NAED

NATIONAL ASSOCIATION OF
ELECTRICAL DISTRIBUTORS

Terms and Conditions: **Reading the Fine Print**

Developed and Published by the NAED Education & Research Foundation

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Introduction

All orders are not created equal. You love an order that brings in a healthy gross margin, ships correctly and is paid for promptly. You also recognize that mistakes happen, material is returned or damaged in shipment, and that while mistakes make some orders less profitable, they are the cost of doing business. However, have you considered that there are also orders that could cost your company an unimaginable amount of money? Exposure to uncapped awards of "consequential damages" could cost you dearly. The National Association of Electrical Distributors (NAED) and its Channel Advantage Partnership (CAP) present this report in an effort to make electrical distributors more competitive by providing them with information on the dangers inherent in the "fine print" [1] of certain contracts with customers. What kind of dangers? Let's start with an example we will study in detail later in this paper.

What happens if you supply equipment to an OEM customer for use in their production process and the equipment fails, costing the plant production time? Besides damages measured by the price of the equipment, you may also have to pay "consequential damages" to compensate the customer for lost profits resulting from a loss of production. Consequential damages will likely dwarf the cost of the material. Knowing how to protect yourself against these liabilities can save your company plenty of heartache and money. This report will help you spot some of the more common potentially troublesome provisions and will offer options for negotiating fair agreements.

Most NAED members' sales are done through written contracts or purchase orders. In addition to what most people would think of as the essential terms of such contracts, i.e., the item, number of units, unit price, etc., written contracts often include numerous additional terms, the fine print. These terms may also be included in bid documents, quotations, service agreements, purchase orders and other preprinted form documents exchanged by the parties; they may also be insisted upon after the bid has been submitted. The fine print often has potential litigation and balance sheet exposure.

Reviewing Liability and Negligence

In 2005 and 2007, NAED issued two reports and provided a series of webinars (check www.naed.org/research for further information) on legal exposures in the channel. Product liability, negligence, breach of warranty and service liability exposures were increasing.

To review, in these lawsuits, claimants who sustained property damage or bodily injuries do not need to prove that wholesalers acted negligently in order to recover damages. Under the legal theory known as "strict liability," claimants need only prove that the electrical product was defective (unsafe if used as intended) or unreasonably dangerous (likely to cause harm) when it left the control of the wholesaler and that it caused the claimed damages – either directly (the circuit breaker exploded) or indirectly (a GFCI failed to trip, causing a fire). The most common claims are:

- a defect in design;
- a defect in manufacturing; or
- a failure to warn or provide adequate instructions.

[1] The term "fine print" has been around for many years and carries a definite negative connotation. Webster's defines "fine print" as "something thoroughly and often deliberately obscure, esp.: a part of an agreement (as a contract) spelling out restrictions and limitations often in small type or obscure language."

Furthermore, these claims can succeed even where the product was used incorrectly, if the incorrect use was foreseeable.

While strict products liability is the most common basis for liability – and the easiest to prove – claimants may also assert that wholesalers acted negligently: that they had a duty to the claimants, that they breached that duty, and that the breach was responsible for injury or damages sustained.

Legal liability may also be based on warranties. Warranties are statements made by manufacturers, distributors and sellers about the product to the claimant as part of direct commercial connections or transactions. Claimants can assert a number of types of warranty claims:

- breached express warranties (actual statements made about the product);
- implied warranties of merchantability (expectations common to all products implied by industry custom and practice, knowledge of sophisticated purchasers in commercial transactions or the understanding of reasonably prudent people); or
- implied warranties of fitness for a particular purpose (the reasonable understanding that the product is suited for specific purposes).

Products liability laws in the United States may allow claims and lawsuits to be brought against all parties – manufacturers, distributors and sellers -- in the stream of commerce for electrical products that are allegedly defective and that have caused injury or damage. If the manufacturer does not operate in the United States, however, it is easier to sue the electrical distributor. The law of "joint and several liability" makes this a practical solution to an injured party.

The concept of joint and several liability was explored extensively in *Product Liability Exposure: Mitigating and Managing the Risks in Today's Global Market,* available on naed.org, but a brief review is in order. Joint and several liability means that even though a wholesaler may have little or no responsibility for the injuries or damages claimed in a law suit, it may be required to pay the entire amount of damages awarded. This is an example of "several" liability. Alternatively, injured parties can recover the entire amount of damages from all of the parties found liable. This is an example of "joint" liability. In cases where other parties such as manufacturers are unable to pay their proportionate share, have no insurance coverage, or are not subject to suit in the United States, wholesalers can be responsible for 100 percent of the judgment – effectively "standing in the shoes" of the manufacturer.

In most cases a wholesaler's customer has no contractual relationship with a manufacturer. They look to the distributor for the warranty protection that is traditionally the manufacturers' responsibility. And these extended protections are often found in the fine print of contracts, where a less-than-diligent wholesaler may neglect to appreciate their implications.

It is important to understand how to negotiate the terms of your written contracts. To understand how to negotiate contractual terms, it is helpful to take a quick look at the foundation of most commercial contracts in the U.S., the Uniform Commercial Code.

The Uniform Commercial Code and the Basics of Contracts

The Uniform Commercial Code (UCC) is a model statute that provides the ground rules for many types of contracts governing commercial transactions.[2] The UCC was drafted by the National Conference of Commissioners on Uniform State Laws.[3] The rationale for this effort is that in a national economy in which transactions are not limited by state boundaries, the regulations and laws governing such transactions should be national in scope as well. The UCC has been adopted in one or another of its several variations as the law in all 50 states.

