

Contractual Mechanics: Covenants, Conditions, Representations, Warranties, Guaranties, and Indemnities

George W. Kuney



George W. Kuney is a California and Tennessee attorney and the W.P. Toms Distinguished Professor of Law and Director of the Clayton Center for Entrepreneurial Law at The University of Tennessee College of Law. He is the author or coauthor of a number of books and articles on bankruptcy, contract, business, and intellectual property law, as well as legal writing and drafting, including the treatise *California Law of Contracts*, published by CEB and updated annually. Professor Kuney holds a B.A. in economics from the University of California, Santa Cruz; a J.D. from the University of California, Hastings College of the Law; and an M.B.A. from the University of San Diego. <http://www.law.utk.edu/faculty/kuney/index.shtml>.

INTRODUCTION

This article defines covenants, conditions, representations, warranties, guaranties, and indemnities and describes their purpose and effect in transactional documents. The author acknowledges and thanks Steven O. Weise, whose 1994 article, *Bringing Further Clarity to Agreements: The Use of Warranties, Guaranties, and Indemnities*, 9 Cal Bus L Prac 73 (Spring 1994), started this taxonomy and discussion of these important contract terms. Like that article, this article uses the example of a sale of substantially all the assets of a business to illustrate the concepts involved.

Covenants, conditions, representations, warranties, guaranties, and indemnities are among the essential mechanical levers and pulleys that make a contract or other transactional document work. They are often highly negotiated by counsel, if not also their clients, in a business transaction, and are quite important in allocating risk among the transaction's participants. They are, however, often labeled and used incorrectly, which may lead to unexpected and unintended results when it is time to seek enforcement of the document. The result may be that the provisions are construed more broadly or narrowly than intended, providing the other party with unintended defenses to enforcement or allowing a court to characterize the provision as something other than what was intended.

Transactional drafting involves three main goals, all of which are really "sales pitches." The drafters are (1) selling the parties on entering into the transaction at the time of contracting, (2) selling the parties on voluntary performance after entering into the transaction, and (3) selling a future court on enforcement of the contract if voluntary performance is not forthcoming. The contractual provisions discussed in this article can assist all three of these objectives.

Covenants, conditions, representations, warranties, guaranties, and indemnities are interrelated and reinforce each other. For example, a represented fact will induce a party to enter into negotiations. If the fact is discovered to be false before closing of the deal, a misrepresentation action will support rescission or damages. The subject matter of the representation may also be cast as a warranty that survives closing and provides a route for a post-closing damages recovery. If the warranty is breached or is incorrect, a covenant may also be used to create a duty on the part of the warranting party to ensure that the facts are or become as they were warranted. Finally, an indemnity or a guaranty provides additional support for recovery of damages.

The focus, then, is on choosing the right provision for the intended purpose. The drafter should focus on the desired remedy first. For example, if certain facts are misstated, what remedy would the client wish to seek? The drafter should select the

type of remedial provision that will produce a claim that is ripe when needed, that is directed at the appropriate, solvent defendant, and that provides the chosen remedy.

If a dispute arises, the prior adoption of the proper type of remedial provision in a particular circumstance should produce the results that the parties intended at the time of contracting. This means that the result of an action to enforce the contract should be predictable and certain when the contract is examined and the parties are assessing their options. This predictability and certainty, in turn, should lower transaction and litigation costs and increase efficiency in the negotiation, performance, and enforcement of the agreement.

If an agreement uses incorrect terminology to characterize these provisions, the mischaracterization may lead a court to apply the legal rules applicable to the provision as labeled. This, of course, may lead to uncertainty, the cost and expense of litigation, and possibly the wrong result. This article turns now to examining each of these provisions in more detail.

COVENANTS

Covenants are promises. They are the contractual provisions that create contractual duties and constitute the consideration that supports enforceable contracts. Black's Law Dictionary 419 (9th ed 2009).

They are manifestations of intentions to act or refrain from acting in a specified way, which are made in a way that justifies the other party to understand that a commitment has been made. Restatement (Second) of Contracts §2 (1981). See California Law of Contracts §6.32 (Cal CEB 2007).

