

MEMORANDUM

Date: 12/5/2004
To: Professor Kleinberger
From: Maggie M. Tatton
RE: Manifestly Unreasonable

ISSUE PRESENTED

Is there case law defining the “manifestly unreasonable” standard used in various versions of uniform statutes, including the Revised Uniform Partnership Act and the Uniform Commercial Code?

SHORT ANSWER

Because the relevant statutes do not provide a workable definition of “manifestly unreasonable,” it is necessary to look to case law and commentary for guidance. Unfortunately, as commentators agree, most courts have not attempted to clearly define how to apply the standard. This leaves only the context in which the cases are decided to help define when an agreement will be considered manifestly unreasonable.

DISCUSSION

I. The statutory sections in which “manifestly unreasonable” appears fail to provide a clear definition of the phrase.

The phrase “manifestly unreasonable” appears in several statutes, including the Revised Uniform Partnership Act (RUPA), the Uniform Commercial Code (UCC), and the Model Business Corporation Act (MBCA). See RUPA § 103(b)(3)(i) (determining under which conditions partners may vary the duty of loyalty); RUPA § 103 (b)(5) (allowing partners to adopt standards for performance of the obligation of good faith and fair dealing that are not manifestly unreasonable); UCC § 1-302(b) (2001) (allowing parties to adopt standards for performance of the obligation of good faith and fair dealing that are not manifestly unreasonable); UCC § 4-103(a) (2002) (allowing parties to adopt standards for a bank’s performance of obligations of good faith and ordinary care that are not manifestly unreasonable); MODEL BUS. CORP. ACT § 6.27(d)(3) (allowing restrictions on the transfer of shares that require approval as long as the requirement is not manifestly unreasonable); MODEL BUS. CORP. ACT § 6.27(d)(4) (allowing shareholders to prohibit transfer of restricted shares if the prohibition is not manifestly unreasonable).¹

Though they do not attempt to define “manifestly unreasonable,” the comments to RUPA § 103 suggest that the phrase was borrowed from the pre-revision version of UCC § 1-102(3). RUPA § 103, cmt. 7 (“The language of

¹ Interestingly, prior to 2003, the Indiana Rules of Appellate Procedure contained a “manifestly unreasonable” standard. Rule 7 (2002). Rule 7 provided that the Indiana Court of Appeals could not revise a sentence “authorized by statute unless the sentence is manifestly unreasonable.” Rule 7(B). Effective in 2003, the Indiana Court of Appeals can now revise such sentences if “after due consideration . . . the sentence is inappropriate in light of the nature of the offense and the character of the offender.” Rule 7(B) (2003).

subsection (b)(5) is based on UCC Section 1-102(3)"); see also J. William Callison, Blind Men and Elephants: Fiduciary Duties Under the Revised Uniform Partnership Act, Uniform Limited Liability Company Act, and Beyond, 1 J. SMALL & EMERGING BUS. L. 109, 158 (1997) (“[t]he manifestly unreasonable standard was derived by NCCUSL from section 1-102 of the UCC”).

Section 1-102(3) of the pre-revision version of UCC Article 1 defines when parties can vary the provisions of the UCC by agreement. It concludes that even where the parties are not permitted to vary the provisions they may “by agreement determine the standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable.” § 1-102(3) (2000). The comments to this section do not define when or how to determine that such standards are or are not manifestly unreasonable. However, they do indicate that course of dealing and usage of trade are relevant to such a determination. § 1-102(3), cmt. 2 (“In this connection, Section 1-205 incorporating into the agreement prior course of dealing and usages of trade is of particular importance.”).

In the revised version of Article 1, the rules for “variation by agreement” were moved from § 1-102(3) to § 1-302. See § 1-302(b) (2001). The comments to § 1-302 have retained the reference to prior course of dealing and usage of trade. In addition, a portion of the comments that appears only in the revised version of the section on “variation by agreement” attempts to add more meaning to the “manifestly unreasonable” standard:

[P]rovision is made for disregarding a clause which whether by inadvertence or overreaching fixes a time *so unreasonable* that it amounts to eliminating all

remedy under the contract. The parties are not required to fix the most reasonable time but may fix any time which is not *obviously unfair* as judged by the time of contracting.

§ 1-302, cmt. 1 (emphasis added).

The phrases “so unreasonable” and “obviously unfair” suggest that “manifestly unreasonable” is a narrower standard than simple unreasonableness. See also UCC § 4-103, cmt. 1 (2002) (“This section therefore, permits within wide limits variation of the effect of provisions of the Article by agreement.”). Unfortunately, as the following analysis of case law will show, this comment has not provided the courts much guidance for applying the “manifestly unreasonable” standard.

