

# The Transactional Lawyer

A Publication of the Commercial Law Center

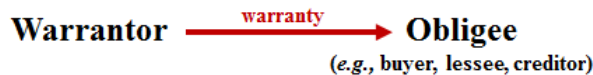


## Distinguishing Warranties, Guaranties and Indemnities

Luke O'Bannan

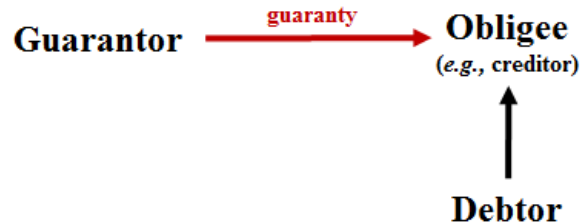
Parties to an agreement may suffer unexpected losses by the improper use of warranties, guaranties, and indemnities. Transactional attorneys must ensure that none of these contractual terms is mistakenly used in place of one of the other because each has a unique legal consequence.

As the following diagram shows, warranties are two-party affairs under which the warrantor promises the obligee that a specified fact – e.g., that goods sold conform to specifications; that leased premises are habitable; that good title is being conveyed; that contracts with third parties are genuine and enforceable – is true.

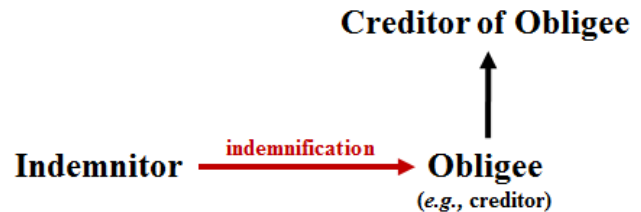


If the statement later proves to be untrue, the warrantor will have contract liability to the obligee, which liability may include both direct economic loss as well reasonably foreseeable and unavoidable consequential damages. Warranties can be used in almost any transaction but are particularly common in sales agreements, leases, and loan agreements.

Guaranties and indemnities are, in contrast, three-party arrangements. A guarantor promises to pay the debt of a third party to an obligee.



An indemnitor promises to reimburse the obligee for its payment or liability to a third party.



Many agreements mistakenly purport to indemnify the obligee for losses arising from the indemnitor's negligent conduct or breach. Such a covenant, however, is not an indemnification to the extent that it deals with the indemnitee's own losses, rather than the indemnitee's liability to a third person.

Warranties, guaranties, and indemnities are all, essentially, risk-allocation devices. However, the legal rules applicable to each are different.

### Suretyship Defenses

The key advice with respect to warranties and indemnities is not to confuse them with guaranties. That is because guaranties – whether labeled as such or not – are subject to numerous suretyship defenses. See Restatement (Third) of Suretyship and Guaranty § 1(3)(a), (b) (suretyship obligation can arise regardless of the form of the transaction or the terms used to describe the obligation), § 37 (delineating the various suretyship defenses). For example, a promisor might “warrant” to A that if B fails to perform a certain obligation satisfactorily or at all, the promisor will complete the specified performance. This purported warranty is in reality a form of suretyship, and therefore the promisor could avoid liability for any one of several reasons. While suretyship defenses can

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generally be waived, *see* Restatement (Third) of Suretyship and Guaranty § 48, it is incumbent on the transactional lawyer to recognize when a contract imposes a suretyship obligation, so those defenses can be waived if it is appropriate to do so.

### *Anti-Indemnity Statutes*

Neither a warranty nor a guaranty should be confused with an indemnity because, even though suretyship defenses do not apply to indemnities, most states have enacted statutes regulating or limiting indemnity agreements. These statutes tend to bar agreements to indemnify a promisee for liability resulting from the promisee's own negligence, but the scope of these statutes varies widely. *See* Kamy Molavi, [\*A Review and Update of Anti-Indemnity Statutes\*](#) (Sept. 2012). A transactional lawyer who fails to recognize a promise as an indemnity might fail to appreciate that the promise is restricted or nullified by statute.