Article Two[4] of the UCC addresses issues of concern to most distributors. Article Two provides rules applicable to all phases of a contract, including contract negotiation and formation, performance, interpretation, and remedies for breach. Importantly, Article Two allows the parties, especially where they are both merchants,[5] wide latitude to negotiate contract terms. Article Two frequently states that a rule applies "unless otherwise agreed." As a result, many of the provisions of Article Two state default rules that will apply if the parties have not specifically addressed the subject in their contract.

While the UCC has functioned well in its purpose, conflicting interpretations of some critical provisions have arisen among different states' courts. One of the most important inconsistencies relates to the so-called "battle of the forms," so let's take a closer look at the contract formation process and how the UCC addresses potentially conflicting terms and conditions.

The Battle of the Forms

The "battle of the forms" concerns determining at what point a contract has been formed - and it's not as simple as you might think. Determining when a contract has been formed determines which terms and conditions constitute the final agreement in situations where the parties exchange preprinted form documents. It may not surprise you to learn that the terms and conditions of the exchanged documents may conflict. Understanding how to negotiate the conflicting provisions can go a long way towards effectively managing your liability. Let's take a look at a hypothetical example, to see how difficult it can be to determine precisely when a contract has been formed.

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[2] The topics dealt with in the UCC are Sales, Leases, Commercial Paper, Negotiable Instruments, Bank Deposits and Collections, Fund Transfers, Letters of Credit, Bulk Sales, Documents of Title, Investment Securities, and Secured Transactions.

[3] The National Conference of Commissioners on Uniform State Laws (NCCUSL) is a non-profit, unincorporated association. It consists of commissioners appointed by each state, the District of Columbia, Puerto Rico and the United States Virgin Islands. The organization drafts proposed statutes in areas of law in which the Commissioners believe there should be uniformity among the states and territories. The results of these discussions are proposed to the various jurisdictions as model legislation or uniform acts. NCCUSL is best known for its work on the UCC, first published in 1952.

[4] All full copy of the Uniform Commercial Code can be found here: http://www.law.cornell.edu/ucc/ucc.table.html.

[5] "Merchant" is defined in the UCC as "persons having knowledge or skill peculiar to the goods involved in the transaction."

The Transaction

An electrical contractor learns of a new or updated version of a product through advertising in a trade publication and calls the distributor to obtain more detailed information. The contractor describes the required specifications for the product. The distributor provides information on the product over the phone and sends additional literature. It also makes a sample available to the contractor.

Later, the contractor requests a price quotation. The distributor responds with a quotation on a form labeled "Quotation," that provides a description of the product, available quantities and a unit price for each quantity, a delivery date and shipping terms and a statement that the "quotation is offered for the buyer's acceptance within 30 days."

Within the 30 days, the contractor calls and verbally places an order for a specific number of items and the seller confirms the unit price at that quantity and the delivery date. The buyer also gives a purchase order number.

A few days later, the buyer sends the purchase order, which identifies the product, the quantity, the unit price and the delivery date, with the statement: "Please supply the following, subject to conditions on reverse side." The reverse side lists a number of "additional terms and conditions applying to this purchase order," and also states that "seller (the electrical distributor), by its acceptance of this order agrees to the unconditional acceptance of the following conditions," including:

> Seller expressly warrants that all goods furnished hereunder will conform to the specifications, drawings, and samples and other descriptions furnished or approved by Buyer and will be fit and sufficient for the purpose intended, merchantable, of good material and workmanship and free from defects. Unless otherwise provided for by an express warranty or by plans and specifications, warranties shall extend for a period of no less than one (1) year from the date of final acceptance by Owner of Buyer's work of which the items supplied hereunder are a part and Seller expressly extends all such warranties to Owner as well as Buyer. Seller further warrants that all work/goods will comply with all warranties, guaranties, and building requirements which are imposed upon the Owner, Contractor, or Seller by municipal, state, or federal or other statutes or rules or regulations. Seller agrees to indemnify Owner and Buyer against all losses, damages, or expenses arising from breach of any warranties. These warranties shall survive any inspection, delivery, acceptance, or payment.

The purchase order is accompanied by an acceptance copy requesting the distributor's signature and return to buyer. However, no one at the distributor reads, signs or returns the acceptance copy and no one at the buyer follows up to request it.

Thereafter, the distributor ships the goods by the date called for in the quotation.

Within a short time after shipment, the distributor sends an invoice to the buyer. The invoice refers to the buyer's purchase order number and states the relevant terms of the sale. It also includes, among others, the following "terms and conditions" on the reverse side:

WARRANTIES - Distributor warrants that all goods sold are free of any security interest and will make available to Buyer all transferable warranties (including without limitation warranties with respect to intellectual property infringement) made to Distributor by the manufacturer of the goods. DISTRIBUTOR MAKES NO OTHER EXPRESS OR IMPLIED WARRANTIES, AND SPECIFICALLY DISCLAIMS ALL IMPLIED WARRANTIES INCLUDING BUT NOT LIMITED TO THE IMPLIED WARRANTIES OF MERCHANTABILITY AND FITNESS FOR PURPOSE.