A functional statement of a covenant reads as follows: "Party A shall [specify action or inaction] [give time perimeters]." When drafting, counsel should test covenants to be sure that they are phrased in the active voice and clearly state (1) who is to do (2) what (3) to or for whom (4) when, and (5) in what manner, quality, or quantity.

Covenants may be express (stated in words) or implied (based on the circumstances), although implied covenants are disfavored. *Ben-Zvi v Edmar Co.* (1995) 40 CA4th 468, 473, 47 CR2d 12. In California, five conditions must be met before a covenant will be implied (*Marriage of Corona* (2009) 172 CA4th 1205, 1222, 92 CR3d 17 (summarizing California case law)):

1. The implication must arise from the language used or it must be indispensable to effectuate the intention of the parties;

2. It must appear from the language used that the implied term was so clearly within the contemplation of the parties that they deemed it unnecessary to express it;

Example

A seller desires to sell the assets of a business to a buyer. The buyer is to pay for the business with a down payment and a note secured by the assets and by other property already owned by the buyer. Covenants, conditions, representations, warranties, guaranties, and indemnities may be used in this transaction in the following manner:

- The seller will *covenant* to transfer the assets to the buyer, and the buyer will *covenant* to pay the down payment and issue the secured promissory note at closing.
- A *condition* will link the covenant to transfer assets to the covenant to pay and issue the note as mutual and dependent covenants; thus, the failure of either one will excuse performance of the other.
- To entice the buyer into entering into the contract, the seller will use *representations* to make statements about the condition of the assets to be sold and the past financial performance of the business.
- The seller may *warrant* to the buyer that the assets sold are free from defects or contamination or that the seller's financial statements have been prepared in accordance with generally accepted accounting principles and are accurate.
- A third party may *guarantee* to the seller that the third party will pay to the seller any amounts owed by the buyer under the note.
- A shareholder of the seller may *guarantee* to the buyer that the seller's warranties are correct.
- The seller may *indemnify* the buyer against any liability the buyer may incur to a third party as a result of a defect in the assets or, e.g., from contamination on the subject property giving rise to environmental clean-up obligations.
- The buyer/borrower may *indemnify* its creditor against any liability the creditor may incur to a third party as a result of a defect in the assets or, e.g., from contamination on the subject property giving rise to CERCLA clean-up obligations.

3. The implied covenant must be justified on the grounds of legal necessity;

4. The implied covenant must be one for which it can be rightfully assumed that the parties would have made it expressly if the parties had been paying attention to the issue; and

5. The subject of the implied covenant must not be otherwise completely covered by the contract.

See also *California Law of Contracts* §6.33 (Cal CEB 2007).

In the example above of a sale of substantially all the assets of a business with seller financing, covenants would provide for the buyer to make the down payment and to provide a note, security agreement, and deed of trust to secure the obligation to pay the balance of the purchase price; for the buyer to maintain adequate insurance coverage for the collateral; and for the seller to transfer the assets to the buyer at closing.

When drafting covenants, counsel should consider what degree of performance will be required. Some covenants are unqualified and provide that a party shall do something, period. Alternatively, they may be drafted in terms of "best efforts," "commercially reasonable efforts," or "reasonable efforts." When drafting or reviewing covenants, counsel should consider whether language qualifying the obligation is appropriate and whether reference to an objective measurement or statement really adds any certainty. Gratuitous, unnecessary adjectives and adverbs should be eliminated; if they are not, a party or a court may later assign them an importance that was not intended.

CONDITIONS

Express conditions are the mechanisms that control how a transaction progresses. They are events that are not certain to occur but that give rise to or modify contractual duties. CC §1434. Conditions precedent trigger or cause duties to ripen; conditions subsequent "un-trigger" or modify duties that are already ripe for performance. See generally *California Law of Contracts* §§6.41-6.50 (Cal CEB 2007).

When the condition relates to the occurrence of an event outside the control of the parties (*e.g.*, death, calamity, effectiveness of a government regulation, a change in a cost-of-living index), the condition adjusts the transaction to the change. For example, a lease may contain a rent escalator clause that increases the rent based on increases in a cost-of-living index. The condition is the increase in the

cost-of-living index; the effect of the condition's occurrence is the increase in rent.