### *Litigation Expense*

Even when the law does not impose a restriction on a promise, the incorrect labeling of that promise can result in unnecessary litigation. For example, in *Wells Fargo Bank v. Trolley Indus., LLC*, [2013 WL 4669822](#) (E.D. Mich. 2013), several entities borrowed \$5.4 million on a nonrecourse basis to acquire commercial real estate. In connection with the financing, the borrowers executed "Indemnity Agreements" that purported to indemnify the lender for any diminution in value of the property arising from the presence or release of hazardous substances. The property securing the loan developed methane gas problems from a landfill that once occupied the lot. After the property was foreclosed, the borrowers denied liability under the indemnity agreements. They claimed that because no third-party claim was filed, there was nothing to indemnify and thus no liability arose from the agreements. Fortunately for the lender, the court ruled that, despite the language of the agreements, the obligation was not really a duty to indemnify and thus the borrowers were obligated for the diminished value of the property. Litigation might have been avoided altogether or resolved more readily if the nature of the agreement had been accurately described in the transaction documents.

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## Further Thoughts on the Assignment of Bankruptcy Voting Rights

*Stephen L. Sepinuck*

The October issue of this newsletter featured an article entitled [\*The Enforceability of an Assignment of Voting Rights in Bankruptcy\*](#), which explained how courts are divided on the enforceability of an assignment of voting rights in a subordination agreement. Some courts, relying on § 510 of the Bankruptcy Code, have concluded that the assignment of voting rights is enforceable; others, relying principally on § 1126, have concluded the opposite.

The problem becomes more acute when the assignment of voting rights is not associated with a subordination agreement. For example, consider a scenario in which several lenders make a loan under a single credit facility. Some of the lenders are affiliates of the borrower. The debt to the affiliated lenders is not subordinated but to prevent the affiliated lenders from controlling or having veto power over how the class votes, the affiliated lenders purport to assign their bankruptcy voting rights to the unaffiliated lenders. Because there is no subordination agreement in such a transaction, § 510 does not apply and thus provides no basis for counteracting the statement in § 1126(a) that the holder of a claim may accept or reject a plan. The bankruptcy court may therefore be left with no statutory basis to enforce the assignment of voting rights.

To deal with this, the lenders may wish to provide for springing subordination. In other words, the lenders could expressly agree that if: (i) the bankruptcy court determines that the assignment of voting rights is unenforceable; and (ii) the affiliated lenders refuse to vote as directed by the unaffiliated lenders, then the obligations owed to the affiliated lenders will automatically become subordinate to the obligations owed to the unaffiliated lenders.

The benefit of this approach is twofold. First, if the subordination clause is triggered, the unaffiliated lenders acquire priority and, depending on the portion of the loan that is subordinated, may become much more likely to receive full payment. Second, the clause itself should qualify the agreement in which it appears as a subordination agreement under § 510, thereby enhancing the possibility that the assignment of voting

rights will be enforceable. In other words, a contingent subordination agreement is still a subordination agreement.

Clever litigators might argue that such a springing subordination clause is an unenforceable liquidated damages provision. Specifically, the contractual remedy – subordination – is or might be disproportionate to the harm suffered by the unenforceability of the assignment of voting rights and the refusal of the affiliated lenders to vote as instructed, rendering the subordination clause void as a penalty. Such an argument should fail, however. After all, a springing subordination clause will not allow the benefitted lenders to collect more than the debt due to them. Instead, a springing subordination merely creates a waterfall for any payments the debtor does make. It is therefore not a liquidated damages clause at all, let alone an invalid penalty.

