



# Warranty Dispute Litigation

## Five Critical Issues

By John R. Trentacosta and Nicholas J. Ellis

Products sold in the marketplace are becoming more complex. Automobiles, for example, have “more computing power than the system that guided the Apollo astronauts to the moon.”<sup>1</sup> Contracts for the sale of goods are governed by a model statutory framework known as the Uniform Commercial Code (UCC). Among the most important considerations for any sale of goods—and, by extension, any dispute concerning the sale—are the warranties that apply to the goods. Warranties can be express or implied. Express warranties are promises that a seller makes to a buyer concerning the goods.<sup>2</sup> Implied warranties arise as a matter of law.<sup>3</sup> Two of the most well-known warranties are the implied warranty of merchantability and the implied warranty of fitness for a particular purpose, set forth in the UCC.<sup>4</sup>

Despite the important role that warranties play in most disputes involving the sale of goods, many issues related to the impact and application of warranties often are misunderstood or overlooked. This article examines five such issues that attorneys and businesses (both buyers and sellers) should consider

### Fast Facts:

For any dispute involving the sale of goods, the most important focus should be on the warranties that apply to the goods. Despite this important role, many issues related to the impact and application of warranties often are misunderstood or overlooked.

Attorneys litigating a breach of warranty claim must review the specific warranties and, often more importantly, the contractual limitations on the warranties and remedies in the contract.

when drafting warranties that will apply to a sale of a complex product in the marketplace.

### Warranty for an extended period: What constitutes the breach and when must it occur?

One of the first issues that must be addressed in any warranty dispute is whether a breach has occurred. To determine whether a breach has occurred, it often is necessary to consider the period for which the warranty applies. Some warranties apply to a product only at time of delivery. Others apply for an extended period. For example, a seller might offer a warranty for an extended period by warranting that a product will be “free from defects for two years.” What if a product fails after the warranty period has expired, but the defect was present, though latent, during the warranty period? In such cases, many sellers will argue that because the warranty period has expired, the warranty has not been breached. This is an overly simplistic view.

To determine whether a breach has occurred, the parties must consider the terms of the warranty at issue and what constitutes the breach. If a seller warranted that the product will “perform” or “last” for a specified period, it may be valid to argue that no breach has occurred as long as the product continued to function until the end of that period.<sup>5</sup> However, if a seller warranted that the product “will be free from defects” for a specified period, the breach of the warranty occurs at the time the defect is present, even if the defect does not manifest in a failure until after the specified warranty period.<sup>6</sup>

Both buyers and sellers must consider the language of the express warranties in their contracts, particularly when the warranty extends late into the future. Are you warranting only performance for a stated period, or is the warranty broader in nature?

### Statute of limitations in cases of repeat purchases over extended periods

Assuming that a breach of warranty exists and the breach occurs within the warranty period, the parties must determine whether the statute of limitations has expired. The UCC provides for a statute of limitations that, unless modified by the

parties, requires any claim for breach of warranty to be brought within four years after the claim accrues.<sup>7</sup> Depending on when a particular claim accrues and the length of the warranty period, it is possible in some cases that a claim may be warranty eligible but still fall outside the statute of limitations.

When the claim accrues depends on whether the warranty extends to future performance. If a warranty explicitly extends to future performance of the goods and discovery of the breach must await the time of performance, the cause of action accrues when the breach “is or should have been discovered.”<sup>8</sup> If not, the breach occurs and the statute of limitations begins to run when tender of delivery is made, regardless of the buyer’s knowledge of the breach.<sup>9</sup>

Seemingly simple at first blush, applying the rule is not always straightforward. Consider a situation in which a buyer purchases thousands of parts over a period of years, but certain parts fail before the warranty period expires. The parties determine that the root cause is a systemic design or manufacturing defect. Assuming that the defect is a breach of the warranty, when does the buyer’s claim accrue such that the statute of limitations begins to run? Is there a single claim that accrues or does the period run separately for each individual part?

