COURT OF APPEALS
DECISION
DATED AND FILED

September 23, 2010

A. John Voelker
Acting Clerk of Court of Appeals

NOTICE

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A party may file with the Supreme Court a petition to review an adverse decision by the Court of Appeals. *See* WIS. STAT. § 808.10 and RULE 809.62.

Appeal No. 2009AP2757 **Cir. Ct. No. 2009CV1092**

STATE OF WISCONSIN **IN COURT OF APPEALS**
DISTRICT IV

GRICE ENGINEERING, INC.,

PLAINTIFF-APPELLANT,

FIFTH THIRD BANK,

INTERVENOR-CO-APPELLANT,

V.

INNOVATIONS ENGINEERING, INC., GORDON J. GRICE, AND FAB MASTERS INC.,

DEFENDANTS-RESPONDENTS.

INNOVATIONS ENGINEERING, INC.,

DEFENDANT-THIRD-PARTY PLAINTIFF-RESPONDENT,

V.

MICHAEL LIDDELL AND PAUL JOHNSON,

THIRD-PARTY DEFENDANTS-APPELLANTS.

APPEAL from an order of the circuit court for Rock County: JAMES WELKER, Judge. *Reversed and cause remanded.*

Before Vergeront, P.J., Lundsten and Sherman, JJ.

¶1 VERGERONT, P.J. This appeal arises out of a dispute between Grice Engineering, Inc., and Innovations Engineering, Inc., after Grice Engineering purchased Innovations' business assets.[1] In the nonfinal order that is the subject of this appeal, the circuit court concluded that Grice Engineering was in default for failure to make payments required under the asset purchase agreement and the promissory note and that Innovations was therefore entitled to enforce its rights under the stock pledge agreements. The circuit court rejected the argument of Grice Engineering and its bank that the subordination agreement between the bank and Innovations, which made Grice Engineering's debt to Innovations subordinate to its debt to the bank, bars enforcement of the stock pledge agreements. The court also rejected their argument that the subordination agreement requires dismissal of Innovations' counterclaims to collect under the note. The court concluded that the stock pledge agreements are not subject to the subordination agreement and, in the alternative, the subordination agreement is unconscionable.

¶2 The first issue we address on appeal is whether the stock pledge agreements are covered under the standstill clause of the subordination agreement, thus barring their enforcement. We conclude they are covered. The second issue

[1] We note that Grice Engineering voluntarily dismissed its complaint against Fab Masters, Inc., on July 16, 2009. Fab Masters, therefore, is not part of this appeal.

we address is whether the subordination agreement, and in particular, the standstill clause, is unconscionable under Illinois law. We conclude it is not. The third issue we address is whether there are factual disputes on the issue of Grice Engineering's default. We conclude it is undisputed that Grice Engineering is in default to Innovations under the note. Accordingly, we reverse and remand for further proceedings consistent with this opinion.

BACKGROUND

¶3 In July 2007 Grice Engineering entered into an asset purchase agreement with the sole owner of Innovations, Gordon Grice, whereby Grice Engineering purchased the majority of Innovations' business assets.[2] The total purchase price was $3,150,000. At the closing, Grice Engineering paid Innovations $500,000. Fifth Third Bank financed the $500,000 closing payment pursuant to a loan and security agreement with Grice Engineering.

¶4 The remainder of the purchase price, $2,650,000, took the form of a promissory note executed by Grice Engineering and payable to Innovations. The note, as amended in an amendment to the asset purchase agreement,[3] calls for twelve quarterly installments and a final payment of $2,065,770.63 due on September 15, 2010. Michael Liddell, Grice Engineering's president, and Paul Johnson, Grice Engineering's vice-president, jointly and severally guaranteed $500,000 of the amount due under the note. The note was secured by a general

[2] After the closing, the corporate parties changed their names. This opinion refers to the parties by their post-closing names. Prior to the closing, Grice Engineering was MLPJ Acquisition Co. and Innovations was Grice Engineering, Inc.

[3] When we refer to the note in this opinion, we mean the note as amended.

business security agreement executed by Grice Engineering. The note was also secured by stock pledge agreements, one executed by Liddell and one by Johnson, under which each granted Innovations a security interest in all the shares in Grice Engineering that each owned.

¶5 Pursuant to provisions in the note, the asset purchase agreement, and the general business security agreement, Innovations entered into a subordination agreement with the bank under which payment of Grice Engineering's debt to Innovations became subordinated to all indebtedness of Grice Engineering to the bank.

¶6 Less than a year after the closing, disputes arose between Grice Engineering and Innovations on their obligations under the asset purchase agreement and the note. It is undisputed that Grice Engineering has not made installment payments under the note since at least March 20, 2008. Grice Engineering claims it is not obligated to make any payments because Innovations has breached its representations and warranties under the asset purchase agreement and the agreement allows Grice Engineering to set off damages for that breach against the payments due under the note. Innovations disputes this on factual and legal grounds. In addition, apparently in response to the cessation of payments under the note, Gordon Grice began to take steps that, according to Grice Engineering, violated the noncompete and nonsolicitation provisions in the asset purchase agreement and the separate restrictive covenant agreement.

¶7 Grice Engineering's complaint alleges a breach by Innovations of the restrictive covenants in the asset purchase agreement and a breach by both

Innovations and Gordon Grice of the separate restrictive covenant agreement.[4] Innovations' counterclaims allege a breach of contract by Grice Engineering for defaulting under the note and a foreclosure of the general business security agreement based on that default. Innovations also filed a third-party complaint against Liddell and Johnson in which it sought to foreclose on the stock pledge agreements and enforce their personal guarantees on the note and requested related injunctive relief.

