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Contracts

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CONTRACTS

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INTRODUCTION

Within the survey period, only three cases were decided involving significant contract issues. The first case involves an application of Uniform Commercial Code Section 2-207(1), providing for an acceptance which is "expressly conditional" on assent. What language constitutes such an acceptance, and is therefore a counter-offer, remains a continuing problem for practitioners and courts alike. The second case also involves a sale of goods and application of the Uniform Commercial Code. In that case course of performance was examined to determine whether the seller breached the "implied warranty of merchantability." The final case involves common law contract principles and the question of whether the City of Detroit's failure to make timely payments constituted a "material breach" of a construction contract.

I. COUNTER-OFFERS UNDER U.C.C. SECTION 2-207

In *Ralph Shrader, Inc., v. Diamond International Corp.*,[1] an aerosol can buyer (Shrader) brought suit against the seller, American Can Company (American), and two other suppliers for damages arising out of a breach of contract. The claims against the other two suppliers (Diamond International and Crown Cork & Seal) were settled, thus leaving American as the sole defendant.[2]

Shrader is the developer-manufacturer of petroleum-based automotive products, particularly carburetor cleaner. The products are marketed under various names and packaged in aerosol cans.

Prior to 1978, all of the cans produced by American, as well as other can manufacturers, were sealed by a soldered

1. 833 F.2d 1210 (6th Cir. 1987).
2. *Id.* at 1212.

seam. Shrader filled the can with its product, sealed a cap onto the can, then added Freon-12, a propellant, to pressurize the can. However, in the fall of 1977, American and the other can manufacturers switched from soldered seams to welded seams on the cans. Shrader switched to the welded seam cans as the soldered seam cans became unavailable.

By December of 1978, the use of Freon-12 as a propellant in pressurized products was banned by the federal government. As a result, the company began testing nitrous oxide but in the older, soldered seamed cans. Sometime in 1978, Shrader then began testing the nitrous oxide in the welded seam cans. The company soon determined that these cans could burst due to increased pressure, the result of a chemical reaction with the welded seam. Shrader thus initiated a recall campaign of these cans in 1980.[3]

Shrader initiated action against two of its suppliers in 1981, joining American as a defendant in September of 1983. Shrader sought two million dollars in damages from American and alleged three causes of action: breach of implied warranty; negligence; and failure to properly design, manufacture, and test the cans.[4]

American motioned for summary judgment, relying on a provision on the back of its acknowledgement form which reduced the period of limitations from four years to two years.[5] American claimed that Shrader's claims were time-barred as the buyer knew of the problems with the cans since 1979. Finally, American relied on another provision on the back of its acknowledgement form which excluded claims for consequential damages.[6]

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3. *Id.*

4. *Id.*

5. *Id.* Under the provisions of the Uniform Commercial Code (U.C.C.) a four year statute of limitations period is adopted for contracts involving the sale of goods. The U.C.C. further provides that the parties may reduce the period of limitation, to a period of time not less than one year. The instant case was brought in the district court on the basis of diversity of citizenship, thus Michigan law controls. Accordingly, the Michigan version of the U.C.C. applies. *See* MICH. COMP. LAWS § 440.2725(1) (West 1967).

6. 833 F.2d at 1212. The Sixth Circuit opinion refers to a clause in American's acknowledgement form which excludes recovery of consequential damages and then quotes the following language from the acknowledgement form: "[I]f supplier is

In response, Shrader argued that the provisions in American's acknowledgement form were not part of the contract because the acknowledgement form was a "conditional acceptance" or counter-offer under Section 440.2207(1) of the Michigan Statute, requiring assent.[7] Alternatively, Shrader argued that American's acknowledgement form was an acceptance of Shrader's offer to purchase. However, the stated terms materially altered Shrader's offer and thus are not part of the contract under Section 440.2207(2) of the Michigan Statute.[8]

The federal district court granted American's motion for summary judgment, finding as a matter of law that the acknowledgement form was an acceptance.[9] Additionally, the

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liable to buyer for breach of . . . warranty and any actionable negligence of supplier, [such] liability on any claim, whether in tort or in contract, shall not exceed the cost to buyer of the faulty goods and any materials packed therein." Technically, this term is a limitation of remedy provision which impliedly excludes recovery of consequential damages. Section 2-719 provides that the parties may agree to limit the remedies available in the event of breach. *See* MICH. COMP. LAWS § 440.2719.