When the condition relates to an event that is in the control of one or more of the parties, most commonly when the condition is the performance of a covenant by a party, the condition ensures that each party's duties arise and ripen at precisely the time needed to ensure that the parties' performances are properly ordered. For example, a construction contract may provide for periodic payments to the contractor as work progresses, conditioned on submission of a pay application to the project architect who is to certify that the job is *x*-percent complete and that the progress payment is appropriate. The contractor's work and the architect's certification are two express conditions to the owner's duty to make a progress payment to the contractor, which ripens when these events occur.

By negotiating broad subjective conditions, the buyer can more easily walk away if due diligence reveals that the facts are other than as expected or can take the opportunity to renegotiate contract terms later in exchange for a waiver of the condition.

Conditions must be carefully drafted and integrated into the rest of the contract. First, counsel must take care to draft the condition so that its terms are clear. Conditions generally trigger duties ("shall clauses") or rights ("may clauses"). The reader must be able to determine when the condition is satisfied and, if not, what consequences follow. Word choice is key.

In most contract negotiations, one party (normally, a seller or a borrower) will seek to include very few conditions, especially conditions to closing or any other event when the other party must part with value, while the other side will want many. In the purchase and sale agreement example above, the seller will try to limit the conditions to closing to as few objective conditions as possible, such as any needed third party approvals. These objective conditions are generally subject to a limitation of reasonableness on the buyer's discretion, unless the contract specifies otherwise. By thus limiting the conditions, the seller is seeking to lock the buyer into the deal and restrict the buyer's ability to walk away based on a failed condition to closing.

The buyer or lender, on the other hand, will want to build in many conditions and to keep the condi-

tions subjective and dependent on the buyer's or seller's own judgment. These subjective conditions are subject only to a limitation of good faith on the buyer's discretion. By negotiating broad subjective conditions, the buyer can more easily walk away if due diligence reveals that the facts are other than as expected or can take the opportunity to renegotiate contract terms later in exchange for a waiver of the condition. For example, a buyer may seek to include a condition that its due diligence will conclude with satisfactory results, as judged by the buyer in its sole discretion. This sort of condition can also be framed as a "lack of material adverse change" condition to closing. See *Nichols v Canoga Indus.* (1978) 83 CA3d 956, 960, 148 CR 459. See generally *In re IBP, Inc. Shareholders Litig. v Tyson Foods, Inc.* (Del Ch 2001) 789 A2d 14 (refusing to allow party to invoke material adverse change provision to cancel merger and discussing relevant case law); Kuney, *Material Adverse Change Clauses*, 23 CEB Cal Bus L Prac 101 (Fall 2008).

REPRESENTATIONS AND WARRANTIES

Representations

Classically, a *representation* is a statement of presently existing facts that is intended to induce reliance and action by a party, such as entering into a contract. Black's Law Dictionary 1415 (9th ed 2009). See also *California Law of Contracts* §6.2 (Cal CEB 2007). An incorrect representation will support an action for rescission or damages sounding in contract (and tort, if fraud is present).

Representations are generally drafted in this form: "[Buyer, Seller, or other defined term] represents [representation carefully stated as to scope and substance]." Representations should normally be drafted in the present or past tense, not the future tense, to prevent them from being interpreted as covenants.

Unless otherwise specified, the representation speaks as of the execution of the document in which it is contained. Pre-closing representations may terminate at the time of closing by operation of law unless the contract specifies that they survive the closing, which they normally should unless the parties intend to cut off liability for misrepresentation at that point.

Warranties

Classically, a *warranty* is a statement made about certain facts whereby the warrantor promises to ensure that those facts are as stated. Black's Law

Dictionary 1725 (9th ed 2009). See also *California Law of Contracts* §6.7 (Cal CEB 2007). A breached or incorrect warranty will support an action for damages sounding in contract that, in a non-Uniform Commercial Code context, does not survive the closing absent a provision in the contract to the contrary (a "survival clause"). *Western Filter Corp. v Argan, Inc.* (9th Cir 2008) 540 F3d 947, 952 ("Unless the parties agree to a survival clause—extending the representations and warranties past the closing date—the breaching party cannot be sued for damages post-closing for their later discovered breach."). The rule of nonsurvival or merger into the deed or other transfer document appears to be a default rule that can be overcome by evidence of non-integration or, put another way, evidence that the representation or warranty was a "collateral agreement." See *Szabo v Superior Court* (1978) 84 CA3d 839, 148 CR 837 (1978); Teich, *A Second Call for Abolition of the Rule of Merger by Deed*, 71 U Det Mercy L Rev 543 (1994). The best practice is to include a survival clause for all representations and warranties that the seller expects to enforce post-closing to avoid the issue.

