

SURVEY OF 1999 INDIANA CASES ON THE UNIFORM COMMERCIAL CODE

JUDY L. WOODS*

INTRODUCTION

In 1999, the Indiana Supreme Court addressed Article 9 of the Uniform Commercial Code (“UCC”)¹ in only one case,² and did not construe any other portions of the UCC. That case deals with the competing interests of a secured creditor and a third party receiving proceeds from the transfer of collateral.³ In addition, two Indiana Court of Appeals decisions dealt with impairment of collateral and release of a guarantor.⁴

Several decisions of the Indiana Court of Appeals addressed issues concerning warranties and limitation of remedies under Article 2 of the UCC,⁵ the general duty imposed on all contracts covered by the UCC to perform in good faith,⁶ and what is a reasonable notice for termination of a contract.⁷ In addition, the Indiana Tax Court discussed the role and usefulness of the UCC when it is interpreting and construing Indiana tax laws.⁸

None of the 1999 Indiana cases dealing with the UCC represents a significant divergence or major change in Indiana law. Rather, these cases clarify and refine the law, offering helpful points for those engaged in commerce as well as lawyers and judges applying the law.

* Partner, Bose McKinney & Evans LLP, Indianapolis. B.A., 1973, Macalester College; M.A., 1978, Bryn Mawr College; J.D., 1987, Indiana University School of Law—Indianapolis.

1. Indiana’s version of the UCC is enacted at IND. CODE § 26-1-1-101 (1998).

2. *See HCC Credit Corp. v. Springs Valley Bank & Trust Co.*, 712 N.E.2d 952 (Ind. 1999).

3. *See id.* at 954.

4. *See Cole v. Loman & Gray, Inc.*, 713 N.E.2d 901 (Ind. Ct. App. 1999); *Alani v. Monroe County Bank*, 712 N.E.2d 19 (Ind. Ct. App. 1999), *reh’g denied*, No. 53A05-9904-CV-154, 1999 Ind. LEXIS 844 (Ind. Ct. App. Sept. 21, 1999).

5. *See Rheem Mfg. Co. v. Phelps Heating & Air Conditioning, Inc.*, 714 N.E.2d 1218 (Ind. Ct. App. 1999), *trans. granted*, No. 49A02-9807-CV-620, 2000 Ind. LEXIS 288 (Ind. Mar. 23, 2000); *Frantz v. Cantrell*, 711 N.E.2d 856 (Ind. Ct. App. 1999); *Town and Country Ford, Inc. v. Busch*, 709 N.E.2d 1030 (Ind. Ct. App. 1999).

6. *See Best Distrib. Co. v. Seyfert Foods, Inc.*, 714 N.E.2d 1196 (Ind. Ct. App. 1999), *trans. granted*, No. 49A04-9802-CV-98, 2000 Ind. LEXIS 286 (Ind. Mar. 23, 2000).

7. *See id.*

8. *See Mynsberge v. Department of State Revenue*, 716 N.E.2d 629 (Ind. Tax 1999); *W.H. Paige & Co. v. State Bd. of Tax Com’rs*, 711 N.E.2d 552 (Ind. Tax), *trans. denied*, 726 N.E.2d 312 (Ind. 1999); *Tri-States Double Cola Bottling Co. v. Department of State Revenue*, 706 N.E.2d 282, 285 (Ind. Tax 1999).

I. USE OF THE OFFICIAL COMMENTS TO THE UNIFORM COMMERCIAL CODE
IN STATUTORY CONSTRUCTION AND INTERPRETATION IN INDIANA

In *HCC Credit Corp. v. Springs Valley Bank & Trust*,⁹ the Indiana Supreme Court noted that in adopting the 1972 version of Article 9 of the UCC, the Indiana legislature did not adopt the official comments of the National Conference of Commissioners on Uniform State Laws as authoritative in Indiana.¹⁰ However, Indiana courts and practitioners have often looked to the official comments to the UCC for guidance in interpreting and applying Indiana's version of the UCC.¹¹ Although many states adopted the official comments as part of their statutory enactments of the UCC, Indiana did not.¹² This situation can be contrasted with, for example, the official comments to the Business Corporation Law which "may be consulted by the courts to determine the underlying reasons, purposes, and policies of [the BCL] and may be used as a guide in its construction and application."¹³ The decision not to adopt the official comments to the UCC is similar to the decision by the legislature not to adopt the official comments to other uniform laws.¹⁴ In *HCC*, the court nevertheless looked to the language of the official comments for guidance in applying the statute, noting that comment 2(c) to Indiana Code section 26-1-9-306 "is an exception to the Indiana U.C.C.'s general priority rules."¹⁵

