

# RECENT DEVELOPMENTS IN CONTRACT AND COMMERCIAL LAW

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## INTRODUCTION

This Article surveys the most significant developments in Indiana contract and commercial law from January 1, 1993 through September 30, 1993. The opinions reviewed include both Indiana decisions and federal court decisions construing Indiana law.

### I. UNIFORM COMMERCIAL CODE—APPLICATION OF ARTICLE 2

On April 20, 1993, the Indiana Supreme Court resolved a disagreement among the districts of the Indiana Court of Appeals<sup>1</sup> regarding the application of Article 2 of the Uniform Commercial Code to transactions involving both sales of goods and performance of services.<sup>2</sup> The scope provisions of Article 2 do not clearly include or exclude these “mixed” or “hybrid” transactions,<sup>3</sup> and as a result, disputes often arise as to the applicability of the provisions of the UCC.<sup>4</sup> Because Article 2 provides many benefits which the common law does

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1. See *Data Processing Serv., Inc. v. L.H. Smith Oil Corp.*, 492 N.E.2d 314 (Ind. Ct. App. 1986); *Insul-Mark Midwest, Inc. v. Modern Materials, Inc.*, 594 N.E.2d 459 (Ind. Ct. App. 1992), *modified*, 612 N.E.2d 550 (Ind. 1993). See discussion *supra*, Parts I.A. and I.B.

2. For a discussion of various types of transactions involving both sales of goods and provision of services, see Sonja A. Soehnel, Annotation, *Applicability of UCC Article 2 to Mixed Contracts for Sale of Goods and Services*, 5 ALR 4th 501 (1981). See also *Matthews v. Metropolitan Contract Carpets*, 1988 WL 124900 (E.D. Pa. 1988) (installation of wooden floor); *Grossman v. Aerial Farm Serv., Inc.*, 384 N.W.2d 488 (Minn. Ct. App. 1986) (aerial application of herbicide); *McCool v. Hoover Equip. Co.*, 415 P.2d 954 (Okla. 1966) (chroming of crankshafts); *Perlmutter v. Beth David Hosp.*, 123 N.E.2d 792 (N.Y. 1954) (transfusion of blood).

3. IND. CODE § 26-1-2-102 (Supp. 1992) provides in relevant part: “Unless the context otherwise requires, I.C. § 26-1-2 applies to transactions in goods.” The term “goods” is defined by IND. CODE § 26-1-2-105(1) (1988): “‘Goods’ means all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale . . . .” Article 2 does not, however, address whether it should be applied to transactions involving both goods and services.

4. The definition of goods contained in IND. CODE § 26-1-2-105(1) specifically includes specially manufactured goods. As the Sixth Circuit Court of Appeals explained in *Wells v. 10-X Mfg. Co.*, 609 F.2d 248 (6th Cir. 1979), although “[i]t is clear that Article 2 of the Code is intended to have broad application. . . it also follows from the Code’s continued focus on ‘goods,’ the definition of which is cast in terms of a ‘contract for sale,’ that a contract which calls merely for the rendition of services is not subject to the sales provisions of the Code.” *Id.* at 254. “We conclude that, even in the context of a contract for special manufacture, initial inquiry should focus not on the fact of special manufacture, but on whether the contract is one for the sale of goods or one for the

not—such as warranties and remedies—the applicability determination can be a dispositive issue.

### A. *Factual Background*

In the case of *Insul-Mark Midwest, Inc. v. Modern Materials, Inc.*,<sup>5</sup> the Indiana Supreme Court adopted the “predominant thrust” test used by a majority of jurisdictions that have addressed this issue.<sup>6</sup> The dispute in *Insul-Mark Midwest* arose after Insul-Mark contracted to have Modern Materials treat roofing fasteners with a fluorocarbon coating so that the fasteners would meet specified rust-resistance standards. Modern Materials received customer parts, processed them with various treatments, and returned them to the customer.<sup>7</sup> Modern Materials invoiced these transactions with work orders rather than purchase orders and computed charges based upon the weight and length of fasteners treated.<sup>8</sup> When the rust-resistant coating failed to meet the specified requirements, Insul-Mark brought suit against Modern Materials based in part upon breach of express and implied warranties of Article 2 of the UCC.<sup>9</sup>

The trial court granted Modern Materials’ motion for summary judgment on the warranty claims because it found the transactions between the parties were service contracts not subject to the warranty provisions of Article 2 of the UCC.<sup>10</sup> On appeal, Judge Staton, writing for the Third District Court of Appeals, affirmed the trial court’s entry of summary judgment on the warranty claims, noting a split of authority among the Indiana Court of Appeals’ districts on the proper test for determining whether a transaction involving both sales of goods and rendition of services is within the scope of Article 2 of the UCC.<sup>11</sup> In order to resolve this conflict, the Indiana Supreme Court granted transfer.

### B. *Two Approaches*

The two tests previously used by Indiana courts to determine whether Article 2 of the UCC applies to a transaction are generally referred to as the “bifurcation approach” and the “predominant thrust approach.”

1. *The Bifurcation Approach.*—An Indiana case which attempted to utilize the bifurcation approach was the Fourth District Court of Appeals decision in

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rendition of services.” *Id.* Thus, the first inquiry—whether goods or services predominate—remains the same when a transaction involves specially manufactured goods.

5. 612 N.E.2d 550 (Ind. 1993).

6. *Id.* at 554.

7. *Id.* at 551.

8. *Id.* at 552.

9. *Id.* at 551.

10. *Insul-Mark Midwest, Inc. v. Modern Materials, Inc.*, 594 N.E.2d 459, 461 (Ind. Ct. App. 1992), *modified*, 612 N.E.2d 550 (Ind. 1993).

11. *Id.* at 462, 464.

