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Contracts

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CONTRACTS

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INTRODUCTION

Only a handful of cases decided during the survey period involved contract issues. Of those cases, three appear worthy of review. Two cases were decided under the Uniform Commercial Code involving (1) whether a repair or replacement limitation of remedy provision prevents a buyer from recovering the purchase price when a defective part reduces the entire unit to scrap; and (2) whether damages attributable to a recall campaign by the manufacturer of an end product are recoverable from a parts supplier as consequential damages. The third case involved an option contract for the purchase of real property and the availability of damages to the option holder when the option has not been exercised.

I. REPAIR OR REPLACEMENT LIMITATIONS

In *Rudd Construction Equipment Company v. Clark Equipment Company*,[1] the Sixth Circuit Court of Appeals applied Kentucky law[2] in a diversity action to determine the damage recovery available to the buyer where a latently defective component destroyed the entire unit five months after purchase. Rudd, a heavy equipment dealer and distributor, purchased a tractor shovel from the manufacturer, Clark, for $268,434. After less than 400 hours of demonstration use, the shovel caught fire, reducing the entire unit to scrap valued at $20,000. Evidence established that the fire was caused by a ruptured hydraulic hose and that the hose was defective at the time it was delivered.[3] The sales agreement contained a limitation of remedy provision, limiting Clark's obligation to repair or replace any new part which proved defective within six months

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1. 735 F.2d 974 (6th Cir. 1984).

2. Although the purchase agreement of the parties contained a choice of laws provision designating Michigan, the parties and the trial judge appear to have relied primarily on Kentucky law. The court of appeals followed suit. *Id.* at 978 n.1.

3. *Id.* at 975.

after delivery or 1,000 hours of use.[4] Additionally, the agreement expressly negated any liability on the part of Clark for consequential or special damages resulting from a breach of warranty.[5] In light of these provisions, Clark maintained that Rudd should recover only the replacement cost of the hose which ruptured.[6]

The trial court determined that even though the ruptured hose was the only defective part, the buyer could still recover the purchase price plus freight expenses less the scrap value, under a breach of warranty theory.[7] Alternatively, the trial court held that under strict liability and negligence theories, the buyer would also be entitled to its loss of profits on the resale of the tractor shovel.[8] Accordingly, the district court awarded a judgment for $315,945 plus interest, the greater measure of recovery calculated on the tort theories. The court of appeals affirmed the award on the breach of warranty theory,[9] revised the alternative award on the tort theories,[10] and, therefore, remanded the case for a modification of judgment as to the dollar damages awarded.[11]

Rudd is significant because it deals with the often troublesome questions of when a limited remedy fails of its essential purpose[12] and, what remedies are accorded the non-breaching party under such circumstances. Freedom of contract is a major principle of the U.C.C.,[13] and thus remedies, like most contractual provisions, may be limited by agreement:

> (1) Subject to the provisions of subsections (2) and (3) of this section and of the preceding section on liquidation and limitation of damages,
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> (a) *the agreement may provide for remedies in addition to or in substitution for those provided in this Article* and may limit or

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4. *Id.* at 976.

5. *Id.* The agreement stated: "IN NO EVENT SHALL CLARK BE LIABLE FOR CONSEQUENTIAL OR SPECIAL DAMAGES." *Id.*

6. *Id.* at 977.

7. *Id.*

8. *Id.*

9. *Id.* at 982.

10. *Id.* at 985.

11. The dollar figure in the judgment representing the tractor's value was to be reduced from $315,945, resale value less salvage, to $255,913.88, the wholesale value less salvage. *Id.* at 986.

12. This question was raised in Lewis Refrigeration Co. v. Sawyer Fruit, Vegetable and Cold Storage Co., 709 F.2d 427 (6th Cir. 1983), reviewed in the last survey issue. *See* Payne, *Contracts, Fifth Annual Survey of Sixth Circuit Law*, 1984 DET. C.L. REV. 451, 456-63.

13. U.C.C. § 1-102(3) (1977).

> alter the measure of damages recoverable under this Article, as by limiting the buyer's remedies to return of the goods and repayment of the price or to repair and replacement of non-conforming goods or parts; and
>
> (b) resort to a remedy as provided is optional unless the remedy is expressly agreed to be exclusive, in which case it is the sole remedy.[14]

Clark attempted to limit Rudd's remedy to repair or replace defective parts.[15] Since repairing or replacing was Clark's "sole obligation" under the warranty provision, Clark undoubtedly intended this remedy to be exclusive. Although not discussed in the case and, thus, probably not dealt with by the parties, some courts might find the language inadequate to create an exclusive remedy.[16] Such a finding would eliminate the necessity of establishing that the remedy failed of its essential purpose. Where a remedy provided for by agreement is optional rather than exclusive, the cumulative remedies of the U.C.C. are available to the aggrieved party.[17]

Nevertheless, even treating the repair or replacement limitation as exclusive, there are parameters on the parties' ability to limit

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14. U.C.C. § 2-719(1) (1977) (emphasis added).

