Defendant showed that it was only beginning in the poultry trade in 1957, thereby bringing itself within the principle that “when one of the parties is not a member of the trade or other circle, his acceptance of the standard must be made to appear” by proving either that he had actual knowledge of the usage or that the usage is “so generally known in the community that his actual individual knowledge of it may be inferred.” 9 Wigmore, Evidence (3d ed. § 1940) 2464. Here there was no proof of actual knowledge of the alleged usage; indeed, it is quite plain that defendant’s belief was to the contrary. In order to meet the alternative requirement, the law of New York demands a showing that “the usage is of so long continuance, so well established, so notorious, so universal and so reasonable in itself, as that the presumption is violent that the parties contracted with reference to it, and made it a part of their agreement.” *Walls v. Bailey*, 49 N.Y. 464, 472-473 (1872).

Plaintiff endeavored to establish such a usage by the testimony of three witnesses and certain other evidence. Strasser, resident buyer in New York for a large chain of Swiss cooperatives, testified that “on chicken I would definitely understand a broiler.” However, the force of this testimony was considerably weakened by the fact that in his own transactions the witness, a careful businessman, protected himself by using “broiler” when that was what he wanted and “fowl” when

he wished older birds. Indeed, there are some indications, dating back to a remark of Lord Mansfield, *Edie v. East India Co.*, 2 Burr. 1216, 1222 (1761), that no credit should be given “witnesses to usage, who could not adduce instances in verification.” 7 Wigmore, Evidence (3d ed. 1940), § 1954. While Wigmore thinks this goes too far, a witness’ consistent failure to rely on the alleged usage deprives his opinion testimony of much of its effect. Niesielowski, an officer of one of the companies that had furnished the stewing chicken to defendant, testified that “chicken” meant “the male species of the poultry industry. That could be a broiler, a fryer or a roaster,” but not a stewing chicken; however, he also testified that upon receiving defendant’s inquiry for “chickens,” he asked whether the desire was for “fowl or frying chickens” and, in fact, supplied fowl, although taking the precaution of asking defendant, a day or two after plaintiff’s acceptance of the contracts in suit, to change its confirmation of its order from “chickens,” as defendant had originally prepared it, to “stewing chickens.” Dates, an employee of Urner-Barry Company, which publishes a daily market report on the poultry trade, gave it as his view that the trade meaning of “chicken” was “broilers and fryers.” In addition to this opinion testimony, plaintiff relied on the fact that the Urner-Barry service, the Journal of Commerce, and Weinberg Bros. & Co. of Chicago, a large supplier of poultry, published quotations in a manner which, in one way or another, distinguish between “chicken,” comprising broilers, fryers and certain other categories, and “fowl,” which, Bauer acknowledged, included stewing chickens. This material would be impressive if there were nothing to the contrary. However, there was, as will now be seen.

Defendant’s witness Weininger, who operates a chicken eviscerating plant in New Jersey, testified “Chicken is everything except a goose, a duck, and a turkey. Everything is a chicken, but then you have to say, you have to specify which category you want or that you are talking about.” Its witness Fox said that in the trade “chicken” would encompass all the various classifications. Sadina, who conducts a food inspection service, testified that he would consider any bird coming within the classes of “chicken” in the Department of Agriculture’s regulations to be a chicken. The specifications approved by the General Services Administration include fowl as well as broilers and fryers under the classification “chickens.” Statistics of the Institute of American Poultry Industries use the phrases “Young chickens” and “Mature chickens,” under the general heading “Total chickens.” and the Department of Agriculture’s daily and weekly price reports avoid use of the word “chicken” without specification.

Defendant advances several other points which it claims affirmatively support its construction. Primary among these is the regulation of the Department of Agriculture, 7 C.F.R. § 70.300-70.370, entitled, “Grading and Inspection of Poultry and Edible Products Thereof.” and in particular 70.301 which recited:

Chickens. The following are the various classes of chickens:

- (a) Broiler or fryer . . .
- (b) Roaster . . .
- (c) Capon . . .
- (d) Stag ...
- (e) Hen or stewing chicken or fowl . . .
- (f) Cock or old rooster . . .

Defendant argues, as previously noted, that the contract incorporated these regulations by reference. Plaintiff answers that the contract provision related simply to grade and Government inspection and did not incorporate the Government definition of “chicken,” and also that the definition in the Regulations is ignored in the trade. However, the latter contention was contradicted by Weininger and Sadina; and there is force in defendant’s argument that the contract made the regulations a dictionary, particularly since the reference to Government grading was already in plaintiff’s initial cable to Stovicek.

Defendant makes a further argument based on the impossibility of its obtaining broilers and fryers at the 33¢ price offered by plaintiff for the 2½-3 lbs. birds. There is no substantial dispute that, in late April, 1957, the price for 2½-3 lbs. broilers was between 35 and 37¢ per pound, and that when defendant entered into the contracts, it was well aware of this and intended to fill them by supplying fowl in these weights. It claims that plaintiff must likewise have known the market since plaintiff had reserved shipping space on April 23, three days before plaintiff’s cable to Stovicek, or, at least, that Stovicek was chargeable with such knowledge. It is scarcely an answer to say, as plaintiff does in its brief, that the 33¢ price offered by the 2½-3 lbs. “chickens” was closer to the prevailing 35¢ price for broilers than to the 30¢ at which defendant procured fowl. Plaintiff must have expected defendant to make some profit – certainly it could not have expected defendant deliberately to incur a loss.

Finally, defendant relies on conduct by the plaintiff after the first shipment had been received. On May 28 plaintiff sent two cables complaining that the larger birds in the first shipment constituted “fowl.” Defendant answered with a cable refusing to recognize plaintiff’s objection and announcing “We have today ready for shipment 50,000 lbs. chicken 2½-3 lbs. 25,000 lbs. broilers 1½-2 lbs.,” these being the goods procured for shipment under the second contract, and asked immediate answer “whether we are to ship this merchandise to you and whether you will accept the merchandise.” After several other cable exchanges, plaintiff replied on May 29 “Confirm again that merchandise is to be shipped since resold by us if not enough pursuant to contract chickens are shipped the missing quantity is to be shipped within ten days stop we resold to our customers pursuant to your contract chickens grade A you have to deliver us said merchandise we again state that we shall make you fully responsible for all resulting costs.” Defendant argues that if plaintiff was sincere in thinking it was entitled to young chickens, plaintiff would not have allowed the shipment under the second contract to go forward, since the distinction between broilers and chickens drawn in defendant’s cablegram must have made it clear that the larger birds would not be broilers. However, plaintiff answers that the cables show plaintiff was insisting on delivery of young chickens and that defendant shipped old ones at its peril. Defendant’s point would be highly relevant on another disputed issue – whether if liability were established, the measure of damages should be the difference in market value of broilers and stewing chicken in New York or the larger difference in Europe, but I cannot give it weight on the issue of interpretation. Defendant points out also that plaintiff proceeded to deliver some of the larger birds in Europe, describing them as “poulets”; defendant argues that it was only when plaintiff’s customers complained about this that plaintiff developed the idea that “chicken” meant “young chicken.” There is little force in this in view of plaintiff’s immediate and consistent protests.

When all the evidence is reviewed, it is clear that defendant believed it could comply with the contracts by delivering stewing chicken in the 2½-3 lbs. size. Defendant's subjective intent would not be significant if this did not coincide with an objective meaning of "chicken." Here it did coincide with one of the dictionary meanings, with the definition in the Department of Agriculture Regulations to which the contract made at least oblique reference, with at least some usage in the trade, with the realities of the market, and with what plaintiff's spokesman had said. Plaintiff asserts it to be equally plain that plaintiff's own subjective intent was to obtain broilers and fryers; the only evidence against this is the material as to market prices and this may not have been sufficiently brought home. In any event it is unnecessary to determine that issue. For plaintiff has the burden of showing that "chicken" was used in the narrower rather than in the broader sense, and this it has not sustained.

This opinion constitutes the Court's findings of fact and conclusions of law. Judgment shall be entered dismissing the complaint with costs.

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### *Note*

In an homage to Judge Friendly's opening question, "what is a chicken?" the Supreme Court of Wyoming began its opinion in a similar case with "What is a cow?" *Shrum v. Zeltwanger*, 559 P.2d 1384 (Wyo. 1977). The court did not answer the question, however. It merely reversed a summary judgment rendered by the trial court on the basis of the existence of a factual question.

The misunderstanding in *Frigalimont* went to the heart of the deal: what the seller was to sell and the buyer was to buy. If the parties' misunderstanding is not material – for example, one dealing with a minor delivery term – then a contract will be formed despite the misunderstanding. A contract will also be formed despite a subjective misunderstanding about a material matter if one of the parties had reason to know of the meaning ascribed by the other to their manifestations of assent. In making the determination of what the parties had reason to know, contract law looks to both course of dealing and usage of trade. Read Restatement (Second) of Contracts §§ 203(b), 219-223. Now read U.C.C. §§ 1-303.

### *Problem 4-1*

Write a one-sentence description of how course of dealing and usage of trade differ. Which takes priority over the other?

Usage of trade can be very important in interpreting the parties' manifestation of assent. Consider an agreement under which Buyer agreed to purchase 1,000 ounces of silver from Seller. Does that agreement call for an amount measured in avoirdupois ounces (437.5 grains) or troy

ounces (480 grains)? Or consider a contract for the purchase and sale of 1,000 tons of steel. Does that call for long tons (2,240 lbs.), short tons (2,000 lbs.) or metric tons (2,200 lbs.)? Usage of trade can and often does supply the answer to these questions.

***RAGUS COMPANY V. CITY OF CHICAGO***  
**628 N.E.2d 999 (Ill Ct. App. 1993)**

Justice RIZZI delivered the opinion of the court:

This action arises out of a contract between Ragus Company (Ragus) and the City of Chicago (City). The contract called for Ragus to supply the City with a certain quantity of rodent traps. As a result of differing interpretations regarding the number of traps specified in the contract, Ragus supplied the City with only half of the rodent traps the City expected. The City refused delivery and suspended Ragus from its bidding process for six months. Ragus subsequently brought a five-count complaint against the City and three of the City's employees, Alexander Grzyb, Walter Brueggen and Mark Pofelski.

Following a hearing on defendants' motion to dismiss, the trial court dismissed three of the five counts with prejudice. Ragus now appeals alleging \* \* \* that the trial court erred in its interpretation of the contract \* \* \*. We affirm and remand.

The facts of this case are undisputed. In July 1991, the City announced that it was seeking bids from companies to supply the City with Gotcha Glue Boards, a brand of rodent traps. The City's announcement called for the following specifications for the traps:

150 cases of 5½" x 11"; 24/case  
75 cases of 11" x 11"; 12/case.

Ragus submitted a bid offering to supply the City with the traps at a price of \$30.00 a case, for a total of \$6,750.00. The City awarded the contract to Ragus on August 18, 1991. On October 3 and 4, 1991, Ragus attempted to deliver to the City 150 cases each containing 24 of the bigger traps and 75 cases each containing 12 of the smaller traps. The City refused delivery because it was expecting 150 cases containing 24 *pairs* of the larger traps and 75 cases containing 12 *pairs* of the smaller traps. On October 16, 1991, the City notified Ragus that it had 10 days to cure what it perceived as a defect in Ragus' performance by delivering twice the number of traps. Ragus claimed that it was in compliance with the contract and did not tender the additional traps demanded by the City. On November 7, 1991, the City suspended from the bidding process until April 26, 1992.

Ragus then filed a five-count complaint seeking declaratory relief and money damages. In count I of the complaint, Ragus asked the court to construe the contract and declare that Ragus had complied with the contract. \* \* \*

Defendants in turn filed a motion to dismiss the complaint \* \* \*. A hearing was had on this motion. At the hearing defendants presented affidavits to show that usage of trade demonstrates that “24/case” refers to 24 pairs per case.

The president of the manufacturer of Gotcha Glue Boards averred that for the last 10 years Gotcha Glue Boards have been packaged in pairs. Defendant Alexander Grzyb, the City’s purchasing agent averred that once the contract was terminated with Ragus, he awarded a contract for Gotcha Glue Boards to Production Dynamics Company. That contract called for “150 cases of Gotcha Glue Boards, 5½” x 11”; 24/case.” Production Dynamics Company supplied the City with 150 cases each containing 24 pairs of traps. Lastly, Tony Proscia, a City employee averred that he oversees goods shipped by various suppliers to the City. Every other case of 5½” x 11” Gotcha Glue Boards he inspected contained 24 pairs of traps.

In an attempt to counter the above affidavits, Ragus presented the affidavit of its president, George L. Lowe. This affidavit, however, simply did not address the factual allegations concerning usage of trade. Accordingly, the factual averments of defendants’ affidavits are admitted.

Following the hearing, the trial court construed the contract in favor of defendants and dismissed count I of the complaint. \* \* \* [Ragus appealed].

Ragus initially contends that the trial court improperly granted the motion to dismiss as to count I because the court treated the motion to dismiss as a motion for summary judgment. Under the circumstances present in the case at bar, a [motion to dismiss] and a motion for summary judgment are essentially the same. The question raised by both motions is whether there is a genuine issue of fact. In this case there is no factual dispute. Where no issue of fact exists concerning a contract, a court may interpret the contract as a matter of law and make an appropriate ruling, including a dismissal \* \* \*.

Ragus next argues that the court erred when it referred to usage of trade pursuant to the Uniform Commercial Code section 1-205(4), in order to interpret the contract where the contract itself was unambiguous. We, however, disagree that the contract was unambiguous. The dispute focused on the interpretation of whether “24/case” and “12/case” refer to individual traps or to pairs of traps. In order to eliminate ambiguity from a contract it is necessary to exclude other reasonable interpretations. The above quoted language does not exclude the reasonable interpretation that 24 pairs and 12 pairs per case are the number of traps called for in the contract. Therefore, reference to usage of trade was proper.

Ragus also argues that defendants failed to present sufficient evidence establishing usage of trade. We disagree. Defendants presented the affidavits of three people who currently deal with Gotcha Glue Boards, including the president of the company that manufactures these traps. Taken together, the affidavits establish that the sole manufacturer of Gotcha Glue Boards packages and sells the traps in pairs, middle men purchase and resell the traps in pairs, and the City buys and receives the traps in pairs. Ragus failed to counter these factual averments. We hold that the trial court had before it sufficient evidence to find that when a party dealing in Gotcha Glue Boards spoke of

“24/case” or “12/case,” this meant 24 pairs and 12 pairs per case. The trial court properly construed the contract and dismissed count I of Ragus’ complaint.

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### Questions

1. How did the court in *Frigalment* deal with usage of trade? What would the result have been if the seller had sued the buyer?
2. Did the usage of trade in *Ragus* supplement the terms of the parties’ written agreement or to contradict the terms of their written agreement?
3. Why should courts consider course of dealing and usage of trade in interpreting a contract? Are the reasons for considering course of dealing the same as or different from the reasons for considering usage of trade? Do you agree that usage of trade should be used to interpret private agreements? For a critical analysis of the use of usage, see Lisa Bernstein, *The Questionable Empirical Basis of Article 2’s Incorporation Strategy: A Preliminary Study*, 66 U. Chi. L. Rev. 710 (1999).
4. Should usage of trade be considered when one of the contracting parties is new to the trade? Compare *Foxco Industries, Ltd. v. Fabric World, Inc.*, 595 F.2d 976 (5th Cir. 1979), with *Flower City Painting Contractors, Inc. v. Gumina Construction Co.*, 591 F.2d 162 (2d Cir. 1979). Do the Restatement (Second) of Contracts and the U.C.C. deal with this issue in the same way?
5. In assessing usage of trade, how should courts determine what the applicable trade is, given that competitors probably do not contract with each other nearly as often as they contract with their own suppliers and customers? See *Martin Rispens & Son v. Hall Farms, Inc.*, 621 N.E.2d 1078 (Ind. 1993) (“Rispens and Hall Farms are not in the same trade; Rispens is in the business of selling seeds while Hall Farms is in the business of planting seeds and producing crops. Thus, Rispens can [rely on the usage of trade] only by establishing that Hall Farms was or should have been aware of the asserted usage of trade.”). Cf. *Mieske v. Bartell Drug Co.*, 593 P.2d 1308 (Wash. Ct. App. 1979) (evidence established existence of trade “usage among film processors, but not as between commercial film processors and their retail customers”).

Numerous other rules of interpretation exist. Read Restatement (Second) of Contract §§ 202, 203(a), (c), (d), 206, 207, 227. Now, try the following problems.

***Problem 4-2***

An employment contract prohibits the employee, for the three years after the employment period ends, from competing with the employer anywhere “within 50 miles of the Company office.” How should that distance be measured, by radius (*i.e.*, by air) or by driving route? What rule or rules of interpretation are most relevant in deciding this question?

***Problem 4-3***

An agreement for a student loan provides that payment becomes due “the end of the ninth month following the month in which Student ceases to be matriculated.” After receiving a law degree, Student continues to take graduate-level classes part time but not in a degree program. Will the payment become due while Student continues to take those classes (*i.e.*, is Student still “matriculated”)? What rule or rules of interpretation are most relevant in deciding this question?

***Drafting Exercise 4-A***

You are an attorney who has been presented with a draft loan agreement containing the clause at issue in Problem 4-3. Redraft the clause to avoid the interpretive problem.

1. If your last name begins with a letter from A to L, you represent the lender.
2. If your last name begins with a letter from M to Z, you represent Student.

***Problem 4-4***

A lease of premises for a drug store provides for a monthly rental equal to \$10,000 plus 2.75% of the “gross sales” of the business. The lease defines “gross sales” as “the aggregate of all retail sales of every kind, type, and description, and services performed for patrons made in, upon, or from the demised premises.” In computing the rent obligation, must the lessee treat as “gross sales” amounts paid by customers for state lottery tickets? What rule or rules of interpretation are most relevant in deciding this question?

**Problem 4-5**

Subcontractor's agreement with Contractor provides that "Contractor shall pay Subcontractor within 10 days after receiving payment from Owner." Subcontractor has fully performed its obligations and Contractor has properly completed the construction project, but Owner is insolvent and has not paid Contractor. Must Contractor pay Subcontractor? What rule or rules of interpretation are most relevant in deciding this question?

**Drafting Exercise 4-B**

You are an attorney who has been presented with a draft agreement for construction services between Contractor and Subcontractor. The draft contains the clause at issue in Problem 4-5. Redraft the clause to avoid the interpretive problem.

1. If your last name begins with a letter from A to L, you represent Contractor.
2. If your last name begins with a letter from M to Z, you represent Subcontractor.

Some common maxims of statutory interpretation are also used when interpreting contracts. Two of the most common – both of which were discussed in the Orientation Materials – are known by their expression in Latin: (i) *ejusdem generis* ("of the same genus or class"); and (ii) *expressio unius est exclusio alterius* ("the expression of one thing excludes another").

**Problem 4-6**

Which maxim of interpretation would you rely to resolve each of the following interpretive questions? How would you resolve the questions asked?

- A. An apartment lease provides that the tenant may keep "cats and dogs" in the leased apartment. May the tenant keep a gerbil there?
- B. A lease provides that the tenant may keep "sheep, cows, pigs, and other animals" on a leased farmland. May the tenant keep alpacas? What about ostriches? What about tigers?

**Problem 4-7**

A contract for the sale of a photography business that the seller will not compete with the buyer "for the school photography work in any school in Grant County, with the exception of Marion High School and Bennett High School." May the seller compete with the buyer for the photography of Marion College students? What interpretive rules and maxims would you use in resolving this question?

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## THE PAROL EVIDENCE RULE

As we saw in the last unit of study, courts sometimes struggle when interpreting the parties' agreement. When the parties' agreement is in writing, that struggle is complicated by the question of whether it is appropriate to even consider the evidence that one or both parties seek to admit. This issue is the focus of the parol evidence rule. The parol evidence rule protects the integrity of the parties' written agreement. It does this by restricting either party's ability to contradict or supplement the terms expressed in that writing. In other words, the parol evidence rule operates as a gate keeper that determines what evidence the finder of fact may consider in determining to what terms the parties have agreed. If the parol evidence rule bars a party from attempting to prove that the agreement includes a particular term outside of the parties' writing, the agreement will be enforced as written, without regard to the parol term to which the parties have allegedly agreed.

Note that while the word "parol" literally means "oral," for this purpose its meaning is much broader. The parol evidence rule covers not only terms allegedly agreed to orally, but also evidence of written terms that are extrinsic to the written memorial of agreement. In other words, when a written memorial of an agreement exists, the parol evidence rule limits a party's ability to offer extrinsic evidence of prior or contemporaneous terms to supplement or contradict the written memorial, whether the evidence be written or oral.

The parol evidence rule is based on the assumption that when parties record their agreement in writing, they usually intend the writing to supersede the terms that they discussed or even agreed to in prior communications or negotiations. Therefore, unless the writing is obviously preliminary in nature or has a clear omission, the parol evidence rule considers evidence of any term alleged by one of the parties to have been agreed to, but not reflected in the writing, to be questionable. The rule treats evidence that directly contradicts the writing as particularly suspect.

The parol evidence rule is also premised, at least in part, on the fact that testimony of oral agreements is inherently unreliable. People rarely remember the exact words that were spoken. They may remember what they *meant* and may remember what they *understood* the other party to have said, but those things may differ in important ways from the precise words used. When the only evidence of the agreement is oral,<sup>4</sup> courts accept all the offered testimony and do the best they can to sort through it. But when the parties have a written memorial of their agreement, the parol evidence rule mandates that courts prefer the written record over the parties' recollections.

One note of caution on the application of the parol evidence rule. When a proffered term gets past the parol evidence rule, that does not mean it will necessarily be treated as part of the parties' agreement. It means merely that the fact finder will be permitted to receive and evaluate evidence of the term. Just as satisfaction of the statute of frauds does not prove the existence of an agreement – it merely allows a party the chance to prove the existence of an agreement – satisfaction of the parol evidence rule does not prove the existence of a term. Instead it merely allows evidence of a term to be admitted.

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<sup>4</sup> This assumes no problem with the statute of frauds.

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## THE OPERATION OF THE PAROL EVIDENCE RULE

The parol evidence rule is occasionally codified in a statute,<sup>5</sup> but more commonly is part of the common law of contracts. Although the exact contours and nuances of the common-law rule vary from jurisdiction to jurisdiction, for the most part the rule requires courts to do two things: (i) classify the writing which memorializes the agreement; and (ii) classify the type of evidence that one party seeks to admit.

### Classifying the Writing

Read Restatement (Second) of Contracts §§ 209, 210. The parol evidence rule has three different classifications for the writing that memorializes the agreement of the parties: (i) fully integrated agreements, (ii) partially integrated agreements, and (iii) non-integrated agreements. As we will see, fully integrated agreements get the most protection under the parol evidence rule, partially integrated agreements get some, and non-integrated agreements fall outside the parol evidence rule entirely.

A written agreement is integrated – either partially or fully – if it constitutes “a final expression of one or more terms of the agreement.”<sup>6</sup> In other words, an agreement is integrated if one or more of the agreed terms is recorded in (*i.e.*, integrated into) a writing. No particular form need be used for a writing to be an integrated one. Nor need the writing contain all the terms. The key elements are that it be final – that is, that it not be created during negotiations with the expectation that the terms reflected in it may change – and that it be adopted in some way by both parties.<sup>7</sup> Such adoption could be in the form of a signature but need not be. It could also be through a failure to object.<sup>8</sup>

A fully integrated agreement is one adopted by the parties as “a complete and exclusive statement of the terms of their agreement.”<sup>9</sup> Any integrated agreement that is not fully integrated is classified as partially integrated.<sup>10</sup>

As may already be apparent, there is a sort of chicken and egg problem here. If the proffered parol evidence is true, then the integrated writing really cannot be a complete and exclusive statement of the terms agreed upon. Thus we get to one of the principal problems in dealing with

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<sup>5</sup> See, e.g., U.C.C. § 2-202.

<sup>6</sup> Restatement (Second) of Contracts § 209(1).

<sup>7</sup> See U.C.C. § 2-202 (referring to a writing “intended by the *parties* as a final expression of their agreement”) (emphasis added).

<sup>8</sup> See Restatement (Second) of Contracts § 209, ill. 2.

<sup>9</sup> Restatement (Second) of Contracts § 210(1).

<sup>10</sup> Restatement (Second) of Contracts § 210(2).

the parol evidence rule. How is the court to determine whether an integrated agreement is fully or partially integrated?

Many older cases, and even some more modern ones, use the “four corners” approach. Under this approach, the judge determines the nature of the writing by looking only at the “four corners” of the writing itself, paying no attention to the specific circumstances of the parties or the credibility of the proffered parol evidence. If the writing appears to be complete on its face, it is treated as fully integrated. This “four corners” approach to integration emphasizes the logical and objective resolution of disputes in accordance with formal rules. It also is faithful to the underlying purpose of the parol evidence rule: to treat the written record as more reliable and more authoritative of the parties’ agreement. If judges were to look at the proffered parol evidence in determining whether a writing was fully integrated, they would necessarily have to evaluate the reliability of the parol evidence, which is precisely what the rule is designed to avoid.

Nevertheless, there are problems with the four corners approach. After all, how is a court to determine if a written agreement is complete on its face? Frequently, the judge will try to determine if the writing lacks any critical terms. But if you think about that, that’s not the correct question. The issue is not whether the writing contains everything that the parties *should have* agreed to – which is what that inquiry addresses – but whether it covers everything they *did* agree to. The parties’ actual agreement may cover more or less. A writing that omits some critical terms might nevertheless represent the parties’ entire agreement. Similarly, a writing that seems complete may in fact omit some terms, particularly if the omitted terms deal with a separate transaction or are otherwise only marginally related to the recorded terms.

In short, the strict “four corners” approach strained to account for situations in which the parties have entered into an agreement entirely unrelated to the terms contained in an integrated writing. Even the early cases admitted the possibility that such agreements should have been enforceable, yet they struggled to distinguish completely independent collateral agreements, which should have been enforced, from those that were supplemental to the terms in an integrated writing, which presumably should not have been enforced. Professor Williston forcefully argued that the analysis should remain objective – rather than seeking to uncover what the parties in fact intended, a court should seek to determine whether reasonable parties would naturally and normally agree to the omitted term and not demand that it be included in the writing. If so, the parol evidence was allowed to supplement the terms of the writing. If not, the omitted term was excluded from evidence. Williston successfully advocated this approach in the original Restatement of Contracts. Although it represented a departure from the “four corners” approach as courts had traditionally applied it, the departure was a modest one. The focus remained on what the judge thought objectively reasonable parties would do, rather than on the actual intentions of the litigants at hand.

Over time, the Willistonian version of the “four corners” test began to yield to a more contextual approach advanced by legal realists. Many of them argued the futility of judging the completeness of an agreement on its face or of interpreting words in isolation. They also bemoaned the potential of the four corners approach to the parol evidence rule to frustrate the actual expectations of the parties. Ultimately, largely due to the influence of Professors Corbin, Llewellyn, and other legal realists, both the Second Restatement and the UCC adopted a parol evidence rule that

was much more liberal than that followed by earlier courts. The approach adopted by these authorities makes it clear that a court may consider parol evidence when determining whether a writing is fully integrated, partially integrated, or not integrated at all.<sup>11</sup> Nevertheless, remnants of the “four corners” approach are still alive in some jurisdictions.

