



News & Types: Commercial, Competition & Trade Update

Are Remedies Limitations Enforceable When a Limited Remedy "Fails of its Essential Purpose?"

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Practices: Commercial, Competition & Trade, Litigation

Recently, the 7th Circuit Court of Appeals had to deal with a state law issue under the Uniform Commercial Code that has tormented courts for decades. (*Sanchelima International, Inc. v. Walker Stainless Equipment Co., LLC, et al*, 7th Circuit Court of Appeals, No. 18-1823, April 10, 2019)

As background, Article 2 of the UCC is the uniform state law that governs the sale of goods. Under UCC Article 2-719, parties to a sales contract are free to modify, alter, substitute or limit a buyer's remedies, including the limitation or exclusion of consequential damages. But there are exceptions. The exceptions are what courts have struggled with.

An "unconscionable" limitation or exclusion of consequential damages is not permitted. (UCC 2-719(3)). But "limitation of damages where the loss is commercial" is not unconscionable. (UCC 2-719(3))

There's another exception. "Where circumstances cause an exclusive or limited remedy to fail of its essential purpose, remedy may be had as provided in this Act." (UCC 2-719(2)).

So what happens when the parties agree to a limited remedy that excludes consequential damages and the limited remedy fails of its essential purpose? Can the buyer recover consequential damages, even though the buyer had, in the contract, agreed to exclude consequential damages? This was precisely the issue that the 7th Circuit dealt with in the *Sanchelima* case.

Judge Brennan, who wrote the opinion, provided some history of this conflict. Courts have generally taken one of two positions.

The "dependent" position provides that a seller whose limited remedy fails of its essential purpose should not get the benefit of an exclusion or limitation of consequential damages, even when the buyer agreed to the limitation. An exclusion of consequential damages when the limited remedy fails of its essential purpose is *per se* unconscionable.

The "independent" position provides that even when a limited remedy fails of its essential purpose, a freely negotiated limitation of consequential damages is not necessarily *per se* unconscionable, but should be examined independently of the failure of essential purpose. A litigant must separately prove unconscionability to invalidate the limitation on consequential damages.

Behind the different approaches is an underlying philosophical debate about contract law. On the dependent side is the argument that a seller should not benefit from a limitation when the limited remedy the seller negotiated failed of its essential purpose. So the seller should not have it both ways.

On the independent side is freedom of contract, permitted and indeed promoted in the UCC in general. Why shouldn't a buyer that freely agreed to give up consequential damages be held to its bargain, provided that the court provide some adequate remedies to the buyer?

The comments under Article 2-719 only add to the muddle:

"1. . . . However, it is of the very essence of a sales contract that at least minimum adequate remedies be available. . . . Thus any clause purporting to modify or limit the remedial provisions of this Article in an unconscionable manner is subject to deletion and in that event the remedies made available by this Article are applicable as if the stricken clause had never existed. Similarly, under subsection (2), where an apparently fair and reasonable clause because of circumstances fails in its purpose or operates to deprive either party of the substantial value of the bargain, it must give way to the general remedy provisions of this Article.

. . . .

3. Subsection (3) recognizes the validity of clauses limiting or excluding consequential damages but makes it clear that they may not operate in an unconscionable manner. . . ."

The comments, read closely, seem to distinguish between unconscionability, which would result in deleting the exclusion of consequential damages, and a failure of essential purpose that did not rise to the level of unconscionability, which would "give way to the general remedy provisions of this Article", but not necessarily restore the remedy of consequential damages. In further support is UCC 2-719(3) that explicitly states that limitation of damages in a commercial contract is not unconscionable. Finally, it can be argued that freedom of contract should permit a commercial buyer to exclude consequential damages, even in a situation where the remedy fails of its essential purpose, but the failure does not rise to the level of unconscionability.

The facts in *Sanchelima* illustrated the two sides of this debate. Walker manufactured dairy silos. Sanchelima sold dairy silos in Latin America. In 2013, Walker agreed that Sanchelima would serve as Walker's exclusive distributor of dairy silos in thirteen Latin American countries. Walker agreed not to sell silos directly to third parties in those thirteen countries. The contract limited Sanchelima's remedies:

"Manufacturer Liability Limitations. To the extent a . . . claim . . . arises out of any purchase order . . . or otherwise aris[es] out of this agreement, [Walker's] aggregate total liability for any and all such claims shall be capped at, and [Walker] shall have no liability to Sanchelima . . . in excess of, the amount(s) paid by [Sanchelima] to Walker under such purchase order, subject to section X(G)."

Section X(G) excluded consequential damages:

"Liability Exclusions. No [Walker-affiliated company] shall be liable to any [Sanchelima-affiliated company] for any special, indirect, incidental or consequential losses or damages including, without limitation, any lost profits"

Walker breached this agreement. In 2014, Walker sold over \$600,000 worth of dairy silos in Mexico, part of Sanchelima's exclusive territory. Walker also sold silos to a Nicaraguan company for over \$66,000. In 2015, Walker sold silos to a plant in Mexico for almost \$3 million. In 2017, Walker sold products to a Mexican company for almost \$160,000.

Sanchelima notified Walker that it considered Walker in breach. Mediation was not successful. Walker lost the ensuing bench trial. The trial court, applying Wisconsin law, found that Walker had breached the agreement, that the limited remedy had failed of its essential purpose, and awarded Sanchelima \$778,306.70 in damages, which included lost profits on the sales made by Walker. Walker, of course, appealed the verdict, citing the agreed limitation of remedies and exclusion of consequential damages.

But Walker had problems. First, in a brief Walker argued that the agreement gave Sanchelima "no recoverable damages." Judge Brennan and the 7th Circuit took this as a virtual admission by Walker that its remedy failed of its essential purpose.

Second, in 1978, the Wisconsin Supreme Court adopted the "dependent" approach, which voids an exclusion of consequential damages when a limited remedy fails of its essential purpose. (*Murray v. Holiday Rambler, Inc.*, 265 N.W.2d 513 (Wis. 1978)). So Walker's effort to exclude consequential damages did not stand.

Walker appealed to the 7th Circuit and asked the 7th Circuit to reverse the Wisconsin Supreme Court. Judge Brennan acknowledged that there was some basis to change this ruling based on the history interpreting UCC 2-719.

At the time of the *Murray* decision in 1978, a majority of states adopted the dependent approach. But since then many courts have shifted to the independent approach. The leading UCC treatise now endorses the independent approach as the "majority view." (White, Summers & Hillman, *Uniform Commercial Code Section 13:22* (6th Ed.)) Now, most state courts apply the independent approach, including states that had earlier adopted the dependent approach. Unfortunately for Walker, Wisconsin was not one of these.

Recall under the dependent approach, adopted in Wisconsin, a failure of essential purpose is *per se* unconscionable. Under the independent approach, a failure of essential purpose is not *per se* unconscionable and, as Judge Brennan noted, "a litigant must still prove procedural and substantive unconscionability to invalidate a limitation on consequential damages." But, under Wisconsin's dependent approach, Sanchelima was spared this step.

So Walker had a strong argument. Unfortunately, the 7th Circuit could not overrule the Wisconsin Supreme Court on a matter of state law. Nor could the 7th Circuit ask the Wisconsin Supreme Court for an advisory opinion. Walker would just have to wait until the Wisconsin Supreme Court was faced with a case that could lead to overturning *Murray*, which would no doubt be too late for Walker to avoid the significant damages it owed to Sanchelima.

So, while the trend towards the independent approach is clear, there are still states that apply the dependent approach. So it is still a state by state analysis as to whether a failure of essential purpose will void an exclusion of consequential damages.