LIMITATION OF LIABILITY - Buyer's remedies under this agreement are subject to any limitations contained in manufacturer's terms and conditions to Distributor, a copy of which will be furnished upon written request. Furthermore, Distributor's liability shall be limited to either repair or replacement of the goods or refund of the purchase price, all at Distributor's option, and IN NO CASE SHALL DISTRIBUTOR BE LIABLE FOR INCIDENTAL, SPECIAL, OR CONSEQUENTIAL DAMAGES. In addition, claims for shortages, other than loss in transit, must be made in writing not more than five (5) days after receipt of shipment.

The "battle of the forms" is now in play.

No one at the buyer reads the terms on the back of the invoice, which is paid in due course.

The electrical contractor incorporates the product in a project on which it is acting as subcontractor, involving the enlargement and modernization of the operating equipment at a large manufacturing facility.

Within a year following the owner's acceptance of the contractor's work, the operating equipment fails under catastrophic circumstances, causing not only the destruction of the new equipment in which the product was installed, but additional damage as well, requiring the lengthy shutdown of other manufacturing lines at the plant. In addition, a number of employees are seriously injured. The plant owner's damages from this incident include a wide array of losses and costs:

- workers' compensation costs for the injured employees;
- costs to repair and replace the damaged plant equipment;
- costs and delay damages owing for the inability to comply with supply chain and other delivery deadlines of its products to its customers;
- costs for the failed product purchased; and
- lost revenues and profits from the lengthy shutdown of all operations.

In the inevitable litigation, the owner, the subcontractor and the injured employees all sue the distributor (and the manufacturer). The distributor attempts to defend, in part, based on the limitation of warranties and limitation of liability provisions printed on the back of its invoice.

Analysis of the Transaction: What Was The Contract?

The first issue is whether and when a contract has been formed, which then allows determination as to which terms are part of the formal contract.

The UCC, under UCC §2-204, provides a broad rule of contract formation:

"A contract for sale of goods may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract."

Thus, the existence of a contract may be inferred in retrospect from the conduct of the parties rather than based on specific express communications.

Under traditional contract law (which applies under the UCC unless stated otherwise), the formation of a contract requires three things: an offer by one party, an acceptance of the offer by the other party, and consideration or payment for the goods. While the UCC does not define what an "offer" is, under contract law an offer is "a manifestation of a willingness to enter into a bargain, so made as to justify another person in understanding that his assent to that bargain is invited and will conclude it."

This generally means that one party, the "offeror," has made an "offer" when his statement of the terms of the proposed contract is sufficiently definite and complete that the party receiving the offer, the "offeree," has the power to form a binding contract by an expression of assent to those terms. Pursuant to UCC §2-206, this assent (unless otherwise indicated) may be expressed in any manner that is reasonable:

> **(a) General rule.**--Unless otherwise unambiguously indicated by the language or circumstances:
> (1) an offer to make a contract shall be construed as inviting acceptance in any manner and by any medium reasonable in the circumstances; . . .

In the example given above, it may not be clear which of the numerous communications exchanged was the "offer". The first communication in the sequence was the advertisement seen by the contractor. Then followed the telephone calls between the parties, the submission of additional literature and the inspection of the sample. After those came the contractor's request for a quotation. It seems that none of these had the requisite definiteness, specificity or expression of willingness to be bound necessary to constitute an offer (although there may be situations where the content of such communications will be relevant in determining the terms of the parties' agreement).

Next was the seller's quotation. Generally, quotations are not considered "definite" enough to be held as offers; however, in cases where they are sufficiently definite, they may well be considered offers. In the present case, although the quotation document stated that it was being "offered for the buyer's acceptance within 30 days," it was also titled "Quotation," which a buyer might argue did not give notice that is was intended as an offer. Also, in the present example, the quotation was indefinite, as it listed per-unit prices based on a number of different quantities, so the buyer would have to select a specific number of units. Finally, the statement that the quotation was offered for acceptance within 30 days could be interpreted as simply meaning that the price would be good for that period. There is no hard and fast rule that a quotation is not an offer, as each case depends on the specific facts.

If the quotation in our case was not an offer, then the next communication in the chain was the phone call in which the contractor orally placed an order for a specific number of items at a confirmed price and provided a purchase order number. It was only after that telephone call that the contractor sent the purchase order containing the provision under which the distributor agreed "to indemnify Owner and Buyer against all losses, damages, or expenses arising from breach of any warranties." As noted, the distributor did not sign or return the acknowledgement copy. Instead, the distributor delivered the goods and sent an invoice containing its own proper yet conflicting terms and conditions that would, if they became part of the contract, negate the contractor's indemnity provision.

This chain of events presents two possible offers: the placing of the order orally over the phone and the sending of the confirming purchase order. (Arguably the acceptance could be the distributor's oral confirmation during the phone call, the shipment of the goods, or the sending of the invoice.) It may make a difference whether the offer is the oral placement of the order or the written purchase order, as only the written purchase order contained the onerous warranty and indemnity provisions; the oral offer did not.

Let us assume that the oral placement of the order during the telephone call is found to be the offer and that the distributor accepted the offer by its acceptance on the phone. In that case, a contract was formed that did not include either party's terms and conditions. This result would not be changed by the fact that the contractor later sent a purchase order with its additional terms and conditions or that the distributor then sent an invoice with its own terms and conditions. In that situation, the UCC's default rules regarding warranties (and other subjects) will apply.

As noted above, UCC §2-204 provides that a contract "may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract." This means that a court may conclude that a contract has been formed based on conduct by the parties showing the existence of a contract without regard to their written communications.