15. The sales agreement between Clark and Rudd provided:

> There are no warranties, expressed or implied, AND THERE IS NO IMPLIED WARRANTY OF MERCHANTABILITY OR OF FITNESS FOR A PARTICULAR PURPOSE, made by CLARK to DISTRIBUTOR on products or parts except as follows:
>
> CLARK warrants each new part of the product manufactured by it to be free from defects in material and workmanship under normal use and maintenance. CLARK'S sole obligation under this warranty shall be limited to replacing or repairing F.O.B. CLARK'S plant, or allowing credit for, at CLARK'S option, any new part which under normal and proper use and maintenance proves defective in material and workmanship within six (6) months after delivery to or one thousand (1,000) hours of use by the first ultimate user, whichever shall occur first;
>
> THIS WARRANTY IS IN LIEU OF ALL OTHER WARRANTIES (EXCEPT OF TITLE), EXPRESSED OR IMPLIED, AND THERE ARE NO IMPLIED WARRANTIES OF MERCHANTABILITY OR OF FITNESS FOR A PARTICULAR PURPOSE. IN NO EVENT SHALL CLARK BE LIABLE FOR CONSEQUENTIAL OR SPECIAL DAMAGES.

735 F.2d at 976.

16. *See* J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 463-65 (2d ed. 1980), for a discussion of Ford Motor Co. v. Reid, 250 Ark. 176, 465 S.W.2d 80 (1971).

17. Remedies are presumed to be cumulative rather than exclusive. U.C.C. § 2-719 comment 2 (1977).

remedies. Section 2-719(2) states one such limitation: "Where circumstances cause an exclusive or limited remedy to fail of its essential purpose, remedy may be had as provided in this Act."[18] The difficult question is to determine what is required for such a remedy to fail of its essential purpose. The U.C.C. Official Comments (Comments) provide that "an apparently fair and reasonable limitation clause" must give way to the general remedy provisions of Article 2 when the clause "operates to deprive either party of the substantial value of the bargain."[19]

The purpose of an exclusive remedy of replacement or repair of defective parts is to give the seller an opportunity to make the goods conform while limiting his risks by excluding potential direct and consequential damages. From the buyer's point of view, the purpose of the exclusive remedy is to give him goods that conform to the contract within a reasonable time after a defective part is discovered.[20]

> This rosy picture of the limited repair warranty, however, rests upon at least three assumptions: that the warrantor will diligently make repairs, that such repairs will indeed "cure" the defects, and that consequential loss in the interim will be negligible. So long as these assumptions hold true, the limited remedy appears to operate fairly . . . . But when one of these assumptions proves false in a particular case, the purchaser may find that the substantial benefit of the bargain has been lost.[21]

Accordingly, in the great majority of cases where courts have held that limited remedies fail of their essential purpose, the seller is either unwilling or unable to conform the goods to the contract.[22]

The instant case is atypical in that the seller was never afforded an opportunity to repair, since the defect resulted in the immediate destruction of the entire tractor shovel. On this basis, Clark

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18. U.C.C. § 2-719(2) (1977).

19. U.C.C. § 2-719 comment 1 (1977).

20. Beal v. General Motors Corp., 354 F. Supp. 423 (D. Del. 1973).

21. Eddy, *On the "Essential" Purposes of Limited Remedies: The Metaphysics of U.C.C. Section 2-719(2)*, 65 CALIF. L. REV. 28, 63 (1977).

22. Chatlos Sys., Inc. v. Nat'l Cash Register Corp., 635 F.2d 1081 (3d Cir. 1980), *cert dismissed*, 457 U.S. 1112 (1982). *See, e.g.*, AES Technology Sys. Inc. v. Coherent Radiation, 583 F.2d 933, 939 (7th Cir. 1978) ("If after repeated efforts by a seller to place a product into warranted condition, and the seller cannot or will not do so, the remedy of repair or replacement may be deemed to have failed of its essential purpose . . . ."). S.M. Wilson & Co. v. Smith Int'l Inc., 587 F.2d 1363, 1375 (9th Cir. 1978) ("[T]he inability to cure substantial defects does indicate that the repair remedy so failed.").

argued that only if there is an opportunity for the seller to repair and the seller fails to repair can the limited remedy be said to have failed of its essential purpose.[23] Both the district court and the court of appeals rejected this reasoning. In reaching this result, the Sixth Circuit referred to *Russo v. Hilltop Lincoln-Mercury, Inc.*[24] which also involved a repair or replacement clause and a latent defect discovered simultaneously with the destruction of the goods. In *Russo*, a defective electrical system caused a fire which totally destroyed a new automobile. Oddly enough, the Missouri court found that the repair or replace limitation in the automobile warranty had not failed of its essential purpose. Nevertheless, the court allowed the buyer to recover benefit of the bargain damages on the grounds that the limited warranty implied that the car was repairable.[25] Commentators White and Summers consider the *Russo* case to be a classic failure of essential purpose case.[26] In upholding the trial court's finding that Clark's limited remedy provision failed of its essential purpose, the *Rudd* court appears to have relied on the commentators' analysis of *Russo*.[27]

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23. 735 F.2d at 979-80 (referring to Clark's agreements on motion for reconsideration before the trial court). The case discusses "the limited warranty in the contract" and whether it can be said to have failed of its essential purpose. It should be noted that limited warranties do not fail of their essential purpose; limited remedies for breach of warranty may fail of their essential purpose. See the statutory language of U.C.C. § 2-316(4) and § 2-719(2) (1977).

24. 479 S.W.2d 211 (Mo. Ct. App. 1972).

25. *Id.* at 213.