For example, in *Linden Partners v Wilshire Linden Assocs.* (1998) 62 CA4th 508, 524, 73 CR2d 708, 717, the agreement at issue obligated the sellers to deliver "true, accurate and complete copies of all leases and other contracts" containing "no untrue statement of material fact" and further provided that the sellers' related representations and warranties "shall survive the close of escrow." As a result, the buyers had a cause of action for breach of warranty and misrepresentation and a contract remedy after the close of escrow when the sellers' estoppel certificate stating the purported rent paid by a tenant proved to be inaccurate.

In any case, the best practice is for the contract to explicitly address the issue of survival, and the forms provided in the most authoritative collections of forms and exemplars do so. See, e.g., *Drafting Business Contracts: Principles, Techniques & Forms* §§17.21–17.22 (Cal CEB 1994).

Warranties are generally drafted in this form: "[Buyer, Seller, or other defined term] warrants that [warranted facts carefully stated as to scope and substance]." Like representations, warranties should be drafted in the present or past tense, not the future tense, to prevent them from being interpreted as covenants.

Typical Examples

Typical representations and warranties include (1) the party is duly organized, in good standing, and

authorized to enter in the transaction; (2) the transaction is not a breach of any other agreement and does not violate the law; (3) a seller or lessor has good title to all assets being sold or leased, and those assets are free of liens and encumbrances; and (4) all material facts have been disclosed. Each is often phrased as “except as disclosed on schedule X to this agreement, [representation or warranty].” This structure makes the provision more than just a representation or warranty—it becomes a due diligence tool that shifts the burden of finding and discussing exceptions to the statement to the representing and warranting party. Representations and warranties of this type are often combined with a covenant to defend against claims that are adverse to any of the representations and warranties and an indemnification against losses caused by inaccurate representations or warranties.

Risk Allocation

One major distinction between representations and warranties, at least analytically, is that while representations focus on the truth of the matter asserted in the provision, warranties are about allocating risk, which implicates pricing. In other words, when thinking about the warranty function of a provision, the drafter should focus on who bears the loss if the fact does not exist as warranted, not whether or not it is true. The level of risk affects the purchase price or interest rate to be charged. This is different from a representation, which is wholly concerned with whether a fact is true or not, a binary go/no-go function that may allow a party to rescind the contract and avoid any obligation to close the transaction. Thus, it may be appropriate for a party to make a warranty but not a representation concerning the particular fact at issue.

Note that the distinctions between representations and warranties are blurring, due in part to the common practice of drafting the provisions as joint representations and warranties. One commentator has even suggested that the distinction be scrapped and the entire subject be addressed by a provision called simply a “representation.” See Adams, *A Lesson in Drafting Contracts: What’s Up with “Representations and Warranties,”* 15 ABA Bus L Today No. 2 (Nov/Dec 2005), at 32, available at <http://www.abanet.org/buslaw/blt/2005-11-12/adams.shtml>. See also Stark, *Nonbinding Opinion: Another View on Reps and Warranties,* 15 ABA Bus L Today No. 3 (Jan/Feb 2006), at 8, available at <http://www.abanet.org/buslaw/blt/2006-01-02/nonbindingopinion.html>; 11 Lorne & Bryan, *Acquisitions & Mergers: Negotiated & Contested Transactions* §3:57, at 3-

317 (2009) (distinction between “warranties” and “representations” is that representations assert the truth of the represented statements, while warranties simply “allocate financial responsibility” for the warranted statement’s accuracy).