On a related note, the Indiana Tax Court commented in *Tri-States Double Cola Bottling Co. v. Department of State Revenue*,¹⁶ that it may look to Indiana's version of UCC Article 2A in interpreting tax laws and determining the meaning of a lease.¹⁷ Taking a similar approach, in *W. H. Paige & Co. v. State Board of Tax Commissioners*,¹⁸ the tax court looked to Articles 2 and 9 of the UCC in considering whether a transaction creates a lease or a security agreement. However, the tax court held that regardless of how a transaction would be treated under the UCC, it "is only looking to the law of security interests for guidance in this area," and that the UCC is not dispositive in issues involving taxation.¹⁹

9. 712 N.E.2d 952 (Ind. 1999).

10. *See id.* at 954.

11. *See id.* at 954, 958 n.1

12. *See* Pub. L. 152-1986.

13. *HCC*, 712 N.E.2d at 955 n.1 (quoting IND. CODE § 23-1-17-5 (1998)).

14. *See id.* (quoting *Benham v. State*, 637 N.E.2d 133, 136 n.3 (Ind. 1994) (commenting on Indiana Penal Code not being a guide for courts because there was no evidence "that it was not adopted or even considered by the legislature")).

15. *Id.* at 954.

16. 706 N.E.2d 282 (Ind. Tax 1999).

17. *See id.* at 285; *see also* *Monarch Beverage Co. v. Department of State Revenue*, 589 N.E.2d 1209, 1212 (Ind. Tax. 1992) (tax court may look to "law of sales for assistance in interpreting tax laws that relate to the sale of goods").

18. 711 N.E.2d 552, 556 (Ind. Tax), *trans. denied*, 726 N.E.2d 312 (Ind. 1999).

19. *Id.* at 560 (emphasis added).

Similarly, in *Mynsberge v. Department of State Revenue*,²⁰ the tax court noted that its conclusion that electricity should not be treated as tangible personal property under the tax laws, may be viewed as being in “tension” with the treatment of electricity as goods under the UCC.²¹ The tax court concluded that “[t]his is not problematic” because the legislature may treat electricity differently under the tax laws and the UCC.²² “Undoubtedly, the UCC is an important body of law; however, in the area of taxation, it gives helpful guidance, not iron-clad orders.”²³

II. ARTICLE 9—SECURED TRANSACTIONS

A. *Competing Interests in Proceeds from Collateral Between a Secured Party and Other Creditors*

In *HCC Credit Corp. v. Springs Valley Bank & Trust*,²⁴ the Indiana Supreme Court addressed the respective rights of a secured party and another creditor when the debtor used proceeds from the collateral of the secured party to voluntarily pay the debt of the other creditor.²⁵ In this case, there was no dispute that the secured party, HCC, had a valid and perfected security interest in proceeds from the sale of the debtor’s tractors.²⁶ After the sale of the tractors, the debtor deposited the proceeds in its general checking account at the bank and then wrote a check to the bank to pay off the debtor’s bank loans, some of which were not yet due.²⁷ The bank did not compel the debtor to make the payment, did not seize or set off against the account, and did not discuss paying off the notes with the debtor before payment was made.²⁸ The debtor did not inform the bank that the source of funds was the sale of tractors in which HCC had a security interest.²⁹ The debtor filed a bankruptcy liquidation proceeding several months after the payment to the bank.³⁰

In weighing the competing interests of the secured creditor and the bank, the court noted there are sound commercial policy considerations in favor of each position.³¹ The secured party should be able to rely on its compliance with the UCC requirements for perfecting a security interest and not run the risk that its

20. 716 N.E.2d 629 (Ind. Tax 1999).

21. *Id.* at 637 n.13.

22. *Id.* at 638.

23. *Id.*

24. 712 N.E.2d 952 (Ind. 1999).

25. *See id.* at 955. UCC § 9-306 deals with a secured party’s rights to proceeds from disposition of the collateral. *See* IND. CODE § 26-1-9-306 (1998).

26. *See HCC*, 712 N.E.2d at 953.

27. *See id.* at 953-54.

