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## Warranty Disputes in the Seventh Circuit under Article Two, Sales: Advantage Seller

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# WARRANTY DISPUTES IN THE SEVENTH CIRCUIT UNDER ARTICLE TWO, SALES: ADVANTAGE SELLER?

RICHARD E. SPEIDEL\*

## I. INTRODUCTION

### A. *Focus of this Article*

This symposium asks whether the United States Court of Appeals for the Seventh Circuit has emerged as a major commercial law court. This article will ask how well this Court<sup>1</sup> has performed in resolving commercial disputes governed in whole or in part by Article 2 of the Uniform Commercial Code. In particular, it will examine disputes over liability and remedy when the buyer claims that the seller made and breached a warranty of quality.<sup>2</sup>

These are important Article 2 cases which typically involve the sale of "big ticket" items between commercial parties. They include contracts for the sale of complex or unique goods which are often designed and manufactured with the buyer's particular business needs in mind. They are, in the main, disputes which stem from direct contractual dealings between merchants, many of whom have continuing trade relationships. These disputes involve transactions where product failure results in economic loss, both direct and consequential, rather than damage to person or property. The risks, therefore, are outside the scope of conventional first and third party insurance and the redistributive policies of the law of torts. As such, risk allocation depends upon both the provisions of Article 2 and the agreement of the parties. The transactions, therefore, put a high premium upon the quantity and quality of the information communicated between seller and buyer over needs and risks<sup>3</sup>

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1. References to the "Court" in this Article mean the United States Court of Appeals for the Seventh Circuit. I have not discussed or cited decisions of the federal district courts.

2. For helpful background, see Special Project, *Article Two Warranties in Commercial Transactions*, 64 CORNELL L. REV. 30 (1978)[hereinafter Project]. This Project was updated in Special Project, *Article Two Warranties in Commercial Transactions: An Update*, 72 CORNELL L. REV. 1159 (1987) [hereinafter Update]. See also J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE, chs. 9-12 (3d ed. 1988); Speidel, *Warranty Theory, Economic Loss, and the Privity Requirement: Once More Into the Void*, 67 B.U.L. REV. 9 (1987).

3. Insufficient information by the seller may foreclose the buyer from establishing either an

and the effort, if any, by the seller to allocate the various risks of product failure to the buyer by agreement. Moreover, they test the success of Article 2 as a framework within which private risk allocation can take place.<sup>4</sup>

My general conclusion is that, on balance, Seventh Circuit has favored the seller rather than the buyer in warranty disputes. The question this raises is whether such an advantage is supported on the facts and under a sound interpretation of Article 2.

### B. *Limitations on Judicial Process*

This study is conditioned by the fact that the type of warranty dispute which reaches the Court is fortuitous. The Court must wait for the case (many are settled or resolved at a lower level) and it has no control over the issues presented for decision. When the case arrives, the Court is further confined by the limitations of the adversary system and, in diversity cases, by the dictates of *Erie Ry. v. Tompkins*.<sup>5</sup> In addition, the procedural posture of the case and the nature of the district court's ruling will shape the issues which the court will decide and the scope of judicial review.

Any evaluation, therefore, must consider how well the Court has dealt with the disputes which did arrive under these constraints imposed in the federal judicial process. The "how well," in turn, will depend upon the quality of the methodology used by the Court when interpreting and applying or filling the gaps in and around Article 2. In essence, has the Court given reasonable effect to the intention of the language of Article 2?

### C. *Code Methodology and Policy*

An important aspect of this methodology is the recognition that Ar-

implied warranty of fitness for particular purpose, U.C.C. § 2-315 (1987), or recovering consequential damages, U.C.C. § 2-715(2)(a) (1987).

4. The text of Article 2 is, with minor exceptions, the same in Illinois, Indiana and Wisconsin. The Code became effective in Illinois on July 1, 1962, ILL. REV. STAT. ch. 26 (1962), in Indiana on July 1, 1964, IND. CODE §§ 26-1-1-101-26-1-10-106 (1964) and in Wisconsin on July 1, 1965, WIS. STAT. tit. XL, chs. 401-09 (1965).

Article 2 in these states is, in essence, the 1958 Official Text of the U.C.C., which emerged from the Permanent Editorial Board of the Uniform Commercial Code after the critical study of the 1953 Official Text by the New York Law Revision Commission in 1956-57. See Braucher, *The Legislative History of the Uniform Commercial Code*, 58 COLUM. L. REV. 798 (1958). Over the last thirty years, Article 2 has been interpreted and applied in literally hundreds of judicial opinions and subjected to extensive analysis by commentators. In the Seventh Circuit alone, the Court has decided at least sixty-five cases since 1967 which relied in whole or in part on Article 2.

5. 304 U.S. 64 (1938).

Article 2 is an integral part of a code which has a definite order and system. The important hallmarks of the code form of legislation must be observed by the court.<sup>6</sup> Any opinion which fails to consider all of the relevant sections, definitions, cross-references and comments in Article 2 and the pervasive policies of Article 1<sup>7</sup> is highly suspect.

In addition, the court must articulate and apply the general substantive policies underlying the order and system of Article 2.<sup>8</sup> The starting point is the definition of the term "agreement" in section 1-201(3) of the UCC. "Agreement" is the "bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance . . ." as defined in sections 1-205 and 2-208.<sup>9</sup> Around this expansive core definition, the bargain in fact of the parties ending must be determined on a sliding scale. On the one extreme, the parties can draft a careful and complete written agreement which, within certain limits, can vary the

6. Some of these hallmarks are identified and discussed in Gedid, *U.C.C. Methodology: Taking a Realistic Look at the Code*, 29 WM. & MARY L. REV. 341, 376-77 (1988). They are:

(1) a principle is stated in the text of a particular section, exceptions to that principle are stated in the section itself or in statutory cross-references;

(2) There are permanent, safety valve provisions, such as the duty of good faith in the performance and enforcement of the contract and the prohibition against unconscionable contracts;

(3) The underlying policies of various provisions are intended to be compatible;

(4) Mechanisms to keep the legal principles current and to fill gaps in the agreement are provided in the statute;

(5) There are principles of coordination, in that Code sections refer to each other and their meaning remains consistent when more than one section applies; and

(6) There are principles of superordination, in that methods for handling competing and conflicting principles are provided.

7. See generally U.C.C. § 1-102 (1987) for underlying purposes, rules of construction and variation by agreement. In addition, see *id.* § 1-106 (remedial policy); *id.* § 1-203 (obligation of good faith); *id.* § 1-205 (course of dealing and usage of trade.); and *id.* § 1-201 (general definitions).

8. Article 2 does not govern all issues that may arise in and around a contract for sale of goods. Its provisions may be supplemented, see *id.* § 1-103 ("unless displaced by the particular provisions" of the U.C.C., the "principles of law and equity . . . shall supplement its provisions") or preempted by other state law. See, e.g., Leary & Frisch, *Is Revision Due for Article 2*, 31 VILL. L. REV. 399, 405-422 (1986) (discussing non-uniform state law regulating certain aspects of warranty law).

Moreover, in warranty disputes involving commercial leases, Article 2A, Leases §§ 2A-210 through 216 may govern and where consumer buyers are involved, Article 2 is preempted in part by federal legislation, such as the Magnuson-Moss Warranty Act, and by the state "lemon" laws. See Rice, *Product Quality Laws and the Economics of Federalism*, 65 B.U.L. REV. 1 (1985). Finally, the Convention on Contracts for the International Sale of Goods, effective in the United States in January 1, 1988, has potential application to warranty disputes. Thus, the search for substantive sales policies may transcend the scope of Article 2.

9. "Contract" is defined as the "total legal obligation which results from the parties' agreement as affected by this Act and any other applicable rules of law." U.C.C. § 1-201(11) (1987). Article 2, of course, determines when an agreement to sell becomes a contract for sale. See *id.* § 2-106(1).

effect of Article 2.<sup>10</sup> Product description, essential characteristics and suitability, for example, could be set forth in great detail. Toward the center of the scale, gaps in and around the written agreement can be filled by extrinsic evidence of agreement, found primarily in trade usage and the conduct of the parties, either before or after the particular bargain is struck.<sup>11</sup> At the other end of the scale, gaps in the agreement, express or implied, can be filled with standard or "off the rack" terms supplied by Article 2, Part 3 "if the parties have intended to make a contract."<sup>12</sup> These "off the rack" terms are designed to provide a balanced and fair hypothetical agreement for parties who have intended to conclude their bargain in fact but have failed to fill in all of the gaps. To use an obvious example, if the parties have intended to contract but have not agreed on a price, the gap filler is "a reasonable price at the time for delivery."<sup>13</sup> Assuming that the contract terms, i.e., the bargain in fact and the "gap fillers," have been determined, judicial efforts to resolve disputes over performance and remedy must take other principles into account. Under Article 2, the court may be required to: (1) Impose a higher standard of conduct on merchant sellers and buyers;<sup>14</sup> (2) Respond to the frequent statutory invitation to use the surrounding commercial context to particularize standards;<sup>15</sup> (3) Police the conduct of the parties against unconscionability at the time of contracting<sup>16</sup> and bad faith in the performance and enforcement of the contract;<sup>17</sup> and (4) Administer the remedial structure to insure that an aggrieved party is provided a remedy that protects its expectation interest, but not more.<sup>18</sup>

Finally, the methodology must also take into consideration the objective of uniformity. Section 1-102 states that "[t]his Act shall be liberally construed and applied . . . to make uniform the law among the

10. See generally *id.* § 1-102(3), which sets the parameters for the power to vary the provisions of the Code by agreement.

11. For example, "implied warranties may arise from course of dealing or usage of trade." U.C.C. § 2-314(3) (1987).

12. *Id.* § 2-204(3).

13. *Id.* § 2-305(1).

14. *E.g., id.* §§ 2-314(1) and 2-104(1). See Wiseman, *The Limits of Vision: Karl Llewellyn and the Merchant Rules*, 100 HARV. L. REV. 465 (1987).

15. On the jurisprudence of Article 2, compare Casebeer, *Escape from Liberalism: Fact and Value in Karl Llewellyn*, 1977 DUKE L. J. 671 with Danzig, *A Comment on the Jurisprudence of the Uniform Commercial Code*, 27 STAN. L. REV. 621 (1975). See also Gedid, *U.C.C. Methodology: Taking A Realistic Look at the Code*, 29 WM. & MARY L. REV. 341 (1988).

16. U.C.C. § 2-302 (1987). See, e.g., Mallor, *Unconscionability in Contracts Between Merchants*, 40 SW. L.J. 1065 (1986).

17. U.C.C. §§ 1-203 and 2-103(1)(b) (1987). See, e.g., Burton, *Good Faith Performance of a Contract Within Article 2 of the Uniform Commercial Code*, 67 IOWA L. REV. 1 (1981).

18. On the importance of U.C.C. § 1-106(1), see White, *The Decline of the Contract Market Damage Model*, 11 U. ARK. LITTLE ROCK L.J. 1 (1988).

various jurisdictions.”<sup>19</sup> Since section 1-102 is state law, a federal court should, in the absence of clear local decisions to the contrary, seek to facilitate this goal. Thus, where a state court has not yet ruled on a particular question of statutory interpretation, the court should not only strive to reach a decision which is sound in terms of code methodology and policy, but which also promotes uniformity. In short, the Court should make every effort to reach the best interpretation of the *Uniform Commercial Code*.

## II. WARRANTY DISPUTES BETWEEN SELLER AND BUYER: THE ARTICLE 2 BALANCE

### A. Framework for Agreed Risk Allocation

Beneath the order and system of the Code and its general policies lies a more particular inquiry. In disputes over product quality, two questions must be answered: (1) What balance does Article 2 strike between seller and buyer on questions of liability and remedy; and (2) To what extent can the parties, by agreement, vary that balance? The answers to these questions require a brief look at the legislative framework for product risk allocation.