Although no courts have ruled specifically on the enforceability of a springing subordination clause, judicial support for this conclusion is nonetheless readily available. Courts have almost uniformly concluded that so-called “bad boy” clauses in nonrecourse notes and guarantees – clauses that impose liability if the borrower becomes insolvent, files for bankruptcy, or interferes with the creditor’s foreclosure efforts – are not invalid liquidated damages clauses, penalties, or terms that violate public policy, but are instead fully enforceable according to their terms. *See, e.g., U.S. Bank v. Kobernick*, [454 Fed. App’x 307](#) (5th Cir. 2011) (term in note triggering recourse liability if the collateral became an asset in a bankruptcy proceeding was not an unenforceable as a penalty or a term that violated public policy); *Bank of America v. Freed*, [983 N.E.2d 509](#) (Ill. Ct. App. 2012) (clause in guaranty stating that guarantors would become liable for full debt, rather than limited amount, if guarantors contested the appointment of a receiver or the foreclosure of security interests was enforceable, not an invalid penalty or restraint on due process); *G3-Purves Street, LLC v. Thomson Purves, LLC*, [953 N.Y.S.2d 109](#) (N.Y. App. Div. 2012) (provision of guaranty that allowed for full recourse liability against guarantors was not a liquidated damages provision that imposed an unenforceable penalty); *UBS Commercial Mortgage Trust 2007-FL1 v. Garrison Special Opportunities Fund L.P.*, [938 N.Y.S.2d 230](#) (N.Y. Sup. Ct. 2011) (guarantee of nonrecourse mezzanine loan that became recourse upon the filing of a voluntary bankruptcy petition was enforceable, not a penalty or clause in violation of public policy); *Bank of America v. Lightstone Holdings, LLC*, [938 N.Y.S.2d 225](#) (N.Y. Sup. Ct. 2011) (guarantees of nonrecourse mezzanine

loans that became recourse upon the filing of a voluntary bankruptcy petition were enforceable); *CSFB 2001-CP-4 Princeton Park Corporate Center, LLC v. SB Rental I, LLC*, [980 A.2d 1](#) (N.J. Super. Ct. 2009) (carve-out clause to non-recourse obligation that provided for debt to become fully recourse if the borrower failed to obtain the lender’s prior written consent to any subordinate financing encumbering the collateral was enforceable, not a liquidated damages clause or a penalty). *But see Wells Fargo Bank v. Cherryland Mall Ltd. Partnership*, [835 N.W.2d 593](#) (Mich. Ct. App. 2012) (provision in guaranty of nonrecourse loan purporting to impose liability on guarantor for violation of a post-closing solvency covenant was invalid and unenforceable under the Michigan Nonrecourse Mortgage Loan Act).

The rationale of these decisions applies equally to springing subordination. Such a clause is about liability, not damages, and there is no chance that the clause will result in an excessive recovery.

*Stephen L. Sepinuck* is a professor and associate dean at Gonzaga University School of Law and director of the Commercial Law Center.



## The Unintended Consequences of a Severability Clause

*Nick Fay*

Severability clauses are often found in the standard boilerplate language of many different types of contracts. Generally, they are included for purposes of preserving the remainder of an agreement if a court rules that portions of that agreement are unenforceable. But their inclusion can have unintended and severe consequences. In examining those concerns, this article first addresses the common-law approach to severability when the agreement contains no severability clause. Next, the article shows how the presence of a traditionally worded severability clause operates against that common-law backdrop, potentially causing two different types of unintended problems. Finally, this article will examine drafting alternatives to help alleviate these concerns.

### *Common Law Approach – Severance without a Severability Clause*

Courts have long severed an unenforceable provision of an otherwise valid agreement, leaving the remainder in effect, provided the unenforceable portion is not an “essential part of the agreed exchange.” [Restatement \(Second\) of Contracts § 184\(1\)](#). To determine whether a provision is essential, courts attempt to give effect to the intention of the parties, inquiring as to whether the “parties would not have entered into the agreement absent that provision.” *Panasonic Co. v. Zinn*, [903 F.2d 1039](#), 1041 (5th Cir. 1990); *see also Hughes v. Schaeffer*, [452 A.2d 428](#) (Md. 1982) (clauses in municipal loan agreements requiring the trustees’ approval for future loans were an invalid restriction on the city’s powers but were not essential to the overall transaction and were therefore severable).

