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Seller's Warranty Liability Under the Uniform Commercial Code: Should Buyer's Merchant Status Affect His Right of Recovery?

OLIN W. JONES*

I. INTRODUCTION

What are the limits of a seller's liability for breach of warranty in goods transactions under the Uniform Commercial Code? The question posed is not a new one; much debate has raged over the past century between legal educators, commentators and the judiciary as to the appropriate answer. Many discussions of damages for breach of warranty in goods transactions involve some sort of ominous hypothetical situation wherein the seller who supplied a defective, fifty-cent bolt is being sued for the damages which resulted from the long breakdown of a giant generator needed to operate a factory. Whether or not the supplier of the defective bolt will be held accountable for the enormous losses which may result from the factory shutdown is said to depend upon the application of sections 2-714 and 2-715 of the Uniform Commercial Code, and to the latter section's claimed progenitor, *Hadley v. Baxendale*.¹

Over a century ago, the English Court of Exchequer attempted to define the limits of the breacher's liability in the landmark *Hadley* case. In essence, the court declared that the breaching party was liable for all loss resulting from the breach which both parties would have foreseen at the time of the contract as likely to result from the breach. The rules enunciated in that case have been subject to two diverse interpretations. One group of commentators and judges interprets *Hadley* as defining liability limits only in terms of *foreseeability* of the seller. Another group feels that such an interpretation will lead to too harsh a result. They

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1. 9 Ex. 341, 156 Eng. Rep. 145 (1854).

interpret *Hadley* as requiring more than foreseeability on the part of the seller. Rather, they view the case as requiring either an express or "tacit" agreement between the parties concerning liability for *some* of the consequences which may result.

The issue has always been an important one to buyers and sellers of goods. Recent events have made the seller's responsibility more than just important — it has become critical. It is unnecessary to document the fact that since *Hadley* was decided, we have developed and built industrial complexes and machinery far beyond the vision or imagination of those judges who rendered it in 1854. When a modern complex grinds to a halt, the consequences may be enormous. The uncontrovertible fact is that today the ultimate consequences of selling are far greater than they were in 1854. We now make it relatively easy to find that the seller has breached a warranty. Should we also make it easy to place on the seller all its consequences, both general and special?

It is the purpose of this article to review the suggested answers of legal scholars involved in the debate over the limits of warranty liability and to suggest that the status of the aggrieved buyer should be given greater weight in resolving the question. Should the fact that the buyer is a merchant have any impact on the debate? By focusing on the status of the buyer while attempting to resolve the question, it is urged that the limits of the seller's warranty liability should fall upon some middle ground of the debate — between "foreseeability" and "tacit agreement."

Throughout this article the hypothetical fact situation should be kept in mind. Restated, the situation supposes that a five-hundred million dollar energy facility will be constructed on the coast of California. Much of this installation will no doubt consist of "transactions in goods"² and indeed the entire project may be analogized to such a transaction.³ If so, all or part of Article 2 of the Uniform Commercial Code will be pertinent.⁴ Assume that one of the suppliers furnishes a fifty-cent bolt, and that a defect in

2. See U.C.C. § 2-105(1). "'Goods' means all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities (Article 8) and things in action" *Id.*

3. It is becoming commonplace to find courts using the principles of the U.C.C. in non-goods transactions. There is often no valid reason to use one set of principles in a contract for the construction and sale of a giant supertanker and yet a different set of principles in a contract for the construction and sale of a large apartment complex. See *Pollard v. Saxe & Yolles Dev. Co.*, 12 Cal. 3d 374, 525 P.2d 88, 115 Cal. Rptr. 648 (1974).

4. See U.C.C. § 2-102. Unless the context otherwise requires, this Article applies to transactions in goods; it does not apply to any transaction which although in the form of an unconditional contract to sell or present sale is intended to operate only as a security transaction nor does this Article impair or repeal any statute

the bolt causes losses to the purchaser. It is, of course, possible that the losses were caused by the negligence of the bolt supplier. In that event, even absent a contract between seller and buyer, the seller of the bolt would have owed a duty to fabricate it in such a manner so as not to create an unreasonable risk of harm to the energy company's interest.⁵

In our hypothetical situation, however, assume that the supplier's duties arose out of the four corners of a contract document in which one party was properly called a "buyer"⁶ and the other a "seller"⁷ of goods. Assume also that the seller made a warranty regarding the bolt, either express or implied; that the bolt did not comply with the warranty and only in that sense was defective; that the defective bolt is extremely difficult (expensive) to repair or replace upon proper discovery of the defect; and that the installation is necessarily shut down for several months as a proximate result of the defect. Is our bolt supplier liable for all the crushing direct and consequential damages?

II. "DIRECT" DAMAGES FOR BREACH OF WARRANTY

A. "Value" Versus "Cost" as the Measure of Damages

One of the losses suffered by the buyer in our hypothetical fact situation involves the defective bolt itself. It must either be repaired or replaced. The cost of such repair or replacement is the buyer's "direct damage," one resulting immediately and proximately from the occurrence, and not remotely from some of the consequences or effects thereof. The basis in law for that recovery is found in the interaction between the Uniform Commercial Code and principles of the common law of contracts. The relevant section of the Code is 2-714 which sets forth the buyer's remedy for damages resulting from a breach of warranty in regard to accepted goods. The section reads:

- (1) Where the buyer has accepted goods and given notification (subsection (3) of Section 2-607) he may recover as damages for any non-conformity of tender the loss resulting in the ordinary course of

regulating sales to consumers, farmers or other specified classes of buyers.

