

VII. Contracts and Commercial Law

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During the past year there were several significant developments in commercial law, including state court decisions, federal court decisions, and federal trade regulation. The following discussion is a cursory review of some of the most interesting of those developments; it begins with a description of the development and application of the Federal Trade Commission's (FTC's) rule on preservation of defenses.

A. *FTC Rule on Preservation of Consumer Defenses*

The legal system has provided various mechanisms by which consumers can be prevented from raising claims or defenses against the party which finances a consumer sale transaction. First, the doctrine of holder in due course can prevent the maker of a promissory note from raising defenses against the holder, such as fraud or breach of warranty, which he would have been able to assert against a seller in whose favor the note was originally drawn.¹ Secondly, waiver of defense clauses have been enforced.² These clauses generally stipulate that the consumer understands that the retail credit contract right will be assigned by the seller to a financier and that the consumer will not raise any claims or defenses based on the underlying sale in any action brought by the assignee. Finally, consumer defenses have been cut off in related loan transactions, in which the consumer borrows money directly from the financier and uses the proceeds of the loan to purchase the goods or services. If the lender and seller are related by agreement or ownership and combine to finance consumer purchases on a regular basis, the transaction is functionally similar to one in which a negotiable instrument or a waiver of defense provision is used. Only the formalities differ. Of course, if the financier simply lends money, and does not sell goods or services, claims or

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¹IND. CODE § 26-1-3-305 (Burns 1974).

²*Id.* § 26-1-9-206.

defenses which might arise in the sale transaction would be irrelevant in a suit to collect the proceeds of the loan.³

There has been dissatisfaction with the result produced by these mechanisms. Consumers who are forced to pay for goods or services which prove to be defective or which have been misrepresented to them are the object of much sympathy. It is argued that consumers should not be required to pay unless they obtain the goods or services for which they bargained, and that consumers often do not understand that they will bear the risk of seller misconduct and will be unable to withhold payment if the seller defaults.⁴ In addition, the consumer is not in a good position to estimate the risks he bears when he purchases on credit by a contract that cuts off his defenses against a third party financier. Consumers cannot accurately estimate the likelihood of seller default or unavailability, or the costs involved in the event of a default; these costs, in general, can be estimated more readily by the financier.⁵ Also, the financier is in a better position to prevent seller misconduct by policing the system through which it finances consumer transactions. Finally, there have been cases in which fraudulent schemes may have been furthered by cutoff mechanisms and it is argued that the mechanisms should be eliminated or modified to prevent that possibility.

Dissatisfaction with cutoff mechanisms has stimulated activity on at least two fronts. First, there are judicial decisions in some states which deny enforcement of some of these mechanisms.⁶ For example, courts have refused to apply the holder in due course doctrine where there is a "close connection" between the financier

³There is a fourth common method by which a consumer's claims or defenses can be cut off by a financing device—the credit card transaction. In this transaction the credit card issuer (the financier) issues a credit card to a consumer. In the contract by which this credit card is issued the consumer agrees to seek redress for any grievances directly against the merchant from whom he purchased goods or services and not to raise these grievances in any suit brought by the credit card issuer. This device has been restricted by the 1974 amendments to the Consumer Credit Protection Act. The contract provision limiting the consumer's right to raise defenses is now enforceable only if a purchase takes place more than 100 miles away and in a state other than the one in which the consumer has his mailing address, or if the transaction is for less than \$50. 15 U.S.C. § 1666i(a) (Supp. V. 1975).

⁴See Federal Trade Commission Statement of Basis and Purpose, 40 Fed. Reg. 53,506, 53,523 (1975) [hereinafter cited as FTC Statement].

⁵For an excellent discussion of this subject, see Schwartz, *Optimality and the Cutoff of Defenses Against Financiers of Consumer Sales*, 15 B.C. IND. & COM. L. REV. 499 (1974).

⁶The most heralded and widely read case on this subject is *Unico v. Owen*, 50 N.J. 101, 232 A.2d 405 (1967).

and seller.⁷ In doctrinal terms, this is based on a finding that there is no good faith transfer of the note, or that the consumer has actually dealt with the financier through its agent, the seller. In addition, courts have held that waiver of defense clauses are unconscionable and have refused to enforce them where there is this "close connection."⁸ Secondly, there have been legislative responses in some states to the consumer's plight. For example, in Indiana, the Uniform Consumer Credit Code (UCCC)⁹ has been adopted; it deals with cutoff mechanisms in two ways. Section 2-403¹⁰ provides that in a consumer credit sale a seller "may not take a negotiable instrument other than a check." If, in violation of this provision, a negotiable instrument is taken in a consumer credit transaction, it is unlikely that the instrument could be transferred to a person who qualifies as a holder in due course, since a holder with notice that the instrument has been issued in violation of the section cannot be a holder in good faith.¹¹ The version of section 2-404¹² of the UCCC adopted in Indiana places substantial restrictions on the use of waiver of defense clauses. It requires the financier which seeks to employ a waiver of defense provision to give notice of an assignment to the consumer. The notice must state, among other things, that the consumer will lose the right to raise defenses if he does not notify the financier of any defense within sixty days of the mailing of the notice of assignment. With respect to defenses which arise during this sixty-day period and which the consumer does not report to the financier the waiver of defense clause can be enforced. Defenses which arise after the sixty-day notice period has expired are preserved for the consumer. The waiver of defense clause is completely unenforceable in cases in which retailer and financier are "related."¹³ Unlike the doctrine of holder in due course and waiver of defense clauses, the third cutoff device—the related loan—has not been the subject of much reform activity.¹⁴ In fact there is some evidence that there has been an increase in volume of related loans where the other two devices have been restricted.¹⁵

⁷*Id.* See also J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 479-84 (1972).

⁸*Id.*

⁹IND. CODE §§ 24-4.5-1-101 to -6-203 (Burns 1974).

¹⁰*Id.* § 24-4.5-2-403.

¹¹*Id.*

¹²*Id.* § 24-4.5-2-404.

¹³*Id.*

¹⁴One such reform took place in Massachusetts. See MASS. ANN. LAWS ch. 255, § 12F (Michie/Law. Co-op Supp. 1975).

¹⁵FTC Statement, *supra* note 4, 40 Fed. Reg. at 53,514-15.