26. WHITE & SUMMERS, *supra* note 16, at 469.

> There are probably relatively few situations where a remedy can fail of its essential purpose. Section 2-719 (2) has been called into action most often in cases . . . when the exclusive remedy involves replacement or repair of defective parts, and the seller because of his negligence in repair or because the goods are beyond repair, is unable to put the goods in warranted condition. Section 2-719(2) might also apply when the exclusive remedy requires performance of an act by the buyer that is precluded by the seller's breach. For example, suppose an automobile manufacturer limits remedy to repair and replacement of defective parts if such parts are delivered to its plant. If the entire car is destroyed as a result of defective wiring, the buyer would be unable to return the wiring to the manufacturer's plant. Even if the buyer could return the defective parts, repair or replacement would not restore the car to working condition. The exclusive remedy would therefore fail of its essential purpose.

Id.

27. 735 F.2d at 982. After quoting the White & Summers text, *supra* note 26, the court of appeals concluded that "although none of the cited cases is precisely on point," the construction of the Code adopted by the trial court is more reasonable than the construction urged by Clark. *Id.*

After detailed analysis of the failure of essential purpose issue, the court of appeals summarily dismissed a need for analysis of the second and more difficult question: the damage remedy available to Rudd. More specifically, the court failed to address whether replacement value of the tractor constitutes consequential damages, rather than direct damages, which were expressly excluded in the purchase agreement.[28]

There is a split of authority as to whether an exclusion of consequential damages clause may be given effect where a limited remedy provision has failed of its essential purpose.[29] One view prohibits application of the exclusionary clause.[30] Another view, probably the majority position today, enforces the exclusion of consequential damages and limitation of remedy clauses independently, upholding the exclusionary clause unless to do so would be unconscionable.[31] Recently, in *Lewis Refrigeration Co. v. Sawyer Fruit, Vegetable and Cold Storage Co.*[32] the Sixth Circuit adopted the latter view. Thus, the *Lewis* court held that absent a finding of unconscionability, the exclusion of consequential damages provision survived.[33] Although *Lewis* was decided under Washington state law, the Kentucky provision is virtually identical with regard to limitation or exclusion of consequential damages in commercial settings.[34] Accordingly, if the Sixth Circuit had addressed the spe-

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28. After indicating that commentators White and Summers would classify most of the fire damage to the tractor shovel as consequential, the court summarily upheld the trial court's award of the net replacement value of the shovel. The court stated:

> The trial judge did not analyze his award of the net replacement value in terms of whether it was for "direct" or "consequential" damage. Nonetheless, his analysis of Kentucky case law makes it clear that regardless of how the fire damage is characterized, to the extent that express limitations in the contract precluded the owner in these circumstances from recovering at least the purchase price of the truck, such limitations were ineffective under Ky. Rev. Stat. 355.2-719(2).

735 F.2d at 982. This conclusion appears inconsistent with the *Lewis* rationale discussed *infra* in the text.

29. *See generally* Eddy, *supra* note 21.

30. *See, e.g.*, Fargo Mach. & Tool Co. v. Kearney & Trecker Corp., 428 F. Supp. 364, (E.D. Mich. 1977); Morris v. Chevrolet Motor Div. of General Motors Corp., 39 Cal. App. 3d 917, 114 Cal. Rptr. 747 (1974).

31. Stutts v. Green Ford, Inc., 47 N.C. App. 503, 267 S.E.2d 919 (1980); Lincoln Pulp & Paper Co. v. Dravo Corp., 436 F. Supp. 262 (D. Me. 1977); Kohlenberger, Inc. v. Tyson's Foods 256 Ark. 584, 510 S.W.2d 555 (1974).

32. *See supra* note 12.

33. 709 F.2d at 435.

34. The Washington statute is non-uniform and contains special provisions covering lim-

cific question in the instant case it probably would have followed the lead of *Lewis* and prevented Rudd's recovery of consequential damages.

Due to the exclusion of consequential damage, the difficult question in a case where a latent defect in a part results in the total destruction of the unit is whether the damage suffered by the unit may be classified as direct or general damages under section 2-714.[35] The court of appeals, quoting commentators White and Summers, stated: "Whenever a defective component part causes an accident that damages the entire product, a large part of the total damages may be consequential."[36] Such a conclusion appears logical in light of the U.C.C. definition of consequential damages including "injury to . . . property proximately resulting from any breach of warranty."[37] The direct remedy provision appears consistent by providing that "[t]he measure of damages for breach of warranty is 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."[38] Since the usual standard of damages is measured at the time of acceptance—a time at which the defect has not rendered the unit worthless—the damage award would be limited to the cost of the defective part. The subsequent damage to the entire unit would be labeled consequential.[39] Nonetheless, in the instant case the court

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itation of remedy provisions and consumer goods. *See* WASH. REV. CODE § 62 A 2-719(3) (1974).

35. U.C.C. § 2-714 (1977) providing for buyer's damages in regard to accepted goods states:

> (1) Where the buyer has accepted goods and given notification [of breach] he may recover as damages for any non-conformity of tender the loss resulting in the ordinary course of events from the seller's breach as determined in any manner which is reasonable.
>
> (2) The measure of damages for breach of warranty is 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.
>
> (3) In a proper case any incidental and consequential damages under the next section may also be recovered.

Id.