*Data Processing Services, Inc. v. L.H. Smith Oil Corp.*<sup>12</sup> Under the bifurcation approach, “the portion of a transaction involving goods is governed by code principles, while those parts relating to the provision of services are controlled by the common law.”<sup>13</sup>

The bifurcation approach is not feasible in many situations and many problems may result from such an approach.<sup>14</sup> For example, inconsistent application may occur when the transaction at issue is not easily divisible into goods and services portions (e.g., a contract for laying asphalt).<sup>15</sup> Also, if the dispute concerns the creation of a contract, the bifurcation approach may result in enforcement of only the service portion of the contract while the goods portion is left unenforceable.<sup>16</sup> Such a result would be contrary to the parties’ intent to enter into a single contract providing for both goods and services.<sup>17</sup>

2. *The Predominant Thrust Approach.*—In comparison to the bifurcation approach, the predominant thrust approach focuses on the parties’ expectations. In *Insul-Mark Midwest*, Chief Justice Shepard clearly sets forth the appropriate considerations when applying the predominant thrust approach to a mixed transaction.<sup>18</sup> The “parties seeking the benefit of the code . . . bear the burden of establishing that the thrust of the transaction was predominantly for goods and only incidentally for services.”<sup>19</sup> In establishing the thrust of the contract, one should look “to the language of the contract in light of the situation of the parties and the surrounding circumstances. Specifically, one looks to the terms describing the performance required of the parties, and the words used to describe the relationship between the parties.”<sup>20</sup> Next, one considers the “circumstances of the parties, . . . the primary reason they entered into the contract,” and the “final product the purchaser bargained to receive . . . .”<sup>21</sup> “Finally, one examines the costs involved for the goods and services, and whether the purchaser was charged only for a good, or a price based on both

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12. 492 N.E.2d 314 (Ind. Ct. App. 1986). See also *Stephenson v. Frazier*, 399 N.E.2d 794 (Ind. Ct. App. 1980).

13. *Insul-Mark Midwest*, 612 N.E.2d at 554 (citing *Stephenson v. Frazier*, 399 N.E.2d 794 (Ind. Ct. App. 1980)).

14. See Gerald L. Bepko, *Contracts, Commercial Law, and Consumer Law*, 14 IND. L. REV. 223, 224 (1981).

15. *Id.* This problem is especially evident in *Data Processing Serv., Inc. v. L.H. Smith Oil Corp.* where, as Judge Staton pointed out in *Insul-Mark Midwest, Inc. v. Modern Materials, Inc.*, 594 N.E.2d 459 (Ind. Ct. App. 1992), the court purported to apply the bifurcation approach, but instead applied common law to the entire transaction. “The effect was a de facto application of the predominant thrust doctrine.” *Insul-Mark Midwest*, 594 N.E.2d at 463 n.1.

16. Bepko, *supra* note 14.

17. *Id.*

18. 612 N.E.2d 550, 555 (Ind. 1993). For an early yet complete statement of the predominant thrust approach, see *Bonebrake v. Cox*, 499 F.2d 951 (8th Cir. 1974).

19. 612 N.E.2d at 555.

20. *Id.* (citations omitted).

21. *Id.*

goods and services. If the cost of the goods is but a small portion of the overall contract price, such fact would increase the likelihood that the services portion predominates."<sup>22</sup> In *Insul-Mark*, application of these factors led the Indiana Supreme Court to conclude that the contract in question was primarily for services, and thus, the UCC should not be applied.<sup>23</sup>

### C. *Contracts for the Sale of Computer Software*

Although the Indiana Supreme Court has stated the appropriate factors to consider when determining whether to apply Article 2 to mixed transactions, application of this test to transactions involving computer software<sup>24</sup> is still unclear. Indiana's only reported case dealing with whether Article 2 applies to contracts involving computer software is *Data Processing Services, Inc. v. L.H. Smith Oil Corp.*<sup>25</sup> There, the court purported to apply the now-outdated bifurcation test, but actually used an analysis more consistent with the predominant thrust approach.<sup>26</sup> Data Processing Services was engaged to develop and implement a data processing system for Smith Oil's new computer. Smith Oil refused to pay for the system because even after several attempts by Data Processing Services to correct problems, the system did not work properly. Data Processing Services brought suit to recover the contract price. The trial court found the contract was for the sale of goods, and thus, applied Article 2.<sup>27</sup> On appeal, the Fourth District noted that the parties' language indicated the contract was for a transaction in services; the contract included no sale of computer hardware; Smith Oil bargained for Data Processing Services' skills, knowledge, and ability rather than for standardized software; and the means by which Data Processing Services' skills and knowledge were to be transferred to Smith Oil were incidental to the contract.<sup>28</sup> Because the means of transmission, a disk, which would otherwise be considered a "good," was not the essence of the transaction, the service portion of the contract predominated.<sup>29</sup> Thus, the Court of Appeals concluded that Article 2 of the UCC was not applicable.

The *Data Processing Services* case is cited by courts throughout the United States as authority for the proposition that customized software is a service rather than a good.<sup>30</sup> In contrast, the majority of courts have held that packaged

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22. *Id.*

23. *Id.* at 556.

24. Computer software is defined as a medium that stores output and input data as well as programs—sets of statements or instructions to be used in a computer to perform various functions. See Federal Copyright Act, 17 U.S.C. § 101 (1988).

25. 492 N.E.2d 314 (Ind. Ct. App. 1986).

26. See *supra* note 15.

27. *Data Processing Serv., Inc.*, 492 N.E.2d at 316.

28. *Id.* at 318-19.

29. *Id.* at 319.

30. See, e.g., *Micro-Managers, Inc. v. Gregory*, 434 N.W.2d 97 (Wis. Ct. App. 1988).

software sales and combined hardware and software sales are sales of goods subject to Article 2.<sup>31</sup> Thus, whether Article 2 of the UCC applies to a transaction in software appears currently to depend upon the type of software involved in the transaction. Three basic categories of software transactions exist: sales of pre-existing software, sales of custom software, and transactions where software is delivered through remote access.<sup>32</sup>

1. *Transactions In Pre-Existing Software.*—Transactions in pre-existing software include both sales of operating system software, which often is sold along with and as part of the computer hardware system (e.g., Microsoft DOS), and sales of pre-packaged software (e.g. Lotus 1-2-3, WordPerfect). These types of transactions are typically deemed by the courts, without discussion, to be subject to the provisions of Article 2.<sup>33</sup>