Against this backdrop, in 1971 the Federal Trade Commission began the process of promulgating a rule to preserve consumer defenses. The original proposed rule was published January 21, 1971, and a revised version of the rule was published January 5, 1973.¹⁶ During the process of developing the final rule, which was published November 14, 1975, the commission produced some 2,250 pages of hearing transcripts and recorded 7,362 pages of written comment. The rule became effective May 14, 1976.¹⁷

The rule is divided into two parts.¹⁸ The first part deals with the holder in due course doctrine and waiver of defense clauses. It requires sellers to include specified language in consumer credit contract documents which will preserve consumers' defenses. The required language must be printed in the contract in at least ten point boldface type. Failure to include this language constitutes an unfair or deceptive act within the meaning of section 5 of the Federal Trade Commission Act.¹⁹

The presence of this language will have only slight impact on the rights of consumers in Indiana, since taking negotiable instru-

¹⁶*Id.* at 53,506.

¹⁷*Id.*

¹⁸The rule provides:

In connection with any sale or lease of goods or services to consumers, in or affecting commerce as "commerce" is defined in the Federal Trade Commission Act, it is an unfair or deceptive act or practice within the meaning of Section 5 of that Act for a seller, directly or indirectly, to:

(a) Take or receive a consumer credit contract which fails to contain the following provision in at least ten point, bold face, type:

NOTICE

ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED PURSUANT HERETO OR WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.

or, (b) Accept, as full or partial payment for such sale or lease, the proceeds of any purchase money loan (as purchase money loan is defined herein), unless any consumer credit contract, made in connection with such purchase money loan contains the following provision in at least ten point, bold face, type:

NOTICE

ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICE OBTAINED WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.

⁴⁰ Fed. Reg. 53,506 (1975).

¹⁹15 U.S.C. § 45 (1970).

ments in consumer transactions has been proscribed by section 2-403 of the UCCC. However, with respect to the use of waiver of defense clauses there may be some impact since waiver of defense clauses seem incompatible with the language mandated by the rule. As a result, those financiers and sellers who used waiver of defense clauses despite their limited efficacy in Indiana, will probably have to change their practices.

The second part of the rule, subsection (b),²⁰ deals with the related loan transaction. The rule makes it an unfair and deceptive trade practice for a seller to receive the proceeds of a consumer loan made by a related lender unless the contract documents recording the loan transaction include specified language causing the lender to be subject to all the consumer's defenses. Since the related loan device does not appear to have been restricted in Indiana, this part of the rule may have significant impact on consumer rights.

Subsection (b) of the rule applies to loans made by lenders to whom the retailer has *referred* customers or which are *affiliated* with the retailer by *common control, contract or business arrangement*. Common control includes circumstances in which one holding company owns both seller and financier, one shareholder owns both, or there is a parent-subsidiary relationship between financier and seller.²¹ The expressions "contract" and "business arrangement" are both defined in the rule.²² These somewhat overlapping definitions suggest that any continuing relationship between financier and seller which relates to the financing of consumer transactions will create an affiliation. In its guidelines on the rule

²⁰Subsection (b) of the rule applies to purchase money loans, which are defined as follows:

Purchase money loan. A cash advance which is received by a consumer in return for a "Finance Charge" within the meaning of the Truth in Lending Act and Regulation Z, which is applied, in whole or substantial part, to a purchase of goods or services from a seller who (1) refers consumers to the creditor or (2) is affiliated with the creditor by common control, contract, or business arrangement.

40 Fed. Reg. 53,506 (1975).

²¹Preservation of Consumers' Claims and Defenses; Statement of Enforcement Policy, Invitation to Comment, 41 Fed. Reg. 34,594 (1976).

²²The rule provides the following definitions:

Contract. Any oral or written agreement, formal or informal, between a creditor and a seller, which contemplates or provides for cooperative or concerted activity in connection with the sale of goods or services to consumers or the financing thereof.

Business arrangement. Any understanding, procedure, course of dealing, or arrangement, formal or informal, between a creditor and a seller, in connection with the sale of goods or services to consumers or the financing thereof.

40 Fed. Reg. 53,506 (1975).

the FTC has specified several relationships that will constitute a contract or business arrangement. Among these are: (1) maintaining loan application forms in the seller's place of business; (2) an agreement by the seller to prepare loan forms for the financier; (3) an agreement by the financier to refer customers to the seller's place of business; (4) an agreement by the financier to pay the seller for referrals; (5) an agreement by which the seller agrees to pay the financier for referrals; and (6) participation by the financier in a sales program of the seller.²³ Situations which will not constitute an affiliation are: (1) a relationship created by credit card plan whereby the seller is a member of the plan and the financier is the credit card issuing company; (2) maintenance by seller of a checking account with the financier; (3) a general loan by a financier to seller; (4) commercial lease in which the financier and seller are both parties; and (5) discussion between seller and financier regarding security agreements.²⁴ The second basis for imposing the notice requirement occurs when the retailer "refers customers to the creditor." The word "refer" means a continuing pattern of sending customers to the lender; simply suggesting that the lender might lend money to the consumer is not a referral which would require notice.²⁵

If an affiliation exists between financier and seller, the FTC has indicated that the notice must be included, whether or not that particular consumer was actually sent to the lender by the seller.²⁶ For example, suppose a consumer borrowed money from a financier and then went to an affiliated seller to make a cash purchase with the loan proceeds. The seller could be acting in violation of the rule, unknowingly, by accepting proceeds of the loan made without the required protective language. In its statement on enforcement policy the FTC has announced that a seller cannot be held responsible if he has no reason to know that the consumer is using purchase money loan proceeds; the seller is under no duty to inquire of every person who makes a cash purchase.²⁷ However, some circumstances should alert the seller to the possibility that the source of the consumer's funds was a loan from an affiliated lender. For example, if the consumer presented a cashier's check drawn by an affiliated financier the seller would be on notice that the cash payment for goods or services might have been generated by a purchase money loan. Also a jointly

²³Preservation of Consumers' Claims and Defenses; Statement of Enforcement Policy, Invitation to Comment, 41 Fed. Reg. 34,594 (1976).

²⁴*Id.* at 34,595.

²⁵*Id.* at 34,596.

²⁶*Id.*

²⁷*Id.*

payable cashier's check drawn by an affiliated financier might give actual knowledge to a seller that the payment constituted proceeds of a purchase money loan. If the seller is put on notice by receipt of a cashier's check from an affiliated financier the seller must determine directly from the financier whether the loan arrangement contained the requisite language. The seller cannot satisfy the rule's requirements by making an inquiry only of the consumer.²⁸

It is clear that if the required language is included in a retail installment sales contract the consumer will have a right to refuse to pay the financier to the extent that there are defenses against the seller. In addition, the required language provides that the financier will be subject to any *claim* which the consumer may have. This means that the financier could be responsible for consequential losses suffered by the consumer. For example, if the consumer was injured because of a defect in the product, he could make a claim against the financing entity for his injuries. However, the required language clearly states that the maximum recovery against the financier will be equal to the amount paid under the agreement. In its staff guidelines the FTC has indicated that this amount includes all moneys paid to the financier and, in a case involving a retail installment sales contract, any down payment made to the seller.²⁹ A down payment could not be recovered from the financier if the purchase was made, in part, with the proceeds of a purchase money loan.