Caselaw addressing this scenario is limited. However, under Michigan jurisprudence, there is a single breach of the warranty and the statute of limitations begins to run at the time the existence of the systemic defect is discovered. Under Michigan law, a cause of action for breach accrues only once—when the buyer discovers or should have discovered the breach.<sup>10</sup> In the circumstance previously described involving a future warranty, the claim for breach accrues when the buyer becomes aware (or should have been aware) that there is an inherent defect in the parts causing them to fail.<sup>11</sup>

### Implied warranty of fitness under the UCC versus express warranties

In a warranty dispute, one of the most frequently invoked implied warranties under the UCC is the warranty of fitness for a particular purpose. The warranty of fitness for a particular purpose will be implied by law if, at the time of contracting, a seller has reason to know (1) the purpose for which the goods are required and (2) that the buyer is relying on the seller’s skill or judgment to select or furnish suitable goods.<sup>12</sup>

In addition to the implied warranty under the UCC, many contracts contain an express warranty that goods will be fit for the buyer's intended purpose. Such contracts often include express language acknowledging that the seller is aware of the buyer's intended use. Although Michigan courts have not addressed the issue directly, ignorance of a buyer's purpose is unlikely to save a seller from an express warranty that goods will be fit for the buyer's intended purpose. Michigan law holds parties responsible for understanding the contents of the contract.<sup>13</sup> A party that agrees to a contract warranting that goods will be fit for a particular purpose, without actually making inquiry, will not be allowed to argue that it lacked sufficient knowledge.<sup>14</sup> Accordingly, any seller that is asked to provide an express warranty that goods will be fit for a particular purpose should ensure that (1) it has received sufficient information regarding the buyer's purpose and (2) that the goods are, in fact, fit for the use disclosed by the buyer.

### Limitation of remedies versus limitation of damages

Under the UCC, parties may contract to limit both their available remedies and damages that result from the breach.<sup>15</sup> The classic example of a limitation of remedies is an agreement that, if a product is defective, the seller will repair or replace the product.<sup>16</sup> A limitation on damages typically provides for a cap on the damages that a party can recover or excludes certain categories of damages altogether.<sup>17</sup>

Limits on damages and limits on liability may have a similar goal (reducing risk), but they are different concepts subject to different rules. Limitations on remedies are subject to review for a determination of whether the remedy "fail[s] of

its essential purpose."<sup>18</sup> A remedy fails of its purpose when it operates to deprive a party of the value of the bargain.<sup>19</sup> If a remedy fails of its essential purpose, the parties are free to pursue other remedies allowed under the UCC.<sup>20</sup> Returning to the example of a provision limiting the buyer's remedy to repair or replacement, such remedies will be found to have failed of their essential purpose if the seller is unable to correct the defect within a reasonable amount of time.<sup>21</sup>

Unlike limitations on remedies, limits on the measure of damages are not subject to review as to whether they fail of their essential purpose.<sup>22</sup> However, under Michigan law, when a contract contains a limitation both on remedies and damages, these provisions are considered to be intertwined. If a limitation on remedies fails of its essential purpose, the entire provision—including the limit on damages—will be treated as unenforceable.<sup>23</sup> To the extent that a provision limits consequential damages, it is further subject to review for whether it is "unconscionable."<sup>24</sup> However, courts are hesitant to find provisions in an agreement between two sophisticated business entities to be unconscionable.<sup>25</sup>

### Use of "vouching in" and third-party claims

Modern manufacturing, particularly in the automotive industry, involves complex supply chains with different levels of suppliers and sub-suppliers. Absent a specific contractual carve-out, a seller's warranty to its buyer covers the entire product sold, including components manufactured by third-party suppliers for the seller. This means that the seller will be responsible to answer for breach of any warranty, even if the ultimate fault lies with a sub-supplier.

There are a number of steps a seller can take to mitigate the risk posed by problems caused by its sub-suppliers. One step is to have consistency in the buy-side warranties it receives from its sub-suppliers as compared to the sell-side warranties the seller makes to its customer. For example, if a seller warrants that its product will function for five years or 50,000 miles, the seller's contracts with each of its suppliers should include the same warranty.