36. 735 F.2d at 982 (quoting WHITE & SUMMERS, *supra* note 16, at 387 n.54).
37. U.C.C. § 2-715(2)(b) (1977).
38. U.C.C. § 2-714(2), *see supra* note 35 for provision's text.
39. *See supra* note 36 and accompanying text.

upheld the trial court's award of net replacement value whether for "direct" or "consequential" damage.[40]

This holding is misleading. The trial court relied on the Kentucky case of *Cox Motor Car Company v. Castle.*[41] Under that case when a machine bursts into flames the entire unit is one big defective part. Applying the general damage provision of section 2-714(2), the value of the goods accepted in such a case is nothing or scrap value. Thus, in *Cox* the Kentucky court allowed as the measure of damages the "cost of replacing the truck with one not defective, which would be the same as the difference in market value."[42] Labeling the damages in the instant case as direct damages through reliance on the *Cox* case would be less misleading and troublesome. Alternatively, the court could have looked to the "special circumstance" clause of section 2-714(2) and modeled a different standard for measuring damages in latent defect cases. While the standard breach of warranty formula may be the usual, reasonable method of ascertaining the damages, it is not intended as an exclusive measure.[43]

Finally, the *Rudd* court found it unnecessary to resolve the difficult question of whether a commercial buyer may recover damages in tort from the seller if the only injury is to the good which was the subject of the sales contract. The court avoided this issue by revising the trial court's conclusion that a tort recovery entitled Rudd to a larger damage award.[44] However, it does appear that if the court of appeals had addressed the controversial issue, Kentucky case law resolves it in favor of Rudd, permitting the tort recovery even though both of the parties were commercial entities.[45]

II. Consequential Damages

In *Taylor & Gaskin, Inc. v. Chris-Craft Industries,*[46] the court of appeals examined whether the damages attributable to a manufacturer's recall campaign of an end product are recoverable from a

40. *See supra* note 28.
41. 402 S.W.2d 429 (Ky. 1966).
42. *Id.* at 431.
43. 735 F.2d at 983.
44. *Id.*
45. *See, e.g.*, C.D. Herme, Inc. v. R.C. Tway Co., 294 S.W.2d 534 (Ky. 1956); C & S Fuel, Inc. v. Clark Equipment Co., 524 F. Supp. 949 (E.D. Ky. 1981).
46. 732 F.2d 1273 (6th Cir. 1984).

parts supplier as consequential damages. Factually, Chris-Craft, a manufacturer of pleasure boats, developed plans for a new model called the MXA-25. Unlike predecessor boats, the new model was to have the fuel tank located at the stern of the craft and attached to the lining of the boat.

Chris-Craft, as the buyer, entered into negotiations with Taylor & Gaskin, the seller, to obtain fuel tanks for the MXA-25. Seller quoted a price for hot-dipped galvanized tanks[47] and buyer inquired whether it was possible to reduce the cost of the tanks. The seller indicated that ten dollars per tank could be saved by using a slush compound tank.[48] This type of tank, as opposed to the hot galvanized tanks previously used by Chris-Craft, had a painted exterior.

Seller offered to produce the slush compound tanks covering them with one coat of enamel paint 1.5 mils. thick. Seller knew the tanks would be exposed to the marine environment, but was unaware of the buyer's intended placement of the tanks.[49] The seller, however, was aware that these slush compound tanks would not be able to resist corrosion.[50] This fact was not communicated to the buyer.

Buyer ordered 550 slush compound tanks and began installing them in the MXA-25 boats. In April of 1974, buyer began receiving numerous complaints regarding corrosion of the tanks. Buyer notified seller and suggested that the two institute a joint recall campaign. Seller refused to participate in the recall, contending that the responsibility was on the buyer, Chris-Craft.[51] Buyer conducted an investigation of the fuel tank problems and concluded that the corrosion problems were due to the breakdown of the tanks' exterior paint. In March of 1975, buyer initiated a voluntary recall of the tanks.[52]

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47. Hot-dipped galvanized tanks were routinely used by Chris-Craft for gasoline tanks. *Id.* at 1274. Chris-Craft had used painted steel tanks in diesel boats. *Id.* at 1275.

48. *Id.*

49. *Id.*

50. *Id.*

51. *Id.*

52. *Id.* at 1276. The recall was not completely voluntary. The Federal Boat Safety Act of 1971 provides that:

> Every manufacturer who discovers or acquires information which he determines in the exercise of reasonable and prudent judgment, indicates that a boat or associated equipment . . . contains a defect which creates a substantial risk of per-

Three months later, the seller filed suit to obtain the balance of buyer's payments due on the tanks.[53] Buyer counterclaimed alleging negligence and breach of warranties. The district court found that the seller had breached the implied warranty of merchantability.[54] The court awarded the buyer the difference between the value of the tanks at the time they left the manufacturer and the value of the tanks had they been as warranted.[55] This amount was offset by the unpaid balance owed the seller. Despite the breach of warranty, the district court refused to award to the

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> sonal injury to the public shall, if such boat or associated equipment has left the place of manufacture, furnish notification of such defect [.] . . . The notification . . . shall contain a clear description of such defect . . . , an evaluation of the hazard reasonably related thereto, a statement of the measures to be taken to correct such defect . . . , and an undertaking by the manufacturer to take such measure at his sole cost and expense.

46 U.S.C. §§ 1451, 1464 (1983).

53. Filing a law suit to recover the balance due when the seller knows the goods are defective is risky at best. Such action is an invitation to counterclaim for direct and consequential damages. Nevertheless, Chris-Craft might have initiated litigation with the same result.

