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RISK OF ECONOMIC LOSS AND IMPLIED WARRANTY LIABILITY IN TRIPARTITE FINANCE LEASES

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I. INTRODUCTION

During recent years, business leasing has become more prevalent. Leasing is often preferred for accounting and tax reasons. The desire to use equipment on a short-term basis without incurring capital expenditures, the desire to avoid responsibility for maintenance and related costs, or the desire to keep pace with rapid technological change by leasing state-of-the-art equipment are reasons more and more businesses use leases to procure needed equipment, machinery, computer and communications systems, and vehicles.

Although leasing offers many economic and business advantages,[1] unfortunately, risks exist for the lessee. When equipment is found to be inadequate or defective, the lessee may find that neither the lessor nor the equipment vendor or manufacturer is willing to accept responsibility. This article will explore recent Indiana cases relating to remedies available to the equipment lessee for economic loss under tort and contract law for breach of warranty.[2] Problems related to application of Uniform Commercial Code (U.C.C.) provisions and privity requirements also will be discussed.

The typical pattern in a tripartite finance lease[3] begins with a vendor or seller of equipment such as computer systems, electronic equipment, vehicles, or heavy equipment and machinery. Usually because of considerations regarding capital resources, cash flow, or tax planning, the lessee de-

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1. Discussion of accounting and tax treatment of leases is beyond the scope of this article.

2. This article is limited to a discussion of economic loss in personal property lease transactions and will not discuss strict liability in tort imposed on lessors and/or equipment manufacturers where personal injury or property damage results from defective equipment.

3. The term "tripartite finance lease" is used herein to describe the mechanism whereby a lessee obtains equipment from a financial institution or other lender as lessor of the equipment. The lessor obtains the equipment by purchase from a third party vendor. There are always three parties involved: lessee, lessor, and vendor, as well as two contracts: a sales contract and a lease.

cides that a lease or a lease with an option to purchase is a better means of obtaining needed equipment. A bank, leasing company, or other lending institution provides the necessary funds, most often by purchasing the equipment from the seller and then entering into a lease purchase agreement with the lessee.

In the routine tripartite lease situation, a contract exists between the lessor and the seller for the purchase of the equipment; a lease agreement exists between the lessor and the lessee covering the amount and terms of the financing. There is no contract between the equipment seller and the lessee, who is the ultimate user and consumer of the equipment. There is no single agreement which ties the obligation to pay for the equipment to the user's performance expectations for the equipment. Although the necessary elements for applying U.C.C. warranty theory and common law contract remedies exist, they are not found in a configuration which permits their application. When the equipment fails to perform as expected by the lessee, resulting in loss of bargain or other economic injury to the lessee's business or enterprise, the juxtaposition of buyer and seller roles among the three parties results in an inequitable situation. Even without injury, the lessor has remedies against the seller, while the lessee has injury without the remedies. The seller has failed to perform under the terms of his or her contract, yet has no liability to the injured party.

This article will first discuss the general nature of lease transactions and risk of loss for economic damages. The application of U.C.C. provisions to leases, specific U.C.C. warranty provisions, and privity requirements for applying warranty remedies will then be discussed. Finally, two exceptions to privity requirements, based on theories of agency and participation in the transaction, will be discussed as a means for providing warranty remedies to the lessee in a tripartite finance lease.

II. NATURE OF LEASE TRANSACTIONS

Numerous authors have struggled to characterize the nature of lease transactions, particularly in relationship to sales and bailments.[4] Some have gone so far as to conclude that "there is no intelligible border between sale and lease."[5] The value of pigeonholing leases as distinct from other kinds of transactions depends on the context of other legal and business issues involved.[6] For example, ownership and title are important in taxation and

4. *See, e.g.*, A.L.I.-A.B.A. COMMITTEE ON CONTINUING PROFESSIONAL EDUCATION INVITATIONAL SYMPOSIUM, PERSONAL PROPERTY LEASING: PROSPECTS AND PROPOSALS FOR A UNIFORM STATUTE (1983); J. Ayer, *On the Vacuity of the Sale/Lease Distinction*, 68 IOWA L. REV. 667 (1983).