### **The Relevance of a Merger Clause to the Classification of the Writing**

Sometimes, one or both parties want to be sure that a written memorialization of their agreement will be treated as a fully integrated agreement, so as to invoke the greatest amount of protection under the parol evidence rule. To do this, they add language to the writing that states, in one form or another, that the writing contains the entire agreement of the parties. These clauses are frequently referred to as “merger” clauses because they often state that all prior agreements are “merged” into the writing.

Courts typically give a merger clause great weight when determining whether a writing is fully or partially integrated. The absence of a merger clause does not necessarily mean that the parties did not intend the writing to fully integrate their agreement, but its absence is a factor that a court may consider.

In the power of merger clauses also lies their danger. A sophisticated and powerful party in charge of drafting an agreement may include language that strongly favors its interests, omit terms previously agreed to that favor the other party, or even add a term that contradicts the explicit understanding of the parties. These provisions may go unnoticed or, if noticed, unchallenged by the less sophisticated or less powerful contracting partner. The hazard is not limited to the unsophisticated, however. A complex commercial agreement may take weeks or even months to draft, negotiate, and revise. Often, the lawyers work late into the night leading up to the closing in an effort to finalize the contractual language. Occasionally, surprises come up at the closing table, and the parties scurry to find a last-minute accommodation to prevent the transaction from collapsing. Woe to the lawyer, not to mention the client, who in the rush to completion fails to make sure that everything agreed to is properly recorded into a written agreement that contains a merger clause.

Because of the potential of merger clauses to defeat a party’s legitimate expectations, courts do not always give them conclusive effect. In the usual case, however, the plaintiff who seeks to introduce parol evidence to contradict or supplement a written agreement containing a merger clause faces a steep, uphill battle.

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<sup>11</sup> Restatement (Second) of Contracts § 214(a), (b). Indeed, the comments expressly state that this “may be proved by any relevant evidence.” *Id.* at § 210, cmt. b.

### ***Problem 5-1***

Consider all the agreements you have made in which there was some written expression of the deal. Identify and describe one in which the writing was a fully integrated agreement, another in which the writing was a partially integrated agreement, and a third in which the writing was not an integrated agreement at all. If possible, bring a copy of each to class. If, for any of the three, you cannot identify an example from your own transactions, then prepare a written description of an example of such a writing.

#### **Classifying the Evidence**

Read Restatement (Second) of Contracts §§ 215, 216. These provisions lay out the heart of the parol evidence rule. In sum, they provide that parol evidence may not be admitted to contradict a fully or partially integrated written agreement and may not even be used to supplement the writing if it is a fully integrated agreement. By negative implication, and pursuant to the general principle that all relevant evidence is admissible, parties are free to submit parol evidence to supplement or contradict a writing that does not qualify as an integrated agreement.

Thus, for the moment we have two classes of parol evidence: (i) evidence that contradicts the written agreement; and (ii) evidence that supplements the written agreement. To these we need to add a third category: (iii) evidence proffered to explain the terms in the writing. Although the Restatement treats such evidence as admissible, regardless of the nature of the writing,<sup>12</sup> not all courts agree. Some refuse to admit evidence to explain a term in a fully or partially integrated agreement unless the term is ambiguous or unclear on its face.

Unfortunately, we are not yet done classifying the potential types of parol evidence. The parol evidence rule rests on the assumption that the writing reflects a valid contract. Suppose two friends at a bar, both slightly inebriated, begin a friendly argument about who owns the nicer car, each preferring the one owned by the other. As a dare, one of them offers to sell his car to the other for \$1,000, a price well below its true value. The other friend agrees and they sign a writing to that effect on one of the napkins available at the bar. Should evidence be admissible to show that the whole thing was a joke and therefore should not be enforceable?<sup>13</sup> Similarly, if you were forced to sign a written agreement because someone was holding a gun to your head, should you not be allowed to admit evidence of that coercion to avoid contract liability? Generally speaking, parol evidence is admissible to demonstrate that an alleged contract is either void or voidable.<sup>14</sup>

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<sup>12</sup> See Restatement (Second) of Contracts § 214(c).

<sup>13</sup> See *Lucy v. Zehmer*, 84 S.E.2d 516 (Va. 1954). This case is a classic, included in most contracts casebooks. Compare *Leonard v. Pepsico, Inc.*, 88 F. Supp. 2d 116 (S.D.N.Y. 1999), *aff'd*, 210 F.3d 88 (2d Cir. 2000), a case that is quickly becoming another classic.

<sup>14</sup> See Restatement (Second) of Contracts § 214(d). See also *Citizens State Bank v. Symington*, 780 N.W.2d 676 (N.D. 2010) (parol evidence rule does not bar evidence of fraud, mistake, or accident).

Application of this exception is, however, sometimes problematic, particularly when the evidence is offered to show that the agreement was induced through misrepresentation. Suppose for example, that Armas has brought suit against Burrelson to enforce a written agreement. Burrelson wants to introduce evidence of prior negotiations. Perhaps that evidence will be to show that Armas misrepresented the content of the writing. An example might be if Armas and Burrelson had exchanged several drafts of the proposed agreement but right before Burrelson signed, Armas secretly revised a provision in the middle of the document. Burrelson did not notice the change and did not look carefully because Armas expressly stated that the document was identical to the last draft Burrelson had reviewed. Or perhaps Burrelson alleges that Armas made a false representation of fact some time during negotiations, but the signed agreement says that no representations were made. If courts routinely consider evidence of such misrepresentations, particularly if courts routinely allow juries to hear such evidence, the exception for misrepresentation would have the potential to swallow the parol evidence rule. Yet at the same time, judges may seethe at the prospect of enforcing the parol evidence rule in a manner that lets a party profit from such behavior.

In any event, we now see a fourth category of parol evidence: (iv) evidence relevant to whether the agreement is avoidable for illegality, fraud, duress, mistake, or other reason. To this we add one final category: (v) evidence of a condition precedent. Most courts admit evidence that both parties intended that the written agreement be subject to a condition.<sup>15</sup> For example, suppose Speaker and Boyd sign an agreement for Speaker to sell a car to Boyd. At the same time, they orally agree that the agreement will be effective only if Boyd's spouse approves. Evidence of the oral condition is generally admissible.<sup>16</sup>

### Summary

The following chart summarizes what is to happen under the parol evidence rule, once the judge classifies the writing and classifies the proffered parol evidence.

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<sup>15</sup> See Restatement (Second) of Contracts § 217.

<sup>16</sup> See Restatement (Second) of Contracts § 217, ill. 1, 2.

		Nature of the Writing		
		Fully Integrated	Partially Integrated	Not Integrated
Nature of the Proffered Evidence	Contradictory	Inadmissible	Inadmissible	Admissible
	Supplemental	Inadmissible	Admissible	Admissible
	Explanatory	Admissible*	Admissible*	Admissible
	Condition Precedent	Generally Admissible	Admissible	Admissible
	Basis for Avoidance	Admissible	Admissible	Admissible

\* Some courts require that the writing be ambiguous or unclear before they admit evidence to explain a fully (or partially) integrated writing.

### APPLICATION OF THE PAROL EVIDENCE RULE

Although the parol evidence rule is relatively easy to state, it can be extraordinarily difficult to apply. These difficulties can emerge at each stage of the analysis. Whether a writing is integrated, and if so, whether it is partially integrated or fully integrated are questions of some subtlety, and their answers are elusive. Similarly whether a party is offering parol evidence merely to explain a written agreement, to supplement it, or contradict it can be a matter of hot debate.

It is important to recognize that the complexity in applying the parol evidence rule arises from the fact that it has a potential for both good and harm. The rule serves the cause of fairness by acting as a barrier to a claim that the parties' agreement includes a term that was in fact never agreed to. However, the rule can just as easily be used to defeat the cause of fairness by excluding evidence of something to which the parties had truly agreed. This causes some courts to apply the rule quite gingerly, as they try to walk the narrow line between too harsh and too liberal an application of the rule. As a result of this balancing act, courts have shaped a rule that is complex, subtle, and occasionally incoherent. Indeed, an in-depth study of the cases might suggest that judges may be using the rule to exclude from the jury only the evidence that judges do not believe. Consider the following two cases. The first is a fairly recent application of the parol evidence rule. The second is a classic case that appears in most casebooks on contracts.

***MYSKINA V. THE CONDÉ NAST PUBLICATIONS, INC.***  
**386 F. Supp. 2d 409 (S.D.N.Y. 2005)**

Mukasey, District Judge.

In this diversity action, plaintiff Anastasia Myskina sues defendants Condé Nast Publications, Inc. (“Condé Nast”) and its magazine Gentleman’s Quarterly (“GQ”), Mark Seliger, and Mark Seliger Studio for \* \* \* breach of contract. The claims arise out of the alleged unauthorized dissemination of photographs taken of Myskina by defendants in connection with the October 2002 “Sports” issue of GQ, and publication of these photographs in the July/August 2004 issue of the Russian magazine Medved. Defendants move \* \* \* for summary judgment \* \* \*. For the reasons set forth below, defendants’ motion is granted.

Myskina, a Russian citizen, is the 2004 French Open champion who at the time of the filing of this complaint was ranked fourth among female professional tennis players worldwide. She was 20 years old at the time that the photographs at issue were taken. Condé Nast is a New York publishing company; GQ is one of its publications. Seliger, who owns Seliger Studio, is a professional photographer who resides in New York.

In July 2002, Condé Nast editor Beth Altschull contacted International Sports Advisors – a publicity agency that represented Myskina at the time – to inquire whether Myskina would be interested in being photographed in the nude by Seliger for the cover and interior of GQ’s 2002 “Sports” issue as part of a pictorial and profile of female tennis players. Myskina expressed interest, and her agent instructed Kenneth Gantman, a 23-year-old administrative assistant at International Sports Advisors, to set up the appointment and accompany Myskina to the photoshoot. Altschull and Gantman spoke on several occasions before the date of the photoshoot to agree on a convenient date and time for Myskina to come to New York and participate in the photoshoot.

On July 16, 2002, Myskina arrived at the photoshoot with Gantman and Jens Gerpach, who was her coach and then-boyfriend. Gantman claims that it was only at the photoshoot – and not during previous conversations with Altschull – that Altschull explained that the cover photograph of Myskina would depict her as “Lady Godiva” – lying nude on the back of a horse. It is not clear from Altschull’s affidavit whether she claims that this information was communicated before the date of the photoshoot. In any event, Myskina expressed concern about being photographed in the nude. According to Myskina and Gantman, Altschull explained that Myskina would wear nude-colored underpants and have long hair taped to her body to cover her breasts and that, except for the Lady Godiva photographs to be published in the GQ issue, the photographs taken during the photoshoot would not be published anywhere. Myskina claims that only after this assurance did she agree to be photographed.

Before shooting began, Altschull presented Gantman with Condé Nast’s standard release form (“Release”) for models appearing in Condé Nast publications and informed him that absent his objection, she would ask Myskina to sign it. The Release, which is printed on Condé Nast letterhead, provides that the signatory model “hereby irrevocably consent[s] to the use of [her] name

and the pictures taken of [her] on [a specified date] by [Condé Nast], . . . and others it may authorize, for editorial purposes.” The Release does not contain a merger clause.

Myskina claims that Gantman was neither an agent nor a publicist at International Sports Advisors and did not represent himself as such to Altschull, anyone at GQ, or anyone at the studio where the photoshoot took place. Defendants claim that Gantman voiced no objection to the Release or to Myskina’s signing it. In addition to denying that he was ever presented with the Release, Gantman claims that he neither discussed the Release with Myskina nor observed her signing it. Myskina does not recall signing or discussing a Release with Condé Nast. Moreover, Myskina claims that she could not have understood the terms of the Release because at the time she was not fluent in English and “would not have signed [the Release] had it been explained to her that [it] would or might authorize GQ and Mark Seliger to publish, sell or disseminate her photographs from [the photoshoot] beyond publication of the Lady Godiva photograph for the 2002 ‘Sports Issue’ of GQ.”

Myskina claims that she was photographed topless in blue jeans after Seliger finished with the Lady Godiva photographs and that these had “nothing to do with the ‘Lady Godiva’ concept.” She recalls that Seliger asked her whether he could take these topless photographs “for himself” so long as they were already in the studio. She “told him he could only take these photographs if these photographs would not be published anywhere,” to which he “understood and agreed.”

Condé Nast eventually published Myskina’s profile and a “Lady Godiva” photograph from the photoshoot, which appeared on both the issue’s cover and in a two-page spread inside the issue. Myskina was not paid in connection with the publication of her photograph in GQ.

[Seliger’s contract with Condé Nast authorized him to exploit all photographs taken on assignment by Condé Nast after expiration of an “exclusivity period,” during which Condé Nast possessed the exclusive right to publish the photographs. The exclusivity period expired on November 23, 2003, after which Seliger licensed five of the photoshoot images to Medved.]

In July 2004, these photographs appeared in the July/August 2004 issue of Medved, and soon after on Medved’s website. One of the photographs was published on the issue’s cover, and the other four appeared inside. Three, including the cover shot, depict frontal nudity and two appear to be versions of the Lady Godiva photograph that appeared in the October 2002 GQ issue.

Meanwhile, Medved had approached Myskina after her French Open win about an interview and photography session. She “told them that [she] couldn’t do it.” However, it appears that she granted the interview but not the photoshoot. Medved represented to her that it would use an “on the court” action photograph of her by a Russian sports photographer.

The Medved article, entitled “Nastya Myskina: The Champion’s Private Life,” included a biography of Myskina and excerpts from the interview, which covered her thoughts on her French Open win, press reports of her romantic life, and life on the professional tennis tour. \* \* \* Myskina claims that the publication of the photographs in Medved “are highly embarrassing and have caused [her] great emotional distress and economic harm and injury to her reputation.” She also claims that Seliger has sold the same photographs to other parties.

Myskina filed the instant complaint on August 5, 2004. She sues for compensatory and exemplary damages as well as injunctive relief restraining the sale and dissemination of the photographs at issue. \* \* \*

Myskina contends that the Release was not “knowingly or intelligently signed, that she could not in any event understand its meaning,” and that regardless, “defendants agreed with [ ] Myskina to limit publication to [the] ‘Lady Godiva’ photograph” in the October 2002 issue of GQ. \* \* \*

According to Myskina, Altschull assured her and Gantman “that the only photographs of [her] that would ever be published would be the Lady Godiva photographs in the October 2002 sports issue of GQ.” Gantman states the same. Myskina claims also that the other photographs that appeared in Medved were taken after the Lady Godiva photographs, and only upon Seliger’s request to “take [them] for himself since [they] were already in the photo studio.” “He indicated that he understood and agreed” with Myskina’s condition that these photographs could not be published anywhere. None of these understanding and agreements were put in writing.

Absent allegations of fraud, duress, or some other wrongdoing, Myskina’s claimed misunderstanding of the Release’s terms does not excuse her from being bound on the contract. Nor can she avoid her obligations under the Release because of her purported failure to read its contents. *See Holcomb v. TWR Express, Inc.*, 782 N.Y.S.2d 840 (N.Y. App. Div. 2004) (“A person who is illiterate in the English language is not automatically excused from complying with the terms of a contract simply because he or she could not read it”).

As for the oral agreement that Myskina claims limited her consent to publication only of the GQ photographs, the parol evidence rule bars the admission of any prior or contemporaneous negotiations or agreements offered to contradict or modify the terms of a written agreement. Even where an agreement is not completely integrated – meaning that the writing was intended by the parties to be a final and complete expression of all the terms agreed upon – parol evidence may be admitted only to complete the agreement or to resolve some ambiguity therein, and not to vary or contradict its contents. *See* Restatement (Second) of Contracts § 215 (1981).

Application of the parol evidence rule involves a three-step inquiry: (i) determine whether the written contract is an integrated agreement; if it is, (ii) determine whether the language of the written contract is clear or is ambiguous; and, (iii) if the language is clear, apply that clear language.

Absent a merger clause or language that explicitly states that the written agreement is integrated, the issue of whether the writing is an integrated agreement is determined “by reading the writing in the light of surrounding circumstances, and by determining whether or not the agreement was one which the parties would ordinarily be expected to embody in the writing.” *Wilson-Gray v. Jay Feinberg, Ltd.*, 1990 WL 209635, at \*2 (S.D.N.Y. Dec.17, 1990) (quoting *Braten v. Bankers Trust Co.*, 60 N.Y.2d 155, 162 (1983)).

Several factors indicate that the Release is an integrated agreement as to which photographs Myskina authorized the defendants to use for editorial purposes. The Release does not mention the alleged oral agreement – or any other agreement outside the Release, for that matter – that would

limit Myskina's consent to the GQ photographs. Further, it addresses a straightforward transaction and plainly sets forth that Myskina consented to defendants' use of all photographs taken on July 16, 2002. Although the Release does not contain an explicit merger or integration clause, its language ("I, the undersigned, hereby irrevocably consent . . .") indicates an intention to treat the issue of consent comprehensively and to be bound only by the terms of the Release.

Moreover, the purported oral agreement contemplates a condition fundamental to Myskina's consent, such that it hardly would have been omitted by the parties. Also, however unwise it may have been to bring only an administrative assistant from the publicity firm to the photoshoot, there appears to be no dispute that Myskina was still represented by the firm throughout the process. Under these circumstances, the Release constitutes a fully integrated contract as to Myskina's consent.

The purported oral agreement contradicts the plain language of the Release. Under the alleged oral agreement, Myskina consented only to the publication of the photographs in the October 2002 issue of GQ. By contrast, under the Release, Myskina expressly consented to the "use . . . for editorial purposes" by defendants of all photographs taken of her on July 16, 2002. Hence, the Release and the oral agreement are inconsistent in that the Release does not single out or otherwise limit which photographs taken during the July 16, 2002 photoshoot could be used for editorial purposes. Hence, the oral agreement is not admissible.

Although the Release is plainly integrated, evidence of an extrinsic oral agreement to limit Myskina's consent nevertheless could be considered if it satisfies three conditions: "(1) the agreement must in form be a collateral one; (2) it must not contradict express or implied provisions of the written contract; (3) it must be one that parties would not ordinarily be expected to embody in the writing. . . . It must not be so clearly connected with the principal transaction as to be part and parcel of it." *Namad v. Salomon*, 537 N.Y.S.2d 807 (N.Y. App. Div. 1989). However, the alleged oral agreement in this case fails to satisfy any of the three conditions. It is not "collateral," but central to the parties' agreement as to Myskina's consent. It contradicts directly the plain language of the Release. Finally, its central provision – restriction of publication – was Myskina's main, if not only condition of participating in the photoshoot, and is a matter that the parties would have been expected to memorialize in writing. Hence, "[f]ailure to include it in the written contract bars proof of its existence." *Gulf Int'l Bank B.S.C., New York Branch v. Othman*, 1994 WL 116015, at \*6 (S.D.N.Y. Mar.28, 1994). \* \* \*

Myskina alleges that because Condé Nast "agreed with [her] that a photograph selected from the Photoshoot for the GQ October 2002 issue would be the only photographs that would be published, . . . Condé Nast . . . materially breached [the] Agreement by failing to prevent photographs from the Photoshoot to be published in other publications, including Medved." As discussed above, the Release defeats such a claim. \* \* \*

For the reasons set forth above, defendants' motion for summary judgment is granted.

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***MASTERSON V. SINE***  
**436 P.2d 561 (Cal. 1968)**

Traynor, Chief Justice.

Dallas Masterson and his wife Rebecca owned a ranch as tenants in common. On February 25, 1958, they conveyed it to Medora and Lu Sine by a grant deed “Reserving unto the Grantors herein an option to purchase the above described property on or before February 25, 1968” for the “same consideration as being paid heretofore plus their depreciation value of any improvements Grantees may add to the property from and after two and a half years from this date.” Medora is Dallas’ sister and Lu’s wife. Since the conveyance Dallas has been adjudged bankrupt. His trustee in bankruptcy and Rebecca brought this declaratory relief action to establish their right to enforce the option.

The case was tried without a jury. Over defendants’ objection the trial court admitted extrinsic evidence that by “the same consideration as being paid heretofore” both the grantors and the grantees meant the sum of \$50,000 and by “depreciation value of any improvements” they meant the depreciation value of improvements to be computed by deducting from the total amount of any capital expenditures made by defendants grantees the amount of depreciation allowable to them under United States income tax regulations as of the time of the exercise of the option.

The court also determined that the parol evidence rule precluded admission of extrinsic evidence offered by defendants to show that the parties wanted the property kept in the Masterson family and that the option was therefore personal to the grantors and could not be exercised by the trustee in bankruptcy.

The court entered judgment for plaintiffs, declaring their right to exercise the option, specifying in some detail how it could be exercised, and reserving jurisdiction to supervise the manner of its exercise and to determine the amount that plaintiffs will be required to pay defendants for their capital expenditures if plaintiffs decide to exercise the option.

Defendants appeal. They contend that the option provision is too uncertain to be enforced and that extrinsic evidence as to its meaning should not have been admitted. The trial court properly refused to frustrate the obviously declared intention of the grantors to reserve an option to repurchase by an overly meticulous insistence on completeness and clarity of written expression. The trial court erred, however, in excluding the extrinsic evidence that the option was personal to the grantors and therefore nonassignable.

When the parties to a written contract have agreed to it as an “integration” – a complete and final embodiment of the terms of an agreement – parol evidence cannot be used to add to or vary its terms. When only part of the agreement is integrated, the same rule applies to that part, but parol evidence may be used to prove elements of the agreement not reduced to writing.

The crucial issue in determining whether there has been an integration is whether the parties intended their writing to serve as the exclusive embodiment of their agreement. The instrument itself may help to resolve that issue. It may state, for example, that “there are no previous understandings or agreements not contained in the writing,” and thus express the parties’ “intention to nullify antecedent understandings or agreements.” See 3 Corbin, Contracts (1960) § 578, p. 411. Any such collateral agreement itself must be examined, however, to determine whether the parties intended the subjects of negotiation it deals with to be included in, excluded from, or otherwise affected by the writing. Circumstances at the time of the writing may also aid in the determination of such integration.

California cases have stated that whether there was an integration is to be determined solely from the face of the instrument. Neither of these strict formulations of the rule, however, has been consistently applied. The requirement that the writing must appear incomplete on its face has been repudiated in many cases where parol evidence was admitted “to prove the existence of a separate oral agreement as to any matter on which the document is silent and which is not inconsistent with its terms” – even though the instrument appeared to state a complete agreement. Even under the rule that the writing alone is to be consulted, it was found necessary to examine the alleged collateral agreement before concluding that proof of it was precluded by the writing alone. It is therefore evident that “The conception of a writing as wholly and intrinsically self-determinative of the parties’ intent to make it a sole memorial of one or seven or twenty-seven subjects of negotiation is an impossible one.” 9 Wigmore, Evidence § 2431, p. 103 (3d ed. 1940). For example, a promissory note given by a debtor to his creditor may integrate all their present contractual rights and obligations, or it may be only a minor part of an underlying executory contract that would never be discovered by examining the face of the note.

In formulating the rule governing parol evidence, several policies must be accommodated. One policy is based on the assumption that written evidence is more accurate than human memory. This policy, however, can be adequately served by excluding parol evidence of agreements that directly contradict the writing. Another policy is based on the fear that fraud or unintentional invention by witnesses interested in the outcome of the litigation will mislead the finder of facts. McCormick has suggested that the party urging the spoken as against the written word is most often the economic underdog, threatened by severe hardship if the writing is enforced. In his view the parol evidence rule arose to allow the court to control the tendency of the jury to find through sympathy and without a dispassionate assessment of the probability of fraud or faulty memory that the parties made an oral agreement collateral to the written contract, or that preliminary tentative agreements were not abandoned when omitted from the writing. See McCormick, Evidence § 210 (1954). He recognizes, however, that if this theory were adopted in disregard of all other considerations, it would lead to the exclusion of testimony concerning oral agreements whenever there is a writing and thereby often defeat the true intent of the parties. *Id.* at § 216, p. 441.

Evidence of oral collateral agreements should be excluded only when the fact finder is likely to be misled. The rule must therefore be based on the credibility of the evidence. One such standard, adopted by section 240(1)(b) of the Restatement of Contracts, permits proof of a collateral agreement if it “is such an agreement as might *naturally* be made as a separate agreement by parties situated as were the parties to the written contract” (italics added). The draftsmen of the Uniform

Commercial Code would exclude the evidence in still fewer instances: “If the additional terms are such that, if agreed upon, they would *certainly* have been included in the document in the view of the court, then evidence of their alleged making must be kept from the trier of fact.” § 2-202, cmt. 3(italics added).

The option clause in the deed in the present case does not explicitly provide that it contains the complete agreement, and the deed is silent on the question of assignability. Moreover, the difficulty of accommodating the formalized structure of a deed to the insertion of collateral agreements makes it less likely that all the terms of such an agreement were included. The statement of the reservation of the option might well have been placed in the recorded deed solely to preserve the grantors’ rights against any possible future purchasers and this function could well be served without any mention of the parties’ agreement that the option was personal. There is nothing in the record to indicate that the parties to this family transaction, through experience in land transactions or otherwise, had any warning of the disadvantages of failing to put the whole agreement in the deed. This case is one, therefore, in which it can be said that a collateral agreement such as that alleged “might naturally be made as a separate agreement.” A fortiori, the case is not one in which the parties “would certainly” have included the collateral agreement in the deed.

It is contended, however, that an option agreement is ordinarily presumed to be assignable if it contains no provisions forbidding its transfer or indicating that its performance involves elements personal to the parties. The fact that there is a written memorandum, however, does not necessarily preclude parol evidence rebutting a term that the law would otherwise presume. \* \* \* Of course a statute may preclude parol evidence to rebut a statutory presumption. Here, however, there is no such statute. In the absence of a controlling statute the parties may provide that a contract right or duty is nontransferable. Moreover, even when there is no explicit agreement – written *or* oral – that contractual duties shall be personal, courts will effectuate presumed intent to that effect if the circumstances indicate that performance by substituted person would be different from that contracted for.

In the present case defendants offered evidence that the parties agreed that the option was not assignable in order to keep the property in the Masterson family. The trial court erred in excluding that evidence.

The judgment is reversed.

Burke, Justice.

I dissent. The majority opinion:

(1) Undermines the parol evidence rule as we have known it in this state since at least 1872 by declaring that parol evidence should have been admitted by the trial court to show that a written option, absolute and unrestricted in form, was intended to be limited and nonassignable;

(2) Renders suspect instruments of conveyance absolute on their face;

(3) Materially lessens the reliance which may be placed upon written instruments affecting the title to real estate; and

(4) Opens the door, albeit unintentionally to a new technique for the defrauding of creditors.

The opinion permits defendants to establish by parol testimony that their grant to their brother (and brother-in-law) of a written option, absolute in terms, was nevertheless agreed to be nonassignable by the grantee (now a bankrupt), and that therefore the right to exercise it did not pass, by operation of the bankruptcy laws, to the trustee for the benefit of the grantee's creditors.

And how was this to be shown? By the proffered testimony of the bankrupt optionee himself! Thereby one of his assets (the option to purchase defendants' California ranch) would be withheld from the trustee in bankruptcy and from the bankrupt's creditors. Understandably the trial court, as required by the parol evidence rule, did not allow the bankrupt by parol to so contradict the unqualified language of the written option.