Finally, problems might arise if financiers or sellers fail to incorporate the required language in contract documents. Of course, parties who fail to protect the consumer with the required language will be in violation of the rule and the Federal Trade Commission, armed with new powers under the Federal Trade Commission Improvement Act,³⁰ may take action against them. This enforcement effort may have a decisive impact on recalcitrant creditors, but some instances of failure to include the required language could raise difficult questions with respect to consumers' rights. For example, assume that a related financier loaned money to a consumer who in turn purchased goods or services from seller. Assume further that, because of a proceeds check made payable jointly to consumer and seller, seller knew that purchase money loan proceeds were being furnished. It is obvious that this seller has violated the rule. But what of the consumer who seeks at a later time to raise defenses against the

²⁸*Id.*

²⁹Guidelines on Trade Regulation Rule Concerning Preservation of Consumers' Claims and Defenses, 41 Fed. Reg. 20,022 (1976).

³⁰Magnuson-Moss Warranty—Federal Trade Commission Improvement Act, 15 U.S.C. §§ 2301-12 (Supp. V 1975).

financer? Since the required language is not present, it is unlikely that the consumer would be able to raise claims or defenses. If the consumer attempted to raise the violation of the FTC rule in this context he would be confronted with two problems. First, the financer has not violated the rule as it is presently written, since the rule applies only to the seller and not to the related financer.³¹ Secondly, even if the related financer were directly affected by the rule the consumer would probably be unable to assert a violation, since the courts have uniformly held that there is no private remedy for violation of Federal Trade Commission rules.³² The only exception to this principle seems to be *Guernsey v. Rich Plan of the Midwest*,³³ a recent case in the Federal District Court for the Northern District of Indiana, discussed elsewhere in this review.³⁴ However, in that case, the plaintiff alleged not only that the defendant's conduct violated an FTC rule but that the FTC had earlier entered a cease and desist order with respect to the same conduct. On that basis the district court found that the plaintiff had stated a cause of action by alleging a violation of an FTC rule. *Guernsey* might be distinguishable from cases in which consumers attempt to raise violations of the rule in a lawsuit brought by a financer.

This problem would seem to be less significant in the case of use of a negotiable instrument or a waiver of defense clause. As mentioned earlier, Indiana has, by statute, proscribed the use of negotiable instruments in consumer credit sales.³⁵ With respect to waiver of defense clauses, a consumer may be able to establish that a financer who became an assignee of a retail installment contract without the required language was not an assignee in good faith, and lack of good faith would prevent enforcement of the waiver of defense clause.

B. Remedies For Breach of Contract

1. Liquidated Damages

In *Mandle v. Owens*³⁶ the court of appeals had an opportunity to address a problem which may occur with some frequency in real estate contracts. In that case, a written agreement between

³¹The FTC has proposed an amendment to the rule which would make it applicable to lenders and other financers as well as sellers. See 40 Fed. Reg. 53,530.

³²See, e.g., *Holloway v. Bristol-Meyers Corp.*, 485 F.2d 986 (D.C. Cir. 1973).

³³408 F. Supp. 582 (N.D. Ind. 1976).

³⁴See Gray, *Consumer Law*, *supra* at 147.

³⁵IND. CODE § 24-4.5-2-404 (Burns 1974).

³⁶330 N.E.2d 362 (Ind. Ct. App. 1975).

buyer and seller provided for a \$300 earnest money deposit. The agreement also provided: "If [the] offer is accepted and if we fail to complete the purchase of the real estate herein mentioned as provided herein, the amount of three hundred (\$300) dollars will be forfeited to you."³⁷ The earnest money was furnished by check which was cashed a few days after receipt. One week later the buyer repudiated the contract and the seller was forced to incur expenses of more than \$2,000 in reselling the property to another buyer. Seller sued buyer for these expenses and buyer defended on the ground that seller was limited to recovery of the \$300 earnest money. He urged that the quoted clause constituted a liquidated damages agreement, and existed in lieu of all other remedies. After a bench trial the court held for the defendant, concluding that the clause was a liquidated damages agreement since it was a "good faith attempt on the part of the parties to estimate the damages which would probably flow from a breach and is fair and reasonable and was intended by the parties to be the sole remedy in the event of the buyers' breach under the contract."³⁸ Also, the trial court held that the plaintiffs were estopped from claiming additional damages "by reason of the defendants' failure to perform the contract by accepting and retaining the earnest money deposit and proceeding to enter into a contract of sale for said premises with a third party."³⁹ The court of appeals reversed this decision and held that the clause was a penalty and not a liquidated damages agreement. It was thus unenforceable and the plaintiff was entitled, on remand, to prove and recover all damages caused by the breach.

The court seems to have based its decision on an inability to determine whether the agreed remedy provision in the writing was to be considered as a penalty or as liquidated damages. Since the written agreement was prepared by the attorney for the buyer, the doubt was resolved against the buyer and the clause was construed as a penalty which was unenforceable. The court found reinforcement for this view in the fact that the damages were not uncertain in this case. The seller proved that the property was resold at a price \$500 lower than the contract price and that he had incurred a broker's fee of \$2,065 in the resale transaction. This proof clearly showed a specific figure which represented the seller's losses and highlighted the arbitrary nature of the \$300 forfeiture clause.⁴⁰

³⁷*Id.* at 363.

³⁸*Id.* at 364.

³⁹*Id.*

⁴⁰*Id.* at 366.

Although there are various formulations, courts have generally listed two criteria to distinguish a liquidated damages agreement from a penalty. To be an enforceable agreed remedy it must appear (1) that the injury which might result from a breach is uncertain or speculative, and (2) that the liquidated amount is a reasonable estimate of the possible loss. The latter of these two criteria seems to be the one most heavily emphasized.⁴¹ Historically, the test of reasonableness was applied as of the time the contract was formed, and actual injury caused by the breach was not considered. Thus a liquidated damages clause could be enforced even though, in light of actual harm, it provided an unreasonably large recovery and had the effect of a penalty.⁴² However, more recently there has been a tendency to test the reasonableness of the estimate both in terms of conditions extant at the time the contract was formed *and* actual harm suffered by the non-breaching party.⁴³ The draftsmen of the Uniform Commercial Code (UCC) seemed to adopt this approach; the Code's focus is on "anticipated or actual harm" and it provides that a "term fixing unreasonably large liquidated damages is void as a penalty."⁴⁴ In *Mandle v. Owens* the court seems to follow this trend, testing the provision in light of actual harm and the certainty with which that harm was proved. It should be noted, however, that the court in this case was dealing with a liquidated figure which was very small compared with actual losses, not an unreasonably large figure.⁴⁵

2. Punitive Damages

Indiana courts this year handed down three opinions on the subject of availability of punitive damages in contract actions. In two of these cases a consumer was suing a vendor of goods or services and in one case a small businessman was suing insurance

⁴¹J. CALAMARI & J. PERILLO, *THE LAW OF CONTRACTS* § 232, at 367 (1970). The authors also note that intent of the parties to create a liquidated damages clause will be considered.

