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BANKING, COMMERCIAL, & CONTRACT LAW
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CHAPTER 2
BANKING, COMMERCIAL & CONTRACT LAW

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I. INTRODUCTION

During the April 2008 to April 2009 reporting period there have been several cases addressing general common law principles regarding banking, commercial, and contract law. There are no significant legislative developments in the banking or commercial law areas to report. The significant legislative development regarding contract law is the extensive amendment of K.S.A. 16-121, which limits the ability to enter into indemnity contracts.

II. COURT DECISIONS

A. Banking Law

1. *Lender Waived Rights Under Acceleration Clause*

CTP borrowed $96,000 from Foundation to purchase a truck stop. The promissory note provided for payments of $673.54 each month from 2004 to 2009, at which time the balance was due in full. However, the note provided that if a monthly payment was not paid on the date due "the whole amount shall become immediately due and payable at the option of the holder without notice." The first four payments were made in a timely manner followed by nine late payments. Following the ninth late payment Foundation informed CTP that it was exercising its option under the acceleration clause to require payment of the balance due on the note. CTP argued Foundation had waived its right to insist on timely payment by accepting the nine late payments without objection. Foundation argued that each month it had the "option" to determine whether it would trigger the acceleration clause and that failing to exercise its option during the nine-month period was not a waiver.

In *Foundation Property Investments, LLC v. CTP*, 286 Kan. 597, 186 P.3d 766 (2008), Justice Nuss, writing for the Court, noted the difference between an "acceleration clause" and an "anti-waiver clause." Rejecting Foundation's argument that its "optional" acceleration clause avoided the need for an anti-waiver clause, the Court provides the following drafting advice: "[W]e strongly encourage the use in Kansas of clearly stated anti-waiver provisions . . . ." Dissenting Justice Beier believed the optional acceleration clause avoided the waiver issue, and therefore additional language, in the form of an "anti-waiver clause," was not necessary.

After determining that the optional acceleration clause was not an anti-waiver clause, the Court concluded: "Nine straight months of Foundation's accepting late payments, without objection, is a waiver of the right to accelerate." The next question was whether the waiver was a total surrender of the right to accelerate or only a temporary limitation on the right. To resolve this issue the Court accepted CTP's concession that "Foundation can 'revive' its right to accelerate the Note if it notifies CTP that future payments will no longer be accepted after the due date."

It appears a "good faith" analysis could harmonize the positions of the Court and dissenting Justice Beier. Although Foundation had the right—the option—to decide whether to accelerate, by its actions it may have led CTP reasonably to believe timely payment was not required. If this was the case, Foundation then became obligated to give CTP adequate notice that it may, in the future, elect to trigger its acceleration rights if a future payment was not timely. This would seem to be the proper role for the obligation of good faith, which applies to the performance *and enforcement* of the contract. The surrounding facts and circumstances, including the express language of the contract, would be used to determine whether CTP reasonably believed timely payment was not required. The existence of such a good faith belief would limit Foundation's ability to exercise freely its acceleration rights because of a late payment. However, if the express contract language indicated that Foundation, after an extended period of accepting late payment, could nevertheless exercise its acceleration rights without advance notice, it would make it difficult for CTP to establish any sort of "reasonable belief" on the issue. This is consistent with a proper good faith analysis because the parties can always limit the need for a good faith gap-filler by expressly addressing the matter in the contract.

2. *Priority Status of Purchase Money Mortgage Holder over Tax Lien Against Buyer of the Property*

Jeff apparently failed to pay his sales taxes, resulting in the Kansas Department of Revenue (KDR) filing a tax warrant, in the amount of $266,550.23, against Jeff and others in 2001. In 2004 Jeff and his wife purchased a home, which they financed with a purchase money mortgage through American General Financial Services, Inc. In 2005 the KDR filed two additional tax liens against Jeff. Jeff and

his wife defaulted on their home mortgage obligations, causing American to foreclose in 2006. The property was sold at a foreclosure sale, and American and KDR competed for the proceeds of sale. The district court awarded KDR priority for its 2001 tax warrant, then American's first and second mortgages obtained in 2004, then KDR's 2005 liens. In *American General Financial Services, Inc. v. Carter*, 39 Kan. App. 2d 683, 184 P.3d 273 (2008), the court reversed the trial court and held that American's purchase money mortgage had priority over KDR's tax warrant and lien.

Characterizing the issue as one of "first impression in Kansas," the court first looked for guidance from K.S.A. 58-2305, which states: "A mortgage given by a purchaser to secure the payment of purchase money shall have preference over a prior judgment against such purchaser." K.S.A. 79-3617 treats an unsatisfied tax warrant as the equivalent of a "judgment." The court was careful to point out what the case was not about–a lien on property being *sold by a seller*. Instead, the case involved a lien against a *buyer* of property who had no interest in the property until it was acquired using the mortgagee's money.