7. MICH. COMP. LAWS § 440.2207(1) (West 1967). Section 2-207, drafted as the codes's solution to the "battle of the forms," is one of the most written about, litigated sections of the U.C.C. The section provides:

> "(1) A definite and seasonable expression of acceptance or a written confirmation which is sent within a reasonable time operates as an acceptance even though it states terms additional to or different from those offered or agreed upon, unless acceptance is expressly made conditional on assent to the additional or different terms.
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> (2) The additional terms are to be construed as proposals for addition to the contract. Between merchants such terms become part of the contract unless:
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> (a) the offer expressly limits acceptance to the terms of the offer;
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> (b) they materially alters it; or
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> (c) notification of objection to them has already been given or is given within a reasonable time after notice of them is received.
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> (3) Conduct by both parties which recognizes the existence of a contract is sufficient to establish a contract for sale although the writings of the parties do not otherwise establish a contract. In such cases the terms of the particular contract consist of those terms on which the writings of the parties agree, together with any supplementary terms incorporated under any other provisions of this Act." *Id.*

8. *Id.*

9. 833 F.2d at 1212. The district court relied on the first clause of § 2-207(1) and determined that the acknowledgement was a definite and seasonable expression of acceptance even though it contained terms additional to or different from those of the offer. In reaching this result, the district court must have rejected the argument that the acknowledgement was made expressly conditional on assent to the additional or different terms. *See* U.C.C. § 2-207(1), *supra* note 8.

district court found that both Shrader and American were merchants, and that since the terms in the acknowledgement form did not materially alter the offer, the terms automatically became a part of the contract.[10]

The question on appeal to the Sixth Circuit is whether the reduced statute of limitations period and the limited remedy provision contained on the reverse side of the acknowledgement form are a part of the contract between American and Shrader. If the terms are a part of the agreement, then the trial court correctly granted summary judgment for American.

In order to resolve this question, the Sixth Circuit had to evaluate the language of the acknowledgement form and determine whether it was an effective acceptance or whether it was a conditional acceptance which would only be effective as an acceptance if the offeror assented to the additional terms.[11] Whether a sale of goods acceptance should be treated as a traditional common law counter-offer depends on the specific language of the acceptance. The language at issue in American's acknowledgement form is found in the following clause:

> The terms set forth on the reverse side are the only ones upon which we will accept orders. These terms supersede all prior written understandings, assurances and offers. Your attention is especially directed to the provisions concerning warranty and liability of supplier and claim procedure. In any event, these terms shall become binding on both parties upon your acceptance of our first delivery of any goods specified herein, or upon commencement of manufacturing operations. Advise us immediately if anything in the acknowledgement is incorrect or otherwise unacceptable.[12]

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10. 833 F.2d at 1212. *See also* U.C.C. § 2-207(2)(b). Between merchants additional terms automatically become a part of the contract unless the offer expressly limits acceptance to its terms, the terms materially alter the contract, or notification of objection to the terms has been given or is given within a reasonable time. Where one or both of the parties are non-merchants, the additional terms are merely proposals which must be agreed to by the offeror.

11. If the acknowledgement form contains a definite and seasonable expression of acceptance it will be treated as an acceptance. If, however, the acknowledgement conditions the seller's acceptance of the buyer's offer on buyer's assent to the additional terms, the acknowledgement form is a counter-offer. Professors White and Summers refer to these methods of contract formation as "Routes A & B." For their lively, informative discussion *see* J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 39 (1988).

12. 833 F.2d at 1213.

Accordingly, the Sixth Circuit was faced with deciding whether the quoted language clearly states a counter-offer. Courts generally strictly construe such language.

Section 2-207 was drafted to solve the battle of the forms problem, at least in part, by adopting an "anti-last shot" policy.[13] If sellers could control the terms of a sale of goods contract by making the so-called acceptance expressly conditional and thus a counter-offer, one of the main purposes of the Code section would be undermined. To avoid this result, courts generally strictly construe the expressly conditional proviso of § 2-207(1).

One of the significant cases that established this standard is the Sixth Circuit case of *Dorton v. Collins & Aikman Corp.*[14] In analyzing the language of the defendant carpet seller's acknowledgement form, the *Dorton* court stated:

> In order to fall within the [Subsection 2-207(1)] proviso, it is not enough that an acceptance is expressly conditional on additional or different terms; rather, an acceptance must be expressly conditional on the offeror's assent to those terms. Viewing the Subsection (1) proviso within the context of the rest of that Subsection and within the policies of Section 2-207 itself, we believe that it was intended to apply only to an acceptance which clearly reveals that the offeree is unwilling to proceed with the transaction unless he is assured of the offeror's assent to the additional or different terms therein . . . . That the acceptance is predicated on the offeror's assent must be "directly and distinctly stated or expressed rather than implied or left to inference."[15]

In the present case, the Sixth Circuit referred to the *Dorton* standard, and then concluded that the instant case fell within the narrow exception and that the acceptance of American was

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13. WHITE & SUMMERS, *supra* note 11.

14. 453 F.2d 1161 (6th Cir. 1972).