Warranty disputes arise when the buyer discovers that the goods purchased do not satisfy its subjective expectations of quality and claims that these expectations conform to the sellers objective obligations under the contract. The seller's obligations, in turn, are determined by the agreement of the parties. The agreement may range from complete written specifications detailing every required characteristic and use of the goods to the other extreme, where the only agreement is the contract description and the price.<sup>20</sup> Given the range of possibilities, the higher the buyer's subjective expectations, the greater the quantity and quality of information and objective agreement that must be available to sustain the claim that a warranty was made and breached.<sup>21</sup>

#### 1. Creation of Warranty

The warranty provisions of Article 2, sections 2-313, 2-314 and 3-

19. The quote is extracted from U.C.C. § 1-102 (1)-(2)(c) (1987).

20. At a minimum, “a contract is normally . . . for a sale of something describable and described.” *Id.* § 2-313 comment 4.

21. See generally Bishop, *The Contract-Tort Boundary and the Economics of Insurance*, 12 J. LEGAL STUD. 241 (1983), who argues that efficient product risk allocation requires that the burden of producing, *ex ante*, information about particular purposes or special consequences from a breach should be placed on the buyer. See U.C.C. §§ 2-315 and 2-715(2)(a) (1987). For an elaboration of Bishop's analysis, see Speidel, *supra* note 2, at 48-52. See also Note, *Imperfect Information, the Pricing Mechanism and Products Liability*, 88 COLUM. L. REV. 1057 (1988).

315, supplement and fill gaps in the express agreement of the parties. Section 2-314(1) provides a baseline warranty: A warranty that the goods are merchantable "shall" be implied when the seller is a "merchant with respect to goods of that kind." Under section 2-313(1), however, express warranties are created when the seller provides information (in the form of affirmations, promises, description or samples) to the buyer about the goods which becomes "part of the basis of the bargain." Under section 2-315 the information flow is reversed. An implied warranty of fitness arises when the buyer informs the seller (or the seller has reason to know) of "any particular purposes for which the goods are required" and the seller has reason to know "that the buyer is relying on the seller's skill or judgment to select or furnish suitable goods." When made, these warranties, express or implied, are terms of the contract for sale. They help determine what the seller has "in essence" agreed to sell.<sup>22</sup> In the absence of a warranty appropriate to the buyer's needs and purposes, however, the buyer assumes the risk of unsatisfied subjective expectations.

## 2. Remedies for Breach

Without more, the warranty provisions of Article 2 give an advantage to the buyer. In contending that a warranty was *created*, there is a good possibility, especially where merchantability is at stake or express warranties are claimed, that the buyer's subjective expectations of quality will coincide with the seller's objective contractual obligation. Moreover, except for section 2-315, there is no requirement that the buyer prove reliance on the claimed warranty.<sup>23</sup>

This advantage is preserved when a *breach* of warranty has been proved and the buyer seeks damages. Although the range of remedial options for direct damages depends upon whether the breach is discovered before or after acceptance of the goods,<sup>24</sup> the buyer may in any case pursue claims for incidental and consequential damages under section 2-715. Although there are limitations upon each remedy, the cumulative effect is consistent with the policy of section 1-106(1) that the "remedies

22. See U.C.C. § 2-313 comment 4 (1987).

23. The requirement in U.C.C. § 2-313 (1987) that the affirmation become "part of the basis of the bargain" will be discussed *infra* text accompanying note 60.

24. If the buyer has rightfully rejected the goods, U.C.C. § 2-601 (1987), or justifiably revoked acceptance, *id.* § 2-608, the remedies catalogued in § 2-711(1) are available. They include cancellation of the contract for breach, restitution of any price paid, and the choice between "cover," *id.* § 2-712(1), and damages, *id.* § 2-713(1). In addition, the buyer may recover incidental, *id.* § 2-715(1), as well as consequential damages, *id.* § 2-715(2)(a). If the buyer can neither reject the goods nor revoke acceptance, the direct damage remedy is found in U.C.C. § 2-714.

provided by this Act shall be liberally administered to the end that the aggrieved party may be put in as good a position as if the other party had fully performed . . . .”

### 3. Limitations on Proof and Remedies

These apparent advantages are limited, however, if the buyer does not discover the breach of warranty until after the goods have been accepted and the acceptance cannot be revoked under section 2-608. As a practical matter, this is a likely situation, especially where the goods are complex and require extensive testing.<sup>25</sup>

One effect of acceptance is that the buyer's direct damages are determined exclusively under section 2-714(2), although incidental and consequential damages are still recoverable under section 2-715. Moreover, the remedial dynamic has clearly changed. If the acceptance cannot be revoked, the buyer is liable for the price as reduced for any damages caused by the breach<sup>26</sup> and has the burden of proving breach of warranty, i.e., that the goods did not conform at the tender of delivery.<sup>27</sup> Finally, the longer the time lapse between tender of delivery and discovery of the breach, the greater the risk that the buyer's remedial options will decrease<sup>28</sup> or be foreclosed. Thus, a breach of warranty claim will be “barred” if the buyer either (a) fails to notify the seller of the breach “within a reasonable time after he discovers or should have discovered any breach,”<sup>29</sup> or (b) fails to file a law suit within four years of the tender of delivery, whether the breach has been discovered or not.<sup>30</sup>

### 4. Disclaimers and Agreed Remedies

This legislative framework for risk allocation can be varied by agreement between the parties. The seller has power through agreement with

25. Under U.C.C. § 2-513(1) (1987), the buyer “has a right before payment or acceptance to inspect [the goods] at any reasonable place and time and in any reasonable manner.” After the buyer has a “reasonable opportunity to inspect . . . ,” the goods are accepted if the buyer “signifies to the seller that the goods are conforming . . . ,” *Id.* § 2-606(1)(a), or “fails to make an effective rejection . . . .” *Id.* § 2-606(1)(b). After acceptance, the buyer must then satisfy the rigorous requirements for revocation under U.C.C. § 2-608 and, even then, may have agreed not to invoke that remedy.

26. See U.C.C. §§ 2-607(1), 2-709(1)(a), and 2-717 (1987).

27. *Id.* § 2-607(4).

28. For example, the remedy of revocation of acceptance must be invoked “within a reasonable time after the buyer discovers or should have discovered the ground for it . . . .” *Id.* § 2-608(2).

29. *Id.* § 2-607(3)(a). For an effective critique of the “notice” requirement, see Reitz, *Against Notice: A Proposal to Restrict the Notice of Claims Rule in U.C.C. § 2-607(3)(a)*, 73 CORNELL L. REV. 534 (1988).

30. U.C.C. § 2-725 (1987).



the buyer to disclaim or limit implied warranties otherwise made<sup>31</sup> and to vary or limit remedies for breach of warranty.<sup>32</sup> This power, however, is limited by policies designed to prevent unconscionable conduct at the time of contracting<sup>33</sup> and unfair surprise in the communication of disclaimers<sup>34</sup> and to preserve, despite agreement, some "minimum adequate" remedy.<sup>35</sup>

These limitations upon the seller's ability to alter the Article 2 balance to the buyer's detriment make good sense. As one court put it, the "enforcement of such a provision is generally justified through the buyer's superior ability to calculate and then to reduce the risk of substantial loss. . . . Without clear notice of that large potential liability, the buyer cannot make use of these supposed advantages."<sup>36</sup>

## 5. Privity

A final requirement, implicit in the text of Article 2, is that there must be privity of contract between the seller and buyer in commercial settings. Thus, a buyer that purchases unmerchantable goods from a retailer cannot sue the manufacturer of those goods for breach of warranty, at least not where the loss was solely economic. Article 2, however, invites non-uniform legislative exceptions through variations on section 2-318 and permits judicial abrogation of the privity requirement. Although the issue remains open, the predominant view in the courts still is that privity is required for warranty claims where the goods do not cause damage to person or property.<sup>37</sup>

### B. Relationship with Tort

In commercial cases, a recurring source of tension exists between Article 2 and the law of torts. If an unmerchantable or "defective" product causes damage to the person or property of the buyer or some third party, the ground rules have become well established. The plaintiff may either pursue a claim in strict products liability or a warranty claim under Article 2. If a tort theory is pursued, the contractual limitations which abound in Article 2 are not applicable.<sup>38</sup>

31. *Id.* § 2-316.

32. *Id.* § 2-718.

33. *Id.* § 2-719(3).

34. *Id.* § 2-316(2).

35. *Id.* § 2-719 comment 1. See Kniffin, *A Newly Identified Contract Unconscionability: Unconscionability of Remedy*, 63 NOTRE DAME L. REV. 247 (1988).

36. *Waters v. Massey-Ferguson, Inc.*, 775 F.2d 587, 592 (4th Cir. 1985) (Wilkinson, J.).

37. See Speidel, *supra* note 2, at 35-37.

38. The U.C.C., in most states, does not foreclose a buyer injured in person by unmerchantable

The problem is more complicated when an unmerchantable product causes only damage to the goods sold or economic loss in the form of direct and consequential damages to the buyer. Article 2 clearly applies to these disputes. But what about tort law? Can the buyer escape to tort and avoid the limitations of Article 2?

In most states the answer is no. If the loss caused is economic, tort is not available even though the goods created a risk of harm to person and property.<sup>39</sup> Despite recurring doubts about a line which depends upon the type of loss created, the effect is to prevent the buyer from using tort to escape the limitations found in Article 2.

In sum, Article 2 favors the buyer in the creation of warranties, express and implied, and in the remedial protection available upon breach. The remedies, however, are limited if the buyer discovers the breach after acceptance—a likely event. Moreover, the earlier advantages may be neutralized through agreed risk reallocation devices such as disclaimers and limited remedies. Finally, the buyer in a commercial case is virtually a prisoner of Article 2 with its implicit requirement of privity. Tort law is not available to escape the Code's risk allocation framework, and the buyer, in many cases, will be required to sue a distributor or retailer rather than the manufacturer of the goods.

Against this backdrop, how has the Seventh Circuit performed in dealing with warranty disputes?

### III. WAS A WARRANTY MADE AND BREACHED?

The first testing ground involves the questions of whether the seller made and breached a warranty, express or implied.<sup>40</sup> Again, the relevant provisions of Article 2 are sections 2-313, 2-314 and 2-315, along with the principles of coordination and superordination in section 2-317.<sup>41</sup> The buyer usually has the burden of proving that the seller made a warranty and, after acceptance, the burden of establishing that the warranty was breached at the time of tender.<sup>42</sup>

goods from suing in strict products liability. The buyer may, in the alternative, sue the seller under the U.C.C. for breach of warranty.

39. In Illinois, Indiana and Wisconsin, the law of torts does not apply if the product has caused only economic loss. The buyer's sole remedy is under Article 2, with its requirement of privity. See *infra* text accompanying notes 136-40.

40. A central inquiry is to determine "what it is that the seller has in essence agreed to sell . . .," U.C.C. § 2-313 comment 4 (1987), and whether the tendered goods conform to that agreement. *Id.* § 2-106(2).

41. For a discussion of U.C.C. § 2-317 and the relevant decisions, see Update, *supra* note 2, at 1283-89.

42. U.C.C. § 2-607(4) (1987).

The Seventh Circuit cases deciding whether warranty was made and breached have had three characteristics: (1) The buyer accepted the goods and, therefore, had the burden to prove the breach, if any; (2) The goods were complex or unique and the buyer had special needs for them; and (3) There was no enforceable agreement to disclaim any warranty or limit the remedies for breach. These characteristics, combined with the Court's interpretation of the Code, have meant a singular lack of success for the buyer.

#### A. *Implied Warranty of Merchantability: Section 2-314*

The question whether a merchant seller made an implied warranty of merchantability has not yet been before the Court. Rather, the warranty was assumed,<sup>43</sup> and the question was whether the buyer proved that the goods were unmerchantable. Under section 2-314(2), "[g]oods to be merchantable must be at least such as (a) pass without objection in the trade under the contract description; and . . . (c) are fit for the ordinary purposes for which such goods are used . . . ."<sup>44</sup> In no case where the merchantability issue was raised, has the buyer prevailed.