Judge McAnany, writing for the panel, did an excellent job of analyzing the nature of the purchase money mortgage and the priority it has been given by courts when others seek to gain priority in the very property the mortgagee has caused to be brought into the debtor's pool of assets. As the court explained:

> [A]t the time of closing the buyer does not acquire title to the property and *then* the purchase money mortgage attaches to and becomes a lien on the property. To the contrary, at closing the buyer acquires title to the property *already encumbered* by the purchase money mortgage. Until the Carters bought their home, there was no real property to which KDR's tax lien could attach. At the moment the Carters acquired title to their home, it was already encumbered by American's purchase money mortgage. At that point, KDR's tax lien attached to the property, but this occurred *after* the creation of American's purchase money mortgage encumbrance. Thus, American's first mortgage has priority over the Carter's other liens.

3. *UCCC Prohibits Assignee from Collecting on "Supervised Loan"*

To purchase their home, Ron and Susan took out a first mortgage, which was held by Countrywide Mortgage. Subsequently they took out a second mortgage with Ditech Funding Corporation, for $85,000, with an interest rate of 13.75%. This second mortgage was subject to the Kansas Uniform Consumer Credit Code (KCCC) as a "supervised loan" because it was a consumer loan with an annual percentage rate exceeding 12%. Although Ditech was a qualified "supervised lender" under the KCCC, Ditech assigned the note and mortgage to Independent Financial, Inc. (IFI), which was not a "supervised lender."

At the foreclosure proceeding, IFI asserted rights under a workout agreement it entered into with Ron, Susan, and their other creditors. Another creditor sought dismissal of IFI's claim in the foreclosure proceeding because IFI was not a licensed supervised financial organization. The district court agreed and held that IFI was prohibited from collecting on the loan and foreclosing on the mortgage because it was not properly licensed to ensure collection procedures within regulatory limits. Affirming the district court in *Independent Financial, Inc. v. Wanna*, 39 Kan. App. 2d 733, 186 P.3d 196 (2008), the Kansas Court of Appeals concluded that K.S.A. 16a-2-301(2) prohibited IFI from collecting on or enforcing the loan so long as it was not a licensed supervised lender.

4. *Judgment Liens Cannot Attach to Homestead or Impair Priority of Purchase Money Mortgage*

Thomas entered into a mortgage on his residence in December 2004. In May 2004 Thomas ceased making court-ordered support payments to Kathleen. Nu-Dell obtained a judgment against Thomas, also in 2004 and prior to the December 2004 mortgage. In 2005 the mortgagee, Deutsche Bank, sought to foreclose against Thomas's residence because Thomas had failed to make the payments required under his note and mortgage. The bank's mortgage was consensual and an express exception to the homestead exemption; therefore the bank's lien attached to the homestead property, and the bank could force a sale of the homestead property to pay the debt. The liens of Kathleen and Nu-Dell, however, were nonconsensual judgment liens encompassed within the protection provided to Thomas under the homestead exemption. Their liens would not attach to the property, nor could they force a sale of the property to pay their liens.

In *Deutsche Bank National Trust Co. v. Rooney*, 39 Kan. App. 2d 913, 186 P.3d 820 (2008), *review denied* (Nov. 4, 2008), Kathleen and Nu-Dell, the judgment creditors, asserted that their liens could attach to Thomas's homestead once the bank commenced foreclosure proceedings. They further argued that because their liens predated the bank's mortgage, they had priority to any proceeds from the foreclosure. Kathleen and Nu-Dell asserted that changes to the Kansas homestead statutes gave them the ability to acquire liens against the homestead; they argued that, although as judgment creditors *they* could not force a sale of the homestead, once another party (the bank) forced a sale, then their previously nonattaching liens attached and dated back to the date the lien accrued.

The court of appeals, relying on *Morris v. Ward*, 5 Kan. 239 (1869), rejected the judgment creditors' theory and held that only liens specifically excepted from the homestead exemption can attach to homestead property. The liens encompassed by the exception are those that are

consensual, for taxes, for purchase money to acquire the homestead, and for improvements to the homestead. The court reaffirmed the protective focus of the *Morris* opinion, noting that allowing a lien to attach at some future date "would prevent families from changing homesteads and perhaps prohibit them from acquiring new homesteads – an outcome contrary to the policy behind the homestead protection, which was to protect families from destitution." Therefore, the liens held by Kathleen and Nu-Dell, as judgment creditors of Thomas, could not be satisfied out of funds generated by a foreclosure sale of Thomas's homestead property. Although not the focus of this opinion, it would appear that if there were any excess funds remaining after payment of the bank, Thomas could have protected them from levy by Kathleen and Nu-Dell by using the money to acquire a new homestead. *See Mitchell v. Milhoan*, 11 Kan. 617 (1873) (proceeds from sheriff's sale); *In re Daniels*, 65 B.R. 703 (Bankr. D. Kan. 1986) (proceeds from involuntary transfer in divorce proceeding). *See generally*, Roger L. Theis & Karl R. Swartz, *Kansas Homestead Law*, 65 J. KAN. BAR ASS'N 20 (1996).

