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Jeffrey S. Mullen

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The increasing number of corporations having debt problems is clearly evident in the cases decided by the Tenth Circuit Court of Appeals during this survey period. Among the commercial and corporate law cases before the court, three were in the area of secured transactions under Article 9 of the Uniform Commercial Code (UCC). *In re Tri-State Equipment, Inc.*[1] and *United States v. Collingwood Grain, Inc.*,[2] addressed the effect of unclear or incomplete descriptions of collateral in the financing statement. In *Maxl Sales Co. v. Critiques, Inc.*,[3] the court applied the provisions of Article 9 concerning perfection in proceeds in the event of insolvency proceedings.

In the area of banking, the case of *In re Continental Resources Corp.*[4] highlighted the impact on a participating bank's security interest under a loan participation agreement when the third-party debtor goes bankrupt. In *Federal Deposit Insurance Corp. v. Palermo*,[5] the court decided the validity of a fraud counterclaim in a suit to recover on a promissory note, where a loan officer misrepresented the loan value of an interest in real property.

Outside of the debtor-creditor field entirely is *McKinney v. Gannett Co.*,[6] in which the court resolved the issue of a parent company's liability for breaching a subsidiary-employee contract.

I. SECURED TRANSACTIONS UNDER ARTICLE 9

In recent years, Article 9 has been a heavily litigated portion of the UCC. For the Tenth Circuit this past year was no exception. The Tenth Circuit cases reflect that creditors continue to be plagued by their own errors. Carelessly prepared financing statements are a particular problem.

A. *Description of Collateral in the Financing Statement*

1. Background

Filing a financing statement is the most common method of perfecting a security interest in personal property. While perfection is not a status that is relevant with respect to the creditor's rights as against the debtor, a secured creditor generally must be perfected to have priority against third-party claimants.[7] Perfection results only when the creditor

1. 792 F.2d 967 (10th Cir. 1986).
2. 792 F.2d 972 (10th Cir. 1986).
3. 796 F.2d 1293 (10th Cir. 1986).
4. 799 F.2d 622 (10th Cir. 1986).
5. 815 F.2d 1329 (10th Cir. 1987).
6. 817 F.2d 659 (10th Cir. 1987).
7. T. CRANDALL, R. HAGEDORN & F. SMITH, JR., DEBTOR — CREDITOR LAW MANUAL ¶ 7.06[1] (1985).

can show: (1) the security interest is attached, and (2) a permissible "applicable step" has been taken.[8] The applicable step usually takes the form of filing a financing statement.[9]

Whether a description of collateral in a financing statement is sufficient for purposes of perfection is determined primarily by applying UCC section 9-402(1)[10] and section 9-110.[11] In interpreting these sections, most courts have focused on Official Comment 2 to section 9-402. This comment makes clear that the filing system of the UCC is a notice filing system, where the financing statement indicates merely that the secured party may have a security interest in the collateral described. The presumption is that prospective creditors will have to make further inquiry to discover the complete state of affairs regarding the debtor's property. As a result, courts generally approve the creditor's use of the appropriate generic term used by the UCC drafters to classify collateral, although creditors run into trouble when the description is too general.[12] Other problems may arise when a description is incorrect[13] or ambiguous.

2. Description Need Only Provide Enough Notice of a Security Interest to Lead Later Creditors to Make Further Inquiry: *In re Tri-State Equipment, Inc.*

a. *Case in Context*

Tri-State Equipment[14] deals with the problem of an ambiguous de-

8. *Id.* Concerning attachment, U.C.C. § 9-203(1) (1978) provides: "[A] security interest is not enforceable . . . and does not attach unless: (a) the collateral is in the possession of the secured party pursuant to *agreement*, or the debtor has signed a security *agreement* . . . (b) *value* has been given; and (c) the debtor has *rights* in the collateral." (emphasis added). Without an enforceable, attached security interest, a creditor has no Article 9 rights.

9. Depending on the type of collateral involved, possession of the collateral or "automatic perfection" may constitute the applicable step. *See* U.C.C. § 9-303(1) (1978).

10. U.C.C. § 9-402(1) (1978) provides in part:

> A financing statement is sufficient if it gives the names of the debtor and the secured party, is signed by the debtor, gives an address of the secured party from which information concerning the security interest may be obtained, gives a mailing address of the debtor and *contains a statement indicating the types, or describing the items, of collateral.*

(emphasis added).

11. U.C.C. § 9-110 (1978) provides: "any description of personal property or real estate is sufficient whether or not it is specific if it *reasonably identifies* what is described." (emphasis added).

12. *See* B. CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE ¶ 2.9[5][c] (1980). *Compare* In re Fuqua, 461 F.2d 1186, 1188 (10th Cir. 1972) ("all personal property" too broad) *with* Leasing Serv. Corp. v. American Nat'l Bank & Trust Co., 19 U.C.C. Rep. Serv. (Callaghan) 252, 263 (D.N.J. 1976) ("any and all property, wherever located" was sufficient); *see also* In re Mitchell Bros. Constr., 52 Bankr. 92, 93 (W.D. Wis. 1985) ("all business assets" not too broad). There are nine generic types of collateral. *See* U.C.C. § 9-105 (1978) (chattel paper, documents, and instruments); *id.* § 9-106 (accounts, and general intangibles); *id.* § 9-109 (consumer goods, equipment, farm products, and inventory).

13. An erroneous description in the financing statement will prevent the security interest from being perfected unless the error is "not seriously misleading." U.C.C. § 9-402(8) (1978).

14. 792 F.2d 967 (10th Cir. 1986) (applying Colorado law).

scription of collateral. The Tenth Circuit held that a description of inventory was sufficient even though there were three possible different interpretations of what was covered.[15] The court concluded that leniency was appropriate in light of Article 9's notice filing system. The important principle established by the case is that ambiguities in a financing statement are to be construed in favor of the secured party.[16]

b. *Statement of the Case*

Two secured creditors each claimed priority in a bankrupt farm equipment dealer's inventory of used farm implements. The creditor who filed first described the collateral as: "The debtor's inventory of new and used Farm Equipment . . . and proceeds therefrom manufactured by or offered for sale by Allis-Chalmers Corporation now owned or hereafter acquired. . . ."[17]

In the bankruptcy court, this description was found to be sufficient to perfect a security interest only in trade-ins the creditor had manufactured. The bankruptcy judge held that the financing statement did not sufficiently describe used equipment not manufactured or sold by the creditor so as to provide inquiry notice to third parties of a possible security interest in the equipment.[18] The district court affirmed the decision.[19]

c. *Discussion and Analysis of the Tenth Circuit's Opinion*

On appeal, the Tenth Circuit reversed the lower courts by holding that the earlier financing statement gave legally sufficient notice of a security interest in all trade-ins, not just those manufactured by the creditor.[20]

The court framed the issue to be whether the description was sufficient to put hypothetical later creditors on notice of a possible security interest in all used farm implements traded in to the debtor.[21] In resolving this type of issue, most courts are faithful to the broad notice filing concept.[22] Some courts have relied on UCC section 9-402(8) which provides that a financing statement "substantially complying with the requirements of [§ 9-402] is effective even though it contains minor errors which are not seriously misleading."[23]

The dominant trend in this area is represented by the Eighth Cir-

15. *Id.* at 970-72.

16. Professor Clark takes this position. B. CLARK, *supra* note 12, ¶ 2.9[5][b] n.167.6 (cum. supp. no. 1, 1987).

17. *Tri-State Equip.*, 792 F.2d at 969.

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.*

22. This basically means that the function of the financing statement is to merely indicate that the secured party *may* have a security interest in the collateral described. *See* Official Comment 2 to U.C.C. § 9-402 (1978).

23. *See* B. CLARK, *supra* note 12, at ¶ 2.10 (citing cases).

cuit's decision in *Thorp Commercial Corp. v. Northgate Industries*.[24] In *Thorp*, a financing statement covering accounts receivable was held valid even though it described the collateral as "assignment accounts receivable." Under the broad notice filing philosophy of Article 9, the use of the extraneous word "assignment" did not prevent perfection in accounts acquired in the future. The court held that the financing statement served its purpose of alerting subsequent creditors of the need for further inquiry into the exact collateral covered.[25]

The Tenth Circuit's decision in *Tri-State Equipment* (under Colorado law) is consistent with *Thorp*. In Colorado, the rule is that the description "need only put other creditors on notice of a possible security interest in the collateral in question."[26] The burden is then placed on subsequent creditors to protect themselves by making further inquiry into any prior security agreements flagged by the financing statement; in fact, they are *obligated* to make further inquiry.[27]

Extensive authority exists for the proposition that a marginally adequate description imposes an obligation upon a prospective creditor to make further inquiry before accepting property offered by a debtor as collateral.[28] For example, in *In re Kline*,[29] the court held that if the description is sufficient to permit a course of inquiry concerning the property allegedly covered, the later creditor will be charged with notice of all facts ascertainable by pursuing such an inquiry.

The Tenth Circuit supported its conclusion by stating that the description was not "seriously misleading."[30] In this regard, Professor Clark states that the test should be whether the error was serious enough to throw a third-party searcher off the trail.[31] The court apparently adopted this test when it held that the notice was not so misleading as to "simply stop future creditors from making the further inquiries they were obligated by the U.C.C. to make."[32]

In light of the lenient policy behind the UCC's notice filing system, the *Tri-State Equipment* decision is at least defensible. It does, however, stretch this policy to the limit. The bankruptcy judge's interpretation appears to be the most plausible of the three possible interpretations. A

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24. 654 F.2d 1245 (8th Cir. 1981).

25. *Id.* at 1249-53. *See also* United States v. Southeast Miss. Livestock Farmers Ass'n, 619 F.2d 435, 438-39 (5th Cir. 1980).

26. *Tri-State Equip.*, 792 F.2d at 971 (quoting Platte Valley Bank v. B & J Constr., 44 Colo. App. 21, 22, 606 P.2d 455, 456 (1980) (quoting Mountain Credit v. Michiana Lumber & Supply, 31 Colo. App. 112, 116, 498 P.2d 967, 969 (1972)).