28. *See id.*

29. *See id.*

30. *See id.*

31. *See id.* at 955.

interest will be trumped by the unrecorded interest of a bank exercising a right to set off against the debtor's bank account.³² Allowing the bank to take priority over a secured creditor "undercuts significant values of certainty, efficiency, and reliance which are at the heart of the [UCC's] emphasis on public filing."³³

On the other hand, sound policy reasons favor allowing third party transferees (including banks) who receive proceeds of another's collateral in the ordinary course of business to retain such payments.³⁴ The payment to the bank in this case was arguably made in the ordinary course of the debtor's business and was not a payment forced by the bank or a setoff by the bank against the debtor's checking account.³⁵ Imposing liability "too readily" or defining ordinary course of business "too narrowly" could impose substantial burdens on those who do business with a debtor to return payments for routine or ordinary transactions to the secured party.³⁶ The negative impact such a rule of law would have on commerce is obvious.

Strong policy considerations support both positions: "[R]educing the burden on perfected [security interests]" on the one hand, and "reducing the burden on ordinary course payees" on the other.³⁷ The goal of the Uniform Commercial Code is to streamline and reduce legal impediments to commerce and to make the legal implications of commercial transactions predictable and consistent.³⁸ In trying to reconcile both policy considerations, the supreme court reaffirmed that the "security interest continues in any identifiable proceeds of collateral including collections received by the debtor," and that "Comment 2(c) [to UCC § 9-306] is the law of Indiana: a recipient of a payment made 'in the ordinary course' by a debtor takes that payment free and clear of any claim that a secured party may have in the payment as proceeds."³⁹

The key to reconciling the two positions is determining when a payment is made in the ordinary course of a debtor's business.⁴⁰ The court held that two factors must be assessed: "(1) the extent to which the payment was made in the routine operation of the debtor's business and (2) the extent to which the recipient was aware that it was acting to the prejudice of the secured party."⁴¹ In applying these two factors to the facts in *HCC*, the court commented on the holding in the *J. I. Case Credit Corp. v. First National Bank*,⁴² noting its general

32. *See id.*

33. *Id.* (quoting *Citizens Nat'l Bank v. Mid-States Dev. Co.*, 380 N.E.2d 1243, 1250 (Ind. Ct. App. 1978)).

34. *See id.* at 956.

35. *See id.*

36. *Id.* (quoting *Harley-Davidson Motor Co. v. Bank of New England-Old Colony, N.A.*, 897 F.2d 611, 622 (1st Cir. 1990)).

37. *Id.*

38. *See id.* at 957.

39. *Id.* at 958 (quoting U.C.C. § 9-306 cmt. 2 (1977)).

40. *See id.*

41. *Id.*

42. 991 F.2d 1272 (7th Cir. 1993).

agreement with the analysis of the Seventh Circuit Court of Appeals.⁴³ However, the court declined to follow *J. I. Case Credit Corp.* for the reason that the Seventh Circuit focused almost exclusively on the awareness of prejudice factor and did not examine the routine operation of the debtor's business factor.⁴⁴ The court added that it did not intend to "impede the free flow of goods and services essential to business,"⁴⁵ and thus further held that a "transfer will be free of any claim that a secured party may have in it as proceeds unless the payment would constitute a windfall to the recipient."⁴⁶ Thus, a third factor, whether the transfer creates a windfall for the recipient, must also be examined.⁴⁷

The court offers helpful guidance for evaluating all three parameters. For example, as to the first factor, the court suggests that payment of sales tax collections or FICA withholdings would be at the routine and ordinary course of business continuum, while payment of subordinated debt that was not yet due would be at the extraordinary, non-routine end of the continuum.⁴⁸ Along that continuum, courts and practitioners may consider the size and frequency of payments; to what extent the payments are routine to the debtor or the transferee or both; whether the debtor received goods or services for the payments; whether any payment was for an obligation that was then due, overdue or not yet due; and other facts specific to the transaction.⁴⁹

The second factor, the extent to which the recipient of the payment was aware of prejudice to the secured party, can also be viewed on a spectrum, ranging from no knowledge to actual fraud and collusion with the debtor in avoiding the obligation to the secured party.⁵⁰ In the central ranges of that spectrum will lie the cases where the transferee is aware that a security interest exists but does not know that the payment derives from the collateral of the secured party to those cases where the transferee has reason to know or even a "strong suspicion" that the payment derives from the collateral.⁵¹ The case where the transferee takes deliberate steps to keep from learning the source of the payment will obviously place the transfer at the far range of the knowledge of prejudice spectrum.⁵² Furthermore, the court suggested that the relationship between the debtor and the transferee may raise a presumption that the transferee is aware of prejudice to the secured party.⁵³ Similarly where the transferee has agreed to be subordinated to the secured party, knowledge of prejudice may

43. See *HCC*, 712 N.E.2d at 958.

44. See *id.*

45. *Id.* (quoting *J.I. Case Credit Corp.*, 991 F.2d at 1277).