B. Commercial Law

1. Implied Warranty of Merchantability and the Used Car

Johnson was a used car dealer. Johnson sold Hodges a ten-year-old Mercedes S320 automobile with 135,945 miles on it, which, according to Hodges, Johnson represented to be "just pretty much a perfect car." When Hodges discovered the air conditioner was not working properly, he demanded that Johnson fix it. Johnson refused and Hodges sued in small claims court for $3,474, the estimated cost of repair. The vehicle purchase price was $15,900. Hodges prevailed in small claims court and Johnson appealed to district court. The district court also held for Hodges but refused to award him attorney fees under K.S.A. 61-2709(a) as a prevailing appellee from a small claims court award. The court of appeals, in a 2-1 decision, reversed the district court, holding that the implied warranty of merchantability on a used vehicle extends only to major components that are necessary for use of the vehicle to provide transportation.

In *Hodges v. Johnson*, 199 P.3d 1251 (Kan. 2009), the Kansas Supreme Court reversed the court of appeals and held that the district court properly determined, as a matter of fact, that the air conditioning system of the vehicle was properly encompassed within the implied warranty of merchantability. The court, however, reversed the district court's refusal to award attorney fees to Hodges, noting that K.S.A. 61-2709 imposes a mandatory duty to award attorney fees when the appellee is successful on appeal. Although it remanded the case to the district court to determine the award of attorney fees incurred at trial, the Court, under Supreme Court Rule 7.07(b), awarded attorney fees and expenses of $4,106.50 for the cost of the appeal to the Supreme Court.

This case will be of interest to commercial lawyers because of Justice Davis's discussion of the implied warranty of merchantability as applied to used goods. To determine whether the implied warranty has been breached, the initial task is to determine whether, under the facts and circumstances of the transaction, the failure of the air conditioner to work is a matter encompassed by the seller's warranty obligation. After hearing all the facts, the district court concluded that the air conditioner was covered by the seller's implied warranty.

To establish a breach of the implied warranty, Hodges had to show "that the purchased goods were defective, that the defect was present when the goods left the seller's control, and that the defect caused the injury." The Court held that there was substantial competent evidence presented to the district court to support the findings that the car was defective because it had a bad air conditioner, the air conditioner did not work properly at the time the car was sold to Hodges, and Hodges was injured to the extent of the amount of money it took to fix the air conditioner.

Although it is arguable whether the "just pretty much a perfect car" statement attributed to Johnson gave rise to an express warranty, the district court and Supreme Court were able to use the statement to address the factual issue regarding the scope of the implied warranty of merchantability. For example, with a used car that had an air conditioner and that the seller indicated was "just pretty much a perfect car," it was reasonable to conclude the implied warranty for this used car encompassed the air conditioner. This statement took on even greater significance when Johnson indicated he had been driving the car as his personal vehicle for almost two years.

This case is also important because of the efficacy it gave to a favorable ruling in small claims court. Anecdotally, it would appear that the "little guy" or "consumer" will often prevail against the "big guy" in small claims court as judges seek an appropriate resolution of claims made against a supplier or dealer. If the "little guy" loses in small claims court, he will most likely let it end at that point, because the amount of the claim is still "small," and if he wants to appeal to district court, he will most likely need to invest substantial sums in attorney fees. When the "big guy" is the appellant, he can more readily invest in attorney fees to take the battle to the district court. This is where the mandatory attorney fees statute will have the most effect as a deterrent to those who could otherwise afford to prosecute an appeal of an adverse ruling. Because a small claims judgment will have little or no practical precedential impact on the "big guy," he may be willing to forego appeals of adverse rulings. This provides a workable mechanism to compensate individuals who have claims at or below the $4,000 small claims jurisdictional limit. The mandatory attorney fee award against an unsuccessful small claims appellant forces the party to carefully evaluate whether he should just accept the judge's ruling and move on. The Court held that there is a rational basis for imposing

the risk of attorney fees on the appellant, and not the appellee, in order to "keep expenses low and allow for expedited resolutions of small claims."

2. *UCC, Software Goods and Services Contracts, Reasonable Time for Performance, Notice of Default, Right to Cure, and Good Faith*

Inter-Americas Insurance Corporation entered into a contract with Image Solutions Company to have Image develop software, provide hardware to run the software, install the system, and provide support services to Inter-Americas's employees. The parties entered into a contract, Image delivered most of the contracted items, and Inter-Americas paid $213,904.31 then due under the contract. However, there were still things Image needed to do to fulfill its contract and get the system up and running. Despite several attempts by Image to complete the contract, Inter-Americas, without prior complaint or notice, informed Image on October 5, 2005, that it had breached their contract and demanded $225,405.88 in damages. When Image failed to pay, Inter-Americas filed suit.

The district court granted summary judgment to Image, finding that any delay in performance was caused by Inter-Americas and that it was Inter-Americas, not Image, that breached the contract by failing to give Image a reasonable opportunity to perform. In *Inter-Americas Insurance Corp. v. Imaging Solutions Company*, 39 Kan. App. 2d 875, 185 P.3d 963 (2008), the court affirmed the district court's holding that Inter-Americas was the breaching party, but reversed and remanded for the district court to determine Image's recoverable damages.