¶8 The bank was permitted to intervene and filed a motion to dismiss Innovations' counterclaims on the ground that the standstill clause of the subordination agreement between Innovations and the bank barred Innovations' claims because the bank's loan to Grice Engineering had not yet been paid off. On the same ground, Grice Engineering filed a joint motion with Liddell and Johnson to dismiss the counterclaims and third-party claims, respectively.[5] Innovations opposed these motions, contending that the subordination agreement was unconscionable if it precluded Innovations from enforcing Grice Engineering's obligations to it, and also contending that the bank had breached its duty of good

[4] Innovations initiated this action with a complaint against Grice Engineering, Liddell, Johnson, and Fifth Third Bank. For reasons not relevant to this appeal, Innovations voluntarily dismissed its complaint. The action has since proceeded treating Grice Engineering as the plaintiff and treating its counterclaims against Innovations and its third-party claim against Gordon Grice as the complaint. Innovations refiled its claims against Grice Engineering as counterclaims and against Liddell and Johnson as a third-party complaint.

[5] We will refer to Grice Engineering, Liddell, and Johnson collectively as Grice Engineering unless it is necessary to refer to Liddell and Johnson as individuals.

faith and fair dealing implied in the agreement.[6] Innovations filed a counterclaim against the bank seeking a declaratory judgment against it on these same grounds.

¶9 During this same time period, Innovations filed a motion for an order enforcing the stock pledge agreements on the ground that Grice Engineering had defaulted on the note. The responses to this motion raised the same issues on the scope of the subordination agreement and its unconscionability as did the motions to dismiss.

¶10 The circuit court heard the motions to dismiss and the motion to enforce the stock pledge agreements together. Because the parties submitted affidavits with their motions and the court considered them, the court treated the motions as ones for summary judgment pursuant to WIS. STAT. § 802.06(2)(b).

¶11 The circuit court concluded that enforcement of the stock pledge agreements was not covered by the standstill clause of the subordination agreement. In the alternative, it concluded that the subordination agreement was unconscionable because of the standstill clause and therefore unenforceable. With respect to whether there was a default on the note—which is necessary to trigger enforcement of the stock pledge agreements—the court concluded there was a default. The court arrived at this conclusion because it is undisputed that Grice

[6] We note that, in addition to seeking enforcement of the stock pledge agreements and personal guarantees, the third-party complaint against Liddell and Johnson alleged a fraudulent transfer under WIS. STAT. ch. 242. Neither in its brief opposing the motions to dismiss in the circuit court nor on appeal does Innovations contend that the fraudulent transfer claim is subject to a different analysis, with respect to the subordination agreement, than the other third-party claims. Accordingly, we do not separately discuss this claim in our opinion.

Engineering did not make the payments specified in the note.[7] The court did not address Grice Engineering's argument, presented in its brief in opposition to Innovation's motion, that it was not in default because of setoffs to which it was entitled under the asset purchase agreement.

¶12 Accordingly, the circuit court denied the motions to dismiss Innovations' counterclaims and third-party claims and concluded that Innovations was entitled to an order enforcing the stock pledge agreements. We granted the petitions of Grice Engineering and the bank for interlocutory review of the court's decision.

DISCUSSION

¶13 On appeal, Grice Engineering, Liddell, and Johnson, filing one brief, and the bank, filing another brief, contend the circuit court erred on three primary grounds. They assert: (1) the stock pledge agreements are covered by the subordination agreement; (2) the subordination agreement is not unconscionable; and (3) there are factual disputes that warrant a trial on whether Grice Engineering is in default, which is necessary to trigger enforcement of the stock pledge

[7] Under the stock pledge agreements, an event of default includes "[a]ny failure of [Grice Engineering] to pay when due the obligations secured by this Agreement.…" Upon an event of default, "the obligations [of the stock pledge agreements] shall, at [Innovations'] option and without any notice or demand, become immediately payable.…"

agreements. Because the two briefs are identical, we will refer to the four parties collectively as the appellants when discussing their arguments.[8]

¶14 We review de novo the grant of summary judgment, employing the same methodology as the circuit court. ***Green Spring Farms v. Kersten***, 136 Wis. 2d 304, 314-16, 401 N.W.2d 816 (1987). A party is entitled to summary judgment when there are no genuine issues of material fact and that party is entitled to judgment as a matter of law. WIS. STAT. § 802.08(2). Competing reasonable inferences from undisputed facts may create genuine issues of fact. ***Hennekens v. Hoerl***, 160 Wis. 2d 144, 162, 465 N.W.2d 812 (1991). Whether an inference is reasonable and whether there is more than one reasonable inference are questions of law. ***Id.***

I. Subordination Agreement's Application to the Stock Pledge Agreements

¶15 Under the subordination agreement with the bank, Innovations, the subordinate creditor, agrees that payment of "the Subordinate Debt" is and shall remain "subordinated to the full and timely payment of the Senior Debt." Under section 2, until a default occurs on the senior debt, Innovations may accept from Grice Engineering only regularly scheduled payments of principal and interest under the note. Under section 3, if a default on the senior debt occurs, Innovations' right to receive those payments from Grice Engineering is suspended

[8] We recognize that neither Grice Engineering nor Liddell nor Johnson is a party to the subordination agreement. In their brief in the circuit court in support of their motion to dismiss based on this agreement, they asserted they are third-party beneficiaries to the agreement. Innovations disputed this in its responsive brief in the circuit court. It does not appear that this issue was addressed by the circuit court, and it is not argued on appeal. It appears that, once the bank was permitted to intervene, the parties all believed that it was unnecessary to resolve the standing of Grice Engineering, Liddell, and Johnson. Because the issue of their standing is not briefed on appeal, we do not address it.

and Innovations may not receive, nor may Grice Engineering make, any payment or "distribution of any character" unless the bank waives the default in writing or until the senior debt is satisfied.