The court properly admitted parol evidence to explain the intended meaning of the "same consideration" and "depreciation value" phrases of the written option to purchase defendants' land, as the intended meaning of those phrases was not clear. However, there was nothing ambiguous about the *granting* language of the option and not the slightest suggestion in the document that the option was to be nonassignable. Thus, to permit such words of limitation to be added by parol is to *contradict* the absolute nature of the grant, and to directly violate the parol evidence rule.

Just as it is unnecessary to state in a deed to "lot X" that the house located thereon goes with the land, it is likewise unnecessary to add to "I grant an option to Jones" the words "and his assigns" for the option to be assignable. \* \* \* Thus, to seek to restrict the grant by parol is to *contradict* the written document in violation of the parol evidence rule. \* \* \*

At the outset the majority in the present case reiterate that the rule against contradicting or varying the terms of a writing remains applicable when only part of the agreement is contained in the writing, and parol evidence is used to prove elements of the agreement not reduced to writing. But having restated this established rule, the majority opinion inexplicably proceeds to subvert it. \* \* \* The meaning of this rule (and the application of it found in the cases) is that if the asserted unwritten elements of the agreement would contradict, add to, detract from, vary or be inconsistent with the written agreement, then such elements *may not* be shown by *parol* evidence.

The contract of sale and purchase of the ranch property here involved was carried out through a title company upon written escrow instructions executed by the respective parties after various preliminary negotiations. The deed to defendant grantees, in which the grantors expressly reserved an option to repurchase the property within a ten-year period and upon a specified consideration, was issued and delivered in consummation of the contract. In neither the written escrow instructions nor the deed containing the option is there any language even suggesting that the option was agreed or intended by the parties to be personal to the grantors, and so nonassignable. \* \* \* But the majority hold that [the testimony of Dallas Masterson, the bankrupt holder of the claimed option] should have been admitted, thereby permitting defendant optionors to limit, detract from and contradict the plain

and unrestricted terms of the written option in clear violation of the parol evidence rule and to open the door to the perpetration of fraud.

Options are property, and are widely used in the sale and purchase of real and personal property. One of the basic incidents of property ownership is the right of the owner to sell or transfer it. \* \* \* The right of an optionee to transfer his option to purchase property is accordingly one of the basic rights which accompanies the option unless limited under the language of the option itself. To allow an optionor to resort to parol evidence to support his assertion that the written option is not transferable is to authorize him to limit the option by attempting to restrict and reclaim rights with which he has already parted. A clearer violation of two substantive and basic rules of law – the parol evidence rule and the right of free transferability of property – would be difficult to conceive. \* \* \*

[D]espite the law which until the advent of the present majority opinion has been firmly and clearly established in California and relied upon by attorneys and courts alike, that parol evidence may *not* be employed to vary or contradict the terms of a written instrument, the majority now announce that such evidence “should be excluded only when the fact finder is *likely to be misled*,” and that “The rule must therefore be based on the *credibility of the evidence*” (italics added). But was it not, inter alia, to avoid misleading the fact finder, and to further the introduction of only the evidence which is most likely to *be* credible (the written document), that the Legislature adopted the parol evidence rule as a part of the substantive law of this state?

Next, in an effort to implement this newly promulgated “credibility” test, the majority opinion offers a choice of two “standards”: one, a “certainty” standard, quoted from the Uniform Commercial Code, and the other a “natural” standard found in the Restatement of Contracts, and concludes that at least for purposes of the present case the “natural” viewpoint should prevail.

This new rule, not hitherto recognized in California, provides that proof of a claimed collateral oral agreement is admissible if it is such an agreement as might *naturally* have been made a separate agreement by the parties under the particular circumstances. I submit that this approach opens the door to uncertainty and confusion. Who can know what its limits are? Certainly I do not. For example, in its application to this case who could be expected to divine as “natural” a separate oral agreement between the parties that the assignment, absolute and unrestricted on its face, was intended by the parties to be limited to the Masterson family? \* \* \* [A]s loose as the new rule is, one judge might deem it natural and another judge unnatural. And in each instance the ultimate decision would have to be made (“naturally”) on a case-by-case basis by the appellate courts. \* \* \*

I would hold that the trial court ruled correctly on the proffered parol evidence, and would affirm the judgment.

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### *Questions*

1. Why did the court in *Masterson* reach a different decision from the court in *Myskina*? Do the two courts employ different versions of the parol evidence rule or

do they merely apply the same legal rules to materially different facts? How did each court classify the writing before it and how did each court classify the proffered parol evidence?

2. Identify the single sentence in *Masterson* that, in your opinion, is most critical to the court's conclusion. In other words, what is the one sentence in the court's opinion that best explains the result the court reached? Hint, it appears on page 52.

### ***Problem 5-2***

You are drafting a written agreement for a client and wish to include a merger clause. Which of the following clauses would suffice and which would not? Which clause would you be most likely to use? What problems might the other clauses cause? How would you draft the clause?

1. This Agreement represents the final agreement of the parties.
2. This Agreement represents the final agreement of the parties; there are no other agreements not reflected herein.
3. This Agreement is the complete and exclusive statement of the terms of the parties' agreement.
4. All of the parties' negotiations are merged into this Agreement.
5. This Agreement supercedes all prior agreements, whether written or oral, relating to the subject matter hereof.
6. This Agreement may not be modified except by a writing signed by both parties.

### ***Problem 5-3***

You are a judge presiding over an action for rent brought by Landlord against Tenant, which has leased office space in Landlord's building. Landlord claims that Tenant has failed to pay the monthly rent for the last two months. Landlord has submitted a copy of the lease. Tenant admits to nonpayment but claims a defense. Specifically, Tenant claims not to be in breach because of the following agreements, neither of which is reflected in the written lease:

1. Tenant spent \$23,000 remodeling the space to suit its needs and claims the Landlord agreed at the time the parties signed the lease that this amount could be deducted from the rental obligation.
2. Tenant spent \$4,000 on emergency plumbing work after a leak threatened to significantly damage the building. The lease imposes on Landlord the duty to maintain the plumbing but Landlord was out of town when the leak occurred and Tenant claims that Landlord orally authorized Tenant to arrange for the necessary repairs and deduct the cost from the next month's rent.

Landlord seeks to exclude evidence of each alleged term based on the parol evidence rule. If the lease has a merger clause, will you exclude or admit the evidence? What if the lease does not have a merger clause?

***Problem 5-4***

You are a judge presiding over an action brought by Lessee against Landlord. Lessee has leased office space in Landlord's building. Landlord has recently agreed to sell the building to Buyer. Lessee claims that, as part of the lease agreement, Landlord agreed that, before selling the building to anyone else, Landlord would offer to sell the building to Lessee at the same price. The written lease, which does not have a merger clause, says nothing about this alleged right of first refusal. Landlord seeks to exclude evidence of the alleged term based on the parol evidence rule. How should you rule?

## BOILERPLATE

The term “boilerplate” refers to standard terms or clauses that are frequently included in most written agreements, typically near the end. They usually deal with how the parties will govern and administer their relationship or resolve disputes between them. Classic examples include rules on providing notification to each other, severability, amendments, waiver, assignment, and choice of law. Another common boilerplate term is a merger clause.<sup>1</sup> Often, attorneys and their clients pay little attention to these clauses. That is a mistake. Many of the provisions commonly referred to as boilerplate can significantly impact a client’s rights.

A complete study of all the myriad types of boilerplate terms and the law that governs them is beyond the scope of this course. Instead, we will explore boilerplate terms through four examples: (i) clauses providing for recovery of attorney’s fees, (ii) choice-of-law clauses, (iii) forum-selection clauses, and (iv) arbitration clauses. The goal of this material is modest: to show through these examples how much attention the transactional attorney should give to boilerplate terms.

### ATTORNEY’S FEES & OTHER LITIGATION COSTS

Throughout the United States, parties are normally expected to pay their own costs in negotiating, executing, performing, and enforcing their own contracts.<sup>2</sup> Pursuant to this general rule, parties must pay their own expenses in bringing or defending contract actions – even when successful – unless either a specific statute provides to the contrary or the contract both places and, under the law, is permitted to place, the burden on the other party.<sup>3</sup> Thus, parties wishing to reallocate these expenses must ensure that their contract contains a reallocation provision broad enough to cover all the different types of expenses that the party to be recompensed might incur.

#### *Problem 6-1*

Lender is providing working capital financing to Borrower, secured by a lien on virtually all of Borrower’s assets. The Credit/Security Agreement includes the following provision intended to make the Borrower responsible for all of Lender’s expenses and attorney’s fees:

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<sup>1</sup> Merger clauses are discussed *infra* in the materials on the parol evidence rule.

<sup>2</sup> See, e.g., TINA L. STARK, ED., NEGOTIATING AND DRAFTING CONTRACT BOILERPLATE § 12.05 (2003).

<sup>3</sup> There are some exceptions to this general rule. For example, some pre-contract costs may be recoverable in a successful claim for rescission of contract and reliance damages, because the goal of recovery in such a case is to place the aggrieved party in the position it would have occupied had the contract never been made. See *id.* at § 12.05[2]. Similarly, misconduct during litigation may result in sanctions, thereby shifting some costs to the misbehaving party.

**Borrower hereby agrees to indemnify, defend, and hold Lender harmless from any loss, cost, expense, or liability, including reasonable attorney's fees, incurred by Lender in performing or enforcing its rights under this Agreement.**

What expenses, other than attorney's fees, might Lender incur? Does this clause cover them? What attorney services might Lender need in the course of the parties' relationship? Will the fees incurred for those services be covered by this clause?

### A Synopsis of the Law

Because attorney's fees clauses override a general policy of the law that each side bear its own costs, they are often construed rather strictly. Consequently, a clause requiring reimbursement of "costs" or "expenses" may not be adequate to cover attorney's fees.<sup>4</sup>

Similarly, a contract clause providing for reimbursement of attorney's fees for any claim "to enforce the agreement" may not reach a claim for rescission based on fraud or a related claim for damages in tort, such as for misrepresentation.<sup>5</sup> It may similarly not cover actions brought by or against others to establish priority to collateral.<sup>6</sup> Parties who want an attorney's fees provision with broad reach – as most lenders do – should instead use language such as "any action or proceeding arising out of or in any way relating to either this agreement or the relationship of the parties."<sup>7</sup>

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<sup>4</sup> See *Coastal Power Int'l Ltd. v. Transcontinental Capital Corp.*, 182 F.3d 163 (2d Cir. 1999); *Allstate Ins. Co. v. Loo*, 54 Cal. Rptr. 2d 541 (Cal. Ct. App. 1996); *Jackson v. Hammer*, 653 N.E.2d 809 (Ill. Ct. App. 1995). *But cf.* *Boulevard Bank v. Philips Medical Systems Int'l B.V.*, 827 F. Supp. 510 (N.D. Ill. 1993) (clause in guaranty agreement allowing recovery of "collection costs" included attorney's fees).

<sup>5</sup> Compare *Marcus v. Fox*, 723 P.2d 682 (Ariz. 1986) (rescission claim is not one "arising out of a contract"), with *Diamond D Enterprises USA, Inc. v. Steinsvaag*, 979 F.2d 14 (2d Cir. 1992) (franchisor's contractual right to attorney's fees "incurred in enforcing" the agreement extended to those incurred in defending a fraud in inducement claim); *Lerner v. Ward*, Cal. Rptr. 2d 486 (Cal. Ct. App. 1993) ("any action or proceeding arising out of this agreement" covered a fraud in inducement claim).

<sup>6</sup> See, e.g., *Adkins v. Chrysler Financial Corp.*, 344 Fed. Appx. 144 (6th Cir. 2009) (security agreement providing for recovery of attorney's fees incurred "in connection with Secured Party's exercise of any of its rights and remedies under this Agreement," did not cover fees incurred in defending conversion action brought by other creditor).

<sup>7</sup> See, e.g., *Janotta v. Subway Sandwich Shops, Inc.*, 225 F.3d 815 (7th Cir. 2000) (action to recover punitive damages for fraud was "relative to the rights and obligations of the parties").

## Prevailing Party

Written agreements often provide that in the event of litigation, the “prevailing party” shall be entitled to reimbursement of attorney’s fees. One problem with such clauses is that, even when there is only a single claim, it is often difficult to ascertain who is the prevailing party. For example, if the plaintiff obtains a judgment for only a small amount on a very large claim, is it fair to treat the plaintiff as prevailing?<sup>8</sup> Trial courts generally have significant discretion in determining which party prevailed. They are to make their decisions in reference to the extent each party realized its litigation objectives, whether through trial, settlement or otherwise,<sup>9</sup> and in doing so should consider the parties’ contentions in pleadings and settlement discussions.<sup>10</sup> In some cases, neither party substantially prevails and thus neither gets attorney’s fees.<sup>11</sup> A trial court’s ruling on this point is often treated on review as a factual finding, and thus is rarely reversed.

Lenders often want their loan agreements to provide for reimbursement of their legal fees regardless of whether the Lender is successful in bringing a claim against or defending a claim by the borrower. The enforceability of such clauses is questionable, however, if the Lender is found to have breached the contract, and is highly unlikely in any state with a statute providing for reciprocity with respect to attorney’s fees.

## Reciprocity

At least six states have a statute that converts a unilateral attorney’s fees provision into a bilateral one.<sup>12</sup> That is, by law, if one party to a contract is entitled to attorney’s fees in successfully litigating an issue arising under the contract, then whichever party is successful will be entitled to attorney’s fees from the other. Transactional attorneys need to be aware of these laws if there is any chance that one will apply.<sup>13</sup> An attorney’s fees clause made reciprocal by law might interfere with

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<sup>8</sup> See, e.g., *Marine Enterprises, Inc. v. Security Pacific Trading Corp.*, 750 P.2d 1290 (Wash. Ct. App. 1988) (party who won a judgment for \$5,701 in an action for \$600,000 was not substantially prevailing party).

<sup>9</sup> See, e.g., *Santisas v. Goodin*, 951 P.2d 399 (Cal.1998).

<sup>10</sup> See, e.g., *Hsu v. Abbara*, 891 P.2d 804 (Cal. 1995).

<sup>11</sup> See, e.g., *Walton General Contractors, Inc. v. Chicago Forming Co.*, 111 F.3d 1376 (8th Cir. 1997). Cf. *Wilkes v. Zurlinden*, 984 P.2d 261 (Or. 1999) (each party prevailed in defending against the other’s claim). See also Cal. Civ. Code § 1717(b)(1) (providing that a court may determine that there is no prevailing party).

<sup>12</sup> See Cal. Civ. Code § 1717; Fla. Stat. Ann. § 57.105(7); Mont. Code § 28-3-704; Or. Rev. Stat. § 20.096; Utah Code § 78-27-56.5; Wash. Rev. Code § 4.84.330. See also Ariz Rev Stat. § 12-341.01 (authorizing the court to award attorney’s fees to any successful party in a contract action); Tex. Civ. Prac. & Rem Code § 38.001 (authorizing award of attorney’s fees to successful party in a variety of contract actions).

<sup>13</sup> Compare *ABF Capital Corp. v. Grove Properties Co.* 126 Cal. App. 4th 204 (2005) (because California Civil Code § 1717, which makes reciprocal a contractual clause awarding attorney’s fees to only one of the contracting parties, is fundamental policy of the state, it applies to commercial litigation in California even though the parties’ agreement had a valid clause choosing application of New York law), with *ABF Capital Corp. v. Berglass*, 130

a client's preferred dispute resolution strategy, particularly if the client is litigious and tends to take aggressive positions during litigation. Note, however, a reciprocity statute that is otherwise applicable may not cover tort claims, and thus a contract clause broad enough to cover attorney's fees incurred in connection with a tort claim may not become reciprocal with respect to such a claim.<sup>14</sup>

### ***Drafting Exercise 6-A***

Draft for inclusion in a commercial real estate lease a clause that will entitle the landlord to recover from the tenant any attorney's fees that the landlord may incur.

## **CHOICE OF LAW & CHOICE OF FORUM**

### **Choice of Law**

There are a variety of reasons parties may wish to choose which state's law governs their contractual relationship. Doing so may remove uncertainty and eliminate a subject on which briefing is necessary in the event of litigation. More significant, it allows parties, particularly those engaged in many multi-state or international transactions, to focus on compliance with one set of rules, rather than dozens. Most important, it can permit a party to seek refuge under the laws of the jurisdiction that are particularly favorable for its type of business. For example, a business with valuable trade secrets might want its agreements governed by the law of a jurisdiction which offers strong protection for them. A buyer of businesses might want its purchase agreements governed by the law of a jurisdiction that does not readily invalidate covenants not to compete. A merchant that deals with consumers may want its contracts governed by a jurisdiction that interprets the obligation of good faith in a narrow and predictable manner and which does not permit punitive damages for most contract-related torts.

In general, contracting parties are free to select which jurisdiction's law will govern their relationship. The major limitation on this freedom, as expressed in the Restatement (Second) of Conflict of Laws, is that the jurisdiction selected must bear a "substantial relationship" to either the transaction or to the parties, or there must be some other reasonable basis for the parties' choice.<sup>15</sup> A second limitation arises whenever application of the chosen jurisdiction's law would violate a fundamental policy of the jurisdiction whose law would govern but for the parties' selection. In such

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Cal. App. 4th 825 (2005) (because, under choice-of-law principles, New York law would be applicable to this litigation in California court even if the parties had not contractually agreed to the application of New York law, New York rule enforcing unilateral attorney's fees governs and whether that rule violates California fundamental policy is irrelevant).

<sup>14</sup> See *Moallem v. Coldwell Banker Commercial Group, Inc.*, 31 Cal. Rptr. 2d 253 (Cal. Ct. App. 1994).

<sup>15</sup> See Restatement (Second) of Conflict of Laws § 187(2)(a).

cases the parties' selection will not be respected.<sup>16</sup> Courts are sometimes exceedingly willing to identify fundamental state policy, and thus invalidate a contractual choice of law.<sup>17</sup> A third limitation concerns contracts involving real property. Not surprisingly, the law of the jurisdiction where the real property is located will govern the *effect* of the parties' agreement.<sup>18</sup> While parties are generally free to designate a jurisdiction whose law will govern the *interpretation* of their agreement,<sup>19</sup> prevailing practice is to let the law of the jurisdiction where the property is located govern this too.

***State Statutory Variations on Choice of Law.*** Some states allow contracting parties to choose their respective bodies of law regardless of whether the state bears a substantial relationship to the parties or the transaction, provided the contract involves a set minimum amount of money. The most notable of these are New York and Delaware.<sup>20</sup> On the other hand, some have specific rules restricting contractual choice of law in certain types of contracts, such as franchise agreements or insurance policies.<sup>21</sup> Lawyers should check for such restrictions before drafting a choice-of-law provision.

***Caveats.*** Even when well drafted, a contractual choice-of-law clause will not govern contract formation questions.<sup>22</sup> After all, a court cannot logically give effect to the parties' contractual choice of law until it determines that the parties do in fact have a contract. Similarly, questions about the scope of a choice-of-law provision are normally governed by the same law that governs the validity of the clause or contract.<sup>23</sup> Finally, a contractual choice of law is unlikely to determine the law governing issues that arise more by operation of law than from the relationship of the parties.<sup>24</sup>

***Drafting Considerations.*** As in all contract drafting, the wording of a clause can affect its scope. Wording is particularly important in choosing a governing law because some jurisdictions continue to interpret choice-of-law clauses narrowly.<sup>25</sup> Parties wishing to designate a governing law generally want that law to govern all aspects of their relationship. Consider, though, the following.

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<sup>16</sup> *Id.* at § 187(2)(b).

<sup>17</sup> *See, e.g.,* Nutracea v. Langley Park Investments PLC, 2007 WL 135699 (E.D. Cal. 2007) (clauses in stock purchase agreement selecting New York law as the governing law and New York as the forum for all litigation between the parties were unenforceable because of California's strong policy in preventing fraud on California corporations and New York's minimal interest in the litigation); *In re Miller*, 341 B.R. 764 (Bankr. E.D. Mo. 2006) (default rate of interest on business loan, though valid under Iowa law that the parties had chosen in their agreement, violated Missouri law, was against fundamental policy of Missouri, and was therefore unenforceable).

<sup>18</sup> Restatement (Second) of Conflict of Laws §§ 223, 228.

<sup>19</sup> *Id.* at § 224(1).

<sup>20</sup> *See* N.Y. Gen. Oblig. L. 5-1401(1) (\$250,000); Del. Stat. tit. 6, § 2708 (\$100,000).

<sup>21</sup> *See* TINA L. STARK, ED., NEGOTIATING AND DRAFTING CONTRACT BOILERPLATE § 6.02[c] (2003)

<sup>22</sup> *See, e.g.,* B-S Steel of Kansas, Inc. v. Texas Industries, Inc., 439 F.3d 653, 661 n.9 (10th Cir. 2006).

<sup>23</sup> *E.g.,* Finance One Public Co. Ltd., v. Lehman Brothers Special Financing, Inc., 414 F.3d 325 (2d Cir. 2006)

<sup>24</sup> *E.g.,* Berg Chilling Systems v. Hull Corp., 435 F.3d 455 (3d Cir. 2006) (dealing with successor liability).

<sup>25</sup> *E.g.,* Thompson and Wallace of Memphis, Inc. v. Falconwood Corp., 100 F.3d 429, 433 (5th Cir. 1996).

**Problem 6-2**

Lender is providing working capital financing to Borrower. The Loan Agreement includes the following provision:

**This Agreement shall be governed by and construed in accordance with the laws of the State of New York.**

What issues or claims might not be covered by this clause? How should the clause be drafted to make sure such issues and claims will be governed by New York law?<sup>26</sup>

Another drafting issue is whether the choice-of-law clause must exclude the choice-of-law rules of the chosen jurisdiction. Consider the following two alternatives:

**“ . . . governed by the laws of the State of New York.”**

**“ . . . governed by the laws of the State of New York (other than its choice-of-law rules).”**

The latter formulation is thought to be safer because it avoids the argument and the possibility that a court would then look to New York choice-of-law principles and apply some other state’s law. However, this “safer” phrasing is not necessary. The Restatement makes clear that when parties by contract select a governing law, absent some expression to the contrary they are selecting its “local law,” not its conflict-of-law rules.<sup>27</sup> Courts almost universally agree.<sup>28</sup>

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<sup>26</sup> See, e.g., *Thompson and Wallace of Memphis, Inc. v. Falconwood Corp.*, 100 F.3d 429 (5th Cir. 1996) (loan contract providing that the “agreement and its enforcement” were to be governed by New York law did not preclude application of Texas Deceptive Trade Practices Act and tort claims arising thereunder); *Northeast Data Systems, Inc. v. McDonnell Douglas Computer Systems Co.*, 986 F.2d 607 (1st Cir. 1993) (contract clause providing that “[t]his Agreement and the rights and obligations of the parties hereto shall be governed by and construed in accordance with the laws of California” covered all contract claims, whether motivated by bad intent or not, but did not cover fraud in inducement claim because it “concerns the validity of the formation of the contract, it cannot be categorized as one involving the rights or obligations arising under the contract”); *Valley Juice Ltd. v. Evian Waters of France, Inc.*, 87 F.3d 604 (2d Cir. 1996) (contract providing that “the Agreement is to be governed by the laws of the State of New York” did not apply to claim under Massachusetts Unfair Trade Practices Act); *Maltz v. Union Carbide Chemicals & Plastics Co.*, 992 F. Supp. 286 (S.D.N.Y. 1998) (fact that agreement was “to be construed in accordance with the law of New York” did not apply to tort claims); *Sunbelt Veterinary Supply, Inc. v. International Business Systems US, Inc.*, 985 F. Supp. 1352 (M.D. Ala. 1997) (“this agreement and the terms hereof shall be governed by and construed in accordance with the laws of the State of Florida” did not encompass tort claims); *Shelley v. Trafalgar House Public Ltd.*, 918 F. Supp. 515 (D.P.R. 1997) (“this letter shall be subject to and construed in accordance with the laws if the State of New York” did not apply to tort claims).

<sup>27</sup> See Restatement (Second) of Conflict of Laws § 187(3) & cmt. h.

<sup>28</sup> See, e.g., *Chan v. Society Expeditions, Inc.*, 123 F.3d 1287 (9th Cir. 1997); *Mastrobuono v. Shearson*

More importantly, if New York law were selected not by virtue of its relationship to the parties or the transaction, but instead pursuant to the New York statute that permits contracting parties to opt into New York law,<sup>29</sup> the additional language may present a problem. Because that statute is itself a choice-of-law rule, excepting all choice of law rules may, some believe, remove the only basis for applying New York law.

### Choice of Forum

A choice-of-forum provision in a written agreement does far more than provide where litigation must be pursued. It also helps give efficacy to the parties' choice of law. Indeed, a choice-of-law provision unaccompanied by a choice-of-forum clause is almost useless. Consider the following:

1. Lender, a resident of State X, loans \$100,000 to Borrower, a resident of State Y. The loan calls for interest at a rate that is permissible under the law of State X but which is usurious in State Y. The loan agreement specifies that the law of State X governs the parties' relationship. If litigation is commenced in State Y – a likely prospect no matter who brings the action – Lender bears the risk that courts in State Y will decide that State Y's usury laws represent fundamental policy. If State Y's law would have applied had there been no contractual choice-of-law provision, the court may well invalidate the loan agreement. In contrast, if the parties litigated their dispute in State X, there would be little risk that the loan would be deemed usurious.

2. Investment Bank is a New Jersey corporation with its principal place of business in New York. It enters into a large interest rate swap with Importer, whose business is located primarily in Florida. All the negotiations took place in Florida and over the phone. Relying on the New York statute that allows parties to opt into New York law, the swap agreement provides all matters arising under or relating to the swap are to be governed by the laws of the State of New York. A dispute arises and Importer brings an action against Investment Bank in Florida. A Florida court may refuse to enforce the contractual choice of law if it concludes New York does not have a substantial relationship to either the parties or the transaction.

Therefore, parties who select a governing law should always select the same jurisdiction as the *exclusive* forum for any litigation.<sup>30</sup>

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Lehman Hutton, Inc., 20 F.3d 713 (7th Cir. 1994), *rev'd on other grounds*, 514 U.S. 52 (1995).

<sup>29</sup> See *supra* note 20.

<sup>30</sup> In addition to having a statute that allows parties to opt into New York law, the State of New York also has a statute that allows parties to agree to litigate in New York courts regardless of whether jurisdiction would otherwise be proper there. N.Y. Gen. Law § 5-1402. Note, however, that this rule has a \$1 million threshold rather than the \$250,000 threshold for selecting New York law to govern.

Most states will enforce an exclusive choice-of-forum clause by dismissing an action brought in a forum other than the one selected.<sup>31</sup> In federal courts, the matter can be dealt with through a motion to transfer or a motion to dismiss. However, a forum selection clause will be invalidated if it results from fraud or overreaching, violates a strong public policy, or if enforcement of the clause would deprive a party of its day in court.<sup>32</sup> A clause can effectively deprive a party of its day in court, and be substantively unconscionable, if it makes a party – particularly the one with few litigation resources – litigate in a distant place.<sup>33</sup> It can also do so if, because of unforeseen circumstances, the chosen forum is extremely inconvenient.<sup>34</sup>

Even when a forum selection clause is itself enforceable, other limits on its effectiveness may apply. For example, a forum selection not clause will not affect where venue lies for a bankruptcy proceeding.<sup>35</sup> In addition, a forum selection clause will not prevent application of the doctrine of *forum non conveniens* and, in the absence of express language to the contrary, may not be sufficient to create personal jurisdiction where there is none.<sup>36</sup> Because of this last point, a forum selection clause should be drafted to include consent to personal jurisdiction and a waiver of *forum non conveniens*. Be advised, however, that a consent to personal jurisdiction may not be binding on an assignee or successor.