II. The case law contemplating whether an agreement or its terms are “manifestly unreasonable” provides little meaning for the phrase.

A. Commentary

Commentators agree that neither the statutes in which the “manifestly unreasonable” standard is used nor the courts interpreting it have provided a clear interpretation of its meaning. One commentator noted that though the UCC does not define it, “[t]he term probably resides on the spectrum of reasonableness somewhere between ‘unreasonable’ and ‘unconscionable.’” Timothy R. Zinnecker, The Default Provisions of Revised Article 9 of the Uniform Commercial Code: Part I, 54 Bus. Law. 1113, 1124 (1999). Moreover, “where to place the term between those two points remains uncertain,” which requires the courts to engage in “line-drawing.” Id.

Other commentators have agreed that few, if any, courts have interpreted the meaning of “manifestly unreasonable.” See Robert R. Keatinge, Internal Disputes

and Break-ups, VMD0206 ALI-ABA 85, 92 (Feb. 6, 2003) (explaining that, at least in Colorado, no case has interpreted the meaning of “manifestly unreasonable” as used in the Uniform Limited Partnership Act, RUPA, or the UCC); Callison, supra at 159 (“relatively few cases interpret ‘manifestly unreasonable’ in the context of the UCC” and the ‘manifestly unreasonable standard’ . . . is largely undefined in existing law, nebulous, and unworkable in practice”).

According to Callison, most cases that do attempt to interpret “manifestly unreasonable” tend to “support a conclusion that the term means ‘clearly unreasonable’ or ‘facially unreasonable.’” Callison, supra. This statement accords with comment one to § 1-302 discussed above but still does little to provide courts with a test or framework for determining when a term or agreement is clearly unreasonable.

B. Case Law

In light of the statements made by commentators, it is not surprising that courts often cite the “manifestly unreasonable” language of a statute and then merely make conclusory statements regarding whether something is or is not manifestly unreasonable. See Walker v. Modnar Corp., 343 S.E.2d 148, 375 (Ga. Ct. App. 1986) (“These contractual provisions are not ‘manifestly unreasonable’ and consequently it is unnecessary to look beyond them to determine the rights and duties of the parties in this case”); Cont’l Bank & Trust Co. v. Utah Sec. Mortgage, Inc., 701 P.2d 1095, 1099 (Utah 1985) (“The consent provision in the guaranty agreements before us specifically modified the section 9-207 standard, and there is

nothing manifestly unreasonable about such a modification”). In fact, recent research revealed only one case that has explicitly purported to define the “manifestly unreasonable” standard.

That case is Morgan Building & Spas, Inc. v. Turn-Key Leasing, Ltd., in which the court sought to apply the “manifestly unreasonable” standard found in Article 9 of Texas’ version of the UCC. 97 S.W.3d 871, 880 (Tex. Ct. App. 2003). See also UCC § 9-501(3) (1999) (allowing parties to set standards for how to fulfill rights and duties as long as they are not manifestly unreasonable). The court interpreted the plain meaning of the statute by relying on the Black’s Law Dictionary definition of “manifest.” Morgan Building, 97 S.W.3d at 880; see also id. at FN 16 (“Dictionary definitions can be utilized by courts in construing the plain meaning of words.”).

The term “manifestly unreasonable” is not defined in the U.C.C., and no Texas case law has addressed the specific issue raised in this case. Black’s Law Dictionary defines “manifest” as: “Evident to the senses, especially to the sight, obvious to the understanding, evident to the mind, not obscure or hidden, and is synonymous with open, clear, visible, unmistakable, indubitable, indisputable, evident, and self-evident.

Id. at 880 (citing BLACK’S LAW DICTIONARY 962 (6th ed. 1990)).

In this case, plaintiff and defendant had formed a partnership for the “purpose of acquiring, owning, leasing, financing and selling modular buildings.” Id. at 873. Later, as a result of a cash flow shortage, plaintiff signed a promissory note and security agreement with defendant for \$450,000. Id. According to the security agreement, the collateral for the loan consisted of all of plaintiff’s interest in the partnership. Id. In addition, the parties executed an amendment to their partnership

agreement providing that, in the event the “default amount exceeds the defaulting partner’s capital account balance, the partner’s joint venture interest will terminate, and the defaulting partner shall remain liable for the excess amount.” Id. at 874.