2. *Transactions In Custom Application Software.*—The second type of software transaction involves custom developed software. The courts' treatment of these transactions with regard to application of Article 2 has varied widely. For example, in *Micro-Managers, Inc. v. Gregory*,<sup>34</sup> the Wisconsin Court of Appeals was asked to determine whether a contract for the development of a custom computer program for Gregory was a contract for the sale of a good or for the rendition of a service.<sup>35</sup> The trial court reasoned that Article 2 of the UCC should apply because the contract was for the delivery of a "program," which was within the scope of Article 2's provision for specially manufactured goods.<sup>36</sup> The court of appeals, however, held that this contract was actually for

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31. See, e.g., *RRX Industries, Inc. v. Lab-Con, Inc.*, 772 F.2d 543 (9th Cir. 1985) (computer software system contract requiring repair of "bugs" was a contract for goods); *Triangle Underwriters, Inc. v. Honeywell, Inc.*, 604 F.2d 737 (2d Cir. 1979), *aff'd*, 651 F.2d 132 (2d Cir. 1981) (sale of computer package including hardware, operating system software and custom application software deemed a contract for the sale of goods); *First Nationwide Bank v. Florida Software Serv., Inc.*, 770 F. Supp. 1537, 1543 (M.D. Fla. 1991); *D.P. Technology Corp. v. Sherwood Tool, Inc.*, 751 F. Supp. 1038, 1040 n.4 (D. Conn. 1990); *Chatlos Systems, Inc. v. National Cash Register Corp.*, 479 F. Supp. 738 (D.N.J. 1979), *modified*, 635 F.2d 1081 (3d Cir. 1980) (computer hardware and software sold as a package deemed sale of a good); *Neilson Bus. Equip. Ctr., Inc. v. Monteleone*, 524 A.2d 1172 (Del. 1987) (sale of a "turn-key" computer system deemed sale of a good); *Systems Design and Management Information, Inc. v. Kansas City Post Office Employees Credit Union*, 788 P.2d 878 (Kan. Ct. App. 1990) (computer software package deemed a sale of goods).

32. See Raymond T. Nimmer, Donald A. Cohn & Ellen Kirsch, *License Contracts Under Article 2 Of The Uniform Commercial Code: A Proposal*, 19 RUTGERS COMPUTER & TECH. L.J. 281, 307-12 (1993).

33. *Triangle Underwriters, Inc.*, 604 F.2d at 737 (sale of computer package including hardware, operating system software and custom application software deemed a contract for the sale of goods); *Chatlos Sys., Inc.*, 479 F. Supp. at 738 (computer hardware and software sold as a package deemed sale of a good); *Neilson Bus. Equip. Ctr., Inc.*, 524 A.2d at 1172 (sale of a "turn-key" computer system deemed sale of a good); *Communications Group, Inc. v. Warner Communications, Inc.*, 527 N.Y.S.2d 341 (N.Y. Civ. Ct. 1988).

34. 434 N.W.2d 97 (Wis. Ct. App. 1988).

35. *Id.* at 98.

36. *Id.* at 100.

the custom programming services provided rather than for the program itself.<sup>37</sup> The court looked to the method of billing and the language of the contract in making its determination.<sup>38</sup> Thus, Article 2 was deemed inapplicable, and Gregory was forced to rely on common law contract principles.

3. *Transactions in Remote Access Software.*—The final type of software transaction occurs when a purchaser obtains the use of the software through remote access transmission. Because this type of transaction has not been used as frequently as the other types of software transactions previously discussed, no appellate decisions dealing with remote access software are reported. This type of transaction does, however, raise the most interesting issues with regard to Article 2 in that the current Article 2 provisions for delivery, acceptance, and rejection cannot be applied when software is delivered via electronic communication lines without the exchange of any tangible good. Nonetheless, simply denying application of Article 2 to these transactions would be illogical. The essence of a remote access transaction is the same as any other software transaction—the purchaser desires the use of the computer program—and the method of delivery is merely incidental to the transaction.

#### D. Revision of Article 2

The American Law Institute (“ALI”) and the National Conference of Commissioners on Uniform State Laws (“NCCUSL”) are currently drafting a revision of Article 2 of the Uniform Commercial Code. Because software transactions do not easily fit within the current framework of Article 2, resulting in inconsistent application of the UCC among the states, the ALI and the NCCUSL have devoted a significant amount of thought to the treatment of software transactions under the proposed revision.

1. *Current Redraft of Article 2.*—The scope section of the redraft of Article 2 currently is written as follows:

(a) Unless the context otherwise requires, this Article applies to:

(1) any transaction, regardless of form, that creates a contract for the sale of goods, including a transaction in which a sale of goods predominates;

(2) any dispute relating to goods supplied under a transaction in which the sale of goods does not predominate; and

(3) any dispute arising under an agreement obligating the seller to install, customize, service, repair, or replace goods at or after the time of contracting.

(b) If this Article conflicts with Article 2A or 9, those Articles govern.

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37. *Id.*

38. *Id.*

(c) A transaction subject to this Article is also subject to applicable consumer protection laws of this State, including contracts for the sale of farm products.<sup>39</sup>

The redraft appears to codify a combination of the bifurcation test, which has been rejected by most courts,<sup>40</sup> and the predominant thrust test, recently adopted in Indiana.<sup>41</sup> Subsection (1) appears to require application whenever there is a contract for the sale of goods. However, the question remains—at what point does a transaction become a sale of goods rather than a rendition of services? Thus, the predominant thrust test may still be necessary under the redraft approach. Subsection (2) is similar to the bifurcation approach in that the UCC could apply even in transactions where services predominate. The same problems as with the bifurcation approach might arise under this redraft subsection when disparate disputes arise from both the goods portion of the transaction and the services portion.<sup>42</sup> For the same reasons that the Indiana Supreme Court recently rejected the bifurcation test,<sup>43</sup> the Commissioners on Uniform State Laws should reject the current redraft. Instead, several alternatives should be considered.

2. *Alternatives to the Current Redraft.*—Several alternatives have been suggested under which the application or non-application of Article 2 to contracts involving both sales of goods and rendition of services would become clear.

a. *Revise the scope of Article 2*

The first alternative would be to revise the scope of Article 2 to specifically include software contracts and other contracts in which the issue of application of Article 2 most often arises.<sup>44</sup> Adoption of this approach would require extensive redrafting of the existing Article 2 in order to make it compatible with

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39. The American Law Institute and the National Conference of Commissioners on Uniform State Laws, Draft of Uniform Commercial Code Revised Article 2—Sales, Parts 1, 2, 3, and 7 December 21, 1993, at 7-8.