¶16 The "standstill" clause provides that Innovations

> shall not exercise any rights or remedies or take any Enforcement action available upon the occurrence of a default or an event of default or otherwise under the Subordinate Loan Documents or take any action toward the collection of any Subordinate Debt until all of the Senior Debt shall have been indefeasibly paid in full in cash and the Senior Commitment shall have been terminated.

¶17 It is undisputed that Grice Engineering remains obligated to the bank under the loan agreement between them.[9] Thus, the senior debt, as defined in the subordination agreement, has not been paid in full in cash.

¶18 The circuit court concluded that the stock pledge agreements were not "subordinate loan documents" as defined in the agreement. The court reasoned that, in attempting to enforce the stock pledge agreements, Innovations was not attempting to foreclose, liquidate, or dispose of any assets of Grice Engineering, but rather, the "dispute [was] over how the assets can be preserved."[10]

[9] The affidavit of the bank's vice-president avers that, as of July 15, 2009, Grice Engineering owed the bank at least $674,000 pursuant to the senior loan agreement as defined in the subordination agreement.

[10] Apparently the circuit court was adopting Innovations' argument that enforcement of the stock pledge agreements is not an "Enforcement action" under the standstill clause. "Enforcement" in the subordination agreement means:

(continued)

¶19 The appellants contend that the circuit court erred because the stock pledge agreements plainly come within the definition of "subordinate loan documents" in the agreement.[11] They further contend that enforcing the stock pledge agreements constitutes the "exercise [of] rights or remedies … upon the occurrence of default … under the Subordinate Loan Documents."

¶20 Although Innovations argued in the circuit court that the stock pledge agreements were not subordinate loan documents and the court adopted this view, on appeal Innovations concedes that the stock pledge agreements are subordinate loan documents. Innovations argues that, nonetheless, the standstill clause does not apply to its motion to enforce these agreements. Innovations' position is that the standstill clause does not bar all rights and remedies under the subordinate loan documents, but only those rights or remedies that seek

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> collectively or individually, for one or both of Senior Creditor or Subordinate Creditor, any action by Senior Creditor or Subordinate Creditor to (a) accelerate or collect payment of the Senior Debt or the Subordinate Debt, (b) repossess any amount of Collateral, or (c) commence the judicial or nonjudicial enforcement of any of the rights and remedies under the Senior Loan Documents, the Subordinate Loan Documents, related mortgages or agreements or applicable law *in order to foreclose upon, liquidate or otherwise dispose of any assets of any Loan Party in other than the ordinary course of business.* [Emphasis added.]

Innovations does not pursue this argument on appeal.

[11] Subordinate loan documents are "the Purchase Agreement, the Subordinate Note, the Subordinate Security Agreement and any other documents, instruments or agreements by and between Borrower and/or any other person or entity, on the one hand, and Subordinate Lender, on the other hand, executed in connection with the Purchase Agreement…."

"collection of any Subordinate Debt." According to Innovations, enforcement of the stock pledge agreements does not seek collection of any subordinate debt.[12]

¶21 A resolution of this issue requires that we construe the subordination agreement. Because this agreement provides that it is governed by Illinois law, we rely on Illinois law for the principles of contract construction. We conclude the appellants' construction is correct and the motion to enforce the stock pledge agreements is barred by the standstill clause.

¶22 Under Illinois law, "[t]he primary objective in interpreting a contract is to give effect to the intent of the parties." ***Hensley Constr., LLC v. Pulte Home Corp.***, 926 N.E.2d 965, 973 (Ill. App. Ct. 2010). If the contract language is unambiguous, the parties' intent must be derived from the writing itself. ***Id.*** "In interpreting a contract, meaning and effect must be given to every part of the contract including all its terms and provisions, so no part is rendered meaningless or surplusage…." ***Coles-Moultrie Electric Coop. v. City of Sullivan***, 709 N.E.2d 249, 253 (Ill. App. Ct. 1999). Whether a contract is ambiguous is a question of law, ***William Blair and Co. v. FI Liquidation Corp.***, 830 N.E.2d 760, 770 (Ill. App. Ct. 2005), as is the interpretation of a facially unambiguous contract. ***Lease***

[12] The appellant argues that Innovations did not raise this argument or the argument discussed in paragraph 23 in the circuit court and therefore these arguments are waived. It is true Innovations did not make these arguments in its briefs in the circuit court, but they were presented, though briefly, in argument at the hearing. The appellants therefore had the opportunity to respond to these arguments or ask for additional time to brief them. In any case, the waiver rule is one of judicial administration and does not limit the power of an appellate court in a proper case to address issues not raised in the circuit court. ***State v. Sveum***, 2010 WI 92, ¶40, ___Wis. 2d ___, ___ N.W.2d ___. Even if there are arguable grounds for waiver, we choose to address these arguments for the following reasons: our review is de novo, these two arguments present contract construction issues on the same contract clause argued below, the record is adequately developed and there are no relevant factual disputes, all parties have briefed these arguments on appeal, and the appellants do not assert any unfairness to them, nor do we perceive any.