5. Ayer, *Further Thoughts on Lease and Sale*, 1983 ARIZ. ST. L.J. 341, 345.

6. Boss, *Leases and Sales: Ne'er or Where Shall the Twain Meet?*, 1983 ARIZ. ST. L.J.

bankruptcy contexts where it becomes essential to determine how much of and to whom an interest in the property was transferred by the lease. Questions of perfection and rights upon repossession take on different dimensions when a lease is viewed as a financing device, installment sale, or secured transaction.

Most comparisons of leases and sales have placed heavy emphasis on analysis of the distribution of economic risks and benefits between the lessee/buyer and the lessor/seller.[7] The issues which are critical to this inquiry are the nature of implied warranty liability, such as that found in Article 2 of the U.C.C., to be applied to the lessor and the effect of lack of privity between the lessee and the equipment supplier or manufacturer in the typical tripartite finance lease situation.

Lease transactions should be differentiated on the basis of the role of the lessor.[8] A vendor lessor is in the business of supplying equipment for lease or for lease and sale. The vendor lessor may maintain an inventory of equipment and often provides other services such as maintenance, service, and repair for the equipment. Vendor lessors may provide equipment on a short or long-term basis, but often expect the return of the leased item before the end of its useful life so that it may be leased again and again.

A finance lessor is in the business of providing funds to lessees who desire to procure property by means of a lease. Finance lessors are not the direct providers of the equipment. There is always a third party involved from whom the equipment is obtained on behalf of the lessee. Finance lessors perform different functions from those of vendor lessors. Recognizing that finance lessors generally provide funding and credit-related services which are consistent with the terms of the charters of national banks, the court in *M & M Leasing Corp. v. Seattle First National Bank* explained the role of a national bank acting as a finance lessor:

> [G]enerally the customer calls the bank directly and expresses an interest in leasing particular personal property. This contact essentially is to inquire about the availability of credit. The bank performs no procurement function. The customer chooses the property he wishes to lease, selects a vendor and negotiates with him the terms of the purchase. Assuming the bank finds the customer an acceptable credit risk, it then purchases the property

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357, 368.

7. *See, e.g.*, Fraser, *Application of Strict Tort Liability to the Leasing Industry: A Closer Look*, 34 BUS. LAW. 605 (1979). *But cf.* Henszey, *Application of Strict Tort Liability to the Leasing Industry*, 33 BUS. LAW. 631 (1978).

8. Carlin, *Product Liability for the Equipment Lessor? Merchant-Lessor versus Finance-Lessor*, in EQUIPMENT LEASING-LEVERAGED LEASING 847 (B. Fritch & A. Reisman 2d ed. Supps. 1980, 1983).

> and leases it to the customer. Delivery by the seller is made directly to the customer-lessee who makes the lease payments to the bank.[9]

Arguments for imposing strict tort liability on and applying U.C.C. warranty provisions to lessors frequently point out the similarities between lessors and sellers: both inject the subject property into the stream of commerce and fully participate in the chain of distribution.[10] In addition, both are in a position to absorb the effect of losses from liability as a cost of doing business.[11]

Two other important reasons for imposing strict tort or implied warranty liability on sellers do not apply to finance lessors. First, finance lessors have little if any contact with the equipment being leased.[12] They are not in a position to affect changes in product design, packaging, promotion, or in any other way to alter products in response to liability problems. Second, because they are not the direct distributors or promoters of the equipment, it is unlikely that lessees place the kind of consumer reliance on lessors that buyers place on sellers in the ordinary course of business.[13] These differences will be discussed in greater detail below. Given the large number of lease transactions, analogous treatment of leases as compared to sales and other commercial transactions is problematic. Not only are leases treated differently in various jurisdictions,[14] but there is also differing treatment as to who is a proper plaintiff and a proper defendant depending on the nature of the damage or injury involved.[15]

The law in Indiana is well-settled regarding liability for personal injury

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9. 563 F.2d 1377, 1380-81 (9th Cir. 1977), *cert. denied*, 436 U.S. 956 (1977).