54. 732 F.2d at 1276. The statutory provision covering such warranties can be found in U.C.C. 2-314 (1977), which provides:

> (1) Unless excluded or modified (Section 2-316), 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. Under this section the serving for value of food or drink to be consumed either on the premises or elsewhere is a sale.
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> (2) Goods to be merchantable must be at least such as
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> (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
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> (c) are fit for the ordinary purposes for which such goods are used; and
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> (d) run, within the variations permitted by the agreement, of even kind, quality and quantity within each unit and among all units involved; and
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> (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.
>
> (3) Unless excluded or modified (Section 2-316) other implied warranties may arise from course of dealing or usage of trade.

U.C.C. 2-314 (1977).

55. The district court apparently applied U.C.C. § 2-714(2), dealing with buyer's damages in a breach of warranty action, which provides: "[T]he measure of damages for breach of warranty is 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." *Id.* The court found that the tanks had no value and awarded the buyer the contract price less the stipulated unpaid balance.

buyer the recall expenditures as consequential damages. According to the court, the buyer had failed to perform corrosion tests, the rusting was also attributable to faulty installation, the removal and replacement of the tanks was not proximately caused by the breach, and the expenses of a recall campaign were not within the reasonable contemplation of the parties.[56]

On appeal, the Sixth Circuit Court of Appeals stated that the issue presented was "the foreseeability of Taylor & Gaskin's knowledge at the time of contracting that a breach of warranty as to the merchantability of the tanks would result in a recall."[57] The court summarily disposed in a brief footnote of the issue of Chris-Craft's duty to mitigate[58] and held that the buyer was entitled to consequential damages representing the recall expenditures. The case was remanded for a determination of the amount.[59] The concurrence focused on the duty to mitigate, noting that the buyer should not be entitled to recover, as consequential damages, those recall expenses which were occasioned by the buyer's own negligence or fault.[60] As the concurrence noted, the trial court found as a matter of fact that the rusting was caused not only by the slush compound painting technique, but also by faulty installation, the design of the support shocks, and the location of the tank on the boats. All of these factors were attributable to Chris-Craft and contributed to the need for a recall campaign.

The court of appeals majority avoided two major considerations in deciding the instant case.[61] First, as pointed out by the concurrence, the court failed to examine the buyer's duty to mitigate the consequential damages. Secondly, the court did not address the

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56. 732 F.2d at 1277. Based upon these factors the trial court concluded that this was not a proper case for the imposition of consequential damages attendant to a recall. U.C.C. § 2-714(3) (1977).

57. 732 F.2d at 1278.

58. Of course, the recovery of consequential damages is permissible only to the extent that damages "could not reasonably be prevented by cover or otherwise." MICH. COMP. LAWS § 440.2715(2)(a) (1970), U.C.C. § 2-715(2)(a) (1977). Herein, the district court's finding, that Chris-Craft conducted a reasonable inspection of the fuel tanks and that the failure to test the slush compound tanks to determine the corrosion resistance of the units was not blameworthy, precluded any determination that Chris-Craft could reasonably have prevented its consequential damages. *See* Michigan Sugar Co. v. Jebary Sorenson Orchard Co. 66 Mich. App. 642, 646, 239 N.W.2d 693, 695-96 (1976). *Id.* at 1278, n.2.

59. 732 F.2d at 1279.

60. *Id.*

61. *Id.* at 1280.

question of whether the consequential damages of a recall campaign should be awarded where the seller's liability would be vastly disproportionate to the purchase price of the goods.

The U.C.C. has adopted the reasonable foreseeability test of *Hadley v. Baxendale*,[62] for determining whether a seller should be liable for the consequential damages suffered by the buyer.[63] Section 2-715(2)(a) provides that a defendant is liable for "any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know . . . ."[64] This objective test has been adopted by the vast majority of jurisdictions, and is consistent with Professor Corbin's view:

> All that is necessary, in order to charge the defendant with the particular loss, is that it is one that ordinary follows the breach of such a contract in the usual course of events, or that reasonable men in the position of the parties would have foreseen as a probable result of breach.[65]

Although the U.C.C. has adopted the liberal *Hadley* foreseeability test, additionally the Code explicitly imposes a requirement that the buyer can only recover those consequential damages "which could not reasonably [have been] prevented by cover or otherwise."[66] Thus, the Code imposes an affirmative duty upon the

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62. 156 Eng. Rep. 145 (1854). The concept of reasonable foreseeability was introduced into the determination of contractual damages as follows:

> Where two parties have made a contract which one has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally . . . or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they had made the contract, as the probable result of the breach of it . . . ."

Id. at 151.

63. The Code Comments acknowledge adoption of the *Hadley* "reason to know" test and rejection of the tacit agreement test. U.C.C. § 2-715 comment 2 (1977). The tacit agreement test requires not only that the damages be foreseeable at the time of contracting, but it also requires that the defendant expressly or impliedly assent to assume the liability. *See* E. ALLAN FARNSWORTH, CONTRACTS 875 (1982).

64. U.C.C. § 2-715(2) (1977) provides in its entirety:

> Consequential damages resulting from the seller's breach include
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> (a) 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; and
>
> (b) injury to person or property proximately resulting from any breach of warranty.

Id.

65. 5 CORBIN, CONTRACTS § 1010 (1964).

66. *See* U.C.C. § 2-715(2)(a) (1977), *supra* note 64.

buyer to mitigate damages.