The court held in part that this clause was manifestly unreasonable because the UCC makes it “abundantly clear” that debtor’s rights are to be carefully protected after default. Id. at 880-81. Interestingly, even after providing a definition of “manifest” as “obvious” or “evident,” the court never again refers to that definition in its holding. Instead, the court refers to UCC comments that discuss the policy of protecting a debtor’s rights. The court fails to even add analysis concluding that such a policy makes the unreasonableness obvious or evident.

However, by at least attempting to define “manifestly unreasonable,” the Texas court went further than many other courts that merely cite the statute and then drop the “manifestly” standard from their analysis. For example, Gornicki v. M&T Bank, concerned a plaintiff who executed a revocation of power of attorney in favor of a third party for fear that the third party would remove the funds from her account. 617 N.Y.S.2d 448, 449 (N.Y. Sup. Ct. 1994). Defendant M&T Bank did not inform plaintiff that the power of attorney would not be effective immediately. However, the original power of attorney agreement contained a clause giving the bank at least until “the close of business of the next banking day” to cancel the power of attorney. Id. The bank asserted the clause as an affirmative defense to plaintiff’s action for recovery of the funds, claiming that it could set a reasonable time to act upon the cancellation of a power of attorney. Id. at 449-50.

The court began its analysis by explaining that “the parties may formulate their own definition of reasonable time, [but] it is not effective if the time fixed is manifestly unreasonable.” Id. at 450. In its very next sentence, however, the court dropped the “manifestly” part of the standard by stating, “Whether a time so formulated is unreasonable is a question of fact based upon all of the circumstances.” Id. Indeed, the court never again mentioned the word “manifestly” in its analysis. In its conclusion, the court stated, “Plaintiff has brought forth sufficient facts to raise an issue as to what constitutes a reasonable time to allow defendant to act upon cancellation of the power of attorney.” Id.

Like Gornicki, other decisions quote the “manifestly unreasonable” standard when they cite the relevant statute but then drop the standard from their analysis. E.g., Mitchell Buick & Oldsmobile Sales, Inc. v. McHenry Savings Bank, 601 N.E.2d 1360 (Ill. Ct. App. 1992) (concluding “[p]laintiff’s interpretation is unreasonable, and we must reverse the judgment”); Rapp v. Dime Savings Bank of N.Y., 408 N.Y.S.2d 540 (N.Y. Sup. Ct. 1978) (citing the “manifestly unreasonable” requirement of UCC § 4-103 and continuing with analysis of whether time restrictions set by agreement were unreasonable”). However, research revealed some guideposts for applying the “manifestly unreasonable” in certain situations. In particular, case law suggests that contractual remedy limitations are likely to be manifestly unreasonable in cases of latent defects, that the bargaining ability of the parties bears an inverse relationship to manifest unreasonableness, and that manifest unreasonableness may be defined by usage of trade.

Before looking at each of these guideposts in turn, attention should be drawn to the paucity of cases available to help determine when a transfer restriction would be considered manifestly unreasonable, as prohibited by the section of the MBCA cited above. The few cases that were available each considered different factors in its discussion, making it difficult to discern any guideposts for predicting when a transfer restriction may be manifestly unreasonable. For example, one court, applying Pennsylvania's stock transfer restriction statute, defined "manifestly unreasonable" as passing beyond "the outer limits of permissiveness." Baron v. Strawbridge & Clothier, 646 F.Supp. 690, 698 (E.D. Pa. 1986). Important to the Baron court's conclusion that the transfer restrictions in question were not manifestly unreasonable were its findings that shareholders had multiple choices available to them and that the restrictions did not harm the value of the stock. Id.

In another case concerning stock transfer restrictions, the Supreme Court of Indiana stated that "A restriction is reasonable if it is designed to serve a legitimate purpose of the party imposing the restraint and the restraint is not an absolute restriction on the recipient's right of alienability." F.B.I. Farms, Inc. v. Moore, 798 N.E.2d 440, 447 (Ind. 2003). The court then suggested that "manifestly unreasonable" is a more "generous" standard than mere unreasonableness, giving parties more room to establish transfer restrictions. Id. The court also listed factors for determining the reasonableness of transfer restrictions, including:

the size of the corporation; the degree of restraint upon alienation; the time the restriction was to continue in effect, the method to be used in determining the transfer price of shares, the likelihood of the restriction's contributing to the attainment of corporate objectives, the possibility that a hostile stockholder

might injure the corporation, and the probability of the restriction's promoting the best interests of the corporation.

Id. The court, however, does not provide any analysis for how to apply these factors.