46. *Id.*

47. See *id.*

48. See *id.* at 957.

49. See *id.*

50. See *id.*

51. *Id.* at 957-58.

52. See *id.* at 958.

53. See *id.*

generally be presumed.⁵⁴ Whether the transfer creates a windfall for the recipient will depend on the parties' reasonable expectations for payment, including both the amount and timing of payment vis-a-vis other creditors.⁵⁵

The determination as to whether a transfer was made in the ordinary course of the debtor's business is a question of law; however, determination of the routine operation of business, knowledge of prejudice and windfall factors requires factual analysis.⁵⁶ In practice, this issue will usually present mixed questions of fact and law. Applying the three factors to the facts in *HCC*, the court concluded that the payment to the bank was not made in the ordinary course of the debtor's business based on the following undisputed facts: (1) the bank knew that HCC had a valid and perfected security interest in the tractors; (2) the bank knew of this security interest when it extended credit to the debtor; (3) the debtor had refinanced with the bank more than 100 times, with the average debt balance owed being between \$100,000 and \$200,000; (4) after the payment to the bank, the debtor was in the unprecedented position of owing the bank only about \$2000 to \$15,000; (5) a substantial portion of the debt paid off was not yet due to the bank; and (6) the bank's senior loan officer recognized the payment as being "extraordinary" and the largest payment ever made to the bank by the debtor.⁵⁷ The court further concluded based on these facts that the bank would receive a windfall, if it were allowed to retain the payment because the bank had no reasonable expectation of being paid in advance of HCC or at the expense of HCC.⁵⁸ The grant of summary judgment for the bank was reversed and the case remanded for entry of summary judgment in favor of HCC.⁵⁹

B. Impairment of Collateral by the Secured Party

In *Cole v. Loman & Gray, Inc.*,⁶⁰ the appellate court held that failure to perfect a security interest in the collateral for a debt impaired the collateral and entitled the guarantors of the debt to be discharged on a *pro tanto* basis to the extent of the impairment.⁶¹ Failure to perfect a security interest in the collateral is an impairment because it makes the collateral unavailable to the surety, particularly in a case such as this where the debtor has filed a bankruptcy petition. In *Cole*, the court found that the failure to perfect a security interest in the collateral impaired the collateral and entitled the guarantors to be released from their guaranty despite the fact that the creditor had instructed its attorney

54. *See id.*

55. *Id.* at 959.

56. *See id.* at 958.

57. *See id.* at 959.

58. *See id.*

59. *See id.*

60. 713 N.E.2d 901 (Ind. Ct. App. 1999), *reh'g denied*, No. 53A05-9904-CV-154, 1999 Ind. LEXIS 844 (Ind. Ct. App. Sept. 21, 1999).

61. *See id.* at 904-05.

several times to perfect the security interest.⁶² The creditor was bound by the actions or inactions of its attorney agent.⁶³ The court affirmed that an unconditional guaranty is not a waiver of the impairment of collateral defense, and noted that neither the note nor the security agreement contained a waiver or consent provision with respect to impairment of the collateral.⁶⁴ Presumably, inclusion of such provisions in one or both of these documents would have led to a different result.

The *Cole* court did not adopt the theory of *strictissimi juris* to release the guarantor from any liability for the debt,⁶⁵ but released the guarantor only to the extent that the value of the collateral had been impaired.⁶⁶ The court remanded the case to the trial court to determine the value of the collateral at the time of contracting and the amount of the impairment.⁶⁷

In *Alani v. Monroe County Bank*,⁶⁸ a second case dealing with the impairment of collateral by the creditor, the court of appeals held that the guarantor was not discharged despite the bank's failure to record a mortgage securing the debt.⁶⁹ In *Alani*, the bank attempted to record a deed and mortgage on the day after it made a loan to the debtor.⁷⁰ The county auditor refused to transfer the deed on two occasions and erroneously informed the bank that county planning department approval was necessary for transfer of the property.⁷¹ By the time the planning department determined such approval was not necessary and the deed and mortgage were recorded, the debtor had filed for bankruptcy relief.⁷² The property was eventually sold, but the bank sought to recover the shortfall from the guarantor.⁷³

The court focused on whether the collateral securing the debt had been *unreasonably* impaired by the creditor bank and whether the bank's failure to record the mortgage separately, when the auditor refused to transfer the deed, was unjustified.⁷⁴ The court looked to prior case law and Indiana Code section 26-1-3-606 which provides that "[W]hen a creditor releases or negligently fails to protect security put in his possession by the principal debtor, the surety is

62. See *id.* at 904.

63. See *id.*

64. See *id.* at 904 n.2 (citing *Farmers Loan & Trust Co. v. Letsinger*, 652 N.E.2d 63, 67 n.3 (Ind. 1995)).

65. Under the doctrine of *strictissimi juris*, "a surety is completely discharged of any liability under the promissory note where the collateral was impaired whether or not the surety has sustained loss of prejudice as a result of the impairment." *Id.* at 905.