Conflicting Terms and Conditions

Let us now change the facts somewhat to see how the UCC attempts to resolve conflicts between parties' varying terms and conditions. Assume that the contractor, instead of calling to place the order, simply sends a purchase order containing the buyer-friendly terms and conditions and that the distributor responds by shipping the goods with an invoice containing its terms and conditions.

Under this scenario, there has there been an offer and an acceptance, so that a contract has been formed. The question then is, how is the conflict between the two sets of terms and conditions to be resolved?

Resolving the Battle of the Forms

UCC §2-207 attempts to provide guidance on this problem. It states, in part:

> **(a) General rule**. - A definite and seasonable expression of acceptance or a written confirmation which is sent within a reasonable time operates as an acceptance even though it states terms additional to or different from those offered or agreed upon, unless acceptance is expressly made conditional on assent to the additional or different terms.
>
> **(b) Effect on contract.** - The additional terms are to be construed as proposals for addition to the contract. Between merchants such terms become part of the contract unless:
>
> - the offer expressly limits acceptance to the terms of the offer;
> - they materially alter it; or
> - notification of objection to them has already been given or is given within a reasonable time after notice of them is received.

In the scenario given above, the contractor's purchase order (including its fine print terms and conditions) was the offer and the distributor's delivery of the goods with invoice was the acceptance. As a result, under Section 2-207(a), a contract has been formed despite the additional and different terms stated in the invoice, unless the invoice expressly states that the distributor's acceptance of the contractor's purchase order is conditioned on the contractor's acceptance of the additional or different terms in the invoice. In that case, a contract has not yet been formed and the burden is then on the contractor/buyer to respond as it deems appropriate to the new terms. If the contractor accepts and pays for the goods in the face of the distributor's conditional acceptance, the contractor will likely be held to have accepted the distributor's additional or different terms and conditions.

What happens, however, if the purchase order does not expressly condition the buyer's acceptance on the seller's assent to the additional or different terms? This is dealt with in UCC §2-207(b). We noted above that there existed a conflict of interpretation regarding the battle of the forms provision of the UCC. This is where that conflict comes into play:

The additional terms are to be construed as proposals for addition to the contract. Between merchants such terms become part of the contract unless:

- the offer [in this case, the Quotation] expressly limits acceptance to the terms of the offer;
- they materially alter it; or
- notification of objection to them has already been given or is given within a reasonable time after notice of them is received.

Note that, while Section 2-207(a) referred to the inclusion in the acceptance of "terms additional to or different from" those in the offer, Section 2-207(b) relates solely to the treatment of additional terms. It nowhere refers to "different" terms. Thus, as written, Section 2-207(b) provides a solution only for additional terms in the acceptance and is ineffective when the offer and the acceptance are in conflict. This is discussed further below.

Under Section 2-207(b), where the transaction is not between merchants (e.g. a distributor and private party/end user consumer), the additional terms are proposals for addition to the contract, i.e., they do not change the terms of the contract that has just been made. If the deal, however, is between merchants, the additional terms will be part of the contract only if they are not "material" to the deal. If they are deemed material, then the offeror (in this case the contractor) may seek to protect itself by making sure that its offer (the purchase order) contains language limiting the distributor's acceptance to the terms of the offer. Second, the contractor can promptly notify the distributor of its objection to the new terms. As noted above, parties frequently do not read the terms and conditions on the back of a form, so unless an objection is made, the new terms will become part of the contract.

Courts have developed two approaches to deal with the conflicting terms. In many cases, courts use the so-called "knockout" rule. Under this rule, if the court has first determined that a contract has been formed, and has dealt with "additional" terms under Section 2-207(b), then the "different" conflicting provisions in the offer and acceptance cancel each other out, so neither is effective. The rationale for this rule is that the terms of a contract should not depend on which party is held to have sent the offer, especially as parties are often willing to proceed with the sale even though they have obviously not agreed to all of the terms.

The result of application of the knockout rule to the facts of our hypothetical is that:

- a contract was formed by the exchange of the purchase order and the invoice,
- nonmaterial additional terms in the invoice were added to the terms of the purchase order and
- conflicting terms of both documents knocked each other out.

As a result, the UCC's default provisions on warranties and remedies would apply. However, some states read the term "different" into UCC Section 2-207(b), so that it applies to both different as well as additional terms. The justification for this rule is that there is no rational difference between additional terms and different terms, so they should be treated in the same way. Under this interpretation, the terms of the offer would control. Considering the different interpretations, it's important to understand the laws of the states in which you do business.

Now let's examine other fine print issues, including warranties and remedies.

Warranties and Remedies

Warranties

Express Warranties: The UCC provides for both express and implied warranties. Express warranties are, generally, created by the seller's representations, promises, affirmations and descriptions of the goods that are made a part of the basis of the bargain (including statements in advertising and preliminary communications) (UCC §2-313).

Implied Warranties: The UCC also creates "implied warranties," which, if their conditions are met, become part of a contract for the sale of goods, unless effectively modified or excluded by the contract. First is the implied warranty of merchantability, which is effective if the seller is a merchant in goods of the kind being sold (UCC §2-314). To be merchantable, goods must, among other requirements, be "fit for the ordinary purposes for which such goods are used."

Second is the implied warranty of fitness for particular purpose, under UCC §2-315, which creates an implied warranty that the good will be fit for such purpose where the distributor at the time of contracting has reason to know: (1) any particular purpose for which the goods are required; and (2) that the buyer is relying on the skill or judgment of the distributor to select or furnish suitable goods.