10. Fraser, *supra* note 7, at 610-12 and cases cited therein. *See also*, Gilbert v. Stone City Constr. Co., 171 Ind. Ct. App. 418, 357 N.E.2d 738 (1977).

11. While products liability decisions such as Escola v. Coca Cola Bottling Co., 24 Cal. 2d 453, 150 P.2d 436 (1944); and Greenman v. Yuba Power Products, Inc., 59 Cal. 2d 57, 377 P.2d 897 (1962), recognize that the loss spreading rationale is support for finding liability, the mere existence of a deep pocket somewhere is not a fair basis for imposing liability. Fraser, *supra* note 7, at 614. *See also* W. KEETON, D. DOBBS, R. KEETON & D. OWENS, PROSSER & KEETON ON THE LAW OF TORTS § 98 (5th ed. 1984).

12. *M & M Leasing*, 563 F.2d at 1381.

13. Most, but not all, equipment lessors will be commercial entities rather than individual consumers who have bargaining power equal to that of the lessor. *See* Fraser, *supra* note 7, at 608-09. *See also* the discussion in Zimmerman v. Moore, 441 N.E.2d 690, 695-96 (Ind. Ct. App. 1982) (rejecting application of warranty liability to a nonmerchant lessor of real property based in part on the inapplicability of the loss spreading, reliance, and superior product knowledge rationales for imposing liability on manufacturers and merchants).

14. *See infra* notes 50-54 and accompanying text.

15. *See* the discussion and cases cited in Hertz Commercial Leasing Corp. v. Transportation Credit Clearing House, 59 Misc. 2d 226, 298 N.Y.S.2d 392 (Civ. Ct. 1969), *rev'd on other grounds*, 64 Misc. 2d 910, 316 N.Y.S.2d 585 (Sup. Ct. 1970).

and property damage.[16] Where personal injury is involved, under any theory of recovery, whether negligence, strict liability, or warranty, Indiana grants a remedy without requiring privity between the parties.[17] Indiana courts have liberally construed section 402A of the Restatement Second of Torts[18] in determining who is responsible for injecting a defective product into the stream of commerce[19] and in determining who is protected as a user or consumer.[20]

In *Gilbert v. Stone City Construction Co.*, a federal court applying Indiana law held that a commercial sale is not an essential element of recovery under section 402A.[21] In *Stone City*, the court found the lessor of highway construction equipment liable to an injured bystander because the lessor was the one who placed the equipment into the stream of commerce.[22] As long as the lessor "was engaged in the business of providing construction equipment to others — even if the corporation pursued other business as well," status as a lessor and not as a seller was deemed irrelevant.[23] "Therefore, liability under section 402A will attach to one who places such a product in the stream of commerce by sale, lease, bailment, or other means."[24] The significance of this holding is not the inclusion of lessors in the category of those who inject goods into the stream of commerce, but the application of strict liability for personal injury on lessors as well as other business actors.

III. LIABILITY FOR ECONOMIC LOSS

In Indiana, as in most jurisdictions, economic loss is generally distinguished from property and personal injury damages.[25] One Indiana court has defined economic loss as "diminution in value of a product and conse-

16. Thiele v. Faygo Beverage, Inc. provides an excellent synopsis of products liability law in Indiana. 489 N.E.2d 562, 576-84 (Ind. Ct. App. 1986).

17. Filler v. Rayex Corp., 435 F.2d 336 (7th Cir. 1970); Dagley v. Armstrong Rubber Co., 344 F.2d 245 (7th Cir. 1965). It should be noted that the plaintiff must fall within the class of those to whom a duty of care is owed or be a "user" or "consumer" as defined by IND. CODE § 33-1-1.5-3 (Supp. 1986).