In *Royal Business Machines v. Lorrain Corps.*,<sup>45</sup> the buyer purchased two high-tech copying machines from the seller over an eighteen month period. Despite the seller's efforts to cure alleged deficiencies, the machines did not produce the volume expected by the buyer and were expensive to operate and maintain. After reviewing the evidence, the trial court ruled that the copiers were *unmerchantable*. The Seventh Circuit, however, reversed on the ground that the buyer had not proved unmerchantability. The Court found that the buyer failed to establish the trade standards or usages for copiers of that type and description. Without such standards, there was no basis for the Court to determine whether the machines were "fit for the ordinary purposes for which such goods are used." Since there was "no evidence" to support the ruling, the Seventh Circuit held that the trial court was wrong as a matter of law.<sup>46</sup>

43. U.C.C. § 2-314(1) (1987) provides that "[u]nless excluded or modified . . . , a warranty that the goods shall be merchantable is implied in a contract for their sale if the seller is a merchant with respect to goods of that kind." Note that reliance by the buyer is not required. The Court has stated that the implied warranty of merchantability is "implied in law," see *Bethlehem Steel Corp. v. Chicago Eastern Corp.*, 863 F.2d 508, 513 (7th Cir. 1988), a dubious characterization in a commercial case.

44. I have quoted only two of the six standards defining merchantability in U.C.C. § 2-314(2) (1987).

45. 633 F.2d 34 (7th Cir. 1980).

46. *Id.* at 46-47. The Court also held that the buyer had not properly revoked acceptance under § 2-608. This failure left the burden of proof on the buyer, although the Court did not cite § 2-607(4). *Id.* at 47-48.

Similar reasoning has been employed in more recent decisions which affirmed the trial court's granting of a directed verdict *against* the buyer. In *Bethlehem Steel Corp. v. Chicago Eastern Corp.*,<sup>47</sup> the Court emphasized that the buyer must prove both the ordinary purposes for which "such goods" are used and that particular characteristics of the goods made them unfit for ordinary purposes.<sup>48</sup> As illustrated by *Binks Manufacturing Co. v. National Presto Industries*,<sup>49</sup> this is difficult to do where the goods are a unique, custom designed machine which was the largest and most complex that the seller had ever built. Thus, evidence consisting solely of the contract description, the price charged, and specifications which were incomplete on essential characteristics was insufficient as a matter of law.<sup>50</sup>

At first blush, it is difficult to fault the result in these cases. Goods which are reasonably capable of performing their ordinary functions, but do not satisfy the buyer's particular needs, are merchantable under section 2-314(2)(c).<sup>51</sup> Because the buyer claimed substantial losses, however, one should expect a more elaborate analysis by the Court, especially where, as in *Royal Business Machines*, a trial court ruling *in favor* of the buyer was reversed. Instead, the discussion in that case was limited to a sparse analysis of the essential statutory provisions and the record. Few cases were cited and none were discussed. There was no reference to history, legislative or otherwise, the Code's comments were ignored, and the few references to secondary sources were not informative. At best, acceptable results were achieved through incomplete Code methodology. At worst, the Court, by focusing exclusively on the lack of proof of "ordinary" uses, failed to develop a sufficiently broad conception of merchantability that might have sustained the trial court's judgment for the buyer and also provided enlightenment in future disputes over that

47. 863 F.2d 508 (7th Cir. 1988), affirming a directed verdict against the buyer.

48. *Id.* at 513, 514. The question was whether steel which satisfied designations in the contract and would "pass without objection in the trade under the contract description," U.C.C. § 2-314(2)(a) (1987), was unmerchantable because of a high nitrogen content. The Court affirmed the trial court's decision to direct a verdict against the buyer. On the evidence presented, no reasonable juror could know the ordinary purposes of such steel and that the nitrogen content made the steel unfit for those purposes.

49. 709 F.2d 1109, 1121-22 (7th Cir. 1983) (in the absence of evidence of the ordinary purposes for which the unique goods were used, the Court affirmed a directed verdict against the buyer, entered at the conclusion of evidence).

50. The Court relied upon *Price Bros. Co. v. Philadelphia Gear Corp.*, 649 F.2d 416 (6th Cir. 1980), *cert. denied*, 454 U.S. 1099 (1981), stressing that the parties were sophisticated and of equal skill and knowledge, the contract was bargained at arms length and the machine was larger and more complex than any previously made by the seller. *Id.* at 1122.

51. See Project, *supra* note 2, at 76-79; Update, *supra* note 2, at 1206-13; J. White and R. Summers, *supra* note 2, at § 9-8.

implied warranty.<sup>52</sup>

### B. Implied Warranty of Fitness: Section 2-315

In similar transactions, buyers have been unable to establish that a warranty of fitness for particular purpose was made under section 2-315, much less breached. The seller has been held not to have had "reason to know" at the time of contracting either "any particular purpose for which the goods are required" or that the buyer was "relying on the seller's skill or judgment to select suitable goods . . ." These results are typical of those reached by other courts under section 2-315.<sup>53</sup>

A good example is *Wisconsin Electric Power Co. v. Zella Bros., Inc.*,<sup>54</sup> where the seller sold the buyer, an electric power company, "bellows" type expansion joints to be incorporated into a thirty-inch steam pipeline then under construction. The combination of normal stress and the presence of an unexpected and unidentified corrosive agent caused cracks to develop in the joints. Although the parties had extensive negotiations and discussed the corrosive effect of chlorides in steam on joints, the trial court held that there was no implied warranty of fitness and the Court affirmed.

After analyzing section 2-315, the Seventh Circuit concluded that while the seller knew the use to which the joints would be put and that there was a risk of corrosion, the seller had no reason to know of the specific agent that caused the crack. Furthermore, there was no industry standard that defined a norm of expectation for "bellows" type expansion joints. Given what the seller did not know and what the buyer did not tell it, the Court was unable to imply a warranty that the joint would resist corrosion from all unknown elements in the system. These facts reinforced the conclusion that the seller had no reason to know that the buyer was relying on its skill and judgment to provide protection against all corrosion agents.<sup>55</sup>

52. Such a broad conception should include at least three ingredients: (1) recognition that the six definitions of merchantability in § 2-314(2) are cumulative and conjunctive—a failure to satisfy any one is sufficient; (2) even though the goods appear to satisfy "ordinary" uses, if they malfunction and cause loss to the buyer, this is evidence that they are not merchantable, see *Streich v. Hilton-Davis*, 692 P.2d 440 (Mont. 1984); (3) proof of unmerchantability is frequently inferential, and wide latitude should be given to the trier of fact. See, e.g., *Chatfield v. Sherwin-Williams Co.*, 266 N.W.2d 171 (Minn. 1978); *J. White & R. Summers*, *supra* note 2, at 413-14; *Phelan and Falkof, Proving a Defect in a Commercial Products Liability Case*, 24 TRIAL LAW GUIDE 10 (1980).

53. See, e.g., *Project*, *supra* note 2, at 85-104; *Update*, *supra* note 2, at 1213-17.

54. 606 F.2d 697 (7th Cir. 1979).

55. The Court made a useful distinction between the purposes for which the joints were purchased (use in a pipeline) and the characteristics of the joints (resistance to corrosion). *Id.* at 701-02. In other cases where complex goods and particular purposes were involved, the Court stressed the fact specific nature of the inquiry into what the seller had reason to know and whether

The Seventh Circuit implied warranty decisions highlight the risk to a buyer that is purchasing complex goods with no "ordinary purposes" in the trade that such goods will fail to meet particular purposes not clearly communicated to the seller or expressed in a written agreement. In the absence of proof of ordinary uses and purposes, or detailed communication by the buyer to and reliance upon the seller, the Seventh Circuit has been unwilling to fill the gaps with implied warranties. Although the results reached are generally sound, the Court, because of incomplete methodology, has missed an opportunity to perfect a broader framework within which the implied warranty of merchantability could be understood.

### C. *Express Warranties: Section 2-313*

Buyers have also had difficulty persuading the Court that the seller made and breached an express warranty that complex or unique goods would satisfy the buyer's particular purposes. Once again, the gap between the buyer's subjective expectations and what the seller objectively represented that the goods were or would do has been too large, especially where there were no industry practices or norms to support the buyer's expectations.<sup>56</sup> To add to this difficulty, the Seventh Circuit has complicated the buyer's burden of proof by a questionable interpretation of section 2-313.

In *Royal Business Machines v. Lorraine Corp.*,<sup>57</sup> the trial court ruled that the seller made and breached eight express warranties, allegedly made over an eighteen-month period, about the characteristics and capacities of two copying machines. The Seventh Circuit affirmed in part

the buyer relied upon the seller's skill and judgment. In *Royal Business Machines*, 633 F.2d at 46-47, the seller knew the buyer's particular purpose but the trial court failed to make a finding on which copier, if either, the buyer had relied upon the seller's skill and judgment. The case was remanded for more evidence on the buyer's "actual reliance" for each copier. In *Bethlehem Steel Corp.*, 863 F.2d at 515-17 (7th Cir. 1988), for example, the Court affirmed a jury verdict for the seller over buyer's claim that there was an erroneous instruction on reliance. The seller had reason to know of the buyer's particular purpose in ordering steel. The jury, however, was instructed that the buyer did not rely on the seller's skill and judgment when it furnished technical specifications for the storage bins, even though the steel was originally ordered by brand name. The Court concluded, however, that the instruction, although not perfect, did not prevent the jury from considering all of the facts relevant to the reliance requirement in § 2-315.

56. In *Wisconsin Elec. Power Co. v. Zallea Bros., Inc.*, 606 F.2d 697, 700-01 (7th Cir. 1979), the Court affirmed the trial court's conclusion that there were no express warranties that the bellows type expansion joint would protect against all corrosion agents in the buyer's thirty inch steam pipeline. Among other things, the Court concluded that language of guarantee in a letter was not an express warranty, especially since "there were no general industry standards regarding acceptable steam quality and levels of chemicals and corrodents against which the performance of Zallea's bellows could be measured." *Id.* at 701.

57. 633 F.2d 34, 41-45 (7th Cir. 1980).

and reversed in part and developed a complex test, not clearly required by section 2-313, which made it more difficult for the buyer.

First, the Court properly distinguished between affirmations by the seller to the buyer about the goods and affirmations which were "merely of the value of the goods" or "merely the seller's opinion or commendation of the goods." The former were express warranties under section 2-313(1) and the latter, under section 2-312(2), were not.<sup>58</sup> The test, according to the Court, is whether the seller states a fact of which the buyer was ignorant or "merely states an opinion or judgment on a matter of which the seller has no special knowledge and on which the buyer may be expected also to have an opinion and to exercise his judgment."<sup>59</sup> This test is found in neither the text of, nor the comments to section 2-313. Rather, comment 8 to section 2-313 states that the test for affirmations of fact and affirmations of value or opinion is the same: "What statements of the seller have in the circumstances and in objective judgment become part of the basis of the bargain?"<sup>60</sup> The Court, however, drew the line without reference to the "basis of the bargain" test.

Second, if the affirmations were express warranties under section 2-313(1), the question is whether they became "part of the basis of the bargain." According to the Court, this is in essence a reliance test—a test which would be influenced over the eighteen month relationship by the buyer's increasing knowledge of the product's shortcomings and risks. The same affirmation made later in the relationship might not justify reasonable reliance. Since the trial court in *Royal Business Machines* failed to consider the effect of time upon the buyer's reliance, the case was remanded for further findings. The Seventh Circuit, however, did not comment on who had what burden of proof on the remand. As a result, the trial court could require the buyer to prove reasonable reliance on the affirmations (the law before the UCC) rather than providing the benefit of the presumption that all representations were part of the basis of the bargain unless the seller produced "clear affirmative proof" that they were not.<sup>61</sup>

The Seventh Circuit's interpretation of section 2-313 is questionable. It ignores the suggestion, made in the comments and supported by most

58. The Court quoted § 2-313(1) in full in a footnote, but paraphrased it in the opinion. The Court neither cited nor discussed § 2-313(2). *Id.* at 41.

59. *Id.* at 41. The test was derived from cases, some of which were decided before enactment of Article 2. There was no attempt to relate cases cited to § 2-313 or the comments. For example, U.C.C. § 2-313(2) comment 8 (1987), which suggests a different test, was ignored.