5. RESTATEMENT (SECOND) OF TORTS, § 323 (1965).

6. U.C.C. § 2-103(1)(a). "Buyer means a person who buys or contracts to buy goods."

7. U.C.C. § 2-103(1)(d). "Seller means a person who sells or contracts to sell goods."

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.

Subsections (1) and (2) are determinant in the matter of measuring direct damage. Subsection (1) describes the damages which may be had where the action is based on non-conformity of tender. Official Comment 2 to Section 2-714 describes non-conformity of tender in this manner:

The "non-conformity" referred to in subsection (1) includes not only breaches of warranties but also any failure of the seller to perform according to his obligations under the contract. In the case of such non-conformity, the buyer is permitted to recover for his loss "in any manner which is reasonable."

When our hypothetical buyer brings an action for direct damages, one of his theories will be that seller's tender did not conform to its obligations under the contract. If that is his theory, the Code does not mandate the use of any certain measure of damages. Rather, the Code simply tells the aggrieved party that he may recover all direct damages which result "in the ordinary course of events from the seller's breach as determined in any manner which is reasonable."⁸ This absence of Code specificity, together with section 1-103 of the Code, triggers application of common law principles of contract law. Section 1-103 reads:

Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions.

The Code seems to say that where non-conformity of tender is claimed, the aggrieved buyer may have damages determined in a reasonable manner, as that is ascertained by application of the common law.

Under common law, two opposing damage measures are recognized. They usually are referred to as "value" and "cost" measures. Under the *value* measure, the aggrieved party is allowed to recover the difference in value between the item, as tendered, and the value it would have had if it had met the contract requirements. Under the *cost* measure, the aggrieved party is allowed to recover the reasonable cost of remedying the defects and the bringing of the defective item up to contract specifications. Although these measures are easy to state, they are more difficult to

8. U.C.C. § 2-714(1).

apply due to the many and varied fact patterns which have emerged.

Because it sets the tone for compensating aggrieved parties, one of the major policies of the Code should be considered in determining what measure of damages is appropriate. Section 1-106 states specifically that remedies are to be liberally administered:

The remedies provided by this act shall be liberally administered to the end that the aggrieved party may be put in as good a position as if the other party had fully performed but neither consequential or special nor penal damages may be had except as specifically provided in this Act or by other rule of law.

The Official Comment to this section develops the theme of liberal compensation and states its purpose is to "negate the unduly narrow or technical interpretation of some remedial provisions of prior legislation by providing that the remedies in this Act are to be liberally administered to the end stated in the section."⁹ The Code comment manifestly rejects the proposition that the proper damage recovery is necessarily the smallest damage recovery. Instead, it embraces the concept that an aggrieved party is entitled to be placed in as good a position as performance.

The Code's policy, together with existing case law, must be utilized to determine the proper choice in the measure of damages between a *value* measure and a *cost* measure. In our hypothetical case, for example, it seems clear that a *value* measure of damages is only about fifty cents. The *cost* measure, however, could realistically be several hundred thousand dollars, or more.

B. Defining "*Special Circumstances*" Permitting *Cost Measure*

The bolt seller may well argue that the Code provides only one measure of recovery for non-conforming goods accepted by the buyer. Section 2-714(2) of the Code does indeed set forth the *value* measure of damages. It states: "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."

It seems clear that the "proximate damages" referred to in section 2-714(2) means direct damages. This proposition is sufficiently dealt with in Black's Law Dictionary: "Proximate damages

9. U.C.C. § 1-106(1), Comment 1.

are the immediate and direct damages and natural results of the act complained of, and such as are usual and might have been expected."¹⁰ However, a proper reading of section 2-714(2) along with the relevant Official Comment makes it clear that the *value* measure is not intended to be exclusive. Official Comment 3 states: "Subsection (2) describes the usual, standard and reasonable method of ascertaining damages in the case of breach of warranty *but it is not intended as an exclusive measure.*"¹¹

Since there are only two measures of damages which apply to the kind of problem presented by the hypothetical, if the *value* measure is not exclusive then the *cost* measure may be an appropriate alternative under proper circumstances. The inclusion of the terminology, "special circumstances," would therefore provide an opportunity for the aggrieved buyer to recover a greater amount of *direct* damages than the *value* measure would allow.

Unfortunately, the courts have not often addressed the problem of the "special circumstances" allowing a shift from *value* to *cost* measures. Professors White and Summers mention the problem in their treatise on the Uniform Commercial Code:

In many cases, courts will find a ready measure of damages by using the cost of repair that the buyer has incurred or will incur in order to bring the goods up to snuff. In other cases the courts will have to turn to the familiar but difficult standards for measuring value. In all such cases the courts should give due concern to the particular needs of the buyer.¹²

In a 1974 case,¹³ the Court of Common Pleas of Connecticut described "special circumstances" as a Code-sanctioned means of recovering greater direct damage than would be available through the value measure. The court said:

The difference between the value of the goods delivered and that which they would have had if they had complied with the warranty is not the exclusive measure of damages in breach of warranty cases. The rule is more generous when special circumstances are present. In essence, the loss directly and naturally resulting is the measure of damages.¹⁴

