Automotive industry supply relationships frequently involve a prolonged, multi-stage contract process. This process typically begins with some form of "award letter" that designates a supplier as the source of a part and establishes, with varying degrees of specificity and firmness, price and other commercial terms of the transaction. Many months, even years, may pass before actual production begins. Before the start of production, initial terms may be modified. Once production begins, sales are typically governed by a blanket purchase order, which should, but does not always, reflect the terms of the initial award and any subsequent changes. The terms may stay in place for the "life of the program," typically four to six years, but sometimes for well over a decade. Throughout this long cycle, profound changes in raw material costs, customer needs, and other aspects of the commercial environment can and do occur.

This complex and prolonged process poses many potential legal challenges. This article will focus on just one, which arises when breaches go undiscovered, or when terms of the deal simply get misplaced. Over the lifetime of such long-term agreements, memories fade, faces change, and attention focuses on the "crises du jour." Consider the following:

The Operative Facts

Acme Assemblies and Wonder Widgets entered into a 10-year contract for Acme to purchase its widget requirements for new assemblies, scheduled to go into production two years later. In addition to agreeing on a piece price of $10, Acme agreed to reimburse Wonder for the $10,000 cost of required tooling by applying a 10¢ surcharge to the sale of just the first 100,000 widgets.

Two years later, Acme began purchasing widgets at $10.10, as agreed. Eighteen months later, Acme purchased its 100,000th widget, and thus fully reimbursed Wonder for the tooling. However, the parties failed to adjust the price. This situation went unnoticed for three years, until a new Acme employee reviewed the Wonder Widget contract to learn the relationship.

Acme promptly demanded a refund of past overcharges and the elimination of the 10¢ surcharge for the remaining years of the contract. Wonder refused to do either, arguing that the continued sales at $10.10 reflected a changed deal and, in any case, Acme had waited too long to discover and notify Wonder of the problem.

Acme sued, and a jury found that (1) Wonder had overcharged Acme, but (2) Acme had failed to discover and notify Wonder of the overcharges within a reasonable time.

In simplified form, this was the dispute addressed by the Sixth Circuit in *Johnson Controls, Inc v Jay Industries, Inc* (hereinafter *JCI*).[1]

UCC §2-607(3), provides, in pertinent part, that:

> Where a tender has been accepted:
>
> (a) the buyer must within a reasonable time[2] after he discovers or should have discovered any breach notify the seller of breach or be barred from any remedy.[3]

Long-term Contracts, Breach, and the Uniform Commercial Code's Notice Requirement

He Who Hesitates—or Forgets—May Have Lost

By Sheldon H. Klein, Daniel P. Malone, and Robin K. Luce

This article will review the pertinent Michigan law outlining the outer boundaries of this provision, including (1) What types of claims trigger the notice requirement? (2) When must notice be given? and (3) To be effective, what should the notice include? Using the *JCI* decision to initiate discussion, the article points out that §2-607(3) has a broader scope than just defective goods or even UCC claims, and it may require more than mere notice. Indeed, the scope of UCC §2-607(3) is broader and more rigorous than commonly recognized.

UCC §2-607(3) is Not Limited to Defective Goods

JCI addressed whether UCC §2-607(3) requires a buyer to give notice that it has been overcharged for goods. In greatly simplified form, the dispute in *JCI* arose out of the following facts. JCI awarded Jay a contract for certain parts. As part of the award letter, Jay agreed that it would use reusable packaging, would add a surcharge to the piece price to cover the cost of the reusable packaging, and would eliminate the surcharge once it recovered its cost. At the time of the award letter, the parties did not, for several practical reasons, agree on the details of the amount of the surcharge or the total cost of the packaging. The parties later agreed on those terms with repayment to occur and surcharges to end at a then unknown time. Jay then failed to eliminate the surcharges, and JCI failed to discover the overcharges for more than four years. The jury found that, while Jay had overcharged, JCI had failed to discover and notify Jay of the overcharges within a reasonable time.