60. See Project, *supra* note 2, at 59-61 for an analysis of that language as of 1979.

61. U.C.C. § 2-313 comment 3 (1987). The Court recognized but apparently rejected this proposition in a footnote. *Royal Business Mach., Inc.*, 633 F.2d at 44 n.7.

commentators,<sup>62</sup> that all affirmations about the goods made by the seller to the buyer should be presumed to be part of the basis of the bargain. Proof by the buyer of actual reliance is not required. Rather, the burden is on the seller to establish by "clear and affirmative proof" that the statements were not part of the buyer's bargain. One aspect of that proof may be that the buyer did not rely in fact or that purported reliance was unreasonable. But the burden should be on the seller to establish the negative, rather than the other way around.<sup>63</sup> If this view were accepted, the district court's failure to make certain findings would be fatal to the seller rather than the buyer.

#### D. *Misuse of the Parol Evidence Rule: Section 2-202*

Resort to section 2-313 may not be needed when a written agreement is clear and detailed enough about the contract's essential elements. The written contract, without more, establishes the standard for conformity and the terms are clearly part of the bargain. In these situations, however, disputes over interpretation may arise.

Such a case is *Binks Manufacturing Co. v. National Presto Industries, Inc.*,<sup>64</sup> where a dispute over the "maximum capacity" of an industrial spray system arose. Although the dispute appeared to involve interpretation of *terms* in the writing, the Court applied the parol evidence rule in section 2-202 to exclude evidence from earlier negotiations and course of performance that was arguably relevant to explain the meaning of those terms. Stressing that the parol evidence rule was a "rule of law," the Court concluded that the extrinsic evidence was not in harmony with the language of the writing and should be excluded.<sup>65</sup>

Although the line is difficult to draw, the Court took the wrong approach to the parol evidence rule. By excluding evidence introduced to interpret rather than to add to or vary terms in the writing, the Court ignored the language of and the comments to section 2-202 and an ac-

62. For a then contemporaneous discussion, not cited by the Court, see Project, *supra* note 2, at 50-67. For more recent commentary, see, e.g., Murray, "Basis of the Bargain": *Transcending Classical Concepts*, 66 MINN. L. REV. 283 (1982); Coffey, *Creating Express Warranties Under the UCC: Basis of the Bargain—Don't Rely on It*, 20 U.C.C. L.J. 115 (1987).

63. *Royal Business Mach.*, 633 F.2d at 44 n.7. The Court bootstrapped itself into the "reliance" test. Although citing comments 3 and 8 to § 2-313, the Court quoted not the comments but the paraphrase of them in *Sessa v. Riegler*, 427 F. Supp. 760 (E.D. Pa. 1977), *aff'd mem.*, 568 F.2d 770 (3d Cir. 1978). That paraphrase concluded that a reliance test was required, a conclusion that has been hotly debated. See Project, *supra* note 2, at 53-54. This debate and the criticism of *Sessa* were not revealed in the opinion.

64. 709 F.2d 1109 (7th Cir. 1983).

65. *Id.* at 1114-17.



cepted limitation on the exclusionary rule.<sup>66</sup> By explaining section 2-202 as a rule of law rather than the product of the parties' intention, the Court undercut the consensual underpinnings of the rule itself. The result, in that case at least, was a highly questionable victory for the seller.

#### IV. MEASURE OF DAMAGES FOR BREACH OF WARRANTY

When the buyer has accepted goods and has not revoked acceptance,<sup>67</sup> and the seller has made and breached a warranty, the buyer's "direct" damages are computed by the "difference at the time and place of acceptance between the value of the goods accepted and the value they would have had if they had been as warranted, unless special circumstances show proximate damages of a different amount."<sup>68</sup> Section 2-714(3) states that in a "proper case any incidental and consequential damages . . . may also be recovered . . ." under section 2-715. Incidental damages include reasonable expenses incurred by the buyer after the breach to effect substitute remedies, preserve the seller's goods and otherwise mitigate damages.<sup>69</sup> Where loss other than injury to person or property is involved, consequential damages compensate for the loss of use of the promised performance. Section 2-715(2)(a), however, limits consequential recovery to "any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which could not reasonably be prevented by cover or otherwise . . ." Lurking in the text of section 2-715(2)(a), therefore, is the omnipresent ghost of *Hadley v. Baxendale*<sup>70</sup> and an enhanced "duty" to mitigate damages.

In general, once it is established that a warranty was made and breached, the Seventh Circuit's interpretation of the remedy provisions of Article 2 has been more favorable to the buyer than its decisions on whether a warranty was made or breached.

66. See, e.g., *Pacific Gas and Elec. Co. v. G.W. Thomas Drayage & Rigging Co.*, 69 Cal. 2d 33, 442 P.2d 641 (1968); RESTATEMENT (SECOND) OF CONTRACTS § 212 comment b (1980); U.C.C. § 2-202 comment 1 (1987).

67. If the buyer rightfully rejects the goods, U.C.C. § 2-601 (1987), or justifiably revokes acceptance, *id.* § 2-608, the catalogue of remedies listed in § 2-711(1) becomes available. See U.C.C. § 2-608(3) (1987). In addition, the buyer may recover incidental and consequential damages under § 2-715.

68. U.C.C. § 2-714(2) (1987). The presence of "special circumstances" invites the court to find another way to measure "direct" damages.

69. *Id.* § 2-715(1).

70. 156 Eng. Rep. 145 (1854). Under the *Hadley* test, the damages, if they did not arise "naturally . . . from such breach of contract . . .," must be such "as may reasonably be supposed to have been in the contemplation of both parties at the time they made the contract, as the *probable* result of the breach of it" (emphasis added). This "foreseeability" test is relaxed in U.C.C. § 2-715(2)(a) (1987). Cf. RESTATEMENT (SECOND) OF CONTRACTS § 351 (1980).

### A. Direct Damages: Section 2-714(2)

In *Continental Sand & Gravel v. K & K Sand & Gravel*,<sup>71</sup> the seller sold equipment expressly warranted to be in "good order, condition and repair" for \$50,000.<sup>72</sup> In fact, the equipment, although operable, was not in good repair and the seller did not correct the deficiency. The buyer spent \$23,000 in partial repairs and then shifted to an alternative method of operation. The total estimated cost to repair was \$164,000. The seller argued that the value of the goods as warranted was limited by the contract price. The trial court, however, used the total cost of repair as the value the goods "would have had if they had been as warranted" and awarded the buyer the difference between \$164,000 and the market value of the goods as delivered.

Upon appeal, the Seventh Circuit affirmed, concluding that the result was proper under section 2-714(2) and "general commercial law."<sup>73</sup> After noting that it was not unusual for the value of the goods as warranted to exceed the contract price, the Court stated that "[t]his result is logical, since to limit recoverable damages by the purchase price . . . would clearly deprive the purchaser of the benefit of its bargain in cases in which the value of the goods as warranted exceeds the price."<sup>74</sup>

Assuming that the repair costs, if incurred, were reasonable, the result clearly squares with the policy of section 1-106(1) and is consistent with the language of section 2-714(2), read in context. Repair costs are also an analogue for "cover" under section 2-712, a remedy which the Court noted was not available to a buyer of accepted goods.<sup>75</sup> They protect the buyer's reasonable efforts to repair and, in effect, to obtain goods of the quality warranted by the seller. Cost of repair, therefore, is an important method by which to measure the value of the goods "as warranted" under section 2-714(2) and the Court's conclusion is clearly sound.<sup>76</sup> One would prefer, however, an opinion that drew and elabo-

71. 755 F.2d 87 (7th Cir. 1985).

72. The Court affirmed the trial court's conclusion that express warranties, clearly made, were breached. The trial court considered evidence of trade usage, among other things, to determine that the goods were not in "good" order. *Id.* at 91-92.

73. *Id.* at 91.

74. *Id.* at 91, 92.

75. *Id.* at 92 n.5. By cover, the buyer makes a "reasonable purchase of . . . goods in substitution for those due from the seller," U.C.C. § 2-712(1) (1987), and recovers as damages the "difference between the cost of cover and the contract price . . ." *id.* § 2-712(2). It is only available when the buyer has properly rejected or revoked acceptance of the goods. *Id.* § 2-711(1)(a).

76. See J. WHITE & R. SUMMERS, *supra* note 2, at § 10-2. The subtrahend in § 2-714(2) (1987) is always the market value of the goods delivered, i.e., the nonconforming goods. The contract price is only presumptive evidence of the value of the goods as warranted. In *Chatlos Systems, Inc. v. National Cash Register Corp.*, 670 F.2d 1304 (3d Cir. 1982), *cert. dismissed*, 457 U.S. 1112 (1982), an opinion from the Third Circuit cited by the Court, the market value of the computer system

rated its conclusions more from the text and policy of Article 2 rather than from "logic" and "general commercial law." Rather than discussing sections 1-106(1), 2-711(1), 2-712 and 2-714, the Court, once again, indulged in rather spare Code methodology.<sup>77</sup>

### B. Consequential Damages: Section 2-715(2)(a)

Section 2-715(2)(a) relaxed the common law foreseeability requirement announced in *Hadley v. Baxendale* and its progeny.<sup>78</sup> Under the Code, consequential damages "resulting from the seller's breach include . . . any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know . . ." Thus, the Seventh Circuit, with little fanfare, has generally permitted a commercial buyer to claim lost profits resulting from the inability to use the goods as planned. The primary issue in these cases is whether the buyer has proved losses of which the seller had reason to know with reasonable certainty. The answer varies with the quantity and quality of the evidence presented.<sup>79</sup>

An exception which emphasizes the lack of "reason to know" is *Chrysler Corp. v. E. Shavitz & Sons*,<sup>80</sup> where the Seventh Circuit reversed a judgment by the trial court for damages stemming from loss of good will. The seller breached by making late and defective deliveries of equipment that the buyer had agreed to install in commercial buildings for third persons. The disruptions upset the third persons and they refused to deal with the buyer again. The buyer claimed that the profits lost from the subsequent refusals to deal were recoverable as consequential damages under section 2-715(2)(a).

actually delivered was \$6,000, the contract price was \$46,020, and the market value of a computer system as warranted by the seller was \$207,826.50. The court affirmed a judgment for \$201,826.50, the difference between \$6,000 and the value of the computer system that should have been delivered.

77. The Court has not had the opportunity to consider either the scope of incidental damages under § 2-715(1) or when "special circumstances" show damages of an amount different from the formula in § 2-714(2).

78. See, e.g., Epstein, *Beyond Foreseeability: Consequential Damages in the Law of Contract*, 18 J. LEGAL STUD. 105 (1989).

79. See, e.g., *Hoeffler Truck Sales v. Divco-Wayne*, 523 F.2d 543, 550-51 (7th Cir. 1975) (where seller delayed delivery, jury verdict for profits lost on resale of new trucks and warranty repairs, established from evidence of diminished volume and operating costs, reinstated); *Cates v. Morgan Portable Bldg. Corp.*, 591 F.2d 17, 21-22 (7th Cir. 1979) (Court reversed trial court rulings on proof of consequential damages as too restrictive and requiring excessive certainty: damages should depend upon a "fair and reasonable" estimate after a broader consideration of all the evidence, including occupancy rates before and after the breach). *But see Continental Sand & Gravel v. K & K Sand & Gravel*, 755 F.2d 87, 91-92 (7th Cir. 1985) (Court affirmed trial court ruling against consequential damages, where plaintiff failed to prove the amount of sand that it actually processed during the relevant time period, "a figure that must be compared to the amount that should have been processed if the . . . equipment had been as warranted").

80. 536 F.2d 743 (7th Cir. 1976).