40. See *supra* Part I.B.1.

41. See *supra* Part I.B.2.

42. See *supra* Part I.B.1.

43. *Id.*

44. See Nimmer, Cohn & Kirsch, *supra* note 32, at 315-18. A definition of “software contract” was recommended by Professor Nimmer, Reporter on Technology Issues for the Drafting Committee to Revise UCC Article 2:

An agreement that transfers or promises to transfer one or more rights in specific computer software, including the right to access, the right to use or to have used, the right to modify, the right to copy or the right to otherwise employ the computer software. A transaction is a software contract whether the software is in existence at the time of the contract or is to be developed. A contract is a software contract regardless of whether or not the contract also contemplates transfer of tangible property containing the computer software or services to develop or support the software.

*Id.* at 294.

technologically advanced transactions.<sup>45</sup> For example, software delivered through remote access transmission would not be compatible with the current Article 2 provisions regarding delivery and acceptance.

Although this approach is better than the current redraft, merely revising the scope provisions of Article 2 appears to be only a temporary solution. Article 2 and its predecessors were drafted during the industrial age. Since then, we have entered what many call the information age, where technological advancements frequently occur in the area of intellectual property. The future is sure to provide us with new technological innovations that will raise similar issues with respect to the application of Article 2. If the Commissioners on Uniform State Laws choose simply to revise the current Article 2, they must be prepared to make revisions every few years in order to keep pace with technology.

*b. The "hub and spoke" configuration*

A second option would be to adopt a "hub and spoke" approach to Article 2. Under this approach, Article 2 would contain general principles which are applicable to all commercial contracts. Several sub-articles would then be developed, similar to Article 4A—Electronic Funds Transfers, in which more specific transactions, such as software contracts, could be addressed with particularity.<sup>46</sup>

The hub and spoke approach to drafting the revision appears to be the most forward-thinking of the options available. As technology advances, this configuration would allow new types of transactions to be subject to the provisions of Article 2 without having to redraft and enact an entire Article. Instead, new sub-articles could be added as they become necessary. This approach would provide for faster adaptation of Article 2 to technological advances and would promote uniformity of laws because the states may be more likely to adopt new sub-parts without significantly altering the "hub" Article.

*c. Exclude various transactions from Article 2*

A final alternative would be to remove various types of contracts from the scope of Article 2. New articles of the UCC could then be created to deal specifically with transactions such as intangibles licensing.<sup>47</sup>

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45. For a detailed analysis of necessary changes, see Nimmer, Cohn & Kirsch, *supra* note 32, at 284-85.

46. See Nimmer, Cohn & Kirsch, *supra* note 32, at 318-22. Similar problems to those which arise in applying Article 2 to software sales also arise on text of electronic funds transfers and Article 4. These problems were addressed by the adoption of Article 4A—Electronic Funds Transfers. See National Automated Clearing House Association, Uniform Commercial Code Article 4A and the Automated Clearing House System 6-7, 1990; MICHAEL K. MCCRORY & JUDY L. WOODS, UNIFORM COMMERCIAL CODE UPDATE: SECTIONS 2A AND 4A (1991).

47. See Nimmer, Cohn & Kirsch, *supra* note 32, at 322-25.

Although this alternative is preferable to simply expanding the scope of Article 2 to include those transactions in which application questions often arise, merely excluding these transactions from the scope of Article 2 also has significant drawbacks. First, these transactions, such as software transactions, share several characteristics with other types of commercial transactions. The commercial public would be best served by simplification of the laws applicable to commercial transactions. This simplification would occur by placement of the core rules in one location, rather than creating a separate set of rules to apply to what may seem to the public to be very similar transactions. Also, a well-developed body of case law exists interpreting the provisions of Article 2. These cases could be a valuable resource to use in applying the basic principles of Article 2 to software transactions. If software and similar transactions are removed from the scope of Article 2 and a new Article is adopted to deal specifically with licensing transactions, the precedential value of these cases would be diminished.

### *E. Conclusion*

The recent adoption by the Indiana Supreme Court of the predominant thrust approach to determine whether Article 2 of the Uniform Commercial Code applies to transactions involving both a sale of goods and rendition of services was an appropriate step to keep Indiana law consistent with the majority of the states. Adoption of the predominant thrust test, however, does not resolve whether various types of computer software transactions are subject to the provisions of Article 2. In the coming years, when the American Law Institute and the National Conference of Commissioners on Uniform State Laws complete a redraft of Article 2 for consideration by the states, they should propose a configuration of Article 2 using a hub and spoke format that anticipates and is adaptable to future technological advances.

## II. CONTRACT ACTIONS—AWARD OF PUNITIVE DAMAGES

The Indiana Supreme Court, in a three-justice majority opinion authored by Justice Krahulik, recently clarified the previously stated "general rule" that punitive damages are not allowed in breach of contract actions and held that "there are no exceptions" to this rule.<sup>48</sup> Thus, punitive damages are not recoverable for "tort-like" conduct. Instead, "in order to recover punitive damages in a lawsuit founded upon a breach of contract, the plaintiff must plead and prove the existence of an independent tort of the kind for which Indiana law recognizes that punitive damages may be awarded."<sup>49</sup>

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48. *Miller Brewing Co. v. Best Beers of Bloomington, Inc.*, 608 N.E.2d 975, 981 (Ind. 1993).

49. *Id.* at 984.

### A. *Factual Background*

In *Miller Brewing Co. v. Best Beers of Bloomington, Inc.*,<sup>50</sup> Best Beers brought suit against Miller for wrongful termination of its distributorship agreement, seeking both compensatory and punitive damages.<sup>51</sup> Evidence presented at trial established that Miller wrongfully terminated the contract, but such evidence was insufficient to prove an independent tort.<sup>52</sup> The trial court entered judgment for Best Beers in the amount of \$397,852 for compensatory damages and \$1,989,260 for punitive damages. The Court of Appeals affirmed the trial court's award of compensatory damages and the entitlement of Best Beers to punitive damages, but remanded for a redetermination of the amount.<sup>53</sup> On transfer to the Indiana Supreme Court, Best Beers asserted that the evidence at trial only demonstrated a "serious wrong tortious in nature."<sup>54</sup> Because the evidence at trial was sufficient to support a finding of tortious-like conduct but not an independent tort, the key issue for the Supreme Court was whether a plaintiff must prove the elements constituting an independent tort in order to be entitled to a punitive damage award.