⁴²*See, e.g.*, *Bethlehem Steel Corp. v. City of Chicago*, 350 F.2d 649 (7th Cir. 1965).

⁴³*E.g.*, *Priebe & Sons, Inc. v. United States*, 332 U.S. 407 (1947); *Norwalk Door Closer Co. v. Eagle Block & Screw Co.*, 153 Conn. 681, 220 A.2d 263 (1966).

⁴⁴IND. CODE § 26-1-2-718(1) (Burns 1974). For a recent case interpreting this section of the Uniform Commercial Code, see *Equitable Lumber Corp. v. I.P.A. Land Development Corp.*, 38 N.Y.2d 516, 344 N.E.2d 391, 381 N.Y.S.2d 459 (1976).

⁴⁵There may be another basis for invalidating liquidated damages provisions that are unreasonably small. U.C.C. § 2-718, Comment 1, provides that an unreasonably small amount might be invalidated under the section on unconscionable contracts or clauses. See IND. CODE § 26-1-2-302 (Burns 1974); R. NORDSTROM, *HANDBOOK OF THE LAW OF SALES* § 154, at 272-73 (1970).

companies.⁴⁶ In each case the trial court awarded punitive damages. Two of these awards were affirmed on appeal and one was overturned. In *Vernon Fire & Casualty Insurance Co. v. Sharp*,⁴⁷ the Indiana Supreme Court affirmed an award of punitive damages against two insurance companies who were accused of refusing to pay an insured's claim in an "intentional and wanton" manner. In *Jones v. Abriani*⁴⁸ the court of appeals upheld a punitive damage award against the seller of a mobile home who was accused of misleading the consumer with respect to the consumer's right to reject the home, failing to deliver a warranty booklet on demand which caused a forfeiture of a manufacturer's warranty, and willfully and fraudulently refusing to acknowledge and repair defects in the mobile home. In the third case, *Hibschman Pontiac, Inc. v. Batchelor*⁴⁹ the court of appeals overturned an award of punitive damages against an auto dealer who was accused of misconduct in failing to make warranty repairs. The *Hibschman* opinion may be in conflict with the supreme court decision in *Vernon*; a petition for transfer of *Hibschman* is pending, which may result in the supreme court addressing that conflict.⁵⁰

In the *Vernon* case the supreme court found three separate grounds for upholding the award of punitive damages. First, the court found that the trial court's award of punitive damages could have been based on a finding that the insurance companies were guilty of fraud, an independent tort. Many Indiana courts have stated that if the plaintiff establishes an independent intentional tort, such as fraud, a punitive damages award is justified.⁵¹ The fraud in this case was based on the companies' promise to pay the proceeds of the policy, knowing at the time that they had no intention of doing so.⁵² This representation was undoubtedly relied upon by the plaintiff. The court stated that "[v]iewed in this manner, plaintiff's evidence establishes the elements of fraud

⁴⁶A small businessman has been treated as a consumer. See, e.g., *Weaver v. American Oil Co.*, 257 Ind. 458, 276 N.E.2d 144 (1971).

⁴⁷349 N.E.2d 173 (Ind. 1976), *aff'g* 316 N.E.2d 381 (Ind. Ct. App. 1974). This case is also discussed in Gray, *Consumer Law, supra*, and Frandsen, *Insurance, infra*.

⁴⁸350 N.E.2d 635 (Ind. Ct. App. 1976), also discussed in Gray, *Consumer Law, supra*, and Frandsen, *Insurance, infra*. A petition to transfer this case to the Indiana Supreme Court is pending.

⁴⁹340 N.E.2d 377 (Ind. Ct. App. 1976) (rehearing denied).

⁵⁰*Id.*

⁵¹*E.g.*, *Rex Ins. Co. v. Baldwin*, 323 N.E.2d 270 (Ind. Ct. App. 1975); *Vernon Fire & Cas. Ins. Co. v. Sharp*, 316 N.E.2d 381 (Ind. Ct. App. 1974); *Jerry Alderman Ford Sales, Inc. v. Bailey*, 154 Ind. App. 632, 291 N.E.2d 92 (1972).

⁵²349 N.E.2d at 184.

...⁵³ Secondly, plaintiff's complaint charged that the insurance companies acted in an intentional and wanton manner in refusing to pay plaintiff the proceeds of the policies. This allegation was based on the fact that the insurance carriers refused to pay plaintiff's claim until an unrelated claim, filed by plaintiff's plant manager, was settled. Implicit in the insurance companies' refusal to pay was a demand that the plaintiff obtain a settlement agreement from his plant manager in the unrelated claim. The court stated that this evidence was sufficient to justify a finding by the jury that there was "intentional and wanton" conduct, that the insurers dealt with plaintiff's claim "with an 'interested motive' and wrongfully attempted by virtue of their superior position to exact additional consideration from the plaintiff before performing their obligations . . ."⁵⁴ Although this evidence did not prove an independent tort, it was held sufficient to establish "a serious intentional wrong" which justified the award of punitive damages.⁵⁵ Finally, the court stated that punitive damages were justified because the insurance carriers' attempt to force the plaintiff to settle an unrelated claim before the carriers would pay plaintiff's claim constituted a violation of the statutory scheme in Indiana providing for fixed premium rates and prohibiting carriers from altering the rates by demanding premiums in excess of those established by law.⁵⁶

In the second case upholding a punitive damage award, *Jones v. Abriani*,⁵⁷ the trial court found that the seller delivered a substantially defective mobile home to the plaintiff. When plaintiff attempted to reject the mobile home defendant threatened that, despite the defects, plaintiff would lose his \$1,000 deposit if he refused to accept the mobile home. In addition, although plaintiff made repeated demands, the defendant did not deliver the manufacturer's warranty booklet which resulted in forfeiture of the

⁵³*Id.* In his dissent, Justice Prentice criticized this finding of fraud on the ground that the plaintiff did not rely on the alleged misrepresentation of intent. 349 N.E.2d at 193-94. In addition, the court's conclusion that the evidence supported a finding that the insurance companies did not intend to fulfill their promises at the time they made them is subject to some criticism. Generally, promissory fraud is not established simply by showing a breach of the contract. If a promise is followed by an immediate breach, the timing of the breach can be evidence of the promisor's fraudulent state of mind. However, in this case, the breach took place long after the promise had been made and no evidence of the state of mind of the party accused of fraud is apparent in the opinion.