In rejecting the buyer's contention, the Court almost, but not quite, held that damages from loss of good will were not recoverable as a matter of law. Instead, the Court concluded that the seller, who had no previous dealings with the buyer, had "no reason to foresee" that the breach would result in lost profits from reduced future demand for the buyer's services, especially where at the time of contracting, "no other jobs existed or were within the offing." Thus, the "consequential damages claimed . . . were totally speculative and did not arise naturally from the breach itself."<sup>81</sup>

### C. Mitigation of Damages

A further limitation on the recovery of consequential damages is the "mitigation of damages" principle, explicitly imposed by section 2-715(2)(a) which provides that consequential damages do not include losses "which could not reasonably be prevented by cover or otherwise."<sup>82</sup>

In *Cates v. Morgan Portable Building Corp.*,<sup>83</sup> the question presented was whether the buyer had reasonably avoided consequential damages (lost profits) resulting from defective modular units intended to expand his motel business. More specifically, the question was whether any losses incurred during the time between after the seller's first promise to repair expired and a second promise to repair was made were recoverable where both parties had an "equal opportunity" to mitigate.

The Seventh Circuit, speaking through Judge Posner, held they were not. The Court first noted that although the UCC required the buyer to mitigate damages,<sup>84</sup> it did not say who had the burden of proof. Under Illinois law, however, the burden was on the seller to prove that the buyer had *not* mitigated and Illinois law controlled. Next, the Court, again reasoning without reference to or assistance from Article 2, held that the buyer's responsibility to mitigate, normally arising at the time of breach, was suspended if, after the breach, the seller promised to repair the goods. The buyer's mitigation responsibility, however, arose again at

81. *Id.* at 744-46. The Court, for once, actually quoted § 2-715(2)(a) in the text of the opinion and stated the issue precisely in terms of the statutory language. The Court relied upon *Neville Chemical Co. v. Union Carbide Corp.*, 422 F.2d 1205 (3d Cir. 1970), which, applying Pennsylvania law, rejected loss of good will because it did not arise from the buyer's "inability . . . to use specific property destroyed, damaged or withheld by a defendant's wrong . . . ." For a discussion of cases permitting the recovery of good will, see Update, *supra* note 2, at 1250-52.

82. U.C.C. § 2-715(2)(a) (1987).

83. *Cates v. Morgan Portable Bldg. Corp.*, 780 F.2d 683 (7th Cir. 1985). For the first *Cates* opinion, see *Cates v. Morgan Portable Bldg. Corp.*, 591 F.2d 17 (7th Cir. 1979).

84. In support for this, the Court cited the comment to § 1-106(1) but not the explicit language of § 2-715(2)(a). *Cates*, 780 F.2d at 688.

the time when the buyer should have known that the seller would not repair.<sup>85</sup>

Finally, the Court rejected the buyer's argument that where the parties have an "equal opportunity" to mitigate, damages should not be reduced for losses that the seller could have avoided. On the contrary, since the buyer was in the best position, cost and other factors considered, to make repairs or purchase substitutes, and those costs could be recovered from the seller,<sup>86</sup> the responsibility to mitigate was on the buyer. The Court reasoned:

Contract law seeks to preserve the buyer's incentive to consider a wide range of possible methods of mitigation of damages, by imposing a duty to mitigate even if some of the possibilities are equally within the seller's power. This incentive would be lost if Morgan's ability to repair its defective units—only one method, and maybe not the cheapest method, of reducing the Cateses' consequential damages—excused the Cateses from all duty of mitigation.<sup>87</sup>

However sensible this result may be, the opinion omits relevant Code sections and does not discuss cases to the contrary.<sup>88</sup> Rather than rooting a reasonable conclusion in the language and policy of Article 2, the Court treated Article 2 as if it were just another source to consider. This approach both ignored the complexities of the Article 2 analysis<sup>89</sup> and missed an opportunity to develop a more complete approach to analyze how the mitigation principle fits into disputes over warranty liability and remedy.<sup>90</sup>

## V. EFFECT OF AGREEMENTS DISCLAIMING WARRANTIES OR LIMITING REMEDIES

### A. *The "Limited Warranty Package"*

In the prototype transaction before the Court, the seller has manufactured or designed complex, expensive machinery to meet the ordinary

85. The trial court had concluded that the time was six months and this was affirmed as an "informed and sensible guess . . ." *Id.* at 687.

86. *Id.* at 688-89. These costs, presumably, would be incidental damages, although the Court cited no authority. See U.C.C. § 2-715(1) (1987).

87. *Cates*, 780 F.2d at 689-90. The Court concluded, however, that the buyer's failure to mitigate during the six month period did not bar consequential damages forever. Once the seller made a fresh promise to repair, the duty to mitigate was again suspended during that new period.

88. See, e.g., *S.J. Groves & Sons Co. v. Warner Co.*, 576 F.2d 524, 530 (3d Cir. 1978), where the court, in an alternative holding, adopted the "equal opportunity" doctrine: "Where both the plaintiff and the defendant have had equal opportunity to reduce the damages by the same act and it is equally reasonable to expect the defendant to minimize damages, the defendant is in no position to contend that the plaintiff failed to mitigate."

89. See Update, *supra* note 2, at 1252-56.

90. See Speidel, *supra* note 2, at 39-53.

and not so ordinary purposes of the buyer. In this setting, as already discussed, the buyer has had difficulty in proving that the seller made and breached any warranty, express or implied. If a warranty was made and breached, however, the buyer has had success in recovering direct and, to a lesser extent, consequential damages.

The buyer's risks are high in these transactions. If the goods fail to conform to a warranty, the buyer bears both the initial burden of obtaining conforming goods<sup>91</sup> and the business disruption caused from the inability to use the goods. That these losses will be fully compensated is not a foregone conclusion. In this setting, many sellers have been successful in obtaining buyer assent to what we will call a "limited warranty package."<sup>92</sup> This "package" typically has four elements.

First, the seller makes a limited express warranty that the goods are free from defects in material or workmanship at the time of delivery or installation. By inclusion in a writing signed by the buyer, this express warranty clearly becomes "part of the basis of the bargain."

Second, the seller disclaims all other warranties express or implied. A disclaimer assumes that a warranty made or imposed at one point in the transaction can be contracted away at a later time. Article 2 permits disclaimers of implied warranties,<sup>93</sup> but section 2-316(2) imposes explicit conditions upon such disclaimers. Thus, "to exclude or modify the implied warranty of merchantability or any part of it the language must mention merchantability and in case of a writing must be conspicuous . . . ."<sup>94</sup>

Third, the parties agree to a limited, exclusive<sup>95</sup> remedy if the seller breaches the express warranty. The seller agrees to repair or replace defects in material or workmanship within a stated period of time. Frequently, other limitations are agreed upon, such as imposing the contract price as an outer limit on damages. These limitations are, in general, permitted by section 2-719, subject to a requirement that there "be at least a fair quantum of remedy for breach. . . ."<sup>96</sup>

Fourth, the seller may, either as part of, or separate from, the "package," exclude any liability for consequential damages, whether

91. The seller has a limited power but not a legal obligation to "cure" a nonconforming tender. U.C.C. § 2-508 (1987).

92. I have found no reported cases where a seller agreed to give the buyer more protection than that afforded by Article 2.

93. Disclaimers of express warranties are not permitted. U.C.C. § 2-316(1) (1987). *Cf.* U.C.C. § 2-202 (1987).

94. *Id.* § 2-316(2). The terms "writing" and "conspicuous" are defined in § 1-201.

95. An exclusive limited remedy is "the sole remedy." *Id.* § 2-719(1)(b).

96. *Id.* § 2-719 comment 1.

caused by breach of warranty, or the obligation to repair and replace, or by tort. Where commercial losses are involved, these clauses excluding consequential damages are, when included without the "package," enforceable unless they are unconscionable.<sup>97</sup>

In commercial deals, this exclusive "package" has at least three justifications: (1) The seller has an incentive to price the product without including contingencies for consequential damages; (2) The buyer understands that it must take precautions, either before or after the breach, to avoid consequential losses; and (3) An implicit "trade off" is that the buyer agrees to assume greater risks because the seller promises to "cure" any non-conformity within a reasonable time.

How has the Court dealt with issues arising in and around the "warranty package"? By and large, the results reinforce the pattern of decisions in the Seventh Circuit favoring the seller.

## B. *Some Discrete Issues*

### 1. Battle of the Forms

The "package" or discrete segments of it, such as disclaimers and excluders of consequential damages, are usually contained in standard forms prepared by the seller. The question whether these terms have become part of the contract frequently involves a "battle of the forms" and, thus, requires a confrontation with section 2-207. In this confrontation, the seller usually prevails in the Seventh Circuit.

In *Twin Disc, Inc. v. Big Bud Tractor*,<sup>98</sup> the buyer's offer form said nothing about consequential damages, but the seller's acknowledgment form contained clauses disclaiming warranties and excluding liability for consequential damages. The goods were accepted without objection by the buyer and, later, defects were discovered.

The Seventh Circuit held that the seller's standard form terms were

97. *Id.* § 2-719(3). For an early example of a "package" not fully in compliance with § 2-316(2), see *V-M Corp. v. Bernard Distrib. Co.*, 447 F.2d 864, 868 (7th Cir. 1971).

98. 772 F.2d 1329 (7th Cir. 1985). Seller contracted to sell transmissions to buyer for installation in large farm tractors made by buyer. A third party contracted with seller to supply electronic shift controllers. Problems with the shift controllers caused delays in delivery of the transmissions to buyer. As a result, buyer lost two seasons and was unable, despite efforts to sell the inventory, to avoid bankruptcy. Seller then sued for the unpaid price (\$1 million). Buyer filed a counterclaim seeking \$53 million damages and brought a third party action for \$49 million against the manufacturer of the controllers. Buyer claimed breach of express and implied warranties, negligence, strict liability and breach of contract. The trial court granted summary judgment to seller and third party on all negligence and strict liability claims against both parties and dismissed the warranty claim against the third party for lack of privity. The trial court ultimately entered a judgment for seller for the price, which was offset by damages caused buyer by seller's failure to deliver or repair on time. This was a breach of contract, not a breach of warranty. The decision was affirmed on appeal.

part of a contract formed under section 2-207(1) by the seller's "definite acceptance." Although they constituted "material" additional terms under section 2-207(2)(b), the buyer had "expressly assented" to them by a course of dealing and conduct after the goods were delivered. The failure of the parties to expressly discuss the clauses was not fatal. Rather, the buyer's actual knowledge of, and conduct which invoked the express warranty contained in the writing with the disclaimer and excluder clauses was sufficient.<sup>99</sup> In short, the buyer, because of what it had reason to know, was not unfairly surprised and, therefore, its manifested assent without objection to the limiting clauses was binding.<sup>100</sup>

The issue was more complicated in *Western Industries, Inc. v. Newcor Canada, Ltd.*<sup>101</sup> The buyer's offer form *required*, while a form sent by the seller *excluded* consequential damages. They were "different" rather than additional terms, therefore not fitting the language of section 2-207(2). The seller also tried to introduce evidence of a trade custom negating consequential damages. The trial court excluded the evidence of custom and held that the contract between the parties was formed six days before the seller's form was mailed. Consequently, that form did not become part of the contract under section 2-207.

The Seventh Circuit, speaking through Judge Posner, reversed on the ground that the trial court had improperly excluded evidence of trade custom and evidence relevant to when the contract was formed. He concluded that if the contract were formed at the earlier date, the excluder clause in the seller's form was not effective, even though the trade usage might be. In that case, however, the seller's requirement of consequential damages, which was part of the contract, would conflict with the custom. This conflict would arise only if the contract were formed at the earlier time.

99. *Id.* at 1334-35. *Cf.* *Schulze & Burch Biscuit Co. v. Tree Top, Inc.*, 831 F.2d 709 (7th Cir. 1987) (holding that an arbitration clause, which was not a material additional term under § 2-207(2) but did not unfairly surprise the buyer, became part of the agreement).

100. One of U.C.C. § 2-207's many shortcomings is the failure to say when, if ever, a material, additional term under § 2-207(2) becomes part of the bargain. U.C.C. § 2-207 comment 3 (1987) states that "they will not be included unless expressly agreed to by the other party" and this language has figured in many of the decisions. *See* J. WHITE & R. SUMMERS, *supra* note 2, at 36-38.