A choice-of-forum clause should specify whether actions may be brought in state courts, federal courts, or either. In choosing among these options, bear in mind that parties cannot in their contract create subject matter jurisdiction for federal courts. For this reason, providing for litigation exclusively in federal court is quite risky. If federal courts have no subject matter jurisdiction, the contractual choice will likely be invalidated, perhaps leaving the parties free to litigate in any state

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<sup>31</sup> *But see, e.g.*, Idaho Code § 29-110 (invalidating some contractual restrictions on forum); Mont. Code § 18-1-403. *But see* Fisk v. Royal Caribbean Cruises, Inc., 108 P.3d 990 (Id. 2005) (invalidating the Idaho statute with respect to certain maritime claims).

<sup>32</sup> Afram Carriers, Inc. v. Moeykens, 145 F.3d 298, 301 (5th Cir. 1998) (*quoting* Mitsui & Co. (USA), Inc. v. Mira M/V, 111 F.3d 33, 35 (5th Cir. 1997)).

<sup>33</sup> This is especially true with respect to arbitration fora. *See* Nagrampa v. Mailcoups, Inc., 469 F.3d 1257 (9th Cir. 2006) (arbitration provision was substantively unconscionable because it selected a forum at the franchisor's headquarters, 3,000 miles away from the franchisee's location and where the franchise agreement was to be performed); Brower v. Gateway 2000, Inc., 676 N.Y.S.2d 569 (N.Y. Sup. Ct. 1998) (arbitration clause that required N.Y. consumer to arbitrate in Chicago was financially prohibitive and effectively barred consumer from enforcing his rights, and was therefore unconscionable).

<sup>34</sup> *See* TINA L. STARK, ED., NEGOTIATING AND DRAFTING CONTRACTUAL BOILERPLATE § 6.03[2] (2003).

<sup>35</sup> *See* 28 U.S.C. § 1408. Because bankruptcy courts apply the law of the jurisdiction in which they sit with respect to nonbankruptcy law issues, such venue can affect which state law governs. *See* In re Miller, 341 B.R. 764 (Bankr. E.D. Mo. 2006) (default rate of interest on business loan, though valid under Iowa law that the parties had chosen in their agreement, violated Missouri law, was against fundamental policy of Missouri, and was therefore unenforceable).

<sup>36</sup> *But cf.* Chan v. Society Expeditions, Inc., 39 F.3d 1398, 1406-07 (9th Cir. 1994); Heller Financial, Inc. v. Midwhey Powder Co., Inc., 883 F.2d 1286, 1292 (7th Cir. 1989) (both indicating that a forum selection clause could operate as a consent to personal jurisdiction).

court having personal jurisdiction over the parties. Similarly, if litigation in federal court is to be permitted or required, be careful not to specify a city or county in which no federal court sits. That might render the clause completely unenforceable or at least undermine the use of federal courts.<sup>37</sup>

Note, a forum selection clause does not have to be exclusive. Occasionally, contracting parties wish merely to provide for the freedom to litigate in a particular forum, rather than to restrict all litigation to that forum. If a clause is intended to be exclusive, however, state that clearly. Otherwise, it may be deemed not to be mandatory.<sup>38</sup>

Finally, some parties like to have what is occasionally referred to as a “floating forum clause.” Such clauses provide for all suits to be brought in whatever jurisdiction one of the parties or its assigns resides. Thus, if that party assigns the contract, the choice of forum may switch to the residence of the assignee. There are at least two problems to such clauses, however. First, because such a clause will not always point to the same state, there is no way to ensure the applicability of the parties’ choice of law. Second, courts have shown some hostility to such clauses.<sup>39</sup>

## ARBITRATION

Parties are free to arbitrate almost any type of dispute pertaining to a contract. In addition, they may by agreement bind themselves to arbitrate disputes concerning private commercial rights created by many statutes, including those arising under the Securities Act of 1933, the Securities Exchange Act of 1934,<sup>40</sup> the Age Discrimination and Employment Act,<sup>41</sup> ERISA,<sup>42</sup> the Fair Labor

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<sup>37</sup> See *Phillips Elec. Co. of Durham, Inc. v. Hirani Eng’g and Land Surveying, P.C.*, 2009 WL 3787213 (M.D.N.C. 2009) (contractual designation of Durham County, NC as the venue for litigation prohibited action in federal court because there is no way to initiate an action in federal court in Durham); *Bassett Seamless Guttering, Inc. v. GutterGuard, LLC*, 2006 WL 156874 (M.D.N.C. 2006) (contract clause requiring litigation in Boulder, Colorado prohibited suit in federal court because Colorado has only one federal district court and even though a division of it sits in Boulder, all complaints must be filed in Denver).

<sup>38</sup> E.g., *Excell Inc. v. Sterling Boiler & Mechanical, Inc.* 916 F. Supp. 1063 (D. Colo. 1996).

<sup>39</sup> Compare *IFC Credit Corp. v. Aliano*, 437 F.3d 606 (7th Cir. 2006) (upholding such a clause); *FTC v. IFC Credit*, 543 F. Supp. 2d 925 (N.D. Ill. 2008) (same), with *Preferred Capital, Inc. v. Power Eng’g Group, Inc.*, 860 N.E.2d 741 (Ohio 2007) (ruling such a clause unenforceable, at least if assignment was anticipated but not disclosed at the time the parties entered into the agreement); *Preferred Capital v. Sarasota Kennel Club*, 489 F.3d 303 (6th Cir. 2007) (applying Ohio law to deny enforcement of floating forum selection clause). See also *Polzin v. Appleway Equip. Leasing, Inc.*, 191 P.3d 476 (Mont. 2008) (upholding a lease clause providing for venue to be, at the option of the lessor, wherever the equipment is located or in Spokane, Washington).

<sup>40</sup> See *Rodriquez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989) (concerning the 1933 Act); *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987) (concerning the 1934 Act).

<sup>41</sup> See *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20 (1991).

<sup>42</sup> See *Pritzker v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 7 F.3d 1110 (3d Cir. 1993).

Standards Act,<sup>43</sup> and the Magnuson-Moss Warranty Act.<sup>44</sup> Indeed, arbitration agreements can be binding even in bankruptcy, where the strong federal policy in favor of arbitration can conflict with the goal of having a centralized and expeditious resolution of issues pertaining to the debtor's financial affairs.<sup>45</sup>

Perhaps because so many different types of claims are now arbitrable, arbitration clauses have become a fixture of both commercial and consumer contracts. Today it is difficult – if not impossible – to open a deposit account with a bank or a securities account with a broker without agreeing to arbitrate any disputes that may arise. Nevertheless, before including an arbitration clause in a standardized form or a negotiated agreement, the parties and their counsel should consider the attributes of arbitration. Because most – and possibly all – of these attributes can be altered by agreement, any arbitration clause should be crafted to the particular contractual relationship.

### **Principal Attributes of Arbitration**

The process involved in any particular arbitration proceeding can and will vary depending on the nature of the dispute, the arbitrator or arbitration association selected, and the language of the parties' arbitration clause. Obviously, it is essential that any arbitration clause specify – either explicitly or through incorporation of the rules of some arbitration association – how the arbitrators will be selected,<sup>46</sup> who will bear the costs, and how the arbitration itself will be conducted. Two of the most common arbitration associations for domestic commercial disputes are the American Arbitration Association (“AAA”) and the National Association of Securities Dealers (“NASD”).<sup>47</sup> Each organization has fairly detailed rules and procedures governing the arbitrations they conduct.

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<sup>43</sup> See, e.g., *Floss v. Ryan's Family Steak Houses*, 211 F.3d 306, 313 (6th Cir. 2000), *cert. denied*, 531 U.S. 1072 (2001); *Kuehner v. Dickinson & Co.*, 84 F.3d 316 (9th Cir. 1996). Cf. *Albertson's Inc. v. United Food & Commercial Worker's Union*, 157 F.3d 758 (9th Cir. 1998) (individual employee's FLSA claim not required to be arbitrated merely because it falls under the arbitration clause of the employer's collective bargaining agreement with the union.).

<sup>44</sup> See *Davis v. Southern Energy Homes, Inc.*, 305 F.3d 1268 (11th Cir. 2002), *cert. denied*, 538 U.S. 945 (2003); *Walton v. Rose Mobile Homes LLC*, 298 F.3d 470 (5th Cir. 2002).

<sup>45</sup> See *MBNA America Bank, N.A. v. Hill*, 436 F.3d 104 (2d Cir. 2006) (debtor's core class actions against creditor for violations of the stay must be arbitrated); *In re Mintze*, 434 F.3d 222 (3d Cir. 2006) (debtor's action for rescission of home equity loan must be arbitrated even though qualifying as a core proceeding). Cf. *In re White Mountain Mining Co., LLC*, 403 F.3d 164 (4th Cir. 2005) (bankruptcy court did not abuse its discretion by refusing to order – or permit – international arbitration of core proceeding by insider to determine that prepetition advances to debtor were debt, not equity).

<sup>46</sup> For example, perhaps each party will select one and the two chosen will select a third. If the arbitration agreement does not specify how the arbitrator(s) will be selected and the parties do not otherwise agree, the applicable rules of an arbitration association will likely provide a mechanism. See, e.g., AAA, Commercial Arbitration Rules and Mediation Procedures, Rule 1(a).

<sup>47</sup> From 2001 through 2006, an average of slightly more than 7,040 arbitration cases have been filed with the NASD. See [www.nasd.com/ArbitrationMediation/NASDDisputeResolution/Statistics/index.htm](http://www.nasd.com/ArbitrationMediation/NASDDisputeResolution/Statistics/index.htm).

In fact, the AAA has different rules and procedures for dealing with different types of disputes, indeed, quite a large number of different sets of rules and procedures.<sup>48</sup> The most important is probably the Commercial Arbitration Rules and Mediation Procedures (Including Procedures for Large, Complex Commercial Disputes). These rules govern an AAA arbitration if either the parties' agreement specifies or if the dispute is a domestic commercial dispute and the parties have merely agreed to arbitrate pursuant to the rules of the AAA.<sup>49</sup> For that reason, much of the discussion below is based on these rules.

**1. Discovery & Motion Practice.** Arbitration is often expeditious compared to litigation in court. This is because much of the legal and political maneuvering commonplace in litigation is not available in arbitration. For example, there is little or no motion practice. A dispute might be resolved without a formal hearing, but there is usually no equivalent of a motion to dismiss or motion for summary judgment followed by a lengthy wait for a decision. Similarly, discovery in arbitration is fairly limited and thus fights about discovery are infrequent. The parties may file pleadings and exchange documents,<sup>50</sup> but interrogatories and depositions are rare and subject to the arbitrator's discretion.<sup>51</sup>

These attributes may be desirable for a particular client or transaction, or they may not. Some clients benefit from a speedy resolution of a dispute, but others may want to use the prospect of lengthy and expensive litigation as part of their negotiating strategy. Similarly, some clients may have secrets that they would not want to disclose – such as the internal e-mail message revealing a hidden and improper motive – while others may need access to the other party's internal records to successfully present a claim. A transactional attorney should consider what is most likely to be in the client's interests when deciding whether to include an arbitration clause and, if so, whether to expand the types of discovery that will be available.

**2. No Juries, Rules of Evidence, or Class Actions.** Arbitration is less formal than litigation. It is conducted without a jury. In part because of that, the parties need not comply with the rules of evidence. Instead, they may submit and the arbitrator may consider any relevant and material evidence.<sup>52</sup> Contracting parties are no doubt free to require that arbitration proceedings be conducted in conformity with the rules of evidence, but that would be unusual.

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<sup>48</sup> See [www.adr.org/RulesProcedures](http://www.adr.org/RulesProcedures).

<sup>49</sup> See AAA, Commercial Arbitration Rules and Mediation Procedures, Rule 1(a).

<sup>50</sup> See AAA, Commercial Arbitration Rules and Mediation Procedures, Rule 21(b); NASD, Uniform Code of Arbitration, Rules 10314(a),(b), 10321(c).

<sup>51</sup> See AAA, Commercial Arbitration Rules and Mediation Procedures, Rule 21(a), (c); NASD, Uniform Code of Arbitration, Rule 10321(a), (b). See also Philip D. O'Neill, *The Powers of Arbitrators to Award Monetary Sanctions for Discovery Abuse*, 60 DISP. RES. J. 60 (2006).

<sup>52</sup> See AAA, Commercial Arbitration Rules and Mediation Procedures, Rule 31(a); NASD, Uniform Code of Arbitration, Rule 10323.

A somewhat related point is that most arbitration associations do not have a procedure for class actions. This can be very significant. In consumer transactions where the amount in controversy in any dispute is low, the typical consumer has insufficient economic incentive to bring an individual action. Class actions are often the only way consumers can effectively assert and enforce their contractual and statutory rights. If their contracts require the consumers to arbitrate, the consumers are essentially left without recourse. While this may render an arbitration clause unconscionable and unenforceable, such arguments are notoriously difficult to win.<sup>53</sup>

**3. Privacy.** Most arbitration proceedings are private. The proceedings themselves are not open to the public,<sup>54</sup> and the arbitrators are expected to maintain confidentiality.<sup>55</sup> A corollary to this is that the decisions of arbitrators are generally not known, discoverable, or precedential. This can be a powerful incentive to include an arbitration clause in a written agreement. A party may not want the resolution of one dispute to have *stare decisis* effect or even to be persuasive authority for resolving similar disputes. Moreover, to the extent that an arbitrator may be persuaded by the decisions of prior arbitrators, the private nature of the proceedings may give one party a virtual monopoly on the relevant information. For example, a business that arbitrates disputes with its consumer customers will certainly have a record of all prior arbitrations, but individual consumers will not.

**4. Basis of Decision.** In general, an arbitrator's decision may be based on notions of justice and equity; it need not be consistent with the law. Thus, for example, an action barred by the applicable statute of limitations may nevertheless be arbitrable.<sup>56</sup> Accordingly, some arbitrations will result in decisions contrary to what the law requires. Regrettably, this is also true with respect to litigation, but for different reasons. With respect to litigation, however, appellate review provides an opportunity to correct legal errors by the trial judge. Arbitration decisions are not generally reversible for legal error. Contracting parties that expect their counterparts to strictly comply with their contractual and legal duties, may not want to grant such wide discretion to an arbitrator. They

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<sup>53</sup> See, e.g., *Anders v. Hometown Mortgage Services, Inc.*, 346 F.3d 1024 (11th Cir. 2003) (limitations on remedies do not affect the enforceability of an arbitration agreement); *Rosen v. SCIL, LLC*, 799 N.E.2d 488 (Ill. Ct. App. 2003) (credit card arbitration agreement not unconscionable because it prohibited class actions). *But see Fensterstock v. Education Finance Partners*, 611 F.3d 124 (2d Cir. 2010) (arbitration clause in student loan note that contained waiver of class action unconscionable under California law); *In re Checking Account Overdraft Litigation.*, 718 F. Supp. 2d 1352 (S.D. Fla. 2010) (arbitration and class action waiver provisions of account holders' contract with bank unconscionable under Washington law); *Ingle v. Circuit City Stores, Inc.*, 328 F.3d 1165 (9th Cir. 2003) (arbitration clause in employment agreement unconscionable because of its one-way application, one-year limitations period, bar on class actions, and cost splitting provisions); *Ting v. AT&T*, 319 F.3d 1126 (9th Cir. 2003) (arbitration clause unconscionable because it barred class actions, split costs inappropriately, and mandated that results be kept confidential); *Szetela v. Discover Bank*, 118 Cal. Rptr. 2d 862 (Cal. Ct. App. 2002), *cert. denied*, 537 U.S. 1226 (2003) (striking a ban on class actions from arbitration clause).

<sup>54</sup> See AAA, Commercial Arbitration Rules and Mediation Procedures, Rule 23.

<sup>55</sup> AAA, Code of Ethics for Commercial Arbitrators, Canon VI. In contrast, NASD Arbitration awards are made public. NASD, Uniform Code of Arbitration, Rule 10330(f).

<sup>56</sup> *Broom v. Morgan Stanley DW Inc.*, 236 P.3d 182 (Wash. 2010).

should therefore consider including in their arbitration clause a requirement that the arbitrator's decision be based upon and consistent with the parties' legal rights.

**5. Remedies Available.** In general and unless agreed otherwise, an arbitrator may make any award the arbitrator deems just and equitable and which is within the scope of the agreement of the parties.<sup>57</sup> This includes specific performance (that is, an order compelling the breaching party to perform its contractual duties), interest starting at any date the arbitrator deems appropriate, assessment of costs and fees, and an award of attorney's fees if authorized by law or by the parties' agreement.<sup>58</sup>

Contrary to popular belief, arbitrators may award punitive damages. Even if the governing law selected by the parties would not allow for an award of punitive damages, as long as the arbitration procedures do not expressly prohibit them, punitive damages may be awarded.<sup>59</sup> Thus, parties wishing to foreclose the possibility of punitive damages should make that clear in their agreement.

**6. Appeal of Decision.** By submitting a dispute to arbitration, the parties implicitly consent to entry of a judgment on that award by any court of competent jurisdiction.<sup>60</sup> They also implicitly agree that the award is not subject to appellate review for legal or factual error. Review on appeal is typically restricted to instances where the award was procured by fraud or corruption, the arbitrator was patently partial to one side, the arbitrator's misconduct prejudiced one party's rights, or the arbitrator exceeded his or her authority.<sup>61</sup> This is one of the things that makes arbitration inherently risky.

The parties may, however, provide by contract for a more expansive review, one that scrutinizes for error the arbitrator's findings of fact and conclusions of law. While the Supreme Court has ruled that the parties cannot by agreement authorize courts to review for legal error,<sup>62</sup> they

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<sup>57</sup> AAA, Commercial Arbitration Rules and Mediation Procedures, Rule 43(a).

<sup>58</sup> AAA, Commercial Arbitration Rules and Mediation Procedures, Rule 43(a), (c), (d).

<sup>59</sup> *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52 (1995); *Stark v. Sandberg, Phoenix & Von Gontard, P.C.*, 381 F.3d 793, 803 (8th Cir. 2004), *cert. denied sub nom. Stark v. EMC Mortgage Corp.*, 544 U.S. 1000 (2005).

<sup>60</sup> See AAA, Commercial Arbitration Rules and Mediation Procedures, Rule 48(c).

<sup>61</sup> See 9 U.S.C. § 10(a). *But cf. Broom v. Morgan Stanley DW Inc.*, 236 P.3d 182 (Wash. 2010) (a *facial* legal error is a basis for vacating an arbitral award because it indicates that the arbitrators exceeded their powers).

<sup>62</sup> See *Hall Street Assocs. v. Mattel, Inc.*, 128 S. Ct. 1396 (2008). Prior to the Supreme Court's decision, lower courts were divided on whether parties could by contract provide for judicial jurisdiction over an arbitrator's decision. Some permitted it. See, e.g., *Syncor International Corp. v. McLeland*, 120 F.3d 262 (4th Cir. 1997), *cert. denied*, 522 U.S. 1110 (1998); *Gateway Technology v. MCI Telecommunications Corp.*, 64 F.3d 993 (5th Cir. 1995). See also Richard C. Csolomon, *Appeals of Arbitration Awards By Agreement: Why They Should Be Allowed*, 58 DISP. RES. J. 58 (May/July 2003). Other did not. See, e.g., *Kyocera Corp. v. Prudential-Bache Trade Services, Inc.*, 341 F.3d 987 (9th Cir. 2003); *Bowen v. Amoco Pipeline Co.*, 254 F.3d 925 (10th Cir. 2001); UHC

apparently can provide for a review to be conducted by an appellate arbitrator or a panel of appellate arbitrators. Indeed, the rules of some arbitration organizations expressly envision an appeals process while those of others, such as the AAA, implicitly permit it.<sup>63</sup> If such review is desired, the arbitration clause should specify the grounds for reversal, the standard of review, and the procedures to be followed.

### Scope of Arbitration Clause

Even if the parties want to arbitrate their disputes, arbitration may not be an appropriate or desirable procedure for dealing with all types of disputes or protecting all types of contractual rights. For example, a secured party may wish to preserve its ability to get a writ of replevin – something that in most jurisdictions can be accomplished quickly and on an *ex parte* basis even before a judgment is entered – without first seeking arbitration. Similarly, a licensor of intellectual property may wish to preserve its ability to seek and obtain a temporary restraining order and preliminary injunction.

Generally a contractual arbitration clause does not bar efforts to obtain a preliminary injunction; a court may grant preliminary injunctive relief pending arbitration, provided the requirements for such relief are met.<sup>64</sup> Indeed, the standard procedures of most arbitration organizations contemplate the availability of interim judicial relief.<sup>65</sup> One would think, therefore, that any effort to make this explicit in the arbitration clause would be proper, albeit perhaps unnecessary. Nevertheless, arbitration clauses that require one party to seek arbitration while

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Management Co. v. Computer Sciences Corp., 148 F.3d 992, 998 (8th Cir. 1998); Chicago Typographical Union v. Chicago Sun-Times, 935 F.2d 1501 (7th Cir. 1991) (dicta); Crowell v. Downey Community Hospital Foundation, 115 Cal. Rptr. 2d 810 (Cal. Ct. App. 2002).

<sup>63</sup> See Paul B. Marrow, *A Practical Approach to Affording Review of Commercial Arbitration Awards: Using an Appellate Arbitrator*, 60 DISP. RES. J. 10 (2005) (referring to rules of the International Institute for Conflict Prevention and Resolution, the Judicial Arbitration and Mediation Services, and the National Arbitration Forum).

<sup>64</sup> See Teradyne, Inc. v. Mostek Corp., 797 F.2d 43 (1st Cir. 1986); Roso-Lino Beverage Distributors, Inc. v. Coca-Cola Bottling Co. of New York, 749 F.2d 124 (2d Cir. 1984); Ortho Pharmaceutical Corp. v. Amgen, Inc., 882 F.2d 806 (3d Cir. 1989); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bradley, 756 F.2d 1048 (4th Cir. 1985); Performance Unlimited, Inc. v. Questar Publishers, Inc., 52 F.3d 1373 (6th Cir. 1995); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Salvano, 999 F.2d 211, 213-14 (7th Cir. 1993); PMS Distrib. Co. v. Huger & Suhner, A.G., 863 F.2d 639 (9th Cir. 1988); Wine Not Int'l v. 2atec, LLC, 2006 WL 1766508 (M.D. Fla. 2006). See also Cal. Civil Proc. Code § 1281.8(b). *Contra* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Hovey, 726 F.2d 1286 (8th Cir. 1984). *But see* Ferry-Morse Seed Co. v. Food Corn, Inc., 729 F.2d 589 (8th Cir. 1984) (affirming, subsequent to *Hovey*, the grant of a preliminary injunction in an arbitrable dispute).

<sup>65</sup> See AAA, Commercial Arbitration Rules and Mediation Procedures, Rule 34(c); NASD, Uniform Code of Arbitration, Rule 10335.

permitting the other to seek recourse in the courts run the risk of being declared unconscionable.<sup>66</sup> Attorneys drafting arbitration clauses should therefore tread carefully in this area.

### ***Problem 6-3***

You are general counsel to a regional provider of internet services. You are considering adding a compulsory arbitration clause to each of the following form agreements that your company uses.

1. Agreements with suppliers who sell goods and services to the company on a recurring basis.
2. One-year and two-year agreements to provide internet service to consumers and small businesses.
3. Employment agreements with senior executives.

For each of these agreements, why should you include an arbitration clause? What reasons, if any, are there for not including an arbitration clause?

### ***Problem 6-4***

Using one of the links below, access the form service agreement of one of the three main providers of cellular telephone service. Identify each boilerplate term in the agreement and the purpose of each such term (note, some sections may have more than one term). For each of at least three boilerplate terms in the service agreement, identify some circumstance in which the service provider would not be happy with the term.

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<sup>66</sup> See *Nagrampa v. Mailcoups, Inc.*, 469 F.3d 1257 (9th Cir. 2006) (arbitration clause in franchise agreement was substantively unconscionable in part because it gave the franchisor access to a judicial forum to obtain provisional remedies to protect its intellectual property, while providing the franchisee with only the arbitral forum to resolve her claims); *Horton v. California Credit Corp.*, 2009 WL 2488031 (Cal Ct. App. 2009) (arbitration clause in home mortgage agreement was substantively unconscionable because it covered all of the borrower's causes of action but excepted foreclosures, which was virtually the only thing the lender would seek); *Cordova v. World Finance Corp. Of New Mexico*, 208 P.3d 901 (N.M. 2009) (lender's form arbitration provision that requires the borrower to arbitrate all disputes while permitting the lender the option to access courts for all remedies the lender is most likely to pursue against a borrower is unconscionable). *But cf.* *U.S. ex rel. Gillette Air Conditioning Co., Inc. v. Satterfield and Pontikes Construction, Inc.*, 2010 WL 5067683 (W.D. Tex. 2010) (arbitration clause that required subcontractor to arbitrate disputes, if contractor so elected, was enforceable because mutuality of obligation to arbitrate is not required and one-sided clause is not unconscionable); *GE Commercial Distribution Fin. Corp. v. RER Performance, Inc.*, 476 F. Supp. 2d 116 (D. Conn. 2007) (exception in arbitration clause for replevin actions was enforceable, and thus lender could bring judicial action despite arbitration clause); *Salley v. Option One Mortgage Corp.*, 925 A.2d 115 (Pa. 2007) (it is not presumptively unconscionable for arbitration clause in sub-prime home mortgage loan to have an exception for foreclosure by the lender); *Delta Funding Corp. v. Harris*, 912 A.2d 104 (N.J. 2006) (exclusion of foreclosure actions from arbitration clause did not render clause unconscionable, although cost-shift and attorney fee provisions might be unconscionable).

1. If your last name begins with a letter from A to G, access the terms of [AT&T](#);
2. If your last name begins with a letter from H to M, access the terms of [Sprint](#).
3. If your last name begins with a letter from N to Z, access the terms of [Verizon](#).

## A BRIEF REVIEW

### *Problem 7-1*

Below are some additional terms of the form commercial lease we first saw in Unit 2. Review the terms closely. For each provision, determine what type or types of contract terms it contains, what it means, and why it is included. In addition, answer the questions in blue.

## Commercial Lease Agreement

\* \* \*

20. **Notice.**

Any notice required or permitted under this Lease shall be deemed sufficiently given or served if sent by United States certified mail, return receipt requested, addressed as follows:

If to Landlord to:

\_\_\_\_\_

**[Landlord]**

\_\_\_\_\_

**[Landlord's Address]**

If to Tenant to:

\_\_\_\_\_

**[Tenant]**

\_\_\_\_\_

**[Tenant's Address]**

Landlord and Tenant shall each have the right from time to time to change the place notice is to be given under this paragraph by written notice thereof to the other party. [What problems might arise in applying this provision?]

21. **Brokers.**

Tenant represents that Tenant was not shown the Premises by any real estate broker or agent and that Tenant has not otherwise engaged in, any activity which could form the basis for a claim for real estate commission, brokerage fee, finder's fee or other similar charge, in connection with this Lease.