Most courts do not attempt to define what is meant by "special circumstances." In *General Supply and Equipment Company, Inc. v. Harry S. Phillips*,¹⁵ roof panels for a greenhouse turned out

10. H. BLACK, BLACK'S LAW DICTIONARY 469 (4th ed. 1968).

11. U.C.C. § 2-714(2), Comment 3 (emphasis added).

12. J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 311 (1972).

13. *Acme Pump Co. Inc. v. National Cash Register Co.*, 32 Conn. Sup. 69, 337 A.2d 672 (1974). National Cash Register Co. sold a defective bookkeeping machine to plaintiff who sued for breach of warranty. The court allowed plaintiff's recovery for the reasonable expenses of defending itself in an action by a finance company for a deficiency judgment after the finance company had repossessed the bookkeeping machine. The court determined that the breach of warranty was a direct cause of the repossession.

14. *Id.* at 677.

15. 490 S.W. 2d 913 (Tex. Civ. App. 1973). The jury had awarded the plaintiff

to be defective. The court allowed the cost of replacing the panels after simply concluding:

In the instant case the ordinary measure of damages for breach of warranty as stated in § 2-714(b) is not applicable because of special circumstances showing proximate damages of a different amount. The proximate damages in this case consist of incidental and consequential damages as provided by § 2-715.¹⁶

The court made no effort to determine what is meant by the "special circumstances" of section 2-714(2); instead it found "a proper case" under section 2-714(3) and applied the cost measure of direct damages although classifying them as incidental damages.

Another Texas court, in the 1975 case of *Lanphier Construction Company v. Fowco Construction Company*,¹⁷ emphasized the "special circumstances" language of section 2-714(2), and explained why the normal formula giving the value measure was not the appropriate one:

There is abundant evidence that Servtex knew the exact needs of Fowco at the time of supplying the asphalt. Thus, Servtex could have reasonably foreseen that if the asphalt proved defective and failed, the entire job would have to be taken up and would have to be completely redone. . . . Since the asphalt was defective, it had no value. . . . In the instant case, the ordinary measure of damages for breach of warranty stated in section 2-714(b) of the Uniform Commercial Code is not applicable because of special circumstances showing proximate damages of a different amount.¹⁸

Thus the court reasoned that the "special circumstances" of section 2-714(2) are satisfied by foreseeability on the part of the supplier that more than the normal measure of damages would be appropriate.

In *Water Works & Industrial Supply Company v. Wilburn*,¹⁹ a Kentucky court of appeals found a breach of an implied warranty for fitness regarding pipe gaskets and approved a jury award which apparently included the expense of digging up the pipe, re-filling and reblocking connections, and back filling. The court dismissed as unmeritorious the appellant's suggestion that liability was limited to replacement costs only, saying: "Consequential damages are recoverable for breach of implied warranty of fitness.

damages measured by the diminution in the cash market value of the greenhouse. The appellate court reversed, stating that the proper measure of damages is the replacement cost of the paneling.

16. *Id.* at 919.

17. 523 S.W. 2d 29 (Tex. Civ. App. 1975).

18. *Id.* at 42.

19. 437 S.W. 2d 951 (Ky. Ct. of App. 1969).

KRS 355.2-715.”²⁰ Nowhere does the court explain why the suggestion had no merit, nor does it explain its reference to consequential damages as opposed to warranty damages which appear to have been the damages claimed and awarded.²¹

In *Appalachian Power Co. v. John Stewart Walker, Inc.*,²² the Virginia court did give some guidelines for choosing between the two measures: “The test is the nature of the motivation which induced the promisee to make the contract. If his primary interest was the value of the result performance would have produced, then the ‘value’ formula is applicable; if performance itself, then the ‘cost’ formula.”²³

This case seems to stand for the proposition that if the buyer wants goods for purposes of resale, he is concerned with their value because that is what determines the price he can obtain for

20. *Id.* at 955.

21. In *General Supply*, *supra* note 15, *Lanphier Construction*, *supra* note 17, and *Water Works*, *supra* note 19, the courts cited either section 2-715(1) or 2-715(2) as the legislative authority for the recovery of direct warranty damages. In *General Supply*, the remedy sought and awarded was the cost of replacing defective panels. The court improperly based its award on 2-715(1), the Code’s provision for incidental damages resulting from the seller’s breach. The cost of replacing the defective panels was not the type of incidental *expense* provided for by 2-715. Rather, it was simply the measure of damages for breach of warranty which is provided for by either 2-714(1) or (2).

Another instance can be found in the 1972 Georgia Court of Appeals case of *Southern Concrete Products Company v. Martin*, 126 Ga. App. 534, 191 S.E. 2d 314 (1972). That case required bricks to be sandblasted in order to make them conform to the contract. The court said the cost of making repairs was recoverable as consequential damages under section 2-715. *Id.* at 316. Again, that cost is not an item of consequential damages, a subject discussed *infra*, but rather it is a measure of warranty damages as provided for by section 2-714.

Similarly, a California Court of Appeals in *Camrosa County Water District v. Southwest Welding and Manufacturing Co.*, 49 Cal. App. 3d 951, 123 Cal. Rptr. 93 (1974), a case involving repairs necessary to correct defective water tanks, held that a buyer who suffers damages for breach of warranty is entitled to consequential damages which are reasonable and foreseeable. The reference to consequential damages, which were not claimed, is not explained.