15. 453 F.2d at 1168. In *Dorton*, the "Customer Acknowledgement" form provided: "This order is given subject to all of the terms and conditions on the face and reverse side hereof, including the provisions for arbitration and the exclusions of warranties, all of which are accepted by Buyer, supersede Buyer's order form, if any and constitute the entire contract between Buyer and Seller." *Id.* at 1164. In evaluating this language the Sixth Circuit held that although the words "subject to" suggest that the acceptances were conditional, the acceptances were not made expressly conditional on the Buyer's assent to the additional terms as required by the Subsection 2-207(1) proviso. *Id.* at 1168.

conditional. The court further noted that the language, taken as a whole, clearly indicated that American would accept only its own terms.[16]

Having found that the acceptance of American was expressly conditional, the Sixth Circuit then addressed the question of whether Shrader had "assented" to the additional terms. The court noted that assent, for purposes of Section 2-207(1), was not clearly defined by Michigan law. Where acceptance is conditional, as in the case at bar, the Sixth Circuit held that assent is a question for the trier of fact. Accordingly, the court found that summary judgment was not appropriate and the case was reversed and remanded.[17]

Application of Section 2-207 is difficult; even the hornbook authors disagree on several points.[18] With respect to the instant matter, this author finds the facts indistinguishable from the *Dorton*[19] case. Although the Sixth Circuit found that the seller was "unwilling to proceed unless assured of the offeror's assent to the additional or different terms,"[20] no language to that effect can be found in the acknowledgement form. The court is correct in holding that American's form attempted to create a contract only on its own terms. However, that is not the standard for determining whether the acknowledgement should be treated as a counter-offer. "[I]t is not enough that an acceptance is expressly conditional on additional or different terms; rather, an acceptance must be *expressly* conditional on the offeror's *assent* to those terms."[21] Applied to the instant acknowledgement form it was a binding acceptance and the parties were contractually bound.

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16. 833 F.2d at 1214-15.

17. *Id.* at 1215.

18. For example, Professors White and Summers are not in accord with respect to the treatment of different terms under § 2-207(2). WHITE & SUMMERS, *supra* note 11, at 33-35. Furthermore, the hornbook authors disagree as to whether a buyer who receives and accepts good shipped by the seller has expressly assented to the terms of a conditional acceptance. Most courts are unwilling to find that such conduct constitutes assent to the terms. *Id.* at 40.

19. 453 F.2d 1161 (6th Cir. 1972).

20. 833 F.2d at 1214 (quoting Challenge Machinery Co. v. Mattison Machine Works, 138 Mich. App. 15, 359 N.W.2d 232 (1984) (per curiam)).

21. This is the standard enunciated in the *Dorton* case. 453 F.2d at 1168 (emphasis in original).

However, before determining whether the district court's grant of summary judgment was appropriate, it is necessary to ascertain whether the terms in the acknowledgment form materially alter the offer. The terms in question are a reduced statute of limitations period and a limitation of remedy provision. The Code does not delineate those terms which materially alter a contract. However, the Code Comments do give examples.

Comment number five lists examples of clauses which involve no element of unreasonable surprise and therefore are to be incorporated into the contract unless notice of objection is given. None of the examples given speak specifically to narrowed statute of limitations, however, one example does cover "a clause fixing a reasonable time for complaints within customary limits." A clause "limiting [a] remedy in a reasonable manner" is listed as an example of a clause which would not materially alter the contract.[22] Based upon the Code Comments, it would appear that the acknowledgement terms in question do not materially alter the contract.

Nevertheless, not all commentators and courts agree with the Code Comments, at least with respect to a term which limits a remedy in a reasonable manner.[23] Since a limitation of remedies provision could result in hardship, a determination of whether a given term constitutes a material alteration may present a question of fact which can not be dealt with summarily.

II. Implied Warranty of Merchantability

This case was decided exclusively on its facts and, thus, is not illustrative of Code interpretation. Nevertheless, it is presented here to illustrate the necessity of taking prompt action if goods are unsuitable and the buyer believes that the seller has breached the implied warranty of merchantability.

In *Lancaster Glass Corp. v. Philips ECG, Inc.*,[24] the seller-manufacturer of glassware (Lancaster) brought an action against

22. *See* Code Comments, U.C.C. § 2-207.

23. *See* the discussion and cases found in Murray, *The Chaos of the Battle of the Forms: Solutions*, 39 Vand. L. Rev. 1307, 1362-63 (1986).

24. 835 F.2d 652 (6th Cir. 1987).

the buyer of electronic bulbs (Philips) to recover the contract price for bulbs which the buyer[25] had contracted to purchase but refused to accept. The buyer defended on the ground that the tendered bulbs were defective and counterclaimed to recover for allegedly defective bulbs which had already been paid for.

Prior to 1980, Lancaster manufactured and sold an electronic glass bulb known as the LEA-1015B. In essence, this bulb was an empty television tube made entirely of glass. When Philips began purchasing the LEA-1015B bulbs, it requested a copy of Lancaster's engineering drawing, which was last revised in 1973. Philips purchased more than a half-million bulbs from Lancaster between 1974-1979. Philips also purchased twelve-inch bulbs from other suppliers during the same time period. Philips then converted the bulbs into cathode ray tubes for eventual use as computer screens and similar video display monitors.