18. IND. CODE § 33-1-1.5-3 (Supp. 1986). *See also* Cornette v. Searjeant Metal Products, Inc., 147 Ind. App. 46, 258 N.E.2d 652 (1970).

19. Reliance Ins. Co. v. Al E. & C. Ltd., 539 F.2d 1101 (7th Cir. 1976); Perfection Paint Color Co. v. Konduris, 147 Ind. App. 106, 258 N.E.2d 681 (1970).

20. Ayr-Way Stores, Inc. v. Chitwood, 261 Ind. 86, 300 N.E.2d 335 (1973). *But see* Thiele v. Faygo Beverage Co., 489 N.E.2d 562 (Ind. Ct. App. 1986).

21. 171 Ind. App. 418, 357 N.E.2d 738 (1977).

22. *Id.* at 423, 357 N.E.2d at 742.

23. *Id.* at 422, 357 N.E.2d at 742.

24. *Id.* (citations omitted).

25. *See* the discussion at J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE §§ 11-5 to -7, at 406-410 (2d ed. 1980) and cases cited therein.

quent loss of profits because the product is inferior in quality and does not work for the general purposes for which it was manufactured and sold."[26] The distinction between economic loss and property damage is upheld by courts because allocation of the risk of economic loss is part of the expectation interests of the parties. Buyers and sellers, as well as lessees and lessors, bargain for the allocation of risk for lost profits, inferior product quality, and related damage elements when reaching agreement on price and other contract terms. Absent specific property damage or personal injury, courts are loathe to remake the contract when the bargain does not meet the expectations of one party, but the other has fulfilled the contract terms.

The difference between property damage and economic loss is sometimes difficult to identify where the product itself has sustained loss or damage.

> It may therefore be said, as a general rule, that when damage is sudden and calamitous, resulting from an occurrence hazardous to human safety, recovery may be had in tort, but damage resulting merely from deterioration, internal breakage, depreciation, failure to live up to expectation, and the like, will be considered economic loss, as to which recovery may be had only on a contract theory.[27]

In the majority of states, including Indiana, economic loss is recoverable only in a contract action.[28] As Justice Traynor explained in the leading case on the subject, *Seely v. White Motor Co.*:

> The distinction that the law has drawn between tort recovery for physical injuries and warranty recovery for economic loss is not arbitrary and does not rest on the "luck" of one plaintiff having an accident causing physical injury. The distinction rests, rather, on an understanding of the nature of the responsibility a

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26. Sanco, Inc. v. Ford Motor Co., 579 F. Supp. 893, 895 (S.D. Ind. 1984), *aff'd*, 771 F.2d 1081 (7th Cir. 1985) (citing Comment, *Manufacturers' Liability to Remote Purchasers for "Economic Loss" Damages — Tort or Contract?*, 114 U. PA. L. REV. 539, 541 (1966) and Note, *Economic Loss in Products Liability Jurisprudence*, 66 COLUM. L. REV. 917, 918 (1966)).

27. *Sanco*, 579 F. Supp. at 898. *See also* IND. CODE § 34-4-20-2 (Supp. 1986) which defines "physical harm" under the Indiana Products Liability Act as "bodily injury, death, loss of services, and rights arising from any such injuries, as well as sudden major damage to property. The term does not include gradually evolving damage to property or economic losses from such damage."

28. J. WHITE & R. SUMMERS, *supra* note 25. *See also* Sanco v. Ford Motor Co., 579 F. Supp. at 896 and cases cited therein. Privity is required to recover under contract or U.C.C. warranty theories and is therefore a necessary element for recovery of economic loss. *See also*, Gregory v. White Truck and Equipment Co., 163 Ind. App. 240, 249-50, 323 N.E.2d 280, 285 (1975) (distinguishing tort and contract warranty concepts).

manufacturer must undertake in distributing his products.