Mgmt. Equip. Corp. v. DFO P'ship, 910 N.E.2d 709, 715 (Ill. App. Ct. 2009). Because the parties agree that the stock pledge agreements are "subordinate loan documents" as defined in the agreement, we accept their consensus and focus on their disagreement over the scope of the standstill clause.

¶23 Innovations' proposed construction depends upon reading "toward the collection of any Subordinate Debt" as modifying not only the immediately preceding "or take any action" but all the conduct beginning with "exercise of any rights or remedies." In other words, Innovations reads the standstill clause to bar, as long as the senior debt has not been paid in full, (1) the exercise of any rights or remedies *toward the collection of any subordinate debt* available upon the occurrence of default under the subordinate loan documents; and (2) any enforcement action *toward the collection of any subordinate debt* available upon the occurrence of default under the subordinate loan documents; and (3) any action toward the collection of any subordinate debt.

¶24 As the appellants point out, under Illinois law, the "last antecedent clause" rule of contract construction provides that "a qualifying phrase is to be confined to the last antecedent unless there is something in the instrument requiring a different construction." ***Illini Fed. Sav. & Loan Ass'n v. Elsah Hills Corp.***, 445 N.E.2d 1193, 1196 (Ill. App. Ct. 1983). Thus, unless something in the subordination agreement requires another construction, the phrase "toward the collection of any Subordinate Debt" modifies only "or take any action."

¶25 Innovations contends that another section of the agreement—section 8—is rendered meaningless if the phrase "toward the collection of any Subordinate Debt" modifies "exercise any rights or remedies." This section provides in part:

> Nothing herein shall impair, as between each Loan Party and Subordinate Creditor, the obligation of such Loan party, which is unconditional and absolute, to pay to Subordinate Creditor the principal of and interest on the Subordinate Debt as and when the same shall become due in accordance with their terms, *nor shall anything herein prevent Subordinate Creditor from exercising all remedies otherwise permitted by applicable law upon default under the Subordinate Loan Documents, subject, however, to the provisions of this Agreement and the rights of Senior Creditor to the extent provided herein.* [Emphasis added.]

Innovations contends that, if the standstill clause covers *all* rights and remedies under the subordinate loan documents then there are no rights or remedies that Innovation retains, and the italicized section is meaningless.

¶26 We disagree that section 8 requires that the standstill clause be read as Innovations proposes. The above italicized language in section 8 plainly means that the agreement does not alter Innovations' rights under the subordinate loan documents *except as stated in the agreement.* In other words, Grice Engineering's obligation to pay the subordinate debt as provided in the agreement remains unchanged. If Grice Engineering does not pay as obligated, the standstill clause prevents, as long as the senior debt is unsatisfied, any action to enforce the rights and remedies available under the subordinate loan documents for that default. However, Grice Engineering still owes its debt to Innovations, and Innovations retains its rights and remedies under the subordinate loan documents and may exercise them when the senior debt is satisfied. While section 8 may have a limited practical effect given the standstill clause, this does not render section 8 meaningless. Nor does it require a deviation from the rule that the modifier

"toward the collection of any Subordinate Debt" applies only to the preceding phrase and not to the "exercise any rights or remedies" phrase.[13]

¶27 We conclude the standstill clause plainly bars Innovations from exercising any rights or remedies available upon default under the subordinate loan documents until the senior debt is fully paid. Innovations does not argue that, under this construction, its motion to enforce the stock pledge agreements does not come within the standstill clause. Accordingly, based on the undisputed facts, we conclude that Innovations' motion to enforce the stock pledge agreements is subject to the standstill clause.

II. Unconscionability of the Subordination Agreement

¶28 We next address whether the subordination agreement is unconscionable because of the standstill clause and therefore unenforceable as a bar to Innovations' motion, counterclaims, and third-party claims. If the agreement is enforceable, the standstill clause as we have construed it would bar not only the motion to enforce the stock pledge agreements but also Innovations' counterclaims seeking other relief based on its claims of default under the note and its third-party claims. Innovations makes no argument supporting the conclusion that, if the standstill clause is enforceable as we have construed it, the subordination agreement nonetheless does not bar its counterclaims and third-party claims.[14]

[13] Because we reject Innovations' proposed construction of the standstill clause, we need not address Grice Engineering's argument that, even if we were to adopt that construction, enforcement of the stock pledge agreements is an action to collect on the subordinate debt.

[14] *See* footnote 6.

¶29 The circuit court concluded that the standstill clause is unconscionable if it allows Grice Engineering to avoid paying what it owes Innovations because it still owes money to Fifth Third Bank, while the bank continues to lend Grice Engineering money on what is essentially a revolving line of credit. Such a result, the court said, "would make the subordination agreement an entirely one-sided document giving all the rights to Grice Engineering and providing no rights or benefits to Innovations Engineering."

¶30 The appellants contend that the undisputed facts establish that the standstill clause, interpreted as we have in the preceding section, is not unconscionable, either procedurally or substantively. Innovations counters that the circuit court was correct.

¶31 Under Illinois law, a determination that a contract clause is unconscionable may be based on either procedural unconscionability or substantive unconscionability or a combination of both. ***Kinkel v. Cingular Wireless LLC***, 857 N.E.2d 250, 263 (Ill. 2006). The burden of proving unconscionability is on the party alleging unconscionability. ***Reuben H. Donnelley Corp. v. Krasny Supply Co.***, 592 N.E.2d 8, 11 (Ill. App. Ct. 1991). Because Innovations has the burden of proof, we analyze its factual submissions and its arguments to determine whether it has made a prima facie showing of unconscionability. We conclude it has not.