Exclusion of Warranties: UCC §2-316 allows for the exclusion or limitation of both express and implied warranties if specific requirements of reasonableness of their terms and the conspicuousness of the language are met in the provision seeking to exclude or limit. See example below for illustration of reasonableness and conspicuousness.

Remedies

UCC minimum remedies: Most sales contracts in our industry contain minimum remedies such as refund of purchase price or replevin. However, Section 2-719(b) of the UCC addresses circumstances where these minimum remedies fail to meet their essential purpose. If minimum remedies are deemed unconscionable, additional damages (such as consequential damages) may be awarded.

Consequential Damages: Consequential damages are defined in UCC §2-715(b) as:

> (1) any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which could not reasonably be prevented by cover[6] or otherwise; and (2) injury to person or property proximately resulting from any breach of warranty.

We are particularly concerned here with paragraph (1),[7] which courts often paraphrase by stating that the damages must have been reasonably foreseeable at the time of contracting. Let's start with a new hypothetical to illustrate. Assume that the distributor's contract for the sale of the equipment is with the end user, such as the owner of the facility in which the equipment will be installed. Assume also that after installation the equipment malfunctions or fails, so that the owner is unable to conduct operations and incurs loss of revenue and profits as a result of an extended shutdown of the facility.

In this case, the buyer's consequential damages can include – but are not limited to –the cost of removing and replacing the defective product, replacement labor costs, and lost profits resulting from a loss of production and sales caused by a failure of a product to perform as warranted. While there are often questions as to whether the evidence of the claimed lost profits was speculative, there is no question that in principle such damages are available. As a result, the seller may find that it is liable for an amount far in excess of the value of the contract.

Liquidated Damages: A liquidated damages provision (UCC §2-718(a)) states a specific sum that the parties agree in advance will be the measure of damages for a possible breach of the contract. Such a provision would provide, for example, that in the event of non-delivery or late delivery of the goods or a defect in the product causing delays and costs for replacement, the distributor would agree to pay a predetermined amount.

Liquidated damages provisions are permitted so long as they are reasonable in light of:

- the anticipated or actual harm,
- the difficulty in proving the actual loss, and
- the difficulty of otherwise obtaining an adequate remedy.

If these conditions are not met, an unreasonably large liquidated damages amount is void as a penalty. By way of example, here is a generic liquidated damages provision:

> Liquidated damages chargeable shall be: ___ per cent of the contract price of each order or portion thereof for each and every day's delay in delivering the article or articles, supplies, or materials after the date when the same are to be delivered under the terms of this contract; but the maximum amount of liquidated damages that may be deducted on account of such delay shall be not more than the sum of ____ Dollars per day for such article or articles, materials, or supplies not delivered against each respective purchase order within the time specified therefore in the contract, and such deduction may be made from any payment due the contractor.

[6] "cover" means "substitute goods"

[7] Section 2-715(b)(2) includes in consequential damages injury to the person or property of the insured proximately resulting from the breach. Thus, if the product malfunctions in such a way as to cause physical damage to property in which it is incorporated, that damage could constitute consequential damages.

Please note two important elements regarding liquidated damages:

- Liquidated damages provisions usually do not limit the imposition of consequential damages unless specifically included within the provision. Please see example below for illustration of a liquidated damages provision specifically limiting consequential damages.
- Liquidated damages provisions may be unnecessary if the distributor carries indemnification from manufacturers and sells the product "off the shelf." However, distributors will be well advised to verify the manufacturer's ability to stand behind the indemnification provided by virtue of the insurance policy occurrence and annual aggregate limits of liability in force at the time, or other assets the manufacturer would use at the time the indemnification would be due.

Example of a Provision Seeking to Limit Distributor's Liability

Here is an example of a provision intended to limit or exclude warranties and remedies:

> **WARRANTIES** - Distributor warrants that all goods sold are free of any security interest and will make available to Buyer all transferable warranties (including without limitation warranties with respect to intellectual property infringement) made to Distributor by the manufacturer of the goods. DISTRIBUTOR MAKES NO OTHER EXPRESS OR IMPLIED WARRANTIES, AND SPECIFICALLY DISCLAIMS ALL IMPLIED WARRANTIES INCLUDING BUT NOT LIMITED TO THE IMPLIED WARRANTIES OF MERCHANTABILITY AND FITNESS FOR PURPOSE.
>
> **LIMITATION OF LIABILITY** - Buyer's remedies under this agreement are subject to any limitations contained in manufacturer's terms and conditions to Distributor, a copy of which will be furnished upon written request. Furthermore, Distributor's liability shall be limited to either repair or replacement of the goods or refund of the purchase price, all at Distributor's option, and IN NO CASE SHALL DISTRIBUTOR BE LIABLE FOR INCIDENTAL, SPECIAL, OR CONSEQUENTIAL DAMAGES. In addition, claims for shortages, other than loss in transit, must be made in writing not more than five (5) days after receipt of shipment.

This provision attempts to cover all the bases from the distributor seller's point of view.

In conspicuous capital letters it:

- disclaims all express warranties other than as relate to security interests and warranties transferable from the manufacturer,
- disclaims all implied warranties, mentioning specifically the implied warranty of merchantability, as required by UCC §2-316, as well as the warranty of fitness for purpose,
- provides that buyer's remedies are limited to repair or replacement of the goods or refund of the purchase price, as provided in UCC §2-719(a), and
- excludes liability for consequential damages, as permitted by Section 2-719(c).