Case law confirms that a court must address the issue of mitigation before an aggrieved party may be awarded consequential damages. For example, in *Karlen v. Butler Manufacturing Co.*,[67] the plaintiff entered into an agreement to purchase a weatherproof storage unit for storing wheat from the defendant manufacturer. Plaintiff brought suit against the manufacturer for breach of express and implied warranties when the wheat spoiled due to moisture and the plaintiff was forced to sell in a low market.[68] Although the court of appeals reversed and remanded for a new trial, at least in part because evidence of the consequential loss was uncertain and speculative,[69] the question of the possible mitigating options available to the plaintiff was raised. In addressing the question of whether the plaintiff's damages could otherwise have reasonably been prevented this court quoted Professor Williston on mitigation:

> [D]amages which the plaintiff might have avoided with reasonable effort without undue risk, expense or humiliation are either not caused by the defendant's wrong or need not have been, and therefore, are not to be charged against him.
>
> The principle has wide application and frequently involves the establishment of a standard of reasonable conduct.
>
> Where inferior goods have been furnished under a contract, the buyer cannot recover greater consequential damages caused by using them when he knew of their unfitness, than would have been caused by another possible course, although the seller had sold the goods for that purpose. And the principle is general that there can be no recovery for consequences that reasonably could have been avoided.[70]

Similarly, in *Plastics Molding Corporation v. Park Sherman Co.*,[71] the issue before the court was whether plaintiff was improperly awarded consequential damages because the loss was due to plaintiff's decision to accept and use defective goods. Framed in U.C.C. terms, the issue before the court was whether plaintiff's damages could have been prevented by cover or otherwise.[72] The

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67. 526 F.2d 1373 (8th Cir. 1975).
68. *Id.* at 1378.
69. *Id.* at 1380.
70. *Id.* at 1379 (*citing* 11 S. WILLISTON, CONTRACTS § 1353 (Jaeger, 3d ed. 1968)).
71. 606 F.2d 117 (6th Cir. 1979).
72. The consequential damages awarded included:
    1) $5,275.68 for increased production costs caused when Park Sherman was

Sixth Circuit Court of Appeals, after a careful examination of the evidence, determined that the plaintiff had not acted unreasonably in attempting to salvage usable portions of the defendant's nonconforming tender.[73] The importance of this case is that the court of appeals directly considered and determined the reasonableness of the plaintiff's actions before affirming an award of consequential damages.

In determining whether a buyer has failed to mitigate loss, the question is whether the loss incurred could have reasonably been prevented, not whether the buyer's actions constitute a concurring proximate cause of the damages.[74] The test of proximate causation applies to recovery for "injury to person or property proximately resulting from any breach of warranty."[75] There is no foreseeability requirement. However, when dealing with buyer's economic loss,[76] buyer's damages must be reasonably foreseeable and avoided or prevented by cover or otherwise. Case law has confused the issue by interchanging these standards.[77] Proximate cause language appears in the concurrence to the instant case;[78] the question should

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forced to use hand labor to assemble the usable parts rather than machines;

2) $18,147.05 for the cost of hand sorting and matching usable lighter tanks and bottoms which would not have been incurred had the tanks and bottoms conformed to specifications;

3) $17,783.49 for the purchase of certain substitute parts necessitated by the fact that valve openings in the parts supplied by Plastic Moldings were undersized; and

4) $14,447.15 lost on the return of numerous finished lighters to Park Sherman by its customers because the lighters were defective.

Id. at 119-20.

73. *Id.* at 120.

74. Compare the language of U.C.C. § 2-715(2)(a) with § 2-715(2)(b), *supra* note 64. *See also*, U.C.C. § 2-715 comment 5 (1977).

75. U.C.C. § 2-715(2)(b) (1977).

76. U.C.C. § 2-715(2)(a) (1977).

77. For example, *see* El Fredo Pizza, Inc. v. Roto-Flex Oven Co., 199 Neb. 697, 261 N.W.2d 358 (1978) (lost profits, *proximately caused by the seller's breach of warranty*, are consequential damages) and compare with Bemidji Sales Barn v. Chatfield, 312 Minn. 11, 250 N.W.2d 185 (1977) (lost profits, *provided they are foreseeable by the seller*, are recoverable for breach of warranty) (emphasis added). This problem is somewhat understandable. Hypothetically, a buyer's failure to properly inspect goods might have two results. First, a court could deny loss of profits on a subsequent contract based upon failure to reasonably prevent the loss by inspecting the goods before resale. Additionally, a court could deny recovery for injury to person or property, because the failure to inspect was the proximate cause of the injury rather than the seller's breach of warranty. *See* U.C.C. § 2-715 comment 5 (1977).

78. 732 F.2d at 1280.

be whether the buyer, Chris-Craft, could have reasonably prevented part or all of its recall expenditures.

Finally, the court of appeals did not address the question of whether consequential damages should be awarded where the seller's liability would be vastly disproportionate to the purchase price of the goods. Recall expenditures of an ultimate manufacturer may be within the contemplation of a parts supplier at the time of contracting with the manufacturer, subjecting the parts supplier to liability for the consequential damages of the recall. Professor Bradford Stone has commented extensively on such liability and whether other factors should be considered by a court in determining liability for consequential damages vastly disproportionate to the purchase price.[79] The other factors to be considered center on the economic realities of the transaction: compensation, bargaining power, and allocation of risk of loss. A recent article included an examination of the district court's opinion in the instant case:

> What was apparently bothering the court in this opinion was the perception that buyer, for competitive reasons, unnecessarily cut a corner on a safety-related item to save ten dollars and then wanted seller to pay for the whole loss. The court reasoned:
>
> > As between the two parties, Chris-Craft was in a stronger bargaining position and opted for production of an untried and cheaper tank, a risk which they now seek to transfer *in toto* to Taylor & Gaskin although they did not make Taylor & Gaskin aware of their particular requirements for use of the tank.[80]

The consequential damage provision of the U.C.C. does not evaluate the disproportionality of the damages. Thus, case law indicates that a buyer should recover the full amount of foreseeable consequential damages regardless of the disproportionate relationship between such damages and the purchase price.[81] A new sec-

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79. B. Stone, Product Recall and Consequential Damages: Effects of the National Traffic and Motor Vehicle Safety Act (1971). This indepth report, published by the Bureau of Business Research, Graduate School of Business Administration at the University of Michigan, was referred to by Judge Boyle in the district court opinion in the instant case.

80. B. Stone, *Recovery of Consequential Damages for Product Recall Expenditures*, 1980 B.Y.U. L. Rev. 485, 529 (emphasis supplied).

81. *See* for example, Lewis v. Mobil Oil Corp., 438 F.2d 500 (8th Cir. 1971); Ford Motor Co. v. Reid, 250 Ark. 176, 465 S.W.2d 80 (1971). Consequential damages for recall expenses have previously been allowed in Upjohn Co. v. Rachelle Laboratories 661 F.2d 1105 (6th Cir. 1981). However, the direct expenses of the recall awarded, $182,858.19, appear insignificant

tion in the Restatement (Second) of Contracts may ultimately impact upon this type of recovery. Section 351(3) provides: "A court may limit damages for foreseeable loss by excluding recovery for loss of profits, by allowing recovery only for loss incurred in reliance, or otherwise if it concludes that in the circumstances justice so requires in order to avoid disproportionate compensation."[82] The comments to this section indicate that the disproportionality of the damages to the purchase price should be considered by the court. "The fact that the price is relatively small suggests that it was not intended to cover the risk of such liability."[83] Minimally, this new section should cause reflection in an era of million dollar damage awards.

III. Option Contracts

The third case being surveyed does not involve extremely complicated contract law principles, nor does it represent a change or shift in the law; rather it serves as a basic refresher on option contracts. In *Eaton Corporation v. Easton Associates, Inc.*,[84] the Sixth Circuit Court of Appeals was presented with an appeal from a summary judgment dismissing both a specific performance contract claim and a damages claim sounding in tort. The facts are complicated because of numerous communications between the parties and their attorneys; accordingly, the following statement is abbreviated.

Eaton Corporation owned a five acre parcel in Farmington Hills, which was subject to a repurchase right held by the original owners. The repurchase right was to be triggered by Eaton's failure to effectuate substantial construction on the property within two years of the sale. Eaton, apparently anxious to sell the property, tried to force the original owners into exercising their repurchase rights or waiving them.[85] The original owners refused to do either; nevertheless, Eaton entered into an option contract[86] with Sloan

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in comparison to the total contract breach judgment of $3,446,059.19.

82. Restatement (Second) of Contracts § 351(3) (1979).

83. Restatement (Second) of Contracts § 351 comment f (1979).

84. 728 F.2d 285 (6th Cir. 1984).

85. *Id.* at 287.

86. An option contract is an irrevocable offer. Restatement (Second) of Contracts § 25 (1979) provides: "An option contract is a promise which meets the requirements for the formation of a contract and limits the promisor's power to revoke an offer." *Id.* Such irrevo-

for the purchase of the five acres. The option contract required that $10,000 be deposited into escrow as consideration for the option to be held open for 150 days.[87] In order to exercise the option, Sloan was required to tend $30,000 within the 150-day period.[88]

Shortly thereafter Sloan discovered that the prior owners had repurchase rights.[89] Under the terms of the option contract, seller Eaton was to provide buyer Sloan with an owner's title commitment[90] and Sloan had fifteen days to object in writing to any title deficiency.[91] Failure of the seller to remedy such defect within twenty days gave the buyer the right to "proceed with this Agreement (in which event, the warranty deed to the property will be delivered subject to any title defects) or to cancel this Option

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cable offers under seal were called options. Thomason v. Bescher, 176 N.C. 622, 97 S.E. 654 (1918).

87. 728 F.2d at 287.

88. *Id.* Paragraph 2.3(b) of the option contract provided:

> At the time of exercise of the Option, Seller shall deliver to Escrow Agent a deposit of Thirty Thousand Dollars ($30,000.00)(the "Deposit"), to be applied against the purchase price and Escrow Agent shall deliver a portion of the Option Payment to Seller and a portion of the Option Payment to Purchaser as indicated in the schedule set forth in Section 2.3(c) below. Should Purchaser exercise the Option at any time after 120 days from the date hereof, the entire Option Payment shall be paid to Seller.

Id.

89. Although there was some dispute as to how Sloan obtained the knowledge, Sloan had constructive, if not actual, knowledge, through his attorney. *Id.* at 288.