66. See *id.*

67. See *id.*

68. 712 N.E.2d 19 (Ind. Ct. App. 1999).

69. See *id.* at 22.

70. See *id.* at 20.

71. See *id.*

72. See *id.*

73. See *id.*

74. See *id.*

released to the extent of the value of the security so impaired.”⁷⁵

The results in *Cole* and *Alani* are consistent, because in both cases the court focused on whether the creditor (or its agent) was negligent or acted reasonably in failing to perfect a security interest in the collateral. Both cases allow for discharge of the guarantor only when the failure to perfect is unreasonable and only to the extent the collateral is actually impaired.

III. ARTICLE 2—LIMITATION OF WARRANTIES AND REMEDIES

Three 1999 Indiana Court of Appeals decisions addressed warranties under Article 2 of the UCC.⁷⁶ In *Frantz v. Cantrell*,⁷⁷ the court provides a concise summary of the basic elements of a cause of action for breach of the implied warranty of merchantability.⁷⁸ Although this case does not change existing Indiana law, it provides a simple road map for a cause of action of breach of the implied warranty of merchantability.

In *Frantz*, a homeowner brought an action against a roofer for breaching the implied warranty of merchantability under Indiana Code section 26-1-2-314(1) with respect to defective roof shingles used in installing a new roof.⁷⁹ The shingles had no apparent defects and after the roof was installed, Cantrell was satisfied for several months.⁸⁰ However, after the onset of winter, Cantrell noticed the shingles were curling at the edges and the tabs of the shingles were not properly sealed. A representative of Frantz inspected the roof and determined the shingle manufacturer should be contacted.⁸¹ The manufacturer reported that the curling of the edges of the shingles would correct itself when the weather turned warmer, but did not address the issue concerning the sealing of the shingle tabs.⁸² When the curling problem did not correct itself by the time the weather grew warmer, Cantrell tried again to get Frantz to correct the problems.⁸³

In Indiana, the implied warranty of merchantability applies to all goods sold

75. *Id.* at 23 (quoting *White v. Household Fin. Corp.*, 302 N.E.2d 828, 833 (1973)).

76. In addition, in *Town and Country Ford Inc. v. Bush*, the court of appeals affirmed without comment or discussion that “[i]t is well-settled that a dealer of used automobiles may disclaim implied warranties through the use of conspicuous language containing expressions like “as is” or “with all faults” or other language which in common understanding call the buyer’s attention to the exclusion of warranties and makes plain that there is no implied warranty.” 709 N.E.2d 1030, 1033 (Ind. Ct. App. 1999) (citing IND. CODE § 26-1-2-316 (1998); *DeVoe Chevrolet-Cadillac Inc. v. Cartwright*, 526 N.E.2d 1237, 1240 (Ind. Ct. App. 1988)).

77. 711 N.E.2d 856 (Ind. Ct. App. 1999).

78. *See id.* at 858.

79. *See id.*

80. *See id.*

81. *See id.*

82. *See id.*

83. *See id.*

by a merchant, unless it has been expressly disclaimed or limited.⁸⁴ The warranty arises by operation of law for the protection of the buyer and is strictly construed against the seller.⁸⁵ There is no special relationship between a seller and a manufacturer required for the imposition of the warranty.⁸⁶ While the implied warranty of merchantability may be modified by trade practices or uses, such modifications apply only when both the buyer and seller are merchants in the trade or industry specific to the goods at issue, or when both buyer and seller are otherwise aware of the trade or industry-specific modifications to the implied warranty.⁸⁷ In this case, the implied warranty of merchantability, applied without trade limitations or modifications.⁸⁸

Here, the court found that shingles that curl at the edges and do not seal are defective and do not meet the minimum standards required by the implied warranty of merchantability.⁸⁹ Under Indiana Code section 26-1-2-314(2), “merchantable” goods must pass without objection in the trade, be of fair and average quality, and be fit for the ordinary purposes for which such goods are used.⁹⁰ The roof was defective because it did not have a flat, smooth appearance, and it had great potential for failing after only a short time.⁹¹ As such, the shingles did not “conform to ordinary standards and . . . [were not] of the same average grade, quality, and value as similar goods sold under similar circumstances.”⁹² Having determined (1) that the sale was the type of sale in which the implied warranty of merchantability arose, and had not been limited or modified by the parties, and

84. See IND. CODE § 26-1-2-314(1) (1998).

85. See *Frantz*, 711 N.E.2d at 859.

86. See *id.*

87. See *id.*

88. See *id.*

89. See *id.* at 860.

90. Indiana Code section 26-1-2-314(2) provides:

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

IND. CODE § 26-1-2-314(2) (1998).