These limiting provisions are provided for illustration only and every company must consider its overall risk management strategy and develop protections for its unique position in the market.

Indemnification: In an indemnity agreement, one party (the "indemnitor") agrees that if the other party (the "indemnitee") sustains loss or liability connected to the transaction, the first party will protect the second party from financial harm. While that may seem like a fairly simple agreement, there are numerous possible variations to the indemnity obligation, some of which can be very burdensome. For example, many indemnity provisions require that the indemnitor, in addition to paying for the indemnitee's liability, also pay for its defense costs. It is not surprising, therefore, that indemnity provisions often include a requirement that the indemnitor maintain liability insurance naming the indemnitee as an additional insured. Here is an example of a generic indemnification provision:

> Indemnification: you agree to protect, indemnify, hold harmless and defend us, our officers, directors and employees, against all actions, claims, damages, demands, suits and other liabilities, including attorney fees and other expenses of litigation arising out of, in whole or in part, you or your employees, agents and subcontractors breach of any term of this contract, or any act or omission in the performance of this contract.

With indemnity agreements, as with many other contractual obligations, distributors should take great care to understand the details. Some provisions require the indemnitor to protect the indemnitee not only from liability arising out of the actions or fault of the indemnitor, but also liability arising out of the indemnitee's own fault. Suppose a sales contract obligates the distributor to indemnify the subcontractor for any liability arising out of or connected with the equipment or goods sold. Suppose also that a third party injured as the result of a malfunction of the equipment sues the subcontractor (along with everyone else), and that it turns out that the injury resulted from improper assembly or installation of the equipment by the subcontractor and not as the result of any defect in the equipment as delivered. In that situation, the distributor would arguably be required to indemnify the subcontractor for the latter's own fault, even though the injury was not the result of a defect in the equipment. Enforcement of agreements indemnifying a party against actions of its own fault varies from court to court. This unpredictability serves to underscore the importance of understanding the obligations your company accepts.

In addition, our study found it is not well understood that the "defense" provision of an indemnification agreement does not stop with the costs of the attorney, but will also include the prospect of the supervising attorney, paralegal, legal research fees, court stenographers, exhibits, expert witnesses, document productions, and other expenses connected with any legal proceeding.

While indemnity provisions typically run from the seller in favor of the buyer, there is no reason why each party may not seek indemnity from the other where its liability (or litigation costs) are the result of the other's fault. In other words, indemnification can be a two-way street. Consider this example of an indemnity provision a seller may ask a buyer to accept:

> It is agreed that whatever liability may derive from the goods, due to events occurring after the passage of risks to the buyer, including any damage to person or to property (even when such property includes parts or accessories of the machine), shall be borne solely by the Buyer, who shall indemnify the Seller and further undertakes to take out adequate insurance against all relative risks without being entitled to make recourse to the Seller. The Buyer henceforth agrees to be cited in any instance of legal proceedings taken against the Seller in pursuance of the liability for herein.

Third-Party Liability: In the hypothetical described previously, as the result of a defect in the product sold by the distributor to the contractor, the project owner and the owner's employees sustained injuries or damage. These included: (a) the cost of the product (including the cost to remove and replace the product); (b) physical damage to the owner's property in the manufacturing facility; (c) bodily injury to the employees; and (d) the owner's economic harm from down time, consisting of lost revenues, profits, etc.[8]

Under our hypothetical, of these four types of damages, only the first would give rise to a claim for breach of contract by the electrical contractor. The other injured parties, the owner and its employees, were not parties to the contract between the distributor and the electrical contractor. As a result, they would not be bound by any contract provisions seeking to limit the seller's liability. The rights of such third parties are not based on contract law, but on tort law.[9] On the limited facts in our hypothetical, they would have claims against the distributor based on such tort law theories as strict liability for unreasonably dangerous defective products and for negligence. In these cases, the seller's protections come not from limitations of liability, but from indemnity provisions and liability insurance.

Liability Insurance: A Measure of Protection Against Damage Claims

Virtually all businesses carry liability insurance. However, if you do not maintain the right insurance coverage, you may still find your company more exposed than necessary.

In our previous hypothetical situation, the distributor's industrial customer installed the product in its factory. Assume that the defective product simply malfunctioned and failed to perform properly, which resulted in repeated delays and stoppages, but did not result in an accident or physical damage to property in the owner's facility.

Liability insurance covers liability arising out of physical injury to tangible property. The operative provisions of the traditional Commercial General Liability insurance policy usually provide:

> a. We will pay those sums that the insured becomes legally obligated to pay as damages because of "bodily injury" or "property damage" to which this insurance applies.
> b. This insurance applies to "bodily injury" and "property damage" only if:
> (1) The "bodily injury" or "property damage" is caused by an "occurrence" . . . ;"

An "occurrence" is defined as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions."

[8] It is important to realize that under the rule of consequential damages, lawyers for the injured or damaged party(ies) will allege, and courts will allow presentation of, damages and losses (even those not immediately quantifiable), so long as they were proximately caused or are substantially related to the incident giving rise to them.

[9] While there are numerous important distinctions between contract and tort law the reference here is to the nature and type of damages awardable. In a breach of contract case, damages are usually limited (unless otherwise arranged) to the value/amount of the contract. In a tort case, the damages do not relate to the amount of the contract but, rather, are awarded to compensate the injured party for bodily injuries/ property damages arising from a breach of duty. These will include reimbursement of medical bills, pain and suffering, lost income and profits, property damages and costs of reconstruction/relocation and other losses to make the party whole.