⁵⁴349 N.E.2d at 184.

⁵⁵*Id.*

⁵⁶*Id.* at 185. See IND. CODE § 27-1-22-18 (Burns 1975).

⁵⁷350 N.E.2d 635 (Ind. Ct. App. 1976).

warranty protection provided by the manufacturer, since a warranty registration had to be returned by the consumer within five days of purchase in order to be effective. Finally, the defendant refused to acknowledge defects, and refused to repair acknowledged defects, while at the same time making assurances that the defects would be cured.⁵⁸ In sustaining the award of punitive damages the court of appeals emphasized that it is not necessary to prove all the elements of an independent tort in order to establish a basis for punitive damages. Heavy reliance was placed on the second ground in the *Vernon* case, which emphasized the same point. When the defendant's conduct is tortious in nature, but does not fit all the elements of a tort, it nevertheless may be the basis for a punitive damage award if "the public interest will be served by the deterrent effect punitive damages will have upon future conduct of the wrongdoer . . ."⁵⁹ The court of appeals found the defendant's conduct in the *Jones* case tortious in nature and held that the public interest would be served by the punitive damage award.⁶⁰

In *Hibschman Pontiac, Inc. v. Batchelor*,⁶¹ the first of the three cases involving this issue decided during the survey year, the court of appeals overturned a punitive damage award. In this case the plaintiff was the purchaser of a lemon automobile which was returned on repeated occasions to the dealer for repair without satisfactory results. In his suit for breach of warranty the plaintiff alleged that certain statements and acts of the defendant auto dealer were made willfully, maliciously, and in wanton disregard of plaintiff's rights. Those statements were attributed to a service manager at Hibschman Pontiac, who apparently informed Batchelor on several occasions that the car was repaired. In each case the car had not been repaired.⁶² The court of appeals held that in order to support a punitive damage award the plaintiff must establish all the elements of an independent tort,⁶³ and that in

⁵⁸*Id.* at 639-40.

⁵⁹*Id.* at 650, quoting *Vernon Fire & Cas. Ins. Co. v. Sharp*, 349 N.E.2d 173, 180 (Ind. 1976) (emphasis omitted).

⁶⁰In the *Jones* case there may have been proof of actual fraud. When the defendant said that the plaintiff had no right to reject the defective mobile home there may have been a misrepresentation of the law. Generally, a misrepresentation of law is not actionable as fraud. See RESTATEMENT (FIRST) OF CONTRACTS § 474, comment d(1932). However, this may be a case in which the person making the misrepresentation has expert knowledge and is communicating with a person who is entitled to rely on that knowledge. See *id.* § 474(b).

⁶¹340 N.E.2d 377 (Ind. Ct. App. 1976).

⁶²*Id.* at 379, 383.

⁶³*Id.* at 380-81.

this case no independent tort was proved. There was no proof of fraud because there was no reliance by plaintiff on the false statement of the service manager. In this connection, the court quoted testimony in which Batchelor admitted that he knew that all the defects had not been repaired when he drove his automobile out of Hibschman's service department.⁶⁴

The court's focus in this case on the necessity of showing reliance, and all the elements of an independent tort, not only is inconsistent with the supreme court's views expressed in *Vernon*, but raises other questions as well. In *Hibschman* the court acknowledged that the principal purpose of a punitive damage award is to deter and punish, rather than to compensate for loss.⁶⁵ In light of this purpose, reliance and injury to the plaintiff would seem to be less important than the culpability of the defendant. In addition, it may be that there *was* proof of reliance on the misrepresentations in the *Hibschman* case. In testimony quoted by the court, the plaintiff stated that he had called the service manager from Bethel (presumably Bethel College in Mishawaka) and asked if his car was ready. The service manager said, "[T]he car is all ready to go. We want you to come pick it up."⁶⁶ This seems to be one of the misrepresentations proved and Batchelor apparently went to pick up the car thereafter in reliance on it. To the extent that plaintiff traveled from Bethel to defendant's place of business there would seem to be reliance sufficient to complete the elements of the independent tort.

3. *Rejection and Revocation of Acceptance*

In the *Jones* case, discussed in the previous section, the Indiana Court of Appeals offered some guidelines on rejection and revocation of acceptance under the Uniform Commercial Code.⁶⁷ In *Jones* the defects in the mobile home sold to the plaintiff constituted breaches of express warranties and the implied warranty of merchantability. The court pointed out that, based on these defects, the plaintiff had a right to reject the home under UCC

⁶⁴*Id.* at 383.

⁶⁵*Id.* at 380.

⁶⁶*Id.* at 383.

⁶⁷The buyer's right to reject for defects in the seller's performance is found in IND. CODE § 26-1-2-601. (Burns 1974). The buyer may cancel the contract after rejection; *id.* § 26-1-2-711. The buyer must furnish notice of his rejection; *id.* § 26-1-2-602. The buyer has responsibilities with respect to goods which have been rejected; *id.* §§ 26-1-2-603, -604. Buyer's conduct may constitute acceptance of the goods, which prevents rejection; *id.* § 26-1-2-606. However, the buyer still may cancel the contract by revoking his acceptance; *id.* § 26-1-2-608.

section 2-601⁶⁶ and, presumably, to cancel the contract under UCC section 2-711.⁶⁹ The plaintiff was not obligated to make the decision to reject immediately upon discovery of the defects. Instead, a buyer in these circumstances is entitled to "try out" the goods to discover defects for a reasonable time before his retention of the goods will constitute acceptance, and this period may be extended when the seller makes assurances of cure.⁷⁰ Generally, after the buyer gives notice of rejection, use of the goods can negate the rejection, constitute an acceptance, and prevent the buyer from cancelling the contract.⁷¹ In the *Jones* case the buyer continued to use the mobile home after notice of rejection had been given, but the court held that this continued use was provoked by the seller's oppressive conduct, including the representation that rejection would result in forfeiture of buyer's down payment.⁷² The seller's conduct thus justified the buyer's continued use and the use did not negate buyer's earlier rejection. In addition, the court noted that a buyer who rightfully rejects or revokes acceptance is entitled to control the goods in furtherance of a security interest for the amount of the purchase price paid and any incidental damages incurred.⁷³ In this case the plaintiff had given a negotiable promissory note for the mobile home⁷⁴ and, according to the court, was entitled to control the mobile home until that note was returned. However, use of the mobile home during this period above and beyond simple custody might not be justified by the buyer's security interest.⁷⁵ Such use would only be justified, if at all, on the ground that it was necessary to preserve the collateral.⁷⁶

Even if the buyer's conduct after notice of rejection in this case constituted an acceptance of the goods, and negated his rejection, the buyer was still entitled to cancel by revoking his

⁶⁶*Id.* § 26-1-2-601.