The Sixth Circuit held that the "any breach" language of §2-607(3) means that timely and adequate notice is required for any breach, not just a breach relating to defective goods.[4] This includes, the court held, overcharges, without regard to whether the overcharges were the result of a mistake, whether the seller was aware of the breach,[5] or whether the seller was prejudiced by the delay.

FAST FACTS:

UCC §2-607(3) has a broader scope than just defective goods or even UCC claims, and it may require more than mere notice.

JCI v Jay Industries is the first opinion in any jurisdiction to address whether UCC §2-607(3) applies to overpayment by mistake.

The most recent 2003 amendments to the Official Draft of Article 2 (not yet adopted in Michigan) essentially harmonize the UCC with the common law of mistaken payment.

JCI is the first opinion in any jurisdiction to address whether UCC §2-607(3) applies to overpayment by mistake.[6] The court declined to apply the Michigan common law of mistake,[7] which allows a buyer to recover a mistaken overpayment "unless the mistake caused such a change in the position of the payee that it would be unjust to require the refund,"[8] even if the buyer was negligent.[9] Michigan courts had previously applied the common law of mistake to Article 2 claims.[10]

The court's conclusion that UCC §2-607(3) prevents a buyer from recovering mistaken payments without regard to prejudice is supportable, but not compelled, by the text of the statute. Further, it may result in perverse or inequitable outcomes. Certainly, ordinary standards of equity do not support imposing a forfeiture on an unwitting but indiligent buyer to the benefit of a seller who knowingly imposes or accepts overpayments.[11] Moreover, the notice requirement applies only to buyers. Sellers claiming to have been underpaid have the full limitations period to bring claims. No apparent reason for this disparity exists. One can imagine a situation in which, for example, a long-term contract called for price adjustments, both up and down, tied to various factors (e.g., raw material costs and productivity). If the price adjustments were never implemented, *JCI* might bar the buyer from enforcing the downward adjustments, while leaving the seller free to recover the upward adjustments.

As it happens, the most recent 2003 amendments to the Official Draft of Article 2[12] (not yet adopted in Michigan) addressed these concerns. Section 2-607(3) of the new version provides (modified language blacklined):

> (3) Where a tender has been accepted
>
> (a) the buyer must within a reasonable time after ~~he~~ the buyer discovers or should have discovered any breach notify the seller ~~of breach or be barred from any remedy;~~ ; however, failure to give timely notice bars the buyer from a remedy only to the extent that the seller is prejudiced by the failure and....

These proposed revisions essentially harmonize the UCC with the common law of mistaken payment.

Although *JCI* held that UCC §2-607(3) barred recovery of overpayments made before notice was given, it rejected the seller's argument that §2-607(3) also allowed the seller to continue the overcharges once the buyer gave notice. The court based this holding on two grounds: (1) on its face, §2-607(3) applies only "[w]here a tender has been accepted," so there could be no lack of notice for transactions after notice was given; and (2) the contract was an installment contract under UCC §2-612, meaning that each transaction was a separate contract.

UCC §2-607(3) is Not Limited to Claims Under the UCC

Failure to give timely and proper notice under UCC §2-607(3) does not merely bar claims under the UCC. For example, in *American Bumper & Mfg Co v Transtechnology Corp*,[13] the court held that express and implied indemnity claims were barred by lack of notice, explaining:

> To the extent that plaintiff argues that the "any remedy" language applies only to any remedy under the UCC and does not include its claims of express and implied indemnification, we disagree. [UCC §1-201(34)] broadly defines "remedy" as "any remedial right to which an aggrieved party is entitled with or without resort to a tribunal." Further, [§2-607(3)] also clearly states that if notice of the breach is not given within a reasonable time, the buyer is "barred from any remedy."…Further, the indemnification claims here should be included as "any remedy" where the indemnification claims are based on the underlying breach of warranty claims for which the buyer also seeks a remedy.

The final sentence of the above language suggests that the notice requirement might be limited to non-UCC claims that are based on or arise out of an Article 2 claim, such as indemnity claims. On the other hand, the holding might even extend to tort, statutory, or other claims that arise independently of Article 2.