### B. *The Vernon Fire & Casualty Case*

The general rule that punitive damages are not allowed in breach of contract actions has been frequently repeated in Indiana.<sup>55</sup> Labelling such a rule a general rule suggests that exceptions to the rule do exist, as exemplified by the opinion in *Vernon Fire & Casualty Ins. Co. v. Sharp*.<sup>56</sup> In *Vernon Fire & Casualty*, the plaintiff sued his insurer for breach of his insurance contract. Because the insurer refused to pay the proceeds which were admittedly due—an action which closely resembles fraud due to the nature of the relationship between the insurer and the insured—the plaintiff sought and obtained punitive damages as well.<sup>57</sup>

On appeal, the Indiana Supreme Court concluded that punitive damages are inappropriate in breach of contract cases because "the well defined parameters of compensatory and consequential damages which may be assessed against a promisor who decides for whatever reason not to live up to his bargain lend a needed measure of stability and predictability to the free enterprise system."<sup>58</sup>

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50. 608 N.E.2d 975 (Ind. 1993).

51. *Id.* at 978.

52. *Id.* at 984.

53. *Miller Brewing Co. v. Best Beers of Bloomington, Inc.*, 579 N.E.2d 626 (Ind. Ct. App. 1991).

54. *Miller Brewing Co.*, 608 N.E.2d at 984.

55. *Id.* at 981. *See, e.g.*, *Lawyers Title Ins. Corp. v. Pokraka*, 595 N.E.2d 244, 250 (Ind. 1992); *Bud Wolf Chevrolet, Inc. v. Robertson*, 519 N.E.2d 135, 136 (Ind. 1988).

56. 349 N.E.2d 173, 180 (Ind. 1976).

57. *Id.* at 185.

58. *Id.* at 180.

However, because the plaintiff also proved the elements of common law fraud, punitive damages were awarded for that independent tort.

Confusion as to the requirements for the award of punitive damages arises from a statement in the *Vernon Fire & Casualty* opinion.<sup>59</sup> The majority in that case stated that "when it appears from the evidence as a whole that a serious wrong, tortious in nature, has been committed, but the wrong does not conveniently fit the confines of a pre-determined tort,"<sup>60</sup> the requirement that the elements of an independent tort be proved seems unnecessary, especially when "the public interest will be served by the deterrent effect punitive damages will have upon future conduct of the wrongdoer and parties similarly situated."<sup>61</sup>

### C. *The Majority Opinion in Best Beers*

The majority in *Best Beers* determined that the *Vernon Fire & Casualty* Court's suggestion that an independent tort was unnecessary in order to recover punitive damages in contract actions was merely dicta.<sup>62</sup> The factors that led to this conclusion included, first, the majority's view that the Court had never applied the dicta in *Vernon Fire & Casualty* to a case and, secondly, public policy arguments.<sup>63</sup>

The public policies cited by the Court in the decision include the legal legacy that "there is no right to punitive damages, which are in the nature of a criminal penalty."<sup>64</sup> "Once a plaintiff has been awarded compensatory damages, then he has been awarded all that he is entitled to receive as a matter of law."<sup>65</sup>

Further, the common law has long recognized a party's right to breach a contract and pay compensatory damages.<sup>66</sup> Judge Posner recently explained this

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59. See also *Lawyers Title Ins. Corp. v. Pokraka*, 595 N.E.2d 244, 250 (Ind. 1992); *Bud Wolf Chevrolet, Inc. v. Robertson*, 519 N.E.2d 135, 136 (Ind. 1988); *Travelers Indem. Co. v. Armstrong*, 442 N.E.2d 349, 362 (Ind. 1982); *Art Hill Ford, Inc. v. Callender*, 423 N.E.2d 601, 602 (Ind. 1981); *F.D. Borkholder Co., Inc. v. Sandock*, 413 N.E.2d 567, 570 (Ind. 1980); *Hibschman Pontiac, Inc. v. Batchelor*, 362 N.E.2d 845, 847 (Ind. 1977). In each of these cases the Court states the "general rule," thus suggesting that exceptions to the rule are recognized.

60. 349 N.E.2d at 180.

61. *Id.*

62. 608 N.E.2d 975, 983 (Ind. 1993).

63. *Id.* at 983-84. See also *Orkin Exterminating Co., Inc. v. Traina*, 486 N.E.2d 1019, 1021 (Ind. 1986); *Travelers Indem. Co. v. Armstrong*, 442 N.E.2d 244, 250 (Ind. 1982); *Carroll v. Statesman Ins. Co.*, 493 N.E.2d 1289, 1292 (Ind. Ct. App. 1986).

64. *Id.* at 983 (citing *Travelers Indem. Co. v. Armstrong*, 442 N.E.2d 349, 363 (Ind. 1982)).

65. *Id.* at 983 (citing *Orkin Exterminating Co., Inc. v. Traina*, 486 N.E.2d 1019, 1022 (Ind. 1986)).

