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Warranties, Remedies and Related Peccadilloes: Steps to Successful Contract Negotiation

What do you promise when you sell something? What rights might you give up when you buy? And who pays when things go wrong?

BY STEVEN KELLEY AND DAVID ALLGEYER

Purchases move fast in an electronically connected world, often without contracts or any other negotiated agreements. That's fine when the buyer is happy, but can cause confusion and arguments when the buyer finds its purchase less than satisfactory. In that case, does the seller have to offer a refund? Is it also responsible for lost sales, personal injury or claims of infringement?

As is common in the legal world, the answers vary with the particulars of the case. Outcomes often depend on the agreements that the parties did or did not make as a transaction began.

The unadorned sale

To illustrate, let's look at a hypothetical purchase. Our story begins with a factory that made snacks. The factory's owners needed to keep their product fresh and wholesome for longer periods of time. They decided to buy a machine known as the SnackPacker. This machine sterilized snacks, then packaged them and sealed the package to, as the promotional materials said, "lock in food safety."

One of the buyer's employees researched snack sterilizers and packaging machines, determining which would best meet the needs of the company. She settled on the SnackPacker, and company officials watched the product in action at another plant.

Everyone was impressed, so the snack company asked the seller for a price quote. The seller sent an email containing the product number and price. The buyer sent a purchase order, again by email. Neither party sent a full contract or terms and conditions — just a quote and an order.

When the SnackPacker arrived, it didn't sterilize snacks as fast as the buyer thought it would. The slowdown meant lost volume, which translated into lost sales when the snacks weren't available to distributors.

The SnackPacker didn't thoroughly sterilize snacks either, and occasionally didn't properly seal the packages. Some consumers became ill after eating the company's products, and they threatened to sue. Meanwhile, a competitor sued the buyer for infringing on its patent for a snack sterilization and packaging process. The buyer lost hundreds of thousands of dollars and faced two lawsuits. It began investigating its legal options against the seller.

The buyer in this case discussed the SnackPacker with the seller and read promotional information about what the product would do. But the parties signed no contract, and neither the buyer nor the seller included terms and conditions on the documents they exchanged. What warranties and remedies apply? Legally speaking, how responsible is the seller for the buyer's SnackPacker-related problems?

What warranties apply?

This is a sale of goods. By selling the SnackPacker without contracting for any other sale terms, the seller created two sets of warranties under the Uniform Commercial Code.

The first set is express warranties, a group that includes facts or promises, descriptions and representative samples of the SnackPacker that the buyer ultimately purchased



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(U.C.C. 2-313). The seller told the buyer about the SnackPacker and its capabilities, then arranged for company officers to watch the product at work. The information the buyer received in those interactions formed part of the basis for the bargain. Therefore, the seller created an express warranty that the SnackPacker would perform as described and demonstrated.

The second set includes implied warranties: those of title, non-infringement, merchantability and fitness for a particular purpose. You can't sell what you don't own. By selling an item, the seller warrants that it holds legal title to whatever it is selling and is legally able to transfer that title (U.C.C. 2-312(1)).

The seller also warrants that the goods sold are free of any rightful claim of infringement (U.C.C. 2-312(3)). Proof of infringement isn't necessary to breach this warranty. A substantial infringement claim, one that's reasonably likely to subject the buyer to litigation and have a significant adverse effect on the buyer's right to use the goods, is enough to cause a breach. See *Sun Coast Merchandise Company v. Myron Corp.*, 395 N.J. Super. 55, 922 A.2d 782 (App. Div. 2007).

Whether it meant to or not, our seller provided an implied warranty that the buyer could reasonably expect to be free of any infringement claim. That warranty may have been breached when another firm claimed to

own a patent on the snack pasteurization process. (When a company makes goods to a buyer's specifications, on the other hand, it's the buyer — not the seller — who provides the warranty of non-infringement (U.C.C. 2-312(5)).