Even if limited to non-UCC claims arising out of an Article 2 claim, *American Bumper* potentially significantly expands the consequences of failure to give notice and thus increases the importance of giving notice. A prudent buyer may decide not to notify a seller of a potential defect or other breach after taking into account factors such as the desire to maintain a commercial relationship, the cost and uncertainty of seeking redress, the initial assessment of the seriousness of the defect, and the ability to work around the defect. In light of *American Bumper*, that prudent buyer must also consider that by foregoing notice, it may lose not only the ability to recoup its direct damages (such as the cost of repair or cover), but also the right to seek indemnity in the event that the buyer is subject to suit—along with other potentially greater and more difficult to foresee and assess non-UCC claims.

More Than Notice of Defect May be Required

UCC §2-607 requires notice, but does not specify the content of the requisite notice.[14] There is significant disagreement as to whether the requisite notice is "lenient" (i.e., notice that the goods or the seller's performance is "troublesome") or "strict" (i.e., notice that seller will be held legally accountable.)

There is limited Michigan authority on this issue, which *American Bumper* raised, but did not resolve. In dictum, *Michigan Sugar Company v Jebavy-Sorenson Orchard Company*[15] stated that notice "must only inform the seller that there are outstanding problems with the transaction."

In *Allmand Associates, Inc v Hercules, Inc,*[16] the court adopted the "strict" standard. Quoting *K & M Joint Venture v Smith Int'l, Inc,*[17] the court held that "it is not merely enough for the buyer to notify the seller that it is having difficulty with the goods. Rather, the seller must be notified that the buyer considered him to be in breach."[18]

In light of the uncertainty regarding the nature of the requisite notice, it is prudent to provide strict notice by expressly stating that the seller will be held accountable for the breach, and by updating the notice if the buyer later learns materially different information regarding the nature of the notice.

Conclusion

This article discusses a potential issue that can arise during the life of any long-term supply agreement. Clearly, myriad other potential issues abound. In the automotive industry, increased competition and relentless pursuit of increasing efficiencies are sure to exacerbate the issues that led to the outcome in *JCI*. Indeed, as the drama in this industry unfolds and changes in costs, needs, and other aspects of the commercial environment appear, the scope and applicability of every word and provision in long-term supply contracts appear to be fair game for review. ■

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FOOTNOTES

1. *Johnson Controls, Inc v Jay Industries, Inc,* 459 F3d 717 (CA 6, 2006). Butzel Long represented JCI in the matter. The Sixth Circuit affirmed the district court's holding that, on these facts, the notice requirement of Article 2, §2-607(3) barred JCI (the buyer) from recovering the mistakenly paid overcharges incurred before the time that it discovered and notified Jay (the seller), but did not bar JCI from relief on goods sold after notice was given, MCL 440.2607(3).
2. Although outside the scope of this article, what is a "reasonable time" is an issue of fact. *S C Gray, Incorporated v Ford Motor Co,* 92 Mich App 789, 286 NW2d 34 (1979); *Nartron Corp v Hamilton/Avnet Elec of Arizona, Inc,* 1991 US Dist LEXIS 19238, 1991 WL 303604 at *4 (WD Mich, November 1, 1991).