The court first found that this mixed goods and services contract was governed by Article 2 of the UCC as a "sale of goods." Under Kansas precedent, a sale of computer software is a sale of "goods," and in this case, where $35,000 of the $240,000 contract related to services, the services were incidental to the sale of goods. Although not mentioned by name, the court applied the "predominant factor" test to conclude that since this contract was predominantly a sale of goods as opposed to services, Article 2 of the UCC would apply to all of the contract provisions, whether pertaining to goods or services. *See Care Display, Inc. v. Didde-Glaser, Inc.*, 225 Kan. 232, 589 P.2d 599 (1979) (applying predominant factor test to determine contract was primarily for services and therefore not subject to the UCC statute of frauds for a sale of goods).

Because the contract did not specify a timeline for performance, Image was obligated to perform its contract duties within a "reasonable time" as required by K.S.A. 84-2-309(1). Under K.S.A. 84-1-204(2), "reasonable time" for taking any action depends on the nature, purpose, and circumstances of the required action. The uncontroverted facts indicated that Image performed within a reasonable time and therefore did not breach the contract.

Image counterclaimed for breach of contract against Inter-Americas for its actions in preventing Image's performance. Image also asserted Inter-Americas was in breach for failing to give Image notice of the alleged breach and a reasonable time to cure any breach. Affirming the district court's grant of summary judgment on Image's counterclaim, the court of appeals noted that the UCC imposed a duty on Inter-American to give "seasonable" notice of any claimed breach and an opportunity to cure. As the court noted: "[I]f Inter-Americas believed ISC [Image] was in breach of the contract, under the UCC it had a duty to tell ISC of its breach." For this proposition, the court referred to K.S.A. 84-2-602(1), dealing with "rejection of goods," which requires: "Rejection of goods must be within a reasonable time after their delivery or tender. It is ineffective unless the buyer seasonably notifies the seller." Under K.S.A. 84-1-204(3), "seasonable" means within the time agreed or within a reasonable time.

Regarding the opportunity to cure, the court quoted K.S.A. 84-2-508 and then observed that that section "allows ISC [Image] the right to cure any claimed breach if it could do so within the time for performance under the contract or within a reasonable time if it had reasonable grounds to believe that Inter-Americas was satisfied with its performance." The right to cure under UCC § 2-508 has created some interesting interpretive issues. The buyer's duty to give notice of "rejection" and the seller's ability to cure a defect in performance are ongoing obligations and rights for contracts that contemplate a series of performances. Note how this ongoing process is further expanded when you mix goods and services. The goods may be delivered in a one-shot deal, followed by a long-term set of performances related to the "service" component of the transaction.

In the course of its opinion the court also noted that "Kansas courts imply a duty of good faith and fair dealing in every contract." Although the court stated this rule, it failed to discuss how it applied to the facts of this case. The concept can be applied in at least two contexts. First, when one party is dependent upon the other in order for performance to take place, the parties must cooperate to allow performance to go forward. In this case, Inter-Americas had to cooperate with Image to the extent that Image could have access to Inter-Americas facilities and personnel so that it could perform its contracted duties. Although this was not specified in the parties' contract, it was clearly implied that the parties would do whatever was necessary to allow for performance, as contemplated by the contract, to take place. This is the obligation of good faith in the *performance* of the contract. The other context is in the *enforcement* of the contract. If a party does not believe that the other party is acting in accordance with the contract, it is implied, absent express language addressing the matter, that it will let the other party know about the problem so that it can correct its nonperformance.

Technically, it is not correct to say these obligations are "implied" in the UCC context because K.S.A. 84-1-304 provides a *statutory* basis for good faith: "Every contract or duty within the [UCC] imposes an obligation of good faith in its *performance and enforcement*." (Emphasis added.) Although the statutory obligation of good faith cannot be negated by a blanket disclaimer, it can be limited through express terms that provide precise direction on the matter at issue. This is provided for in K.S.A. 84-1-302(b), which states in part: "The parties, by agreement, may determine the standards by which the performance of those [good faith] obligations is to be measured if those standards are not manifestly unreasonable." This allows the parties to exercise their freedom of contract to specify their obligations, which will be enforced as stated, so long as they are not unconscionable. In a commercial setting, where unconscionability is almost impossible to establish, it permits the parties to settle these matters through negotiation and agreement, with the statutory good faith obligation being triggered only in those situations where the parties have not fully expressed their agreement.

For non-goods situations, the common law, as restated by the RESTATEMENT (SECOND) OF CONTRACTS § 205, provides: "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement." The development of the law in this non-goods setting has tracked closely the development of the law under Article 2 of the UCC.

3. *Court Interprets Application of UCC Setoff Provisions as Applied to a Holder In Due Course*

Cactus Roofing, LLC, issued a $4,768.47 check to Tomas Hernandez for roofing work. Hernandez took the check to Hurst Enterprises, LLC, d/b/a Mr. Payroll Check Cashing, and cashed the check less a 1% check cashing fee of $47.68. Three days after the check had been paid by Hurst, Cactus placed a stop payment on the check because Hernandez had not completed the roofing job properly. Hurst was not paid on the check and brought suit to recover the amount due. At trial, the court determined that Hurst was a holder in due course under K.S.A. 84-3-302, but was subject to a subsection (d) setoff because Hernandez had only partially performed the roofing work, resulting in Cactus having to spend $4,500 to complete the contracted work. Therefore, the trial court awarded Hurst $268.47 ($4,768.47 - $4,500).