> He can appropriately be held liable for physical injuries caused by defects by requiring his goods to match a standard of safety defined in terms of conditions that create unreasonable risks of harm. He cannot be held for the level of performance of his products in the consumer's business unless he agrees that the product was designed to meet the consumer's demands. A consumer should not be charged at the will of the manufacturer with bearing the risk of physical injury when he buys a product on the market. He can, however, be fairly charged with the risk that the product will not match his economic expectations unless the manufacturer agrees that it will. Even in actions for negligence, a manufacturer's liability is limited to damages for physical injury and there is no recovery for economic loss alone.[29]

Federal courts applying Indiana law have followed *Seely* noting,

> Qualitative defects which merely disappoint the buyer's expectations of the product's performance do not expose the user or his property to any risk of physical harm. When a product does not perform as expected, the buyer's remedy should be governed by the rules of contract, which traditionally protect expectation interests.[30]

The Indiana Supreme Court appears to disagree with *Seely* in *Barnes v. Mac Brown*,[31] a case involving property damage without personal injury under the warranty of habitability for newly-constructed residences. The court rejects the distinction drawn between personal injury and property damage, but maintains a distinction between these and loss of bargain without attendant property damage or physical injury.

> The contention that a distinction should be drawn between mere "economic loss" and personal injury is without merit. Why there should be a difference between an economic loss resulting from injury to property and an economic loss resulting from personal injury has not been revealed to us. When one is personally injured from a defect, he recovers mainly for his economic loss. Similarly, if a wife loses a husband because of injury resulting from a defect in construction, the measure of damages is totally

29. 63 Cal. 2d 9, 18, 403 P.2d 145, 151, 45 Cal. Rptr. 17, 23 (1965) (citations omitted).

30. *Sanco*, 579 F. Supp. at 897.

31. Barnes v. Mac Brown and Co., 264 Ind. 227, 230, 342 N.E.2d 619, 621 (1976). *Barnes* was cited in *Sanco* and distinguished on the grounds that it is an action based on warranty where recovery of economic loss is appropriate, and therefore the court did not have to choose between warranty and tort concepts as a basis for recovery. *Sanco*, 771 F.2d at 1085-86.

> economic loss. We fail to see any rational reason for such a distinction.
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> If there is a defect in a stairway and the purchaser repairs the defect and suffers an economic loss, should he fail to recover because he did not wait until he or some member of his family fell down the stairs and broke his neck? Does the law penalize those who are alert and prevent injury? Should it not put those who prevent personal injury on the same level as those who fail to anticipate it?[32]

Justice DeBruler's dissent in *Barnes* was in line with the reasoning in *Seely* and points out that the basis for the action was contract and that the plaintiffs suffered only economic loss.[33] Finding no indication that the builder bargained for liability to subsequent buyers, DeBruler would have denied recovery to the plaintiffs based on lack of privity.[34]

> Disposing of the requirement of showing privity in a contract case involves consideration not present when doing away with it for the purpose of suing a builder or manufacturer for injury to person or property caused by a negligently manufacture[d] or dangerously defective product. The determination of damages recoverable from this defendant-builder must rest in part upon the expectation about the house created in the minds of the Barneses at the time of their purchase of the house for the Shipmans. Those expectations would have arisen out of the bargaining which took place between them. Defendant-builder did not engage in that bargaining and thereby participate in establishing the perimeters of any expectations. And the expectations of bargaining parties end up translated into the purchase price. Defendant-builder had nothing to do with determining the purchase price paid by the Barneses.[35]

As Justice DeBruler pointed out, the special remedy created for home purchasers would not extend to an ordinary sale of goods.[36] The buyer of goods who suffers economic loss would be left to whatever contract and U.C.C. warranty remedies had been negotiated and agreed to with the seller. The lessee, unlike the buyer of goods who suffers economic loss without personal injury or property damage, does not have U.C.C. warranty remedies against the lessor and is unlikely to have express warranty coverage in the usual finance lease agreement.