### *The Effect of a Severability Clause*

A severability clause functions against this common-law backdrop. A typical severability clause reads as follows: “If any provision of this Agreement is held invalid, illegal or unenforceable, the validity, legality and enforceability of the remaining provisions of this Agreement will remain effective.” Such a clause does not address the crucial issue of severability – essentiality – and consequently leaves courts with two options, both of which are troublesome to the transactional attorney.

The first option is to give the severability clause its most natural reading, which is to sever *any* unenforceable provision. In other words, this option treats the clause as a declaration that no provision of the agreement is truly essential. For example, in *Schuiling vs. Harris*, [747 S.E.2d 833](#), 837 (Va. 2013), an employer and employee executed an arbitration agreement providing that disputes were to be resolved exclusively through the National Arbitration Forum (NAF). When a dispute arose, the NAF was unavailable as a forum, leading both parties to acknowledge that provision was unenforceable due to impossibility. The employer, relying on the severability clause in the agreement, argued that the remainder of the arbitration agreement was enforceable and sought to compel arbitration. The court agreed, even though the employee argued that such an exclusive designation of the NAF was “integral” to the agreement to arbitrate. In doing so, the court noted that the severability clause applied if any provision “or any part of any provision” was invalid, and the selected arbitrator was a part of one provision. *See also Estate of Eckstein v. Life Care Centers of America, Inc.*, [623](#)

[F. Supp. 2d 1235](#), 1238 (E.D. Wash. 2009) (reaching same result on nearly identical facts).

This approach is problematic because it renders the severability clause potentially over-inclusive. Not all invalid provisions should be severed. Consider, for example, a noncompete clause in an agreement for the purchase and sale of a dentistry practice or other small business. In all likelihood, the noncompete clause is essential to the deal. That is, much of the purchase price may be attributable to the promise not to compete. If the noncompete clause is unreasonably broad and therefore stricken from the agreement, the buyer may not wish to be bound to pay the full price. *Cf. Restatement (Second) of Contracts § 184(1)*, cmt. a (“a promise not to compete that is unreasonably in restraint of trade will often not invalidate the entire agreement of which it is a part”).

The second option is to disregard the severability clause and evaluate the essentiality of the unenforceable provision. For example, in *Miller v. GGNCS Atlanta, LLC*, [746 S.E.2d 680](#) (Ga. Ct. App. 2013), the court was faced with facts nearly identical to those in *Schuiling* but disregarded the severability clause and ruled that “the severance of an essential contract term ‘is not allowed,’ even where the contract contains a severance clause.” *Id.* at 688; *see also Small v. Parker Healthcare Mgmt. Org., Inc.*, [2013 WL 5827822](#) (Tex. Ct. App. 2013) (refusing to apply a severability clause in the articles of association for a medical services association that illegally consisted of both physicians and non-physicians).

This approach is problematic because it renders the severability clause a nullity. Depending on how the court rules on the essentiality of the offending provision, this could mean that the invalidity of a term your client regards as relatively unimportant to the deal has rendered the entire transaction unenforceable or a term that your client regarded as critical was simply stripped from the transaction. At best, if the court’s essentiality determination aligns with your client’s, the client has nonetheless been exposed to costly and time-consuming litigation to resolve the matter with all the attendant uncertainty of such a process.