The court of appeals, in *Hurst Enterprises, LLC v. Crawford*, 40 Kan. App. 2d 1018, 197 P.3d 882 (2008), reversed, holding that the subsection (d) portion of UCC § 3-302 focuses on the partial performance of the holder in due course, not the payee who presented the check for payment. In this case Hurst had fully performed by paying the full sum of the check, less a check cashing fee. There was no partial performance on the part of the holder in due course, so subsection (d) was never triggered. As a holder in due course, Hurst was entitled to recover the full amount of the check, $4,768.47, from Cactus.

C. Contract Law

1. *Courts Apply Conflicting Analyses to Determine Whether a Contractual Remedy (Liquidated Damages Clause) Constitutes a Penalty*

One of the major aspects of freedom of contract is the ability to define, in advance, the consequences of a breach of covenant or failure to satisfy a condition. It allows the parties to evaluate the precise risk they are undertaking by entering into the contract; it also supports the concept of "efficient breach" where a party may find it more economically "efficient" to pay damages, or suffer a defined loss, instead of performing. The major limit on this freedom is an equally foundational concept of contract law, which also supports the "efficient breach" model, that a failure to perform under a contract will give rise only to compensatory remedies, not punitive remedies. Therefore, the freedom to contract for remedies in the event of a breach is limited by the inability to use remedies to force, or "encourage," the other party to perform by imposing punitive measures. The inter-relationship of these concepts provides strong support for the "efficient breach" model. Traditionally, the restriction on contractual remedies designed to force a party to avoid a breach, as opposed to compensating another party in the event of a breach, has been described as the difference between enforceable "liquidated damages" and an unenforceable "penalty."

During 2008 three court opinions were issued that addressed the proper analysis for distinguishing damage from penalty. It appears from the opinions that the court of appeals is following a route that the Kansas Supreme Court does not desire to take. The commentary that follows identifies the diverging paths that have been taken and offers guidance on what the ultimate path should be.

The issue was directly addressed by the court of appeals in *Carrothers Construction Co. v. City of South Hutchinson*, 39 Kan. App. 2d 703, 184 P.3d 943 (2008), *rev. granted* (Nov. 4, 2008), in which the city provided for liquidated damages of $850 for each day Carrothers failed to complete construction of a wastewater treatment plant. This resulted in the city seeking $145,350 in liquidated damages for the 171-day delay in completion of the $5.6 million project. Carrothers argued that the city did not suffer any actual loss by the delay and that in any event the $145,350 was an unlawful "penalty" as opposed to legitimate liquidated damages. First, the court found that the city suffered damages as a result of Carrothers's delay. The city asserted that the $145,350 figure was reasonable "based upon the facts available to the parties at the time they executed the contract." Traditionally, the inability to predict damages has been the key element for supporting a liquidated damages clause which reflects a reasonable effort to predict future damages. The *Carrothers* case chronicled the efforts of the city's engineers, MKEC Engineering Consultants, Inc., to estimate damages objectively in the

event Carrothers failed to complete the project on schedule. MKEC's precontract analysis of the damage issue provided a factual basis for the difficult task of predicting future damage and for the reasonableness of the per-day figure it selected as liquidated damages. MKEC did it right.

Carrothers, relying upon the 10th Circuit's analysis in *Hutton Contracting Co., Inc. v. City of Coffeyville*, 487 F.3d 772 (10th Cir. 2007), and the prior holding of the court of appeals in *IPC Retail Properties v. Oriental Gardens, Inc.*, 32 Kan. App. 2d 554, 86 P.3d 543 (2004), argued that any liquidated damages provision must also be found reasonable using a retrospective analysis that compares the known actual damages at the time of breach with the predicted damages in the liquidated damages clause. The court applied this step-two retrospective analysis, which requires "that liquidated damages must bear some reasonable relationship to the actual injury or damages caused by the breach." Although the court concluded that the city's actual damages at the time of breach were in line with the liquidated damages provision in that case, the court's second-step retrospective analysis has the potential to limit severely the utility of a liquidated damages clause by leaving every clause open to litigation to determine whether the parties accurately predicted actual damages. This would appear to be a conflicting analysis since the required foundation for any liquidated damages clause is the inability to accurately predict actual damages at some unknown future time when the contract is breached.

The court of appeals addressed this issue again in *Wichita Clinic, P.A. v. Louis*, 39 Kan. App. 2d 848, 185 P.3d 946 (2008), in the context of a restrictive covenant not to compete in an employment agreement. The employer sought specific performance of the restrictive covenant, and the court applied the specialized body of law that has developed to determine the enforceability of such a covenant considering its business purpose and reasonable time, place, and activity limitations. The final issue was whether the optional payment provisions of the covenant constituted a penalty as opposed to liquidated damages. Citing the *IPC Retail Properties* case, the court stated: "To recover liquidated damages, the amount must have some reasonable relationship to the *actual* injury caused by the breach; if there is no relationship, the provision is a penalty." (Emphasis added.)