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32. *Barnes*, 264 Ind. at 230, 342 N.E.2d at 621.
33. *Id.* at 231, 342 N.E.2d at 621.
34. *Id.* at 231, 342 N.E.2d at 622.
35. *Id.*
36. *Id.*

The plight of the lessee who has defective equipment and has suffered economic loss is well illustrated in *Ridge Co. v. NCR Corp.*[37] In this case the lessee had no warranty remedies against the finance lessor due to disclaimers in the lease contract and had no contractual remedies against the equipment vendor because of lack of privity. Ridge Co. needed a computer system and decided for various business reasons to lease the equipment through an established leasing company rather than purchase it outright. After delivery of the equipment, Ridge claimed numerous defects and deficiencies in the system, including latent defects, which constituted a breach of the implied warranty of merchantability under section 26-1-2-314 of the Indiana Code. Ridge claimed economic loss, but suffered no property damage or personal injury as a result of the defective computers.[38]

Applying Indiana law, the District Court for the Northern District of Indiana noted that privity of contract remains a necessary requirement for a claim based on breach of the implied warranty of merchantability.[39] Although the exceptions to the privity requirement found in other Indiana cases[40] were noted, the record did not support a finding that there was an agency relationship between the lessee and certain component part manufacturers, or that these remote manufacturers had participated in the transaction to such a degree that the need for privity between the parties was obviated.[41] The court discerned no trend in Indiana law toward elimination of the privity requirement, notwithstanding the holding in *Barnes v. Mac Brown*[42] on the warranty of habitability for residential buildings, and refused to extrapolate or surmise beyond existing case law.[43] Although the component part manufacturers were entitled to judgment as a matter of law and summary judgment was granted in their favor based on the particular facts of this case, in appropriate circumstances, U.C.C. warranty protection may be extended from equipment suppliers to lessees in tripartite finance lease situations.[44] As *Ridge Co. v. NCR Corp.* clearly illustrates, Indiana courts continue to recognize significant differences between tort and contract actions and between economic loss and personal injury or property damage. Only in the area of new home construction have Indiana courts deviated from traditional tort and contract theories of relief.[45]

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37. 597 F. Supp. 1239 (N.D. Ind. 1984).

38. *Id.* at 1241.

39. *Id.* at 1242.

40. Thompson Farms, Inc. v. Corno Feed Products, 173 Ind. App. 682, 366 N.E.2d 3 (1977); Richards v. Goerg Boat & Motors, Inc., 179 Ind. App. 102, 384 N.E.2d 1084 (1979).

41. *Ridge Co.*, 597 F. Supp. at 1242.

42. Barnes v. Mac Brown, 264 Ind. 227, 342 N.E.2d 619 (1976).

43. *Ridge Co.*, 597 F. Supp. at 1243.

44. *Id.*

45. The precedents for finding liability even where there was no direct privity between the buyer and a remote manufacturer in Thompson Farm, Inc. v. Corno Feed Products, 173 Ind. App. 682, 366 N.E.2d 3 (1977), and in Richards v. Goerg Boat & Motors, Inc., 179 Ind.

IV. APPLICATION OF THE U.C.C. TO LEASES

Article 2 of the U.C.C. and Indiana's statutory version, sections 26-1-2-101 to -725 of the Indiana Code, explicitly applies to "transactions in goods."[46] Although the phrase "transactions in goods" is not defined in the U.C.C. or used elsewhere in Article 2, it is clear from the Official Comments[47] that Article 2 applies to sales and that leases are not within the purview of Article 2.[48]

Courts have used at least three theories to apply Article 2 to nonsales transactions, including leases:[49] (1) by claiming leases fall within the phrase "transactions in goods,"[50] (2) by analogizing leases to sales,[51] and (3) by

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App. 102, 384 N.E.2d 1084 (1979), can be analyzed within the traditional contract privity framework and represent expansion rather than elimination of privity requirements. These two exceptions are discussed *infra* at notes 126-164 and accompanying text.

46. U.C.C. § 2-102 (1977); IND. CODE § 26-1-2-102 (Supp. 1986).

47. J. WHITE & R. SUMMERS, *supra* note 25, § 2-2, at 51-52. Indiana did not adopt the Official Comments to the U.C.C. when its statutory version of the U.C.C. was enacted. IND. CODE §§ 26-1-1-101 to -206 (Supp. 1986). *But see* U.C.C. § 2-102 Official Comments (1977).