⁶⁹*Id.* § 26-1-2-711(1).

⁷⁰350 N.E.2d at 643. This is consistent with the buyer's right of inspection. See IND. CODE § 26-1-2-513 (Burns 1974).

⁷¹See Whaley, *Tender, Acceptance, Rejection and Revocation—The UCC's "TARR"-Baby*, 24 DRAKE L. REV. 52, 65-66 (1974).

⁷²350 N.E.2d at 644.

⁷³*Id.* The buyer's security interest under these circumstances is defined in IND. CODE § 26-1-2-711(3) (Burns 1974).

⁷⁴It should be noted that under present law acceptance of a negotiable promissory note in this transaction would be prohibited by IND. CODE § 24-4.5-2-403 (Burns 1974).

⁷⁵350 N.E.2d at 644.

⁷⁶See *Jorgensen v. Pressnall*, 274 Ore. 285, 545 P.2d 1382 (1976), in which the court held that continued occupancy of a mobile home was the most feasible method of protecting the mobile home from continuing water damage caused by a leaky roof.

acceptance, since all requirements for revocation seem to have been met.⁷⁷ The buyer's acts of acceptance were probably induced by the seller's assurances that cure would be forthcoming, and the court found that the nonconformities in the mobile home substantially impaired the value of the home to the plaintiff. Finally, there had been no substantial change in the condition of the mobile home other than changes which resulted from defects present in the home at the time of tender.⁷⁸

One interesting aspect of the *Jones* case is the court's conclusion that the trial court decision on monetary damages could be supported by use of the formula found in UCC section 2-714.⁷⁹ This section applies when the buyer has accepted and kept the goods, and clearly is not to be used when the buyer has rightfully rejected or revoked acceptance.⁸⁰ The court's decision presumed that the buyer, although he was entitled to do so, did not cancel pursuant to a valid rejection or revocation of acceptance. Therefore, the court's discussion of rejection and revocation of acceptance was either voluntary or primarily related to questions of monetary recovery. There is some indication that it was the latter. In its opinion the court suggests that "grounds for relief were made out on at least four different theories: refusal to recognize a valid rejection; refusal to recognize a rightful revocation of acceptance; breach of express warranty; and breach of implied warranty of merchantability."⁸¹ To the extent the court's decision creates a separate and independent basis for damages based on the seller's refusal to recognize a rejection or revocation of acceptance, the court may have broken new ground. It does not appear that the Uniform Commercial Code drafters provided explicitly for monetary liability under these circumstances. The principal danger for a seller in refusing to recognize a rejection or revocation of acceptance appears in the risk of loss sections of the UCC which shift the risk of loss back to the seller.⁸²

4. *Proof of Damages Under UCC Section 2-714*

The court of appeals in *Jones* also provided some standards for proving damages under UCC section 2-714.⁸³ That section provides that, in general, the measure of recovery is the difference

⁷⁷The requirements for a revocation of acceptance are found in IND. CODE § 26-1-2-608 (Burns 1974).

⁷⁸350 N.E.2d at 644.

⁷⁹IND. CODE § 26-1-2-714 (Burns 1974).

⁸⁰*Id.* § 26-1-2-711.

⁸¹350 N.E.2d at 645.

⁸²See IND. CODE § 26-1-2-510 (Burns 1974).

⁸³IND. CODE § 26-1-2-714 (Burns 1974).

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." In *Jones*, the only evidence to support the trial court's award of \$5,000 damages was evidence that the cost of repair of the mobile home would be \$3,000 to \$4,000. The court stated that since one of the breached express warranties was a warranty of repair, the proof on the cost of repair would be adequate to support the trial court's judgment, at least to the extent of \$4,000. In addition, the court focused on the language which indicates that in special circumstances proximate damages of a different amount may be shown. In this case the seller's refusal to recognize a rightful rejection or revocation of acceptance and continued assurances of cure were special circumstances which justified using the cost of repair as a measure of recovery for any of the breached warranties.⁶⁴

C. *Employee Termination*

During the survey year the Indiana Court of Appeals considered four suits by dismissed employees claiming wrongful discharge against former employers.⁶⁵ In *Shaw v. S.S. Kresge Co.*,⁶⁶ the plaintiff was an employee who had worked for Kresge for about three years. After he was dismissed because of chronic absenteeism and tardiness, Shaw brought suit for breach of the employment agreement. Shaw alleged that Kresge had published a handbook which incorporated the conditions of employment and that the handbook contained a provision which required Kresge to utilize a system of formal warnings and a hearing before dismissing an employee. Shaw claimed that he was not accorded this procedure. In its answer, Kresge admitted that it had furnished the handbook with the provision cited, and that the handbook set forth terms and conditions of the employment relationship. However, Kresge denied that it was obligated to furnish warnings prior to discharging the plaintiff for chronic absenteeism and tardiness since there were other provisions in the handbook which authorized Kresge to terminate an employee without warnings or a hearing and since the relationship was terminable at will. Both

⁶⁴350 N.E.2d at 646.

⁶⁵In a fifth case, an appeal by an employee whose complaint against the East Chicago School Board had been dismissed, the court of appeals found that the complaint stated a cause of action and reversed. Emphasizing that it did not appear from the complaint itself that plaintiff was precluded from recovery, the court held that a missing allegation would not serve as a basis for dismissal. *Soltes v. School City*, 344 N.E.2d 865 (Ind. Ct. App. 1976).

⁶⁶328 N.E.2d 775 (Ind. Ct. App. 1975).

parties moved for summary judgment and the trial court granted the defendant's motion and entered judgment for Kresge.

The court of appeals affirmed the trial court's decision and held that the employment relationship was terminable at will by either employer or employee, despite the provision in the handbook cited by the plaintiff. Since the employment agreement was terminable at will, the court found a want of mutuality of obligation or consideration and therefore any arrangement between the parties was held unenforceable "in respect of that which remains executory."⁸⁷ In addition, the court concluded that there was no basis for a cause of action under the principle found in section 90 of the *Restatement (First) of Contracts*,⁸⁸ since the defendant made no promise of employment for any ascertainable period.