91. See *Frantz*, 711 N.E.2d at 860.

92. *Id.* (quoting *Jones v. Abriani*, 350 N.E.2d 635, 645 (Ind. Ct. App. 1976)).

(2) that breach of the warranty was the proximate cause of the buyer's damages, the court looked to Indiana Code section 26-1-2-714(1) to determine the amount of damages.⁹³ The evidence showed that the only way to correct the defects in the shingles was to remove them and install a new roof.⁹⁴ Thus, the award of damages by the trial court was affirmed.⁹⁵

Rheem Manufacturing Co. v. Phelps Heating & Air Conditioning, Inc.,⁹⁶ discusses the provisions of UCC § 2-719 with respect to limitations or exclusions of remedies. In this case, Phelps installed Rheem gas furnaces in residences.⁹⁷ Phelps obtained the furnaces from an authorized distributor of the furnaces.⁹⁸ All of the Rheem furnaces were sold with a limited warranty excluding consequential and incidental damages and providing for limited replacement parts and an exclusion of labor costs.⁹⁹ The agreement between Rheem and its distributor provided that the distributor was an independent contractor and not an agent of Rheem.¹⁰⁰

Under the UCC, parties are generally free to shape their remedies for breach and to exclude or limit remedies and warranties.¹⁰¹ However, at least minimum adequate remedies must be provided for breach.¹⁰² Under the UCC, where circumstances cause a contract term providing for a limited or exclusive remedy to fail of its essential purpose or to operate in a manner to deprive either party of the substantial value of the bargain, the contract provision may be set aside and a remedy supplied by the court.¹⁰³ Similarly, a limited or exclusive remedy that is unconscionable or deprives a party of a fair remedy for breach by the other party may be stricken.¹⁰⁴ Section 3 of UCC § 2-719 expressly provides that parties may limit or exclude their responsibility for consequential damages except in cases involving personal injury or where it would be unconscionable to do so.¹⁰⁵

Courts of various jurisdictions do not agree on whether consequential damages may be recovered when a limited warranty provision fails its essential

93. See *id.* at 860-61. The Indiana Code section 26-1-2-714(1) provides: "Where the buyer has accepted goods and given notification . . . he may recover as damages for any nonconformity of tender the loss resulting in the ordinary course of events from seller's breach as determined in any manner which is reasonable." IND. CODE § 26-1-2-714(i).

94. See *Franz*, 711 N.E.2d at 861.

95. See *id.*

96. 714 N.E.2d 1218 (Ind. Ct. App. 1999).

97. See *id.* at 1219-20.

98. See *id.* at 1220.

99. See *id.*

100. See *id.*

101. See IND. CODE § 26-1-2-719 (1998).

102. See *id.* § 26-1-2-719(2).

103. *Id.* "Where circumstances cause an exclusive or limited remedy to fail of its essential purpose, remedy may be had as provided in I.C. 26-1." *Id.*

104. See IND. CODE § 26-1-2-719(2) cmt. 1 (1986).

105. See *id.* § 26-1-2-719(3) (1998).

purpose and a separate contractual provision excludes consequential damages.¹⁰⁶ Indiana courts have not previously addressed this question.¹⁰⁷

The “independent” view treats sections 26-1-2-713(2) and 26-1-2-713(3) of the Indiana Code as separate and distinct, and has been followed by the majority of jurisdictions.¹⁰⁸ Under this view, a separate provision restricting or precluding consequential damages is enforceable even when other provisions of the contract limiting or excluding certain remedies are not enforceable and the remedy must be supplied by the court.¹⁰⁹

The other view, variously termed the “dependent” or “interdependent” view, treats a limitation on consequential damages as “dependent upon the availability of a limited remedy clause in the same agreement.”¹¹⁰ Courts following this approach look first to determine whether a limited remedy under section 26-1-2-719(2) of the Indiana Code has failed of its essential purpose, and, if so, then any other provision excluding consequential damages is deemed automatically void.¹¹¹