3. UCC §2-607(3) has a subpart (b), relating to notice of infringement. Subpart (b) is outside the scope of this article; any references in this article to UCC §2-607(3) are to subpart (a) only.
4. In addition to pricing disputes, which were the subject of *JCI,* untimely or erroneous delivery could be characterized as a "non-defect" breach. A number of courts have held that UCC §2-607(3) applies to delivery breaches. See, e.g., *Roth Steel Products v Sharon Steel Corp,* 705 F2d 134 (CA 6, 1983) (Ohio law).
5. The court relied on its earlier opinion in *Alliance Industries, Inc v Clawson Co,* 587 F2d 813, 825 (CA 6, 1978) (Ohio law). No Michigan state court has addressed this question.
6. *Chainworks, Inc v Webco Industries, Inc,* 2006 US Dist LEXIS 9194 (WD Mich, February 24, 2006), which did not involve a mistake, applied UCC §2-607 to a pricing dispute, but apparently the buyer did not challenge, and the court did not address, whether it was applicable. The surprisingly few cases in other jurisdictions that have addressed whether UCC §2-607(3) applies to pricing likewise did not involve mistakes. See *Thomas Creek Lumber & Log Co v State Forester,* 970 P2d 659 (Ore App 1998) (UCC §2-607(3) applies to claim that price increase was not permitted under agreement); *Attrash v Shell Oil Co,* 1993 WL 495241 (CA 9, 1993) (UCC §2-607(3) bars untimely claim that price was unfair); *Neugent v Beroth Oil Co,* 560 SE2d 829 (NC Ct App 2002) (UCC §2-607(3) does not apply to overcharge claim). No Michigan state court has addressed this issue.
7. The common law of mistake is generally applicable pursuant to UCC §1-103, which provides: "Unless displaced by the particular provisions of this act, the principles of law and equity, including...the law relative to...mistake...shall supplement its provisions."
8. *General Motors Corp v Enterprise Heat & Power Co,* 350 Mich 176, 181 (1957); See also *Durant v Servicemaster Co,* 159 F Supp 2d 977, 981 (ED Mich, 2001); *Wilson v Newman,* 463 Mich 435, 441 (2000).
9. *Couper v Metropolitan Life Ins Co,* 250 Mich 540, 544 (1930).
10. See *Bennett v Wright,* 79 Mich App 566, 571; 263 NW2d 17 (Mich App 1977) ("code is supplemented by pre-Code Michigan law regarding mistake"); *Gen'l Equip Mfg v Bible Press, Inc,* 10 Mich App 676 (1968).
11. See, e.g., Restatement (2d) of Contracts, Section 229, excusing a condition where the failure is not material and implementation would result in disproportionate forfeiture.
12. The "Official Drafts" are adopted by the National Conference of Commissioners of Uniform State Laws (NCCUSL).
13. *American Bumper & Mfg Co v Transtechnology Corp,* 252 Mich App 340 (2002).
14. The Official Comments to UCC §2-607(3) address the issue in general terms as follows:

    The *content* of the notification need merely be sufficient to let the seller know that the transaction is still troublesome and must be watched. There is no reason...for requiring the notification to be a claim for damages or of any threatened litigation or other resort to a remedy. The notification which saves the buyer's rights under this Article need only be such as informs the seller that the transaction is claimed to involve a breach, and thus opens the way for normal settlement through negotiation.
15. *Michigan Sugar Company v Jebavy-Sorenson Orchard Company,* 66 Mich App 642; 239 NW2d 693 (196).
16. *Allmand Associates, Inc v Hercules, Inc,* 960 F Supp 1216 (ED Mich 1997).
17. *K & M Joint Venture v Smith Int'l, Inc,* 669 F2d 1106 (CA 6, 1982) (Ohio law).
18. On the other hand, *Chainworks, Inc v Webco Industries, Inc,* 2006 US Dist LEXIS 9194 (WD Mich, February 24, 2006) questioned whether *K & M* remained good law in Ohio. *Chainworks* expressed a clear preference for the lenient standard, although it did not squarely adopt it. Instead, it assessed the specific communications at issue (which probably would have passed muster under the strict standard) in light of policies behind UCC §2-607(3), as stated in *American Bumper:*

    1) to prevent surprise and allow the seller the opportunity to make recommendations how to cure the nonconformance; 2) to allow the seller the fair opportunity to investigate and prepare for litigation; 3) to open the way for settlement of claims through negotiation; and 4) to protect the seller from stale claims and provide certainty in contractual arrangements.

    Eaton Corp v The Magnavox Co, 581 F Supp 1514 (ED Mich, 1981) did not address the "strict" v. "lenient" issue as such, but did find notice untimely where the buyer had notified the seller of one defect (solder failures), but had delayed providing further notice when it later concluded that the problem was use of an incorrect component.