Since Kresge admitted that the handbook set forth terms and conditions of Shaw's employment, it constituted part of the contractual relation between the parties. Therefore, the court was required to interpret this writing to determine if it established a contract for permanent employment or was sufficient to cause reliance for which plaintiff might have sued under the principle found in section 90 of the *Restatement*. This interpretation question could be viewed as a question of fact. Moreover, plaintiff submitted an affidavit in which he recited his understanding of language in the handbook and the fact that he had remained in Kresge's employ on the basis of these understandings. This might be viewed as evidence of the commercial setting in which the contract was formed and course of performance, both of which would be relevant in interpreting the writing. To the extent that the interpretation of the writing involved weighing evidence of commercial setting and course of performance, a further fact question is brought into focus, one which would normally be decided by a jury.⁸⁹ The existence of these fact questions may have made summary judgment inappropriate.

In a second case, *Town of Highland v. Powell*,⁹⁰ the court of appeals was confronted with a question concerning the measure of recovery for a police officer who was dismissed from employ-

⁸⁷*Id.* at 779.

⁸⁸RESTATEMENT (FIRST) OF CONTRACTS § 90 (1932) provides: "A promise which the promissor should reasonably expect to induce action or forbearance of a definite and substantial character on the part of the promisee and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise."

⁸⁹If the meaning of words in a writing depends on the credibility of extrinsic evidence or on a choice among reasonable inferences to be drawn from extrinsic evidence, it is a question for the trier of fact. See RESTATEMENT (SECOND) OF CONTRACTS § 238(2) (1973).

⁹⁰341 N.E.2d 804 (Ind. Ct. App. 1976).

ment without regard for the proper dismissal procedure. The trial court had ordered the officer's reinstatement and directed that the Highland Police Department pay all wages and salary withheld during the period between his termination and reinstatement. On appeal, the town argued that the award should be modified to reflect income which the officer had earned in other employment during his dismissal period. Generally, the measure of recovery for a wrongfully dismissed employee is the salary which would have been paid under the employment contract less any earnings actually generated during the employment period. However, the court of appeals refused to apply this formula and affirmed the award of the trial court, relying on cases decided under a provision of the Cities and Towns Act.⁹¹ That statute provides a procedure for disciplining police or fire department employees of cities and towns covered by the Act, and specifies various grounds for dismissal.⁹² If a police officer or fireman is dismissed under this law the officer has a statutory right to appeal to the circuit or superior court of the county in which the city is located within thirty days from the date of decision of the Board of Metropolitan Police Commissioners. If the decision of the board is reversed, the statute requires the city to "pay to the party entitled thereto any salary or wages withheld from such party pending such appeal and to which he or she may be entitled under the judgment of said court."⁹³ On the basis of this language courts have permitted a recovery of back wages without an offset for money earned in other employment.⁹⁴ The court of appeals in *Powell* followed these cases and, finding that the statutory provisions were applicable to the officer's dismissal and that the appeal to the circuit court was effected in a timely manner, the court determined that an offset for wages earned by Powell during his dismissal period was not required.

In *Seco Chemicals v. Stewart*,⁹⁵ another question was raised concerning wages earned in substitute employment. In that case the employment agreement provided:

Any violation of the terms of this contract by employer shall render the contract voidable by employee, in which event employee shall have the option to continue working under the terms of the contract or terminate said working relationship and receive as liquidated dam-

⁹¹IND. CODE §§ 18-1-1-1 to -24-1 (Burns 1974).

⁹²*Id.* § 18-1-11-3.

⁹³*Id.*

⁹⁴*Bole v. Civil City of Ligonier*, 242 Ind. 627, 181 N.E.2d 236 (1962); *City of Lebanon v. DeBard*, 110 Ind. App. 79, 37 N.E.2d 718 (1941).

⁹⁵349 N.E.2d 733 (Ind. Ct. App. 1976).

ages the balance due under the remainder of the term of the contract as set out in Section 3(a) of this contract.

After the employee, Stewart, was wrongfully discharged, he worked at three different jobs in other communities during the remainder of the twenty-three-month period covered by the employment agreement. Salary earned in these other jobs was deducted from the total salary remaining due under the breached employment agreement to compute Stewart's recovery in the trial court. This award was based on the principle mentioned above that an employee should recover total salary for the employment period less any amount he could have earned in comparable employment at a similar compensation rate in the same community or less what the employee *actually* earned in *any* substitute employment.⁹⁶ The latter amount is deducted for the following reason: when a wrongfully discharged employee fails to find work during the employment period the measure of recovery is simple and direct; he can be put in the position he would have been in had the contract been performed by being given the full salary due under the agreement. However, to the extent that the employee uses the free time made available by the breach to earn money, he has not suffered a loss and can be put in the full performance position by being given the difference between what he earned and what he would have earned under the breached agreement. In either case the employee ends up with the full salary for the employment period.⁹⁷

On appeal the court reversed on the issue of damages. It held that the quoted language constituted a liquidated damages agreement. Since damages were fixed in the agreement, the trial court "should not have included a consideration of what Stewart earned—or could have earned"⁹⁸ during the employment period. However, the court did not consider whether the failure of the agreed damage clause to take account of actual earnings in substitute employment prevented it from being a reasonable estimate of anticipated losses, and thus void as a penalty.⁹⁹

In *Kiyose v. Trustees of Indiana University*¹⁰⁰ the court of appeals was asked to address a question concerning the enforceability of an oral contract for lifetime employment. The plaintiff,

⁹⁶J. CALAMARI & J. PERILLO, *THE LAW OF CONTRACTS* 351 (1970).

⁹⁷The court of appeals quoted from 5 CORBIN, *CONTRACTS* § 1039, at 242 (1963), on this subject. 349 N.E.2d at 740.

⁹⁸*Id.* at 741.

⁹⁹The court showed less sympathy for agreed remedies in *Mandle v. Owens*, discussed at text accompanying notes 36-45 *supra*.

¹⁰⁰333 N.E.2d 886 (Ind. Ct. App. 1975).

a lecturer and student at Indiana University, was told by university officials that if he obtained a Doctor of Philosophy degree in East Asian languages he would be given a permanent faculty appointment. After obtaining the degree in April 1973, he was appointed to the rank of assistant professor. When he was notified that he would not be reappointed for the 1974-75 academic year, plaintiff initiated this action alleging breach of an oral agreement for permanent employment. The trial court sustained defendant's motion to dismiss based on the fifth section of the Statute of Frauds, which provides that no action shall be brought "[u]pon any agreement that is not to be performed within one [1] year . . . unless the promise . . . shall be in writing . . ."¹⁰¹ The court of appeals reversed on this issue, acknowledging numerous authorities holding that a contract for lifetime employment need not be in writing to be enforceable. The fifth section of the Statute of Frauds has been interpreted to require a writing only if the contract *could not* be performed within one year.¹⁰² In *Kiyose* the plaintiff could have died within one year, which would have constituted complete performance of the lifetime employment contract. Since the contract *could have been performed* within one year, it did not have to be in writing to be enforceable. This suggests the somewhat anomalous situation in which a thirteen-month employment contract for an octogenarian might have to be in writing to be enforceable because it could not be performed within one year, while an oral agreement to hire a healthy young employee for life would be enforceable.