These cases reveal one of the major difficulties in working with the Uniform Commercial Code. Assuredly, it codified many common law principles; some were changed but others were not. Unfortunately, many courts, in interpreting a Code section that sounds generally familiar, tend to ignore what may be rather precise language in the Code. Under the Code, for example, incidental and consequential damages are clearly recoverable, in a proper case, in addition to direct damages. They are not, however, properly described as warranty damages. Section 2-714(3) seems plain enough: “In a proper case any incidental and consequential damages under the next section *may also* be recovered.” (Emphasis added.)

22. 214 Va. 524, 201 S.E. 2d 758 (1974). In *Appalachian Power*, the supreme court approved an award of damages based on the reduced value of a developer’s lots due to the utility company’s failure to install underground service as agreed. The electric company had argued that the proper measure of damages should have been the cost of installation of the underground service.

23. *Id.* at 535, 201 S.E. 2d at 767.

them. On the other hand, when he gives a specification and describes the use to which he will put the goods, he is looking for the best performance he can get at a reasonable cost.

Thus, while most courts simply ignored the Code language, those that did "interpret" it made the cost measure available under one of the following circumstances:

- (1) when the value measure failed to give due concern to the buyer's particularized needs; or
- (2) when the value measure failed to compensate the buyer for the loss directly and naturally resulting; or
- (3) when the seller could reasonably have foreseen that the value measure would not compensate the buyer for the breach; or
- (4) when it was evident that the buyer was seeking performance of the product rather than its resale.

These "special circumstances" have a common thread; all reflect the court's language in *Hadley*. Indeed, in that case, the court allowed damages which "would ordinarily follow from a breach of contract under these *special circumstances* so known and communicated."²⁴ The same phrase in section 2-714(2) may well have been lifted from *Hadley* itself, in which case it simply refers to facts communicated to the buyer.

Perhaps there is yet another situation where "special circumstances" would permit the cost rather than the value measure. As noted earlier, the policy of the Code is to put the aggrieved party in as good a position as performance would have put him. Therefore, if the value measure fails to achieve this overall Code objective, that fact alone should allow the shift to a measure of damages other than the usual or standard one.

In any event, the cases make it evident that the courts have had little trouble with the "special circumstances" requirement, and it is relatively safe to predict that the cost measure would be allowed in our hypothetical case.

III. CONSEQUENTIAL DAMAGES FOR BREACH OF WARRANTY

Once the direct damages have been ascertained, the aggrieved buyer will then turn to section 2-714(3) which, pursuant to section 2-715, provides, in a proper case, for incidental and consequential damages in addition to direct damages. That section reads:

- (1) Incidental damages resulting from the seller's breach include expenses reasonably incurred in inspection, receipt, transportation and care and custody of goods rightfully rejected, any commercially rea-

24. 9 Ex. 354-355, 156 Eng. Rep. 151 (1854) (emphasis added).

sonable charges, expenses or commissions in connection with effecting cover and any other reasonable expense incident to the delay or other breach.

- (2) Consequential damages resulting from the seller's breach include:
 - (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.

As has been noted in the analysis of section 2-714, an aggrieved buyer can make a larger direct damage recovery than would be possible using the value measure where "special circumstances" are present. *Additional* recovery for incidental and consequential damages is available, however, only in a "proper case."²⁵ It would appear, therefore, that "special circumstances" are not required as a prerequisite to incidental and consequential damages. They are recoverable "in a proper case" whether or not "special circumstances" exist. One would assume that the terms are not synonymous, for if the drafters of the Code had intended them to have the same meaning, would they not have used the same term twice? Since different language was used, would it not be improper statutory construction is to treat them as synonymous?

What, then, is meant by a "proper case"? One meaning is supplied in section 2-715(2)(a). Therein, consequential damages are proper when the seller, at the time of contracting, had reason to know of the possibility of loss based on the general or particular needs of the buyer. Virtually everyone concedes that subsection (2)(a) springs from *Hadley v. Baxendale*. Professor Grant Gilmore has called that case a "fixed star in the jurisprudential firmament."²⁶ Professor Richard Danzig, however, in an equally fascinating contribution²⁷ suggests it would be more appropriate to say that the star needs fixing. At the least, he suggests that the rule of *Hadley* will become too firmly entrenched even as it becomes outmoded. Among other reasons, he suggests that in mass-transactions a seller cannot plausibly engage in an individualized contemplation of the consequences of a breach and an appropriate tailoring of the transaction. He recognizes, however, that many believe that the market system will become distorted unless losses are borne by those in the best position to avoid them — the breachers.²⁸

The debate over the proper method for determining the extent

25. See U.C.C. § 2-714(3).

26. G. GILMORE, *THE DEATH OF CONTRACT* 49 (1974).

27. R. Danzig, *Hadley v. Baxendale: A Study in the Industrialization of the Law*, 4 J. LEGAL STUDIES 249 (1975).

28. *Id.* at 2.

of liability for consequential damages continues to rage. The drafters of section 2-715 could have settled the dispute by plain language, but instead adopted a text as ambiguous as the court's language in *Hadley*. Only the Official Comments to section 2-715 are bold enough to choose "foreseeability" and to reject the "tacit agreement" test. What is plain, however, is that liability of our bolt seller, at least for the very considerable consequential damages that may result in this case, depends upon judicial interpretation of section 2-715(2)(a). This interpretation requires a preliminary examination of the cases that preceded its adoption.