66. *Id.* at 984.

policy principle in *Patton v. Mid-Continent Systems, Inc.*,<sup>67</sup> wherein he stated that

Indiana allows punitive damages to be awarded in suits for breach of contract if, “mingled” with the breach, are “elements of fraud, malice, gross negligence or oppression.”<sup>68</sup> In trying to give concrete meaning to these terms (especially “oppression”), it is important to bear in mind certain fundamentals of contractual liability. . . . Even if the breach is deliberate, it is not necessarily blameworthy. The promisor may simply have discovered that his performance is worth more to someone else. If so, efficiency is promoted by allowing him to break his promise, provided he makes good the promisee’s actual losses. If he is forced to pay more than that, an efficient breach may be deterred, and the law doesn’t want to bring about such a result.<sup>69</sup>

Considering these policy reasons, the *Best Beers* Court held “that in order to recover punitive damages in a lawsuit founded upon a breach of contract, the plaintiff must plead and prove the existence of an independent tort of the kind for which Indiana law recognizes that punitive damages may be awarded.”<sup>70</sup>

#### D. *The Minority Opinion in Best Beers*

Justice Dickson, in a dissent to which Justice Givan concurred, argued that the general rule that punitive damages are not available in contract actions has two exceptions. The first exception is consistent with the majority opinion, requiring proof of the elements of an independent tort. The second exception, consistent with the dicta in *Vernon Fire & Casualty*, arises when “the evidence reveals that a serious wrong, tortious in nature, has been committed, although the wrong ‘does not conveniently fit the confines of a pre-determined tort.’”<sup>71</sup> Justice Dickson disagreed with the majority’s public policy reasoning as well as their view that the second exception had never been used by the Court. In support of his argument that the second exception had been utilized by the Court, Justice Dickson cited *Liberty Mutual Insurance Co. v. Parkinson*.<sup>72</sup> In *Parkinson*, the Indiana Supreme Court affirmed an award of punitive damages against an insurance company that demonstrated bad faith when it failed to settle

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67. 841 F.2d 742 (7th Cir. 1988). See also RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* § 4.8 (1986).

68. *Id.* at 750 (quoting *Travelers Indem. Co. v. Armstrong*, 442 N.E.2d 349, 359 (Ind. 1982)(citations omitted)).

69. *Id.*

70. 608 N.E.2d at 984.

71. *Id.* at 985 (quoting *Vernon Fire & Ins. Co. v. Sharp*, 349 N.E.2d 173, 180 (Ind. 1976)).

72. *Id.* at 986 (citing *Liberty Mut. Ins. Co. v. Parkinson*, 487 N.E.2d 162 (Ind. 1985)).

Interestingly, the majority did not mention this case in its analysis.

an uninsured motorist claim.<sup>73</sup> The Court in *Liberty Mutual* concluded that it previously found “no reason to adopt bad faith as an independent tort in this state and we see no need to adopt such action now.”<sup>74</sup> Thus, it affirmed the punitive damages award without proof of an independent tort.

With regard to the public policy concerns, Justice Dickson recognized the benefits of a “bright-line” rule such as the one adopted by the majority. However, because “reprehensible behavior often defies strict tort categorization . . . [it] should not go undeterred merely because it fails to completely conform to the precise contours of pre-existing tort classifications.”<sup>75</sup>

### *E. Conclusion*

Through its opinion in *Best Beers*, the Indiana Supreme Court adopted a straightforward approach to the issue of whether punitive damages are recoverable in breach of contract cases. A steadfast rule requiring pleading and proof of an independent tort before punitive damages may be awarded in contract actions provides stability to contractual relationships and certainty to difficult decisions to exercise the common law right to breach contracts.

## III. SECURED TRANSACTIONS—PAYMENTS IN THE “ORDINARY COURSE” OF BUSINESS

In *J.I. Case Credit Corp. v. First National Bank of Madison County*,<sup>76</sup> the United States Court of Appeals for the Seventh Circuit created a working definition for “ordinary course” of business, thus clarifying the circumstances under which the proceeds from the sale of collateral may be recovered by the secured party.<sup>77</sup> The court held that “a payment is within the ordinary course if it was made in the operation of the debtor’s business and if the payee did not know and was not reckless about whether the payment violated a third party’s security interest.”<sup>78</sup>

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73. *Id.*

74. *Id.* at 165. Regardless of whether punitive damages are available upon a showing of bad faith in insurer/insured relationships, such relationships are clearly distinguishable from commercial relationships. See *Erie Ins. Co. v. Hickman*, 622 N.E.2d 515, 518 (Ind. 1993).

75. *Miller Brewing Co. v. Best Beers of Bloomington, Inc.*, 608 N.E.2d 975, 987 (Ind. 1993). With regard to Justice Dickson’s characterization of some breaching behavior as “reprehensible,” see POSNER, *supra* note 67 § 4.8; *Patton v. Mid-Continent Systems, Inc.*, 841 F.2d 742, 750-51 (7th Cir. 1988).

76. 991 F.2d 1272 (7th Cir. 1993).

77. This same approach was also recently adopted by the Fourth Circuit in *Orix Credit Alliance, Inc. v. Sovran Bank, N.A.*, 4 F.3d 1262 (4th Cir. 1993).

78. 991 F.2d at 1279.

### A. *Factual Background*

The dispute in *J.I. Case Credit Corp.* arose when James Humphrey, the sole shareholder of a farm equipment sales business, applied the proceeds from the sale of farm equipment subject to a perfected purchase money security interest in favor of J.I. Case Credit to debts the company owed to the First National Bank of Madison County.<sup>79</sup> The Bank was aware the purchase money security interest covered both the equipment and the proceeds from its sale and required Humphrey to immediately pay ninety percent of the proceeds from Case farm equipment sales to Case. The security agreement also provided that all proceeds should be placed in an express trust for Case.<sup>80</sup>

Instead of creating such a trust, Humphrey simply deposited all proceeds from the Case farm equipment sales, as well as all other types of sales, into his business checking account from which he made all his business disbursements.<sup>81</sup> As the financial health of Humphrey's company declined, Humphrey made several large payments to the Bank to extinguish debts. Although these payments were admittedly unusually large compared to Humphrey's past payment record, the Bank was not aware that such payments were made with proceeds from the sale of the secured Case equipment.<sup>82</sup> After making several of these payments, Humphrey went out of business.<sup>83</sup>

Shortly thereafter, Case learned of the use of the proceeds from the sale of the secured Case equipment to pay other creditors, including the Bank. Case subsequently brought suit against the Bank upon several theories, including unjust enrichment and common law conversion.<sup>84</sup> At trial, the Bank asserted the defense that Humphrey made the payments to the Bank in the ordinary course of business and thus, according to Indiana Code section 26-1-9-306, Comment 2(c), the Bank was not liable to Case. District Court Judge Barker rejected this defense, finding that because the Bank did know of the security interest in the proceeds from the sale of Case equipment, this "should have put a reasonable bank, exercising prudent business practices, on notice that something was awry."<sup>85</sup> Thus, the district court awarded judgment in favor of Case in the amount of \$188,000.<sup>86</sup>

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79. *Id.* at 1273.