¶32 We address procedural unconscionability first. This term refers to "some impropriety during the process of forming the contract depriving a party of a meaningful choice." ***Kinkel***, 857 N.E.2d at 264 (quoting ***Frank's Maint. & Eng'g, Inc. v. C.A. Roberts Co.***, 408 N.E.2d 403, 410 (Ill. App. Ct. 1980) (citation omitted)). All the circumstances surrounding the transaction are to be considered,

including the manner in which the contract was entered into, whether important terms were hidden, and whether each party had a reasonable opportunity to understand the terms. ***Id.*** In determining whether a party had a meaningful choice, a court may consider a party's commercial experience. ***Reuben H. Donnelley Corp.***, 592 N.E.2d at 12. The disparity in bargaining power between the contract drafter and the party claiming unconscionability is also considered: the inquiry on this point is whether there is a "gross disparity." *See* ***id.*** However, a disparity in bargaining power alone is insufficient for a finding of unconscionability. ***Streams Sports Club, Ltd. v. Richmond***, 457 N.E.2d 1226, 1232 (Ill. 1983).

¶33 Innovations argues that the bank was in a stronger position than it was because the bank could either loan the money to Grice Engineering or deny the funds necessary to make the sale of the business happen. Innovations quotes from argument by Grice Engineering's attorney to the effect that the bank wanted the subordination agreement, and in order to get the bank to make the loan "which ultimately put money into Innovations, [Innovations] agreed to the subordination agreement."

¶34 An attorney's argument is not a proper submission for purposes of summary judgment. *See* WIS. STAT. § 802.08(2) and (3). Innovations points to no factual submissions describing the circumstances of the transactions or negotiations. Examining the documents that are part of the transaction, it is reasonable to infer that it was the bank that wanted a subordination agreement and Innovations entered into one because it wanted the bank to loan Grice Engineering money with which to purchase Innovations' assets. However, it is not reasonable to infer from this that there was a gross disparity in bargaining power. The only reasonable inference from the asset purchase agreement is that Innovations is a

sophisticated commercial actor, and the only reasonable inference from the subordination agreement is that Innovations was represented by counsel in entering into this agreement.

¶35 Innovations also contends that the language of the subordination agreement fails to bring to its attention that it is barred from pursuing any remedy under any agreement related to the purchase agreement until the senior debt is paid. To the extent this contention is based on Innovations' argument that the proper construction of section 8 is that it limits section 6, we have already addressed and rejected that argument. As for the standstill clause itself, it is not hidden. It is in a separately numbered and titled section ("Section 6. Standstill.") in the middle of the agreement in the same type as the rest of the agreement.

¶36 Innovations appears to contend that it understood the subordination agreement applied only to the $500,000 loan the bank made to Grice Engineering and not to any amounts it might lend thereafter. However, the definition of "Senior Debt" in section 1 ("Definitions") of the subordination agreement plainly includes future loans of the type described:

> "Senior Debt": shall mean and include all indebtedness, obligations and liabilities of any Loan Party under the Senior Loan Documents, including, without limitation, all principal and interest (including interest accrued subsequent to, and interest that would have accrued but for, the filing of any petition under any bankruptcy, insolvency or similar law) and other amounts payable thereunder, in either case whether now or hereafter arising, direct or indirect, primary or secondary, joint, several or joint and several, final or contingent and whether incurred as maker, endorser, guarantor or otherwise. Notwithstanding the foregoing, the principal amount of Senior Debt to which Subordinate Creditor agrees to subordinate hereunder shall be limited to (i) *any accounts receivable financing (which accounts receivable financing shall include any letters of credit issued by Senior Lender under a revolving line of credit secured by accounts receivable) now or hereafter*

> *provided by Senior Lender to Borrower, without limitation on the amount thereof,* plus (ii) other financing now or hereafter provided by Senior Lender to Borrower in an aggregate principal amount not to exceed Five Hundred Thousand Dollars ($500,000.00), plus (iii) all interest accrued on any of the forgoing, plus (iv) all costs, fees and expenses now or at any time hereafter owed by Borrow to Senior Lender. [Emphasis added.]

This definition is in the same text as the rest of the agreement, and the title, "Senior Debt," is bolded, underlined, and in quotes, as are the other definitions.

¶37 Innovations has identified no evidence that it did not have a reasonable opportunity to review and understand the terms of the subordination agreement, and we have discovered none. As we have already noted, the only reasonable inference is that it was represented by counsel.

¶38 We conclude Innovations has not presented evidence which, if believed, would entitle it to a trial on whether the subordination agreement, and in particular the standstill clause, is procedurally unconscionable. We turn to substantive unconsionability.

¶39 "Substantive unconscionability 'concerns the actual terms of the contract and examines the relative fairness of the obligations assumed.'" ***Kinkel,*** 857 N.E.2d at 267 (quoting ***Hutcherson v. Sears Roebuck & Co***., 793 N.E.2d 886, 894 (Ill. App. Ct. 2003)). Illinois courts are more reluctant to conclude that negotiated contracts between commercial enterprises are unconscionable than they are where the contract is between a consumer and a business. ***Walter E. Heller & Co. v. Convalescent Home of the First Church of Deliverance***, 365 N.E.2d 1285, 1289 (Ill. App. Ct. 1977) ("Although the courts will readily apply [the unconscionability] doctrine to contracts between consumers and skilled … corporate sellers, they are reluctant to rewrite the terms of a negotiated contract

between businessmen."). However, the mere existence of a commercial setting does not insulate a contract from a determination of unconscionability. ***Frank's Maint. & Eng'g***, 408 N.E.2d at 409. In commercial settings, "[s]ubstantive unconscionability concerns the question whether the terms themselves are commercially reasonable." ***Id.*** at 410. A determination of a contract provision's commercial reasonableness includes a consideration of the benefits received by the party arguing that the provision is unconscionable. *See* ***Reuben H. Donnelley***, 592 N.E.2d at 12 (concluding that a contractual limitation on consequential damages was commercially reasonable because the advertisers received the benefit of a lower price for advertising than they would if liability for consequential damages were not limited.)