A. *Pre-Code Foreseeability and the Inroads of Tacit Agreement*

An examination of *Hadley* and the cases that immediately followed it shows the foreseeability concept to be one of *limitation* on recovery by plaintiffs. Liability would not lie for *special* damages which were not within the contemplation of the parties unless the defendant possessed knowledge of special circumstances indicating that the plaintiff would, in the event of breach, sustain special losses — those arising *other* than in the ordinary course of events.

Many commentators have said the rule gained outright acceptance by the courts and that it did not come under fire until about fifty years later. At that time, its detractors included Justice Holmes and the United States Supreme Court. Holmes, in authoring the Court's 1903 opinion in *Globe Refining Co. v. Landa Cotton Oil Co.*,²⁹ was confronted with a case involving an agreement for the purchase of cotton seed oil. The buyer had sent cars from Kentucky to Texas to no avail due to seller's breach. The buyer claimed the difference between the contract price and the market value of the oil. It also sought the *special* expense of sending the cars to Texas, and for the loss of their use. In denying recovery for these foreseeable consequences, Justice Holmes first delineated the difference between tort liability and contract liability:

When a man commits a tort, he incurs, by force of the law, a liability to damages, measured by certain rules. When a man makes a contract, he incurs, by force of the law, a liability to damages, unless a certain promised event comes to pass. But, unlike the case of torts, as the contract is by mutual consent, the parties themselves, expressly or by implication, fix the rule by which the damages are to be measured. . . . It is true that as

29. 190 U.S. 540 (1903).

people when contracting contemplate performance, not breach, they commonly say little or nothing as to what shall happen in the latter event, and the common rules have been worked out by common sense, which has established what the parties probably would have said if they had spoken about the matter. But a man never can be absolutely certain of performing any contract when the time of performance arrives, and, in many cases, he obviously is taking the risk of an event which is wholly, or to an appreciable extent, beyond his control. The extent of liability in such cases is likely to be within his contemplation, and, whether it is or not, should be worked out on terms which it fairly may be presumed he would have assented to if they had been presented to his mind. . . . If a contract is broken, the measure of damages generally is the same, whatever the cause of the breach. *We have to consider, therefore, what the plaintiff would have been entitled to recover in that case, and that depends on what liability the defendant fairly may be supposed to have assumed consciously, or to have warranted the plaintiff reasonably to suppose that it assumed, when the contract was made.*³⁰

Holmes' view had early support. In *Hooks Smelting Co. v. Planters Compress Co.*,³¹ bronze screws were ordered for the purpose of repairing a cotton compress. When they were defective, the buyer sought damages nearly ten times greater than the gross amount to be paid for the screws. The court said:

While the fact that the damages are greater than ordinarily follow the breach of contracts to furnish materials of that value, of course, does not show that the judgment is wrong, it calls attention to the case as one somewhat out of the beaten track of damage cases, and we therefore proceed with some interest to examine the law and the evidence upon which the judgment is based.³²

The court proceeded to discuss the facts and the law of *Hadley*, and stated, "If we look at what the court actually decided in that case, it seems itself to support the modification subsequently ingrafted on the rule as stated in that case, to the effect that mere notice is not always sufficient to make one liable for special damages."³³ After further discussion of the foreseeability rule, the court said:

Now, the first two rules laid down by the decision in *Hadley v. Baxendale* have never been questions or doubted; but the third rule — the one we are asked to enforce in this case — has often been criticised, and many cases could be cited where the courts have refused to apply it so broadly as stated in the principal case, for, if thus applied, it would in many cases result in obvious injustice. Suppose, for instance, that a large manufacturing establishment is driven by power from a single engine, and that, by reason of an accident to some small but important part of the engine or machinery, it becomes necessary to stop the operation of the whole plant until a new part can be made, or the old one repaired. If thereupon a blacksmith or machinist is called in, and for the price of a few dollars un-

30. *Id.* at 543-544 (emphasis added).

31. 72 Ark. 275, 79 S.W. 1052 (1904). The cotton compress company ordered specially made screws at a cost of approximately \$700. Due to the fact that the screws were too large to fit the buyer's machine, the buyer's plant operation was suspended. As a result of the delay caused by the improperly made screws, the buyer claimed damages in excess of \$5000.

32. *Id.* at 1055.

33. *Id.*

dertakes to make the repairs, but, through some mistake or unskillfulness, the part supplied by him should fail to fit, requiring it to be remade, and entailing still further delay, would any court hold that the blacksmith or machinist could be held liable for all the damages entailed by the delay, when they were large, in the absence of a contract on his part to be thus liable, unless the notice and the circumstances under which he made the contract were such that he ought reasonably to have known that in the event of his failure to perform his contract the other party would look to him to make good the loss?³⁴

Holmes' modification of the foreseeability test attracted other state support as well.³⁵ It was also followed by lower federal courts prior to 1938 when the federal courts under *Erie Railroad Co. v. Tompkins*,³⁶ were no longer obliged to do so. Since that time, the tacit agreement test has been both accepted and rejected. More important, however, is the reaction of the courts to this issue following adoption of the Uniform Commercial Code.

B. Post-Code Applications of the Two Tests

Since the advent of the Uniform Commercial Code, numerous decisions have been handed down which speak to the issue. In *Keystone Diesel Engine Co. v. Irwin*,³⁷ perhaps the earliest interpretation of section 2-715, the Pennsylvania Supreme Court followed the tacit agreement test.³⁸ The court quoted Holmes in

34. *Id.* at 285, 79 S.W. at 1056.