90. Paragraph 4.1 required that Eaton would provide Sloan with an owner's title insurance agreement within 15 days of the option agreement. *Id.*

91. Paragraph 4.2 provided:

> If objection is made by written notice from Purchaser to Seller that title is not in the condition required within fifteen (15) days after receipt of such commitment by Purchaser, Seller shall have twenty (20) days from the time it is notified in writing of the particular defects claimed to remedy the title or to obtain endorsements to the title insurance commitment which guarantee that Lawyers Title shall insure against such defects. If Seller is unable to remedy the title or obtain the endorsements within said twenty (20) day period, Purchaser shall have the option to proceed with this Agreement (in which event, the warranty deed to the property will be delivered subject to any such title defects) or to cancel this Option Agreement and receive back from Seller the Option Payment. Notwithstanding the foregoing, should any liens or encumbrances upon the Property appear which arose because of any action or failure to act on the part of Seller, then Purchaser shall have the right to apply that portion of the purchase price as may be required to discharge any such liens and/or encumbrances and to deduct the amount thereof from the purchase price, or to take title subject to such defects.

Id. at 289.

Agreement and receive back from Seller the Option Payment."[92]

Sloan did not cancel the option because of the title defect but instead paid an additional $2,500 into escrow to extend the option period.[93] Furthermore, Sloan never exercised the option. Instead, on the last day of the extended option period he demanded that Eaton remedy the title defect, and advised Eaton that he was in breach of the option agreement and, accordingly, the option would remain in effect until the title was cured.[94] Eaton filed this diversity action to recover the escrowed option premiums and Sloan counterclaimed seeking specific performance of the option contract and damages for alleged fraud and misrepresentation. Eaton then sold the property to Manufacturers Hanover Mortgage Corporation, which took with full knowledge of the original owners' repurchase rights.[95]

The court of appeals correctly affirmed the trial court's summary judgment that Sloan was not entitled to damages or specific performance under the option contract. Even though Eaton was unable to deliver title, Eaton was not in breach of the option contract. The option contract provided the remedy in the case of a title defect, giving the buyer an alternative and relieving the seller from liability for contract breach.[96] More importantly, Sloan never acquired any rights in the property because he failed to timely exercise the option. The option contract, after all, is not a contract to purchase land, but merely an offer, irrevocable for a specified period of time because supported by consideration. "An option is but an offer, strict compliance with the terms of which is required; acceptance must be in compliance with the terms proposed by the option both as to the exact thing offered and within the time specified; otherwise the right is lost."[97]

Although the Restatement (Second) of Contracts adopted the term "option contract" to replace the common law term "option," a party's ability to sue for specific performance of the proposed

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92. See paragraph 4.2, *supra* note 91.

93. Additionally, Sloan claimed that he incurred $50,000 worth of expenses in preparation for construction on the property during this option period. 728 F.2d at 289.

94. *Id.*

95. *Id.* at 290.

96. *See* paragraph 4.2 of the option contract, supra *note 91.*

97. Bailey v. Grover, 237 Mich. 548, 554 (1927).

contract is not altered.[98] The long standing majority rule, throughout the country and in Michigan, is that the option holder must exercise the option in order to have rights pursuant to the underlying contract.[99] Furthermore, time is of the essence in exercising an option right,[100] so much so that the mailbox rule does not apply. While acceptance of a revocable offer is valid upon dispatch, the weight of authority holds that acceptance of an irrevocable offer, i.e. exercise of an option, is only valid upon receipt.[101] Sloan's mistake was that he never tendered the $30,000 necessary to exercise the option during the option period.

Sloan also counterclaimed for damages on a fraud theory. The district court granted a summary judgment on this count holding that in order for Sloan to have a claim for fraud he would have to have exercised the option.[102] The court of appeals reversed and remanded. While it is true that fraud and misrepresentation are contract defenses and the bases for damage claims on a breach of contract action, it is not necessary for a defendant to be in privity of contract or a party to the transaction to be liable for fraud.[103] In order to sustain a tort action for common law fraud the plaintiff must establish:

> 1) there was a material representation by defendant that was false; 2) the defendant knew that it was false when he made it or made it recklessly without any knowledge of its truth and as a positive assertion; 3) the defendant made it with the intention that it should be acted upon by plaintiff; 4) plaintiff acted upon it and 5) thereby suffered injury for which he sues.[104]

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98. *See supra*, note 86. The RESTATEMENT (FIRST) OF CONTRACTS § 46 (1932) did not use option language to define an irrevocable offer:

> An offer for which such consideration has been given or received as is necessary to make a promise binding, or which is in such form as to make a promise in the offer binding irrespective of consideration, cannot be terminated during the time fixed in the offer itself or, if no time is fixed, within a reasonable time, either by revocation or by the offeror's death or insanity.

Id.

99. Muirhead v. Friemann, 270 Mich. 181, 258 N.W. 238 (1935); Gurunian v. Grossman, 331 Mich. 412, 49 N.W.2d 354 (1951).

100. Wesley v. United States, 384 F.2d 100 (9th Cir. 1967).

101. *See* 1A CORBIN, CONTRACTS § 264 (1963) and the cases cited therein. *See also*, RESTATEMENT (SECOND) OF CONTRACTS § 68 (1979).

102. 728 F.2d at 291.

103. Butler v. Watkins, 80 U.S. 456 (13 Wall. 1872).

104. Michael v. Jones, 333 Mich. 476, 53 N.W.2d 342 (1952); Hi-Way Motor Co. v. International Harvester Co., 398 Mich. 330, 247 N.W.2d 813 (1976).

The court of appeals held that depending upon the facts established at trial, Sloan might be entitled to a refund of the $12,500 consideration paid for the option and damages for his expenditures in preparation to build on the five acre parcel.[105] The case was appropriately remanded to give Sloan an opportunity to establish the alleged misrepresentation of Eaton.

105. 728 F.2d at 292.