Although the court in *Wichita Clinic* upheld the liquidated damages clause, it clearly adopted a two-step analysis to get there:

> There was evidence . . . that actual damages would be extremely difficult to calculate. Consequently, use of such a provision would have been justified. [This is step one – the traditional prospective analysis.] The amount of liquidated damages seemed to bear some reasonable relationship to the actual injury caused by the breach. [This is step two – the court of appeals's retrospective analysis.]

The holdings of the court of appeals in *Carrothers* and *Wichita Clinic* run counter to the observations made by the Kansas Supreme Court in *Kansas Heart Hospital, L.L.C. v. Idbeis*, 286 Kan. 183, 184 P.3d 866 (2008), where the Court applied a one-step prospective analysis to test the validity of a liquidated damages clause in the form of a set redemption price for stock if the owner associated with a competing hospital. The bylaw at issue provided for a forced sale of stock at the original price paid plus an inflation factor. The parties who were being forced to sell their stock argued that a failure to pay them current market value for their stock made the bylaw an illegal penalty. The court rejected this argument, stating: "The determination of whether there is a penalty does not depend on speculating on the performance of investments." The Court then quoted from *TMG Life Insurance Co. v. Ashner*, 21 Kan. App. 2d 234, 898 P.2d 1145 (1995), as follows: "The reasonableness of a liquidated damages clause should be determined as of the time the contract was executed, not with the benefit of hindsight." The *Carrothers* and *Wichita Clinic* cases imposed an additional "hindsight" requirement that will often negate the direction that the reasonableness of the clause should be tested "as of the time the contract was executed." The Kansas Supreme Court has granted review of the court of appeals's opinion in *Carrothers*. It will be interesting to see which analysis the Court applies.

The Restatement (Second) of Contracts has not provided the clarifying guidance you would expect. The black letter provisions found at § 356 expressly require only a one-step analysis: the amount must be "reasonable in the light of the anticipated *or* actual loss caused by the breach and the difficulties of proof of loss." (Emphasis added.) This is followed by the statement: "A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty." RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (1981). What is "unreasonably large" could be tested in two ways: was it reasonable in light of the "anticipated" loss or was it reasonable in light of the "actual" loss. The use of the term "or" in the black letter statement of the rule would seem to provide for a broader basis in which to *validate* a liquidated damages clause. For example, even if it was not reasonable in light of the "anticipated" loss, if it turns out to be reasonable in light of the "actual" loss, the clause will be enforced. The court of appeals in *Carrothers* and *Wichita Clinic* has effectively changed "or" into "and" by turning the analysis into a two-part *invalidating* test in which the anticipated *and* actual damages must be compared to the liquidated damage figure.

Comment a to Restatement § 356 lists two seemingly conflicting goals. First, it notes the importance of "the principle of compensation" in contract law. If our main goal is to ensure that the innocent party is compensated, this would support a two-step analysis to avoid paying

liquidated damages when they substantially exceed actual damages. The second goal, however, is that "liquidated damages saves the time of courts, juries, parties and witnesses and reduces the expense of litigation." This is inconsistent with a two-step analysis because the latter promotes litigation in each case to determine actual damages so they can be compared with the liquidated damages number. The prospective only, one-step approach discussed in *Kansas Heart Hospital* promotes freedom of contract and allows efficient breach concepts to operate because the parties know that the liquidated damages clause will not be second-guessed through a future actual damages comparison. Arguably, a prospective analysis provides the appropriate level of protection against penalties, recognizing that the same uncertainty that allows the parties to contract regarding future damages may indeed depart from what, under unknown circumstances at some unknown time in the future, may be the actual damages.

2. Statutory Duties Cannot Be Avoided by Contract

Double M Construction, Inc. was the excavation subcontractor for Double J Pipeline, LLC. Pursuant to their contract, Pipeline, the prime contractor, agreed to identify existing pipelines in the area so they could be safely crossed when Double M excavated. Pipeline contacted Kansas One Call to coordinate the spotting of existing utilities in the excavation path. Apparently Pipeline failed to communicate with Double M, which resulted in Double M excavating the area before it had been marked through the Kansas One Call system. Double M struck a high-pressure natural gas transmission line resulting in the death of a Double M employee and property damage. The Kansas Corporation Commission assessed a $25,000 penalty against Double M for failing to comply with the Kansas One Call statutes. Double M's defense was that it had a contract with Pipeline that required Pipeline to locate utilities before Double M's excavation.