¶40 Before discussing Innovations' contentions of substantive unconscionability, we briefly discuss, in general, subordination agreements between creditors. The typical characteristics of these agreements are that there is a common debtor who owes debts to two creditors—a junior creditor who agrees to subordinate its debt, and a senior creditor "who obtains the benefit of the subordination and acquires priority over the junior creditor." ***Sumitomo Trust & Banking Co. v. Holly's Inc.***, 140 B.R. 643, 668 (Bankr. W.D. Mich. 1992) (surveying commentators' articles because of the paucity of case law on subordination agreements). The definitions in the agreements of the subordinate debt and the senior debt vary; each type of debt may be defined as "all present or future debt, or only specified existing or future debt." ***Id.*** (citation omitted). The precise terms of subordination and priority also vary. *See* THOMAS S. HEMMENDINGER, HILLMAN ON COMMERCIAL LOAN DOCUMENTATION chs. 18, 19, Forms 18.2 §§ 1-4, 18.4 §§ 1-5, 19.4 §§ 1-4 (5th ed. 2010). While the subordination agreement between Innovations and the bank allows Innovations to

receive principal and interest payments under the note as long as Grice Engineering does not default on its debt to the bank, some subordination agreements provide that the subordinate creditor will accept *no* payment on its debt until the senior loan is paid off. *See* ***Sumitomo Trust & Banking***, 140 B.R. at 668 (describing a subordination agreement as one in which the junior or subordinated creditor "agrees that the claims of specified senior creditors must be paid in full before any payment on the subordinated debt may be made to, and retained by, the subordinated creditor") (citation omitted); *see also* HEMMENDINGER, Forms 18.3, 18.4 § 2. In short, while we cannot say how frequently subordination agreements are used, we are satisfied they are not rare.

¶41 With respect to a standstill, or standby, clause of the type at issue here—barring collection of the subordinate debt and enforcement of all related rights and remedies as long as the senior debt remains unpaid—the parties have cited no case law discussing the validity of such a clause and our own research has discovered none. Our research suggests, however, that this type of a clause is used in subordination agreements. *See* HEMMENDINGER, Form 18.3 (U.S. Small Business Administration Standby Creditor Agreement), Form 18.4 § 5, Form 19.4 § 6. In addition, we note that Illinois courts have enforced similar clauses, although not against a challenge of unconscionability but against a challenge that they were not binding after an assignment. *See* ***Strosberg v. Brauvin Realty Servs., Inc.***, 691 N.E.2d 834, 837-45 (Ill. App. Ct. 1998); ***Rovak v. Parkside Veterans' Home Project, Inc.***, 132 N.E.2d 11, 12-14 (Ill. App. Ct. 1956). While these cases, like the forms in a treatise, do not by any means resolve the unconscionability issue, they provide a context for our discussion of this issue.

¶42 Innovations contends the standstill clause, in conjunction with the definition of the senior debt, is substantively unconscionable because together they

permit Grice Engineering to "enjoy the benefit of the bargain while failing to pay Innovations the purchase price." Even as a commercial actor, Innovations contends, it could not have foreseen that the bank would extend Grice Engineering a revolving line of credit of potentially infinite duration, while simultaneously refusing to enforce its own loan covenants. According to Innovations, the bank has "unforeseeably[] aligned itself with Grice Engineering in an effort to prevent any payments to Innovations."

¶43 These assertions do not establish a prima facie factual showing of commercial unreasonableness. The subordination agreement was part of the transaction of the sale of Innovations' business assets to Grice Engineering. As a result of that transaction, Innovations received the $500,000 that the bank lent Grice Engineering. As already noted, the language of the subordination agreement makes clear that the senior debt includes "any accounts receivable financing … now or hereafter provided by Senior Lender to Borrower, without limitation on the amount thereof…." In addition, the note provides that Innovations' security interests "shall be subordinate to any present loans and security interests, or future accounts receivable loans and related security interests of [Grice Engineering's] commercial lenders…." Thus, from the face of the documents it was foreseeable that the bank could lend more money to Grice Engineering after the closing, and, if the purpose of the loans was as prescribed in the subordination agreement and the note, those future loans would be the senior debt to which Innovations' debt was subordinated.

¶44 As we have explained above, it is not uncommon for subordination agreements to include future debt in the definition of the senior debt. *See* ***Sumitomo Trust & Banking***, 140 B.R. at 668. One reason that subordinate creditors enter into subordination agreements is to induce the senior lender to

advance new funds to the debtor. ***Id.*** at 668 n.37. It is reasonable to infer from all the documents that are connected to the transaction here that Innovations would benefit if the bank lent Grice Engineering money it needed to continue in business and thus to pay Innovations under the note. Innovations has made no factual showing that, at the time of entering into the agreement, it was unreasonable to expect that it would benefit from subsequent loans the bank was authorized to make to Grice Engineering.