101. 739 F.2d 1198 (7th Cir. 1984). Buyer had a contract to supply cavities for microwave ovens to a foreign manufacturer. Buyer agreed with the resale buyer to use projection welding for the cavities, a method not used in the United States. Buyer then purchased from Seller several custom made welding machines for the project, machines that had not been built before. After extended discussions and the exchange of forms, the machines were built and, because of American safety standards, were unusable. Seller rebuilt them, but one year delay in use resulted. There was no issue over the existence and breach of warranty. Seller sued for the unpaid price and buyer counter-claimed for consequential damages. The jury awarded buyer \$1.3 million on the counterclaim and seller the unpaid price. On appeal, both verdicts were reversed and case was remanded.



Judge Cudahy, concurring, agreed that the trade custom evidence was improperly excluded and argued that if the contract were formed at the later date, the conflicting forms would "fall out" under section 2-207(3), thus leaving a gap in the agreement to be filled, presumably by the trade usage. This was a possibility which Judge Posner did not explicitly consider.

In my opinion, Judge Cudahy was correct in his reading of section 2-207, when "different" material terms collide after some contract is formed under section 2-207(1), both should drop out, leaving a gap in the agreement to be filled under the formula in section 2-207(3).<sup>102</sup> The critical issue for both judges, however, was the time when the contract was formed and the potential effect of a trade usage negating consequential damages. Under Judge Posner's assumption that the contract was formed earlier, the evidence if admitted would still collide with the seller's express requirement of consequential damages. Under Judge Cudahy's assumption that the contract was formed later, the seller's requirement would have dropped out and the custom, if otherwise provable, would simply fill the gap and become part of the agreement.<sup>103</sup>

## 2. Disclaimers

Assuming that the disclaimer is part of the contract, the Court has had few occasions to evaluate the enforceability of the seller's attempt to disclaim express and implied warranties under section 2-316. Early decisions approved without discussion disclaimers of implied warranties not meeting the conditions of section 2-316(2).<sup>104</sup>

In *Twin Disc, Inc.*,<sup>105</sup> the Court was presented with a disclaimer that clearly was not "conspicuous." It was in small print on the back of a standard form.<sup>106</sup> Nevertheless, the buyer had actual knowledge of it and, presumably, was not surprised. The Court stated that there is "no need to determine whether a disclaimer is conspicuous . . . when the buyer has actual knowledge of the disclaimer"<sup>107</sup> and thus enforced the disclaimer.

102. So holding is *Daitom, Inc. v. Pennwalt Corp.*, 741 F.2d 1569 (10th Cir. 1984). *But see J. WHITE & R. SUMMERS, supra* note 2, at 31-36, who disagree with each other.

103. For a proposed solution to the § 2-207 mess, see Murray, *A Proposed Revision of § 2-207 of the Uniform Commercial Code*, 6 J. L. & COM. 337 (1986).

104. *E.g.*, *V-M Corp. v. Bernard Distrib. Co.*, 447 F.2d 864, 868 (7th Cir. 1971).

105. 772 F.2d at 1329.

106. Under U.C.C. § 1-201(10) (1987), a "term of clause is conspicuous when it is so written that a reasonable person against whom it is to operate ought to have noticed it." *See Update, supra* note 2, at 1266-72.

107. *Twin Disc, Inc.*, 772 F.2d at 1335, n.3.

This result ignores the objective requirement of section 2-316(2), which states that a disclaimer in writing "must" be "conspicuous" and, in the process, the cases which have reached a contrary result.<sup>108</sup> Under this regulatory subsection, form is important both to insure the consistent communication of essential information and to avoid evidentiary conflicts over how much the buyer actually knew.<sup>109</sup> Since the issue and the alternatives were not fully discussed, *Twin Discs* is another dubious decision which favors the seller.

### 3. Agreed Exclusion of Consequential Damages

Under section 2-715(2)(a), a buyer may recover consequential damages for a seller's repudiation or failure to deliver and for breach of warranty. Under section 2-719(1)(a), the agreement between the parties may, among other things, "limit or alter the measure of damages recoverable" under Article 2. More specifically, section 2-719(3) provides that "[c]onsequential damages maybe limited or excluded unless the limitation or exclusion is unconscionable . . . ," and that a limitation of damages where the loss is commercial is not prima facie unconscionable. The comments suggest that agreements limiting remedies must permit "at least minimum adequate remedies" or a "fair quantum of remedy" and that clauses excluding consequential damages "may not operate in an unconscionable manner."<sup>110</sup>

The Seventh Circuit has enforced clauses excluding consequential damages where the buyer has manifested assent and unconscionability was not established. In *V-M Corp.*, the Court, in enforcing an excluder, stated that section 2-719 was intended to "encourage and facilitate consensual allocations of risks . . . where commercial, rather than consumer sales are involved."<sup>111</sup>

This pro-excluder policy was put to the test in *Western Industries, Inc. v. Newcor Canada, Ltd.*,<sup>112</sup> where the seller sought to introduce evidence of a "custom" in the specialty welding trade of excluding consequential damages for breach of warranty and of limiting the remedy to return of the purchase price. Absent proof of unconscionability, such a

108. See Update, *supra* note 2, at 1270-71.

109. See J. WHITE & R. SUMMERS, *supra* note 2, at 502, who argue that deviations from the formal requirement "would reward the convincing liar . . . ."

110. U.C.C. § 2-719 comments 1 and 3 (1987).

111. 447 F.2d at 869. U.C.C. § 2-719 (1987) comment 3 states that excluders "are merely an allocation of unknown or undeterminable risks." See also *Dow Corning Corp. v. Capitol Aviation, Inc.*, 411 F.2d 622 (7th Cir. 1969) (seller excludes liability for consequential damages for delay in delivering an experimental aircraft).

112. 739 F.2d 1198 (7th Cir. 1984), discussed *supra* at note 101.

"custom" would clearly be enforceable if manifested in a clause contained in the written contract for sale.<sup>113</sup> The trial court excluded the evidence and the Seventh Circuit reversed, with Judge Cudahy concurring in the result. Based upon the preferred evidence, the policy favoring exclusion clauses and the increased damage exposure of the seller if there were no exclusion,<sup>114</sup> the Court concluded that "a rational jury could have concluded that, yes, it was the custom for manufacturers of specialty welding machines not to be liable for consequential damages."<sup>115</sup> The trial court was, therefore, reversed and the case remanded.

The "custom" issue raises problems that the Court did not fully address. Judge Posner was probably correct in concluding that evidence of "custom" was not excluded simply because the limited remedy was not mentioned in the written agreement. A fair reading of section 2-719(1)(a) does not support this result, especially since the definition of "agreement" in Article 1 includes "usage of trade."<sup>116</sup> As Judge Cudahy argued, however, the Court should have instructed the lower court on the limitations upon trade usage imposed by section 1-205, a section cited by the majority but not elaborated upon.<sup>117</sup> Section 1-205(1), for example, provides a statutory definition of trade usage (the word "custom" is not used) and section 1-205(3) makes it clear when one party to the deal is bound by such usage, i.e., when they are "engaged" in the trade or vocation or they "are or should be aware" of the usage.

More importantly, section 1-205(3) states that trade usage is to be used to "give particular meaning to and supplement or qualify terms of an agreement." But suppose that the contract contains no term on consequential damages or a term providing that consequential damages are required. Can trade usage be admitted to supply an entirely new term or to contradict a term in the contract? These are important questions<sup>118</sup> which were, apparently, left to the discretion of the same trial court whose decision was just reversed for two errors in excluding evidence. Arguably, this was precisely the case where complete Code methodology

113. See U.C.C. § 2-719(3) (1987).

114. In discussing the effect of breach, the Court noted that § 2-715(2) adopted an "especially liberal stand" toward consequential damages.

115. *Id.* at 1204.

116. *Id.*

117. *Id.* at 1208 (Cudahy, J., concurring). The Court cites § 1-205(2) to establish that the existence of trade usage is a question of fact and § 1-205(3) on when the buyer might not be bound by a usage even though proved. *Id.* at 1201-02.

118. See generally Kastely, *Stock Equipment for the Bargain in Fact: Trade Usage, "Express Terms," and Consistency Under Section 1-205 of the Uniform Commercial Code*, 64 N.C.L. REV. 777 (1986).

and some direction by the Seventh Circuit on how to read a statute was required.

### C. Failure of Essential Purpose

In the "warranty package," the exclusive limited remedy for breach of the express warranty is that the seller will "repair or replace" the defects in material and workmanship within a stated or reasonable period of time. The implicit tradeoff is that the seller will undertake an obligation to "cure," and the buyer will assume the risk of both direct and consequential damages during that period. An important question, frequently litigated, is the effect of the seller's failure to "cure" within the time specified. What remedies are available to the buyer upon this second breach by the seller?

The debate has centered around section 2-719(2), which provides: "Where circumstances cause an exclusive or limited remedy to fail of its essential purpose, remedy may be had as provided in this Act." Two important questions therefore are presented: (1) When does a limited, exclusive remedy "fail of its essential purpose"; and (2) If the remedy fails, may the buyer recover consequential damages even though the contract contains an excluder clause which otherwise would be enforceable under section 2-719(3)?<sup>119</sup>

In *V-M Corp.*,<sup>120</sup> the Seventh Circuit conceded that a breach by the seller of its obligation to cure might cause the remedy to fail its essential purpose and cases from other jurisdictions are in accord. The seller, however, had fully performed the agreed limited remedy and there was thus no occasion to apply section 2-719(2). Even so, the Court exhibited a strong reluctance to negate a commercial risk allocation "[e]ven where the defects . . . cause substantial difficulties to those involved in wholesale and retail distribution." There was no evidence that the defects, which had been cured, "caused a failure of consideration for the distributorship agreement as such which would justify altering the particular allocation of these costs by making the manufacturer the insurer of distributor prof-

119. A subsidiary question is what direct damage remedies are available. For example, can the buyer now revoke acceptance and cover under § 2-712? For the seminal article on this problem, see Eddy, *On the "Essential" Purposes of Limited Remedies: The Metaphysics of U.C.C. § 2-719(2) (1987)*, 65 CALIF. L. REV. 28 (1977).

120. 447 F.2d 864 (7th Cir. 1971). The dispute arose after the termination of a wholesale distributorship agreement, under which the buyer had distributed for over 12 years electronic equipment made by the seller. The buyer claimed that product quality had decreased, making the distributorship unprofitable. One issue was how much buyer owed seller for goods accepted before the termination. The trial court dismissed six counterclaims by buyer based upon a claimed breach of warranty (seeking lost profits and extra expenditures) and the jury found against the buyer on the setoff. Held, affirmed: The seller may recover \$26,333 without any offset.

its and extraordinary expenses.”<sup>121</sup>

The analysis was advanced in *AES Technology Systems, Inc. v. Coherent Radiation*,<sup>122</sup> where the seller breached an express warranty in the sale of a laser and failed, over an eleven month period, to correct the problem. The Court, speaking through Judge Moore,<sup>123</sup> concluded that the limited remedy had failed its essential purpose even though the breach was neither willful nor negligent. Did this failure mean that the buyer could recover consequential damages even though there was an excluder clause in the contract? The Court held no, reversed the trial court and remanded the case for a determination of direct damages.

For Judge Moore, the issue was not unconscionability of the excluder but whether the seller's double breach deprived the buyer of “a substantial benefit of the bargain.” Because of a stipulation, this question was to be answered under the provisions of the official text of the UCC rather than the legislation adopted and interpreted by either California or Illinois.<sup>124</sup> This meant that the Court was, despite Illinois law to the contrary, freer to conclude, as it did, that the excluder clause did not fall automatically if the limited remedy failed its essential purpose.<sup>125</sup> Rather, it held that a court must examine the “individual factual situation,” keeping in mind the judicial objective not to “rewrite contracts by ignoring parties' intent . . .,” but to “interpret the existing contract as fairly as possible when all events did not occur as planned.”<sup>126</sup> On the facts, the Court concluded that the buyer was to assume the risk involved with the project, subject to recovery of the minimum adequate remedy, i.e., direct damages, mandated by section 2-719.