Property damage is defined as:

> a. Physical injury to tangible property, including all resulting loss of use of that property. All such loss of use shall be deemed to occur at the time of the physical injury that caused it; or
> b. Loss of use of tangible property that is not physically injured. All such loss of use shall be deemed to occur at the time of the "occurrence" that caused it.

While the definition of property damage does include loss of use of tangible property that has not been physically injured, it is still necessary that the loss of use resulted from an "accident." While courts disagree on the issue, in general, it is questionable whether the failure of a product to perform as warranted would be considered an "accident." As a result, there is a serious question whether standard liability insurance policies would provide coverage for the consequential damages in this case. While other types of liability insurance policies may be available to cover such losses, the likely lack of coverage under standard policies underscores the need to obtain a limitation or exclusion of consequential damages wherever possible.

Other Fine Print Issues

In addition to those already discussed, the following issues surfaced in interviews with NAED members as some of the most problematic terms and conditions:

- Pay-When-Paid/ Pay-If-Paid
- Retainage
- Commencement of Warranty / Extended Warranty

Pay-When-Paid/Pay-If-Paid

Under these provisions, the buyer, such as an electrical contractor on a project, seeks an agreement that it is not required to pay for the material it buys and installs until it has been paid by the general contractor. The distributor is therefore subject to delays in payment having nothing to do with the distributor's or the product's performance. While these provisions are potentially very harsh in their impact, many courts have traditionally upheld them, so long as they are clearly and unambiguously expressed, evidencing that they were in fact bargained for.

There is an important distinction to be drawn between the two clauses. Generally, a "pay-when-paid" clause only creates what lawyers call a "timing mechanism," meaning the contractor is still expected to pay for the material, but is allowed to delay payment; "pay-if-paid" means the electrical contractor is "off the hook" if they aren't paid by the general contractor. Lawyers call this a "condition precedent to payment."

Example of a typical "Pay-When-Paid" clause:

> Subcontractor shall pay supplier within seven (7) days of subcontractor's receipt of payment from contractor.

Example of a typical "Pay-If-Paid" clause:

> Subcontractor's receipt of payment from the contractor is a condition precedent to subcontractor's obligation to make payment to the supplier; the supplier expressly assumes the risk of the contractor's nonpayment and the sales price includes this risk.

The rationale for pay if/when paid provisions is that they create an incentive for contractors to complete their work properly and promptly. However, a distributor has no control over events at the job site once it has delivered the product, so the distributor gives up even more control when agreeing to these provisions.

In many jurisdictions, courts will enforce a "pay-if-paid" provision only if the language is clear and unequivocal. An ambiguous "pay-if-paid" provision may be treated as a reasonable timing provision, so the electrical contractor will still be required to pay for the material when they are paid.

Electrical distributors confronted with these terms and conditions may be advised to object, and negotiate these provisions out of the contract entirely, or, as described below, propose less egregious payment provisions by requiring payment within 30, 60, 90, or 120 days following the order.

As a last resort, a distributor would want to ensure that the provision is only a "pay-when-paid" and not a "pay-if-paid" clause.

Payment bonds. Our interviews noted a tangential issue arising in the "pay when paid/paid if paid" scenario involving the use of payment bonds.

A payment bond is an agreement by a bonding company, in a transaction similar to an insurance policy, by which the bonding company guarantees the payment obligations of the contractor upon stated conditions, usually default.

Bonds may offer protection for suppliers in contracts with provisions such as pay-when-paid, or retention where the lengthy deferral of payment is a possibility.

Contractor's and supplier's liens on public property are not permitted by law. So in many jurisdictions, including federal law, contractors in public works projects are required to maintain bonds for the benefit of subcontractors and suppliers. The bond acts as a substitute for lien rights. Suppliers should look to the construction contract for any existing bond protection before considering additional bond protection from their customer.

Retainage

The electrical subcontractor may seek an agreement to hold back a portion of payment until the end of the contract (to parallel the retainage applicable under the electrical contractor's contract with the general contractor).

Example of a typical "Retainage" clause:

> Following is a provision found in government contracts:
> In making such progress payments, there shall be retained 10 percent of the estimated amount until final completion and acceptance of the contract work. However, if the Contracting Officer finds that satisfactory progress was achieved during any period for which a progress payment is to be made, he may authorize such payment to be made without retention of a percentage. Also, whenever the work is substantially complete, the Contracting Officer shall retain an amount he considers adequate for protection of the Government and, at his discretion, may release to the Contractor all or a portion of any excess amount. Furthermore, on completion and acceptance of each separate building, public work, or other division of the contract, on which the price is stated separately in the contract, payment may be made therefore without retention of a percentage.

As in pay-if/when-paid provisions, a distributor is subject to delays that may be caused by problems out of its control and having nothing to do with its performance.

As noted above, warranty issues and product liability laws sometimes force distributors to "step into the shoes" of the manufacturer. The retainage provision can compound the exposure by effectively forcing the distributor to "step into the shoes" of the contractor.

Ideally, this condition of payment will be negotiated out of the contract. If this is not possible, then a distributor should make sure its retainage provisions parallel those in the construction contract, so that they are paid without retention if in fact the owner does not enforce its own retainage rights. Distributors may also consider insisting on interest charges for any funds withheld due to retainage.