¶45 To the extent Innovations' argument rests on its assertion that the bank is acting unreasonably in not enforcing its loan agreements with Grice Engineering, Innovations does not point to any factual submission showing that Grice Engineering is in default to the bank. Even if it is true, the subordination agreement does not obligate the bank to exercise its rights against Grice Engineering; that is within the bank's discretion under the terms of the subordination agreement.[15] Moreover, the subordination agreement expressly states in section 3 that, if there is a default on the senior debt, Innovations' right to receive payments on the principal and interest under the note is suspended unless the bank waives the default in writing or the senior debt is satisfied in full. This is consistent with the very nature of the subordination agreement: if the debtor cannot pay both creditors as it agreed, the senior creditor's debt takes priority. Thus, if Innovations is correct that Grice Engineering is in default to the bank, it does not have a right to receive the payments under the note at this time.

[15] Section 4(c) of the subordination agreement provides: "Subordinate Creditor acknowledges and agrees that Senior Creditor *may*, at any time and from time to time, exercise any of its rights and remedies pursuant to the Senior Loan Document, at law, in equity or otherwise, without any duty, obligation or liability to Subordinate Creditor whatsoever." (Emphasis added.)

¶46 Innovations appears to suggest that the bank is making unreasonable decisions in lending money to Grice Engineering after the closing and Innovations could not have anticipated that it would act unreasonably. Assuming without deciding that this is relevant to the issue of substantive unconscionability, Innovations points to no factual submissions that support this suggestion.[16]

¶47 Finally, Innovations' arguments—and the circuit court's analysis—rely in part on the proposition that Grice Engineering unfairly benefits from the standstill clause at Innovations' expense. However, the subordination agreement is between Innovations and the bank. No doubt Grice Engineering benefits from the agreement, which presumably was necessary for the bank's agreement to lend it money. However, as we have already explained, Innovations benefited as well. The inability to pursue remedies against Grice Engineering now does not alter Grice Engineering's obligations to it under the asset purchase agreement and note. What Innovations characterizes as the unfair benefit to Grice Engineering—not paying Innovations now—is in reality a benefit to the bank: Grice Engineering has more money to pay the senior debt which, according to Innovations, is in default. This benefit to the bank is plainly what the subordination agreement provides for,

[16] Innovations' argument in paragraph 46 appears to be more relevant to a claim that the bank breached the duty of good faith and fair dealing implied in every contract than to a claim of unconscionability. Innovations argued a breach of this duty in its brief in the circuit court but does not make a separate argument on this ground on appeal. However, even if we view Innovations' assertion—that the bank has acted unreasonably in lending to Grice Engineering after the closing—within the framework of a breach of the duty of good faith and fair dealing, the same problem exists. There are no factual submissions demonstrating that the bank acted unreasonably in a manner that could not have been contemplated by the parties, given the express terms of the agreement. Under Illinois law, "parties to a contract are entitled to enforce its terms to the letter, and an implied covenant of good faith cannot overrule or modify the express terms of a contract." ***Bank One, Springfield v. Roscetti***, 723 N.E.2d 755, 764 (Ill. App. Ct. 1999) (citation omitted).

and Innovations points to no factual submissions that show it is commercially unreasonable.

¶48 We conclude that Innovations has not made a prima facie showing that the subordination agreement and, in particular, the standstill clause, is unconscionable. Accordingly, the circuit court erred in granting summary judgment to Innovations on this issue and instead should have granted summary judgment to the appellants**.** It follows from this conclusion that the circuit court should have granted the appellants' motions to dismiss Innovations' counterclaims and third-party claims and should have denied Innovations' motion to enforce the stock pledge agreements.

III. Default and Setoff

¶49 Our conclusion that the subordination agreement bars Innovations' counterclaims and motion to enforce the stock pledge agreements makes it unnecessary to decide whether Grice Engineering is in default under the note for purposes of these claims. However, as we understand the record, Innovations is also asserting this default as a defense to Grice Engineering's claims of breach of the restrictive covenants, and those claims remain to be tried. We therefore address this issue.

¶50 Grice Engineering acknowledges that it has not made payments called for under the note, but it asserts it is not in default because of the setoff provision in the asset purchase agreement. The amount of the setoffs to which it is entitled, according to Grice Engineering, is greater than the payments it has not made under the note. Grice Engineering's position is that its affidavits are sufficient to entitle it to a trial on the amount of the setoffs.

¶51 The setoff amounts claimed by Grice Engineering fall into two categories: damages for breach of certain of Innovations' representations and warranties in the asset purchase agreement and damages from Innovations' and Gordon Grice's breach of the restrictive covenants. As evidence of the first category, the appellants refer to Liddell's and Johnson's affidavits, which aver that Innovations and Gordon Grice made material misstatements to them prior to the sale that resulted in damages of at least $1.5 million dollars. The affidavits describe with some specificity the types of misstatements but do not further explain the basis for the $1.5 million dollar figure. As evidence of the second category, Grice Engineering relies on this averment in both affidavits:

> Based on documents produced to Grice Engineering by Grice Innovations, Grice Innovations has contacted solicited [sic] several actual or potential Grice Engineering customers for business. Grice Innovations has succeeded in winning at least one job from Sierra Detention Systems, a company that Grice Engineering had done business with as recently as this year and which has paid Grice Engineering $150,902.14 in the past year.

¶52 Innovations contends that, for a number of reasons, these affidavits are insufficient to show that it owes Grice Engineering anything. We need not address these objections to the affidavits because we conclude that the plain language of the purchase agreement resolves the setoff issue against Grice Engineering. We turn to an examination of this agreement.

