K Drafting- Indemnities

Time Limitations

One way to avoid the uncertainty caused by issues such as merger, the collateral promise rule,[15] and survival is to include a "time limits" provision for claims by each party. A time limits provision should first disclaim post-closing liability broadly, and then specify exceptions to this general rule. For example:

12.4 Time Limits; Buyer's Claim.

If the closing occurs, the Seller will have no liability under this Agreement except for claims arising under [specific sections] that are asserted by the Buyer against the Seller by no later than one year after the date of closing, written notice specifying the factual basis of the claim in reasonable detail, given under section 12.5 of the Agreement.

6. Guaranties, Indemnities, and Releases.

a. Guaranties

A guarantor is one who promises that, if another party does not perform a duty, the guarantor will. BLACK'S LAW DICTIONARY 773 (9th ed. 2009). A guarantor is not a party to the primary contact. The guarantor stands behind the primary obligor, promising to perform those obligations if the primary obligor does not do so.

The word "guarantee," when used in the colloquial sense of a warranty (on your microwave oven, for example) has one spelling, and "guaranty," when used in its formal legal meaning (a promise to perform a third party's obligation) has a different spelling. There should be no double-e guaranties in your contracts.

If the beneficiary of the guaranty wants a right of direct action against the guarantor without first needing to pursue the primary obligor, the drafter should use a guaranty-of-payment provision, rather than a guaranty-of-performance provision. The following is an example of guaranty-of-payment language:

> In consideration of the sale of goods and the extension of credit to the Buyer, [name of guarantor] ("Guarantor") hereby guaranties to Seller payment of the balance of the purchase price on the terms stated above. Upon default in payment of any or installment of the credit extended or in the performance of any requirement or provision contained in the security between Buyer and Seller, Guarantor shall, upon demand, pay the full amount of the unpaid purchase price with accrued interest.

[15] Michael Madison, *The Real Properties of Contract Law*, 82 B.U. L. REV. 405, 429-30 (2002); *see also* Paul Teich, *A Second Call for Abolition of the Rule of Merger by Deed*, 71 U. DET. MERCY L. REV. 543 (1994). The collateral promise rule is an exception to the merger rule. If a real estate purchase agreement, for example, contains covenants other than those that will merge into and appear in the deed, a court may find that these covenants are part of a portion of the purchase agreement that is severable and that survives the closing and may be sued upon notwithstanding the doctrine of merger. In fact, some would suggest that the doctrine of merger has never been as absolute as it is often characterized in property law courses and casebooks due to the collateral promise rule.

Contrast it with the following guaranty-of-performance language:

> This guaranty is conditional and is guaranty of collection only. Guarantor shall not be obligated to make any payment under this guaranty until all attempts to collect from obligor, with due diligence and using reasonable legal means, have failed.

Further, the creditor should negotiate a waiver of the guarantor's exoneration rights which may arise by operation of law from events such as a change in the principle obligation without the surety's consent. Typically, this sort of waiver language is in the form:

> Notice of acceptance of this guarantee, notices of non-payment and non-performance, notices of amount of indebtedness outstanding at any time, protests, demands, and prosecution of collection, foreclosure, and possessory remedies are hereby expressly waived.
>
> It is understood and agreed that the liability of Guarantor shall not be affected by any settlement, extension, or variation of terms of the security agreement or by the discharge or release of any obligation of the buyer or any other interested person, by operation of law or otherwise.

b. Indemnities

An indemnity is a collateral contractual obligation where one party, the indemnitor, engages to hold another, the indemnitee, harmless from losses to third parties. BLACK'S LAW DICTIONARY 837 (9th ed. 2009). A common indemnity is one that covers any losses from a breach or inaccuracy of any representation or warranty in the agreement. The indemnitor need not be the other party to the contract. Like guaranties, indemnities are only as good as the indemnitor.

The basic issues that arise with indemnities are related to scope. Scope of indemnification is defined or limited by (i) the time period during which claims can be asserted, (ii) the time period during which the event underlying the claim occurred, (iii) the minimum and maximum amount of any claim or of all claims in the aggregate, or over a particular period of time, (iv) the damages covered (actual pecuniary loss to third parties, consequential damages, punitive damages, liquidated damages), and (v) the mechanism for presenting claims and solving disputed claims. But, unlike guarantors, an indemnitor is usually a party to the primary contract. Typically, the indemnity arrangement provides that A agrees that if B becomes liable to a third person, A will pay B the amount of B's liability to the third person.

The scope of an indemnity agreement typically falls into one of three categories: limited,

intermediate, and broad. A limited indemnity agreement will obligate the indemnitor to indemnify the indemnitee only to the extent of the indemnitor's own fault. An intermediate indemnity agreement obligates the indemnitor to assume all of the liabilities of the indemnitee, except where the injury or damage has been caused by the indemnitee's own negligence. A broad indemnity agreement obligates the indemnitor to hold the indemnitee harmless for *all* liabilities, even if the injury or damage is due solely to the indemnitee's own negligence.

c. Releases

A release of a right, claim, or privilege is a cancellation of the right to assert a right, claim, or privilege. BLACK'S LAW DICTIONARY 1292 (7th ed. 1999). A similar result may be achieved by assignment of the claim, which can have other different effects that are useful in creatively structuring a transaction, such as maintaining the subordinate priority of other claims or one party's judgment-proof status.

7. Cautionary Procedures.

At the outset, consider including a master provision that eliminates or disclaims, as far as legally possible, all express or implied representations, warranties, covenants, indemnities, and releases except as expressly provided in the contract. This is an attempt to wipe the slate clean of common law and statutorily implied provisions such as the UCC's warranty of merchantability or fitness for intended use provisions. *But see* U.C.C. § 2–316(1) (disclaimers of express warranties in conflict with apparent warranty will be inoperative if that construction is unreasonable); U.C.C § 2–316(2), (3) (disclaimer of implied warranties with specific disclaimers, general disclaimers, buyer inspections, and course of performance). A disclaimer of warranties may be subject to different, peculiar drafting requirements that seem to indicate the potential judicial hostility to overreaching disclaimers and releases obtained by economically dominant parties. Include a merger or integration clause to trigger the parol evidence rule to exclude evidence of any statements that could be construed as agreements, representations, warranties, covenants, etc. made during negotiations or earlier rounds of documentation.

Though some courts may be wary of enforcing broad disclaimer provisions, others are not. The following case illustrates just how important disclaimers can be.

MEEHAN v. UNITED CONSUMERS CLUB FRANCHISING CORP.
United States Court of Appeals, Eighth Circuit

312 F.3d 909 (2002)

RILEY, Circuit Judge.

[1] Harry D. Meehan, Jr., and Harry D. Meehan, Sr., (Meehans) entered into a franchise agreement with appellees United Consumers Club Franchising Corp., United Consumers Club, Inc., and National Management Corporation (collectively, Consumers Club). Appellee Jack Allen (Allen) negotiated the franchise agreement on behalf of Consumers Club. The franchise allowed the Meehans to sell memberships to the general public in a merchandise and services buying club. The