For example, consider the dollar amount of potential claims against a business that is being sold. The buyer may ask the seller to represent and warrant that those claims do not exceed \$2 million. Neither party may actually know the amount of the potential claims, and the buyer is not only asking for a representation and warranty as of the time of signing the asset purchase agreement, but is also requesting a “bring down” certificate (a re-representation and re-warranty as of a later date) at the closing of the sale. In such a circumstance, it is probably most appropriate for the seller to warrant, but not represent, that claims do not exceed \$2 million. This would accomplish the risk-allocation function of the warranty without implicating the truth-telling function of a representation. If the threshold amount is exceeded and a survival clause applicable to the warranty is present, the buyer would then be left with a claim for breach of warranty, *i.e.*, damages in the amount that the claims exceeded \$2 million plus reasonably foreseeable consequential damages, but not for misrepresentation, which could include claims of fraudulent misrepresentation and punitive damages.

Limitations on Scope

An important method of reducing the scope of a representation or warranty, and any covenant or indemnity linked to it, is a knowledge limitation, such as “the representations and warranties of section X below are limited to facts of which *a*, *b*, or *c* [people] have actual knowledge on the date of this agreement.” This is a fair limitation, as long as the appropriate persons are specified, *i.e.*, those who would normally have the knowledge sought. The drafter should not stop at the senior executive level, because knowledge at that level is usually generalized, but should delve down to cover the knowledge of middle management or others at the operational level of a business, as appropriate.

Survival Clauses

As noted above, in the non-Uniform Commercial Code context, the inclusion of a survival clause is an important way to extend the protections of representations and warranties into the post-closing period. Survival clauses can be drafted with great particularity, specifying exactly which representations and warranties survive and which terminate after expira-

tion of a variety of different time periods. When drafting, it is important to clarify whether the survival clause provides a period of "coverage" or discovery for incorrect representations or breached warranties or whether it acts as a private, contractual statute of limitations that determines when the action may be brought. See, e.g., *Western Filter Corp. v Argan, Inc.* (9th Cir 2008) 540 F3d 947, 951.

California's basic statute of limitations for breach of contract is 4 years. For fraud or intentional misrepresentation, it is 3 years, and for negligent misrepresentation claims, it is 2 years. CCP §§337, 338(d). See generally *California Law of Contracts* §§9.2-9.6 (Cal CEB 2007). These periods may be shortened by contract, although agreements to shorten statutory limitations periods are disfavored and will be construed against parties asserting them. See *Western Filter Corp.*, 540 F3d at 952. Drafters should strive to be clear regarding what they are seeking to accomplish with a survival clause. Case law interpreting ambiguous survival clauses is fact-specific and divided; as a result, any litigation over the issue is likely to be fraught with uncertainty, with the potential for differing interpretations at different levels of review, and therefore costly. The *Western Filter* case is an example of litigation over survival-clause ambiguity.

Representations and Warranties in Operation

A representation is often combined with a warranty, in which case the form is: "[Buyer, Seller, or other defined term] represents and warrants [representation and warranty carefully stated as to scope and substance]." This combination ensures that a cause of action will lie post-closing even if the representation has terminated as of closing, as long as the agreement includes a survival clause applicable to the warranty. As discussed above, this structure leaves the buyer, post-closing, with a cause of action for contractual (economic) damages for breach of warranty, but without a cause of action for misrepresentation, which, as a tort, can include punitive or exemplary damages in addition to economic damages.

Representations and warranties are meant to give one party some reassurance that the other party's statements of fact are true. Representations are also used to shift the burden and cost of investigation and disclosure in the due diligence process. In the example above, assume that the buyer wants to know whether there are any claims or lawsuits against the business. The buyer and its counsel could search relevant court records, perhaps nationwide. They

could also dig through all of the business records looking for evidence of claims. These are burdensome and expensive activities. Alternatively, the buyer could insert a representation and warranty into the purchase agreement in which the seller states that no claims or lawsuits have been asserted against the company. This type of blanket statement is known as a flat or unqualified representation. It shifts the burden of investigation and disclosure back to where it belongs, the seller, which is the entity best able to provide the information at the least cost. If the seller discovers any claims, it can modify the representation and warranty to provide for exceptions listed on a schedule to the agreement. The seller could also respond with a suggestion that the representation be qualified, e.g., by narrowing it to relate to claims or lawsuits of a certain type or over a certain size (a "materiality threshold") or known to certain specific individuals (a "knowledge limitation").