80. *Id.*

81. *Id.* at 1273-74.

82. *Id.* at 1274.

83. *Id.*

84. *Id.*

85. *Id.*

86. *Id.*

*B. Comment 2(c) to Indiana Code section 26-1-9-306*

The Indiana Code provides that a “security interest continues . . . in any identifiable proceeds . . . .”<sup>87</sup> It is a well-established rule that a secured party may bring an action for conversion to recover proceeds wrongfully paid to a third party.<sup>88</sup> However, Comment 2(c) to Indiana Code section 26-1-9-306 provides that:

[w]here cash proceeds are covered into the debtor’s checking account and paid out in the operation of the debtor’s business, recipients of the funds of course take free of any claim which the secured party may have in them as proceeds. What has been said relates to payments and transfers in the ordinary course. The law of fraudulent conveyances would no doubt in appropriate cases support recovery of proceeds by a secured party from a transferee out of ordinary course or otherwise in collusion with the debtor to defraud the secured party.<sup>89</sup>

Thus, the question arises: What does “ordinary course” mean?

*C. The Meaning of “Ordinary Course”*

Although the Code does not define ordinary course as it is used in this context, the Court of Appeals concluded that the Comment gives some guidance as to the meaning. “At the very least, to be made in ordinary course, payments must be made ‘in the operation of the debtor’s business.’”<sup>90</sup> An important factor considered by the court in its determination of the meaning of ordinary course is commercial policy. As the First Circuit recently indicated, “good commercial reasons” justify giving the term ordinary course a broad interpretation.<sup>91</sup> “If . . . courts too readily impose liability upon those who receive funds from the debtor’s ordinary bank account . . . then ordinary suppliers of gas, electricity, tables, chairs, etc., might find themselves called upon to return ordinary payments . . . to a debtor’s secured creditor.”<sup>92</sup> The Seventh Circuit found this reasoning persuasive, stating that “[i]mposing liability too readily on payees from commingled accounts could impede the free flow of goods and services essential to business . . . as suppliers take steps to ensure that they will ultimately not have to return the money they receive.”<sup>93</sup>

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87. IND. CODE § 26-1-9-306(2) (1988).

88. 991 F.2d at 1275. *See also* Citizens Nat’l Bank of Whitley County v. Mid-States Development Co., 380 N.E.2d 1243, 1244 (Ind. Ct. App. 1978).

89. 991 F.2d at 1276 (quoting Comment 2(c) of IND. CODE § 26-1-9-306 (1988)).

90. 991 F.2d at 1276.

91. *Id.* at 1277 (quoting Harley-Davidson Motor Co. v. Bank of New England, 897 F.2d 611, 622 (1st Cir. 1990)).

92. *Id.*

93. *Id.*

Furthermore, the court noted that “[t]he Code and comment justify a fairly broad definition of ‘ordinary course.’ Comment 2(c)’s language suggests that when determining whether a payment is made in ordinary course, the most important factor to consider is the payee’s knowledge about whether the payment was made with money that rightfully belongs to another.”<sup>94</sup> Thus, the court, taking the Comment at face value, concluded that “where a debtor pays commingled funds in the operation of its business to a third party, the third party takes those funds in ‘ordinary course’ unless it knows the payment violates a superior secured interest in those funds.”<sup>95</sup>

The court then looked to Indiana Code section 26-1-1-201(9) which defines a similar term. There, the Code defines “buyer in the ordinary course of business” as requiring both “good faith” and lack of “knowledge.” Thus, the court determined the reasonable conclusion to draw is that “the drafters intended for the same factors [specifically stated in section 1-201(9)]—good faith and lack of knowledge—to qualify a payment or transfer as one in the ordinary course.”<sup>96</sup> Because the Code defines “knowledge” as “actual knowledge,”<sup>97</sup> constructive knowledge will not suffice. However, the court noted that there are situations in which a person without actual knowledge can participate in a transaction that is out of the ordinary course. “A person may have information causing him to suspect strongly that a payment violates a secured party’s interest, yet take deliberate steps to avoid discovering more for fear of what he may learn.”<sup>98</sup> Such intentional avoidance of discovery is the equivalent of recklessness, generally equated with actual knowledge. Thus, the court established the rule to be applied: “[A] payment is within the ordinary course if it was made in the operation of the debtor’s business and if the payee did not know and was not reckless about whether the payment violated a third party’s security interest.”<sup>99</sup>

#### *D. Application of the Newly Established Rule to the Facts*

The District Court found that because the Bank knew of the existence of a security interest and because the payments made by Humphrey were unusually large, the Bank had sufficient information to “put a reasonable bank, exercising prudent business practices, on notice that something was awry.”<sup>100</sup> However, the conduct noted by the District Court, essentially the equivalent of negligence, does not rise to the level of recklessness. Additionally, “[t]he Bank may have known about Case’s security interest, but as we have seen that does not

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94. *Id.*

95. *Id.*

96. *Id.* at 1277-78 (quoting *Anderson, Clayton & Co. v. First Am. Bank*, 614 P.2d 1091, 1094 (Okla. 1980)).

97. IND. CODE § 26-1-1-201(25) (1988).

98. 991 F.2d at 1278.

99. *Id.* at 1279.

100. *Id.* at 1274.

necessarily mean the Bank knew Humphrey's payments violated that interest."<sup>101</sup> Thus, the Court of Appeals concluded that "since Humphrey made his payments in the operation of his business, those payments were made in the ordinary course of business and Case is not entitled to recover them."<sup>102</sup>

### *E. Conclusion*

Consistent with other jurisdictions, the Seventh Circuit has established an uncomplicated working definition of payments in the ordinary course of business as payments made in the operation of business without knowledge or recklessness on the part of the payee about whether the payment violates another's security interest. This explanation provides straightforward guidance as to the circumstances under which the proceeds from the sale of collateral may be recovered by the secured party.