D. Broad Form Indemnity

The court of appeals recently heard two cases in which a party was seeking indemnity for injuries caused by its own negligence.¹⁰³ In *Vernon Fire & Casualty Insurance Co. v. Graham*,¹⁰⁴

¹⁰¹IND. CODE § 32-2-1-1 (Burns 1973).

¹⁰²333 N.E.2d at 889. The court cited *Frost v. Tarr*, 53 Ind. 390 (1876); *Hurd v. Ball*, 128 Ind. App. 278, 143 N.E.2d 458 (1957); *Holcomb & Hoke Mfg. Co. v. Younge*, 103 Ind. App. 439, 8 N.E.2d 426 (1937).

¹⁰³The 1975 Indiana General Assembly enacted a law declaring broad form indemnity clauses to be void and unenforceable in construction contracts. IND. CODE § 26-2-5-1 (Burns Supp. 1976). However, since the law does not affect agreements which were made before July 1, 1975, it would not affect either of the cases discussed in this section. In addition, the law does not apply to highway construction contracts and thus the *Thomas* case, discussed at text accompanying notes 105-08 *infra*, would not be governed by this new law even though it is a construction contract. And, since the *Graham* case, discussed at text accompanying note 104 *infra*, involved a lease it would not be covered by the new law. See *Bepko, Contracts and Commercial Law, 1975 Survey of Recent Developments in Indiana Law*, 9 IND. L. REV. 132, 136-38 (1975).

¹⁰⁴336 N.E.2d 829 (Ind. Ct. App. 1975).

a lessor who had incurred liability for negligence to a third party on leased premises was attempting to obtain indemnification from the lessee. In *Indiana State Highway Commission v. Thomas*,¹⁰⁵ the State of Indiana, which had incurred liability to a worker for negligence on a construction job, was attempting to obtain indemnification from the contractors. In both cases the court affirmed trial court opinions which refused to interpret indemnity agreements to protect against negligence on the part of the party seeking indemnification. In the *Graham* case the court repeated the often-stated principle that contracts which provide indemnification for one's own negligence may be valid, but the agreement must be knowingly and willingly made in order to be enforced. In addition, these provisions are strictly construed and will not be held to require indemnity for loss caused by the negligence of the party seeking indemnification unless the requirement is expressed in clear and unequivocal terms.¹⁰⁶ In the *Thomas* case, which was decided after *Graham*, the court went one step further and held not only that such a clause will be strictly construed, but that general language will never be sufficient to require indemnification for negligence of the party seeking indemnification. The language must specifically mention indemnity against the indemnitee's own negligence.¹⁰⁷ This is justified since "lawyers who specialize in this field are well aware that clauses such as those under consideration in this case demand laborious judicial parsing . . . [and] it is not too much to require them to stop waging verbal duels and to state unmistakably whether or not a contract purports to burden the indemnitor with another's negligence."¹⁰⁸

E. Conditional Payment Terms in Subcontracts

In written agreements between general contractors and subcontractors for construction work there is often a conditional payment clause. The clause may provide, for example, that the contractor will pay the subcontractor for the subcontract work "after completion of the work, certification by the architect, and payment by the owner."¹⁰⁹ General contractors have urged that such

¹⁰⁵346 N.E.2d 252 (Ind. Ct. App. 1976).

¹⁰⁶336 N.E.2d at 831.

¹⁰⁷346 N.E.2d at 260.

¹⁰⁸*Id.* at 263-64, quoting from *Jordan v. City of New York*, 3 App. Div. 2d 507, 514, 162 N.Y.S.2d 145, 152 (1957), *aff'd*, 5 N.Y.2d 723, 152 N.E.2d 667, 177 N.Y.S.2d 709 (1958).

¹⁰⁹HANDBOOK FOR SUBCONTRACTORS E-6 (1973). In this handbook, compiled by the Indiana Subcontractors Association, Inc., 4755 Kingsway Drive, Indianapolis, Indiana 46205, the association warns against the use of this clause and suggests that it might result in a contingent right to payment.

clauses create express conditions precedent to the general contractor's obligation to pay. Therefore, if the owner failed to pay the general contractor, or delayed payment for a substantial period, the general would not have to pay the subcontractor, at least until the end of that period of delay. The subcontractor's right to payment would thus be contingent on a variety of circumstances which may be beyond his control and he would bear the risk of the owner's insolvency. Some courts have applied conditional payment clauses in this manner.¹¹⁰ This year, however, in *Midland Engineering Co. v. John A. Hall Construction Co.*,¹¹¹ the United States District Court for the Northern District of Indiana joined other courts in restricting this type of clause. In this case the conditional payment clause provided that the contractor was to make "payment, which the said contractor shall pay to said subcontractor immediately after said material and labor installed by said subcontractor to have been completed, approved by said architect, and final payment received by the contractor"¹¹² The owner did not pay the general contractor and no payment was made to the subcontractor for approximately three years. The court held that this provision did not create a perpetual excuse for nonpayment, but simply provided the general contractor with a reasonable time within which to obtain payment from the owner before making payment to the subcontractor.¹¹³ The three-year delay was beyond this reasonable period and payment was due.

In reaching this conclusion the court expressed concern about the effect of a different rule in circumstances such as those presented in the *Midland Engineering* case. In *Midland Engineering* the owner kept a five percent retainage from the general contractor until final payment was due while the general contractor kept a ten percent retainage from the subcontractor. In this situation the general contractor is in the position of holding some of the subcontractor's money until final payment becomes due and, therefore, it may be in the interest of the general contractor to delay payment. The court said that "it would not be inconceivable that a malefic general contractor might intentionally maintain a dispute with the owner which would cause the owner to refuse to make payment; the general contractor could thereby avail himself for several years of funds to which he has no right."¹¹⁴

¹¹⁰See, e.g., *Mascioni v. I.B. Miller, Inc.*, 261 N.Y. 1, 184 N.E. 473 (1933).

¹¹¹398 F. Supp. 981 (N.D. Ind. 1975).

¹¹²*Id.* at 993.

¹¹³The language of the standard form for subcontracts distributed by the American Institute of Architects produces a similar result. See AIA Document A401, Standard Form of Agreement Between Contractor and Subcontractor, art. 12.5 (American Institute of Architects, Jan. 1972).

¹¹⁴398 F. Supp. at 994.