48. U.C.C. § 2-313 Official Comment 2 (1977) indicating:

> Although this section is limited in its scope and direct purpose to warranties made by the seller to the buyer as part of a contract for sale, the warranty sections of this Article are not designed in any way to disturb those lines of case law growth which have recognized that warranties need not be confined either to sales contracts or to the direct parties to such a contract. They may arise in other appropriate circumstances such as in the case of bailments for hire, whether such bailment is itself the main contract or is merely the supplying of containers under a contract for the sale of their contents. The provisions of Section 2-318 on third party beneficiaries expressly recognize this case law development within one particular area. Beyond that the matter is left to the case law with the intention that the policies of this Act may offer useful guidance in dealing with further cases as they may arise.

But see Thompson Farms, Inc. v. Corno Feed Products, 173 Ind. App. 682, 702, 366 N.E.2d 3, 13 (1977), wherein the court stated, "The warranty provisions of Article II of the Uniform Commercial Code are clearly limited to the sale of goods."

49. Glen Dick Equip. Co. v. Galey Constr., Inc., 97 Idaho 216, 220, 541 P.2d 1184, 1188 (1975).

50. Cases which have applied the U.C.C. to leases under the theory that they are "transactions in goods" include: Hertz Commercial Leasing Corp. v. Joseph, 641 S.W.2d 753 (Ky. Ct. App. 1982); Hertz Commercial Leasing Corp. v. Transportation Credit Clearing House, 59 Misc. 2d 226, 298 N.Y.S.2d 392 (Civ. Ct. 1969), *rev'd on other grounds*, 64 Misc. 2d 910, 316 N.Y.S.2d 585 (Sup. Ct. 1970); Mieske v. Bartell Drug Co., 92 Wash. 2d 40, 593 P.2d 1308 (1979). *But see* Bona v. Graefe, 264 Md. 69, 285 A.2d 607 (1972) (if U.C.C. was intended to cover leases it would say leases and sales); Debbis v. Hertz Corp., 269 F. Supp. 671 (D. Md. 1967) (applying Virginia law).

51. Cases which have held that leases are similar to sales and that the U.C.C. may thereby be applied by analogy include: Knox v. North Am. Car Corp., 80 Ill. App. 3d 683, 399 N.E.2d 1355 (1980); Belger Cartage Serv., Inc. v. Holland Constr. Co., 224 Kan. 320, 582 P.2d 1111 (1978); All-States Leasing Co. v. Bass, 96 Idaho 873, 538 P.2d 1177 (1975); Addressograph-Multigraph Corp. v. Zink, 273 Md. 277, 329 A.2d 28 (1974); Baker v. Seattle, 79 Wash. 2d 198, 484 P.2d 405 (1971); Sawyer v. Pioneer Leasing Corp., 244 Ark. 943, 428

classifying some leases as sales.[52] Other courts have used multiple theories to justify the application of Article 2 to leases[53] or have simply applied Article 2 without explanation.[54]

A "sale" is "the passing of title from the seller to the buyer for a price."[55] Passing of title distinguishes sales from nonsales transactions such as leases[56] and bailments.[57] The U.C.C. provisions found at section 2-401[58] set forth the requirements for and effect of passing title in a sales transaction. It should be noted that a purchase option in a lease does not necessarily convert the transaction into a sale or secured transaction.[59] The intent of the parties as to whether a particular transaction is or is not a sale is generally determinative.[60] Because the intent of the parties to lease specifically reserves title in the lessor, leases in Indiana are not subject to the

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S.W.2d 46 (1968).