22. **Waiver.**

No waiver of any default of Landlord or Tenant hereunder shall be implied from any omission to take any action on account of such default if such default persists or is repeated, and no express

waiver shall affect any default other than the default specified in the express waiver and that only for the time and to the extent therein stated. One or more waivers by Landlord or Tenant shall not be construed as a waiver of a subsequent breach of the same covenant, term or condition. [How do the three sentences in this provision differ?]

23. **Memorandum of Lease.**

The parties hereto contemplate that this Lease should not and shall not be filed for record, but in lieu thereof, at the request of either party, Landlord and Tenant shall execute a Memorandum of Lease to be recorded for the purpose of giving record notice of the appropriate provisions of this Lease. [Is this provision adequate to achieve its intended purpose?]

24. **Headings.**

The headings used in this Lease are for convenience of the parties only and shall not be considered in interpreting the meaning of any provision of this Lease. [Is “shall” the appropriate verb here?]

25. **Successors.**

The provisions of this Lease shall extend to and be binding upon Landlord and Tenant and their respective legal representatives, successors and assigns. [What is the difference, if any, between the terms “legal representatives,” “successors,” and “assigns”?]

26. **Consent.**

Landlord shall not unreasonably withhold or delay its consent with respect to any matter for which Landlord’s consent is required or desirable under this Lease. [Are the words “shall” and “required or desired” the appropriate words to use? If not, how should this clause be rephrased? What other problems might there be with this clause? To answer this last question, review the earlier portions of the lease.]

27. **Performance.**

If there is a default with respect to any of Landlord’s covenants, warranties or representations under this Lease, and if the default continues more than fifteen (15) days after notice in writing from Tenant to Landlord specifying the default, Tenant may, at its option and without affecting any other remedy hereunder, cure such default and deduct the cost thereof from the next accruing installment or installments of rent payable hereunder until Tenant shall have been fully reimbursed for such expenditures, together with interest thereon at a rate equal to the lesser of twelve percent (12%) per annum or the then highest lawful rate. If this Lease terminates prior to Tenant’s receiving full reimbursement, Landlord shall pay the unreimbursed balance plus accrued interest to Tenant on demand.

28. **Compliance with Law.**

Tenant shall comply with all laws, orders, ordinances and other public requirements now or hereafter pertaining to Tenant’s use of the Leased Premises. Landlord shall comply with all laws, orders,

ordinances and other public requirements now or hereafter affecting the Leased Premises. [What does the word “orders” cover?]

29. **Final Agreement.**

This Agreement terminates and supersedes all prior understandings or agreements on the subject matter hereof. This Agreement may be modified only by a further writing that is duly executed by both parties. [How do the two sentences in this paragraph differ? Is the second sentence enforceable?]

30. **Governing Law.**

This Agreement shall be governed, construed and interpreted by, through and under the Laws of the State of Washington.

IN WITNESS WHEREOF, the parties have executed this Lease as of the day and year first above written.

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**[Landlord Signature]**

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**[Tenant Signature]**

***Drafting Exercise 7-A***

Rewrite the notice provision to avoid the ambiguities and resolve the problems created by the current language.

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## ASSIGNMENT AND DELEGATION

Contracts by their very nature create rights and obligations. Each promise creates a duty of the promisor and a correlative right in the promisee. Contracts with mutual promises – which are the bulk of contracts – create rights and duties for both parties.

In the modern commercial world, contracting parties often want to transfer their contractual rights or duties to others. Sometimes, such transfers involve all of the rights and duties with respect to one or more contracts. When a business is to be sold, for example, the seller often transfers all of the outstanding contractual rights and duties of the business to the buyer. More commonly, only a portion of the rights or duties are transferred. Consider, for example, General Contractor, who enters into an agreement with Owner to construct a new office building on Owner's property. In the agreement, General Contractor promises to build the building pursuant to certain specifications and Owner promises to make a series of payments. In the normal course of affairs, General Contractor may want to transfer both some of its contractual rights and some of its contractual duties. Specifically, General Contractor may need to pay its employees before Owner is required to make payment under the construction contract. To get the funds to pay the employees, General Contractor may wish to transfer (*e.g.*, sell) the right to future payment from Owner to a bank or finance company (presumably at a discount). Similarly, General Contractor may not have the expertise needed to perform all of construction work. It may therefore need to transfer the duty to perform the electrical or plumbing work to an electrician or plumber.

In short, contract rights are essentially a type of incorporeal property. They can be bought and sold just as other types of property – real estate or goods – can be bought and sold. The analogy is imperfect, though. If you sell a car or a house, the only two people affected by the transaction are you and the buyer. If you sell a right to receive performance under a contract, you not only alter the rights of yourself and the buyer, you are potentially also affecting the promisor under the contract. This is even more clearly the case when contractual duties are transferred. Imagine what would happen if the teacher of this course, who is under contract with the school, were to transfer the obligation to teach the remainder of the semester to a recent college graduate who had never attended law school. No doubt neither the school nor the students enrolled in the course would be happy.<sup>1</sup>

The law deals with the transfer of contractual rights and duties through a variety of rules. Before examining those rules, it is important to understand the applicable terminology. The transfer of a contractual *right* is called an “assignment”; the transfer of a contractual *duty* is referred to as a “delegation.” The transferee of an assignment is an “assignee” and the transferee of a duty is a “delegate.” The diagrams that follow may help.

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<sup>1</sup> Cf. Restatement (Second) of Contracts §§ 318, ill. 5.



on assignment is valid, but often such a restriction will be invalidated by statute.<sup>5</sup> In the absence of a statute, a contractual restriction on assignment is enforceable.

### ***Problem 8-1***

Seller contracts with Homeowner to supply at a stated price all the heating oil Homeowner needs to heat Homeowner's house for the next four months.

- A. The agreement between the parties has no restriction on assignment.
  - 1. May Seller assign the right to payment from Homeowner? *See* U.C.C. § 2-210(2).
  - 2. Homeowner sells the home to Buyer. May Homeowner assign to Buyer the right to receive heating oil from Seller?
  - 3. May Homeowner assign the right to receive heating oil to Neighbor? If so, is Neighbor entitled to receive the amount of heating oil needed to heat Homeowner's house or the amount needed to heat Neighbor's house? *See* Restatement (Second) of Contracts § 334, ill. 3.
- B. How, if at all, does the answer to each question in Part A change if the agreement between Seller and Homeowner contains a clause prohibiting each party from "assigning the contract"? *See* Restatement (Second) of Contracts § 322(1); U.C.C. § 2-210(4).
- C. How, if at all, does the answer to each question in Part A change if the agreement between Seller and Homeowner contains a clause prohibiting each party from "assigning its rights under the contract"? *See* Restatement (Second) of Contracts § 322(2); U.C.C. § 2-210(2). *See also* *Bel-Ray Co. v. Chemrite (Pty) Ltd.*, 181 F.3d 435 (3d Cir. 1999).
- D. How, if at all, does the answer to each question in Part A change if the agreement between Seller and Homeowner contains a clause prohibiting each party from "assigning its rights under the contract" and providing that any attempted assignment of such rights is "void"?

### **DELEGATION OF DUTIES**

The rules on delegation are more restrictive than the rules on assignment. In addition to prohibiting a delegation that is contrary to public policy or to the terms of the contract, they also prohibit delegation whenever the obligee has a substantial interest in having the obligor personally perform. This last restriction covers most personal services contracts. As one court put it, had the Metropolitan Airports Commission "contracted with Luciano Pavarotti to sing in its passenger facilities in order to soothe the souls of weary travelers, it could not be compelled to accept

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<sup>5</sup> Article 9 of the Uniform Commercial Code governs the assignment of most contractual rights to payment and overrides most contractual restrictions and many legal restrictions on assignment. *See* U.C.C. §§ 9-406, 9-408. Article 2 generally permits both buyers and sellers of goods to assign their contract rights. *See* U.C.C. § 2-210(2).

performance from pop-star Michael Jackson.”<sup>6</sup> Of course, it is not always easy to identify what is and what is not a contract for personal services. What is clear is that the payment of money is not normally a personal service. As the same court continued, “the payment of rent pursuant to a lease is hardly the type of performance that depends upon the identity of the party that is to perform, *i.e.*, the lessee.”<sup>7</sup>

Even when delegation is permissible, it does not absolve the delegator of its duty under the contract.<sup>8</sup> To obtain absolution, the assent of the obligee is needed. If that assent is given, the result is a “novation.” A novation is, in essence a new agreement in which the obligee releases the obligor and agrees to accept the obligation of the delegate instead. A novation will not be inferred merely from the obligee’s acceptance of the performance of the delegate; a more clear manifestation of assent is needed. As a result, in most instances in which a contractual duty is delegated, there is no novation. Thus, the original obligor remains obligated on the contract even after it has delegated its duty to perform. Whether the delegate is also obligated (in the absence of a novation) depends on a variety of factors that we will not explore.<sup>9</sup>

## ON TENANTS, SUBLEASES & ASSIGNMENTS

Assignment and delegation works similarly with respect to a lease, but there are some differences arising from the fact that a lease is more than a contract. It not only creates contractual rights and duties, it also divides property rights between the landlord and the tenant. The tenant acquires a leasehold interest: the right to possess the property in exchange for rent, subject to other terms of the agreement between the parties. The landlord retains the reversionary interest: the right to obtain possession when the lease term ends (either at its stated expiration or earlier upon the tenant’s default). Of course, the landlord also acquires the right to rent from the tenant, again subject to other terms of the agreement between the parties.

Under traditional property-law principles, either party may transfer its property interest but may not, of course, transfer the interest of the other. Thus, for example, if the landlord sells the property, the new owner receives what the landlord was able to sell: that is, the landlord’s reversion. The new owner would also receive the right to collect the rent that comes due under the lease because that right *runs with the land*. The new owner does not, however, obtain an immediate right to possess the property; the tenant’s leasehold interest survives.<sup>10</sup> The new owner, of course, may

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<sup>6</sup> Matter of Midway Airlines, Inc., 6 F.3d 492, 495 (7th Cir. 1993).

<sup>7</sup> *Id.*

<sup>8</sup> Restatement (Second) of Contracts § 318(3).

<sup>9</sup> Typically, the delegate will become obligated only if the delegation was pursuant to a contract with the obligor (*i.e.*, the delegate is not agreeing to perform gratuitously) merely and the obligee qualifies as a third-party beneficiary of that contract.

<sup>10</sup> The applicable recording act may change this result, depending on the length of the lease and whether it was recorded. The basic rules of the recording system are discussed in Unit 10.

end a month-to-month tenancy, for example, by giving one month's notice, just as the prior landlord could have done this. If the tenant has six months left on a one-year lease, however, the new owner takes the property subject to the remaining six-month possessory right in the tenant.<sup>11</sup> Because restraints on alienation of a fee interest are generally void, language in the lease purporting to restrict the landlord's right to sell the property – and thereby assign the lease – would likely be ineffective.

Tenants too can normally assign their rights under a lease. However, because they do not have a fee interest in the leased property, the law's traditional hostility to restraints on alienation do not apply. Therefore, the lease can restrict the tenant's ability to transfer all or part of the leasehold, either through an outright prohibition or by requiring the landlord's consent. Accordingly, we now consider what happens in three distinct situations: (i) when the lease agreement is silent on whether the tenant may transfer its rights; (ii) when the lease requires the landlord's consent to a transfer by the tenant; and (iii) when the lease prohibits transfers by the tenant.

### ***When the Lease is Silent on Subletting and Assignment – Who Must Pay Rent***

The transfer of the leasehold is called either an *assignment* or a *sublease*. An assignment conveys *all* the tenant's remaining interest in the property. A sublease conveys less than all of the tenant's remaining interest, with the result that the tenant retains some future interest or the right to control the property in the future. For example, if a tenant has six months remaining on a lease and transfers the property to someone else for four months, the tenant has sublet the property because the tenant retains the right to regain possession for the last two months of the lease term. A sublease may also be created if the tenant retains a right of entry that can be exercised if the subtenant violates one or more of the terms of the sublease agreement.

Why is it important to know whether the arrangement is a sublease or an assignment? Because the answer affects whether the new tenant is liable directly to the landlord. Even after entering into a sublease, the new tenant is not in *privity of contract* with the landlord. The absence of contractual privity is the reason why a delegate of a contractual duty does not normally become directly liable to the obligee.<sup>12</sup> Accordingly, the landlord generally has no cause of action for nonpayment of rent against a subtenant. One exception to this would arise if the subtenant promised the landlord to pay the rent. Another exception may exist if the subtenant expressly promises the tenant to pay the rent to the landlord. In that case, the landlord may qualify as a *third-party beneficiary* of the agreement made between the tenant and subtenant; in other words, the landlord may be the intended beneficiary of the subtenant's promise to the tenant.<sup>13</sup> Note, the landlord probably can enforce directly against a subtenant the other covenants in the lease (*e.g.*, use restrictions), so long as the subtenant has notice of them. Even if the subtenant never saw the

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<sup>11</sup> Of course, these results could be varied by agreement between the new owners and the tenant. For example, the new owner could pay the tenant to terminate the lease and surrender the premises.

<sup>12</sup> See *supra* note 9 and accompanying text.

<sup>13</sup> Of course, the landlord who has not received the required rental payments can maintain an eviction action directly against a subtenant. Some courts will even issue an injunction ordering the subtenant to comply with the covenant to pay rent, on the theory that an injunction is not the equivalent of money damages.

original lease, courts are likely to conclude that the subtenant had notice of its terms; a reasonable subtenant would inquire whether the tenant had made promises to the landlord restricting use of the premises. Enforcement of such covenants is typically done by injunction to enforce an equitable servitude.

A new tenant who is an assignee of the lease also lacks contractual privity with the landlord. Nevertheless, an assignee of a leasehold is normally responsible directly to the landlord for all the undertakings under the original lease. This is because the assignee – unlike a subtenant – is in *privity of estate* with the landlord; because the original tenant has given up all interest in the property, the landlord and the assignee are deemed to share interests in the property. Because most covenants in the original lease – including the obligation to pay rent – run with the land, the landlord has a direct cause of action for breach against a defaulting assignee. In short, an assignment of a leasehold also operates as a delegation – directly enforceable by the landlord – of the obligation to pay rent.

### *Illustrations*

1. Original Tenant assigns a lease with six months remaining on the lease term to a new tenant, Assignee. Assignee fails to pay the rent. Landlord may sue Original Tenant for the unpaid rent because Original Tenant remains in a contractual relationship with Landlord. The assignment does not relieve Original Tenant of the obligation to pay rent. Alternatively, Landlord may sue Assignee directly for the unpaid rent. Since the covenant to pay rent runs with the land, Assignee is directly liable to Landlord for the unpaid rent.

2. Original Tenant *sublets* an apartment for four of the six months remaining on the lease term to a new tenant, Subtenant. Subtenant fails to pay the rent. Landlord may sue Original Tenant for the unpaid rent because Original Tenant remains contractually bound to pay the rent. However, Landlord may have no direct cause of action against Subtenant for the rent. Thus, if Landlord sues Subtenant for the rent, the court may dismiss the complaint for failure to state a claim upon which relief can be granted. However, if neither Original Tenant nor Subtenant pays the rent, Landlord can evict Original Tenant and end the leasehold. This would terminate Subtenant's right of possession because Subtenant has a right to possess only what Original Tenant has a right to possess in the absence of a separate agreement with Landlord. If Landlord evicts Subtenant even though Subtenant has paid Original Tenant (*i.e.*, Subtenant paid Original Tenant but Original Tenant failed to pay Landlord), Subtenant would have a cause of action against Original Tenant.

Note, in both illustrations above, if Landlord sues and recovers from Original Tenant, Original Tenant will have a right to be reimbursed in whole or in part by the new tenant. This is true whether the new tenant is an assignee or a subtenant. In fact, Original Tenant will ordinarily cross-claim the new tenant into the lawsuit brought by Landlord as a third-party defendant. If the new tenant is an assignee, the assignee will be obligated to reimburse the tenant for the full amount of Original Tenant's liability to Landlord. If the new tenant is a subtenant, the subtenant will be liable for whatever amount of rent the subtenant agreed to pay. That amount might be more or less than the rent due under the original lease.

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***When a Lease Requires the Landlord's Consent to Sublease or Assignment***

Many leases provide for subletting or assignment only with the landlord's consent. These clauses may be phrased either in the negative or the affirmative, that is, "tenant may not sublet or assign the lease without the landlord's consent" or "tenant may sublet or assign the lease subject to the landlord's consent."

These clauses sometimes purport refer only to "subletting," without mentioning assigning. To promote the alienability of leaseholds, courts traditionally interpreted such clauses narrowly, construing them to limit only subletting. However, the modern trend is to focus on the intent of the parties. Because modern usage sometimes employs the term "subletting" to mean any transfers of the leasehold interest by the tenant, a clause that provides for "no subletting without the landlord's consent" may very well be interpreted to prohibit subletting or assigning without the landlord's consent. Of course, a careful transactional attorney representing a landlord who wants a broad restriction should not rely on such judicial grace, and should expressly reference both subletting and assignment.

An issue that has occasioned much litigation recently is the question whether a criterion of "reasonableness" should be implied in the phrase "no subletting without the landlord's consent." This issue has arisen in both residential and commercial contexts. The law is currently unsettled in this area, as the following cases illustrate.

***KENDALL V. ERNEST PESTANA, INC.***  
**709 P.2d 837 (Cal. 1985)**

Broussard, Justice.

This case concerns the effect of a provision in a commercial lease<sup>14</sup> that the lessee may not assign the lease or sublet the premises without the lessor's prior written consent. The question we address is whether, in the absence of a provision that such consent will not be unreasonably withheld, a lessor may unreasonably and arbitrarily withhold his or her consent to an assignment.<sup>15</sup> This is a question of first impression in this court.

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<sup>14</sup> We are presented only with a commercial lease and therefore do not address the question whether residential leases are controlled by the principles articulated in this opinion.

<sup>15</sup> Since the present case involves an assignment rather than a sublease, we will speak primarily in terms of assignments. However, our holding applies equally to subleases. The difference between an assignment and a sublease is that an assignment transfers the lessee's entire interest in the property whereas a sublease transfers only a portion of that interest, with the original lessee retaining a right of reentry at some point during the unexpired term of the lease.

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## I.

\* \* \* The allegations of the complaint may be summarized as follows. The lease at issue is for 14,400 square feet of hangar space at the San Jose Municipal Airport. The City of San Jose, as owner of the property, leased it to Irving and Janice Perlitch, who in turn assigned their interest to respondent Ernest Pestana, Inc. Prior to assigning their interest to respondent, the Perlitches entered into a 25-year sublease with one Robert Bixler commencing on January 1, 1970. The sublease covered an original five-year term plus four 5-year options to renew. The rental rate was to be increased every 10 years in the same proportion as rents increased on the master lease from the City of San Jose. The premises were to be used by Bixler for the purpose of conducting an airplane maintenance business.

Bixler conducted such a business under the name “Flight Services” until, in 1981, he agreed to sell the business to appellants Jack Kendall, Grady O’Hara and Vicki O’Hara. The proposed sale included the business and the equipment, inventory and improvements on the property, together with the existing lease. The proposed assignees had a stronger financial statement and greater net worth than the current lessee, Bixler, and they were willing to be bound by the terms of the lease.

The lease provided that written consent of the lessor was required before the lessee could assign his interest, and that failure to obtain such consent rendered the lease voidable at the option of the lessor. Accordingly, Bixler requested consent from the Perlitches’ successor-in-interest, respondent Ernest Pestana, Inc. Respondent refused to consent to the assignment and maintained that it had an absolute right arbitrarily to refuse any such request. The complaint recites that respondent demanded “increased rent and other more onerous terms” as a condition of consenting to Bixler’s transfer of interest.

The proposed assignees brought suit for declaratory and injunctive relief and damages seeking, inter alia, a declaration “that the refusal of ERNEST PESTANA, INC. to consent to the assignment of the lease is unreasonable and is an unlawful restraint on the freedom of alienation.” The trial court sustained a demurrer to the complaint without leave to amend and this appeal followed.

## II.

The law generally favors free alienability of property, and California follows the common law rule that a leasehold interest is freely alienable. Contractual restrictions on the alienability of leasehold interests are, however, permitted. “Such restrictions are justified as reasonable protection of the interests of the lessor as to who shall possess and manage property in which he has a reversionary interest and from which he is deriving income.” Schoshinski, *American Law of Landlord and Tenant* § 8:15, at 578-79 (1980).

The common law’s hostility toward restraints on alienation has caused such restraints on leasehold interests to be strictly construed against the lessor. \* \* \* This is particularly true where

the restraint in question is a “forfeiture restraint,” under which the lessor has the option to terminate the lease if an assignment is made without his or her consent.

Nevertheless, a majority of jurisdictions have long adhered to the rule that where a lease contains an approval clause (a clause stating that the lease cannot be assigned without the prior consent of the lessor), the lessor may arbitrarily refuse to approve a proposed assignee no matter how suitable the assignee appears to be and no matter how unreasonable the lessor’s objection. The harsh consequences of this rule have often been avoided through application of the doctrines of waiver and estoppel, under which the lessor may be found to have waived (or be estopped from asserting) the right to refuse consent to assignment.

The traditional majority rule has come under steady attack in recent years. A growing minority of jurisdictions now hold that where a lease provides for assignment only with the prior consent of the lessor, such consent may be withheld *only where the lessor has a commercially reasonable objection to the assignment*, even in the absence of a provision in the lease stating that consent to assignment will not be unreasonably withheld.

For the reasons discussed below, we conclude that the minority rule is the preferable position.

\* \* \*

### III.

The impetus for change in the majority rule has come from two directions, reflecting the dual nature of a lease as a conveyance of a leasehold interest and a contract. The policy against restraints on alienation pertains to leases in their nature as *conveyances*. Numerous courts and commentators have recognized that “[i]n recent times the necessity of permitting reasonable alienation of commercial space has become paramount in our increasingly urban society.” *Schweiso v. Williams*, 198 Cal. Rptr. 238, 240 (1984).

Civil Code section 711 provides: “Conditions restraining alienation, when repugnant to the interest created, are void.” It is well settled that this rule is not absolute in its application, but forbids only unreasonable restraints on alienation. Reasonableness is determined by comparing the justification for a particular restraint on alienation with the quantum of restraint actually imposed by it. “[T]he greater the quantum of restraint that results from enforcement of a given clause, the greater must be the justification for that enforcement.” *Wellenkamp v. Bank of America*, 582 P.2d 970, 973 (Cal. Ct. App. 1978). In *Cohen v. Ratinoff*, the court examined the reasonableness of the restraint created by an approval clause in a lease:

Because the lessor has an interest in the character of the proposed commercial assignee, we cannot say that an assignment provision requiring the lessor’s consent to an assignment is inherently repugnant to the leasehold interest created. We do conclude, however, that *if such an assignment provision is implemented in such a manner that its underlying purpose is perverted by the arbitrary or unreasonable withholding of consent, an unreasonable restraint on alienation is established.*

195 Cal. Rptr. 84, 88 (Cal. Ct. App. 1983) (italics added). \* \* \*

The Restatement Second of Property adopts the minority rule on the validity of approval clauses in leases: “A restraint on alienation without the consent of the landlord of a tenant’s interest in leased property is valid, *but the landlord’s consent to an alienation by the tenant cannot be withheld unreasonably*, unless a freely negotiated provision in the lease gives the landlord an absolute right to withhold consent.” Restatement (Second) of Property, § 15.2(2) (1977) (italics added). A comment to the section explains:

The landlord may have an understandable concern about certain personal qualities of a tenant, particularly his reputation for meeting his financial obligations. The preservation of the values that go into the personal selection of the tenant justifies upholding a provision in the lease that curtails the right of the tenant to put anyone else in his place by transferring his interest, but this justification does not go to the point of allowing the landlord arbitrarily and without reason to refuse to allow the tenant to transfer an interest in leased property.”

*Id.*, cmt. a. Under the Restatement rule, the lessor’s interest in the character of his or her tenant is protected by the lessor’s right to object to a proposed assignee on reasonable commercial grounds. The lessor’s interests are also protected by the fact that the original lessee remains liable to the lessor as a surety even if the lessor consents to the assignment and the assignee expressly assumes the obligations of the lease.

The second impetus for change in the majority rule comes from the nature of a lease as a contract. As the Court of Appeal observed in *Cohen v. Ratinoff*, “[since the majority rule was adopted], there has been an increased recognition of and emphasis on the duty of good faith and fair dealing inherent in every contract.” 195 Cal. Rptr. at 88. Thus, “[i]n every contract there is an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract.” *Universal Sales Corp. v. Cal. etc. Mfg. Co.*, 128 P.2d 665, 677 (Cal. 1942). “[W]here a contract confers on one party a discretionary power affecting the rights of the other, a duty is imposed to exercise that discretion in good faith and in accordance with fair dealing.” *Cal. Lettuce Growers v. Union Sugar Co.*, 289 P.2d 785, 791 (Cal. 1955). Here the lessor retains the discretionary power to approve or disapprove an assignee proposed by the other party to the contract; this discretionary power should therefore be exercised in accordance with commercially reasonable standards. \* \* \*

Under the minority rule, the determination whether a lessor’s refusal to consent was reasonable is a question of fact. Some of the factors that the trier of fact may properly consider in applying the standards of good faith and commercial reasonableness are: financial responsibility of the proposed assignee; suitability of the use for the particular property; legality of the proposed use; need for alteration of the premises; and nature of the occupancy, *i.e.*, office, factory, clinic, *etc.*

Denying consent solely on the basis of personal taste, convenience or sensibility is not commercially reasonable. Nor is it reasonable to deny consent “in order that the landlord may charge a higher rent than originally contracted for.” *Schweiso v. Williams*, 198 Cal. Rptr. at 240. This is

because the lessor's desire for a better bargain than contracted for has nothing to do with the permissible purposes of the restraint on alienation – to protect the lessor's interest in the preservation of the property and the performance of the lease covenants. \* \* \*

In contrast to the policy reasons advanced in favor of the minority rule, the majority rule has traditionally been justified on three grounds. Respondent raises a fourth argument in its favor as well. None of these do we find compelling.

First, it is said that a lease is a conveyance of an interest in real property, and that the lessor, having exercised a personal choice in the selection of a tenant and provided that no substitute shall be acceptable without prior consent, is under no obligation to look to anyone but the lessee for the rent. This argument is based on traditional rules of conveyancing and on concepts of freedom of ownership and control over one's property.

A lessor's freedom at common law to look to no one but the lessee for the rent has, however, been undermined by the adoption in California of a rule that lessors – like all other contracting parties – have a duty to mitigate damages upon the lessee's abandonment of the property by seeking a substitute lessee. Furthermore, the values that go into the personal selection of a lessee are preserved under the minority rule in the lessor's right to refuse consent to assignment on any commercially reasonable grounds. Such grounds include not only the obvious objections to an assignee's financial stability or proposed use of the premises, but a variety of other commercially reasonable objections as well. The lessor's interests are further protected by the fact that the original lessee remains a guarantor of the performance of the assignee.

The second justification advanced in support of the majority rule is that an approval clause is an unambiguous reservation of absolute discretion in the lessor over assignments of the lease. The lessee could have bargained for the addition of a reasonableness clause to the lease (*i.e.*, "consent to assignment will not be unreasonably withheld"). The lessee having failed to do so, the law should not rewrite the parties' contract for them.