After parsing the logic of both approaches, the *Rheem* court concludes that the majority “independent” approach is more consistent “with Indiana jurisprudence and the purposes of the UCC.”¹¹² In particular, the court noted that sections 2 and 3 of Indiana Code section 26-1-2-719 are tested by different standards: “a limited remedy [is tested] by failure of essential purpose, and an exclusion [is tested] by unconscionability,” and concluded that the two sections of the code “were intended to be read independently of one another.”¹¹³ The *Rheem* court agrees with the reasoning of the United States Court of Appeals for the Third Circuit that the failure of a limited remedy provision in a contract is not alone sufficient to invalidate a separate and distinct term of the contract excluding consequential damages.¹¹⁴

However, the court noted that the cumulative effect of various provisions of a contract may lead to an inequitable result.¹¹⁵ Thus, although the failure of a limited warranty or remedy provision will not automatically invalidate a separate exclusion of consequential damages, the presence of other factors or the

106. See *Rheem Mfg. Co. v. Phelps Heating & Air Conditioning, Inc.*, 714 N.E.2d 1218, 1223 (Ind. Ct. App. 1999), *trans. granted*, No. 49A02-9807-CV-620, 2000 Ind. LEXIS 288 (Ind. Mar. 23, 2000).

107. See *id.*

108. *Id.* at 1223-24.

109. See *id.* at 1224 (citing *Middletown Concrete Prods., Inc. v. Black Clawson Co.*, 802 F. Supp. 1135, 1152 (D. Del. 1992)).

110. *Id.*

111. See *id.*

112. *Id.* at 1227.

113. *Id.*

114. See *id.* (citing *Chatlos Sys., Inc. v. National Cash Register Corp.*, 635 F.2d 1081, 1086 (3d Cir. 1980); accord *Smith v. Navistar Int'l Transp. Corp.*, 957 F.2d 1439, 1443 (7th Cir. 1992)).

115. See *id.* at 1228.

cumulative effect of limitations and exclusions in a contract may.¹¹⁶ Beyond the specific facts here, the court offers no guidance as to what other factors or how great a cumulative effect among the contract's provisions will result in invalidating an exclusion of consequential damages.

In *Rheem*, the court also concluded that lack of "perfect vertical privity" between the manufacturer and a remote buyer of the goods does not preclude the extension of the manufacturer's warranties to the remote buyer.¹¹⁷

IV. ARTICLE 2—REASONABLE NOTICE FOR TERMINATION OF CONTRACT

In *Best Distributing Co. v. Seyfert Foods, Inc.*,¹¹⁸ the Indiana Court of Appeals addressed what is a reasonable time for notice of termination of a contract terminable at will and questions concerning the good faith duty to perform a contract governed by the UCC. When a contract contains no specific time for termination of the agreement, Indiana law permits either party to terminate the contract at will.¹¹⁹ There can be no action for breach of a contract that is terminable at will.¹²⁰ However, in contracts for the sale of goods governed by Article 2 of the UCC, the code requires that reasonable notice be given for termination of any contract lacking a specific term or time for termination.¹²¹ Furthermore, any agreement between the parties to dispense with notification is deemed invalid if its operational effect would be unconscionable.¹²² Official Comment 8 to UCC § 2-309(3) suggests that "principles of good faith and sound commercial practice" generally require a reasonable time for the other party to seek a substitute arrangement.¹²³ What is a "reasonable time" depends on the nature of the transaction and factors such as "the nature, purpose circumstances" of the action at issue.¹²⁴

Several previous cases applying Indiana law have held that thirty days was a reasonable time for notice of termination under Indiana Code section 26-1-2-309(3).¹²⁵ In *Best*, the distributor argued that the thirty day notice of termination

116. *See id.*

117. *Id.* at 1231.

118. 714 N.E.2d 1196 (Ind. Ct. App. 1999).

119. *See Monon R.R. v. New York Cent. R. Co.*, 227 N.E.2d 450, 457 (Ind. Ct. App. 1967).

120. *See House of Crane, Inc. v. H. Fendrich, Inc.*, 256 N.E.2d 578, 579 (Ind. Ct. App. 1970).

121. *See* IND. CODE § 26-1-2-309(3) (1998).