Once a buyer makes a claim for breach of warranty that the seller thinks may be the responsibility of one of its suppliers, the seller must consider involving the supplier in the dispute. This necessarily involves the indemnification provisions in the supply contract. Many contracts require that the seller give the supplier timely notice of the claims. The UCC also requires that buyers give a seller timely notice of an alleged breach.<sup>26</sup> If a seller settles claims by its customer without giving timely notice to its supplier, it will be barred from seeking indemnity.<sup>27</sup>

Next, the seller should tender the defense of the claim to the supplier. If the supplier accepts the tender, the supplier steps into the seller's shoes and becomes responsible for





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defending the action. Some contracts require that the seller tender defense to its supplier as a prerequisite to the seller's right to indemnification. Even if tender is not required, there may be strategic advantages to tendering the defense. Section 2-607(5)(a) of the UCC codifies the common law practice of “vouching in” a supplier.<sup>28</sup> This provision allows a party that has been sued for a breach of warranty that is the responsibility of a sub-supplier to provide the sub-supplier with notice and an opportunity to take over defense of the claim. If the sub-supplier declines, the sub-supplier will be bound by any determination in the first lawsuit of common factual issues if the seller brings a claim of its own against the sub-supplier.

Finally, a seller can bring a third-party claim against its supplier in the same lawsuit in which the seller is named as a defendant. MCR 2.204(A)(1) permits defendants to bring a third-party claim against “a person not party to the action who is or may become liable to the third-party plaintiff for all or part of the plaintiff's claim.” In other words, a seller may deny liability to the buyer but file a third-party claim against a supplier alleging that if the seller is found liable to the buyer, the supplier will be liable to the seller. There are pros and cons to filing a third-party claim instead of waiting to file a separate lawsuit if the seller is found liable to the buyer. A pending third-party claim puts the supplier at immediate risk, which can bring the supplier to the settlement table. On the other hand, filing a third-party claim can result in the seller and supplier pointing fingers at each other instead of focusing on defending the primary issue of whether the buyer can claim breach of warranty.

A seller facing potential liability for an issue caused by its supplier has many tools available. Each tool has different strategic implications for how and whether it should be used in a particular case. ■



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## ENDNOTES

1. Physics.org <<http://www.physics.org/facts/apollo.asp>> (accessed December 6, 2016).
2. *Heritage Res Inc v Caterpillar Fin Servs Corp*, 284 Mich App 617, 633–634; 774 NW2d 332 (2009).
3. *Id.* at 640.
4. MCL 440.2314 and MCL 440.2315.
5. *In re OnStar Contract Litigation*, 600 F Supp 2d 861, 879 (ED Mich 2009).
6. *Pack v Damon Corp*, 434 F3d 810 (CA 6, 2006).
7. MCL 440.2725(1).
8. MCL 440.2725(2).
9. *Id.*
10. See *id.*
11. *Zahler v Star Steel Supply Co*, 50 Mich App 386, 390; 213 NW2d 269 (1973); *Executone Business Sys Corp v IPC Communication, Inc*, 177 Mich App 660, 668–669; 442 NW2d 775 (1989).
12. MCL 440.2315.
13. *Sholz v Montgomery Ward & Co, Inc*, 437 Mich 83; 468 NW2d 845 (1991).
14. *Id.* at 92.
15. MCL 440.2719(1)(a); *Price Bros Co v Charles J Rodgers Constr Co*, 104 Mich App 369, 373; 304 NW2d 584 (1981).
16. See MCL 440.2719(1)(a); *Kelynack v Yamaha Motor Corp*, 152 Mich App 105, 111; 394 NW2d 17 (1986).
17. *Mook v GM Co*, unpublished opinion per curiam of the Court of Appeals, issued June 25, 2013 (Docket No. 309147).
18. MCL 440.2719(2).
19. Trentacosta, *Michigan Contract Law* (2d ed), § 6.44.
20. *Kelynack*, 152 Mich App at 111.
21. *Krupp PM Engineering v Honeywell, Inc*, 209 Mich App 104, 109; 530 NW2d 146 (1994).
22. See MCL 440.2719(2).
23. *Kelynack*, 152 Mich App at 115.
24. MCL 440.2719(3).
25. Trentacosta, *UCC 2-302 Unconscionability in a Commercial Setting*, 7 Mich Bus Law J 8 (October 1989).
26. MCL 440.2607(3)(a).
27. *American Bumper & Mfg Co v Transtechnology Corp*, 252 Mich App 340, 348; 652 NW2d 252 (2002).
28. MCL 440.2607(5)(a); *Old Kent Bank v Kal Custom, Inc*, 255 Mich App 524, 531; 660 NW2d 384 (2003).