Numerous authorities have taken a different view of the meaning and effect of an approval clause in a lease, indicating that the clause is not "clear and unambiguous," as respondent suggests. As early as 1940, the court in *Granite Trust Bldg. Corp. v. Great Atlantic & Pacific Tea Co.*, 36 F. Supp. 77, 78 (D. Mass. 1940), examined a standard approval clause and stated: "It would seem to be the better law that when a lease restricts a lessee's rights by requiring consent before these rights can be exercised, it must have been in the contemplation of the parties that the lessor be required to give some reason for withholding consent." \* \* \*

In light of \* \* \* the increasing number of jurisdictions that have adopted the minority rule in the last 15 years, the assertion that an approval clause "clearly and unambiguously" grants the lessor absolute discretion over assignments is untenable. It is not a rewriting of a contract, as respondent suggests, to recognize the obligations imposed by the duty of good faith and fair dealing, which duty is implied by law in every contract.

The third justification advanced in support of the majority rule is essentially based on the doctrine of *stare decisis*. It is argued that the courts should not depart from the common law majority rule because “many leases now in effect covering a substantial amount of real property and creating valuable property rights were carefully prepared by competent counsel in reliance upon the majority viewpoint.” *Gruman v. Investors Diversified Services*, 78 N.W.2d 377, 381 (Minn. 1956). As pointed out above, however, the majority viewpoint has been far from universally held and has never been adopted by this court. Moreover, the trend in favor of the minority rule should come as no surprise to observers of the changing state of real property law in the 20th century. The minority rule is part of an increasing recognition of the contractual nature of leases and the implications in terms of contractual duties that flow therefrom. We would be remiss in our duty if we declined to question a view held by the majority of jurisdictions simply because it is held by a majority. As we stated in *Rodriguez v. Bethlehem Steel Corp.*, 525 P.2d 669, 676 (Cal. 1974), the “vitality [of the common law] can flourish only so long as the courts remain alert to their obligation and opportunity to change the common law when reason and equity demand it.”

A final argument in favor of the majority rule is advanced by respondent and stated as follows: “Both tradition and sound public policy dictate that the lessor has a right, under circumstances such as these, to realize the increased value of his property.” Respondent essentially argues that any increase in the market value of real property during the term of a lease properly belongs to the lessor, not the lessee. We reject this assertion. \* \* \* Respondent here is trying to get *more* than it bargained for in the lease. A lessor is free to build periodic rent increases into a lease, as the lessor did here. Any increased value of the property beyond this “belongs” to the lessor only in the sense, as explained above, that the lessor’s reversionary estate will benefit from it upon the expiration of the lease. We must therefore reject respondent’s argument in this regard. \* \* \*

#### IV.

In conclusion, both the policy against restraints on alienation and the implied contractual duty of good faith and fair dealing militate in favor of adoption of the rule that where a commercial lease provides for assignment only with the prior consent of the lessor, such consent may be withheld only where the lessor has a commercially reasonable objection to the assignee or the proposed use. Under this rule, appellants have stated a cause of action against respondent Ernest Pestana, Inc.

The order sustaining the demurrer to the complaint, which we have deemed to incorporate a judgment of dismissal, is reversed.

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#### Notes

1. The California legislature codified this ruling in 1989. *See* Cal. Civ. Code §§ 1995.010-1995.270.

2. In commercial leases, the trend appears to be toward adopting a reasonableness limitation on the landlord's right to consent to a sublease or assignment. See *Julian v. Christopher*, 575 A.2d 735, 736 n.1 (Md. 1990) (roughly 13 states have imposed a requirement that the lessor act reasonably); *Warner v. Konover*, 553 A.2d 1138 (Conn. 1989). *Contra First Federal Savings Bank of Indiana v. Key Markets*, 559 N.E.2d 600 (Ind. 1990) (refusing to require that a landlord act reasonably in withholding consent).

3. If a commercial lease provides that the landlord has the "absolute right to approve or disapprove any sublease or assignment for any reason whatsoever," should courts enforce the clause as written or treat it as an unreasonable restraint on alienation? See *Newman v. Hinky Dinky Omaha-Lincoln, Inc.*, 427 N.W.2d 50 (Neb. 1988) (holding that a landlord consent clause contains an implied reasonableness requirement but refusing to address the question whether explicit agreement to grant arbitrary discretion to the landlord to disapprove a sublet violates public policy).

Suppose the tenant of commercial property arranges to sublease the property to a business owned by members of a racial or ethnic minority but the landlord refuses to agree because of prejudice. Should a lease provision granting the landlord the absolute right to approve or disapprove any subleases be enforceable under these circumstances?

4. When residential property is involved, courts are often more willing to allow the landlord to withhold consent for any reason. See *Slavin v. Rent Control Board of Brookline*, 548 N.E.2d 1226 (Mass. 1990).

### ***When a Lease Prohibits All Subleases and Assignments***

The prevailing wisdom is that absolute prohibitions on subleases and assignments are enforceable. They do raise two interesting questions, however. First, is a sublease or assignment made in violation of such a clause void, or is it merely a breach of the lease agreement that gives the landlord a grounds for declaring a default and a cause of action? Second, given that a landlord can always waive any of its rights under the lease, and thus, for example, consent to a sublease or assignment despite a prohibition, why should an absolute prohibition be treated differently from a clause requiring the landlord's consent?

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## ANTICIPATING POSSIBLE PROBLEMS

The Introduction to these materials identified several skills and abilities needed by lawyers engaged in transactional work. We now turn to one of the most fun items on that list: imagining all the events that might later interfere with the transaction or the parties' relationship and determining which ones to provide for in the transaction documents.

When parties are contemplating or negotiating a transaction – whether it is to buy and sell goods or real estate, provide services, loan money, or almost anything else – they tend to focus on the main terms: price, quality, quantity, duration. They usually assume that the other party intends to fulfill its end of the bargain and either assume or determine after some investigation that the other party is able to perform.

Unfortunately, in their zeal to deal, clients sometimes are too generous in their assumptions about the good faith or abilities of those with whom they are about to contract. More important, things can change between the time the parties reach agreement and the time they are to perform. Individuals and business have second thoughts. They suffer financial reversals. Prevailing prices sometimes rise or fall. Laws change. People die. Wars break out. You get the idea. In extreme cases, contract law may provide relief to a party whose performance has become impracticable or impossible (we saw this in the *Hoosier Energy* case that begins on page 7), but what happens in less extreme cases is a matter normally left to the agreement of the parties.

One of the jobs of the transactional lawyer is to determine what contingencies are sufficiently likely and important that they should be expressly addressed in the parties' agreement. In many cases, this must be done in consultation with the client. The lawyer identifies a risk and explains it to the client. The client will then decide whether the risk is something that the transaction documents should cover, given the time constraints on the deal, the cost in legal fees, and the possibility that negotiations over how to handle the risk may jeopardize the deal. But regardless of whether the lawyer or the client will be the one who determines whether to address a particular risk, the fact remains that it is the lawyer's job to identify it in the first place.

Some risks are fairly obvious. For example, any time a contract calls for a buyer or borrower to pay later for property or rights acquired at the closing, there is the risk that the buyer or borrower will not have the ability to pay when payment is due. In other words, while creditworthiness can be evaluated at the time the agreement is entered into, subsequent events may dramatically impair the likelihood of payment. An individual may become sick and lose income. A business may flounder due to an economic recession, poor management, or increased competition. There may be little or nothing that a lawyer can put into an agreement to completely avoid these risks, but sometimes authorizing the seller or lender to sever relations at the first sign of a problem can mitigate the risk, and avoid the transformation of a small loss into a large one.

***Problem 9-1***

You represent Jefferson Properties, Inc., the owner of an office building in a metropolitan area. Jefferson Properties is negotiating a seven-year lease of the building to a four-person law firm that specializes in consumer bankruptcy and foreclosure defense. The firm also does some plaintiff work in small tort cases. Identify all the things that, in preparing the first draft of the lease, you should include as a default by the law firm. In other words, what events or actions should trigger the landlord's right to use its default remedies (whatever those remedies may be)?

When the parties do not contemplate an ongoing relationship – such as in a one-time, sale of goods for cash – most of the risks inherent in the transaction can and should be evaluated before the agreement is reached. For example, the buyer would want to be sure the seller owns the goods to be sold and that the goods conform to whatever description the seller has provided. Although the buyer's lawyer may wish to draft warranties to deal with these issues, greater protection is normally obtained through inspection of the goods and other aspects of the due diligence investigation that we will explore in upcoming units.

Nevertheless, sometimes the value of property sold can be undermined by the seller's actions after the sale. Anyone who has purchased consumer electronics or software shortly before a new and enhanced version came to the market certainly knows this to be true. Another common scenario involves the sale of a small service business, such as a bakery, dentistry practice, or accounting practice. The buyer typically plans to provide future goods or services to the existing clients and expects the seller not to interfere with that plan. If, however, the seller opens up a competing business a few months after the sale, buyer may well lose much or all of the value of the business for which the buyer has paid.

***Drafting Exercise 9-A***

Dentist has been practicing dentistry in Spokane Washington for 37 years. Five years ago, Dentist hired Apprentice, a recent dentistry school graduate, to work with Dentist. Dentist has now decided to retire and to sell the dentistry practice to Apprentice for \$750,000. The sale price will include all the dentistry equipment, accounts receivable, and the leasehold where they work. You represent Apprentice and are preparing the purchase and sale agreement. Draft a clause by which Dentist will agree not to compete with Apprentice. Before doing so, research the applicable law on agreements not to compete, so that you know what kinds of non-compete clauses are enforceable and what kinds are not. Draft the clause to be as broad as possible while being sure that it will be enforceable.

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## CONDUCTING DUE DILIGENCE PART 1: THE RECORDING SYSTEM

Transactional attorneys are commonly called upon to perform due diligence for their client. Due diligence is a term of art that first came into common use as a result of the Securities Act of 1933. That Act included a defense for broker-dealers of securities when accused of inadequate disclosure to investors of material information about the securities. So long as broker-dealers exercised conducted a “reasonable investigation” into the company whose securities they were selling, and disclosed to the investor every material thing they found, they would not be liable for nondisclosure of information that was not disclosed.<sup>1</sup> The entire broker-dealer community quickly institutionalized, as a standard practice, the conducting of due diligence investigations of any stock offerings in which they involved themselves.

Originally the term was limited to public offerings of equity investments, but over time it has come to be associated with the investigation conducted before any asset or business is purchased. Such investigation might be broad, designed to uncover any potential problem. Or, the investigation might focus on one or more specific areas of concern, such as liability for environmental pollution, infringement of copyright, patent or trademark rights, tax problems, or labor disputes. The list can be almost endless. In the acquisition of a business, it would almost certainly include a review of all of the contracts of the business (bearing in mind that some may not be in writing) and an evaluation of whether either party was in breach and whether the agreements could be validly assigned.<sup>2</sup> In the acquisition of a single asset, such as an expensive piece of equipment, it might include making sure:

1. The seller owns the equipment to be sold;
2. No one other than the seller has an ownership interest in the equipment or, if someone does, that interest will be transferred to the buyer as part of the purchase transaction;
3. There are no liens on the equipment or, if there are any liens, they will be discharged as part of the purchase transaction;
4. If the seller is a business entity, the person acting for the seller has the authority to bind the seller;
5. The equipment does not infringe the intellectual property rights of anyone;
6. The equipment is in good working order;
7. The buyer will have or the seller will provide whatever expertise is needed to operate the equipment;
8. If the equipment is under warranty from someone other than the seller, the buyer will acquire the seller’s rights under the warranty; and

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<sup>1</sup> 15 U.S.C. § 77k(b)(3).

<sup>2</sup> The movie *Working Girl* (1988) provides an example of due diligence. The lead character, played by Melanie Griffith, recommended that a client of her financial consulting firm acquire a particular radio broadcaster. At a later critical point in the movie, she counseled a colleague to make sure that the broadcaster’s contract with its star DJ be reviewed, because the value of the broadcasting company would be significantly reduced if the DJ would not be remaining.

9. If the seller will be warranting the equipment, that the seller has sufficient financial stability to make the warranty meaningful (*i.e.*, that the seller is expected to remain in business and have the resources to compensate the buyer for any breach of the warranty).

On particular facts, no doubt other inquiries might be required. As you can see, due diligence can be a massive and time-consuming endeavor. Unfortunately, business pressures often necessitate that the due diligence investigation be conducted in some haste. Fortunately, some aspects may be performed by the client or the client's business advisors, while others are left to the lawyers. No matter what the situation, though, the transactional lawyer should have a clear, written record of what aspects of the due diligence investigation the lawyer has agreed to conduct. The lawyer does not want the client coming back years later, after a problem surfaces, falsely claiming that it was the lawyer's responsibility to uncover the problem.

We will explore the concept of due diligence in the context of a real estate transaction. We will do so in two parts. First, in this Unit, we explore the law and how it can be used to protect the parties to a real estate transaction. Then, in Unit 11, we will apply this law to the results of a factual investigation.

People purchase interests in land for a variety of reasons: to acquire a family home, to develop a shopping center, to locate or construct a factory, to grow crops, or to extract oil or gas. They may simply want to establish a nature preserve. Yet in every transaction, a major concern – if not *the* major concern – of the purchaser is to make sure that relevant property rights will in fact be acquired. The acquisition of real property is usually a major investment and nobody wants to pay the purchase price to get nothing in return.

The American legal system employs three main techniques for protecting people who acquire an interest in real estate:

- (1) the common-law covenants of title that are implied by law into contracts for the sale of land and which are typically expressly included in warranty deeds;
- (2) the recording system in each state, created by statute and administered by the government; and
- (3) title insurance.<sup>3</sup>

An attorney advising or assisting a client who is acquiring an interest in land needs to be aware of how each of these three techniques work, and their limitations. We will therefore explore each in turn.

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<sup>3</sup> In some states, instead of procuring title insurance, parties obtain a lawyer's opinion on the state of the title.

## COVENANTS OF TITLE

Perhaps the most important elements of a real estate transaction are the seller's ability to convey title to the property to the buyer and the buyer's ability to rest assured that the buyer's ownership rights will be secure against other claimants. The buyer's lawyer (or the mortgage lender's lawyer) will certainly want to search the seller's record title. But, as we will discover in the next section, the title search may not reveal some important defects in the chain of title. For this reason, the buyer may want additional assurances.

One form of additional assurances are the *covenants of title* – also known as *warranties of title* – that may be contained in the deed. There are six standard covenants, each of which is explained below.<sup>4</sup>

***Present covenants.*** These covenants are breached, if at all, at the time of the conveyance (the closing). That is when the statute of limitations starts to run.

1. *Covenant of seisin.* This covenant is the grantor's promise that the grantor owns the property interest (the estate) that the grantor is purporting to convey to the grantee. Thus, an owner of a leasehold would breach this covenant by purporting to convey a fee simple. Similarly, an owner of a one-half interest as a tenant in common would breach the covenant by purporting to convey full ownership of the property as a sole fee simple owner.

2. *Covenant of the right to convey.* This constitutes the grantor's promise that the grantor has the power to transfer the interest purportedly conveyed to the grantee. Although in most cases the same as the covenant of seisin, it can differ in several instances. For example, a life estate burdened by an enforceable restraint on alienation would violate this covenant if the owner purported to convey it to the grantee. Similarly, if the property were adversely possessed by someone other than the seller, the seller would have record title (seisin) of the property but not the right to convey it.

3. *Covenant against encumbrances.* This is the grantor's promise that no mortgages, leases, liens, unpaid property taxes, or easements encumber the property other than those acknowledged in the deed itself.

***Future covenants.*** In each of these covenants, the grantor promises to do some act in the future. Therefore, these covenants are breached, if at all, after the closing, when the disturbance to the grantee's possession occurs. The statute of limitations starts to run on these breaches when the grantee's possession is disturbed.

4. *Covenant of warranty.* By this covenant, the grantor promises to defend against superior claims to the property and to compensate the grantee for any monetary loss occasioned by the grantor's failure to convey the title promised in the deed.

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<sup>4</sup> Note, the term "covenant" has a different meaning in real property law than it does in contract law.

5. *Covenant of quiet enjoyment.* The grantor promises by this covenant that the grantee's possession will not be disturbed by any other claimant with a superior title. This covenant is substantially the same as the covenant of warranty.

6. *Covenant for further assurances.* Rarely used, this covenant requires the grantor to take further steps to cure defects in the grantor's title, such as paying an adverse possessor to leave the property or paying the owner of an encumbrance to release the encumbrance.

Some states have standardized the covenants by statute. These covenants may be contained in the deed by reference to the statute in which they are defined. They are thereby incorporated into the deed by reference.

### **Types of Deed**

Not every grantor gives all – or even any – of the covenants of title. Language in the deed will delineate the nature and extent of the grantor's covenants of title, if any. In general, there are three classes of deed:

1. *General warranty deed.* A general warranty deed covenants against all defects in title, and therefore normally includes all six of the covenants of title.

2. *Special warranty deed.* A special warranty deed limits the covenants to defects in title caused by the grantor's own acts but not those caused by the acts of others. Thus, for example, if the title defect is a mortgage created by the grantor's predecessor in title, the grantor will not be liable.

3. *Quitclaim deed.* This is the name generally used for a deed that contains no covenants (or warranties) of title. It purports to convey whatever interests in the property the grantor owns. It does not, however, promise that the grantor in fact owns whatever property interest that the grantor claims to own. Indeed, it does not promise that the grantor owns *any* interest. It merely transfers to the grantee whatever property interests the grantor has, but does not provide the grantee with any real assurance that the grantor has the right to convey any interest in the property.

### ***Problem 10-1***

Below is an example, in some order, of a general warranty deed, a special warranty deed, and a quitclaim deed (each with antiquated, albeit common language). Review their language and determine which is which. Identify for each the language critical to determining the nature of the deed.

***Example A***

Know all men by these by these presents, that I [name of grantor], of [name of city, town, or county], for and in consideration of [amount] dollars, to me in hand paid by [name of grantee], have granted, sold, conveyed, and by these presents do grant, sell, and convey unto the said [name of grantee], of [name of city, town, or county] in the State of [name of State], all that certain [legal description of property]. To have and to hold the above described premises, together with all and singular the rights and appurtenances thereto in any wise belonging, unto the said [name of grantee], [his or her] heirs or assigns forever. And I hereby bind myself, my heirs, executors, and administrators to warrant and forever defend all and singular the premises unto the said [name of grantee], [his or her] heirs and assigns, against every person whomsoever lawfully claiming or to claim the same or any part thereof, by, through, or under me, but not otherwise.

Witness my hand, this [date] day of [month], [year].

***Example B***

Know all men by these by these presents, that I [name of grantor], of [name of city, town, or county], for and in consideration of [amount] dollars, to me in hand paid by [name of grantee], have granted, sold, conveyed, and by these presents do grant, sell, and convey unto the said [name of grantee], of [name of city, town, or county] in the State of [name of State], all that certain [legal description of property]. To have and to hold the above described premises, together with all and singular the rights and appurtenances thereto in any wise belonging, unto the said [name of grantee], [his or her] heirs or assigns forever. And I hereby bind myself, my heirs, executors, and administrators to warrant and forever defend all and singular the premises unto the said [name of grantee], [his or her] heirs and assigns, against every person whomsoever lawfully claiming or to claim the same or any part thereof.

Witness my hand, this [date] day of [month], [year].

***Example C***

Know all men by these by these presents, that I [name of grantor], of [name of city, town, or county], for and in consideration of [amount] dollars, to me in hand paid by [name of grantee], have quitclaimed, and by these presents do quitclaim to the said [name of grantee], of [name of city, town, or county] in the State of [name of State], all my right, title, interest, claim and demand in and to [legal description of property], with all and singular my right, title, interest, estate, claim and demand in and to the hereditaments and appurtenances thereto belonging or in any wise pertaining; to have and to hold the above forever, so that neither I nor my heirs or assigns shall have any right or title to the property, premises, or appurtenances at any time hereafter.

Witness my hand, this [date] day of [month], [year].

***Drafting Exercise 10-A***

Draft a special warranty deed by which Owner will convey to Buyer a fee simple determinable in Fenway Park that will re-vest title in Owner if the Red Sox ever lose more than 90 games in a season. Avoid all unnecessary or arcane language.

**Remedies for Breach of Warranty of Title**

The most widely used covenant is the covenant of warranty. If it turns out that the seller did not have the right to convey the property interest the deed purported to convey, the buyer can sue the seller for breach of the warranty of title. This covenant runs with the land and can be enforced by subsequent grantees as well.

The damages for breach of the covenants of warranty, seisin, right to convey, and quiet enjoyment are generally measured by the price paid for the property that has been lost. This price is generally near the fair market value of the property at the time of the closing. Note, this means that if the breach is discovered after the closing, as is often the case, the ousted buyer will not be able to recover the market value of the property at the time the buyer was ousted or the time judgment is entered. If the price of land has been rising since the closing – which until recent years was the norm – the market value at the time the buyer suffers the loss is likely to be much higher than the original price. Nevertheless, the normal measure of recovery is the price paid. This result has been criticized since it often does not give the buyer the benefit of the bargain and leaves the buyer in the position substantially worse than the buyer would have been in had the warranty not been breached. For example, the buyer may not be able to purchase a similar piece of property for anything close to the amount the buyer paid for the premises from which the buyer was ousted. On the other hand, allowing the buyer to obtain from the seller more than the value paid places an uncertain and possibly onerous obligation on the seller for many years into the future.

The damages for breach of the covenant against encumbrances is either the cost of removing the encumbrance (*e.g.*, paying off the mortgage or buying out the holder of the easement) or the difference between the value of the property without the encumbrance and with it.

The main problem with relying on warranties to protect the buyer is that they can be expensive and time consuming to enforce, and rarely are certain to yield any recovery at all. The seller may have long since left the jurisdiction, filed for bankruptcy protection, or died. Even if the seller can be found, the seller is unlikely to simply admit to the breach and write the ousted buyer a check. Legal action will usually be necessary and the seller may put up quite a fight. Even if the court does enter judgment for the buyer, the seller may not have the ability to pay.

This is the real world in which the transactional lawyer lives. Getting a promise that protects the client is one thing, but it is not enough. The seller may be honest and honorable, but still unable to make the buyer whole. Thus, the transactional lawyer's creed – to borrow a phrase made popular by President Reagan – is “trust but verify.” Find out about and deal with the potential problems before the client agrees to the transaction. This brings us to the recording system.

## THE RECORDING SYSTEM

The recording system is intended to provide buyers of real property with the security of knowing that they will really own the property interests they are buying. They can use the system to find out whether the person purporting to own and sell the property indeed owns it and to confirm that neither the owner nor any of the owner's predecessors in interest has conveyed to someone else all or part of the property interests that the seller has contracted to sell to the buyer.

Every state has passed a recording act, which provides for a central registry at each locality – often at the county level of government – where holders of real property interests can submit copies of deeds, mortgages, leases, easements, general plans, condominium declarations, judgment liens, and the like. Submitting a deed to the registry is called *recording the deed*.

Recording acts define the types of transfer documents that may be recorded. Almost all provide for the recording of deeds, mortgages, and grants of an easement. However, many limit the types of leases that may be recorded to those of a least a specified duration (*e.g.*, over one year).

It is important to recognize that recording acts do not *require* that a deed or other instrument transferring an interest in property be recorded for a conveyance to be legally valid. A deed is valid against the grantor upon delivery to the grantee even if not recorded. Thus, when a seller delivers the deed to a buyer, the buyer becomes the lawful owner of the property – at least in the absence of conflicting claims by other grantees. The seller cannot dispossess the buyer on the ground that the seller remained the owner of record because the buyer had not yet recorded the seller's deed. Indeed, the buyer could dispossess the seller.

What recording acts do is determine the competing claims to real property by and among people who are not in privity of contract with each other. The common-law rule that predates the

recording system was “first in time, first in right.” This rule was based on the theory that the grantor could not convey what the grantor did not own; once the property interest had been transferred to the first grantee, the grantor had nothing left to convey to the subsequent grantee. There is even a Latin phrase commonly used to identify and invoke this principle: *nemo dat qui non habet* (“one cannot give what one does not have”).

Recording acts change the common-law rule<sup>5</sup> by defining the circumstances under which a buyer or other grantee will prevail over a previous grantee who did not properly record its interest in the applicable property registry. In general, a subsequent purchaser who has no notice of a prior conveyance and who records its interest will prevail over any prior unrecorded interest.

As should be immediately apparent, the benefit of this system is that a prospective buyer can search the public record to make sure that prospective seller indeed owns and has the right to transfer the property rights that the prospective buyer wants. If the search indicates that the prospective seller does have these rights and the power to transfer them, the buyer can safely proceed with the purchase, record its deed, and be confident that, if some other claimant does come forward, the buyer’s title will prevail.

It is important to note, however, that the recording system does not document – and therefore does not protect against – all claims to the real estate. In many places, the buyer may have to check the court system to determine whether title to the property may be affected by a pending lawsuit or bankruptcy, a probated will, or a divorce action. Moreover, mechanic’s liens, state and federal tax liens, zoning ordinances, and building codes may be found in other places. Finally, the recording system will not protect a buyer against a claim of adverse possession. For this reason, the buyer must investigate to determine whether any such claims may be in the wings.

### **How to Conduct a Title Search**

Instruments transferring interests in real estate are recorded chronologically, in the order in which the filing office receives them. Therefore, unless you know when a particular document was recorded – and if you do not even know whether a document exists, you cannot possibly know when it was recorded – you need some kind of index.

The simplest way to index and research the title would be to file information by tract. Given the precision with which the geographic boundaries of each parcel of property have been surveyed – even before the age of satellite imaging and GPS – it is possible to create a tract system that classifies every parcel by a tract number and then records under that number all documents that purport to affect the title to that tract. The problem is that this is not how the recording systems in

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<sup>5</sup> They change the rule only for those property interests covered by the recording act. The common-law rule of “first in time, first in right” usually remains applicable to the types of transfers not covered by the applicable recording act.

most states started, and converting to a tract system would be extremely expensive. Few states have a tract index.

The more common method of indexing transaction documents is by grantor and grantee. Under this system, there is one index of all grantors and another index of all grantees. In the grantor index, all instruments are listed both alphabetically and chronologically by the grantor's surname. In the grantee index, all instruments are listed alphabetically by the grantee's last name. Thus, a deed from Able to Baker will be listed under Able's name in the grantor index and under Baker's name in the grantee index. Each index will be comprised of numerous volumes, compiled over time. For example, conveyances by grantors may be divided into one volume that includes conveyances made between 1900 and 1910, a second volume for the years 1910 to 1920, and so on through 2000. There may be one volume for each full year after 2000, with a monthly and daily index for the current year. Therefore, to use an index, the searcher must review numerous volumes. For our purposes, though, it is enough to refer to each index in the singular. Indeed, some jurisdictions have now converted their indexes into one or two databases that can be searched electronically.

The reference in each index lists the bare essentials of each recorded document: the grantor, the grantee, the kind of document (*e.g.*, deed, mortgage), a description of the land involved, the date the document was recorded, and the volume and page number(s) where a copy of the document can be found. A title searcher uses each index to identify documents that *might* be relevant to the current state of the title. The searcher then pulls out the recorded copy of each identified document for further review, to determine what significance it really has. Here is an example of what each index might look like. It was obtained on-line from records of Orange County, California and covers only those documents recorded in 2001.