122. *See id.*

123. U.C.C. § 2-309(3) cmt. 8 (1977).

124. IND. CODE § 26-1-1-204(2).

125. *See, e.g., Monarch Bev. Co. v. Tyfield Importers, Inc.*, 823 F.2d 1187, 1189 (7th Cir. 1987) (holding in an oral agreement terminable at will, with or without cause, by either party, a letter terminating the agreement "immediately" was unreasonable, but 30-days' notice was deemed reasonable); *Communications Maintenance, Inc. v. Motorola, Inc.*, 761 F.2d 1202, 1209-10 (7th Cir. 1985) (finding a contract requiring 30-day notice of termination was reasonable and not unconscionable); *Rockwell Engineering Co. v. Automatic Timing & Controls, Co.*, 559 F.2d 460, 461 (7th Cir. 1977) (holding that where the written contract between parties which required a 30-

of the distributorship agreement was not reasonable because it had been unable to find a substitute arrangement that was as profitable as the arrangement being terminated.¹²⁶ The court rejected the argument that Best had been given unreasonable notice of the termination and its argument that “a ‘reasonable time’ means an indefinite period of time for Best to find an equally financial lucrative substitute.”¹²⁷ The court concluded that “[b]ecause Best found a substitute agreement, Seyfert’s thirty day notice was reasonable.”¹²⁸ The court also held that under Indiana Code section 26-1-2-309 and section 26-1-2-204(2) Seyfert’s thirty-day notice of termination of the contract with Best was reasonable because it provided Best with adequate time to find a substitute supplier.¹²⁹ The test was not whether Best was able to find a substitute that was at least as lucrative as the contract with Seyfert, but whether Best was able to find a substitute agreement.¹³⁰

V. IMPLIED DUTY OF GOOD FAITH IN CONTRACTS UNDER THE UCC

The Indiana Court of Appeals again addressed the question of whether there is a duty of good faith and fair dealing that can form the basis for an independent action in Indiana. In *Best*, the court held that there is no fiduciary relationship as a matter of law between a distributor and distributee, and reaffirmed the holdings in prior Indiana cases that the existence of a fiduciary or confidential relationship between the parties is a question of fact where one party reposes confidence in the other as a result of inequality in bargaining power, dependence, weakness, or lack of knowledge.¹³¹ “However, when the parties involved are in an arm’s length, contractual arrangement, the requisite fiduciary relationship may not be predicated on such an arrangement.”¹³² The court recognized that the UCC (Indiana Code section 26-1-1-203) “imposes an obligation of good faith in . . . performance or enforcement” of every contractual duty, but noted that the official comment to section 1-203 states that this duty does not support an independent cause of action.¹³³ Failure to act in good faith may constitute a breach of the agreement or make a remedial right or power unavailable, but “does not create a separate duty of fairness and reasonableness which can be independently breached.”¹³⁴

In his separate opinion, Judge Sullivan disagreed and noted that Best had

day notice of termination was terminated, but the parties continued to do business under an oral agreement, a 30-day notice of termination of the oral agreement was reasonable).

126. See *Best Distrib. Co. v. Seyfert Foods, Inc.*, 714 N.E.2d 1196, 1207 (Ind. Ct. App. 1999).

127. *Id.*

128. *Id.* (citing *Monarch*, 823 F.2d at 1190).

129. See *id.*

130. See *id.*

131. See *id.* at 1204.

132. *Id.*

133. *Id.* at 1205.

134. *Id.*

alleged a breach of contract claim against Seyfert.¹³⁵ Judge Sullivan therefore would not have affirmed the entry of partial summary judgment for Seyfert, but would have remanded for trial the factual determination as to whether Seyfert's alleged bad faith conduct was a breach.¹³⁶ As noted in Judge Sullivan's separate opinion, concurring in part and dissenting in part, the majority did not address Best's counterclaim alleging several activities in breach of the duty to act in good faith under Indiana Code section 26-1-1-203 and the "reasonable commercial standards of fair dealing in the trade" under Indiana Code section 26-1-2-104 applicable to merchants such as Seyfert.¹³⁷ The court held "that under the Indiana U.C.C. there is no claim for breach of a duty to deal in good faith independent from a breach of contract."¹³⁸

Indiana Code section 26-1-2-103 defines "good faith" among merchants as "honesty in fact and observance of reasonable commercial standards of fair dealing in the trade." The *Best* court does not discuss this definition. Plaintiffs and counter claimants must take heed to plead a breach of the contract, and to include any allegation of a breach of the duty of good faith under Indiana Code section 26-1-1-203 as a part of a claim of breach of the agreement and not as a separate count or independent claim of breach.¹³⁹

135. See *id.* at 1208 (Sullivan, J., concurring in part and dissenting in part).

136. See *id.*

137. *Id.*

138. *Id.* at 1206.

139. See *id.*