After Philips received an order from one of its customers, it would treat the tube with "implosion protection."[26] Implosion systems prevent glass in the tubes from flying outward and causing injury in the event the tubes are shattered. Philips used two systems of implosion protection: the traditional method of "shellbonding," whereby a seal was placed over the face of the tube; and the more recently developed method of "T-bonding," whereby a steel strip is placed around the perimeter of the bulb, then tightened.

T-banding eventually replaced shellbonding because it was less expensive and because T-banded tubes could fit into a smaller cabinet. There were certain disadvantages with this process, however; if the T-band moved or slipped after it was tightened the implosion protection was compromised and the

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25. The original contract for the electronic bulbs was between Lancaster and GTE Products Corp. The GTE division responsible for the issues in this lawsuit was sold to Philips on January 21, 1981. Both Philips and GTE were named a defendants. Hereinafter, both defendants are designated as "Philips." 835 F.2d at 653 n.1.

26. Because the sealed tubes are under a vacuum the glass is subject to excessive atmospheric pressure. A hole made in the face of the tube would cause the glass around the tube to implode from the pressure. Implosion protection systems were utilized by Philips to minimize the risk of violent implosions and to meet industry safety requirements. 835 F.2d at 654.

tube no longer fit into the customer's cabinet or chassis.[27] The shift from shellbonding to T-banding was not unique to Philips and Lancaster was aware of the trend.[28]

The events relevant to this case occurred over a sixteen month period. In January of 1980, Philips ordered 20,000 LEA-1015B bulbs which were released throughout the month. The agreed upon price was $8.90 per bulb. Subsequently, officials from both companies met to discuss prices and anticipated bulb needs. At that time, Philips' sales forecasts were very favorable whereas Lancaster predicted a substantial cost increase. Lancaster suggested that it would be mutually advantageous for Philips to place a large order at that time so that Lancaster could purchase materials immediately at the lowest possible price. Lancaster offered to sell the LEA-1015B bulbs for $8.25 each if Philips agreed to increase its order to 100,000 bulbs. Philips accepted the offer on February 14, 1980, and placed an order for 101,029 bulbs.

Philips then prepared one of its standard purchase orders and sent it to Lancaster. Lancaster returned the signed purchase order to Philips. The purchase order contained several provisions which are relevant to this dispute, including sections entitled "WARRANTIES" and "CANCELLATION AND REMEDIES." The purchase order also provided that shipment of the order was to be "as released."[29] It was understood by Lancaster that this language meant the order would be completed in 1980.[30]

Lancaster began releasing bulbs in March of 1980. In April of 1980, Philips was first notified by one of its customers that the T-bands on a shipment of twelve-inch bulbs had slipped. Upon examination, it was determined that all of the bulbs with slipped bands were Lancaster's LEA-1015B bulbs. Nevertheless, Philips continued to request new releases until the end of June.

Despite Philips' efforts, the problem of T-band slippage continued. Philips' engineers suspected that the slippage prob-

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27. 835 F.2d at 654.
28. *Id.*
29. *Id.* at 655.
30. *Id.* at 654-55.

lem was related to the size of the angles at each of the four diagonal corners of the bulb faceplate. The bulbs were sent to Owens-Illinois for measurement during the summer of 1980 and Philip's suspicions proved correct. Lancaster's engineering drawing showed the diagonal angles to be one-and-one-half degrees with no tolerance indicated.[31] Upon examination, however, Philips learned that some of the angles exceeded one-and-one-half degrees. It was at this same time that the market for twelve-inch tubes declined.

Philips first advised Lancaster of the problem on August 1, 1980. At a meeting of the two companies on August 18, Philips' requested Lancaster's help in finding a solution to the T-band slippage. Philips' engineers suggested that the T-band system might work better if the diagonal angles were straighter. After reviewing the available data, Lancaster agreed that Philip's suggestion would probably work but noted the modification would require a change in the mold used to make the bulbs.[32] Lancaster agreed to modify the molds but only after Philip's had depleted the existing inventory for the February 1980 order. Philips made no objections to this arrangement at that time.[33]

By September of 1980, more than 84,000 bulbs had yet to be released pursuant to the February agreement. Lancaster sent a 1981 price list to Philips indicating the price of the LEA-1015B bulbs would increase from $8.25 to $9.40 effective December 31, 1980. In response, Philips advised Lancaster by phone that the market for twelve-inch bulbs had dropped and that Lancaster's competitors were "holding the line" on bulb prices throughout 1981. Philips repeated its request for price considerations in letters dated November 7, 1980 and December 2, 1980. Philips never mentioned the T-banding problem during this time, and Lancaster continued to deny the requests for considerations.

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31. Plus and/or minus symbols which follow each dimension indicate that there is a specific range within which the bulb may vary from the drawing yet still be considered in conformance. *Id.* at 655.

32. *Id.* at 655-56.

33. Perhaps if Philips had given notice of breach of warranty at this time the court would have viewed the facts differently. The facts seem to show that the slipping of the T-bands was not Philips' major concern, rather, Philips was concerned with a declining market for sales and an increased price for bulbs.