Recording Date	Document Number	Grantee	Other Party	Document
03-27-2001	2001-00178215	Wilbanks Alison S	Weel Marty	Grant Deed
08-03-2001	2001-00531053	Wilbanks Carol Sue	Ba Mtg LLC	Reconveyance
10-17-2001	2001-00731515	Wilbanks Julie A	Associates Finl Serv Co CA Inc	Reconveyance
11-16-2001	2001-00820538	Wilbanks Julie A	American Gen Fin Inc BFC	Reconveyance
03-27-2001	2001-00178215	Wilbanks Roger R	Weel Marty	Grant Deed
10-17-2001	2001-00731515	Wilbanks Steven M	Associates Finl Serv Co CA Inc	Reconveyance
11-16-2001	2001-00820538	Wilbanks Steven M	American Gen Fin Inc BFC	Reconveyance
12-07-2001	2001-00891529	Wilber Bill	Wilber Bill	Grant Deed
12-07-2001	2001-00891529	Wilber Richard	Wilber Bill	Grant Deed
12-07-2001	2001-00891529	Wilber Sharon	Wilber Bill	Grant Deed
12-07-2001	2001-00891529	Wilber Vanessa	Wilber Bill	Grant Deed
08-16-2001	2001-00568540	Wilberg Anne Marie	Bankers Tr Cotr	Reconveyance

Recording Date	Document Number	Grantor	Other Party	Document
03-27-2001	2001-00178216	Wilbanks Alison S	Temple Inland Mtg Corp BFC	Trust Deed
07-11-2001	2001-00462317	Wilbanks Carol Sue	Bank of Amer N a BFC	Trust Deed
09-28-2001	2001-00687289	Wilbanks Julie A	Downey S & L Assn F a BFC	Trust Deed
03-27-2001	2001-00178216	Wilbanks Roger R	Temple Inland Mtg Corp BFC	Trust Deed
09-28-2001	2001-00687289	Wilbanks Steven M	Downey S & L Assn F A BFC	Trust Deed
05-04-2001	2001-00283257	Wilber Lola M Tr	Harold F Wilber Trust A	Grant Deed
12-07-2001	2001-00891529	Wilber Sharon	Wilber Bill	Grant Deed
12-07-2001	2001-00891530	Wilber Sharon	Abn Amro Mtg Group Inc BFC	Trust Deed
12-07-2001	2001-00891530	Wilber Vanessa	Abn Amro Mtg Group Inc BFC	Trust Deed
06-29-2001	2001-00436529	Wilberg Anne-marie	Countrywide Home Lns Inc	Trust Deed
06-29-2001	2001-00436529	Wilberg Dennis R	Countrywide Home Lns Inc	Trust Deed

Searching title bears some resemblance to what a genealogist does in researching a family tree: first trace backwards for the ancestors of an identified individual, and then under each ancestor look forward for descendants. Similarly, in searching title, you go backwards from the current owner (or purported owner) as far as you think necessary to a “root of title” source, and then forward from that source (and everyone in between) to look for any transfers that may have occurred. You use the grantee index to search backward and the grantor index to search forward.

For example, suppose your client is planning to buy a house from Eckersley. Since you want to find out whether and how Eckersley obtained title, you look in the grantee index under Eckersley’s name. Let us say that you discover a deed from DiMaggio to Eckersley recorded in 1990. Now you need to know how DiMaggio obtained title, so you search again in the grantee index, this time under DiMaggio’s name. You discover a deed from Conigliaro to DiMaggio recorded in 1962. You continue this process, running each grantor’s name under the grantee index to find the preceding source of title. How far back you go varies with local custom and the needs of the client. In some jurisdictions, the practice is to go back until title can be traced to some sovereign. In others it is go back to the beginning of the Twentieth Century, 50 or 60 years, or for some shorter period. The search is not ordinarily limited to the period of the statute of limitations because the statute may not have begun to run on various types of interests (*e.g.*, a remainder, easement, or mineral rights).<sup>6</sup> However, some jurisdictions have a marketable title act that dictates a time period beyond which interests are lost if they are not re-recorded. Let us say that, after going back as far as you deem it necessary, you have identified the following sources of Eckersley’s title:

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<sup>6</sup> Because a purchaser is liable under federal law for the costs of cleaning up contaminated land unless the purchaser makes “all appropriate inquiry” into possible contamination, purchasers of commercial properties often commission far more extensive searches to ascertain previous owners for possible sources of pollution on any property they are interested in acquiring.

Source of Title	Date of Deed	Date Deed Recorded
Deed from Aparicio to Boggs	January 1901	January 1901
Deed from Boggs to Conigliaro	February 1932	July 1937
Deed from Conigliaro to DiMaggio	March 1963	March 1963
Deed from DiMaggio to Eckersley	April 1984	April 1984

Now you need to switch to the grantor index and search under each former owner's name forward from the time the owner acquired the property until the time the deed from the former owner to the next person on this list was recorded. Thus, you search under DiMaggio's name from March 1963 until April 1984, to see if DiMaggio transferred the property to anyone else before deeding it to Eckersley. You search under Conigliaro's name from February 1932 through March 1963 for the same reason. Why must your search under Conigliaro's name begin in 1932 (when Conigliaro acquired the property) instead of in 1937 (when the deed to Conigliaro was recorded)? Because Conigliaro could have conveyed title to someone immediately after Conigliaro acquired it. For example, suppose Conigliaro mortgaged the property in 1933. If you began your search for Conigliaro's name in the grantor's index beginning in 1937, you would not discover that valid mortgage.

Finally, you search under Bogg's name from January 1901 through July 1937. Note, even though Boggs deeded the property to Conigliaro in 1932, you need to search through the date that deed was recorded in 1937. Why? Because under the applicable recording act, someone who acquired the property from Boggs after Boggs transferred the property to Conigliaro but before Conigliaro recorded the deed, say in 1935, might well have good title to the property. This brings us to the recording acts.

### Types of Recording Acts

As mentioned previously, each state has its own recording statute. The wording of the statute, as well as court interpretations of it, must be examined in detail to determine how it will apply to a particular dispute. Generally, recording acts are divided into three basic types: (1) race, (2) notice, and (3) race-notice.

**Race statutes.** Under a race statute, as between successive purchasers of Blackacre, the person who *records* first prevails. It does not matter who purchased first, merely who records first. Similarly, each party's state of mind is irrelevant. Even if the person who records first knew – before purchasing – about an earlier conveyance to someone else, the person who records first wins.

O conveys Blackacre to A, who does not record. O subsequently conveys Blackacre a second time to B. B knows of the earlier conveyance to A. B records the deed from O to B. In a lawsuit between A and B, B prevails.

Race recording statutes place a premium on the information available in the public record. They encourage prompt filing and do not really attempt to deal with the equities of particular circumstances. They exist in very few states. An example of one is N.C. Gen. Stat. § 47-18(a):

No (i) conveyance of land, or (ii) contract to convey, or (iii) option to convey, or (iv) lease of land for more than three years shall be valid to pass any property interest as against lien creditors or purchasers for a valuable consideration from the donor, bargainor or lessor but from the time of registration thereof in the county where the land lies, or if the land is located in more than one county, then in each county where any portion of the land lies to be effective as to the land in that county.

**Notice statutes.** Under a notice statute, a subsequent purchaser prevails over an earlier purchaser only if the subsequent purchaser did not have notice of the earlier conveyance. The subsequent purchaser need not record first or even at all. The only requirement is that the subsequent purchaser not have notice of the earlier conveyance. For example:

O conveys Blackacre to A, who does not record. O then conveys Blackacre to B, who has no notice of the earlier conveyance from O to A. B prevails over A even though B does not record the deed from O to B. B also prevails over A even if A subsequently records the deed from O to A (whether before or after B records the deed from O to B).

An example of a notice statute is Iowa Code Ann. § 558.41:

An instrument affecting real estate is of no validity against subsequent purchasers for a valuable consideration, without notice, . . . unless the instrument is filed and recorded in the county in which the real estate is located, as provided in this chapter.

Notice statutes place a premium on the equities of the situation. They are premised on the notion that the subsequent purchaser has suffered a loss by virtue of the prior grantee's failure to record. They do not require actual reliance – for example, the subsequent purchaser need not have actually done a title search at all – but they do limit relief to “purchasers.” This term includes buyers, lenders (mortgagees), lessees, and people who give consideration for easements or mineral rights, but does not include donees or heirs.

**Race-notice statutes.** Race-notice statutes combine, as their name implies, the elements of both race statutes and notice statutes. They therefore seek to balance the equities of the circumstances while also promoting use of the recording system. Under a race-notice statute, a subsequent purchaser prevails over prior unrecorded interests only if the subsequent purchaser: (1) had no notice of the prior conveyance at the time of purchase; and (2) records before the prior conveyance is recorded. For example:

O conveys Blackacre to A, who does not record. O then conveys Blackacre to B. B has no notice of the earlier conveyance from O to A. A records; then B records. A prevails over B because, even though B did not have notice of A's deed, A recorded before B did.

An example of a race-notice statute is Wash. Rev. Code § 65.08.070:

A conveyance of real property, when acknowledged by the person executing the same (the acknowledgment being certified as required by law), may be recorded in the office of the recording officer of the county where the property is situated. Every such conveyance not so recorded is void as against any subsequent purchaser or mortgagee in good faith and for a valuable consideration from the same vendor, his heirs or devisees, of the same real property or any portion thereof whose conveyance is first duly recorded.

About half the states have notice statutes, and about half have race-notice statutes.

The “notice” element in both notice and race-notice statutes is a term of art. It typically encompasses three types of notice. First, it obviously includes actual knowledge. Thus, if before giving value, B had been informed of a prior conveyance from O to A, B would not be entitled to priority under either a notice statute or a race-notice statute. Second, the import of the recording system is that *constructive notice* will also deprive a subsequent purchaser of protection. Constructive notice exists if the grantee would or should have discovered the earlier conveyance by conducting a reasonable title search. The third type of notice is *inquiry notice*. Inquiry notice will be imputed if the purchaser would have discovered the conveyance had the purchaser reasonably investigated facts at the purchaser’s disposal. For example, if the property is being occupied by someone other than the grantor, a purchaser is on inquiry notice that the occupant may have a claim to the property. Inquiry notice will also exist if a recorded instrument refers to another, unrecorded document, such as a lease, condominium declaration, or general plan.

### *Question*

What language in the Washington statute quoted above incorporated the element of notice?

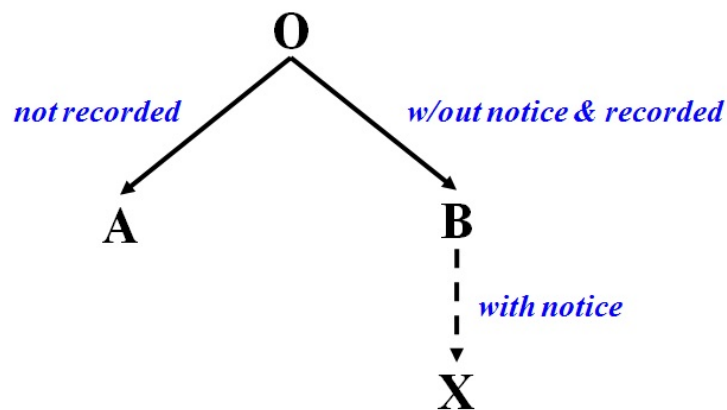
### **Related Doctrines**

In dealing with priority disputes and recording acts, courts have developed two doctrines to help achieve an equitable result in situations about which the recording acts themselves are often silent.

***Estoppel by deed.*** What happens if a grantor purports to convey to a grantee a property interest the grantor does not own, and then the grantor subsequently acquires the property? This can occur when documents relating to a planned series of transactions are executed out of order. It also occasionally arises when there was a mistake about the grantor’s title to the property. The *after-acquired title doctrine*, commonly also referred to as *estoppel by deed*, provides that title automatically vests in the grantee. Thus, if O purports to convey to A property that O does not own, A gets nothing. However, if O later obtains title to the property from X, the doctrine of estoppel by deed immediately vests title in A. In other words, O is estopped from asserting

ownership rights as against A. The doctrine can even bind the heirs and assigns of the grantor, provided they do not qualify for protection under the applicable recording act.<sup>7</sup>

**Shelter doctrine.** The shelter doctrine allows a bona fide purchaser to convey property to a third party even if the third party is on notice of an earlier conveyance. Consider the following example.



In this scenario, O conveyed property to A, who did not record. O then purported to convey the same property to B, a bona fide purchaser without notice of the conveyance to A. B recorded. Because B had no notice of the earlier conveyance to A, and because B recorded first, B would prevail over A in either a notice jurisdiction or a race-notice jurisdiction. B now wants to convey to X, but X has notice of the earlier conveyance to from O to A. The shelter principle allows B to convey the property to X, despite X's knowledge of the earlier conveyance. In other words, X is protected ("sheltered") by B's priority. This doctrine allows bona fide purchasers such as B, who recorded first and thereby obtained priority over an earlier buyer who did not record, to convey good title even after an earlier conveyance is discovered. Any other rule would restrict the bona fide purchaser's ability to transfer the property.

### **Problem 10-2**

Determine how the following cases would be resolved in jurisdictions with (a) a race statute; (b) a notice statute; (c) a race-notice statute? Explain your answer.

- A. O to A (A does not record).  
 O to B (B has notice of the earlier conveyance to A).  
 B records.  
 A records.  
 As between A and B, who wins?

<sup>7</sup> See *Ackerman v. Abbot*, 978 A.2d 1250 (D.C. 2009).

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- B. O to A (A does not record).  
O to B (B has notice of the earlier conveyance to A).  
A records.  
B records.  
As between A and B, who wins?
- C. O to A (A does not record).  
O to B (B has no notice of the earlier conveyance to A).  
B records.  
A records.  
As between A and B, who wins?
- D. O to A (A does not record).  
O to B (B has no notice of the earlier conveyance to A).  
A records.  
B records.  
As between A and B, who wins?
- E. O to A (A does not record).  
O to B (B has notice of the earlier conveyance to A).  
A records.  
B records.  
B conveys to X (X has no actual knowledge of the conveyance from O to A).  
X records.  
As between A and X, who wins?
- F. O to A (A does not record).  
O to B (B has no notice of the earlier conveyance to A).  
B records.  
A records.  
B conveys to X (X has notice of conveyance from O to A).  
X records.  
As between A and X, who wins?

The problems that can arise under a recording statute are legion. One uncommon but interesting type of problem involves what are known as “wild deeds.” These are instruments that are properly recorded but which, for one reason or another, would not be discovered in the process of doing a normal title search. In such cases, courts must determine which of two innocent parties will suffer a loss: the first grantee who recorded properly, or the second grantee who relied on the results of a reasonable search. Consider the following case. Then read the subsequent case, which deals with a related problem.

***SABO V. HORVATH***  
**559 P.2d 1038 (Alaska 1976)**

Boochever, Chief Justice.

This appeal arises because Grover C. Lowery conveyed the same five-acre piece of land twice – first to William A. Horvath and Barbara J. Horvath and later to William Sabo and Barbara Sabo. Both conveyances were by separate documents entitled “Quitclaim Deeds.” Lowery’s interest in the land originates in a patent from the United States Government under 43 U.S.C. § 687a (1970) (“Alaska Homesite Law”). Lowery’s conveyance to the Horvaths was prior to the issuance of patent, and his subsequent conveyance to the Sabos was after the issuance of patent. The Horvaths recorded their deed in the Chitna Recording District on January 5, 1970; the Sabos recorded their deed on December 13, 1973. The transfer to the Horvaths, however, predated patent and title, and thus the Horvaths’ interest in the land was recorded “outside the chain of title.” Mr. Horvath brought suit to quiet title, and the Sabos counterclaimed to quiet their title.

In a memorandum opinion, the superior court ruled that Lowery had an equitable interest capable of transfer at the time of his conveyance to the Horvaths and further said the transfer contemplated more than a “mere quitclaim” – it warranted patent would be transferred. The superior court also held that Horvath had the superior claim to the land because his prior recording had given the Sabos constructive notice for purposes of AS 34.15.290.<sup>8</sup> The Sabos’ appeal raises the following issues:

1. Under 43 U.S.C. § 687a (1970), when did Lowery obtain a present equitable interest in land which he could convey?
2. Are the Sabos, as grantees under a quitclaim deed, ‘subsequent innocent purchaser(s) in good faith’?
3. Is the Horvaths’ first recorded interest, which is outside the chain of title, constructive notice to Sabo?

We affirm the trial court’s ruling that Lowery had an interest to convey at the time of his conveyance to the Horvaths. We further hold that Sabo may be a “good faith purchaser” even though he takes by quitclaim deed. We reverse the trial court’s ruling that Sabo had constructive notice and hold that a deed recorded outside the chain of title is a “wild deed” and does not give constructive notice under the recording laws of Alaska.

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<sup>8</sup> AS 34.15.290 states:

A conveyance of real property in the state hereafter made, other than a lease for a term not exceeding one year, is void as against a subsequent innocent purchaser or mortgagee in good faith for a valuable consideration of the property or a portion of it, whose conveyance is first duly recorded. An unrecorded instrument is valid as between the parties to it and as against one who has actual notice of it.

The facts may be stated as follows. Grover C. Lowery occupied land in the Chitna Recording District on October 10, 1964 for purposes of obtaining Federal patent. Lowery filed a location notice on February 24, 1965, and made his application to purchase on June 6, 1967 with the Bureau of Land Management (BLM). On March 7, 1968, the BLM field examiner's report was filed which recommended that patent issue to Lowery. On October 7, 1969, a request for survey was made by the United States Government. On January 3, 1970, Lowery issued a document entitled 'Quitclaim Deed' to the Horvaths; Horvath recorded the deed on January 5, 1970 in the Chitna Recording District. Horvath testified that when he bought the land from Lowery, he knew patent and title were still in the United States Government, but he did not rerecord his interest after patent had passed to Lowery.

Following the sale to the Horvaths, further action was taken by Lowery and the BLM pertaining to the application for patent and culminating in issuance of the patent on August 10, 1973.

Almost immediately after the patent was issued, Lowery advertised the land for sale in a newspaper. He then executed a second document also entitled "quitclaim" to the Sabos on October 15, 1973. The Sabos duly recorded this document on December 13, 1973.

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The first question this court must consider is whether Lowery had an interest to convey at the time of his transfer to the Horvaths. Lowery's interest was obtained pursuant to patent law 43 U.S.C. § 687a, commonly called the "Alaska Homesite Law." Since Lowery's title to the property was contingent upon the patent ultimately issuing from the United States Government and since Lowery's conveyance to the Horvaths predated issuance of the patent, the question is "at what point in the pre-patent chain of procedures does a person have a sufficient interest in a particular tract of land to convey that land by quitclaim deed." *Willis v. City of Valdez*, 546 P.2d 570, 575 (Alaska 1976).

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In *Willis* we held that one who later secured a patent under the Solders' Additional Homestead Act had an interest in land which was alienable at the time that he requested a survey. Here, Lowery had complied with numerous requirements under the Homesite Law including those of occupancy, and the BLM had recommended issuance of the patent. Since 43 U.S.C. § 687a does not prohibit alienation, we hold that at the time Lowery executed the deed to the Horvaths he had complied with the statute to a sufficient extent so as to have an interest in the land which was capable of conveyance.

Since the Horvaths received a valid interest from Lowery, we must now resolve the conflict between the Horvaths' first recorded interest and the Sabos' later recorded interest. The Sabos, like the Horvaths, received their interest in the property by a quitclaim deed. They are asserting that their interest supersedes the Horvaths under Alaska's statutory recording system. AS § 34.15.290 provides that:

A conveyance of real property . . . is void as against a subsequent innocent purchaser . . . for a valuable consideration of the property . . . whose conveyance is first duly recorded. An unrecorded instrument is valid . . . as against one who has actual notice of it.

Initially, we must decide whether the Sabos, who received their interest by means of a quitclaim deed, can ever be “innocent purchaser(s)” within the meaning of AS § 34.15.290. Since a “quitclaim” only transfers the interest of the grantor, the question is whether a “quitclaim” deed itself puts a purchaser on constructive notice. Although the authorities are in conflict over this issue, the clear weight of authority is that a quitclaim grantee can be protected by the recording system, assuming, of course, the grantee purchased for valuable consideration and did not otherwise have actual or constructive knowledge as defined by the recording laws. We choose to follow the majority rule and hold that a quitclaim grantee is not precluded from attaining the status of an “innocent purchaser.”

In this case, the Horvaths recorded their interest from Lowery prior to the time the Sabos recorded their interest. Thus, the issue is whether the Sabos are charged with constructive knowledge because of the Horvaths’ prior recordation. Horvath is correct in his assertion that in the usual case a prior recorded deed serves as constructive notice pursuant to AS § 34.15.290, and thus precludes a subsequent, recordation from taking precedence. Here, however, the Sabos argue that because Horvath recorded his deed prior to Lowery having obtained patent, they were not given constructive notice by the recording system. They contend that since Horvaths’ recordation was outside the chain of title, the recording should be regarded as a “wild deed.”

It is an axiom of hornbook law that a purchaser has notice only of recorded instruments that are within his “chain of title.” If a grantor (Lowery) transfers prior to obtaining title, and the grantee (Horvath) records prior to title passing, a second grantee who diligently examines all conveyances under the grantor’s name from the date that the grantor had secured title would not discover the prior conveyance. The rule in most jurisdictions which have adopted a grantor-grantee index system of recording is that a “wild deed” does not serve as constructive notice to a subsequent purchaser who duly records.

Alaska’s recording system utilizes a “grantor-grantee” index. Had Sabos searched title under both grantor’s and grantee’s names but limited his search to the chain of title subsequent to patent, he would not be chargeable with discovery of the pre-patent transfer to Horvath.

On one hand, we could require Sabo to check beyond the chain of title to look for pre-title conveyances. While in this particular case the burden may not have been great, as a general rule, requiring title checks beyond the chain of title could add a significant burden as well as uncertainty to real estate purchases. To a certain extent, requiring title searches of records prior to the date of a grantor acquired title would thus defeat the purposes of the recording system. The records as to each grantor in the chain of title would theoretically have to be checked back to the later of the grantor’s date of birth or the date when records were first retained.

On the other hand, we could require Horvath to re-record his interest in the land once title passes, that is, after patent had issued to Lowery. As a general rule, re-recording an interest once title passes is less of a burden than requiring property purchasers to check indefinitely beyond the chain of title.

It is unfortunate that in this case due to Lowery's double conveyances, one or the other party to this suit must suffer an undeserved loss. We are cognizant that in this case, the equities are closely balanced between the parties to this appeal. Our decision, however, in addition to resolving the litigants' dispute, must delineate the requirements of Alaska's recording laws.

Because we want to promote simplicity and certainty in title transactions, we choose to follow the majority rule and hold that the Horvaths' deed, recorded outside the chain of title, does not give constructive notice to the Sabos and is not "duly recorded" under the Alaskan Recording Act, AS § 34.15.290. Since the Sabos' interest is the first duly recorded interest and was recorded without actual or constructive knowledge of the prior deed, we hold that the Sabos' interest must prevail. The trial court's decision is accordingly reversed.

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***WITTER V. TAGGART***  
**577 N.E.2d 338 (N.Y. 1991)**

Bellacosa, Judge.

Plaintiff Witter and defendants Taggarts are East Islip neighboring property owners. Their homes are on opposite sides of a canal on the south shore of Long Island. Witter's home is north of the canal and the Taggarts' home and dock are across the canal on the south side. The Winganhauppage or Champlin's Creek lies immediately west of both parcels. Their property dispute arose when the Taggarts erected a 70-foot long dock on their canal-side frontage. This was done after a title search revealed that their deed expressly permitted building the dock and reflected no recorded restrictions in their direct property chain against doing so. Witter complained of a violation of his scenic easement to an unobstructed view of the creek and an adjacent nature preserve, which he claims is protected by a restrictive covenant contained in his chain of title. He sued to compel the Taggarts to dismantle and remove the dock and to permanently enjoin any such building in the future.

Supreme Court granted the Taggarts' motion for summary judgment dismissing Witter's complaint and denied Witter's cross motion for summary judgment. Relying principally on *Buffalo Academy of Sacred Heart v. Boehm Bros.*, 196 N.E. 42 (N.Y. 1935), the trial court held that the Taggarts are not bound by or charged with constructive notice of a restrictive covenant which does not appear in their direct chain of title to the allegedly burdened land. \* \* \*

The Appellate Division affirmed the instant case, reasoning that under *Buffalo Academy*, the restrictive covenant contained in the chain of deeds to Witter's allegedly benefited parcel was outside the chain of title to the Taggarts' land and did not constitute binding notice to them.

We granted Witter's motion for leave to appeal to decide whether the covenant recited in Witter's chain of title to his purported "dominant" land, which appears nowhere in the direct chain of title to the Taggarts' purported "servient" land, burdens the Taggarts' property. We agree with the lower courts that it does not, and therefore affirm the order of the Appellate Division.

The homes of these neighbors are located on lots which have been separately deeded through a series of conveyances, originally severed and conveyed out by a common grantor, Lawrance. Lawrance conveyed one parcel of his land to Witter's predecessor in title in 1951. The deed contained the restrictive covenant providing that "no docks, buildings, or other structures [or trees or plants] shall be erected [or grown]" on the grantor's (Lawrance's) retained servient lands to the south "which shall obstruct or interfere with the outlook or view from the [dominant] premises" over the Winganhauppauge Creek. That deed provided that the covenant expressly ran with the dominant land. William and Susan Witter purchased the dominant parcel in 1963 by deed granting them all the rights of their grantor, which included the restrictive covenant. In 1984, Susan Witter transferred her interest to William Witter alone.

After common grantor Lawrance died, his heirs in 1962 conveyed his retained, allegedly servient, land to the Taggarts' predecessor in title. Lawrance's deed made no reference to the restrictive covenant benefiting the Witter property and neither did the heirs' deed to the Taggarts' predecessors. The restrictive covenant was also not included or referenced in any of the several subsequent mesne conveyances of that allegedly servient parcel or in the deed ultimately to the Taggarts in 1984. Quite to the contrary, the Taggarts' deed specifically permitted them to build a dock on their parcel.

Restrictive covenants are also commonly categorized as negative easements. They restrain servient landowners from making otherwise lawful uses of their property. However, the law has long favored free and unencumbered use of real property, and covenants restricting use are strictly construed against those seeking to enforce them. Courts will enforce restraints only where their existence has been established with clear and convincing proof by the dominant landowner.

The guiding principle for determining the ultimate binding effect of a restrictive covenant is that "[i]n the absence of actual notice before or at the time of \* \* \* purchase or of other exceptional circumstances, an owner of land is only bound by restrictions if they appear in some deed of record in the conveyance to [that owner] or [that owner's] direct predecessors in title." *Buffalo Academy* 196 N.E. at 45. Courts have consistently recognized and applied this principle, which provides reliability and certainty in land ownership and use.

In *Buffalo Academy*, we held that a restrictive covenant did not run with the dominant land, but added that even if it did, the servient landowners were not bound because the deed to the servient land did not reflect the covenant. We noted that this rule is "implicit in the acts providing for the recording of conveyances." *Id.* The recording act (Real Property Law art. 9) was enacted to

accomplish a twofold purpose: to protect the rights of innocent purchasers who acquire an interest in property without knowledge of prior encumbrances, and to establish a public record which will furnish potential purchasers with actual or at least constructive notice of previous conveyances and encumbrances that might affect their interests and uses.