### *Another Potential Trap*

A recent case reveals another potentially unintended and undesired consequence of a traditional severability clause. In *In re Kline*, [2013 WL 587339](#) (Bankr. D. Or. 2013), parties to an asset purchase agreement contemporaneously executed two commercial leases. The APA, note, and leases contained cross-default clauses. After the buyers filed

for bankruptcy protection, they proposed to assume one of the leases. The seller objected, claiming that the debtors had to cure the default under the note and APA to assume the lease. Relying in part on the severability clause, the court ruled that the debtors' obligations under the different agreements were severable and thus they did not have to cure the default under the APA to assume the lease. While the court may have reached the same result even if there had been no severability clause, *see In re Plitt Amusement Co., Inc.*, [233 B.R. 837](#) (Bankr. C.D. Cal. 1999) (reaching a similar result for much the same reason but also concluding that the obligations were severable as a matter of federal bankruptcy law and that "artful drafting" would not change that result); *but cf. In re Buffets Holdings, Inc.*, [387 B.R. 115](#) (Bankr. D. Del. 2008) (individual leases governed by master lease were not severable and had to be assumed or rejected together), the fact remains that the severability did not help the seller, who in all likelihood drafted it.

#### *Drafting Advice*

The most obvious drafting solution to the problems presented above is to identify which provisions are essential to the transaction and which terms, if any, run the risk of being invalidated. As to the latter, one expert on contract drafting has offered a list of terms that might be invalidated. That list includes indemnification clauses, waivers of liability for intentional torts, liquidated damages and penalty clauses, covenants not to compete, waivers of statutory rights, and a choice of law. TINA L. STARK, *NEGOTIATING AND EXECUTING CONTRACT BOILERPLATE*, 548-49 (2003). Then, instead of using a traditional severability clause that purports to sever every invalid term, draft a clause that severs only the nonessential terms. For example, the clause might be phrased as follows: "If any provision or partial provision of this agreement, except for Sections X, Y, and Z, [or any other provision found by a court to be essential to the larger agreement], is found to be unenforceable for any reason, the remainder of the agreement shall remain effective." Courts have shown themselves to be responsive to such drafting. *See, e.g., Hill v. Names & Addresses, Inc.*, [571 N.E.2d 1085](#) (Ill. Ct. App. 1991) (holding that a provision elsewhere in the agreement naming the unenforceable term as essential overcame the severability clause, resulting in the invalidation of the entire agreement); *see also Schuiling v. Harris*, [747 S.E.2d 833](#) (Va. 2013) (noting the absence of any terms specified as essential in its ruling to sever an unenforceable provision and enforce the remainder of the agreement).

*Nick Fay is a 2013 graduate of Gonzaga University School of Law.*



## **Beware: the "Loss Payee" Need Not Be Paid Following Loss**

*Stephen L. Sepinuck*

Your client takes a security interest in inventory or equipment after dutifully making sure that the goods are insured by a reputable insurer. You arrange for the insurer to make your client the payee in the event of an insured loss. The goods are stolen, and the insurer pays the debtor after the debtor represents that there were no liens on the goods. Your client then sues the insurer.

If you think your client has a good case, think again. These are the essential facts of *Westfield Ins. Co. v. Talmer Bancorp*, [2013 WL 5812027](#) (6th Cir. 2013), in which the court ruled that the secured party had no claim against insurer. The court, in a very short opinion, relied on language in the insurance contract providing that the policy "is void" if the insured at any time "misrepresent[s] a material fact concerning . . . [its] interest in the Covered Property; or . . . [a] claim under this policy." Because the debtor misrepresented the secured party's interest in the property on the proof of loss statements, the policy was void and the insurer had no further liability.

To avoid this result, a secured party needs the insurer to issue a Lender's Loss Liability Payable Endorsement. This industry-standard form, known as a form [438BFU](#), provides that the policy will not be invalidated by, among other things, "any breach of warranty, act, omission, neglect, or non-compliance with any of the provisions of this policy . . . by the named insured."