In fact, the only statement it makes with any certainty is that restrictions that are fraudulent, oppressive or unconscionable will be manifestly unreasonable. Id.

Interestingly, when evaluating the reasonableness of transfer restrictions, Minnesota courts tend to rely on comments to its statute that enumerate specific restrictions that are not manifestly unreasonable. See Roof Depot, Inc. v. Ohman, 638 N.W.2d 782, 785 (Minn. Ct. App. 2002); Miller Waste Mills, Inc. v. Mackay, 520 N.W.2d 490, 494 (Minn. Ct. App. 1994). The comments state:

The following restrictions are always deemed "not manifestly unreasonable": first, any restriction which requires the holder to give the corporation, the other shareholders, or any combination of either or both, a right of first refusal or an option, to purchase the shares; second, any restriction which obligates any person (including non-natural persons) to purchase the shares or securities that are so restricted, (i.e., buy-sell agreements); third, any restriction which requires the consent of the corporation or of any or all of the holders of any or all classes of shares or securities; and fourth, any restriction which is imposed for the purpose of, and which is actually effective in, for example, maintaining the status of the corporation as a Subchapter S corporation.

Minn. Stat § 302A.429. The only other guidance the Minnesota courts give is to state that certain restrictions were not manifestly unreasonable because they were a "reasonable means to ensure that the management and control of the business remain[ed] in the group of investors or with people well known to them." Id. at 786.

Despite the different courts' discussion of transfer restriction statutes the definition of "manifestly unreasonable" remains elusive. However, as stated above, it appears clear that an agreement will be considered manifestly unreasonable in cases

of latent defects.² In one case, where the parties contracted for the design and construction of modular housing, the court was asked to consider whether a contractual limitation of remedies to repair or replacement of defects occurring within one year of the date of completion was manifestly unreasonable. Badgett Constr. & Dev. Co. v. Kan-Build, Inc., 102 F.Supp. 1098, 1102 (S.D. Iowa 2000). The court agreed with the plaintiff that “application of the one-year limitation to latent defects or conditions which could not reasonably have been discovered within the one-year period raises a valid question about whether the limitation is manifestly unreasonable.” Id. at 1105; see also Koch Supplies, Inc. v. Farm Fresh Meats, Inc., 630 F.2d 282, 285 (5th Cir. 1980) (“because the defects . . . were latent and could not be discovered within the forty-eight hours since it required two to three weeks to install the equipment, we hold that the forty-eight hours time provision is manifestly unreasonable and is due to be disregarded”); Fairhaven Textile Corp. v. Sheehan, Phinney, Bass & Green, P.A., 695 F.Supp. 71, 76 (D. N.H. 1988) (an interpretation of the invoices requiring notification of “latent defect within ten days of receipt of the goods would be manifestly unreasonable”); but see Loucks v. New Holland Manu., Inc., No. C0-92-2305, 1993 WL 152288, *1 (Minn. Ct. App. May 11, 1993) (“A warranty is not unreasonable merely because the defect is discovered after the warranty has expired.”).

The idea that the bargaining ability of the parties may be relevant to evaluating manifest unreasonableness is illustrated by PPG Industries v. Shell Oil Co., cited by

² In fact, the majority of the cases in which courts spent a relatively large part of their analysis on the “manifestly unreasonable” standard involved claims of latent defects.

both comment 5 and comment 7 of RUPA § 103, where the court considered the validity of a force majeure clause that provided, “Either seller or buyer will be excused from this contract to the extent that the performance is delayed or prevented by any circumstances . . . reasonably beyond its control or by . . . explosion” 919 F.2d 17, FN 1 (5th Cir. 1990). The court affirmed the district court’s ruling that the “force majeure clause excused non-performance due to explosion irrespective of whether the explosion was ‘beyond the reasonable control’ of defendant. Id. at 18. PPG asserted that such a clause violated a “non-waivable duty of good faith” imposed by Texas’ version of the pre-revision of UCC § 1-102(3). The court explained that the parties could allocate risks among them as long as they were not manifestly unreasonable. Id. at 19. More importantly, the court concluded that the “manifestly unreasonable” standard would be applied deferentially to contracts between sophisticated parties. Id. Because the court considered PPG and Shell to be sophisticated parties, it concluded that the force majeure clause was not manifestly unreasonable.³ Id.

