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News & Types: Commercial, Competition & Trade Update

Parties Held To Contract; Investor In Distressed Loans Loses Chance At Windfall

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Practices: Litigation

Courts, especially the 7th Circuit Court of Appeals, are noted for holding parties to the terms of their contract, particularly sophisticated commercial parties who are expected to know what they are getting into. (See, for example, "Borrower Escapes, But Guarantor Does Not, on $17 Million Debt", May 2, 2014 Risk Management Update; "Former NBA Star Has to Take His Game to Another Level – Appeals Court Refuses to Enforce NBA Star's Personal Guaranty", August 1, 2013 Risk Management Update; "Limitation of Liability Contract Provision Enforced – Hotel Owner Loses $4.1 Million", July 8, 2013 Risk Management Update)

Sure enough, in a recent case written by Chief Judge Wood, the 7th Circuit took advantage of a "straightforward case" to again display their freedom of contract philosophy. (*Southern Financial Group, LLC v. McFarland State Bank*, 7th Circuit Court of Appeals, No. 13-3378 August 15, 2014)

On Friday, January 28, 2011, Evergreen State Bank, Stoughton, WI was closed by the Wisconsin State Department of Financial Institutions, and the Federal Deposit Insurance Corporation (FDIC) was named Receiver. Most of its assets were transferred to McFarland State Bank ("McFarland"), including a loan portfolio with an unpaid balance of $4.42 million. The loan portfolio was secured by 19 properties in Wisconsin.

The loan portfolio caught the attention of Southern Financial Group, LLC ("SFG"), which the court called "a sophisticated player in the distressed-loan business." SFG purchased the loan portfolio, secured by the 19 properties, for $1.27 million (or 28.8¢ per dollar). While the financial terms seemed very favorable to SFG, McFarland was able to negotiate some protections for itself. The critical provision in the Agreement transferring the loan portfolio was the provision limiting remedies in the case of breach by McFarland:

"If such breach or failure is not duly cured within [a] thirty (30) day period . then Seller [McFarland] shall elect, in its sole discretion to either (i) repurchase [the] Loan at the Repurchase Price, or (ii) pay to Buyer [SFG] the Buyer's actual damages directly caused by such breach, up to an amount not exceeding the Repurchase Price. The remedies set forth in this Section 6.3(b) shall be the exclusive remedies of the Buyer for any breach by Seller . . . . ."

One of the representations in the Agreement was that the real estate securing the loans had not been released. Unfortunately for McFarland, it turned out that three of the 19 properties had been released before

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the loan portfolio was transferred to SFG. Ultimately, McFarland admitted its breach. SFG demanded damages. But McFarland paid nothing. Why?

While McFarland and SFG were negotiating the breach and the damages, SFG was able to sell 13 of the remaining 16 properties with proceeds of $1.31 million. To both the district court and the 7th Circuit Court of Appeals, by applying the limited remedies negotiated in the Agreement, it was a simple mathematical comparison. $1.31 million (the amount that SFG received for the 13 properties) is greater than $1.27 million (the "Repurchase Price", with minor adjustments, in the Agreement). Since SFG's remedies in the Agreement could not exceed the Repurchase Price, SFG had already received the benefits which it had negotiated in the Agreement. But SFG was not done and made some valiant, but fruitless, efforts to wring more money out of the transaction.

First the court noted that Wisconsin permits parties to an agreement to limit remedies for breach of contract and to disclaim consequential damages.

"We see no reason to reject the parties' allocation of risk, even if this means that SFG will be uncompensated for McFarland's breach. Wisconsin courts enforce agreements in which parties allocate risk in advance. . . . SFG is a sophisticated, repeat player in the distressed-assets business. It could have negotiated a different contract had it wanted to shift more risk to McFarland. In that case, however, McFarland might have demanded more than 29 cents on the dollar for the portfolio."

But SFG argued further that the limited remedies of the Agreement "failed of essential purpose." Therefore, remedies outside the Agreement should be available to SFG. The court's initial response to SFG's argument was that it assumes that Wisconsin (the governing state law) interprets UCC Article 2 (governing the sale of goods) to apply to the purchase of a loan portfolio.

(As an aside, it is curious why the court made this comment in connection with failure of essential purpose, but not in connection with the exclusion of consequential damages. After all, both are concepts included in UCC Article 2. Consequential damages are recoverable under UCC 2-715, but also excludable under UCC 2-719. A contractual limitation of remedy could become unenforceable under UCC 2-719. But the concept of consequential damages goes back at least to the famous 19th century English case studied by law students, *Hadley v. Baxendale*. So it is a concept in the common law predating UCC Article 2 (i.e., the early 1950s). But the court apparently felt the concept of failure of essential purpose to be part of UCC Article 2, and not part of the common law. Thus, it had to discuss whether a concept introduced in UCC Article 2, governing the sale of goods, was even applicable to the sale of a loan portfolio.)

The court actually considered SFG's argument that the remedies failed of their essential purpose, not because it necessarily agreed that the concept applied to the Agreement selling the loan portfolio, but because it made no difference in the result. The limited remedies did not fail of their essential purpose.

A contractual remedy fails of its essential purpose "when the remedy is ineffectual or when the seller fails to live up to the remedy's provisions", depriving the buyer of the benefit of the bargain. Neither of those conditions was present in this case. The fact that, in this case, SFG received no compensation for breach does not mean the remedies failed of their essential purpose. Said the court, "Indeed, the whole point of limiting remedies is to

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make some remedies unavailable." The Agreement contemplated the scenario which actually took place, i.e., a breach of the warranty that the collateral had not been released. It provided a corresponding limited remedy. "An agreed remedy does not fail of its essential purpose because it results in the party that bears the risk suffering the risk. Rather, it fails only where a party is unfairly deprived of the substantial value of its bargain."

But SFG had already received the benefit of its bargain through its resale of 13 of the remaining 16 properties. The court raised an alternative scenario that would have been open to SFG. SFG could have delayed or rejected the sales of the 13 properties. This would have preserved the remedy against McFarland. But SFG obviously made the same mathematical comparison that the court did and approved the sales of the 13 properties for an amount exceeding the Repurchase Price.

SFG even argued that, by disputing the breach and the extent of its liability, McFarland had waived the limited remedy. But the court made short work of this argument, both on contract grounds and on non-waiver grounds. The Agreement did not require to elect a remedy within a certain deadline. Further, "[I]n the absence of specific contractual language to the contrary, a party does not waive its right to insist on contractual limited remedies by disputing its liability."

In reading the case, one obvious claim that is not mentioned is fraud. Did McFarland knowingly and willfully conceal the fact that three of the properties had been released? This appears not to be the case. In an aside, the court cited "colorable arguments" that McFarland raised that the releases were in public documents and could have been discovered by SFG. This would explain why SFG never made a fraud claim and further weakens SFG's claim for damages.

Concluded the court, "Except in the most extraordinary circumstances, we hold sophisticated parties to the terms of their bargain. The terms of the parties' bargain in this case results in zero recovery for SFG."

This case again illustrates that the 7th Circuit Court of Appeals has the "Unwelcome" mat out for sophisticated business parties that want to avoid the bargain they negotiated and get more than the agreement would otherwise permit.

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