The Supreme Court, in *Double M Construction, Inc. v. State Corporation Commission*, 202 P.3d 7 (Kan. 2009), rejected Double M's contract defense, stating: "Unless a statute expressly or implicitly allows for delegation, statutory duties imposed on one party generally may not be delegated by contract to another party." Double M was the "excavator" required to comply with the Kansas Underground Utility Damage Prevention Act by following the Kansas One Call procedures. Double M's delegation of this responsibility through its contract with the prime contractor did not relieve Double M from its statutory duties. Although Double M may have tort or contract claims against the prime contractor for its failure to communicate the utility marking status to Double M, that will not affect Double M's liability for its failure to comply with the statute.

At one level it may seem as if the Court was saying that Double M could not use an agent or, in this case, the prime contractor, to take the necessary compliance actions for Double M. If the prime contractor was truly acting on behalf of Double M to comply with the statute, Double M would still have been liable because it proceeded with its excavation before the statutory utility marking deadline had passed. Since the prime contractor was aware of the proper marking deadline, this would have been imputed to Double M, resulting in a violation of the Kansas One Call procedures. The Court, however, did not address these issues because Double M's basic defense was purely one of contractual delegation and did not raise agency issues.

3. Court Liberally Interprets "Hold Harmless" Clause

In the process of divorcing, William and Brenda entered into a separation agreement in which William was given control over the sale of a house, with the following proviso: "Once the marital residence is sold, in the event a deficiency exists with regard to the second mortgage, Husband shall completely satisfy any such deficiency and hold wife harmless therefrom." The divorce was precipitated in part by Brenda's fraudulent procurement of $150,000 from William's mother to purchase the house. Brenda pled guilty to one count of federal wire fraud and was ordered, as part of her sentence, to make restitution to William's mother in the amount of $66,000. This amount represented the sum due after the house was sold and the first mortgage paid, which left $84,000 in sales proceeds that were paid to William's mother.

Following the federal court's sentence requiring payment of the $66,000, Brenda sought a contempt order against William because he had failed to hold Brenda harmless for the $66,000, which also constituted the "deficiency" on the second mortgage held by William's mother. After finding that the "hold harmless" agreement was "the same as an indemnity agreement," the court in *Loscher v. Hudson*, 39 Kan. App. 2d 417, 182 P.3d 25 (2008), *rev. denied* (Sept. 22, 2008), concluded that William had to pay the $66,000 to his mother because it was encompassed by his indemnity agreement with Brenda.

In the process of arriving at its decision, the court stated: "The rules governing the interpretation and construction of indemnity agreements are also the same as those relating to other types of contracts." Although the court cited court of appeals and federal cases to support this proposition, it failed to acknowledge *Missouri Pacific Railroad Co. v. City of Topeka*, 213 Kan. 658, 518 P.2d 372 (1974), in which the Supreme Court noted that "hold harmless" clauses, also referred to as "exculpatory agreements," are construed strictly and limited to situations "plainly within the language used." Nor did the court examine *Hunter v. American Rentals, Inc.*, 189 Kan. 615, 371 P.2d 131 (1962), in which the Court held that an indemnity clause relieving the indemnified party from obligations it owes to the public generally, or as defined by statute, is not enforceable. Instead, the *Loscher* court gave Brenda the benefit of the doubt by holding that the restitution order was within the scope of the hold harmless

clause and under the circumstances did not violate public policy.

Dissenting Judge Malone, applying the factors set out in Restatement (Second) of Contracts § 178, believed the indemnity provision violated public policy when used to negate the sentence for restitution. Arguably the court could have arrived at the same conclusion by applying existing Kansas law applicable to indemnity agreements. Indemnity is an area in which the Kansas Supreme Court has been more demanding of the drafter to ensure that the other party is fully apprised, at the time the parties enter into the contract, of the nature and scope of the indemnity obligation. In this case, it seemed clear that since there was a mother-son relationship, the parties would control the mother's demand for repayment by making the son liable through indemnity. It is doubtful the parties contemplated the indemnity would cover discharge of a sentencing condition in a federal criminal proceeding, even though it happened to be measured by the same deficiency amount. This was the sort of situation in which strict interpretation of the indemnity provision should have limited it to the contemplated event – demand for repayment by the mother or her assignee.

III. LEGISLATIVE DEVELOPMENTS: AMENDMENTS TO ANTI-INDEMNITY STATUTE, K.S.A. 16-121

Limiting freedom of contract in indemnity agreements seems to be a favorite topic of the Kansas legislature–it now gets a chance to address the issue every year. In 2008 their focus resulted in significant amendments to K.S.A. 16-121 that took effect on January 1, 2009. As originally enacted in 2004, the statute prohibited, as being "against public policy," an "indemnification provision in a construction contract or other agreement . . . entered into in connection with a construction contract, which requires the indemnitor to indemnify the indemnitee for the indemnitee's negligence." Apparently one segment of the construction industry was losing in the bargaining process over who would be responsible for a party's negligence. In practice this determined who had to buy insurance to cover the risk. Since that segment couldn't win at the bargaining table, it turned to the Kansas legislature. As with any situation in which freedom of contract is ceded to a legislature, there will be unintended consequences. Having a legislature define the terms of a contract makes little sense unless it is acting to protect the general public, as opposed to stacking the deck for one commercial party against another.