27. *See generally* Annotation, *Sufficiency of Description of Collateral*, 100 A.L.R.3d 10, 59 (1980).

28. *Id. See* Biggins v. Southwest Bank, 490 F.2d 1304 (9th Cir. 1973); *In re* Hodgin, 7 U.C.C. Rep. Serv. (Callaghan) 612 (W.D. Okla. 1970).

29. 1 U.C.C. Rep. Serv. (Callaghan) 628 (E.D. Pa. 1956). *See also* Leasing Service Corp. v. American Nat'l Bank & Trust, 19 U.C.C. Rep. Serv. (Callaghan) 252 (D.N.J. 1976); *In re* Hodgin, 7 U.C.C. Rep. Serv. (Callaghan) 612 (W.D. Okla. 1970); Cargill, Inc. v. Perlich, 31 U.C.C. Rep. Serv. (Callaghan) 1159 (Ind. App. 1981).

30. *Tri-State Equip.*, 792 F.2d at 972; *see* U.C.C. § 9-402(8) (1978).

31. B. CLARK, *supra* note 12, at ¶ 2.9[5][6].

32. *Tri-State*, 792 F.2d at 972.

later creditor could very well have looked at the financing statement and concluded, as did the bankruptcy judge, that the words "inventory of new and used Farm Equipment . . . and proceeds therefrom manufactured by or offered for sale by Allis-Chalmers Corporation"[33] meant that Allis-Chalmers only claimed a security interest in the trade-ins that it manufactured or sold. But the financing statement did give other notice. The creditor had checked a box indicating simply that "proceeds of collateral are also covered."[34] Additionally, the words "*new and used* Farm Equipment" preceded the reference to proceeds.[35]

d. *Implications of Holding*

Tri-State Equipment indicates that the financing statement must be read as a whole and that ambiguities are construed in favor of the secured party. Thus, the normal contract rule that documents should be construed against the drafter[36] is simply inappropriate to the question of whether a financing statement contains an adequate description. Since the court took a fairly extreme position in finding for the first-to-file creditor, it is not likely that a more lenient decision will be forthcoming from the Tenth Circuit.[37]

B. *Description of Crops in the Financing Statement*

1. Background

When the collateral involved is a crop, UCC sections 9-203(1)(a) and 9-402(1) require in the security agreement and financing statement, respectively, a description of the real estate upon which the crop is grown or will be grown. Most of the controversy concerning the adequacy of descriptions relating to crops arises over the sufficiency of the description of the real estate upon which the crops are grown, or will be grown, rather than the sufficiency of the description of the crops themselves.[38] UCC section 9-110 provides that the description of both collateral and real estate is sufficient if it "reasonably identifies" what is

33. *Id.* at 969.

34. *Id.*

35. *Id.* (emphasis added). These cases are almost always lessons in drafting. The following corrected version of the collateral description would probably have prevented this case from arising: "The debtor's inventory of new and used Farm Equipment . . . now owned or hereafter acquired. . . ." A creditor does not have to mention the term "proceeds" in either the financing statement or the security agreement. U.C.C. § 9-203(3) (1978).

36. RESTATEMENT (SECOND) OF CONTRACTS § 206 (1979).

37. For another recent decision that is also very lenient see Mid City Bank v. Omaha Butcher Supply, 222 Neb. 671, 385 N.W.2d 917, 922 (1986), where the court upheld a description even though the creditor mixed up Article 9 categories by describing inventory as "all equipment, supplies, and parts."

38. The question of the adequacy of a crop description was touched upon in United States v. Big Z Warehouse, 311 F. Supp. 283 (S.D. Ga. 1970) (reference to "crops" growing or to be grown adequate to describe a tobacco crop where all crops grown on the land were collateral for the debt).

described. Full blown legal descriptions are not necessary.[39] However, omitting a real estate description altogether is not a *de minimus* error under section 9-402.

Courts have become lenient in applying the "reasonable identification" test. Most courts have held that a description is clearly sufficient if it contains the name of the owner or lessor of the real estate, acreage, county, township, and range of the real estate where the crops are growing.[40] More general descriptions often suffice.

Consistent with section 9-110's reasonable identification standard, two courts have provided some vague but at least partially helpful guidance for determining how precise the description must be. In *Chanute Production Credit Association v. Weir Grain & Supply*,[41] the Kansas court stated that a creditor should not be required to make a general search of the record or a general inquiry in the county as to the land involved.[42] In *United States v. Oakley*,[43] the court held that the description need not be of such specificity to enable a stranger to locate the property; a description is sufficient if it enables third persons, aided by inquiries which the financing statement itself suggests, to identify the property.[44]

2. Description Must Provide Clues Sufficient that Third Persons by Reasonable Care and Diligence Might Ascertain the Property Covered: *United States v. Collingwood Grain, Inc.*

a. *Case in Context*

In *Collingwood Grain*,[45] the Tenth Circuit held that a real estate description in a financing statement was sufficient to perfect a security interest in the debtors' crops, even though the description did not give the name of the land owner nor include a legal description. The description still provided clues that were sufficient to enable third persons to reasonably identify the property covered. The court departed from prior law[46] only in holding that the description need not contain the name of the land owner.

39. *See, e.g.*, Chanute Prod. Credit Ass'n v. Weir Grain & Supply, 210 Kan. 181, 499 P.2d 517 (1972); *Big Z Warehouse*, 311 F. Supp. at 283.

40. United States v. Oakley, 483 F. Supp. 762 (E.D. Ark. 1980); *In re* Colbert, 22 U.C.C. Rep. Serv. (Callaghan) 511 (Bankr. N.D. Miss. 1977); *Big Z Warehouse*, 311 F. Supp. 283; *In re* McMannis, 39 Bankr. 98 (Bankr. D. Kan. 1983).

41. 210 Kan. 181, 182, 499 P.2d 517, 518 (1972). The financing statement, which was held to be insufficient, contained the following description: "Crops: Annual and perennial crops . . . on land owned or leased by debtor in Cherokee County, Kansas."

42. *Id.* at 182, 499 P.2d at 518.

43. 483 F. Supp. at 764. The description at issue in *Oakley* contained the name of the owner of the realty, approximate number of acres of land involved, county and state where the realty was located, and the distance and direction of the realty from a named town. The description was upheld.

44. *Id.*

45. 792 F.2d 972 (10th Cir. 1986) (applying Kansas law).

46. *See supra* note 40 and accompanying text.

b. *Statement of the Case*

The debtors gave two different creditors a security interest in growing crops on farm land leased by the debtors. The creditor who was first to file a financing statement described the tract by including the percentage interest, number of acres, section, township, range, county, and state.[47] The district court found the financing statement insufficient because it did not list the record owner of the land and failed to identify precisely which tract within the specified section was encumbered.[48]

c. *Discussion and Analysis of the Tenth Circuit's Opinion*

In holding that the description was sufficiently precise to give the requisite notice, the Tenth Circuit reversed the decision of the district court.[49]

i. Name of land owner not necessary

The court first ruled that a creditor does not have to include in the financing statement the name of the land owner as part of the real estate description.[50] Under existing Kansas law, a real estate description in connection with crops is sufficient if it contains: (1) the name of the land owner, (2) the approximate number of acres, (3) the county of the location of the land, and (4) the approximate distance and direction of the land from the nearest town or city.[51] The court noted that this list shows only what will guarantee sufficient description.

The requirement of listing the land owner finds no support in the UCC, as far as a security interest in crops is concerned. The Kansas version of section 9-402,[52] as well as the Official Text, contain no hint of such a requirement. Under Official Text section 9-402(5), the name of the land owner only has to be included if the financing statement covers timber to be cut, minerals, accounts arising from the sale of minerals at the wellhead or minehead, or fixtures (for a "fixture filing"), and the debtor does not have an interest of record in the real estate. If the drafters had intended to subject a description of crops to the land owner requirement, the word "crops" would have been included.[53]

47. *Collingwood Grain*, 792 F.2d at 973.
48. *Id.*
49. *Id.*
50. *Id.* at 974.
51. *In re* McMannis, 39 Bankr. 98 (Bankr. D. Kan. 1983); *In re* Roberts, 38 Bankr. 128, (Bankr. D. Kan. 1984). Kansas law in this area is in accord with the majority rule; *see* text accompanying note 40.
52. KAN. STAT. ANN. § 84-9-402 (1983).
53. The Kansas version is even less supportive of this requirement where the security interest is in crops. KAN. STAT. ANN. § 84-9-402(5) is similar to the U.C.C. Official Text except that the name of the land owner is always required when the financing statement covers timber, minerals, accounts arising from the sale of minerals, or fixtures. Crops are noticeably absent from this list. Additionally, in KAN. STAT. ANN. § 84-9-402(3), part 2 (crops) of the sample form has a space for a real estate description but no space to include the name of the land owner, while part 3 (fixtures, timber, minerals, accounts generated from sale of the minerals) has separate spaces for both a legal description of the real estate and the name of the record owner.

ii. Full legal description not necessary

The second issue addressed by the Tenth Circuit was whether the real estate description was sufficient despite the fact that it did not identify precisely where the land lay within the particular section specified. In upholding the description, the court noted that a full blown legal description is not necessary.[54] Agreement among courts on this point is virtually unamimous, given the UCC's general notice filing concept and Official Comment 5 to section 9-402 which expressly rejects the notion that the description must be by metes and bounds.[55]

It is the general and vague descriptions that frequently give rise to litigation. The court cited *Chanute Production* as an example of what is not sufficient; the creditor there had described the crops as those "produced on land owned or leased by debtor in Cherokee County, Kansas."[56] The court also mentioned the description requirements set forth in *In re McMannis*[57] and noted that those items will guarantee sufficient description.[58]

While the court expressly does not require the name of the land owner in a real estate description, there is still some uncertainty as to how far a creditor can stray from the *McMannis* requirements. The leading case of *United States v. Big Z Warehouse*[59] seems to represent the limit. There, the financing statement, covering all crops to be grown on the farm of "Oscar R. Chancey" of approximately ninety acres located "1 Mi. North of Offerman, Ga. All in the County of Pierce, State of Georgia,"[60] was held sufficient.[61] This decision finds support, since under the UCC's notice filing system, the financing statement indicates merely that the secured party *may* have a security interest in the described collateral, and that further inquiry will be necessary to disclose the complete state of affairs.[62] The conclusion to be drawn is that a description

54. *Collingwood Grain*, 792 F.2d at 974.