The T-band problem was not mentioned again until the parties met in January of 1981 to negotiate the outstanding order. The official who conducted negotiations on behalf of Philips later testified that he brought up the T-banding problem "as a negotiating ploy" in an attempt to secure price concessions from Lancaster.[34]

The parties continued to negotiate until they finally reached an agreement on January 29, 1981. Throughout February of 1981, Philips continued to accept bulbs and pay for them pursuant to the January 29th agreement. In March, however, Philips again sought release from its contractual obligation. Meetings between the parties continued. At no time throughout these discussions, however, did Philips mention the T-banding problem, nor did Philips request credit for bulbs with slipped T-bands.[35]

During April of 1981, Philips conducted tests on a sample of twenty-five bulbs. The results showed that twenty-four of these bulbs had diagonal angles in excess of the one-and-one-half degrees indicated on the engineering drawing. On April 24, 1981, Philips advised Lancaster that it would accept no further deliveries until a meeting was held. At a meeting held on May 31, Philips claimed that the T-band slippage was caused by excessive angles and this problem prevented Philips from using the bulbs. Philips requested credit for the bulbs in its inventory and further stated it would not accept delivery of LEA-1015B bulbs remaining under the contract of February, 1980.[36]

The ensuing litigation involved several claims and counterclaims. Lancaster sued Philips to recover the purchase price of 13,923 bulbs which Philips had received but not paid for, and also sued to recover the purchase price of 36,113 bulbs which Philips refused to accept under the contract. Philips counterclaimed to recover the price which it had paid for the 21,483 bulbs still in its inventory.

The district court rendered judgment in favor of Lancaster, holding that the non-toleranced diagonal angles did not render

34. *Id.* at 656.
35. *Id.*
36. *Id.* at 657.

the bulbs defective and that the tendered bulbs therefore conformed to the contract. Alternatively, the district court held that the alleged non-conformities did not substantially impair the value of the contract to Philips.[37] The court also held that Philips' claim that Lancaster breached the implied warranty of fitness for a particular purpose failed because Philips was unable to prove that it relied on Lancaster's judgment to furnish suitable goods.[38] Likewise, Lancaster did not breach implied and express warranties of merchantability because the bulbs were of an acceptable quality in the trade.[39]

Philips raised three arguments on appeal: first, Philips contested the district court's conclusion that the tendered bulbs conformed to the contract; second, Philips rejected the lower court's alternative holding that the alleged non-conformity failed to substantially impair the value of the contract; and third, Philips argued that the district court had applied the wrong standard in concluding that Lancaster did not breach implied and express warranties of merchantability. Philips maintained that the proper standard was that the bulbs must be suitable and sufficient for their ordinary and intended purpose.[40]

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37. Under most contracts for the sale of goods, a buyer may reject the goods if they fail in any respect to conform to the contract. *See* U.C.C. § 2-601. Under this "perfect tender rule" Philips would be permitted to reject if notification of rejection were given timely. However, the instant contract was an installment contract: one which authorizes the delivery of goods in separate lots for separate acceptance. *See* U.C.C. § 2-612(1). In an installment contract, the buyer may only reject the goods if the non-conformity substantially impairs the value of the installment and cannot be cured. *See* U.C.C. § 2-612(2). Substantial impairment is also the standard for revocation of acceptance. *See* U.C.C. § 2-608. In light of Philips continued use of the bulbs, substantial impairment would be difficult to prove.

38. The implied warranty of fitness for a particular purpose is provided in U.C.C. § 2-315, which requires that "seller at the time of contracting has reason to know [of the] particular purpose for which the goods are required and that the buyer is relying on the seller's skill or judgment to select or furnish suitable goods." *Id.* Philips did not appeal the district court's conclusion that the cause of action for breach of the implied warranty of fitness for a particular purpose failed. 835 F.2d at 660.

39. 835 F.2d at 657. Philips argues on appeal that this is an inappropriate standard for judging merchantability. U.C.C. § 2- 314(2) proposes several standards for merchantability, one which provides that: "[g]oods to be merchantable must be at least such as pass without objection in the trade under the contract description."

40. 835 F.2d at 657-58.

The district court had noted that the terms of the contract between Lancaster and Philips were those contained in Philips' purchase order. In that contract, Lancaster promised that the LEA-1015B bulbs would "conform to all specifications, drawings, [and] descriptions furnished, specified or adopted" by Philips.[41] Because Philips had used Lancaster's engineering drawing, it was part of the contract. Therefore, Philips had the right to cancel the February, 1980 order if the tendered bulbs did not conform to the drawing.

Although the Sixth Circuit agreed with the conclusion of the district court, it differed in its analysis. Since "course of performance" to explain the agreement had not been excluded by the purchase order, the court chose to begin at that point. When "the contract for sale involves repeated occasions for performance by either party with knowledge of the nature of the performance and opportunity for objection to it by the other, any course of performance accepted or acquiesced in without objection shall be relevant to determine the meaning of the agreement."[42] The Sixth Circuit was satisfied that, in the present case, the prerequisites of U.C.C. Section 2-208(1) were met.