The merchandise that changes hands must be merchantable, meaning that it must be of at least average quality, with an even product run (all of the size smalls must have the same dimensions, for instance, within tolerances agreed to by the buyer and seller), adequately packaged and labeled, and conforming to any affirmations of fact on the labels (U.C.C. 2-314). If the label says the product contains pecans, for instance, peanuts are an inadequate substitute.

Finally, the seller warrants that the product is fit for a particular purpose — but only if the seller knows how the buyer will use the purchase, and also knows that the buyer is relying on the seller's skill and judgment to furnish suitable goods (U.C.C. 2-315). If a buyer asks a seller to provide mosquito nets that will repel insects in Kenya, for instance, the seller that accepts the order offers an implied warranty that the nets are suitable for protection against

The seller may also be liable for incidental and consequential damages.

insects in Kenya. Send nets that allow the local mosquitoes through, and you've breached this warranty.

Both express and implied warranties are made to the buyer, of course, but sometimes also to the buyer's family members or even others who use the goods, as determined by state law. Some states have an expanded provision for liability to third parties, under which the seller also extends warranties to anyone — whether a person or an organization — who might reasonably be expected to consume or be affected by the goods, and who is injured by a breach of warranty (U.C.C. 2-318). This depends on which state's law applies. One thing is true in all states, however: The seller can't exclude or limit its responsibility for injury to an individual to whom the warranty extends (U.C.C. 2-201(32)). In our hypothetical example, the seller has offered its warranties to the seller, but also to the consumers who ate the snacks and became ill.

Possible remedies

Once the buyer has accepted the goods, damages for breach of warranty are the difference between the value of the accepted goods and the value those goods would have had if they had been as warranted (U.C.C. 2-714). The resulting number is easier to determine if the buyer purchases another product to substitute for the first, unacceptable one. The new product often costs more, so buyers frequently claim that they are entitled to the additional money because that is what it cost to buy a product that performed as warranted.

The seller may also be liable for incidental and consequential damages. Those include the reasonable costs of inspecting, storing, caring for or transporting goods that fall short of the mark, and the cost of any loss that occurred because the seller was aware of the buyer's needs in purchasing the product, but did not meet those needs.

These liabilities can be very expensive for sellers. Remember that the SnackPacker didn't work as fast as the buyer thought it would. The buyer will claim the profits it could have made, given greater speed, and may even claim that it lost customers (and therefore profits) because the machine didn't perform as warranted. The seller may also have to pay expenses related to the injury of people or property if the defective merchandise caused those injuries.

In this case, the sick snackers might well recover damages if their illnesses occurred because the machine did not sterilize or package properly.

Adding disclaimers

The seller can disclaim warranties (U.C.C. 2-316). Such disclaimers must be reasonable, specific and prominent. (Prominent disclaimers are usually in the same type size as the rest of the documents, which may still be pretty small.) A seller can disclaim implied warranties by noting that the product is sold "as is," for example.

To disclaim warranties of merchantability and fitness, it's best practice for a seller to mention them by name. The more specific the disclaimer, the better. Sellers almost never disclaim the warranty of title, as a smart buyer wouldn't buy the goods without that warranty. But sellers should specifically mention that they disclaim warranties of non-infringement, for example.

A seller offers no implied warranty of merchantability or suitability on goods that a buyer inspected before the purchase, nor on goods that the buyer refused to inspect when given the opportunity, as long as an examination ought to have revealed the defects in question.

Sellers may also disclaim remedies — but only to a point. They may add to or substitute other remedies for those the law prescribes. Our seller, for example, could have limited the buyer's remedies to repair or replace the nonperforming goods, or to the right to return those goods and receive a refund.

But be careful. Alternate remedies must offer the buyer minimally adequate protection, especially if the parties have unequal bargaining power. The law restricts companies from disclaiming remedies for retail consumers, stating that, "limitation of damages for personal injury in the case of consumer goods is prima facie unconscionable." (U.C.C. 2-719(3)). Limitation of damage to property for commercial losses, on the other hand, is not unconscionable.