55. *See* Annotation, *Sufficiency of Description of Crops*, 67 A.L.R.3d 308 (1975). Creditors should be aware, however, that U.C.C. § 9-402(5) (1978) requires a real estate description sufficient for a mortgage (usually a legal description) where the collateral is timber, minerals, accounts arising from the sale of minerals, or fixtures (for a "fixture filing"). *See also* Official Comment 1 and the important distinction drawn between the function of the description of land in reference to crops and its function in the other cases mentioned. The comment states that:

> [f]or crops it is merely part of the description of the crops concerned, and the security interest in crops is a Code security interest . . . . In contrast, in the other cases mentioned the function of the description of land is to have the financing statement filed in the county where the land is situated and in the realty records, as distinguished from the chattel records.

Id.

56. 210 Kan. 181, 182, 499 P.2d 517, 518. *See also* Piggott State Bank v. Pollard Gin Co., 243 Ark. 159, 419 S.W.2d 120 (1967).

57. 39 Bankr. 98 (Bankr. D. Kan. 1983). *See supra* text accompanying note 51.

58. *Id.* at 100.

59. 311 F. Supp. 283 (1970).

60. *Id.* at 285.

61. *Id.* at 286.

62. U.C.C. § 9-402 Official Comment 2 (1978). *See also* Bank of Danville v. Farmers Nat. Bank, 602 S.W.2d 160, 162-63 (Ky. 1980) ("farm of Dale Wilson on Lancaster Road, 4 miles from Danville, Boyle County, Kentucky" was sufficient). Compare United States v.

is sufficient if it is more precise than a county-wide description.[63]

The Tenth Circuit's holding in *Collingwood Grain* is consistent with *Big Z Warehouse*. The court found it irrelevant that the description failed to identify precisely where the 160 acres of land lay within the single 640-acre section. A reasonable investigation would have disclosed which particular land was involved, without a general search of the record or a general inquiry in the county.

Collingwood Grain is representative of the majority view that if the financing statement provides enough information to enable third persons through the use of reasonable care and diligence to identify the property covered, sections 9-110 and 9-402(1) are satisfied, at least with respect to the real estate description.[64]

d. *Implications of Holding*

Because of the UCC's notice filing concept, most courts have become lenient in judging the sufficiency of crop descriptions in the financing statement. The Tenth Circuit's decision follows this trend, and gives no indication of a more restrictive decision in the future. Yet, creditors should not feel entirely comfortable in relying on any trend when attempting to perfect a security interest in crops—or any other collateral for that matter. The safest approach is to comply with the requirements set forth in *McMannis*.[65]

C. *Maintaining a Perfected Security Interest in Proceeds in the Event of Insolvency Proceedings*

1. Background

UCC section 9-306(1) defines "proceeds" as "whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds." A security interest attached to original collateral also becomes attached to any identifiable proceeds.[66] When the debtor receives cash proceeds and commingles them with other funds in a general bank account, the question that arises is whether the creditor's security interest continues in the commingled proceeds. Courts have generally allowed creditors to trace cash proceeds through the use of the "lowest intermediate balance" rule.[67]

Newcomb, 682 F.2d 758, 762 (8th Cir. 1982) (financing statement that described the land as being located in "Jasper County, Missouri, approximately 15 miles northwest of Carthage, Missouri" was upheld).

63. *See* KAN. STAT. ANN. § 84-9-402 comment at 472 (1983) (discussing *Chanute Production*).

64. *See* KAN. STAT. ANN. § 84-9-110 comment at 409 (1983).

65. *See supra* text accompanying note 51. A creditor should not get the idea that using a legal description is the best course to follow. If a legal description is used, no inquiry beyond the financing statement is required because of the description's specificity. Thus, the secured creditor bears the burden of ensuring that no seriously misleading clerical errors appear. *See In re* Lions Farms, 54 Bankr. 241 (D. Kan. 1985).

66. U.C.C. § 9-306(2) (1978).

67. Under this rule, which is borrowed from the law of trusts, the assumption is that a deposit of proceeds into a commingled account remains identifiable where the commin-

As to perfection in proceeds, there are further complications. If no insolvency proceedings have been instituted section 9-306(3) specifies when perfection in proceeds occurs. When insolvency proceedings have been instituted section 9-306(4) becomes applicable.[68] Concerning "identifiable" proceeds under paragraphs (a), (b) and (c) of section 9-306(4), the secured party's rights are not affected by the insolvency proceedings if such proceeds can still be identified or traced as having been received on the disposition of the collateral. However, the right to trace "identifiable cash proceeds" under paragraphs (b) and (c) does not survive a commingling of the proceeds with other money.[69] When commingling occurs, paragraph (d) applies. The provisions of that paragraph are a substitute for the common law tracing rules, like the lowest intermediate balance rule.[70] Thus, the ability of a creditor to identify and trace a greater sum received prior to the ten-day period is irrelevant; the creditor is limited to the amount deposited by the debtor within ten days before the institution of the insolvency proceedings.[71]

Subsection (4)(d) has been a continuing source of difficulty for the courts. One problem is that the UCC does not specify whether the phrase "any cash proceeds" should include proceeds received from any source or only identifiable proceeds. In *Fitzpatrick v. Philco Finance Corp.*,[72] the Seventh Circuit held that the cash proceeds were limited to funds from the sale of collateral in which the creditor retained a per-

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gled account has equaled or exceeded the amount of the deposit at all times since the intermingling. *See* Universal CIT Credit Corp. v. Farmers Bank of Portageville, 358 F. Supp. 317 (E.D. Mo. 1973).

68. Section 9-306(4) is as follows:

(4) In the event of insolvency proceedings instituted by or against a debtor, a secured party with a perfected security interest in proceeds has a perfected security interest only in the following proceeds:

(a) in identifiable non-cash proceeds and in separate deposit accounts containing only proceeds;

(b) in identifiable cash proceeds in the form of money which is neither commingled with other money nor deposited in a deposit account prior to the insolvency proceedings;

(c) in identifiable cash proceeds in the form of checks and the like which are not deposited in a deposit account prior to the insolvency proceedings; and

(d) in all cash and deposit accounts of the debtor in which proceeds have been commingled with other funds, but the perfected security interest under this paragraph (d) is

(i) subject to any right to set-off; and

(ii) limited to an amount not greater than the amount of any cash proceeds received by the debtor within ten days before the institution of the insolvency proceedings less the sum of (I) the payments to the secured party on account of cash proceeds received by the debtor during such period and (II) the cash proceeds received by the debtor during such period to which the secured party is entitled under paragraphs (a) through (c) of this subsection (4).

69. 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 45.9 at 1338 (1965).

70. WHITE & SUMMERS, UNIFORM COMMERCIAL CODE 1013 (2d ed. 1980).

71. A few courts have disagreed with this analysis and have permitted tracing. For example, in *In re* Intermountain Porta Storage, 59 Bankr. 793, 796 (Bankr. D. Colo. 1986), the court concluded that § 9-306(4)(d) was not applicable because the proceeds were "identifiable" under the lowest intermediate balance rule. *Accord In re* Gibson Products of Arizona, 543 F.2d 652 (9th Cir. 1976), *cert. denied*, 430 U.S. 946 (1977); *In re* Dexter Buick-GMC Truck Co., 28 U.C.C. Rep. Serv. (Callaghan) 243 (D.R.I. Bankr. 1980).

72. 491 F.2d 1288 (7th Cir. 1974).

fected security interest.[73] But, in *In re Gibson Products of Arizona*,[74] the Ninth Circuit held that the phrase referred to all cash proceeds, regardless of whether they arose from the sale of collateral in which the secured creditor held a security interest.[75] Another problem arises from the Bankruptcy Act of 1978. It is at least arguable that a few of the bankruptcy provisions conflict with section 9-306(4)(d).[76]

2. Uniform Commercial Code Section 9-306(4)(d) Provides Exclusive Means for Recovering Commingled Proceeds in the Event of Insolvency Proceedings: *Maxl Sales Co. v. Critiques, Inc.*

a. *Case in Context*

In *Critiques*,[77] the Tenth Circuit viewed the facts as requiring a straight application of section 9-306(4)(d). The court held that the creditor could not reclaim any proceeds since it offered no evidence showing what amounts, if any, were proceeds received by the debtor within ten days before the institution of insolvency proceedings. As a result of this lack of evidence, the court did not reach the issue of what the phrase "any cash proceeds" means. Nor did it discuss the issue of whether the Bankruptcy Act of 1978 created any conflict with section 9-306(4)(d). The dissent concluded that section 9-306(4)(d) was not applicable.[78]

b. *Statement of the Case*

The creditor and debtor entered into two separate transactions. One was a consignment agreement, and the other was a loan represented by a promissory note. For each transaction, a security agreement was executed, and a corresponding financing statement filed. The debtor defaulted on both security agreements.[79] Later, a district court appointed a receiver to operate the debtor's business and hold in trust any net revenue from operations.[80] The receiver liquidated the debtor's existing inventory, plus inventory purchased by the receiver, at a public sale. The debtor then filed for bankruptcy under Chapter VII of the Bankruptcy Code and state court proceedings were stayed. Funds from the sale were transferred to the trustee in bankruptcy and the creditor

73. *Id.* at 1292.

74. 543 F.2d at 656, *cert. denied*, 430 U.S. at 950.

75. *Id.* White and Summers argue that the approach in *Gibson Products* is not defensible and that the phrase "any cash proceeds" limits the creditor to proceeds of his own collateral. WHITE & SUMMERS, UNIFORM COMMERCIAL CODE 1014-17 (2d ed. 1980).