THE UCC APPROACH

In a sale of goods contract covered by the Uniform Commercial Code, any "affirmation of fact or promise made by the seller to the buyer which relates to the goods and becomes part of the basis of the bargain creates an express warranty that the goods shall conform to the affirmation or promise." Com C §2313(1)(a). This approach blurs the distinction between the classic definitions of representations, warranties, and covenants discussed above.

In *Daugherty v American Honda Motor Co., Inc.* (2006) 144 CA4th 824, 830, 51 CR3d 118 (citations omitted), the court reviewed the law governing UCC express warranties, finding it clear that:

A warranty is a contractual promise from the seller that the goods conform to the promise. If they do not, the buyer is entitled to recover the difference between the value of the goods accepted by the buyer and the value of the goods had they been as warranted. A seller may limit its liability for defective goods by disclaiming or modifying a warranty. . . . Several courts have expressly rejected the proposition that a latent defect, discovered outside the limits of a written warranty, may form the basis for a valid express warranty claim if the warrantor knew of the defect at the time of sale.

Disclaimers

At the outset of contract negotiations, counsel for a seller (or borrower) should seek to include a broad provision that eliminates or disclaims as far as legally possible all express or implied representations and warranties except as expressly provided for in

the contract. The seller is thus attempting to wipe the slate clean of common law and statutory implied warranties, such as the UCC warranty of merchantability or fitness for intended use. But see Com C §2316(1) (disclaimer or limitation of warranty inconsistent with an express warranty will be inoperative if consistent construction not reasonable); Com C §2-316(2)-(3) (disclaimer of implied warranties with specific disclaimers, general disclaimers, buyer inspections, and course of performance). A disclaimer of warranties, however, may be subject to court scrutiny that may reflect some hostility to overreaching disclaimers and releases obtained by economically dominant parties. As the court in *Queen Villas Homeowners Ass'n v TCB Prop. Mgmt.* (2007) 149 CA4th 1, 5, 56 CR3d 528 (citing *Saenz v Whitewater Voyages, Inc.* (1991) 226 CA3d 758, 765, 276 CR 672) stated:

Courts have criticized and struck down releases if the language is oversimplified, if a key word is noted in the title but not the text, and if the release is too lengthy or too general, to name a few deficiencies. . . . However, we must remember that "[t]o be effective, a release need not achieve perfection. . . . It suffices that a release be clear, unambiguous, and explicit, and that it express an agreement not to hold the released party liable for negligence."

Counsel should also include a merger or integration clause so that evidence of any prior or contemporaneous statements that could be construed as representations or warranties will be excluded. For a sample clause, see California Law of Contracts §5.36 (Cal CEB 2007).

Releases Distinguished

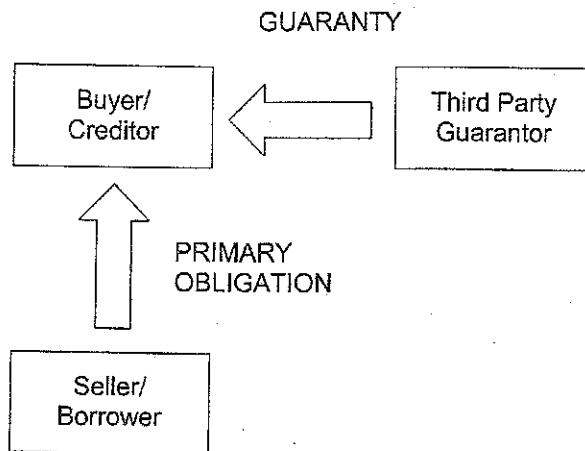
Counsel should not confuse a warranty disclaimer or the absence of a warranty with a release. The former will protect a party from a contract claim but will have no effect on a tort action if, for example, a defect in a product exists. See, e.g., *Continental Airlines, Inc. v McDonnell Douglas Corp.* (1989) 216 CA3d 388, 264 CR 779. As another example, a seller of real estate that uses an "as is" clause protects itself from contractual warranty claims, but not from a buyer's contribution claims for reimbursement of the buyer's CERCLA liability. *Gilroy Canning Co. v California Cannery & Growers* (ND Cal 1998) 15 F Supp 2d 943, 946.

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). Or, in the words of California's Civil Code (CC §2787):

A . . . guarantor is one who promises to answer for the debt, default, or miscarriage of another, or hypothecate property as security therefor.