Courts disagree on whether a consequential damages limitation may still survive if a limited warranty fails to offer a buyer fair, reasonable redress. Courts overseeing some early cases referenced the UCC to declare that when a limited remedy fails, a consequential damages exclusion becomes unenforceable altogether. For the rationale of holding exclusion of consequential damages void upon failure of a remedies essential purpose, see *Kronos Products, Inc. v. Sasib Bakery North America, Inc.*, 2002 WL 1308637, *3 -*4 (N.D. Ill 2002).

Later cases in other states, including Minnesota, have said the consequential damages exclusion survives even the failure of essential purpose. The Minnesota Supreme Court explained this area of the law in some depth in *International Financial Services, Inc. v. Franz*, 534 N.W.2d 261, 268 – 269 (Minn. 1995).

You Promised What?

Some provisions have no place in your contract

In most contracts, the right terms are those to which both parties can agree. There are a few contract provisions, however, that never — or nearly never — belong in any agreement you might make.

Avoid representations and warranties that have nothing to do with your product, included only because they're part of either party's standard vendor contract. You don't need to promise that your product complies with the Consumer Product Safety Improvement Act if you sell commercial or industrial goods that aren't used by consumers, and you're familiar enough with CPSA rules to know whether this matters or not. Nor do you need to promise to meet all FDA requirements for products not regulated by the FDA, all RoHS requirements for products not sold in the EU, or latex or wood fiber requirements for products that don't contain latex or wood fiber. Tailor contract language to the specific situation.

Steer clear of warranties when the seller cannot possibly determine compliance, or would have to go to extreme expense and effort to determine it. Examples might include:

- "All vendors and suppliers providing goods to seller for inclusion in the products have complied with all environmental, labor and safety laws of any applicable jurisdiction."
- "Vendor warrants that all packaging complies with any and all local, state and federal laws regarding toxics in packaging legislation."

In either case, ascertaining compliance would involve tracking components from vendor to distributor to manufacturer, then determining what rules apply to each part of an exponentially expanding universe of people, whom the seller must investigate and rely upon to make the warranty.

Representations of "best price" or "most favored customer" are similarly suspect. Does the seller offer the same price to every customer, or to every customer of a particular type? How will you decide how customers are classified? Does the seller give volume discounts, and might it conceivably give a bigger discount for a future, larger order? These clauses trigger audit rights for the buyer, which lead in turn to confidentiality problems, second-guessing accountants and the need for special reporting and tracking — all headaches that may increase the seller's prices.

Don't create a moving target by agreeing to terms you haven't seen or that you may have difficulty discovering.

For instance:

- "This agreement shall be considered as supplemental to the terms and conditions set forth on each purchase order hereafter issued by purchaser to the vendor, and such terms and conditions as may be published from time to time on purchaser's website."
- "Franchisee agrees to comply with all operational and marketing rules and regulations, and those published and updated from time to time by franchisor in operations and marketing manuals."

Object to clauses that preserve all remedies outside the written contract, including those remedies that are limited or disclaimed in the contract itself. The language could be interpreted to "undo" any limitation or disclaimers of liability or remedies. Adjust the language to make clear that the parties are changing the remedies to the extent permitted by law and equity.

Avoid indemnity obligations that force the indemnifying party to write a never-ending blank check for all of an indemnified party's expenses and settlement costs. You'll buy trouble, particularly when "hold harmless" gets legally culpable parties off the hook, when a "duty to defend" clashes with your need to place legal responsibility with the indemnified party, when you accidentally indemnify both your client and their customers, or when your customer uses a product negligently. Consider adding language that covers cases of comparative fault or responsibility percentages, or the possibility of an informal resolution where there is no adjudication of responsibility.