76. *But see* WHITE & SUMMERS, UNIFORM COMMERCIAL CODE 1017 (2d ed. 1980) (finding no conflict between § 9-306(4)(d) and 11 U.S.C. §§ 547 and 545 (Supp. III 1985) or any other section of the Bankruptcy Act).

77. 796 F.2d 1293 (10th Cir. 1986) (applying Kansas law).

78. *Id.* at 1301.

79. *Id.* at 1295.

80. The receiver was appointed after the state of Kansas had filed a consumer protection complaint against the debtor and the state court had issued a writ of attachment against the debtor's property. *Id.*

filed a reclamation claim. The bankruptcy court rejected the claim,[81] and the district court affirmed.[82]

c. *Discussion and Analysis of the Tenth Circuit's Opinion*

The Tenth Circuit affirmed the decision of the lower courts.[83] Before reaching the ultimate task of applying section 9-306(4)(d), the court had to determine whether the creditor had a perfected security interest in proceeds under the two security agreements. The creditor only had trouble with the consigned goods security agreement, which incorporated a consignment agreement covering "certain items of furniture, household goods, etc. . . . ."[84] Although the creditor's failure to specifically include the term "inventory" in the security agreement did not prevent attachment under section 9-203 in the inventory assigned to the receiver, the same omission in the financing statement did prevent perfection.[85] The court interpreted a Kansas non-uniform amendment to section 9-402(1),[86] an amendment that specifically authorizes the use of generic descriptions of collateral, to mean that a creditor cannot comply with this section by identifying collateral any less specifically than by reference to the general categories of personal property used in Article 9.[87]

The security interest with respect to the promissory note was properly perfected. However, in applying section 9-306(4)(d), the court held that since the creditor failed to show what amounts (if any) were proceeds received by the debtor within ten days before the institution of the bankruptcy proceeding, it had no claim to the proceeds generated by the liquidation sale.[88] It was this application of section 9-306(4)(d) that gave rise to a persuasive dissenting opinion by Judge Logan,[89] who highlighted two important issues: (1) the meaning of "insolvency proceedings," and (2) whether section 9-306(4)(d) applies to proceeds commingled *after* insolvency proceedings have been instituted. The majority overlooked the importance of both of these issues.

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81. *In re* Critiques, Inc., 29 Bankr. 941 (Bankr. D. Kan. 1983).

82. *Critiques*, 796 F.2d at 1295.

83. *Id.*

84. *Id.*

85. The financing statement listed "proceeds, accounts receivable and intangibles arising from a certain consignment agreement. . . ." *Id.*

86. KAN. STAT. ANN. § 84-9-402(1) (1983).

87. *Critiques*, 796 F.2d at 1299. The court's ruling on this issue is strict in comparison with its ruling in *In re* Tri-State Equip., 792 F.2d 967, 971-72 (10th Cir. 1986); *see supra* text and accompanying notes 7-37. Nonetheless, without an appropriate reference to inventory by either "item" or "type" under § 9-402(1), the secured party was limited by the description in the financing statement and could not rely on the broader description in the security agreement. This is an application of what Professor Clark calls the "double filter" rule which limits perfection to the narrower of the two descriptions in the security agreement and financing statement; neither document can expand the scope of the other. B. CLARK, *supra* note 12, at ¶ 2.9[5][b] (cum. supp. no. 1 1987).

88. *Critiques*, 796 F.2d at 1301.

89. *Id.*

i. The meaning of "insolvency proceedings" in Uniform Commercial Code Section 9-306(4)

UCC section 1-201(22) defines "insolvency proceedings" as "any assignment for the benefit of creditors or other proceedings intended to liquidate or rehabilitate the estate of the person involved." Several courts have held that there is an insolvency proceeding even where a Chapter 11 petition in bankruptcy is filed and the debtor is seeking merely to reorganize his estate, rather than liquidate it.[90] Yet, the definition is broad enough to encompass more than bankruptcy situations.[91] It specifically includes an assignment for the benefit of creditors as well as liquidation and reorganization proceedings which may be equity receivership proceedings under state law that continue when not displaced by federal bankruptcy law.[92] The definition of insolvency proceedings is, therefore, broad enough to include a state law receivership.

The majority in *Critiques* treated the bankruptcy proceedings as the "insolvency proceedings" referred to in section 9-306(4), rather than the state law receivership.[93] As discussed in the next section, the result is a misapplication of section 9-306(4) for the purpose of applying the ten day limit in paragraph (d).

ii. Application of Section 9-306(4)(d)

The majority held that it did not matter whether the insolvency proceedings were deemed instituted when the receiver was appointed or when the bankruptcy petition was filed, due to the fact that the creditor offered no proof as to the amount of proceeds received by the debtor within ten days preceding either date.[94] In so holding, the majority assumed that proceeds arising after insolvency proceedings are also controlled by section 9-306(4).

Subsection (4) states that "*[I]n the event* of insolvency proceedings . . . a secured party with a perfected security interest in proceeds has a perfected security interest only in . . . (d) . . . accounts of the debtor in which proceeds *have been commingled* with other funds. . . ." The language indicates that section 9-306(4)(d) applies only to proceeds commingled *prior* to the date of insolvency proceedings.[95] Therefore, section 9-306(4)(d) was simply not applicable to the facts before the court since the proceeds were generated after the appointment of the receiver.

90. *See, e.g.*, Morrison Steel Co. v. Gurtman, 113 N.J. Super. 474, 478, 274 A.2d 306, 310 (1971); *In re* Conklins, Inc., 14 Bankr. 318, (Bankr. D.S.C. 1981).

91. R. HENSON, SECURED TRANSACTIONS at 217-18 (2d ed. 1979).

92. 1 R. ANDERSON, UNIFORM COMMERCIAL CODE, § 1-201:359 (3d ed. 1981). *See also* 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 45.9 at 1337 (1965) (insolvency proceedings may take place either under a state statute or under the liquidation or reorganization provisions of the federal Bankruptcy Act).

93. *Critiques*, 796 F.2d at 1301.

94. *Id.* at 1300 n. 9.

95. *Id. See also In re* Gibson, 6 U.C.C. Rep. Serv. (Callaghan) 1193, 1196 (W.D. Okla. 1969) (holding that the secured party could recover from the trustee in bankruptcy the proceeds received by the debtor within the ten day period prior to bankruptcy, plus the amount collected by the trustee from accounts receivable subsequent to bankruptcy).

What was before the court was basically a straight bankruptcy question.[96]

d. *Implications of Holding*

As the dissent noted, the problem with the majority's assumption that section 9-306(4)(d) applies also to proceeds that were commingled after insolvency proceedings have begun is that there will never be proceeds received within ten days before the institution of insolvency proceedings with regard to items sold after insolvency proceedings. As a result, secured creditors will always lose here, unless they prevent the receiver from commingling the proceeds with other money.[97] Fortunately, other courts are not likely to follow the Tenth Circuit's approach to section 9-306(4)(d). If the same facts were to arise again, the chances are slim that another court would refuse to find that a state law receivership is an insolvency proceeding within the meaning of that section.

II. BANKING

The troubled oil and gas industry was the breeding ground for the two banking cases decided by the Tenth Circuit during the survey period. The issues in both cases were primarily contractual in nature. Not surprisingly, the financial problems of at least one of the parties involved in each case helped to give rise to these issues.

A. *A Participating Bank's Risk Under a Loan Participation Agreement*

1. Background

Under a loan participation agreement, an investing participant advances funds to the originating lender (referred to as the "lead"), either for the purpose of purchasing an undivided interest in the obligation of a third party and in any collateral or as an extension of credit to the lead. Typically, a bank or other financial institution will attempt to participate in a third-party obligation (the "loan") originated by the lead when it has surplus cash to invest.[98]

For an investor contemplating the acquisition of a participation, either by purchase or as security, there are several potential problems, including: (1) insolvency of the lead, in which case the funds entrusted to the lead may be subject to the adverse claims of the lead's creditors or of its trustee in bankruptcy; (2) inability or unwillingness of the lead to perform its contractual undertakings; and (3) insolvency of the third-party obligor. With regard to this last problem, the existence of a future advance clause in the security agreement between the lead and the third-party obligor can have adverse consequences on the participant's security interest in any underlying collateral.

96. *See* 11 U.S.C. § 552(b) (Supp. III 1985).
97. *Critiques*, 796 F.2d at 1302.
98. *See generally* Simpson, *Loan Participations: Pitfalls for Participants*, 31 BUS. LAW. 1977, 1977-85 (1976).

When there is a future advance clause, the lead will want to ensure that the loan is secured not only to the extent of the amount owed on the original advance but also to the extent of the amount owed on the future advance.[99] If the security agreement's future advance clause is effective, the use of the original collateral to secure a future advance may dilute any interest the participant might have in the collateral for the loan if the value and amount of collateral remain the same. The participant's problem in this situation is compounded when the lead drafts the participation agreement[100] and in it disclaims any representations or warranties with respect to the collateral. If the debtor becomes insolvent, the lead may be able to use the collateral to satisfy not only the original advance but the future advance in which the participant may not have an interest, all at the expense of the participant.

Often, the participant's only real chance to avoid such a result is to argue that the future advance clause does not cover the later advance on the ground that it was created for a different purpose than the original advance. In response to this type of argument, several courts hold that unless the future advance clause is ambiguous it encompasses all future advances, and parol evidence is inadmissible to contradict the clear language of the clause.[101] Other courts look at both the security agreement and parol evidence to ensure that the parties intended the future advance clause to cover the particular type of subsequent advance. These courts generally allow parol evidence to show whether the later advance was of the "same class" as the initial obligation. This is an important determination because if the two obligations are not of the same class the original collateral will not secure the later advance.[102]

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99. Achieving attachment to the extent of the future advance requires a security agreement that demonstrates the debtor's intent to give a security interest in the collateral to cover the future advance. *See* T. CRANDALL, R. HAGEDORN & F. SMITH, JR., DEBTOR-CREDITOR LAW MANUAL ¶ 7.04[2][b][vi] (1985). The collateral may be real as well as personal property. For example, a mortgage may secure future advances of value. In fact, many states have enacted statutes validating the use of the mortgage (or trust deed) to secure future advances. *Id.* at ¶ 8.04. As to personal property, *see* U.C.C. § 9-204(3) (1978).