When a third party guarantor promises one of the parties to the primary agreement that it will perform the obligations of the other, their relationship looks like this:



The guarantor is not a party to the primary contract. It stands behind the obligations of a person who is a party to that contract and promises to perform those obligations if the party does not do so. Unlike a warrantor, a guarantor in most cases also has subrogation and reimbursement rights (unless those rights are waived in the guaranty).

A guaranty, unlike a warranty, does not reallocate the risks between the parties to the primary agreement. Instead, it makes a third person responsible for the obligations of one of the parties to the primary agreement. If the creditor or other beneficiary of the guaranty wants a right of direct action against the guarantor without need to first pursue the primary obligor, the drafter should use guaranty-of-payment, rather than guaranty-of-collection, language.

Typical guaranty-of-payment language, here in the context of a sale of goods, is:

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 part or installment of the credit extended or in the performance of any requirement or provision contained in the security agreement between Buyer and Seller, Guarantor shall, upon demand, pay

the full amount of the unpaid purchase price with accrued interest.

In comparison, typical guaranty-of-collection language is as follows:

This guaranty is conditional and is a 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.

The creditor should also negotiate a waiver of the guarantor's exoneration rights. See CC §§2819 (exoneration by act changing obligation of principal without consent of surety), 2845 (surety may require creditor to proceed against principal or pursue other remedies to lighten the surety's burden). Typical waiver language is as follows:

Notice of acceptance of this guaranty, notices of nonpayment and nonperformance, 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.

Finally, counsel should keep in mind that the guarantor's solvency is a key prerequisite for effective enforceability of the guaranty.

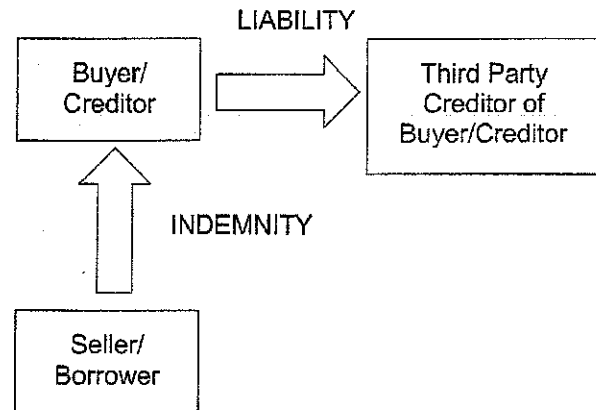
INDEMNITIES

An indemnity is a collateral contractual obligation by which one party, the indemnitor, engages to make good any loss, damage, or liability incurred by another party (classically, to one or more third parties). Black's Law Dictionary 837 (9th ed 2009). See generally *California Law of Contracts* §§6.51-6.59 (Cal CEB 2007). Civil Code §2772 defines indemnity similarly as follows:

Indemnity is a contract by which one engages to save another from a legal consequence of the conduct of one of the parties, or of some other person.

When one party to an agreement has agreed to indemnify or reimburse a second party for its liabili-

ties to a third person who is not a party to the primary agreement, the relationship looks like this:



An indemnitor, like a warrantor, but unlike a guarantor, is usually a party to the primary contract. However, unlike a warrantor, its obligation rests on the liability of the other party to the contract to a person who is not a party to the contract. In other words, in a typical indemnity, Party A agrees that if Party B becomes liable to a third person, Party A will pay Party B the amount of Party B's liability to the third person.

A common contractual 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. As is the case with guaranties, counsel should keep in mind that the solvency of the indemnitor is crucial to enforceability.

The basic issues that arise with indemnities are related to their scope. The scope of an indemnification obligation can be defined or limited by (1) the time period during which claims for indemnity can be asserted, (2) the time period during which the event underlying the claim occurred, (3) the minimum and maximum amount of any claim, or of all claims in the aggregate, over a specified period of time, (4) the damages covered (e.g., actual pecuniary loss to third parties, consequential damages, punitive damages, liquidated damages), and (5) the mechanism for presenting claims and solving disputed claims.