The recording statutes in a grantor-grantee indexing system charge a purchaser with notice of matters only in the record of the purchased land's chain of title back to the original grantor. *Buffalo Academy* recognized that a "purchaser is not normally required to search outside the chain of title," and is not chargeable with constructive notice of conveyances recorded outside of that purchaser's direct chain of title where, as in Suffolk County, the grantor-grantee system of indexing is used. This is true even if covenants are included in a deed to another lot conveyed by the same grantor.

To impute legal notice for failing to search each chain of title or "deed out" from a common grantor "would seem to negative the beneficent purposes of the recording acts" and would place too great a burden on prospective purchasers. *Buffalo Academy*, 196 N.E. at 45. Therefore, purchasers like the Taggarts should not be penalized for failing to search every chain of title branching out from a common grantor's roots in order to unearth potential restrictive covenants. They are legally bound to search only within their own tree trunk line and are bound by constructive or inquiry notice only of restrictions which appear in deeds or other instruments of conveyance in that primary stem. Property law principles and practice have long established that a deed conveyed by a common grantor to a dominant landowner does *not* form part of the chain of title to the servient land retained by the common grantor.

A grantor may effectively extinguish or terminate a covenant when, as here, the grantor conveys retained servient land to a bona fide purchaser who takes title without actual or constructive notice of the covenant because the grantor and dominant owner failed to record the covenant in the servient land's chain of title. One way the dominant landowner or grantor can prevent this result is by recording in the servient chain the conveyance creating the covenant rights so as to impose notice on subsequent purchasers of the servient land.

It goes almost without repeating that definiteness, certainty, alienability and unencumbered use of property are highly desirable objectives of property law. To restrict the Taggarts because of Lawrance's failure to include the covenant in the deed to his retained servient land, or for the failure by Witter's predecessors to insist that it be protected and recorded so as to be enforceable against the burdened property, would seriously undermine these paramount values, as well as the recording acts.

Accordingly, the order of the Appellate Division should be affirmed, with costs.

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## **CONDUCTING DUE DILIGENCE PART 2: REVIEWING THE PRELIMINARY TITLE REPORT**

Title insurance has become a predominant method of protecting title throughout the United States. Title insurance companies provide a service and a promise. The service is an examination of the public land records to ascertain and describe the state of title to a particular tract of land. The promise is to recompense for any losses suffered as a result of errors made by the title examiner.

The examination typically occurs in either of two ways: (i) physically reviewing the public land records in the applicable county office; or (ii) reviewing a summary of the records, called an abstract, which has been prepared by a commercial enterprise. Most title companies now maintain their own title records, called “title plants,” that are organized by tract indexes. These title plants list all recorded property interests attached to a particular tract of land.

The insurance is a promise that title will in fact be as described in the report of the title examiner. In other words, *it does not protect from defects in title, merely from the title examiner’s failure to find and report on a defect in title.* This is an extremely important distinction. In many areas, the title report will note dozens of easements or other potential defects, even on something as simple as a small residential parcel. It is up to the transactional lawyer to review the title report and determine which of the items noted require further inquiry or action.

We now begin that exercise. Start by reviewing the sample title report that will be made available to you electronically. That will give you an idea of what a title report looks like and what it contains.

### *Exercise*

You represent Dentist, who has a private dental practice in Metropolis, the largest city in the State of Columbia. Dentist employs full-time three dental hygienists, one receptionist, and one office manager who does the required accounting, pays bills, bills insurers, and collects accounts. The lease on Dentist’s current office space is expiring and Dentist has been negotiating with Landlord to rent office space in Landlord’s building. The premises will require a significant amount of money to renovate and reconfigure for a dental practice, so Dentist wants to make sure that nothing will interfere with Dentist’s plans or practice if Dentist rents from Landlord and incurs the expense to renovate.

Another attorney in your office will be reviewing all the applicable zoning, environmental, and public health ordinances to make sure that all will be satisfied. You have been asked to review the preliminary title report to: (i) determine which documents referenced in the report require further investigation; (ii) review each of those documents and determine which require further action; and (iii) for each such document, determine what action is necessary and, where appropriate, draft whatever contract language is necessary to deal with the identified problem.

In the event it is relevant to your assigned task, the State's recording act is reproduced below. The preliminary title report for the property and all the underlying documents will be made available to you electronically.

**State of Columbia**  
**General Statutes**  
**Title 11, Part 22, Division 3**

§ 11.22.301. Definitions

(1) The term “real property” as used in Sections 11.22.300 through 11.22.303 includes lands, tenements and hereditaments and chattels real and mortgage liens thereon except a leasehold for a term not exceeding two years.

(2) The term “purchaser” includes every person to whom any estate or interest in real property is conveyed for a valuable consideration and every assignee of a mortgage, lease or other conditional estate.

(3) The term “conveyance” includes every written instrument by which any estate or interest in real property is created, transferred, mortgaged or assigned or by which the title to any real property may be affected, including an instrument in execution of a power, although the power be one of revocation only, and an instrument releasing in whole or in part, postponing or subordinating a mortgage or other lien; except a will, a lease for a term of not exceeding two years, and an instrument granting a power to convey real property as the agent or attorney for the owner of the property. “To convey” is to execute a “conveyance” as defined in this subdivision.

(4) The term “recording officer” means the county clerk.

11.22.302. Recording of Conveyances

A conveyance of real property, when acknowledged by the person executing the same (the acknowledgment being certified as required by law), may be recorded in the office of the recording officer of the county where the property is situated. Every such conveyance not so recorded is void as against any subsequent purchaser or mortgagee in good faith and for a valuable consideration from the same vendor, his heirs or devisees, of the same real property or any portion thereof whose conveyance is first duly recorded. An instrument is deemed recorded the minute it is filed for record.

**11.22.303. Lis Pendens**

At any time after an action affecting title to real property has been commenced, or after a writ of attachment with respect to real property has been issued in an action, the plaintiff or the defendant may file with the recording officer of each county in which the property is situated a notice of the pendency of the action, containing the names of the parties, the object of the action, and a description of the real property in that county affected thereby. From the time of the filing only shall the pendency of the action be constructive notice to a purchaser or encumbrancer of the property affected thereby, and every person whose conveyance or encumbrance is subsequently executed or subsequently recorded shall be deemed a subsequent purchaser or encumbrancer, and shall be bound by all proceedings taken after the filing of such notice to the same extent as if he or she were a party to the action. The court in which the said action was commenced may, at its discretion, at any time after the action shall be settled, discontinued or abated, on application of any person aggrieved and on good cause shown and on such notice as shall be directed or approved by the court, order the notice authorized in this section to be canceled of record, in whole or in part, by the recording officer of any county in which the same may have been filed or recorded, and such cancellation shall be evidenced by the recording of the court order.

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## THE TACTICS AND ETHICS OF NEGOTIATION

Attorneys engaged in transactional work, like their counterparts who litigate, must abide by the applicable rules of professional conduct. That means, among other things, that they must be diligent, be honest, and not disclose confidential information. Consider the following seven rules taken from the ABA Model Rules of Professional Conduct. Most states have adopted rules based on ABA model. Then read the case that follows and consider the problems raised after it.

### ABA Model Rules of Professional Conduct

#### *Client-Lawyer Relationship*

##### **Rule 1.3 Diligence**

A lawyer shall act with reasonable diligence and promptness in representing a client.

##### **Rule 1.6 Confidentiality Of Information**

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

(1) to prevent reasonably certain death or substantial bodily harm;

(2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;

(3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;

(4) to secure legal advice about the lawyer's compliance with these Rules;

(5) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client; or

(6) to comply with other law or a court order.

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### ***Transactions with Persons Other Than Clients***

#### **Rule 4.1 Truthfulness In Statements To Others**

In the course of representing a client a lawyer shall not knowingly:

(a) make a false statement of material fact or law to a third person; or

(b) fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 1.6

Comment:

**Misrepresentation.** A lawyer is required to be truthful when dealing with others on a client's behalf, but generally has no affirmative duty to inform an opposing party of relevant facts. A misrepresentation can occur if the lawyer incorporates or affirms a statement of another person that the lawyer knows is false. Misrepresentations can also occur by partially true but misleading statements or omissions that are the equivalent of affirmative false statements. For dishonest conduct that does not amount to a false statement or for misrepresentations by a lawyer other than in the course of representing a client, see Rule 8.4

**Statements of Fact.** This Rule refers to statements of fact. Whether a particular statement should be regarded as one of fact can depend on the circumstances. Under generally accepted conventions in negotiation, certain types of statements ordinarily are not taken as statements of material fact. Estimates of price or value placed on the subject of a transaction and a party's intentions as to an acceptable settlement of a claim are ordinarily in this category, and so is the existence of an undisclosed principal except where nondisclosure of the principal would constitute fraud. Lawyers should be mindful of their obligations under applicable law to avoid criminal and tortious misrepresentation. [*See also* [Formal Opinion 06-439](#) (2006).]

#### **Rule 4.2 Communication With Person Represented By Counsel**

In representing a client, a lawyer shall not communicate about the subject of the representation with a person the lawyer knows to be represented by another lawyer in the matter, unless the lawyer has the consent of the other lawyer or is authorized to do so by law or a court order.

#### **Rule 4.3 Dealing With Unrepresented Person**

In dealing on behalf of a client with a person who is not represented by counsel, a lawyer shall not state or imply that the lawyer is disinterested. When the lawyer knows or reasonably should know that the unrepresented person misunderstands the lawyer's role in the matter, the lawyer shall make reasonable efforts to correct the misunderstanding. The lawyer shall not give legal advice to an unrepresented person, other than the advice to secure counsel, if the lawyer knows or reasonably should know that the interests of such a person are or have a reasonable possibility of being in conflict with the interests of the client.

**Rule 4.4 Respect For Rights Of Third Persons**

(a) In representing a client, a lawyer shall not use means that have no substantial purpose other than to embarrass, delay, or burden a third person, or use methods of obtaining evidence that violate the legal rights of such a person.

(b) A lawyer who receives a document relating to the representation of the lawyer's client and knows or reasonably should know that the document was inadvertently sent shall promptly notify the sender.

***Maintaining the Integrity of the Profession*****Rule 8.4 Misconduct**

It is professional misconduct for a lawyer to:

(a) violate or attempt to violate the Rules of Professional Conduct, knowingly assist or induce another to do so, or do so through the acts of another;

(b) commit a criminal act that reflects adversely on the lawyer's honesty, trustworthiness or fitness as a lawyer in other respects;

(c) engage in conduct involving dishonesty, fraud, deceit or misrepresentation;

(d) engage in conduct that is prejudicial to the administration of justice;

(e) state or imply an ability to influence improperly a government agency or official or to achieve results by means that violate the Rules of Professional Conduct or other law; or

(f) knowingly assist a judge or judicial officer in conduct that is a violation of applicable rules of judicial conduct or other law.

***IN THE MATTER OF DANIEL R. ROSEN***  
**198 P.3d 116 (Colo. 2008)**

Justice Coats delivered the Opinion of the Court.

The Attorney Regulation Counsel appealed an order of a disciplinary hearing board, dismissing one of the six claims for relief filed against Daniel R. Rosen and ordering probation for the remaining five. The regulation counsel challenges as clearly erroneous the board's finding that he failed to prove by clear and convincing evidence the commission of attempted theft. He further challenges as unreasonable the board's imposition of a six-month suspension, stayed pending a

commensurate period of probation, arguing that this court should increase that discipline to a suspension of a year and a day, without probation.

Because the hearing board did not err in finding unproven the sixth claim for relief and because the form of discipline imposed by the board for the respondent's proven violations is not unreasonable, its order is affirmed.

## I.

In February 2007, the Attorney Regulation Counsel filed a complaint against attorney Daniel R. Rosen, asserting six separate claims for relief. The first five alleged various violations of the prohibition against knowingly making a false statement of material fact or law to a person other than a client, found at Rule 4.1(a) of the Colorado Rules of Professional Conduct. The complaint asserted that these transgressions were designated misconduct by Rule 8.4(c) (engaging in conduct involving dishonesty, fraud, deceit or misrepresentation), and made grounds for discipline by C.R.C.P. 251.5(a). The sixth claim alleged that the respondent committed the crime of attempted theft, in violation of sections 18-4-401 and 18-1-201 of the Colorado Criminal Code, which are designated attorney misconduct by Rule 8.4(b) (committing a criminal act that reflects adversely on the lawyer's honesty, trustworthiness, or fitness as a lawyer, other than by violating or attempting to violate the Rules of Professional Conduct, assisting another to do so, or doing so through the acts of another), and made sanctionable by C.R.C.P. 251.5(b).

All six of the claims for relief arose from Rosen's conduct in connection with a settlement negotiation with Safeco Insurance Company on behalf of his client, David Bouelle. Before the hearing, the parties entered into a stipulation of facts. Few if any facts, apart from the respondent's intent, were therefore disputed.

The board found that the respondent is a sole practitioner with a high-volume practice specializing in the settlement of personal injury claims. Bouelle engaged the respondent in February 2004, to represent him with regard to injuries he suffered in an automobile accident. At his client's direction, the respondent prepared a settlement demand for \$65,000, but before he could deliver it, he was informed by his client's brother that the client had died. The respondent nevertheless delivered to Safeco the written settlement demand, including a demand for damages for pain and suffering.

In April the respondent rejected a counteroffer of \$23,000, indicating in his response to Safeco that his client needed additional medical treatment. Weeks later, after learning for the first time that a claim for pain and suffering abates upon the death of the injured party, the respondent received a second offer to settle, along with a check for \$31,765 and a release from liability, requiring his client's signature. Still without notifying Safeco of his client's death, the respondent faxed a copy of the release to his client's brother in California, along with a closing settlement statement, indicating that the client's share of the settlement would be \$12,579.29.

Only after sending the closing settlement statement did the respondent come to understand that the Bourelle family was not taking action to probate the estate, and therefore his client's father was not, as he had earlier thought, in a position to sign the release on behalf of the estate. In the meantime, the client's brother communicated his concern about the propriety of signing the release to a member of the respondent's staff and, without notifying the respondent, advised Safeco that the family had been provided the release and had been asked to sign it. Finally in August, nearly three weeks after the brother's call, the respondent informed Safeco by letter that his client had died.

Even in this letter, however, the respondent expressly indicated that his client had died subsequent to the settlement offer, and he offered to hold the check until a personal representative was appointed. During the ensuing months, the respondent avoided being interviewed by Safeco's investigator and once more indicated by letter that he had only recently become aware of the client's death. Ultimately, in February 2006, when Safeco requested that its settlement check be returned, the respondent immediately complied.

At the disciplinary hearing, the respondent testified that no other client of his had ever died during the course of his representation, and as a result he was unaware of the effect a client's death would have on the attorney-client relationship. He admitted his misrepresentations constituting the violations alleged in the first five claims for relief, but he denied ever having an intent to steal money from Safeco. He testified instead that his initial settlement demand, delivered after his client's death, was made in ignorance of its impropriety, and that his subsequent delay in notifying Safeco, as well as his misrepresentations concerning the timing of his client's death, were merely part of an attempt to extricate himself from an embarrassing situation rather than an attempt to increase his fee.

In consideration of the respondent's explanation that once he learned of its significance, he always intended his client's death to become known to Safeco, the hearing board was unconvinced that he acted with an intent to deceive Safeco into settling for damages to which his client's estate was not entitled. It therefore dismissed the sixth claim for relief, which alleged an attempt to commit the crime of theft. Although the board considered the respondent's admitted misrepresentations to Safeco to be violations of his duty to the legal profession, which by their very nature caused injury to the profession, it ultimately concluded that the public would be adequately protected by imposing and staying a six-month suspension, pending successful completion of a similar period of probation and ethics school.

The Attorney Regulation Counsel appealed, challenging both the board's failure to find the commission of attempted theft and its sanction of probation.

## II.

With regard to its sixth claim for relief, the Attorney Regulation Counsel assigns error to the board's failure to be convinced that the respondent acted with the specific intent to permanently deprive Safeco of its property. Rather than disputing the board's understanding of the elements of either criminal attempt or theft, regulation counsel marshals the evidence presented at the hearing

disputing the respondent's denial of any such intent and asks this court to find the elements of attempted theft established.

In a disciplinary proceeding, this court is of course not the fact finder. It may review and reverse the hearing board's order only for legal error; for clearly erroneous findings of fact; or for imposing unreasonable discipline. \* \* \* we cannot say, as a matter of law, that no reasonable fact finder could be unconvinced by the circumstantial evidence of the respondent's subjective intent to permanently deprive presented at the hearing, and instead believe the respondent's own explanation for his actions.

### III.

In determining the proper sanction for attorney misconduct, we have consistently recognized the American Bar Association Standards for Imposing Lawyer Sanctions (1992) as our guiding authority. The ABA Standards describe a range of available sanctions, mirroring those permitted by C.R.C.P. 251 (including probation), and they suggest a detailed conceptual framework for choosing an appropriate sanction under the circumstances of each individual case. See ABA Standards 2, 3. That framework entails consideration of the duty violated by the respondent, his mental state, actual or potential injury caused by his misconduct, and the existence of other aggravating or mitigating factors.

More particularly, the Standards initially analyze misconduct in terms of the class of persons or entities to whom specific duties are owed: clients, the public, the legal system, or the legal profession. The need for, and therefore the appropriateness of, any particular sanction is circumscribed, in the first instance, by the person or entity to whom the breached duty is owed; but within that class or category of breaches, the appropriateness of sanctions is further refined according to the offending lawyer's mental state, the injury actually caused or threatened by the lawyer's conduct, and various other aggravating and mitigating factors, unique to the attorney and his disciplinary history. Depending on the class of duty violated, the severity of sanctions considered necessary to protect the public may vary considerably.

Unless deceit or misrepresentation is directed toward a client, a tribunal, or the legal profession itself (as, for example, by making false representations in applying for admission to the bar), it is considered by the ABA Standards to be the violation of a duty owed to the public. As the violation of a duty owed to the public (as distinguished from a client, a court, or the profession), even conduct involving dishonesty, fraud, deceit, or misrepresentation, as long as it falls short of actual criminality or comparable intentional conduct seriously adversely reflecting on one's fitness to practice law, should generally be sanctioned only by reprimand, or censure. Suspension as a sanction for knowingly dishonest conduct directed toward someone other than a client or tribunal is generally reserved for engaging in criminal conduct.

Although dishonesty that is unrelated to the practice of law may merit no professional regulation at all, dishonesty that is related to the practice of law, even though it does not directly

breach duties to a client, the legal system, or the profession, cannot, however, go completely undisciplined.

The ABA Standards also recognize the appropriateness of ordering probation as a sanction under certain circumstances, whether alone or in conjunction with another form of discipline, like reprimand, admonition, or even suspension. Generally, the Standards support the view that probation is appropriate whenever the public will be adequately protected by permitting the lawyer to continue to practice under supervision or subject only to particular educational or other conditions. In addition to imposing private admonition, public censure, a definite period of suspension, or disbarment, Rule 251.19(b) of our own rules specifically authorizes the board to “enter other appropriate orders including, without limitation, probation.”

The Attorney Regulation Counsel reasons that the discipline ordered by the board in this case was inadequate and unreasonable, largely by contrasting it with longer suspensions imposed in cases involving false representations made for the purpose of acquiring property or benefits to which the offending attorneys were not legally entitled. Apart from the fact that individual circumstances make extremely problematic any meaningful comparison of discipline ultimately imposed in different cases, in this case the board expressly found the evidence insufficient to establish an intent to wrongfully deprive Safeco of its property. Rather, it was able to conclude only that the respondent, by referring to his client in the present tense as if he were still alive, and in misinforming Safeco about the actual timing of his client’s death and the respondent’s own awareness of it, was knowingly deceitful.

\* \* \* The ABA Standards clearly contemplate that after applying its scheme to arrive at a presumptive form and range of discipline, a disciplining authority will always consider any other factors, unique to the particular respondent, in the particular case, that should mitigate or aggravate that presumptive discipline. While the ABA Standards enumerate a number of such aggravating and mitigating factors, they are expressly intended as exemplary and are not to be applied mechanically in every case. In this case, the board considered it significant that the respondent had practiced for over twenty years without any prior discipline; that he disclosed his lack of candor to Safeco rather than negotiating their check; that he cooperated fully with the Attorney Regulation Counsel’s investigation into his conduct; and that he was genuinely remorseful. In aggravation the board noted only that the respondent’s conduct constituted a pattern of dishonest behavior, which was the precise allegation of misconduct he was found to have committed, and that he had practiced in this arena for over twenty years, although incompetence was not among the transgressions with which he was charged.

In light of these findings, we cannot say that a decision to make the respondent’s suspension contingent upon failing to successfully complete a commensurate period of probation, including an ethics course, was unreasonable.

## IV.

Because the hearing board did not err in finding the sixth claim for relief unproven and because the form of discipline imposed by the board for the respondent's proven violations is not unreasonable, its order is affirmed.

Justice Eid, dissenting.

The Hearing Board found that Rosen violated Colorado Rules of Professional Conduct 8.4(c) and 4.1(a) by taking actions that were "knowingly deceitful" during his negotiations with Safeco. Yet the Board imposed a penalty of just six months of probation. Because I believe that Rosen's conduct was egregious, I agree with attorney regulation counsel that Rosen's punishment should be increased to suspension of a year and a day, without probation. I therefore respectfully dissent.

Rosen was negotiating a settlement with Safeco when, on February 18, 2005, he learned of Bourelle's death. On April 12, 2005, Safeco made its first counteroffer of \$23,000, which included \$9,000 for pain and suffering. Although Rosen was unaware that death affected pain and suffering damages when he made a \$50,000 counteroffer on April 25, 2005, he learned just three days later that pain and suffering damages abate upon the death of a client. In other words, by the end of April 2005, Rosen knew that he was negotiating with Safeco for a settlement that contained damages to which no one was entitled – neither he, in the form of a one-third contingency fee, nor his client's heirs. Yet Rosen chose not to disclose Bourelle's death to Safeco at this point or at any point in the negotiations.

When Rosen received Safeco's next offer of \$31,750, he promptly accepted it and settled the case. The settlement exceeded the amount of economic damages involved in the case and included damages for pain and suffering, but again, Rosen chose not to disclose his client's death to Safeco.

Once the case was settled, Safeco forwarded to Rosen a liability release and a check. In order to cash the check and collect his contingency fee, Rosen needed to obtain a signature on the liability release. Because he could not obtain Bourelle's signature, he turned to Bourelle's family, forwarding a copy of the release to Bourelle's brother. On or around July 25, 2005, the brother, seeking clarification about the settlement, contacted Safeco and informed the company of Bourelle's death. Safeco asked him not to tell Rosen of the call and subsequently began an investigation. The brother did not tell Rosen about the call, nor did he sign the release.

Upon learning that Bourelle's family would not sign the release, Rosen took initial steps toward commencing a probate action, hoping to have the release signed by a fiduciary of the estate. This option required Safeco to know that Bourelle had died. Consequently, on August 11, 2005 Rosen sent Safeco a letter. He was careful, however, to preserve the pain and suffering damages contained in the settlement amount by stating that Bourelle died "subsequent" to the settlement.

Only after Rosen learned that a Safeco investigator wanted to speak with him did he admit that his client had died, though again, he failed to disclose the whole truth. In his final letter to

Safeco, Rosen stated that he “recently “ learned that Bouelle had died prior to the settlement. His letter sought to negate any implication that he had entered into a settlement agreement, which included pain and suffering damages, while knowing his client was deceased. Upon Safeco’s request, Rosen returned the check to Safeco in February of 2006 – a full ten months after he learned that pain and suffering damages abate upon a person’s death.

It is undisputed that Rosen knew pain and suffering damages abated on death, yet he negotiated a settlement that would include such damages and repeatedly misled Safeco into thinking that such damages were appropriate in this case. Moreover, he took the steps that would be necessary to cash the settlement check and eventually obtain his one-third contingency fee from a settlement amount that included pain and suffering damages. At first, Rosen hoped Bouelle’s family would simply sign the release form on Bouelle’s behalf. After that failed, he sought a probate action where a representative could sign for Bouelle. It appears that Rosen was saved from cashing the check only by chance – that is, by the actions of Bouelle’s family, who refused to sign the release and then alerted Safeco.

The Hearing Board declined to find that Rosen committed attempted theft because it concluded that the People failed to prove that Rosen had the “conscious objective” of permanently depriving Safeco of the settlement funds attributable to pain and suffering to which no one was entitled. But the Board did find that Rosen “acted dishonestly and deceitfully in his negotiations with Safeco” and that he “engaged in multiple misrepresentations” constituting “a pattern of misconduct.” Indeed, as the Board summed it up, “[I]t was more than mistake or misjudgment on [Rosen’s] part to continue to deceive Safeco after he learned of his client’s death and its impact on settling the claim. Such actions were knowingly deceitful.” In my view, given the egregious conduct that occurred in this case, the Board’s probationary sentence is inadequate.

It is somewhat unclear why the Board concluded that probation was a sufficient penalty in this case. The Board may have been influenced by (although it does not expressly reference) Rosen’s explanation that his conduct was motivated by embarrassment. Embarrassment, however, only goes so far. Embarrassment does not explain why Rosen vigorously pursued the steps necessary to cash the settlement check – that is, the fact that he sought a signature on the release form from his client’s family, and, when that failed, sought to establish a probate estate so that a representative could sign the document. Nor does it explain why he would specify in a letter to Safeco discussing probate proceedings that his client died “subsequent “ to the settlement, rather than simply stating that his client had died. Finally, embarrassment does not explain why Rosen returned the check only after being confronted by Safeco. Rosen may have been embarrassed, but he was still “knowingly” and repeatedly deceitful, as the Hearing Board concluded.

\*\*\* Attorney regulation counsel argues that, given the egregious nature of Rosen’s conduct, the penalty should be increased to suspension of a year and a day, without probation. I agree, and therefore respectfully dissent from the majority’s opinion finding otherwise.

I am authorized to state that Chief Justice Mullarkey and Justice Bender join in this dissent.

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***Problem 12-1***

Foxx and Rice are attorneys negotiating a commercial lease on behalf of their clients. After they have exchanged several drafts and reached apparent agreement on most of the language, Foxx and Rice discuss and resolve the last few issues. Foxx promises to send a revised draft reflecting their discussions in the next few days. In each of the following situations, which of the ABA Model Rules of Professional Conduct, if any, will Foxx have violated?

- A. Foxx sent Rice by e-mail a revised draft that changed the last terms agreed to in subtle but significant ways from what Foxx and Rice discussed.
- B. Foxx sent Rice by e-mail a revised draft that accurately reflected the changes to which they last agreed but also changed some other terms in the document in subtle but significant ways. In the transmitting e-mail message, Foxx wrote only the following: "Here is the revised document. It incorporates the changes to which we have agreed."

***Problem 12-2***

Petrocelli and Burleson are attorneys negotiating a complex intercreditor agreement on behalf of their clients, both of whom have made sizeable loans to the same borrower. Under the terms of the agreement, the debt owed to Burleson's client will be subordinated to the debt owed to Petrocelli's client. After they have exchanged several drafts and reached apparent agreement on most of the language, Burleson realizes that the last draft supplied by Petrocelli (and all the previous drafts) fails to include a term vital to Petrocelli's client. Without that term, the agreement will treat the debt owed to both clients equally (and thus significantly benefit Burleson's client). What must Burleson do, what must Burleson not do, and what may Burleson do?