Judge Moore's flexible interpretation of section 2-719 indulges a presumption in favor of the excluder clause. It also permits the identification of extremes which, in turn, indicate probable outcomes.

First, the strongest case for the “double breaching” seller is where (a) the seller has made a good faith but unsuccessful effort to cure, and the defect was not substantial or, if it was, the buyer could obtain restitution of the price or direct damages, or (b) the excluder clause was posi-

121. *Id.* at 869.

122. 583 F.2d 933 (7th Cir. 1978).

123. Sitting by designation from the United States Court of Appeals for the Second Circuit.

124. Since the parties agreed that the provisions of the U.C.C. in California and Illinois were the same, the Court interpreted the sections of the Official Text of the U.C.C. rather than the those of the “individual statutes.” *Id.* at 938 n.2.

125. The Court cited and rejected *Adams v. J.I. Case Co.*, 125 Ill. App. 2d 388, 261 N.E.2d 1 (1970), apparently holding that under Illinois law the excluder clause automatically dropped out. *AES Technology Sys., Inc.*, 583 F.2d at 940 n.7.

126. 583 F.2d at 941.

tioned apart from the "package" in clear, conspicuous language and would otherwise pass muster under the unconscionability test in section 2-719(3).<sup>127</sup>

Second, the strongest case for the buyer is (a) where the excluder is intended to be an integral part of the "warranty package" and the limited remedy fails its essential purpose,<sup>128</sup> or (b) where the defect is substantial, the seller has made no or an unreasonable effort to cure, and no other adequate remedy is available.<sup>129</sup> The first element depends upon contract interpretation and the second element depends, in essence, upon the absence of unconscionability and the need for good faith and minimum adequate remedies in the exchange.

Between the extremes, results in particular cases must turn on the weighing of various factors in individual cases. In the Seventh Circuit, this leaves the buyer to fight an uphill battle.<sup>130</sup>

In *AES Technology Systems*, the Seventh Circuit, with the concurrence of the parties, purported to develop the best interpretation of section 2-719(2) from the Official Text of the UCC. In *Fidelity & Deposit Co. of Maryland v. Krebs Engineers*,<sup>131</sup> however, the Court concluded that it was bound by Wisconsin's interpretation of section 2-719(2), which was strikingly different from that developed in *AES Technology*. Speaking through Judge Manion, the Court concluded that in Wisconsin, the clause excluding consequential damages would drop automatically if the limited remedy failed its essential purpose and that this deletion did not depend upon whether the buyer had any other adequate remedy.<sup>132</sup> Thus, the remedies "as provided in this Act" included consequential damages under section 2-715(2)(a).

There is a certain irony in the *Erie* machinations in *AES Technology* and *Fidelity & Deposit Co.* In the latter, Judge Manion worked hard to

127. See, e.g., *Cayuga Harvester, Inc. v. Allis-Chalmers Corp.*, 95 A.D.2d 5, 465 N.Y.S.2d 606 (1983).

128. See, e.g., *Waters v. Massey-Ferguson, Inc.*, 775 F.2d 587 (4th Cir. 1985), holding that the parties did not intend to exclude consequential damages from a lost soybean crop where the seller, despite promises to cure, did not repair the tractor in time.

129. See Samuels, *The Unconscionability of Excluding Consequential Damages Under the Uniform Commercial Code When No Other Meaningful Remedy is Available*, 43 U. PITT. L. REV. 197 (1981). See also Mather, *Consequential Damages When Exclusive Repair Remedies Fail: Uniform Commercial Code Section 2-719*, 38 S.C.L. REV. 673 (1987).

130. See Foss, *When to Apply the Doctrine of Failure of Essential Purpose to an Exclusion of Consequential Damages: An Objective Approach*, 25 DUQ. L. REV. 551 (1987).

131. *Fidelity & Deposit Co. v. Krebs Eng's.*, 859 F.2d 501 (7th Cir. 1988) (applying Wisconsin law).

132. *Id.* at 504-05. The Wisconsin case is *Murray v. Holiday Rambler Corp.*, 83 Wis. 2d 406, 414-19, 265 N.W.2d 513, 517-20 (1978). In reaching this result, the Court rejected decisions from other states espousing the factorial analysis employed in *AES Technology* (the "majority" view).

apply the Wisconsin interpretation of section 2-719(2), without regard to whether it was the best interpretation. In the former, Judge Moore, free of the constraints of local law, worked hard to develop an interpretation of section 2-719(2) which, arguably, was inconsistent with Illinois law.<sup>133</sup> The position of the buyer in the Seventh Circuit is, therefore, somewhat uncertain and not likely to be determined under the "best" interpretation of the statute.<sup>134</sup>

## VI. THE PRIVACY DEFENSE AND THE TORT INTRUSION

### A. *The Privacy Defense*

In addition to defenses based upon agreement, i.e., disclaimers and agreed limited remedies, Article 2 imposes another<sup>135</sup> important contract defense to a breach of warranty claim: There must be privity of contract between the seller and buyer.

Article 2 requires privity in warranty disputes unless the warranty has been extended to remote purchasers or users by some version of section 2-318<sup>136</sup> or by judicial decision.<sup>137</sup> In commercial disputes where no

133. See *Adams v. J.I. Case Co.*, 125 Ill. App. 2d 388, 261 N.E.2d 1 (1970), which, arguably, is inconsistent with the result reached by the Court.

134. See Update, *supra* note 2, at 1302-10.

135. Two other defenses may also be available. The first is where the buyer has failed to give the seller notice of the breach "within a reasonable time after he discovers or should have discovered any breach . . ." U.C.C. § 2-607(3)(a) (1987). The penalty is that the buyer is "barred from any remedy." There have been no major decisions on this issue in the Seventh Circuit. *But see*, however, *AES Technology Sys., Inc. v. Coherent Radiation*, 583 F.2d 933, 938 (7th Cir. 1978), where the Court held that the buyer had given adequate notice under § 2-607(3)(a).

The second is where the suit for breach of warranty was not "commenced within four years after the cause of action has accrued." U.C.C. § 2-725(1) (1987). A cause of action accrues for breach of warranty when the "breach occurs," i.e., "when tender of delivery is made, except that where a warranty explicitly extends to future performance of the goods and discovery of the breach must await the time of such performance the cause of action accrues when the breach is or should have been discovered." U.C.C. § 2-725(2) (1987).

There have been no decisions of consequence in the Seventh Circuit interpreting U.C.C. § 2-725 (1987). See *Bethlehem Steel Corp. v. Chicago E. Corp.*, 863 F.2d 508, 511-12 (7th Cir. 1988) (seller's counterclaim filed more than four years after goods delivered preserved by special Illinois counterclaim statute of limitations, ILL. REV. STAT., ch. 110 para. 13-207); *Stumler v. Ferry-Morse Seed Co.*, 644 F.2d 667, 669 (7th Cir. 1981) (express warranty did not explicitly run to future performance).

136. U.C.C. § 2-318 (1987) provides three alternatives for the states to enact. Alternative A, which has been enacted in Indiana, Illinois and Wisconsin, and Alternative B, deal with claims for personal injuries. The best possibility for the buyer is Alternative C, which provides that a "seller's warranty whether express or implied extends to any person who may reasonably be expected to use, consume or be affected by the goods and who is injured by breach of the warranty." Variations which explicitly protect remote purchasers from economic loss have also been enacted. See *Speidel*, *supra* note 2, at 36 n.97.

137. A leading decision is *Spring Motors Distrib., Inc. v. Ford Motor Co.*, 98 N.J. 555, 489 A.2d 660 (1985) (dictum).

damage to person or property has resulted, Indiana,<sup>138</sup> Illinois<sup>139</sup> and Wisconsin<sup>140</sup> still require privity of contract. Thus, a disappointed buyer must, in most cases, pursue contract remedies against the immediate seller rather than the manufacturer of the nonconforming product.<sup>141</sup> The Seventh Circuit, mindful of *Erie*, has been careful to defer to local policy on this important defense.<sup>142</sup>

Some of the issues in this area are illustrated by *Collins Co., Ltd. v. Carboline Co.*<sup>143</sup> Carboline, the supplier and installer of roofing material, made an express ten-year warranty to the owner of the building against leakage. Later, the owner sold the building to the plaintiff Collins. At the time of sale, an inspection showed no problems with the roof. Thereafter, when leaks developed within the ten year period, the owner assigned to the plaintiff its rights under the express warranty. Collins then sued Carboline for breach of express warranty, claiming damages in excess of \$5 million. The district court ruled that under Illinois law, privity of contract was required and was not present on the facts.<sup>144</sup> On appeal, the Court certified to the Illinois Supreme Court the question of whether the assignment, under section 2-210(2), satisfied the privity requirement. Judge Cudahy concurred, but thought it clear that privity was present and that the suit could be maintained.

The Illinois Supreme Court answered the certified question in the affirmative: An "assignee of a warrantee's rights under an express warranty, if the assignment is otherwise valid, succeeds to all those rights and thus stands in privity with the warrantor."<sup>145</sup> The Court concluded

138. See Greenberg, *Vertical Privity and Damages for Breach of Implied Warranty Under the U.C.C.: It's Time for Indiana to Abandon the Citadel*, 21 IND. L. REV. 23 (1988).

139. See *Collins Co., Ltd. v. Carboline Co.*, 125 Ill. 2d 498, 532 N.E.2d 834 (1988) (finding an exception to the privity requirement where first buyer has assigned an express warranty to a second buyer who then sues the seller).

140. The authorities are reviewed in *Sunnyslope Grading, Inc. v. Miller, Bradford & Risberg, Inc.*, 148 Wis. 2d 910, 437 N.W.2d 213 (1989) (dictum).

141. A case for the abolition of privity in this setting is developed in Speidel, *supra* note 2, at 35-52.

142. See, e.g., *Corbin v. Coleco Indus., Inc.*, 748 F.2d 411, 415 (7th Cir. 1984). Plaintiff was a third-hand consumer purchaser of an above ground swimming pool manufactured by seller. Plaintiff was injured in person after a deep dive in a shallow pool and sued seller in tort and for breach of warranty under the U.C.C. The trial court granted summary judgment for the seller on the warranty claim under Indiana law for the lack of privity. The Court affirmed on the grounds that Indiana law required privity in breach of warranty claims under the U.C.C. The Indiana version of § 2-318, Alternative A, extended the warranty horizontally (i.e., to "any natural person who is in the family or household of his buyer or who is a guest in his home . . .") but not vertically (i.e., to a second purchaser in the chain of distribution) and the Indiana courts had not exercised their discretion to extend warranties in these cases.

143. 837 F.2d 299 (7th Cir. 1988).

144. *Id.* at 301.

145. *Collins Co., Ltd. v. Carboline Co.*, 125 Ill. 2d 498, 508-09, 532 N.E.2d 834, 837 (1988).



that the result was supported by its previous decisions, the actual language of section 2-210(2)<sup>146</sup> and the decisions of other courts which had considered the question. With that answer in hand, the Seventh Circuit held that the district court had erred and thus remanded the case for a new trial.<sup>147</sup>

*Carboline*, through the certification process, illustrates the Court's caution in this area. Unless state law has clearly dispensed with the privity requirement in commercial cases, the Court will preserve the defense. The defense, however, may not be very important in most commercial disputes. When complex goods are needed to meet particular needs, the seller and a remote buyer will, in all probability, establish a sufficient nexus either before or after the breach is claimed to satisfy the privity requirement.<sup>148</sup>

### B. *The Borderland Between the UCC and Tort*

The tension between contract and tort principles is evident in disputes over economic loss resulting from a breach of warranty. The dispute may arise between the immediate parties to the sale or between the manufacturer and a remote purchaser of the finished product. At stake is whether contract or tort law applies. If contract law applies, the contract incidents associated with warranty law, i.e., the notice and privity requirements, disclaimers and agreed remedies and the contract statute of limitations, apply to the suit. If tort law applies, the UCC limitations may be inapplicable.<sup>149</sup> For example, in tort, privity is not required, consequential damages are more difficult, although not necessarily impossible, to exclude<sup>150</sup> and a potentially longer statute of limitations

146. U.C.C. § 2-210(2) (1987) provides: "Unless otherwise agreed all rights of either seller or buyer can be assigned except where the assignment would materially change the duty of the other party, or increase materially the burden or risk imposed on him by his contract, or impair materially his chance of obtaining return performance. A right to damages for breach of the whole contract or a right arising out of the assignor's due performance of his entire obligation can be assigned despite agreement otherwise."