Watch out for "weasel" provisions that stack the deck against you:

- "Buyer has no duty to inspect the products."
- "Payment does not constitute acceptance."
- "Buyer reserves the right to periodically return products to manage inventory."
- "All price changes must be mutually agreed in writing."
- "The following are entitled to third-party beneficiary rights under this agreement: [big list, including end customers]."
- "Supplier may 'request' . . ."
- "The party shall 'reasonably' comply with. . ."
- "Notwithstanding any term or provision herein to the contrary, the parties agree that. . ."
- "This agreement is entered on behalf of Named Party and any affiliate, parent, subsidiary or related company, the company's accounts and customers. . ."

ACC Extras on... Warranties, Remedies and Related Peccadilloes

ACC Docket

- *Transitioning Your Contract Process from the Artistic to the Industrial* (Dec. 2007). This article provides you with each step in the contracts process, and discusses the challenges involved and new approaches to help address those challenges. It also offers an example of how one such contract was created and implemented. www.acc.com/docket/con-art2ind_dec07
- *Contracts Illustrated* (Sept. 2005). This article discusses a modular approach to drafting contracts — listing and describing a set of modules or individual elements determined by analyzing different contracts, and breaking them down into their component parts. www.acc.com/docket/illcon_sep05

InfoPAKSM

- *Drafting and Interpreting Contracts* (Oct. 2010). This InfoPAK provides in-house counsel who may not have an extensive background in the documentation of commercial transactions with a high-level overview of best practices for drafting and interpreting contracts under US law. www.acc.com/infopaks/contracts_oct10

Program


- For a crash course in contracts, join us at ACC's 2011 Corporate Counsel University,[®] May 15-17 in New Orleans. This program, designed specifically to cover the basics

of in-house practice, includes a session on "Drafting, Negotiating & Administering Contracts." View the rest of the program schedule and register at ccu.acc.com.

Program Material

- *The Who, What & Why of Contracts* (April 2007). In this paralegal track program, a panel of experts explores the legal issues involved with basic contract design and sample clauses to use. It goes on to discuss the benefits of using templates and creating standard procedures to implement controlled, uniform review processes. www.acc.com/3ws_contracts_apr07

Quick Reference

- *Top 10 Innovations to Improve Enterprise-Wide Contract Management* (Aug. 2010). These top 10 innovations illustrate how taking a holistic, enterprise-wide view of contract management can strike the balance between risk and meeting business objectives in a timely and efficient manner. www.acc.com/quickref/ctrct_mgmt_aug10 

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Other states take a more nuanced approach, stating that buyers are entitled to consequential damages when a warranty exclusion contains no separate provision prohibiting a buyer's recovery of consequential damages. For an example, see *Cooley v. Big Horn Harvestore Systems, Inc.*, 813 P.2d 73, 747- 748 (Colo. 1991).

Still other states, including California, have no general rule, approaching the matter on a case-by-case basis. To see this at work, compare *RRX Industries, Inc. v. Lab-Con, Inc.*, 772 F.2d 543, 547 (9th Cir. 1985), in which a trial court properly found the seller's default was so total and fundamental that its consequential damages limitation was expunged from the contract, with *S.M. Wilson & Co. v. Smith Intern, Inc.*, 587 F.2d 1363, 1375 (9th Cir. 1978), in which parties were of relatively equal bargaining power and their contract expressly excluded consequential damages, so the court held that the failure of repair remedy did not permit recovery of consequential damages. The court found that the limited remedy still applied.

It is best to treat the repair or replacement remedy and consequential damage exclusion as discrete, independent contractual provisions. In the circumstances of our *SnackPacker* case, the parties were both merchants, with no great disparity in their bargaining strengths. Where the claim is for commercial loss, there is nothing unconscionable about enforcing the risk allocation that's incorporated into the parties' contract.

