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Rare Case Highlights Pitfalls of Unconscionable Contracts

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While it is not terribly unusual to see a defense of "unconscionability" raised in an action for breach of contract, it is quite rare for a court to find that a contract is "so outrageous as to warrant holding it unenforceable" because it is substantively unconscionable.

The rare case recently arose in the Commercial Part of the Supreme Court in Nassau County. In *Day Op of North Nassau, Inc. v. Viola*, 16 Misc.3d 1122 (A), 2007 WL 2305035 (Nassau Co. Aug. 1, 2007), Justice Ira B. Warshawsky found a provision of a shareholders' agreement that would have terminated a shareholder's ownership interest without cause to be unconscionable and unenforceable. The case provides useful lessons for counsel both from a contract-drafting perspective and with respect to strategies in implementing and enforcing contracts.

Unconscionability

The New York Court of Appeals has instructed that an "unconscionable contract" is "one which 'is so grossly unreasonable or unconscionable in light of the mores and business practices of the time and place as to be unenforceable [sic] according to its literal terms.'" *Gillman v. Chase Manhattan Bank, N.A.*, 73 N.Y.2d 1, 10, 537 N.Y.S.2d 787, 791 (1988) (quoting *Mandel v. Liebman*, 303 N.Y. 88, 94, citing 1 *Corbin on Contracts*, §128, p.

400). Generally, to declare a contract "unconscionable," the court must find that the contract "was both procedurally and substantively unconscionable when made." *Gillman*, 73 N.Y.2d at 11, 537 N.Y.S.2d at 791. The "procedural element" involves consideration of the contract formation process and whether the party alleging unconscionability was given a meaningful choice. Courts focus on "the size and commercial setting of the transaction . . . , whether deceptive or high-pressured tactics were employed, the use of fine print in the contract, the experience and education of the party claiming unconscionability, and whether there was disparity in bargaining power." 73 N.Y.2d at 11, 537 N.Y.S.2d at 791. On the "substantive" side, the courts analyze whether the actual terms of the contract "unreasonably favor" the party against whom unconscionability is urged. 73 N.Y.2d at 12, 537 N.Y.S.2d at 792.

In most instances, courts require a party to show that both the procedural and substantive aspects of the contract rise to the level of unconscionability in order to invalidate a contract in whole or in part. *Id.* Where a contract is negotiated at arms length between sophisticated parties, courts are not likely to invalidate any provision of the resulting contract, even if it is one-sided. See, e.g., *Dallas Aerospace, Inc. v. CIS Air Corp.*, 353 F.3d 775 (2d Cir. 2003) (in transaction between two sophisticated corporations, court affords little sympathy to argument that contractual clause disclaiming warranties was unconscionable in its "real-world application or effects").

Nevertheless, "there have been exceptional cases where a provision of a contract is so outrageous as to warrant holding it unenforceable on the ground of substantive unconscionability alone." *Gillman*, 73 N.Y.2d at 12, 537 N.Y.S.2d at 792. In *Viola*, Justice Warshawsky indeed found such an exceptional case.

'Viola'

Viola involved a dispute between a business corporation that was operating as an ambulatory surgery center and one of its shareholders. The defendant was both a shareholder and an employee of the corporation, with a five-year written employment term. The corporation, as plaintiff, sought to compel the defendant shareholder to sell her shares in the corporation back to the corporation because the corporation allegedly terminated her employment. The corporation initially claimed to have terminated the defendant's employment and, in-turn, her shareholder ownership, under the "for cause" provisions of the respective employment and shareholders' agreements.

At a hastily-arranged special meeting of the board of directors and shareholders, counsel for the corporation accused the defendant of violating her employment duties, as contained in the employment agreement, by failing properly to address health-related regulatory issues in her capacity of administrator. A majority of the shareholders and directors thereafter voted to terminate defendant's employment as a result of the charges leveled against her. While both the employment agreement and the shareholders' agreement did contain provisions for terminating employment and shareholder status "for cause," both agreements required the employee-

shareholder to receive notice and an opportunity to cure the alleged breach as a prerequisite to termination. The corporation, however, never provided the defendant with the required notice or opportunity to cure.