Philips knew that some of the diagonal angles exceeded the one-and-one-half degrees called for in the drawing as early as April of 1980. In spite of this, Philips continued to accept releases of bulbs without objection. When Philips first discussed the T-band problem with Lancaster in August of 1980, Philips again failed to object to Lancaster's response that it would make changes only after the February, 1980 order was completed.

Further, the slipping T-band issue was raised at the January, 1981 meeting merely as a "negotiating ploy" in an attempt to obtain price concessions during a time when sales were slow. The court cited other such instances to support its finding that Philips had acquiesced without objection to Lancaster's tendering of bulbs.[43] The appeals court concluded that the bulbs

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41. *Id.* at 658.

42. 835 F.2d at 659 (quoting U.C.C. § 2-208(1)).

43. From these facts a court might conclude that Lancaster had a defense to an action for breach of warranty, namely, that Philips failed to give timely notice

conformed to the contract, and that such a finding eliminated the necessity of addressing Philips' second argument.[44]

Philips' third argument on appeal, was that the district court used the wrong legal standard and, thus, incorrectly concluded that Lancaster had not breached express warranties and the implied warranty of merchantability.[45] Philips argued that the bulbs must be suitable for their ordinary and intended purposes in order to be merchantable.[46] Philips argued that the production of T-banded tubes was an ordinary purpose for which the bulbs were used. Because the bulbs were not adequate for that ordinary purpose, Lancaster breached the implied warranty of merchantability.

Philips also relied on a clause in the warranties section of the purchase order which obligated Lancaster to tender bulbs which were "merchantable and suitable and sufficient for their intended purposes."[47] The Sixth Circuit concluded that the contract's express warranty provided the same level of protection as that provided by the U.C.C.'s implied warranty of merchantability, thus treating express and implied warranties together.[48]

The court addressed the question of what standard was required to satisfy the requirement of merchantability under U.C.C. § 2-314, and noted that the standard of merchantability

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of the breach. Under U.C.C. § 2-607(3)(a): Where a tender has been accepted the buyer must within a reasonable time after he discovers or should have discovered any breach notify the seller of breach or be barred from any remedy. "Any remedy" includes ancillary rights such as the right to revoke acceptance, as well as the right to damages. *See* WHITE & SUMMERS, *supra* note 11, at 480.

44. 835 F.2d at 659-60. *See* the discussion of Philip's second argument, *supra* at note 40.

45. 835 F.2d at 660. *See* the discussion of "an acceptable quality in the trade" as a standard of merchantability, *supra* note 39.

46. One of the standards by which merchantability may be judged is that "goods to be merchantable must be at least such as . . . are fit for the ordinary purposes for which such goods are used." U.C.C. § 2-314(2)(c).

47. 835 F.2d at 660.

48. In examining the language of the purchase order, the Sixth Circuit noted that the phrase "intended purposes might arguably be interpreted as providing a greater level of protection than that provided by the U.C.C.'s implied warranty of merchantability. However, Philips, the drafter of the contract, had characterized this as an "express warranty of merchantability" throughout the entire appeal, thereby negating a requirement of greater protection.

is not readily defined.[49] The Sixth Circuit found that the "acceptable quality in the trade" standard used by the lower court was satisfactory.[50] The Code Comment to Section 2-314 lends support to the court's conclusion by stating: "Goods delivered under an agreement made by a merchant in a given line of trade must be of a quality comparable to that generally acceptable in that line of trade under the description or other designation of the goods used in the agreement."[51]

The court went on to examine the underlying purpose of Section 2-314 to support its conclusion. In every sale the parties face the risk that the goods will be made just as well as the seller intended, but they will prove to be unsuitable for the buyer's use.[52] Further, "'merchantable' is not a synonym for perfect."[53] "The warranty of merchantability simply directs the seller to do what he typically does, and it informs the buyer that he should only expect to receive goods of the quality he typically gets."[54]

When Philips placed the February, 1980 order, shellbonding was the customary production process; T-banding was a non-customary, particular use. Therefore, Lancaster provided merchantable bulbs under the contract because it supplied the same

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49. 835 F.2d at 661. The hornbook authors state that attempting to define merchantability gives both plaintiffs' and defendants' lawyers ulcers. WHITE & SUMMERS, *supra* note 11, at 411. The Code section gives the Lawyer and the courts some assistance in defining merchantability by providing: "Goods to be merchantable must be at least such as

> (a) pass without objection in the trade under the contract description; and
> (b) in the case of fungible goods, are of fair average quality within the description; and
> (c) are fit for the ordinary purposes for which such goods are used; and
> (d) run, within the variations permitted by the agreement, of even kind, quality and quantity within each unit and among all units involved; and
> (e) are adequately contained, packaged, and labeled as the agreement may require; and
> (f) conform to the promises or affirmations of fact made on the container or label if any." U.C.C. § 2-314(2).