The company that sold the *SnackPacker* did not disclaim warranties or remedies, so it will face claims of liability for the difference between the price of the *SnackPacker* and a more expensive substitute; lost sales and profits due to the product's slowness; incidental damages in the form of equipment storage costs if the buyer replaces the unsatisfactory goods; shipping costs for returning the *SnackPacker*; the cost of defending the patent suit; and damages for the sick snackers' personal injuries. Whether it will actually be held liable for all these things and how much the seller ultimately pays will depend on many specific facts developed during costly litigation.

The Bottom Line: Some contract language is especially important

There's a lot to consider as you think about contract, sales and purchase order terms. Remember that some of those terms are likely more important than others, and concentrate your time and attention where it counts most.

Both buyers and sellers should find out how courts in your area handle the "battle of the forms." Are they part of the majority, which uses the knockout rule to impose UCC rules instead of mutually exclusive terms, or of the minority that rules the seller holds sway in case of contradiction? A battle over forms may ultimately offer you better terms than a negotiated contract — albeit after a potentially expensive lawsuit.

Sellers should consider routinely disclaiming, limiting or clarifying a number of warranties and remedies:

- Use a merger clause to limit express warranties to what is in writing, or risk litigating or arbitrating the issues of who said or showed what, to whom and when.
- In a combined hardware/software contract that warrants that the software will perform "according to the documentation," define the documentation. It is expensive to determine that in court or arbitration.
- Absent an unusual situation, don't spend time disclaiming the implied warranty of title. If you don't own it, you shouldn't be selling it.
- Spend time deciding how you will handle the implied warranty of non-infringement. The average cost of defending a patent case can be well over \$500,000 and it's unclear if the plaintiff has to actually win to trigger this warranty. Consider disclaiming the warranty — requiring an actual judgment of infringement before you must pay — or adding the right to negotiate a license, refund the price or substitute a substantially similar product.
- Limit the time in which a buyer can bring suit, limit the length of warranty, and/or indicate whether the warranty begins at delivery or at some other point.
- Carefully craft or disclaim the implied warranty of merchantability. Determining whether you've met it typically involves expensive proof issues. Treat the implied warranty of fitness carefully, too. Promise to meet specifications, not poorly defined expectations.
- Most sellers promise to repair or replace unsatisfactory products. Make sure you indicate where the repair will take place. A replacement can prove very expensive if the product is part of a larger assembly. It could be costly to replace diesel engine bearings in trucks located all over the country, for instance, or to disassemble an oil rig to replace a component.
- Beware of failure of the essential purpose, depending on the law that applies to it. Courts won't enforce a contract if it leaves a seller without responsibility or a buyer without options for redress, or if it removes responsibility for personal injury claims. You should indicate which state's law applies and know whether that law allows a seller to limit consequential damages, even if a limited remedy fails of its essential purpose.
- Consequential damages can also be costly, particularly for machines used on projects and in processes. Limit these damages to the purchase price, if you can, so you don't find yourself paying for the loss of income and business that results from a delivery truck's defective clutch.

Buyers, of course, would like all the warranties and remedies that the UCC offers, as well as any express warranties and specifications. When that's not possible, buyers should insist on a few crucial contract terms:

- The product will meet express warranties, which will be clear and include detailed specifications.
- The product will be free of defects for a reasonable period of time. Think carefully about what's reasonable for you, particularly if the seller hopes to limit the length of time in which you may return a product or bring a suit.
- Get a clear procedure for returning or repairing a defective product.
- Carefully negotiate how the parties will determine if a product meets specifications, or whether a problem triggers warranty provisions. Many contracts say that these matters are "at the seller's sole discretion." You can't live with that.
- Your seller probably can't afford unlimited liability, so decide how much risk you're willing to take. If you lose millions on a process that doesn't perform, will a refund help you? Or can you agree to a liability cap?

Some companies may be able to invoke the golden rule: The party with the gold makes the rules. If that doesn't work in your favor, consider to what degree you are insuring the deal's success. Short-term insurance may help you carry that load. If not, the bargain may not be a desirable one.