After the corporation demanded that defendant sell her shares back to the corporation, the defendant refused to recognize her alleged termination or that the corporation was authorized to compel the redemption of her shares. Plaintiff proceeded to institute an action alleging two causes of action, seeking (1) a declaratory judgment that defendant had no right to refuse to close on the sale of her shares, and (2) specific performance of the agreements to compel defendant to close.

Defendant moved to dismiss the action, arguing that the complaint was barred by "documentary evidence" and failed to state a cause of action. Defendant asserted that plaintiff was precluded from compelling her to sell her shares because it failed to comply with the notice and cure provisions in the respective shareholders and employment agreements.

In response to the motion, plaintiff conceded that it had not provided defendant with the requisite notice and opportunity to cure as required by the agreements. Thus, plaintiff failed to justify the termination under the "for cause" provisions of the agreements. Plaintiff, however, relied instead on a rather odd legal argument.

In addition to the "for cause" provisions of both agreements, the shareholders' agreement contained a section that purported to terminate a shareholder's ownership interest and force the shareholder to sell back her shares "without cause." This provision provided in relevant part:

[9(b)] Termination Without Cause. Upon termination of any Shareholder's employment agreement with the Corporation for any reason or no reason, including without cause or upon breach of a Shareholder's Employment Agreement by the Corporation, the terminated Shareholder shall be deemed to have offered to sell all of the

Shares or any interest therein owned by said Shareholder as of the Termination Date to the Offerees . . . The Purchase Price for such Shares shall be as stated in Section 6(c). [Emphasis added.]

Relying upon this provision, plaintiff argued that it could force defendant to sell her shares back to the corporation because her employment was terminated, no matter how that termination occurred - even if it resulted from plaintiff's own breach of the employment agreement. Not surprisingly, defendant argued that this provision of the agreement was "unconscionable as a matter of law."

Justice Warshawsky first noted that a finding of unconscionability ordinarily requires the presence of both procedural and substantive elements, as discussed above. The court observed that there was "no allegation or evidence in the moving papers of procedural unconscionability." Nevertheless, Justice Warshawsky went on to consider whether the subject contract provision was so "outrageous" that it was not enforceable based upon its substantive unconscionability alone.

In analyzing the effect of the termination provision, Justice Warshawsky noted the courts' "loathsome disposition to forfeiture," finding that the provision was in fact "oppressive, unjust and unreasonably deprive[d] Defendant of the benefits of her Agreements with Plaintiff Corporation." In particular, the court observed:

Section 9(b) of the Shareholders' Agreement effectively renders the protections of Defendant's Employment Agreement meaningless. The protections are forfeited. Defendant's Employment Agreement provides her with five years of uninterrupted Employment. During this time the Corporation is precluded from forcing her to sell her interest in the Corporation for reasons other than those constituting Cause, as defined by the agreements. Although termination without cause under Section 9(b) of the Shareholders'

Agreement requires the Corporation to buy back shares at full value, Defendant is without remedy to contest the forced sale of her shares if she is terminated for patently improper reasons such as termination by reason of Plaintiff's breach. Most notably, enforcing the provision under the given facts would allow Plaintiff Corporation to benefit from its own breach. This result is oppressive and will not be enforced by this Court.

Lessons

In terms of contract drafting, one of the morals of this story is that "if it sounds too good to be true, it probably is." Drafting a contract so inherently unfair and one-sided is likely to be met with great resistance by the judiciary, who would be loath to enforce it as written. As Justice Warshawsky so aptly observed in *Viola*, for example, a contract that actually rewards one of the contracting parties for its own breach of the contract is the type of oppressive provision that could not possibly be implemented by the courts.

Similarly, if a contract that is so obviously outrageous has been entered into nonetheless, spending time and money seeking to enforce it as written would appear to be imprudent. Rather than proceeding in an attempt to convince a court to endorse what is clearly an unconscionable provision, different strategies should be considered and employed, such as following and relying upon the reasonable provisions of the contract.

In *Viola*, for example, following the simple notice and cure provisions of the contract at issue may have delayed the ultimate termination of the shareholder-employee, but in the end, would have saved both time and money by creating a solid basis for termination that would have been likely to be upheld in court. In fact, Justice Warshawsky observed that, while the "cause" for termination - defendant's failing to abide by her employment duties - seemed to be satisfied, the question as to whether there were sufficient grounds to justify a termination for cause was not even ripe for determination because the "procedural" contractual requirements (notice and cure) had not been met.