35. See, e.g., *Winslow Elevator & Machine Co. v. Hoffman*, 107 Md. 621, 69 A. 394 (1908) where the court expressed its concerns about the foreseeability rule in the following language:

To fix such a liability upon it upon that ground alone . . . would be a startling and dangerous proposition. Under such a rule the plumber, the gas fitter, the stair builder, or the machinist who defaulted in his contract to do certain work upon any of the great office buildings might be held liable for enormous special damages simply because he knew his contract had reference to such a building.

Id. at 638, 69 A. at 397.

36. 304 U.S. 64 (1938). *Erie Railroad Co. v. Tompkins* held, generally, that federal courts, exercising jurisdiction on the grounds of diversity of citizenship, must apply state law as declared by the state's highest court.

37. 411 Pa. 222, 191 A.2d 376 (1963). When the plaintiff, a dealer of diesel engines, brought a cause of action against Irwin for repair work it performed on his engine, Irwin counterclaimed for loss of profits that resulted from the engine breakdowns. The trial court struck the counterclaim and the supreme court affirmed stating that no facts were alleged "that would put the plaintiff on guard to the fact that the defendant would hold plaintiff responsible for any loss of profit arising from the inability to use the machine in question." *Id.* at 379.

38. However, since the time of the *Keystone* decision, the court has reconsidered its interpretation of 2-715. In *R.I. Lampus Co. v. Neville Cement*, 378 A.2d 288 (Pa. 1977), upon discovery that cement blocks failed to meet specifications, plaintiff sued for damages resulting from their use in the production of structural floor and ceiling systems. The court expressly rejected the *Keystone* interpretation and

Globe and expressly adopted his rationale.

Arkansas remains in the tacit agreement camp. In 1977 the Supreme Court in *Morrow v. First National Bank of Hot Springs*,³⁹ although involving facts inapposite to Article 2 of the Code, cited *Hooks*, which had involved a transaction in goods, and said:

The tacit agreement test, to be sure, has been questioned and was rejected by the draftsmen of the Uniform Commercial Code . . . We do not attach great importance to the Commercial Code provision, simply because the legislature, in adopting a uniform act containing hundreds of sections, certainly did not specifically and consciously decide that the rule of the *Hooks* case should be changed in all situations. We adhere to that decision.⁴⁰

However, the tacit agreement test has more often been rejected by courts applying section 2-715. In doing so, they often quote the Official Comments to that section. Although those not enamored with its statement are quick to point out its lack of status, the comment provides:

2. Subsection (2) operates to allow the buyer in an appropriate case, any consequential damages which are the result of the seller's breach. The 'tacit agreement' test for the recovery of consequential damages is rejected. Although the older rule at common law which made the seller liable for all consequential damages of which he had 'reason to know' in advance is followed, the liberality of that rule is modified by refusing to permit recovery unless the buyer could not reasonably have prevented the loss by cover or otherwise.

Thus, according to the Official Comments, the only modification to the rule of foreseeability is the reasonable ability of the buyer to prevent the loss by cover or otherwise. Presumably, these are actions he can and should take after the defect becomes known, not at the time of contracting.

The tacit agreement test was rejected by Illinois in the case of *Adams v. J.I. Case Co.*,⁴¹ where the court referred to the Official Comment and also stated: "The language of that section should not be so narrowly construed as to require a prior understanding or agreement that the seller would be bound for consequential

stated that the proper measure of consequential damages are those of which the seller "*had reason to know* and could not reasonably be prevented by cover or otherwise." *Id.* at 292. "The '*had reason to know*' test does not require that it be shown that the seller contemplated or tacitly agreed to certain consequential damages. A seller '*had reason to know*' that which a reasonable person would have known." *Id.*

39. 550 S.W. 2d 429 (Ark. 1977). In *Morrow*, coin collectors brought suit against the bank for the bank's failure to notify, as promised, that safety deposit boxes were available in the new bank building. A coin collection was stolen from one of the collector's homes several days later.

40. *Id.* at 431.

41. 125 Ill. App. 2d 388, 261 N.E. 2d 1 (1970). In *Adams*, defendant supplied plaintiff with a defective tractor and, by failing to make necessary repairs in a timely manner, caused plaintiff to lose 810 work hours at \$12 per hour. The court allowed recovery of the lost profits as reasonably foreseeable.

damages in the event of his breach. If that is the holding . . . of the Keystone [case] it must be rejected."⁴²

California may also be in the foreseeability camp. In *Gerwin v. Southeastern California Association of Seventh Day Adventists*,⁴³ a District Court of Appeals quoted section 2-715, indicating that it codified the rule of *Hadley v. Baxendale*, and stating the test to be one of foreseeability. The court also cited with approval several pre-Code cases which had followed *Hadley*.

In *Falcon Tankers Inc. v. Litton Systems, Inc.*,⁴⁴ in 1976, a Delaware superior court quoted section 2-715, footnoted rejection of the tacit agreement test by the Official Comments, and said: "By the great weight of authority, consequential damages are only granted where the breach is a proximate cause of the losses and the damages were reasonably foreseeable at the time of contracting."⁴⁵ The Delaware court may well be correct in its count of those jurisdictions rejecting the tacit agreement test. Idaho,⁴⁶ Minnesota,⁴⁷ Nebraska,⁴⁸ North Carolina,⁴⁹ and Texas⁵⁰ seem in-

42. *Id.* at 405, 261 N.E. 2d at 9.