*Stephen L. Sepinuck is a professor and associate dean at Gonzaga University School of Law and director of the Commercial Law Center.*



## Recent Cases

### SECURED TRANSACTIONS

*MBK Services, Inc. v. Cole Taylor Bank*,  
[2013 WL 5436652](#) (Ill. Ct. App. 2013)

Agent that located and procured subcontractors so that debtor could bid on government printing contracts had no claim against the bank that had a perfected security interest in the debtor's assets and which seized the debtor's assets, including its receipts from the government, because even if the agent were the true owner of the government contracts, it had allowed the debtor to exercise full control over the funds received thereon and is therefore estopped from denying the bank's security interest. There was no basis for imposing a constructive trust on the receipts because the agent did not set up an escrow account or do anything else to protect its interest in the proceeds of the government contracts. Even if a constructive trust were imposed, the bank would still be entitled to priority because principles of equity cannot override the UCC's priority rules.

*Catahama, LLC v. First Commonwealth Bank*,  
[2013 WL 5874578](#) (W.D. Pa. 2013)

Bank with a senior security interest in accounts receivable was not liable under promissory estoppel to junior secured party for allegedly agreeing to forbear from enforcing its interest because the junior secured party acted at its own risk by extending money without confirming directly with the Bank the specific details and temporal scope of the alleged subordination agreement.

### BANKRUPTCY

*In re Grewel*,  
[2013 WL 5442058](#) (Bankr. N.D. Cal. 2013)

Bank violated the automatic stay and the discharge injunction by refusing to return some service station equipment that it repossessed under the belief that it was covered by the security interest granted by the corporation that owned the service station because the evidence established that the items were owned by the individual sole shareholder of the corporation.

*In re B & M Land and Livestock, LLC*,  
[2013 WL 5182611](#) (Bankr. D. Nev. 2013)

Sole member of LLC who had filed for relief under Chapter 7 lacked authority to file a bankruptcy petition on behalf of the LLC because upon the filing of the

member's bankruptcy petition, the Chapter 7 trustee automatically acquired the right to manage the LLC without the need to take further specific action.

*In re American Roads LLC*,  
[496 B.R. 727](#) (Bankr. S.D.N.Y. 2013)

The holders of \$162.5 million in senior secured bonds issued in an insured unitranche transaction did not have standing to participate in the debtor's bankruptcy proceeding because the insurer, as the collateral agent, was the sole secured party and the financing documents included "no action" clauses that unambiguously prevent the bondholders from asserting any claims to collateral or enforcing any rights against the debtors.

*In re WM Six Forks, LLC*,  
[2013 WL 5354748](#) (Bankr. E.D.N.C. 2013)

Secured party's \$37 million credit bid at a § 363 sale was a "disbursement" under 28 U.S.C. § 1930(a)(6) and thus obligated the debtor to pay \$30,000 in quarterly fees.

### LENDING & COMMERCIAL CONTRACTING

*CresCom Bank v. Terry*,  
[2013 WL 5495301](#) (D.S.C. 2013)

Guaranty providing that it was to be governed by "the laws of the State in which it was executed" was patently ambiguous given that it could have been – and was – signed by the guarantor in Georgia but delivered to the creditor in South Carolina. Because ambiguous agreements are construed against the drafter – in this case, the creditor – Georgia law controlled.

Although the guaranty imposed liability for attorney's fees incurred by the creditor in enforcing the guaranty, because the creditor did not comply with the Georgia statute that requires a creditor to notify the debtor after default of the debtor's liability for attorney's fees and to provide ten days to repay the debt, the attorney's fees clause was unenforceable.

*Buffets, Inc. v. Leischow*,  
[2013 WL 5677038](#) (8th Cir. 2013)

Restaurant company that lost \$3.5 million when utility bill processor ceased operations had no claim against processor's banks under the Minnesota version of the Uniform Fiduciaries Act because the bank accounts were titled in the processor's individual name and therefore the banks were not required to inquire whether the processor was breaching an obligation as fiduciary.



## Cumulative Index

With this issue, *The Transactional Lawyer* has now been published for three full years. As a service to readers, below is an index of articles appearing in the newsletter during that period. Each title is a hyperlink to the issue on the web page of Gonzaga's Commercial Law Center.

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