100. This agreement, between the lead and the participant, governs the participation relationship. Hibernia Nat'l Bank v. Federal Deposit Ins. Corp., 733 F.2d 1403, 1408 (10th Cir. 1984).

101. *See, e.g.*, First Nat'l Bank in Dallas v. Rozelle, 493 F.2d 1196 (10th Cir. 1974); Kimbell Foods v. Republic Nat'l Bank of Dallas, 557 F.2d 491 (5th Cir. 1977), *aff'd*, 440 U.S. 715 (1979); State Bank of Albany v. United States, 468 F.2d 1211 (2d Cir. 1972).

102. *See, e.g.*, Kitmitto v. First Pa. Bank, 518 F. Supp. 297 (E.D. Pa. 1981); Marine Nat'l Bank v. Airco, Inc., 389 F. Supp. 231 (W.D. Pa. 1975); *In re* Grizaffi, 23 Bankr. 137 (D. Colo. 1982). *See also* T. CRANDALL, R. HAGEDORN & F. SMITH, JR., DEBTOR-CREDITOR LAW MANUAL ¶ 7.04[2][b][vi] (1985).

2. Existence of Future Advance Clause Results in Dilution of Collateral in the Absence of Protective Provisions: *In re Continental Resources Corp.*

a. *Case in Context*

In *Continental Resources*,[103] the Tenth Circuit disallowed parol evidence with respect to the subjective intent of the parties in executing a future advance but did apply the "same class" test. The court stated that the future advance was of the same class as the initial advance and therefore was secured by the original collateral. As a result, the participating bank's interest in the collateral was diluted.

b. *Statement of the Case*

The debtor entered into a revolving loan agreement with the lead bank, the loan being secured by mortgages (collectively referred to as "mortgage") on certain oil and gas properties. The mortgage contained a future advance clause.[104] Following the execution of the note and mortgage, another bank purchased a participation in the loan from the lead bank. A few months later, the lead bank and the debtor entered into an agreement for a second loan. The note for this second loan, in which the participating bank did not have an interest, listed "oil and gas mortgages" as collateral.[105] After the debtor went bankrupt, the lead bank filed an application with the bankruptcy court to have its claim under the second note classified as secured (by the mortgage). The bankruptcy court held that the second loan was subject to the future advance clause and granted the application.[106] The district court affirmed.[107]

c. *Discussion and Analysis of the Tenth Circuit's Opinion*

The Tenth Circuit also affirmed the bankruptcy court's decision[108] and rejected the participating bank's arguments that: (1) the lead bank breached its duty of good faith by using the mortgage to secure the second loan; (2) parol evidence should have been admissible to show that the lead bank and the debtor did not intend to secure the second loan; and (3) the second loan was not of the same class as the original loan.[109]

103. *In re* Continental Resources Corp., 799 F.2d 622 (10th Cir. 1986) (applying Oklahoma law).

104. This clause contained the following language: "This mortgage is given to secure the following indebtedness, to wit [original loan] . . . [and] all loans and advances which Mortgagee may hereafter make to Mortgagor, and all other and additional debts. . . ." Another section in the mortgage stated: "it being contemplated by Mortgagor and Mortgagee that Mortgagee may from time to time make additional loans and future advances hereunder. . . ." *Id.* at 624-25.

105. *Id.* at 623.

106. 43 Bankr. 658 (Bankr. W.D. Okla. 1984).

107. *Continental Resources*, 799 F.2d at 623.

108. *Id.*

109. *Id.* at 624-27.

i. The duty of good faith

Every contract imposes upon each party a duty of good faith and fair dealing. According to the drafters of the Restatement of Contracts (Second), the concept of good faith emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party.[110] Under the UCC, in the case of a merchant, good faith means "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade."[111] A breach of the duty of good faith and fair dealing occurs when one party to a contract seeks to prevent its performance by, or to withhold its benefits from, the other party. Without more, the mere exercise of one's contractual rights cannot constitute a breach.[112]

The participating bank's argument that the lead bank breached this implied duty by using existing collateral to secure a future advance was, not surprisingly, unsuccessful. The participation agreement clearly disclaimed any representations and warranties concerning the sufficiency of the collateral. In addition, as the participating bank was aware, the mortgage contained a future advance clause. In light of these provisions, the participant could not have justifiably expected that the future advance clause would remain dormant. The risk that the collateral might be diluted via the exercise of the clause was apparent.

In a related argument, the participating bank claimed that the lead breached a fiduciary duty. As the court noted, the specific terms of both the participation agreement and mortgage qualified whatever fiduciary relationship may have existed,[113] and therefore precluded a finding of breach.

ii. Application of the parol evidence rule

The parol evidence rule bars evidence of prior or contemporaneous oral or written agreements and understandings which vary or contradict the written contract.[114] The rule only applies if the written contract is an integration, that is, a final expression of the agreement. Moreover, if the written contract is a completely integrated agreement, parol evi-

110. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979). See comments (a) and (d). Comment (d) lists examples of bad faith: "evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance." RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979) Comment (d).

111. U.C.C. § 2-103(1)(b) (1978).

112. Broad v. Rockwell Int'l Corp., 642 F.2d 957 (5th Cir.), *cert. denied*, 454 U.S. 965 (1981).

113. *Continental Resources*, 799 F.2d at 625. The assertion of a fiduciary relationship between the lead and the participant is frequently helpful in the context of the lead's bankruptcy, as opposed to the debtor-obligor's bankruptcy. If a participant can establish a trustee-beneficiary relationship in this situation, it may be entitled to a return of any funds advanced to the lead. *See* Simpson, *Loan Participations: Pitfalls for Participants*, 31 BUS. LAW. 1977, 1992-2003 (1976) and the cases discussed therein; Hibernia Nat'l Bank v. Federal Deposit Ins. Corp., 733 F.2d 1403 (10th Cir. 1984).

114. *See* RESTATEMENT (SECOND) OF CONTRACTS § 213 (1979).

dence is not even admissible to supplement the writing.[115] When a future advance clause is involved, the rule generally followed is that the language of the contract, unless ambiguous, represents the intention of the parties and that testimony concerning the subjective intent of the parties in adopting the clause is inadmissible.[116]

In the present case, the participating bank argued that the parties did not intend to secure the second loan with the existing mortgage but, rather, had agreed to an unsecured negative pledge arrangement.[117] The court held that parol evidence to establish this intent was inadmissible.

The court seems to have been extreme in its application of the parol evidence rule. By definition, the rule should not be applied to evidence of subsequent agreements or modifications.[118] Therefore, if the parties actually did enter into a subsequent agreement that differed from the original, as the participant claimed, then parol evidence should have been admissible. The participating bank, however, could never really prove that there was any kind of subsequent modification.[119] In the cases cited by the court, the issue was whether evidence prior to or contemporaneous with the writing was admissible.[120] In the present case, the issue was whether there was a subsequent modification.

The court also addressed the issue of whether the participant was subject to the parol evidence rule even though it was not a party to the mortgage.[121] In *Fulton v. L & N Consultants, Inc.*,[122] the court noted that in Oklahoma the general rule is "that the parol evidence rule only applies to parties to the agreement and their privies."[123] As Professor Williston notes, such a statement of the rule "has led to misapprehension."[124] Except perhaps for the purpose of showing either fraud against a third person or some invalidating facts which would be available to the parties themselves, the rule should apply with respect to third parties. Furthermore, the parol evidence rule extends to a third

115. *Id.* The exceptions applicable to the parol evidence rule (*e.g.*, when the writing is ambiguous) are found in § 214. *Id.*

116. Kimbell Foods v. Republic Nat'l Bank, 557 F.2d 491, 496 (5th Cir. 1977).

117. *Continental Resources*, 799 F.2d at 625. A negative pledge is merely an agreement to forebear from taking some manner of action. *In re* Continental Resources Corp., 43 Bankr. at 662.

118. The court recognized this facet but called it an "exception" to the parol evidence rule. *Continental Resources*, 799 F.2d at 626.

119. The second note was blank when signed by the debtor's chief financial officer and filled in later by personnel at the lead bank. The court concluded that filling in the blanks of the note was not actually an alteration of the instrument, and that in such cases the issue is whether authority existed to fill in the blanks. *Continental Resources*, 799 F.2d at 626 (citing *In re* Schick Oil & Gas, Inc., 35 Bankr. 282, 286 (Bankr. W.D. Okla. 1983)).

120. Baum v. Great W. Cities, Inc., 703 F.2d 1197 (10th Cir. 1983); Fulton v. L & N Consultants, 715 F.2d 1413 (10th Cir. 1982); Mercury Inv. Co. v. F.W. Woolworth Co., 706 P.2d 523 (Okla. 1985).

121. *Continental Resources*, 799 F.2d at 626.

122. 715 F.2d 1413 (10th Cir. 1982).

123. *Id.* at 1418. *See also In re* Assessment of Alleged Omitted Property, 177 Okla. 74, 77, 58 P.2d 134, 137 (1936).

124. 4 S. WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 647 (3d ed. 1961).

person who makes a claim through the right of a party to a written contract.[125] In the instant case, the Oklahoma rule created no "misapprehension" because the court did not consider the participant a stranger to the contract for the purpose of applying the parol evidence rule. The court reasoned that the participant was closely affiliated with the lead bank and was a beneficiary of the agreement.[126]

iii. The "same class" test

The "same class" test, also referred to as the "relatedness rule," serves to limit the application of a future advance clause to those advances which are of the same class as the original loan.[127] In reference to Article 9 of the UCC, Grant Gilmore (one of the Article 9 drafters) states that "no matter how the clause is drafted, the future advances to be covered must 'be of the same class as the primary obligation . . . and so related to it that the consent of the debtor to its inclusion may be inferred.' "[128]

Different loans intended to provide a debtor with working capital are of the same class.[129] A loan is classified as working capital if the debtor uses the money to obtain current assets or to satisfy current liabilities. Current assets are those assets which are reasonably expected to be converted into cash, sold, or consumed within the normal operating cycle of the business or one year, whichever is longer.[130] The court rejected the participating bank's argument that the second loan was not within the future advance clause, since both the original and second loan were for working capital. Even though the debtor used the money from the second loan for acreage acquisition, that loan was still for working capital. Because the debtor was in the business of oil and gas exploration and development, the properties acquired could be considered current assets.

d. *Implications of Holding*

Continental Resources illustrates the importance to a participating

125. *Id.* at 1165.