Commencement of Warranty/Extended Warranty

Contractors may seek a provision that the period of the warranty for a product does not commence until "substantial completion" of the project. (The reason for this is that the statute of limitations period for claims against contractors will often commence only upon substantial completion.) A similar provision is a demand for an extended warranty, by which the distributor would be expected to warrant the goods for a period beyond that customarily in effect provided by the manufacturer.

One issue with this type of term is that it is not always clear when a project has been "substantially completed." Some contracts provide for a specific definition of when substantial completion is deemed to have occurred. In other circumstances, a manufacturer will agree to a certain length of time for "substantial completion," may add a cost to the price, or send service representatives out for an inspection to check on the completion. However, if not defined clearly in the contract, it will be defined case by case when the issue is brought into litigation.

Another issue is that the manufacturer's warranty will usually commence at the time of shipment. Given the delay that can result between shipment and completion, this potentially leaves the distributor responsible for the warranty.

A possible solution to this problem is to work with and ask the manufacturer to extend its warranty and pass any added cost on to the subcontractor. Regardless of the solution, as with many such provisions, the most important thing is to recognize that the potentially conflicting warranty provisions must be identified and compared in different documents. In these types of terms in the fine print, the distributor is essentially being asked to step into the shoes of the manufacturer on a product the distributor did not manufacture or test.

Conclusions and Recommendations

Electrical distribution is a relationship business. Trust and integrity are critical for fair competition and healthy relationships. Today, however, global competition and alternate channels have placed a strain on the relationships and many customers place more importance on protecting their interests. The imposition of contractual terms and conditions in the "fine print" is all about a party's intent to better manage cash flow; to shift the burden of liability to someone else, extend the protections, and reduce potential exposure in the event something goes wrong.

The best contracts are honestly negotiated – as opposed to being unilateral demands imposed by one upon the other without understanding and due consideration. This project demonstrates that the rules of engagement have changed as distributors described the difficult circumstances they face just to get an order.

Given the appreciation for the fact that the rules of the game have changed, an acronym might be an appropriate place to begin for distributors looking for the best way to now run their operations under these circumstances: "R. U. N." Namely,

- Read
- Understand
- Negotiate

"R.U.N"

Read: Realizing that contractual documents contain meaningful and sometimes not readily recognizable terms and conditions, it is important to read every purchase order and contract document presented before it is accepted and signed. A particular contract form routinely used by a customer may not always be identical. One survey participant shared an experience with a customer who had used the exact same form of purchase order for the last nine years. However, on a particular project new terms and conditions were inserted without notice - and were not read by the distributor. What resulted was a $2.7 million exposure that could have been caught in advance.

Understand: Distributors should consider investing in the resources to understand the ramifications of the agreements they sign. By thinking through the alternatives and "what if's," a distributor will be better prepared to appreciate the impact of the terms and conditions on the enterprise, and the relationship. Reference to the company's risk manager, counsel or insurance broker may be appropriate to fully understand the implications of what is being agreed upon. Thereafter, the following options can be pursued:

Thereafter, the following options can be pursued:

- Accept the terms and conditions as written;
- Accept the terms and conditions as written, but understanding a greater cost factor may be involved in light of the added potential exposure or delayed payment, and in appreciation of the distributor's own appetite to assume the added risk, vary the price point accordingly;
- Negotiate the terms as required; or
- Walk away from the deal.

Negotiate: When the terms and conditions presented are not acceptable to the distributor, a discourse may be warranted to maintain the transaction and proceed with terms and conditions more in keeping with the distributor's risk appetite. This would include the ability to shift the exposure or requirement to the manufacturer or add price to beyond the product cost to compensate for the additional requirements or exposures that may need to be incurred.

Customers may be amenable to either accepting the distributor's contractual wording or negotiating specific terms and conditions. Where the customer is not willing to negotiate or where negotiations have not been able to resolve an issue, the question then becomes whether to agree to the best possible terms to save the deal with a full understanding of the accordant risks, or to simply walk away. There is another reality that must be noted: there are other competitors who may agree to the terms another distributor has refused. That is the nature of the free market system. The good news is that while the competitor may have clinched the deal, they will also be burdened with any consequences that result.

Consensus Docs

Another option for distributors seeking fair and balanced contracts is to utilize ConsensusDocs.

First published on September 28, 2007 with over 70 standard contract documents and a coalition of over 20 members, the ConsensusDocs Coalition now includes 35 leading design and construction industry associations. The Coalition members represent stakeholders at all levels of the design and construction process and include Designers, Owners, Contractors, Subcontractors and Sureties (hence the "DOCS"). The facility has over 90 contract documents available addressing all methods of project delivery. The contracts incorporate industry best practices and fairly allocate risks to help reduce costly contingencies and provide better project results.

The contracts are meant to be edited to meet project-specific needs, but all parties benefit from a good contractual foundation.

By starting with a contract vetted by legal, insurance, design and construction stakeholders with hundreds of years of combined practical experience, parties are positioned to reach consensus sooner, have less disputes, and realize time and cost savings which all lead to better project results. The forms are easily modifiable to meet project-specific needs; however local laws should be reviewed to ensure the terms are also in compliance with the project and jurisdictional specific requirements.

Especially valuable for distributors is the 702 Standard Purchase Order for Commodity Goods, developed by NAED and available for purchase on consensusdocs.org.

Now that we have explored the battle of the forms and the fine print, distributors will hopefully have a better understanding of the issues and considerations to be examined before entering into contracts with terms and conditions that may create potential financial consequences, and be better prepared to "R.U.N." their operations appropriately.

Channel Advantage Partnership

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