43. 14 Cal. App. 3d 209, 92 Cal. Rptr. 111 (1971).

44. 355 A.2d 898 (Del. 1976). In *Falcon Tankers*, a tanker owner sued the shipbuilder for damages caused by long periods of "down time." The shipbuilder, in turn, sued the pump manufacturer who, in turn, sued the supplier of component parts.

45. *Id.* at 907.

46. *Paullus v. Liedkie*, 92 Idaho 323, 442 P.2d 733 (1968). In this action for breach of an implied warranty of fitness, hogs sold by the plaintiff were found to be diseased and unfit for breeding. The buyer also claimed that the infected hogs communicated their disease to his healthy hogs and that, as a result, he had to sell all the hogs for butchering rather than breeding. The court allowed the damages, stating that they were reasonably foreseeable.

47. *Bemidji Sales Barn, Inc. v. Chatfield*, 250 N.W. 2d 185 (Minn. 1977). The buyer alleged breach of express warranty that cattle had been vaccinated for shipping fever and breach of implied warranty of merchantability. The court held that the buyer could recover consequential damages for the loss of the calves and for the increased costs of feed and care. However, in this case, the damages were limited due to the buyer's failure to mitigate his damages.

48. *National Farmers Organization, Inc. v. McCook Feed and Supply Co.*, 196 Neb. 424, 243 N.W. 2d 335 (1976). The seller delivered only 1,714 bushels of corn to the buyer pursuant to a contract to sell 90,000 bushels. The buyer sued to collect lost profits, claiming that the seller had reason to know, at the time of contracting, that the buyer had expected to resell the corn.

49. *Gurney Industries, Inc. v. St. Paul Fire and Marine Ins. Co.*, 467 F.2d 588 (4th Cir. 1972). Plaintiff contracted with defendant contractor to construct a yarn-spinning mill. The court held that the contractor's officials, as they were experienced in the design and manufacture of spinning wheels, knew or could have foreseen the probable result of an ill-equipped mill (increased operating costs and decreased production). Thus, as the operating losses were foreseeable, they were allowable as damages.

terested only in foreseeability. If that is insufficient bad news for the tacit agreement camp, on October 7, 1977, the Supreme Court of Pennsylvania,⁵¹ the earliest post-Code adopter of the tacit agreement test, changed its mind and rejected tacit agreement in favor of foreseeability. The court did not say why *Keystone* incorrectly favored the tacit agreement test, other than to refer to works of prominent legal authorities who also fail to explain why foreseeability is enough. The court seemed impressed by the fact that the *Keystone* result was out of harmony with the text of both section 2-715(2) and Comments 2 and 3. The court, as do so many others, quoted the rejection language of Comment 2, which language also makes no case for either proposition; instead, it simply rejects tacit agreement. Braucher and Reigert say the trend is against the tacit agreement test.⁵² Professor Corbin also had joined with those who approved of the foreseeability test. In order to charge the defendant with the loss he said it was sufficient to find that it was one that ordinarily 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 the breach.⁵³ The loss is recoverable apparently because the buyer communicated "special circumstances" to the seller.

IV. CONCLUSION

The net result of an analysis of the relevant cases would appear to support a prediction that, in most jurisdictions, the buyer in our hypothetical situation will be able to recover its full cost of replacing the defective bolt, and it will likewise be able to recover special damages in the amount of its losses caused by the shutdown of the plant. At least, it seems that at the present time the buyer is entitled to such damages providing it proves "a proper case"; evidently meaning only that such losses were foreseeable by the seller.⁵⁴ The total of these two claims may be staggering,

50. *Ligon v. Chas. P. Davis Hardware, Inc.*, 492 S.W. 2d 374 (Tex. Civ. App. 1973). This case involved a breach of implied warranty action, brought by a store owner against the installer of a burglar alarm system. The burglar alarm failed to activate when the store was burglarized and the owner suffered a loss of merchandise.

51. *R.I. Lampus Co. v. Neville Cement Products Corp.*, 378 A.2d 397 (Pa. 1977). See note 38 *supra* and accompanying text.

52. R. BRAUCHER & R. RIEGERT, *INTRODUCTION TO COMMERCIAL TRANSACTIONS* 313 (1977).

53. 5 A. CORBIN, *CONTRACTS* §1010, at 79 (1964).

54. Earlier in this article it was suggested that it would be improper statutory construction to conclude that "special circumstances" under section 2-714(2) meant the same thing as "in a proper case" under section 2-714(3). Yet, that is the apparent interpretation of the courts.

In both instances, the courts seem interested only in ascertaining whether or

but, nevertheless, it appears that we must answer the interminable rhetorical question presented by the court in *Hooks*⁵⁵ by saying: "Yes, indeed there are such courts, and they appear to be in the clear majority. The blacksmith is liable in spite of the fact that he may have exercised the greatest care in the manufacture of this inexpensive item."