126. *Continental Resources*, 799 F.2d at 626.

127. Security Nat'l Bank & Trust Co. v. Dentsply Professional Plan, 617 P.2d 1340, 1346 (Okla. 1980); Kitmitto v. First Pa. Bank, 518 F. Supp. 297, 300 (E.D. Pa. 1981).

128. 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 35.2 (1965) (quoting National Bank of E. Ark. v. Blankenship, 177 F. Supp. 667, 673 (E.D. Ark. 1959), *aff'd sub nom.*, National Bank of E. Ark. v. General Mills, 283 F.2d 574 (8th Cir. 1960)). *But see* Thorp Sales Corp. v. Dolese Bros. Co., 453 F. Supp. 196, 200 (W.D. Okla. 1978) ("it is no longer necessary, as between the original lender and the original debtor, for future advances to be of the same class as the primary obligation").

129. *Continental Resources*, 799 F.2d at 627 (citing *Dentsply*, 617 P.2d at 1345-46). The term "working capital" refers to a firm's investment in current assets.

130. AMERICAN INST. OF CERTIFIED PUB. ACCOUNTANTS, RESTATEMENT AND REVISION OF ACCOUNTING RESEARCH BULLETINS, ACCOUNTING RESEARCH AND TERMINOLOGY BULLETINS, (final ed. 43 1961), ch.3, § A, ¶ 4. An operating cycle is the average amount of time it takes a firm to spend cash for inventory, process and sell the inventory, and collect the receivables, converting them back into cash; thus, it is the time taken to go from "cash to cash."

bank of obtaining at least some representations and warranties from the lead with respect to underlying collateral. Participating banks who do not obtain these assurances face the very real risk of having their share of the collateral seriously diluted if the third-party debtor borrows pursuant to a future advance clause and then becomes insolvent. The participant in *Continental Resources* made the mistake of placing itself at the mercy of the lead, and found that the court was unwilling to come to its rescue. Other participants who fail to obtain warranties and representations can expect similar judicial treatment.

B. *Fraud Counterclaim in Response to a Suit Seeking Recovery on a Promissory Note*

1. Background

Courts have often stated that fraud cannot be grounded on misstatements of opinion because the element of justifiable reliance is absent.[131] The "puffing" rule, for example, allows a seller the privilege to lie at will, so long as he says nothing specific. Not surprisingly, the rule has not been favored, and whenever it can be found that there was some kind of assurance as to specific facts the question of actionable misrepresentation has been left to the jury.[132]

A statement of value is generally regarded by the courts as a matter of opinion.[133] However, transforming such a statement of opinion into one of fact requires very little. Thus, a representation by the seller of the price paid for the property being sold is considered one of fact.[134] When the seller misrepresents the price paid (cost), courts generally give relief if the other elements of fraud are met.[135]

2. Misrepresentation of Loan Value of Property Provides Basis for Fraud Counterclaim: *Federal Deposit Insurance Corp. v. Palermo*

a. *Case in Context*

In *Palermo*,[136] it was not actually the price paid for the property that

131. *See* W. PROSSER & P. KEETON, THE LAW OF TORTS § 109, (5th ed. 1984) (citing cases) [hereinafter PROSSER & KEETON].

132. *Id.* at 757.

133. Byers v. Federal Land Co., 3 F.2d 9, 11-12 (8th Cir. 1924); Reeder v. Guaranteed Foods, 194 Kan. 386, 394, 399 P.2d 822, 830-31 (1965).

134. PROSSER & KEETON, *supra* note 131, at 758. Representations as to the price at which similar property is selling, the amount of an offer made by a third person, the state of the market, or even the lowest price at which a purchase can be made from another, are also considered to be statements of fact. *Id. See also* RESTATEMENT (SECOND) OF CONTRACTS §§ 168-169. "An assertion is one of opinion if it expresses only a belief, without certainty, as to the existence of a fact or expresses only a judgment as to quality, value, authenticity, or similar matters." *Id.* § 168(1) at 455.

135. Fraud consists of: (1) a material, false representation; (2) made with knowledge of falsity, or recklessly, and made as a positive assertion; (3) with intention that it be acted upon by another; (4) actual reliance; and (5) resulting injury. D & H Co. v. Shultz, 579 P.2d 821, 824 (Okla. 1978); Johnson v. Eagle, 355 P.2d 868, 870 (Okla. 1960).

136. 815 F.2d 1329 (10th Cir. 1987) (incorporating the law of Oklahoma as the federal rule of decision).

was misrepresented, but rather the amount owed on the property. The court held this to be a misrepresentation of fact, not opinion, and upheld a jury verdict in the buyer's favor.[137] In reaching its decision, the court, by analogy, relied on cases holding that a buyer of property may maintain an action for fraud against a seller who misrepresents the price he has paid for the property.[138]

b. *Statement of the Case*

Penn Square Bank was arranging the sale of an interest in oil wells with problem loans. A loan officer at the bank phoned Palermo (buyer) and represented, among other things, that the bank could not take less than $130,000 for the interest because "that's what the man owes the bank for it."[139] Evidence indicated that the loan officer knew that the bank had actually loaned the owner only fifty thousand dollars (secured by the oil wells). The buyer of the wells testified that the amount the bank was willing to loan on the property was important to him in determining the value of the wells and that he would not have bought the property had he known the truth.[140]

After production on the wells was lower than expected, the buyer stopped making payments on the note. The Federal Deposit Insurance Corporation, as receiver of the insolvent bank, sued to recover the balance due. The buyer defended the suit on the basis of fraud, and also counterclaimed, seeking both rescission and damages. A jury rendered a verdict in favor of the buyer.[141]

c. *Discussion and Analysis of the Tenth Circuit's Opinion*

The Tenth Circuit upheld the jury's verdict for the buyer on his claim of fraud.[142] He was not allowed, however, to pursue the fraud claim as one for rescission because he had not acted promptly in exercising his right of rescission.[143] The buyer was able to assert the fraud claim only as a set-off or counterclaim in the nature of recoupment to reduce or eliminate his liability on the promissory note; the running of a two-year state statute of limitations precluded any affirmative relief.[144] On the issue of damages, the court set aside the jury's award and or-

137. *Id.* at 1336.

138. *Id.* (citing Withroder v. Elmore, 187 P. 863, 864 (Kan. 1920); Wisconsin Steel Treating & Blasting v. Donlin, 23 Wis. 2d 379, 383, 127 N.W.2d 5, 8 (1964)).

139. *Palermo*, 815 F.2d at 1333.

140. *Id.* at 1336.

141. *Id.* at 1332.

142. *Id.* at 1341.

143. *See* OKLA. STAT. ANN. tit. 15, § 235 (West 1966).

> Rescission, when not effected by consent, can be accomplished only by the use . . . of reasonable diligence to comply with the following rules: 1. He must rescind promptly, upon discovering the facts which entitle him to rescind . . . and 2. He must restore to the other party everything of value which he has received from him under the contract; or must offer to restore the same . . . .

Id.; *see also* Harmon v. Phillips Petroleum Co., 196 Okla. 607, 167 P.2d 360 (1946).

144. OKLA. STAT. ANN. tit. 12, § 95 (West 1960).

dered a new trial on this issue alone.[145]

i. The fact-opinion distinction

The Tenth Circuit's opinion illustrates the difference between misrepresentations of "fact" and "opinion". The traditional rule is that, while misstatements of fact may be actionable, misstatements of opinion are usually not actionable when parties bargain at arm's length.[146] This attempted distinction may not be a meaningful one; as noted by one scholar, "it is scientifically impossible to distinguish fact from opinion."[147] Still, the words probably have meanings which correspond roughly to concepts sufficiently distinct from each other to justify some differences in treatment.[148] Nonetheless, it is clear that the scope of immunity for misstatements of opinion is constantly shrinking.[149] Notwithstanding a few older cases to the contrary, when a statement goes beyond mere value to include assertions of the amount paid for property, such assertions may be actionable.[150]

The court's holding in *Palermo* that the bank loan officer's statement of the amount loaned on the property was one of fact rather than opinion and its application of the fact-opinion rule were clearly correct. To say that the loan officer's statement was merely an opinion of value would be to ignore reality. The statement is as much a fact as a statement by a seller that he himself paid a certain amount for the property. Therefore, the court could properly apply, by analogy, the law from cases holding that misstatements of the amount paid (cost) are actionable.

Despite this apparent logic, several early cases hold that a misstatement by the seller of the price paid for the property does not lay the foundation for a fraud action.[151] The rationale used is that this type of misstatement is no more than an indication of the seller's opinion of the property's value—or mere "dealer's talk." The driving force behind the cases seems to have been the doctrine of *caveat emptor* ("buyer beware"), which had a significant influence on the courts' analyses. Consistent with this doctrine, courts were strictly applying the materiality and justifiable reliance elements of fraud.

To reach a different result from these cases, the Tenth Circuit

145. *Palermo*, 815 F.2d at 1341.

146. *See* James & Gray, *Misrepresentation—Part II*, 37 MD. L. REV. 488, 490 (1978).

147. Keeton, *Fraud: Misrepresentations of Opinion*, 21 MINN. L. REV. 643, 657 (1937) (citing 7 WIGMORE ON EVIDENCE § 1919 (rev. 1978)). Keeton believed that the important distinction is between assertions of knowledge and those of opinion, rather than assertion of fact and those of opinion. *Id.* at 657. *See also* RESTATEMENT (SECOND) OF CONTRACTS § 168 comment a (1979), which follows this view.