PROBLEMS CAUSED BY INCORRECT USE

Use of the incorrect type of provision may result in the provision operating in unintended ways, limiting a party's rights or giving rise to unintended defenses or consequences. For example, because warranties concern the present existence of facts, draft-

ing a covenant in the form of a representation or warranty may prevent the covenant from applying to a future breach of the obligation. Drafting a covenant in the form of a representation or warranty may also create fraud or misrepresentation tort liability, including potential punitive damages, for the promisor's breach. If the covenant is drafted properly, however, the breach should only give rise to a breach-of-contract claim. See *Hunter v Up-Right* (1993) 6 C4th 1174, 1190, 26 CR2d 8 (dissenting opinion of Justice Mosk); *Walker v Signal Cos.* (1978) 84 CA3d 982, 994, 149 CR 119. Because a warranty is breached, if ever, at the time of closing while a covenant is breached when performance of the obligation is due, which may be post-closing, in the future, the statute of limitations for breach claims relating to the two provisions can be different.

Letters of credit should be distinguished from guaranties. A letter of credit establishes a separate, direct, primary obligation between the issuer of the letter of credit to the beneficiary. A guaranty creates an obligation secondary to that of the primary obligor. A guarantor has subrogation and reimbursement rights against the primary obligor, while an issuer of a letter of credit has only reimbursement rights and whatever security interest it negotiated. See, e.g., *Morgan Creek Residential v Kemp* (2007) 153 CA4th 675, 63 CR3d 232 (letter of credit is not suretyship obligation, thus applicant cannot assert suretyship defenses); *Bank of America v Kaiser Steel Corp. (In re Kaiser Steel Corp.)* (Bankr D Colo 1988) 89 BR 150 (bank, which paid standby letter of credit, was not subrogated to rights of creditor to proceed on its security interest in debtor's assets). The beneficiary of a letter of credit must comply strictly with the terms of the letter of credit, and the issuer has few defenses to payment. More defenses may be available under a guaranty. See generally Turner, *Letters of Credit—A Primer for the Business Law Practitioner*, 18 CEB Cal Bus L Prac 85 (Summer 2003).

Further, failing to recognize a guaranty as a guaranty may lead to a failure to include a waiver of the guarantor's suretyship defenses, exoneration rights, notice, presentment, exhaustion of claims against the primary obligor, or unique California law provisions, such as the antideficiency or "one form of

action" statutes. See, e.g., CCP §580b (antideficiency provision applicable to so-called seller-take-back financing for one-to-four-unit dwelling occupied by borrower); CCP §726 (lender must proceed with judicial foreclosure to prevent waiver of deficiency claim).

If an indemnity is used to cover a warranty claim, the indemnitee may not be able to recover from the indemnitor if the indemnitor has limited its liability to true indemnitor liability, i.e., liability only for reimbursement of the indemnitee's liabilities to third persons. Damages sustained by the indemnitee itself are not included in a traditional, true indemnity clause. See, e.g., *Pacific Gas & Elec. Co. v G.W. Thomas Drayage & Rigging Co.* (1968) 69 C2d 33, 69 CR 561. This limitation can be drafted around by expressly including damages suffered and remedied by the indemnitee itself. An indemnity against liability becomes collectible immediately when the indemnitee becomes liable to a third person. CC §2278(1). An indemnity against anything else (such as claims or damages) becomes collectible only after the indemnitee has paid the third person. CC §2278(2). These indemnities include costs of defense unless expressly excluded. CC §2278(3).

Finally, an indemnity may not be effective if the indemnitee's own negligence contributed to its liability to a third party. Generally, an indemnitee can recover in these circumstances only if the indemnity expressly provides for recovery under those circumstances. *Edmondson Prop. Mgmt. v Kwock* (2007) 156 CA4th 197, 202 n1, 67 CR3d 243. Indemnities should be carefully drafted with this in mind.

CONCLUSION

The parties to sales and financing agreements use covenants, conditions, representations, warranties, guaranties, and indemnities to provide for and order performance of the agreement, to allocate risk, and to ensure the quality and creditworthiness of the parties to the transaction. The parties are more likely to achieve their goals in an efficient manner by using correct legal terminology and well-drafted provisions in their agreements. That approach promotes certainty and predictability, which, in turn, decreases the number of disputed issues that might foster later misunderstandings and litigation.