V. PROPOSAL: EXAMINE THE ROLE OF THE BUYER

As for the rule which so easily casts upon the offender the burden of the total loss, it is easy enough to say that when special circumstances have been communicated to the seller, any loss that would ordinarily follow would be a foreseeable loss. However, to say that it is a foreseeable loss is not necessarily to say it is one that must be borne by the breacher. In the negotiation stage, should we expect a seller to be contemplating or attempting to understand "special circumstances" which might inordinately magnify his ordinary liability? A breach on his part, and its possible extraordinary consequences, are probably the furthest things from his mind. Is not Professor Danzig on the right track when he says a mass-transactions seller cannot plausibly engage in an individualized contemplation of the consequences of breach? Is the trend to foreseeability only a "snow ball effect" generated primarily by an Official Comment?

In our hypothetical fact situation, is not the *buyer* in a far superior position to know the dire consequences that may flow from a defective bolt sold to him? He knows whether or not that bolt will be buried under tons of expensive machinery, all of which may have to be torn apart to get at the offender once it is identified. He knows, or is in a superior position to know, whether it will be simply placed on a shelf. Thus, if the consequences of the bolt's defectiveness are other than those that would ordinarily flow in

not the loss claimed was foreseeable by the seller. This difficulty in working with the Code is also discussed in note 21 *supra*. It would seem that the proper statutory construction would be to the effect that "special circumstances" under 2-714(2) are pertinent in deciding whether warranty damages should be determined by the *cost* rather than the *value* measure, for that subsection speaks only to the issue of warranty damages. Determination of "a proper case," however, seemingly should be important only to see whether or not incidental and/or consequential damages are also recoverable. (Even if that is the correct construction, it must be admitted that *foreseeability* may well be the determinant factor in both subsections.)

55. See text accompanying note 34 *supra*.

the usual course of events, should not the buyer be expected to protect himself?

Obviously, in the past, successful arguments have been made that the buyer need not do so. However, are those arguments impressive today, when the buyer is a merchant or occupies some sort of professional buyer status? Are there not special considerations required when the purchase is in the context of a commercial agreement? Is there a viable middle ground in this debate?

There is, of course a way in which the seller can protect himself. Section 2-719(3) of the Code allows the seller to limit and perhaps even exclude his liability. Indeed any purchaser of goods is beginning to learn what it is like to live in a world of limited liability. Is all of this sea of limitation which presently engulfs us necessary, at least in commercial contracts?

There is no attempt herein to suggest a change in the rules which most properly place on the offending seller the responsibility for all losses which *ordinarily* or *usually* flow from the breach. Instead, the thought thrown upon the table for discussion is whether the buyer, when he is a merchant, should be able to saddle the breaching seller with extraordinary losses without receiving from the seller an agreement, tacit or otherwise, that the seller will bear that special loss.

It would not be unique to examine the role of one of the parties in formulating a new rule. The Code, in several instances, has rules that are applicable only when one party is a merchant,⁵⁶ or when both buyer and seller are merchants.⁵⁷ Why not have a provision pertaining to remedies which would have application to liability for defective products only when the buyer occupies some sort of merchant status?⁵⁸ Professor Corbin in his work on contracts said: "That portion of the field of law that is classified and

56. See, e.g., §§2-205, 2-209(2), 2-314, 2-403(2) and 2-509(3).

57. These sections are fewer in number. See, e.g., §§ 2-207(2), 2-209(2) and 2-609(2).

58. In suggesting a change to the remedies provisions at least two factors must be considered. First, what sort of merchant buyer should be given this added responsibility? Section 2-104(1) now provides three different definitions of a merchant. While it would be desirable to avoid adding a fourth, it is not at all certain that the energy facility buyer would properly be termed a dealer in goods of the kind, a business practices merchant, or an employer of others holding themselves out as having the necessary knowledge or skill. Thus some other provision is dictated. Perhaps the simplest solution would be to add another sentence to the present subsection. It could read: "In determining damages for breach of warranty of defective goods accepted by the seller, 'merchant' also means a person who purchases the goods for use in his business."

Second, should there be a new section pertaining to warranty damages or could the recommendation contained in this article be accomplished by a revision of the present provision? Remembering that section 2-715 is a part of other remedy provisions as well (See 2-712(2) and 2-713(1)), any change to section 2-715 becomes

described as the law of contracts attempts the realization of reasonable expectations that have been induced by the making of a promise."⁵⁹ Is such a goal served by a rule that subjects a supplier of goods to unlimited liability for a defective product, a product that may have been produced with the utmost of care, simply by having received knowledge of "special circumstances" from a better informed, merchant buyer? Would placing some responsibility on a professional buyer promote the simplification, clarification, and modernization of the law governing commercial transactions? That, after all, is the underlying purpose and policy of the Uniform Commercial Code.⁶⁰

most significant. With those thoughts in mind, the following minimum changes (indicated by italicized portions) should accomplish the objective:

1.) U.C.C. § 2-714 would read:

(1)

(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. *If the buyer is a merchant such different amount shall not exceed the contract price of accepted defective goods unless the seller has expressly or impliedly agreed to such excessive damages in the event of breach by him.*

(3)

2.) U.C.C. § 2-715 would read:

(1)

(2) *Subject to the provisions of section 2-715 (3), consequential damages resulting from seller's breach include:*

- (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,

(3) *Unless expressly or impliedly otherwise agreed, a merchant buyer shall not receive consequential damages resulting from acceptance of defective goods.*

59. 1 A. CORBIN, CONTRACTS § 1, at 2 (1964).

60. U.C.C. § 1-102 (2)(a).