## IV. CONTRACTS—"COMPETITIVE" OFFERS

In *PSI Energy, Inc. v. Exxon Coal USA, Inc.*,<sup>103</sup> the United States Court of Appeals for the Seventh Circuit considered the requirements for a bid to be deemed "competitive" when the term "competitive" is not defined in a contract providing for price renegotiation based upon such a bid. The court held that "[a]n offer may be 'competitive' although the non-price terms differ in some material respects from the terms of the [contract under renegotiation], but that one indispensable element of a 'competitive offer' is a price that can be matched by a single Base."<sup>104</sup>

### *A. Factual Background*

PSI Energy entered into a long-term contract with Exxon Coal for the supply of high-sulfur coal. Due to increasingly stringent environmental regulations since the inception of the contract, high sulfur coal became less cost effective for PSI Energy's use.<sup>105</sup> As a result, PSI Energy sought to either terminate the contract with Exxon Coal or reduce the price of the high-sulfur coal in order to offset the cost of removing the sulfur.<sup>106</sup>

The contract between PSI Energy and Exxon Coal provided a mechanism to adjust the price of the coal over the life of the contract. The starting point for the price calculation was the "Base." This amount was defined as the price F.O.B. PSI's power plant.<sup>107</sup> The Base was subject to adjustment based upon

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101. *Id.* at 1279.

102. *Id.* at 1280.

103. 991 F.2d 1265 (7th Cir. 1993), *on remand*, 831 F. Supp. 1430 (S.D. Ind. 1993).

104. *Id.* at 1271.

105. *Id.* at 1266.

106. *Id.*

107. *Id.*

a number of factors, including those specified in Exhibit "A" of the contract and the amount of sulfur in the coal beyond a specified limit.<sup>108</sup> Further, the contract provided that the Base and adjustments could be renegotiated at five-year intervals. As part of this renegotiation process, PSI was permitted to solicit other bids.<sup>109</sup> Exxon was free to either match the competing bid or terminate the relationship. The relevant portion of the contract was as follows:

If the parties are unable to reach agreement [as to renegotiation of the Base], BUYER will accept SELLER'S last offer or present SELLER with a firm, written offer which it has received from another supplier, which it is willing to accept, for the supply of coal . . . SELLER shall have the right to meet such competitive offer.<sup>110</sup>

The contract went on to provide:

It is understood and agreed that the purpose and intent of [the renegotiation provisions], are only to provide for renegotiation of Base and Exhibit "A," and neither party shall inject into such negotiations, as a condition of agreement upon a new Price for the coal, any demand or request that other terms and conditions of this Agreement be altered.<sup>111</sup>

Thus, the contract allowed Exxon Coal to respond to the competitive bids by reducing its Base and Exhibit "A" adjustments without altering the remaining terms of the agreement. This scheme allowed the parties to look to the Base alone to determine whether a competing bid was more or less favorable. The varying quality of the coal was accounted for in the portion of the price calculation not subject to renegotiation.

In accordance with this adjustment mechanism, PSI solicited competitive bids. PSI received several bids it deemed more favorable than the Exxon Coal contract terms. PSI then submitted the most favorable bid to Exxon in accordance with the contract.<sup>112</sup> The competitive bid differed significantly from the Exxon bid in both price and structure in that the competing bid offered to supply coal from three different mines at three different "starting prices."<sup>113</sup> Exxon objected to the submitted bid claiming it was not a competitive offer as contemplated by the contract. Exxon did propose, however, to match the offer by calculating a "weighted price" in the event the submitted bid was deemed to be a competitive offer.<sup>114</sup>

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108. *Id.*

109. *Id.* at 1267.

110. *Id.*

111. *Id.* at 1268.

112. *Id.*

113. *Id.*

114. *Id.* at 1269.

In response, PSI brought suit seeking a declaratory judgment that Exxon failed to match the submitted competitive offer. Exxon filed a counterclaim for a declaratory judgment that the submitted offer was not a competitive offer, but if it was, Exxon's weighted price offer met the terms of the competitive offer.<sup>115</sup> The District Court, finding that the submitted offer was a competitive offer, issued a declaratory judgment that Exxon failed to meet the competitive offer. In making this finding, the District Court held that Exxon could meet the competitive offer by adjusting its Base without matching all of the submitted non-price terms. However, the court also found that the competing non-price concessions must be offset "with corresponding reductions on the Base."<sup>116</sup>

### B. *The Court's Decision*

In deciding this case, the Seventh Circuit noted that "when the language of the contract runs out, we must try to understand the function of the language and complete the agreement in light of the parties' mutual objectives."<sup>117</sup> Because the contract did not specify the required contents of a competitive offer, the District Court was left to make this determination.

In its analysis, the court indicated that

Exxon's ability to limit the competition to price, and price alone, for the kind of coal Exxon has to offer, is what makes this a genuinely long-term contract . . . . This cannot be achieved if Exxon must match the value of a rival's non-price terms by reducing its Base. Moreover, the entire conception of the renegotiation and competitive bid process as a way to mark Base to market would fail if non-price aspects of rival bids had to be evaluated and reflected in the Base.<sup>118</sup>

Thus, policy concerns dictate that "[a]n offer may be 'competitive' although the non-price terms differ in some material respects from the terms of the [contract being renegotiated], but that one indispensable element of a 'competitive offer' is a price that can be matched by a single Base."<sup>119</sup>

Applying this rule to the instant case, the competitive offer submitted by PSI did not meet the requirements for an offer to be considered competitive. Thus, Exxon Coal was under no obligation to meet the terms of the submitted offer.<sup>120</sup>

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115. *Id.*

116. *Id.* at 1270.

117. *Id.*

118. *Id.* at 1270-71.

119. *Id.* at 1271.

120. *Id.*

### C. Conclusion

In *PSI Energy, Inc. v. Exxon Coal USA, Inc.*, the United States Court of Appeals for the Seventh Circuit made clear its view that identical price terms are essential to a competitive offer. “An offer may be ‘competitive’ although the non-price terms differ in some material respects from the terms of the [contract under renegotiation], but that one indispensable element of a ‘competitive offer’ is a price that can be matched by a single Base.”<sup>121</sup> Although it indicated that non-price terms may differ from the terms of the contract under renegotiation, the court did sound a warning that a “rival bid inferior [to the contract under renegotiation] in any material respect runs a substantial risk of being deemed not a ‘competitive offer.’”<sup>122</sup>

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121. *Id.*

122. *Id.* at 1272.