In most contract negotiations, neither buyer nor seller gets everything they want. Decide what's most important to your company and bargain accordingly.

Editor's Note: For regular reading on contract language, view "The Contractual Cogitator" column by Robert A. Feldman in the *ACC Docket*.

The seller and buyer lawyer up

The seller — sadder and poorer, but also much wiser — consults its in-house attorney. The next time the company sells a snack sanitizer its sales sheet provides the buyer with terms and conditions. Under these:

- All express and implied warranties, except warranties herein, are disclaimed, including implied warranty of merchantability and fitness for a particular purpose;
- Buyer remedies are limited to repair and replacement of defective goods or parts; and
- Under no event shall the seller be liable for any consequential damages and in no event shall the seller's liability for anything exceed the item's purchase price.

The second buyer has also been talking with its in-house attorney. It inspected the seller's product and heard a full explanation of the SnackPacker's benefits, including safety and speed, from the seller's salesperson. The buyer's purchase order adds contract terms that say:

- In addition to all warranties and remedies available by law, all products will meet the stated specifications;
- Liquidated damages of \$5,000 per day shall apply for any loss of use of the sanitizer caused by defects or breach of warranties; and
- All disputes will be arbitrated in the buyer's home city.

Notice that the seller's terms and conditions don't match those of the buyer. The seller disclaims all warranties, including the implied warranty of merchantability and fitness for a particular purpose. The buyer wants all warranties and remedies available by law, as well as a product that meets stated specifications. The seller limits remedies to repair and replacement of defective goods, and disclaims any liability for consequential damages, or for any damages that exceed the sanitizer's purchase price. The buyer wants all remedies available by law, plus \$5,000 a day for any loss of use caused by sanitizer defects or breach of warranties. Wiser parties might temporarily halt the sale process to negotiate an agreement that both sides can sign. Nevertheless, these companies move forward with the sale.


Alas, problems ensue. The SnackPacker still doesn't perform fast enough. It's too slow for the buyer's needs, and it doesn't live up to the seller's product specifications. The seller is unable or unwilling to fix the product. What warranties and remedies apply?

To answer that question, you'll need to know whether a court will likely apply the "knockout" rule. Under the knockout rule, two parties' different agreement terms combine to create a total agreement. Where contract terms conflict, they cancel one another, and terms from the Uniform Contract Code take their place. Most courts use the knockout rule.

The best way to sidestep this problem — one often known as the "battle of the forms" — is to negotiate a contract that both parties agree to and sign.

A minority, however, treats conflicting terms differently. Where terms don't materially alter the contract they create a combined agreement. Where they conflict, however, the seller's terms take precedence if the buyer's proposed terms are materially different. Under the knockout rule, the buyer benefits from the UCC rules, which offer more warranties and remedies than does the seller's offer language. But if the court is in the minority that treats the seller's terms as paramount, the buyer has much more limited opportunities for redress. See White and Summers, *Uniform Commercial Code* § 1-3 (5th Ed. 2008) for further discussion of the knockout rule and its alternatives.

In our SnackPacker example, seller's terms and buyer's terms largely cancel one another. The only surviving point is that the disagreement will be arbitrated in the buyer's home city. If a court uses the knockout rule, the parties will likely arbitrate their disagreement in the buyer's home city, because the seller had no provision to "knockout" that location. If, however, the court is in the minority that treats seller's terms as paramount, then the parties will likely head for court, if the court finds the difference between the seller's approach (no arbitration) and arbitration is materially different. Some courts have held that this is a materially different term.

The best way to sidestep this problem — one often known as "the battle of the forms" — is to negotiate a contract that both parties agree to and sign. Negotiation can be time consuming and expensive, and prevents companies from using generic, one-size-fits-all contract forms. It is, however, the gold standard for creating an enforceable agreement that holds few unpleasant surprises for either party. 

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