¶53 The asset purchase agreement provides that it is governed by Wisconsin law. Under Wisconsin law, as under Illinois law, the primary goal in contract interpretation is to give effect to the parties' intent, as expressed in the contractual language. ***Maryland Arms Ltd. P'ship v. Connell***, 2010 WI 64, ¶22, ___ Wis. 2d ___, 786 N.W.2d 15. When the contract terms are clear and unambiguous, we construe the contract according to its literal terms. ***Id.***, ¶23.

¶54 The setoff provision on which Grice Engineering relies, section 8.7, provides that it

> shall have the right to recoup and set off any amounts owing to it or any other Purchaser Indemnified Party from any Indemnity Claims against any and all amounts due or to become due to any Seller from Purchaser under this Agreement, the Promissory Note, [and] any agreement entered into in connection herewith or otherwise.

Grice Engineering contends that it can exercise its rights of recoupment and setoff under this setoff provision at its discretion, in an amount it determines, and without providing notice to Innovations. We disagree. We conclude the unambiguous language of this section read together with related provisions in the same article permits a setoff without a judicial adjudication only if certain events occur, and these events did not occur.

¶55 Because section 8.7 limits "set-offs" to "Indemnity Claims," it is necessary to consider that definition. An indemnity claim means "a claim for indemnification pursuant to Article VIII."[17]

¶56 Article VIII describes the parties' indemnification rights. Section 8.6 describes the indemnification claim procedure in situations where an indemnified party has a claim against an indemnifying party that, as here, does not involve a third-party claim. Under section 8.6, Grice Engineering must send Innovations a written notice that describes the nature of its claim and the basis for the request for indemnification. After receiving the notice, Innovations has thirty days to notify Grice Engineering that it disputes the claim. If Innovations does not

[17] "Claims" are defined as "all claims, complaints, charges, claims [sic], actions, suits, proceedings, disputes and investigations."

dispute the claim, then the claim "shall be deemed a Liability of [Innovations] hereunder, with respect to which [Grice Engineering] is entitled to prompt indemnification hereunder."

¶57 Thus, in order to be entitled to a setoff under section 8.7, Grice Engineering must first be entitled to a "prompt indemnification" under section 8.6. This, in turn, requires the prescribed notice of the claim and absence of a response disputing the claim within thirty days.

¶58 It is undisputed that Grice Engineering first notified Innovations of its indemnity claim for breaches of warranties and representations on May 7, 2009. This notice occurred well after the date when Grice Engineering stopped making payments, which was before March 20, 2008. However, we need not decide the effect, if any, the notice has on payments not made before the date of the notice. The very next day after receiving the notice, Innovations filed a complaint alleging, among other things, breach of contract for failure to pay amounts due on the note. *See* footnote 4. This complaint plainly constitutes a timely dispute of Grice Engineering's claim in the notice, as required under section 8.6. Thus, the claimed setoff did not become a liability of Innovations entitling Grice Engineering to "prompt indemnification."

¶59 With respect to Grice Engineering's claim of a setoff for breach of the restrictive covenants, the May 7, 2009, notice did not refer to that breach. Grice Engineering points to no notice with respect to that claimed setoff.

¶60 Grice Engineering contends that there is no "condition precedent" of a judicial determination before it is allowed to exercise its rights under section 8.7. However, as we have already explained, there is no right to a setoff under sections 8.6 and 8.7 unless notice has been given and Innovations has not disputed the

claim within thirty days. The only reasonable construction of these sections is that, if Innovations does make a timely objection to the notice of an indemnity claim, Grice Engineering must resort to whatever judicial remedies it has outside the contract.

¶61 Other provisions in article VIII are consistent with this construction. In particular, section 8.1(b) addresses indemnification claims due to breaches of warranties and representations and limits suits for these indemnity claims to thirty-six months from the closing, with certain exceptions. One of the exceptions, found in section 8.1(b)(iv), is when the person entitled to indemnification under article VIII has "asserted in writing a specific Indemnity Claim" prior to that thirty-six month deadline; in that case those "representations and warranties shall continue in effect and remain a basis for indemnity with respect to each such asserted Indemnity Claim until such Indemnity Claim is finally resolved (*pursuant to a non-appealable order by a court of competent jurisdiction or agreement of Seller and Purchaser*)" (emphasis added).

¶62 These provisions plainly contemplate adjudication of indemnity claims even after notice has been given—specifically, when there is a timely response disputing the claim. These provisions are inconsistent with Grice Engineering's proposed construction that as long as it gives a notice (or even if it doesn't), it can set off what it claims it is entitled to regardless of Innovations' response.

¶63 Because we conclude that, based on the undisputed facts, Grice Engineering is not entitled to a setoff under section 8.6 for its claims of breach of warranties and representations and breach of restrictive covenants, it is in default under the note. Accordingly, it is not entitled to a trial on the issue of whether

there is a default. As for the amount of the default—if that is relevant to any issue that remains to be litigated—nothing in this opinion precludes a trial on the amount.

CONCLUSION

¶64 We conclude, based on the undisputed facts, that the stock pledge agreements are covered under the standstill clause of the subordination agreement, and the subordination agreement is not unconscionable. We therefore reverse the circuit court's decision to grant Innovations' motion to enforce that agreement and remand with directions to deny the motion. Our conclusion that the subordination agreement is not unconscionable also requires dismissal of Innovations' counterclaims and third-party claims, given that Innovations makes no argument that these claims may proceed even if the agreement is not unconscionable and the standstill agreement is construed as we have done. We therefore reverse the circuit court's decision to deny the motions to dismiss Innovations' counterclaims and third-party claims and remand with instructions to grant the motions. Finally, we conclude that, based on the undisputed facts, Grice Engineering is in default under the note.

By the Court.—Order reversed and cause remanded.

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