148. James & Gray, *supra* note 146, at 489.

149. *Id.*

150. *See, e.g.*, Wisconsin Steel Treating & Blasting Co. v. Donlin, 23 Wis. 2d 379, 383, 127 N.W.2d 5, 8 (1964).

151. *See, e.g.*, Holbrook v. Conner, 60 Me. 578, 11 Am. Rep. 212 (1872); Annotation, *Fraud — Misrepresentation of Price*, 66 A.L.R. 188, 191-93 (1930). Many of the cases so holding state that there must be a fiduciary relation between the seller and buyer before there can be any kind of recovery. *See, e.g.*, Banta v. Palmer, 47 Ill. 99 (1868).

found it necessary to distinguish *Steiner v. Hughes*.[152] As the Tenth Circuit noted, the Oklahoma court in *Steiner* based its decision on a lack of actual reliance.[153] The seller misrepresented the profit per share it would make by selling stock to the buyer; but the buyer could not have been misled because he had checked for himself the price of the stock on the day in question. The Oklahoma court's statement of the law[154] was a portion of some misguided dicta which almost certainly would not be followed today.[155]

ii. Measure of damages

Courts are divided over two standards for measuring damages in fraud actions. One standard is the "out of pocket" rule, followed by a minority of courts, whereby the injured party receives the difference between the value of what he has parted with and the value of the property he has received.[156] This measure is always adopted as to a defense in the nature of recoupment.[157] The other measure, called the "loss-of-bargain" rule, gives the injured party the difference between the value of the property as represented and its actual value on the date of purchase.[158]

After holding that the buyer could assert his fraud claim only as a set-off or counterclaim in the nature of a recoupment, the Tenth Circuit concluded that the appropriate measure of damages was the loss of bargain rule, although the court did not label the rule as such.[159] Technically, the out of pocket rule should have been applied since the buyer could only seek a set-off or recoupment. Yet, the court in effect did so

152. 172 Okla. 268, 44 P.2d 857 (1935). In *Steiner*, the Oklahoma Supreme Court stated that:

> [W]e have found no case, by this court, in which the contended fraud consisted merely of a statement made by the seller, upon inquiry by the purchaser, that the property was costing, or had cost him, the seller, more than it actually cost, where this court has held that such a statement, unless coupled with other elements of fraud, inequality of the parties, overreaching or confidential relations, has been held to constitute actionable misrepresentation.

Id. at 270, 44 P.2d at 860.

153. *Palermo*, 815 F.2d at 1337.

154. *See supra* note 152.

155. *See, e.g.*, Beavers v. Lamplighters Realty, 556 P.2d 1328, 1331 (Okla. Ct. App. 1976) (statement by seller that a third party had offered a certain sum for property is a "statement of material fact affecting the value and may form the basis for an action of deceit,") (quoting Chisum v. Huggins, 55 Okla. 423, 441, 154 P. 1146, 1152 (1916)); Varn v. Maloney, 516 P.2d 1328, 1332 (Okla. 1973); *Johnson*, 355 P.2d at 871. Even many of the earlier cases are in accord. *See* Annotation, *Fraud — Misrepresentation of Price*, 66 A.L.R. 188 (1930). For a more recent case that is representative of the increasing tendency of courts to find that assertions of the amount which has been paid or offered for the property are actionable, see Kabatchnick v. Hanover-Elm Bldg. Corp., 328 Mass. 341, 103 N.E.2d 692 (1952); Annotation, *Fraud — Misrepresentation by Lessor*, 30 A.L.R.2d 923 (1953). In *Kabatchnick*, the defendant-landlord induced a tenant to agree to a substantially higher rent by falsely stating that a prospective tenant had offered to lease the premises at the higher rent.

156. PROSSER AND KEETON, *supra* note 131, at 767-68.

157. *Id.*

158. *Id.* at 768; A.A. Murphy, Inc. v. Banfield, 363 P.2d 942, 946 (Okla. 1961).

159. *Palermo*, 815 F.2d at 1340-41 (citing *A.A. Murphy, Inc.*, 363 P.2d at 946).

when it stated that under the circumstances "the value of the property as represented is equal to the price paid for the property."[160] Where, as here, the injured party can recover only by way of set-off or recoupment, the final result is that the damages for fraud[161] are subtracted from the amount due on the promissory note. The net result is a reduction in the buyer's liability.

d. *Implications of Holding*

The Tenth Circuit's holding is consistent with the increasing tendency among courts to find that misrepresentations of the price paid for property are actionable. The case is certainly not surprising, but is a warning to banks that they cannot misrepresent the loan value of property when selling property covered by a security agreement and thereafter argue that the representation was a mere "opinion."

III. Liability of Parent Company for Breaching Subsidiary-Employee Contract

A. *Background*

While the board of directors of a corporation is entrusted with the general power of managing the business and affairs of the corporation, the directors may delegate many decisions to corporate officers or agents.[162] In most publicly held corporations, the full time, professional management runs the business—the directors having more of an oversight role. The directors of large corporations find it necessary to hire managers with specific expertise and to delegate to those managers extensive authority. Nonetheless, problems may arise when too much authority is delegated.

One problem in particular arises in the context of a parent-subsidiary relationship where an employment contract exists between the subsidiary and its highest ranking employee (usually called the chief executive officer). Perhaps to the dismay of the employee, the parent company might find it desirable from a managerial standpoint to involve itself significantly in the subsidiary's day-to-day operations. When the parent interferes with the employment contract, the employee may decide to sue for breach. Aside from proving breach, the employee may have to overcome some other obstacles before obtaining a judgment against the parent. One obstacle is the parent's argument that the contract is invalid because it gives the employee so much authority that it strips the subsidiary's board of directors of its essential function. Another obstacle is that of holding the parent liable when it is not a party

160. *Id.* at 1341 n.3.

161. The total damages would include consequential damages if proximately caused by the fraudulent conduct. Barnes v. McKinney, 589 P.2d 698, 701-02 (Okla. Ct. App. 1978).

162. "All corporate powers shall be exercised *by or under the authority of*, and the business and affairs of the corporation managed *under the direction of*, its board of directors, subject to any limitation set forth in the articles of incorporation." Revised Model Business Corporation Act § 8.01 (b) (1984) (emphasis added).

to the contract. In this situation, a court may analyze the issue in terms of whether the corporate veil of the subsidiary should be "pierced" in order to reach through to the parent.

B. *Parent Company as Non-Signatory Party Held Liable:* McKinney v. Gannett Co.

1. Case in Context

In *McKinney*,[163] the court held that the parent company could be liable for breaching the subsidiary-employee contract on the ground that the contract was inseparable from another contract to which the parent was a party. Not content to rely on that ground alone, the court also concluded that it was proper to pierce the subsidiary's corporate veil using the "alter ego" doctrine so as to hold the parent liable.[164] The contract itself was held to be a proper delegation of power, even though the employee was in complete charge of most of the business and operating aspects of the subsidiary.[165]

2. Statement of the Case

Pursuant to an "Agreement and Plan of Reorganization," the plaintiff, McKinney, sold his newspaper company to Gannett (parent company). The agreement included a ten year employment contract between McKinney and the newspaper company (subsidiary). The employment contract, which the parent company did not sign, provided that McKinney would remain in charge of the business, operations, news, and editorial policies of the subsidiary for the first five years of the contract period, and in charge of the news and editorial policies for the second five years.[166]

After the relationship between McKinney and the parent company deteriorated, McKinney sued both the parent and the subsidiary. McKinney won on his breach of contract claim in the district court, which ordered the equitable remedy of "tolling" the running of the employment contract for the period from the date the parent effectively abrogated the plaintiff's contract rights until the final disposition of the lawsuit.[167]

3. Discussion and Analysis of the Tenth Circuit's Opinion

The Tenth Circuit affirmed the district court's decision and agreed that the parent company could be held liable for breach of contract;[168]

163. 817 F.2d 659 (10th Cir. 1987) (applying New Mexico law).
164. *Id.* at 666-67.
165. *Id.* at 667-69.
166. *Id.* at 662.
167. *Id.* at 663.
168. The court held that the parent company breached the employment contract on six different occassions; two of the breaches were material. *Id.* at 669-71. A material, or "total," breach of contract is a non-performance of duty that is so important as to justify the injured party in treating the whole transaction as at an end. 4 A. CORBIN ON CONTRACTS § 946 (1951).

that the employment contract was a valid delegation of power from the subsidiary's directors; and that the remedy of tolling was an appropriate form of relief.

a. *Basis for Parent Company Liability*

In holding the parent liable despite the fact that it was not a signatory to the employment contract, the court first ruled that the parent was liable because it was a party to the "Agreement and Plan of Reorganization" which was inseparable from the employment contract. This result seems to follow from an application of ordinary agency rules, which the court did not recognize. Considering that the parent (as principal) dominated and directed the subsidiary (as agent) in the transaction by drafting the employment contract and negotiating with the employee, the subsidiary's act of contracting with the employee could be deemed the act of the parent.[169] Therefore, it was not actually necessary for the court to also "pierce the corporate veil" of the subsidiary as a way of holding the parent liable.[170]

Aside from the question of whether it should have been used at all, the application of the concept of piercing the corporate veil was proper under the circumstances. To pierce the corporate veil is to disregard the separate existence of a corporation and to deny a shareholder the benefit of limited liability. The test—obviously result oriented—is simply whether recognition of the separate existence of the corporation would produce unjust or undesirable consequences inconsistent with any legitimate corporate purpose.[171] Some courts, like the Tenth Circuit in the present case, have applied the "alter ego" doctrine as the

169. *See* C. Krendl and J. Krendl, *Piercing the Corporate Veil: Focusing The Inquiry*, 55 DEN. L.J. 1, 3 n.9 (1978).

170. Professor Hamilton states:

> [N]o conceptual problems emerge when liability is imposed upon shareholders under conventional theories of agency or tort law. To argue that the corporate veil is 'pierced' in such cases is both unnecessary and confusing. If the shareholder is acting as a principal in his own name, he is clearly liable on the obligation.