50. *Id.*

51. U.C.C. § 2-314, Comment 2.

52. 835 F.2d at 661 (citing SCHWARTZ & SCOTT, SALES LAW AND THE CONTRACTING PROCESS 3-5 (1982)).

53. *Id.* (quoting WHITE & SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 356 (2d ed. 1980)).

54. 835 F.2d at 661.

kind of bulbs which it had typically provided, and Philips had no right to expect more than the type of bulbs it had typically received. "If Philips wanted something different than that which it typically received, it was incumbent on Philips to indicate its changed demands, thereby shifting the risk of unsuitability for T-banding to Lancaster."[55] Accordingly, the Sixth Circuit held that Lancaster did not breach any warranty and affirmed the district court's judgment in favor of Lancaster.[56]

Once a buyer discovers a non-conformity or breach of warranty it is incumbent upon the buyer to notify the seller of the complaint. Here, Philips failed to act, leaving the court to conclude that the subsequent claims for unmerchantable goods resulted only because of an increase in price and a disappearing market. Buyers are advised to act quickly in notifying the seller of a breach with respect to the quality of goods. To do otherwise chances a result like that of the instant case or a possible summary judgment and bar from any remedy under Section 2- 607(3)(a).[57]

III. Material Breach

In the third case involving a construction contract, only seven of nineteen payments made to the contractor were made on time in accordance with the contract requirements. One of the questions presented is whether these delays in payment constitute a material breach of the contract thereby excusing the contractor from continued performance.

In *In re American Casualty Co.*,[58] plaintiff, American Casualty Co. (American), appealed from a judgment holding it liable as the surety on a performance bond for two construction contracts between the City of Detroit (City) and Brady Mechanical, Inc. (Brady). American appealed the district court's judgment of liability. In a consolidated case the City, defendant and third party plaintiff, appealed the district court's denial of its claim for attorney fees and additional costs.

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55. *Id.* at 662.
56. *Id.*
57. *See supra* note 43, discussing U.C.C. § 2-607(3)(a).
58. 851 F.2d 794 (6th Cir. 1988).

In May of 1982, two contracts for development and refurbishment of a Detroit housing project were awarded to Brady. The housing project consisted of several buildings which were heated by a centralized steam plant. The steam was distributed from the plant through ten-inch pressure steam lines to various substations located throughout the project, where the pressure was reduced and the steam subsequently distributed to the various buildings. The contract required Brady to replace the main high pressure line and certain low pressure lines which were old or in serious disrepair, and to reroute low pressure lines away from the buildings which were scheduled to be demolished.[59]

Brady commenced work in the spring of 1982 and began to experience problems. Brady required certain periods of time to shut down the lines and cut off the steam heat source. As Brady understood the situation, the steam was to be shut down during the entire summer of 1982. The City, however, understood that the steam would be shut down only for limited periods throughout the summer, and certainly not during the winter because the steam lines provided both heat and hot water for the housing project.[60]

Brady attempted to construct a temporary steam line to be used while the primary line was shut down. The temporary steam line proved ineffective and the parties disputed responsibility for the cost of the ineffective temporary line. Brady argued that it was prevented from constructing adequate temporary lines because of problems with the existing structures. The City countered that Brady had used an inadequate design for the temporary system.[61]

Problems with shutdowns were not the only source of dispute between the parties. Disagreements also arose with respect to payment of invoices sent by Brady. During the early stages of the project the City's construction manager instructed Brady's representatives to add the cost for extra work to various line items on Brady's application for payment. Once the City realized this it put a stop to the practice, calling upon Brady

59. *Id.* at 796.
60. *Id.*
61. *Id.*

to comply with the contract provisions which required change orders to be written.

The City further undertook a review of Brady's applications for payment which included charges for the extra work. This review resulted in delayed payments to Brady.[62] Additionally, there were other delays in payments. Of the nineteen payments made during the construction period, seven were made on time, six were made two months after the City's receipt of Brady's application for payment, and the remainder were made three months after receipt of the application for payment. The contract provided that payments were to be made at approximately thirty day intervals.[63] Brady alleged that the City's delay of payments had a severe effect on its cash-flow so as to threaten its economic survival.

The City retained the firm of Ellis, Naeyaert, Genheimer Associates, Inc. (Ellis) as mechanical engineer designer of the project. As such, Ellis assisted the City in reviewing the progress and quality of Brady's work, as well as reviewing Brady's requests for payment. Ellis questioned Brady's method of compacting the backfill of pipe treaches. Random testing revealed substantial evidence that the compaction and backfill quality requirements were not being met. The City directed Brady to correct the alleged defects. Brady denied the charges and stated conditions with which it expected the City to comply before Brady would, or could, complete the project. The City notified Brady that its conditions were unacceptable. Brady subsequently ceased operations and abandoned the job site in September of 1983.[64]