Lastly, manifest unreasonableness may be defined by usage of trade. For example, the Rapp court concluded that a time restriction of 6-15 days before withdrawals can be made on funds deposited by check was not unreasonable in violation of UCC § 4-103, which allowed such restrictions as long as they were not manifestly unreasonable. 408 N.Y.S.2d at 542, 546. The court made this

³ This conclusion is supported by RUPA comments that state, “A modification of the statutory standard must not, however, be manifestly unreasonable. This is intend to discourage overreaching by a partner with superior bargaining power since the courts may refuse to enforce an overly broad exculpatory clause.” § 103, cmt. 5.

determination in part because defendant's "time restrictions are fully in accord with general banking usage," and even though defendant's "policies may be somewhat more conservative does not mean that they are unreasonable." *Id.* at 546. This decision suggests that terms may not be manifestly unreasonable if they comport with the usage of trade. See also *McCullough v. Gen. Motors Corp.*, 577 F.Supp. 41, 47 (W.D. Tenn. 1982) ("A determination of these issues requires a careful consideration of the purpose and effect of the time limitation, *the commercial setting in which the contract was executed* and the reasonableness at the time of contracting of the time limitation." (emphasis added)).

Of course, the comments to the UCC provision discussed above expressly support the idea that usage of trade is relevant to determining whether an agreement is manifestly unreasonable. For example, the comments to § 1-302 states:

However, the section also recognizes the prevailing practice of having agreements set forth standards by which due diligence is measured and explicitly provides that, in the absence of a showing that the standards manifestly are unreasonable, the agreement controls. In this connection, Section 1-303 incorporating into the agreement prior course of dealing and usages of trade is of particular importance.

§ 1-302, cmt. 1 (2001); see also § 1-102(3), cmt. 2 (2000) ("In this connection, Section 1-205 incorporating into the agreement prior course of dealing and usages of trade is of particular importance.").

III. Statutory comments and case law shed light on when the court must judge manifest unreasonableness.

Given the failure of courts to provide any meaningful definition or interpretation of "manifestly unreasonable," it is not surprising that they rarely state explicitly at what

point in time they are judging the reasonableness of an agreement or its terms. However, a comment cited previously sheds some light on when the court should apply the standard. Specifically, the court must look to the terms of the agreement “as judged by the time of contracting.” § 1-302, cmt. 1. It should be noted, however, that none of the comments to the other uniform statutes cited previously contain similar language or even any indication of when the standard should be applied.

A case applying Indiana’s version of § 6.27 of the MBCA discusses this issue in depth.⁴ In F.B.I. Farms, Inc., the court considered a decision by the trial court, affirmed by the court of appeals, that held that certain restrictions on the transfer of stock were manifestly unreasonable. 798 N.E.2d at 444. The trial court had concluded that the restrictions were reasonable at the time they were adopted but that “lengthy and difficult history between the parties had rendered the restriction unreasonable.” Id. at 447. The Indiana Supreme Court reversed the trial court and explained: “Under basic contract law principles, the reasonableness of a term of a contract is evaluated at the time of its adoption. The same is true of share transfer restrictions. As a result, evaluating the reasonableness of the restrictions in light of subsequent developments is inappropriate.” Id. (internal citations omitted); see also McCullough, 577 F.Supp. at 47 (denying summary judgment in part because determining whether a warranty limitation was manifestly unreasonable would

⁴ The relevant sections of the Model Business Corporation Act allow restrictions on the transfer of shares to:

- (3) require the corporation, the holders of any class of its shares, or another person to approve the transfer of the restricted shares, if the requirement is not manifestly unreasonable; or (4) prohibit the transfer of the restricted shares to designated persons or classes of persons, if the prohibition is not manifestly unreasonable.

§ 6.27(d)(3) & (4); *see also* IND. CODE 23-1-26-7(b).

require, among other things, looking at “the reasonableness of the time limitation at the time of contracting”); Callison, supra (“in determining whether a partnership agreement provision is manifestly unreasonable, the courts should look to the circumstances at the time of the agreement rather than applying hindsight based on future events and transactions”).

In short, the F.B.I. Farms, court provided well-reasoned analysis supporting the conclusion that whether an agreement or its terms are manifestly unreasonable is to be judged at the time of contracting.

CONCLUSION

None of the statutes employing the phrase “manifestly unreasonable” clearly define its meaning, and the Texas Court of Appeals remains the only court that has attempted to define it. However, in doing so, the court failed to apply its own definition in any meaningful way. As a result, the only remaining way to attempt to determine whether a court will consider an agreement to be manifestly unreasonable is to look at the context in which past cases were decided. Past decisions indicate that terms may be considered manifestly unreasonable, judged as of the time of contracting, where they are contrary to usages of trade, are the result of disparate bargaining power between the parties, and/or limit remedies in cases of latent defects.