The Corporate Entity, 49 TEX. L. REV. 979, 983 (1971).

171. *See* H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS § 146, at 346 (3d ed. 1983); C. Krendl and J. Krendl, *Piercing the Corporate Veil: Focusing The Inquiry*, 55 DEN. L.J. 1, 15 (1978) (three requisites to piercing the corporate veil: instrumentality, improper purpose, and proximate causation). In *In re* Clarke's Will, 204 Minn. 574, 578, 284 N.W. 876, 878 (1939) (cited by H. HENN & J. ALEXANDER, *supra*, at 345), the court said:

> Many cases present avowed disregard of corporate entity. But they all came to just this—courts simply will not let interposition of corporate entity or action prevent a judgment otherwise required. Corporate presence and action no more than those of an individual will bar a remedy demanded by law in application to facts. Hence, the process is not accurately termed one of disregarding corporate entity. It is rather and only a refusal to permit its presence and action to divert the judicial course of applying law to ascertained facts. The method neither pierces any veil nor goes behind any obstruction, save for its refusal to let one fact bar the judgment which the whole sum of facts requires.
>
> For such reasons, we feel that the method of decision known as 'piercing the corporate veil' or 'disregarding the corporate entity' unnecessarily complicates decision. It is dialectally ornate and correctly guides understanding, but over a circuitous and unrealistic trail. The objective is more easily attainable over the direct and unencumbered route followed herein.

basis for piercing the corporate veil.[172] To invoke the doctrine, it must be shown that the corporation was a mere instrumentality for the transaction of the shareholder's own affairs; that there is such a unity of interest and ownership that the separate personalities of the corporation and the shareholder no longer exist; and to recognize the corporation's separate existence would promote unjustice or protect fraud.[173]

In its application of the alter ego doctrine, the court relied on the following facts: (1) the parent had complete stock ownership of the subsidiary and controlled its board of directors;[174] (2) the parent in effect treated the subsidiary as a division of the whole; (3) all of the subsidiary's revenue went to the parent; (4) all of the subsidiary's capital expenditures were approved by the parent; (5) the parent drafted the employment contract and negotiated with the plaintiff; and (6) the parent directly intervened in the personnel matters of the subsidiary.[175] Moreover, the court concluded that the parent company's dominion over the subsidiary was used for a wrongful purpose, which was to frustrate McKinney's contract rights.

b. *Delegation of Managerial Authority*

The board of directors has the ultimate responsibility for managing the corporation. However, it may delegate the power to transact not only ordinary and routine business but also business requiring the highest degree of judgment and discretion.[176] What the board may not do is delegate its entire duties of management to an individual officer.[177] The problem is determining when a particular delegation goes too far. Although one of degree, the test seems to be whether the board of directors has retained at least its basic authority to govern. If it has not, the delegation and any contract involved will be invalid. For example, in *Kennerson v. Burbank Amusement Co.*,[178] the board of directors of a corporation organized to operate a theatre employed a member of the board to be general manager, and by contract attempted to transfer all control over bookings, personnel, admission prices, salaries, contracts, expenses and even fiscal policies to the general manager. The California court

172. E.C.A. Environmetal Management Serv. v. Toenyes, 679 P.2d 213 (Mont. 1984) (parent liable for breach of contract damages where subsidiary was alter ego of parent); Harlow v. Fibron Corp., 100 N.M. 379, 671 P.2d 40 (N.M. Ct. App. 1983), *cert. denied*, 100 N.M. 439, 671 P.2d 1150 (1983); McCulloch Gas Transmission Co. v. Kansas-Nebraska Natural Gas Co., 768 F.2d 1199 (10th Cir. 1985).

173. 1 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 41.10 at 397 (perm. ed. 1983).

174. This fact is never conclusive by itself since such control is no more than a normal consequence of controlling share ownership. *See* H. HENN & J. ALEXANDER, *supra* note 171, § 148, at 355; London v. Bruskas, 64 N.M. 73, 324 P.2d 424, 427 (1958).

175. *McKinney*, 817 F.2d at 667. *See* Hamilton, *The Corporate Entity*, 49 TEX. L. REV. 979, 992-93 (1971).

176. 2 W. FLETCHER, *supra* note 173, § 495 at 498. Many statutes expressly authorize delegation subject to certain limitations; *see, e.g.*, N.M. STAT. ANN. § 53-11-48 (1978).

177. Boston Athletic Ass'n v. International Marathons, Inc., 392 Mass. 356, 467 N.E.2d 58 (1984).

178. 120 Cal. App. 2d 157, 260 P.2d 823, 832-33 (1953).

held that the contract was void and unenforceable. The general manager was under a duty to make periodic reports to the board, but that was held not to constitute a sufficient retention of control by the board.[179]

In the instant case, the Tenth Circuit held that the contract was valid because the subsidiary's board of directors had not totally delegated its authority to run the affairs of the corporation to the plaintiff. Unlike *Kennerson*, the employee was still responsible to the board of directors under the employment contract and the board did set corporate and departmental budget limitations.[180]

c. *The Equitable Remedy of Tolling*

After rejecting the parent company's argument based on election of remedies,[181] the Tenth Circuit upheld the district court's order that the employment contract be tolled from the date of the first breach until the date of final judgment.[182]

Tolling is an equitable remedy that is often used to adjust the rights of the parties under an oil and gas lease. Where a lessor has placed a cloud on the title of the lease by seeking judicial cancellation of the lease, a court may suspend (toll) the running of the lease terms. Out of fairness to the lessee, the obligations of the lessee to the lessor are suspended during the time such a claim is being asserted.[183] The purpose of tolling is not to punish the lessor but to restore the parties to the position they occupied originally.[184]

Tolling is not restricted to the oil and gas lease context. As the Tenth Circuit held, the remedy may be appropriate where the term of a

179. *Id.* Apparently, this duty to report did not mean much since the board did not retain the power to act in response to the reports. *See also* Sherman & Ellis, Inc. v. Indiana Mutual Casualty Co., 41 F.2d 588 (7th Cir. 1930); Long Park v. Trenton-New Brunswick Theatres Co., 297 N.Y. 174, 77 N.E.2d 633, 634-35 (1948) (the powers of the directors over the management of the business were "completely sterilized").

180. *McKinney*, 817 F.2d at 668. The fact that a valid employment contract exists in such a case does not limit the board's authority to remove the officer, with or without cause. But removal without cause in breach of the contract usually subjects the corporation to liability for damages. REVISED MODEL BUSINESS CORPORATION ACT §§ 8.43-44 (1984); N.M. STAT. ANN. § 53-11-49 (1978).

181. If a party has more than one possible remedy, her manifestation of a choice of one of them (by bringing suit or otherwise) is a bar to another remedy if the remedies are inconsistent and the other party materially changes her position in reliance on the manifestation. RESTATEMENT (SECOND) OF CONTRACTS § 378 (1979). *See also* Three Rivers Land Co. v. Maddoux, 98 N.M. 690, 652 P.2d 240, 243 (1982), *overruled on other grounds*, Universal Life Church v. Coxon, 105 N.M. 57, 728 P.2d 467, 469 (1986). The court rejected the parent's argument on the ground that under *Maddoux* it was appropriate to consider the conduct of the party asserting the doctrine of election to determine whether that party should be allowed to benefit from its application, and that the parent's conduct was objectionable enough to preclude an application of the doctrine. *McKinney*, 817 F.2d at 673.

182. *McKinney*, 817 F.2d at 672-74. The court relied on Jicarilla Apache Tribe v. Andrus, 687 F.2d 1324, 1340-42 (10th Cir. 1982), where it tolled the primary term of leases on a reservation during the pendency of the tribe's suit to cancel the leases.

183. Continental Oil Co. v. Osage Oil & Refining Co., 69 F.2d 19, 23-24 (10th Cir. 1934), *cert. denied*, 287 U.S. 616 (1932); Morrison Oil and Gas Co. v. Burger, 423 F.2d 1178, 1182-83 (5th Cir. 1970).

184. *See* 2 E. KUNTZ, OIL AND GAS § 26.14 (1964).

contract has been interrupted by the conduct of one of the parties.[185]

4. Implications of Holding

The importance of *McKinney* is its clear indication that a parent company should not expect to be able to dominate a subsidiary to the extent of interfering with the rights of those who have contracted with the subsidiary and still obtain the benefit of limited liability.[186] If the interference is deemed wrongful, courts are generally willing to find some way of holding the parent liable even though it is not a party to the contract. *McKinney* shows that the Tenth Circuit is no exception.

CONCLUSION

In its disposition of the Article 9 issues during the survey period, the Tenth Circuit was faithful for the most part to the Uniform Commercial Code's underlying policy of flexibility and leniency. In *Tri-State Equipment* and *Collingwood Grain*, the court gave the first-to-file creditor in each case the benefit of this policy in holding the description of collateral sufficient to perfect the security interest. In *Critiques*, the creditor was not so fortunate. The court there held a financing statement description of collateral to be insufficient, and erred significantly by applying the insolvency provisions of section 9-306(4), with regard to the secured party's perfected security interest under the second of two security agreements.

Given the present economic environment, it is critically important for creditors to take the proper steps to protect themselves. The participating bank in *Continental Resources* undoubtedly realized this after having its share of the collateral diluted because of the use of a valid future advance clause. In *Palermo*, the bank's attempt to rid itself of a problem loan backfired when the court allowed the buyer of the collateral (real property) to recover for fraud because the loan value of the property was misprepresented.

Finally, in *McKinney v. Gannett* the court held the parent company, Gannett, liable for breaching an employment contract between its subsidiary and the subsidiary's chief executive officer.

Jeffrey S. Mullen

185. *McKinney*, 817 F.2d at 673. The court stressed that the remedy was not specific performance in disguise. *Id.* at n.8 ("we are confronted with a declaration of contract rights and not a coercive order decreeing enforcement of the employment contract.").

186. Of course, nothing is wrong with domination by itself since a majority or sole shareholder always dominates the corporation.