147. 864 F.2d 560 (7th Cir. 1989).

148. Apart from a direct contractual relationship, the buyer may have relied upon seller advertising or negotiated with the seller before the contract was signed. Or, the seller may have known for whom the product was intended and for what purposes or actually attempted to cure the deficiency. Contacts such as these have been held to establish privity. See, e.g., *Crest Container Corp. v. R.H. Bishop Co.*, 111 Ill. App. 3d 1068, 1076, 445 N.E.2d 19, 25 (1982).

149. See Schwartz, *Economic Loss in American Tort Law: The Examples of J'Aire and of Products Liability*, 23 SAN DIEGO L. REV. 37, 51-78 (1986).

150. More difficult, perhaps, but not impossible in the Seventh Circuit. See *Wisconsin Power & Light Co. v. Westinghouse Elec. Corp.*, 830 F.2d 1405 (7th Cir. 1987) (clause clearly excludes consequential damages for both contract and tort); *Gates Rubber Co. v. USM Corp.*, 508 F.2d 603 (7th Cir. 1975) (clause effective to exclude consequential damages even though "negligence" was not mentioned). *But see Berwind Corp. v. Litton Indus., Inc.*, 532 F.2d 1 (7th Cir. 1976) (exclusion of consequential damages not intended to cover damages for negligence).

applies.<sup>151</sup> Obviously, disappointed buyers have an incentive to pursue a tort theory when available.

This escape route, however, may be blocked. Many state and federal courts have concluded that tort law does not apply when the loss caused by the defective product is solely economic.<sup>152</sup> In its narrow sense, economic loss includes the loss of bargain measured by the difference between the value of the goods as warranted and the value of the goods received along with the net profits lost because the buyer was unable to use the goods during the period of repair or replacement. In a broader sense, economic loss may include damage to the goods sold beyond the difference in value measurement. This approach ignores the nature of the risk created by the defect and the manner of the accident, hallmarks of tort law,<sup>153</sup> and emphasizes the importance of using contract theory as a basis for allocating the various risks involved in the sale of commercial products.

Against this backdrop, the Seventh Circuit has drawn the contract-tort line at the point where the state, whose law controls, would probably draw it. Thus, in cases where economic loss in the strict sense was involved, the Court has held that Indiana,<sup>154</sup> Wisconsin,<sup>155</sup> and Illinois<sup>156</sup> would reject tort theory. The issue has not been squarely presented for Indiana, Illinois or Wisconsin. However, in *Twin Disc, Inc. v. Big Bud Tractors*, the Court has also held that in the absence of a clear Wisconsin precedent, it would not hold that tort law applied when the defect caused additional damages to the product sold but not to other personal prop-

151. Under § 2-725, the statute of limitations for breach of warranty expires four years after the seller's tender of delivery, whether the buyer knows of the breach or not. U.C.C. §§ 2-725(1)-(2) (1987). In tort, the statute frequently runs two years after the buyer knew or should have known of the injury. Thus, if the buyer first learns of the non-conformity six years after tender of delivery, the warranty claims will be barred but the tort claim will still be available. See, e.g., *Moorman Mfg. Co. v. National Tank Co.*, 91 Ill. 2d 69, 435 N.E.2d 443 (1982).

152. E.g., *East River S.S. Corp. v. TransAmerica DeLaval, Inc.*, 476 U.S. 858 (1986) (maritime); *Moorman Mfg. Co. v. National Tank Co.*, 91 Ill. 2d 69, 435 N.E.2d 443 (1982). See Fallon, *Physical Injury and Economic Loss—The Fine Line of Distinction Made Clearer*, 27 VILL. L. REV. 483 (1982).

153. In some jurisdictions, if the defect created a risk of harm to persons or property and the accident was "sudden and calamitous," tort law may apply even though the actual loss was solely economic. See *Pennsylvania Glass Sand Corp. v. Caterpillar Tractor Co.*, 652 F.2d 1165, 1173 (3d Cir. 1981).

154. *Sanco, Inc. v. Ford Motor Co.*, 771 F.2d 1081, 1086 (7th Cir. 1985) (Indiana does not permit tort action in action governed by U.C.C. where only economic loss involved).

155. *Wisconsin Power & Light Co. v. Westinghouse Elec. Corp.*, 830 F.2d 1405, 1410 (7th Cir. 1987) (affirms earlier view that Wisconsin would not permit tort to recover economic loss, but avoids question whether damage to goods sold would constitute a tort).

156. *Bethlehem Steel Corp. v. Chicago E. Corp.*, 863 F.2d 508, 524-25 (7th Cir. 1988) (buyer cannot recover consequential economic losses on a negligence theory under Illinois law). The leading Illinois case is *Moorman Mfg. Co. v. National Tank Co.*, 91 Ill.2d 69, 435 N.E.2d 443 (1982). For a review of post-Moorman decisions in Illinois, see *Kishwaukee Community Health Serv. Center v. Hospital Bldg. & Equip. Co.*, 638 F. Supp. 1492, 1498-99 (N.D. Ill. 1986).

erty of the buyer.<sup>157</sup>

The net effect of this deference to state law is, once again, an advantage to the seller when an unmerchtable product causes only economic loss. Resort to tort by the buyer is foreclosed and the claim must be processed under Article 2, where the limitations of contract theory must be surmounted. More particularly, the privity defense is alive and well in Illinois, Indiana and Wisconsin, warranties may be disclaimed, consequential damages caused by breach of warranty may easily be excluded by agreement, and the pitfalls in and around the notice requirements and the statute of limitations must be negotiated.

## VII. CONCLUSION

Warranty disputes involving complex goods raise important issues that test the balance struck by Article 2 between seller and buyer and the capacity of the Seventh Circuit as a commercial court.

The importance of the Article 2 balance and sound methodology is accentuated because the Court, following *Erie*, has left the availability of the privity defense and the applicability of tort where disputes involve economic loss to state law. Because of the decisions in Indiana, Illinois and Wisconsin, privity is required and neither party can escape from Article 2 to the law of torts. In the process, the Court has endorsed local law without attempting to develop a warranty theory within the framework of the official text which might, independently, justify or question those results. In short, it has assumed a passive rather than a leadership role in this area.

Within this restricted context, the pattern of the Court's decisions interpreting Article 2 gives an advantage to the seller. Concededly, some of this advantage is built into Article 2, especially where complex goods and particular purposes are involved. In addition to the buyer's burdens of proof and the usual limitations upon contract remedies, Article 2 permits agreed disclaimers and limited remedies and the UCC, in general, supports agreed risk allocation. Thus, there is a good chance that the risk of product disappointment will be on the buyer, even where the

157. 772 F.2d 1329, 1332-33 (7th Cir. 1985), concluding that Wisconsin would not permit tort recovery for economic loss where two manufacturers had agreed to warranty provisions in a case governed by Article 2. Since the Court was unable to determine whether Wisconsin would classify the goods sold as property damaged by breach as a warranty or tort, it refused to expand Wisconsin law "in the absence of a more direct indication of intent by the state courts or legislature." *Id.* at 1333. More recently, the Wisconsin Supreme Court has refused to apply tort law to a dispute between commercial parties in privity of contract "where the warranty given by the manufacturer specifically precludes the recovery of such damages." *Sunny Slope Grading v. Miller, Bradford & Risberg, Inc.*, 148 Wis. 2d 910, 921, 437 N.W.2d 213, 218 (1989).

Court employs sound Code methodology. In these cases, the problem, if any, is with the Article 2 balance rather than with the Court.

Unfortunately, the Court's methodology has frequently been incomplete or unsound,<sup>158</sup> with the result being that the seller's advantage has been enhanced. Among other things, the Court has:

(1) Substituted its judgment for that of the trier of fact without fully developing the concept of merchantability;

(2) Complicated and misapplied the "basis of the bargain test" in section 2-313(1);

(3) Misapplied and misunderstood the parol evidence rule;

(4) Interjected potential rigidity in the scope and proof of consequential damages;

(5) Rejected the "equal opportunity" variation in mitigation of damage principles;

(6) Interpreted sections 2-207 and 2-316 to permit the inclusion and enforceability of disclaimers and limited remedies where the buyer knew of the terms, even though statutory conditions were clearly not satisfied;

(7) Admitted "custom" that negated consequential damages without exploring or charging the trial court about critical limitations on the scope of section 1-205;

(8) Where *Erie* applied, endorsed state interpretations of section 2-719(2) without an independent inquiry into the remedial consequences where a limited remedy fails its essential purpose;<sup>159</sup>

(9) Facilitated the exclusion of consequential damages where the product claim was in tort; and

(10) Failed, despite repeated opportunities, to develop a coherent approach to warranty disputes, drawn from a thorough and integrated understanding and analysis of Article 2.

The cumulative effect of this litany does not commend the Seventh

158. In summary, the following methodological flaws can be found in the warranty cases just considered: (1) Analysis is limited to just a few sections, omitting others of relevance, and, frequently, Article 2 is treated as if it were an ancillary rather than the primary source of law; (2) Statutory language and key definitions have been ignored; (3) There are no references to the history of the concept at stake or the legislative history of the sections being interpreted; (4) The comments are sometimes ignored or mischaracterized; (5) Cases from other jurisdictions interpreting the same sections are rarely developed and contrary precedents are frequently ignored; (6) References to important secondary sources, such as *J. WHITE AND R. SUMMERS, supra* note 2, are sparse and rarely used to best advantage.

159. An exception, of course, is *AES Technology Sys., Inc. v. Coherent Radiation*, 583 F.2d 933 (7th Cir. 1978), where Judge Moore was permitted to interpret the Official Text of the U.C.C. rather than the Code as enacted and interpreted in either California or Illinois. See *supra* text accompanying note 123.

Circuit. Clearly, no intentional preference for the seller can be detected in the opinions. The cases analyzed arose over a twenty year span from a variety of transactions and were argued before constantly changing panels of judges. The quality of attorney advocacy (and of the judicial clerking) may also have been a factor. But at most points, where a plausible, if not required, interpretation favorable to the buyer could have been adopted, the Court went the other way. This is surprising, because in other cases involving Article 2, the Seventh Circuit has employed better Code methodology with no pattern of outcomes favoring the seller.<sup>160</sup>

Advantage seller? The answer is clearly yes. Is this a legitimate advantage? Given the Court's questionable methodology and the litany recited above, my answer is no. The penalty? At the very least, the Court and its law clerks should be sentenced to take a refresher course in the law of warranty liability and remedy contained in and around Article 2, Sales. Until more sophistication is acquired, it is hard to conclude that the Seventh Circuit—in the warranty area at least—has emerged as a major commercial law court.

160. Recent non-warranty cases where the Seventh Circuit has, in my judgment, employed better Article 2 methodology include: *Empire Gas Corp. v. American Bakeries Co.*, 840 F.2d 1333 (7th Cir. 1988) (Posner, J.); *Schulze & Burch Biscuit Co. v. Tree Top, Inc.*, 831 F.2d 709 (7th Cir. 1987) (Eschbach, J.); *R.E. Davis Chem. Corp. v. Diasonics, Inc.*, 826 F.2d 678 (7th Cir. 1987) (Cudahy, J.); *Wisconsin Knife Works v. National Metal Crafters*, 781 F.2d 1280 (7th Cir. 1986) (Posner, J., with a dissent by Easterbrook, J.); *Jason's Foods, Inc. v. Peter Eckrich & Sons, Inc.*, 774 F.2d 214 (7th Cir. 1985) (Posner, J.); *Thomson Printing Mach. Co. v. B.F. Goodrich Co.*, 714 F.2d 744 (7th Cir. 1983) (Cudahy, J.).