After the enactment of K.S.A. 16-121, there were other industries that rushed to try to have their contracts included in the prohibition on indemnity against negligence. This process caused these other industries to focus on the utility of indemnity agreements–utility they were seeking to surrender voluntarily to the legislature. Often a transaction will not take place unless certain risks can be allocated between the parties by contract. The indemnity against "negligence" is used to avoid having to litigate a negligence defense every time a party desires to enforce a contractual indemnity.

The 2008 amendments to 16-121 demonstrate four trends: first, certain industries want to make it clear that certain activities *are not* encompassed by the law; second, certain segments of other industries want to make it clear that their activities *are* encompassed by the law; third, the scope of the prohibition on certain indemnities has been more fully defined to allow for greater, and lesser, coverage in listed situations; and fourth, certain indemnities have been expressly excluded from the prohibition.

To decipher 16-121, one must carefully read 10 definitions in subsection (a). The 2008 amendments add seven new definitions and extensively revise the prior definition of "construction contract" expressly to exclude listed activities at oil and gas well sites. The amended definition of the term "contract" expands coverage of the prohibition to include "motor carrier transportation contract" and "dealer agreement or franchise agreement." Each of these new "contracts" is also the subject of its own extensive definition. The definitions also distinguish between "mutual" and "unilateral" indemnity obligations.

The basic prohibition is found in subsection (b), which now applies to any "contract," defined to include "construction contract" and the additions noted above. Subsection (b) provides:

> An indemnification provision in a contract which requires the promisor to indemnify the promissee [*sic*] for the promissee's [*sic*] negligence or intended acts or omissions is against public policy and is void and unenforceable.

The amendment adds a prohibition against indemnity for any "intended acts or omissions." Does this mean that if the promisee takes action that is not negligent but nevertheless "intentional," resulting in a loss to the venture, the promisee must alone bear the loss? This puts the party to a venture that is the "doer" or the "operator" at a distinct disadvantage. The passive party could sit back and enjoy the benefits of the operator's actions, but force the active party to shoulder all the risk, and therefore loss, under their contract.

Subsection (c) expands the indemnity prohibition to insurance coverage by providing:

> A provision in a contract which requires a party to provide liability coverage to another party, as an additional insured, for such other party's own negligence or intentional acts or omissions is against public policy and is void and unenforceable.

This provision takes away from the parties the flexibility of placing the burden of insurance on the party who may be best able to insure the risk.

Recognizing that indemnity agreements can serve a useful purpose in some situations, subsection (d) was added to exempt specifically certain transactions from the prohibition. Exemptions include a contractor's agreement to provide "general liability insurance;" indemnification of a contractor against "strict liability under environmental laws;" indemnification as part of certain settlement agreements; insurance contracts and bonds issued by "an insurer or bonding company;" and certain indemnity agreements that "will be supported by liability insurance coverage to be furnished by the promisor" subject to specific limitations. The broadest exemption, however, found at subsection (d)(5), is for

> (5) a separately negotiated provision or provisions whereby the parties mutually agree to a reasonable allocation of risk, if each such provision is: (A) Based on generally accepted industry loss experience; and (B) supported by adequate consideration.

Subsection (d)(5) has the potential to negate the 16-121 prohibition when the provision is "separately negotiated." This is an invitation for the party drafting the agreement to ensure that the indemnity clause receives the appropriate attention by being conspicuous and containing recitations regarding allocation of risk and the industry context for the allocation. The "adequate consideration" requirement should be satisfied by the underlying deal that prompted the parties to contract with one another. It is possible, however, that "adequate" consideration is being used as a statutory opportunity for courts to limit the effect of the indemnity even though all "contract" consideration requirements have been met.

To avoid using choice of forum and choice of law to circumvent the indemnity prohibition, subsection (e) provides:

> Notwithstanding any contractual provision to the contrary, the laws of the state of Kansas shall apply to and govern every contract to be performed in this state. Any litigation, arbitration or other dispute resolution proceeding arising from such contract shall be conducted in this state. Any provision, covenant or clause in such contract that conflicts with the provisions of this subsection shall be void and unenforceable.

An immediate question is whether Kansas law must be applied only to the extent necessary to give effect to 16-121, or whether any "contract" (as defined in this statute) with an indemnity provision must apply Kansas law, in a Kansas forum, as to all issues. For example, could a party to a construction contract subject to 16-121 agree not to enforce the indemnity provision but still litigate contractual performance issues in a forum outside of Kansas? Under similar facts, would the party be compelled to apply Kansas law to the nonindemnity issues? Could a party to a contract allege that it contains language that is tantamount to an indemnity so as to compel application of Kansas law in a Kansas forum?

Although there are no reported appellate cases regarding K.S.A. 16-121, I predict that the statute will be widely used to try to negate allocations of risk within contracts and to negate choice-of-law and choice-of-forum clauses that would otherwise be enforceable absent K.S.A. 16-121. It will become a litigation tool to try to avoid contractual provisions that have proven very useful and beneficial in making deals work that might otherwise fail. It is an example of legislation to address matters that are best left to the marketplace where commercial parties can adjust to the realities of the industry in which they operate.