American initiated action in the district court seeking a declaratory judgment with respect to its liability on the performance bonds for the contracts. The City counterclaimed, impleading Brady as a third party defendant and seeking damages for breach of contract. The district court found that the City's delays in making payments to Brady and the limitations on the steam-shutdowns were not material breaches and that the City had not substantially interfered with Brady's per-

62. *Id.* at 796-97.
63. *Id.* at 797.
64. *Id.*

formance.[65] The district court thus held that Brady had breached its contract through defective work and by abandoning the project without justification. The court also held that the City was entitled to damages, costs and attorney fees.[66]

On American's motion, the district court set aside the award for costs and attorneys' fees and substituted an award of statutory costs because the City filed its application for attorney fees too late under the applicable rules. The district court ruled that the City could not recover costs and attorney fees from American under its indemnity agreement. American filed an appeal, challenging the court's judgment of liability and assessment of damages. The City also appealed the court's denial of costs and attorney fees.[67]

Brady argued on appeal that its abandonment of the contract was justifiable because the City had already materially breached by failing to pay according to the contract terms. The Sixth Circuit noted that the City had indeed breached the contract by its delays in making payments for extra work. However, since the remainder of the contract payments substantially conformed to the contract requirements for payment, the Sixth Circuit found that the level of breach was not material.[68]

In reaching this conclusion, the court referred to Michigan case law which holds that whether there has been a material breach of the contract is a question of fact for the trier of fact to determine.[69] If the breach is material, the aggrieved party may cancel the contract and sue for breach. Thus, the non-breaching party faced with material breach was excused from continued performance under the contract.

The Restatement Second of Contracts[70] changed the terminology used in connection with material breach. Under the

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65. The district court found that while there were payment delays, they were the result of the City's inefficient bureaucracy and were not material delays. Additionally, the court concluded that Brady had held up the procedures for approving its applications for payment. 851 F.2d at 798.

66. *Id.*

67. *Id.* at 797-98.

68. *Id.* at 799.

69. Pratt v. Van Rensselaer, 235 Mich. 633, 209 N.W. 807 (1926). This holding is consistent with other jurisdictions. *See* J. CALAMARI & J. PERRILLO, THE LAW OF CONTRACTS 460 (1987).

70. Restatement, Second, Contracts § 236. J. CALAMARI & J. PERRILLO, THE LAW OF CONTRACTS 459 (1987).

Second Restatement, the term "total" is substituted for material, and only if there is a "total" breach is the injured party justified in cancelling the contract.[71] Under the Second Restatement the term "material" breach is used to cover a breach that justifies the aggrieved party in suspending her performance awaiting cure. As the hornbook commentators indicate, the problem with this new terminology is that an aggrieved party may suspend her performance even though the breach is "immaterial."[72] Because the new terminology only creates confusion, the hornbook authors do not employ it.[73]

The instant case used material breach[74] in the orthodox sense of the term. However, practitioners need to be cognizant of the changes in terminology found in the Restatement Second provisions. As those provisions are adopted by courts, confusion can be expected in light of the changed meaning of "material."

Brady and American also asserted that Brady's abandonment of the contract was justifiable because the City failed to provide steam shutdowns. The Sixth Circuit noted that a conference memorandum made before work began put Brady on notice that an uninterrupted supply of steam was essential to the tenants.[75] Further, steam shutdowns were sometimes granted by the City without problems; on other occasions permission to shut down the steam was withheld for the protection of the tenants.[76] The court recognized that Brady was placed under financial pressure because of the City's delays in payments. However, this did not relieve Brady from performance nor did it justify quitting the job. Brady should have sought the relief provided for in the contract rather than abandoning the project.

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71. *Id.*

72. *Id.*

73. Although the Calamari and Perrillo text refuses to use the new terminology, Farnsworth's treatise on Contracts has adopted the new terminology from the Second Restatement. *See* E. ALLAN FARNSWORTH, CONTRACTS 611-16 (1982).

74. There is not a simple test for determining whether a breach is material. Factors to be considered include: the extent to which the contract has been performed, whether the breach is willful rather than one caused by negligence, and the degree of hardship placed upon the parties.

75. 851 F.2d at 799.

76. *Id.* at 800.

Turning next to the issue of damages, the Sixth Circuit expressed its uncertainty as to whether the City had proven damages with the required degree of certainty.[77] Because American's motion to compel discovery on certain phases of the issue of damages was denied by the lower court, American could not adequately respond or rebut. The evidence also indicated that the award of damages was based upon a "rough estimate rather than an expert appraisal."[78] Additionally, the damage award failed to account for the fact that Brady was financially damaged by the City's delays in payments. The issue of damages was, therefore, remanded for consideration by the district court. Finally the Sixth Circuit affirmed the lower court's denial of costs and attorney fees.[79]

In conclusion, the Sixth Circuit affirmed the district court's decision that Brady and its surety, American, were liable for failure to perform; the issue of damages was remanded; and the denial of attorney fees was affirmed.

77. *Id.*
78. *Id.* at 801.
79. *Id.*