52. Cases which have held that leases may be treated as sales and the U.C.C. applied directly to the lease transaction include Solomon Refrigeration, Inc. v. Osburn, 148 Ga. App. 772, 252 S.E.2d 686 (1979) (purchase option in lease converted transaction to a sales transaction); Todd Equip. Leasing Co. v. Milligan, 395 A.2d 818 (Me. 1978) (parties acknowledge transaction denominated as "lease" was really a sale); KLPR TV, Inc. v. Visual Elecs. Corp., 327 F. Supp. 315 (D. Ark. 1971) (lease treated as a sale and warranty of fitness for particular use may be applied); Granite Equip. Leasing Corp. v. Everett School, Inc. 9 U.C.C. Rptr. 849 (N.Y. Civ. Ct. 1971) (lease is really an installment sale).

53. Glen Dick Equip. Co. v. Galey Constr., Inc., 97 Idaho 216, 541 P.2d 1184 (1975).

54. Cases in which the U.C.C. has been applied directly to a lease transaction without explanation of the court's reasoning include: Chalos Sys., Inc. v. NCR Corp., 479 F. Supp. 738 (D.N.J. 1979); Fairfield Lease Corp. v. Commodore Cosmetique, Inc., 7 U.C.C. Rptr. 164 (N.Y. Civ. Ct. 1969) (applying the warranty of fitness for particular purpose); Vacuum Concrete Corp. v. Berlanti Constr. Co., 206 Pa. Super. 548, 214 A.2d 729 (1965) (applying the warranty of fitness for particular purpose). *But cf.* W.R. Weaver Co. v. Burroughs Corp., 580 S.W.2d 76 (Tex. Civ. App. 1979) (a lease is not a sale).

55. U.C.C. § 2-106 (1977); IND. CODE § 26-1-2-106 (Supp. 1986).

56. Morris v. Lyons Capitol Resources, Inc., 510 N.E.2d 221, 223 (Ind. Ct. App. 1987) (distinguishing leases and security interests); United Leaseshares v. Citizens Bank & Trust, 470 N.E.2d 1383 (Ind. Ct. App. 1984) (explaining the financing objective of lease transactions); McEntire v. Indiana Nat'l Bank, 471 N.E.2d 1216 (Ind. Ct. App. 1984) (distinguishing lease from other transactions).

57. *See* Lyon v. Lenon, 106 Ind. 567, 7 N.E. 311 (1886); Webb v. Clark County, 87 Ind. App. 103, 159 N.E. 19 (1927) (defining bailments).

58. IND. CODE § 26-1-2-401(1) (Supp. 1986) provides, in part, for reservation of title in the goods in the seller as a security interest. As U.C.C. § 2-401 Official Comment 1 explains, the purpose of this section is to make clear that a determination as to who holds the title to goods at any point during the transaction is not determinative of the performance duties owed by the parties.

59. *Morris*, 510 N.E.2d at 223-24; *McEntire*, 471 N.E.2d at 1218.

60. Reissner v. Oaley, 80 Ind. 580 (1881) (intent of the parties determines whether a transaction is a sale or a bailment); Wayne Pump Co. v. Department of Treasury, 232 Ind. App. 147, 110 N.E.2d 284 (1953) (intent of parties determines whether a transaction is a sale or a loan). *But cf.* Frick Co. v. Walter Cox Co., 107 Ind. App. 402, 199 N.E. 462 (1936) (words used by parties to describe transaction are not controlling as to effect of transaction).

provisions of Article 2.[61]

Indiana courts have not dealt definitively with the application of Article 2 to non-sales transactions. Rather, a case-by-case analysis has resulted in holdings which, taken as a whole, indicate that Indiana has not significantly expanded the scope of Article 2 beyond the context of traditional sales. An Indiana court held that a distributorship agreement was a sale and was subject to the provisions of Article 2[62] and, in dicta, in another case, indicated that the time immediately proceeding the exchange of money for goods was within the parameters of a sale.[63] There has been a greater willingness by Indiana courts to expand the application of Article 2 to services and items not usually considered "goods" than to expand the application to nonsales transactions.[64]

In contrast, the provisions of Indiana's statutory version of section 402A of the Restatement Second of Torts[65] are applied to lessors. "The word 'sells' as contained in the text of section 402A is merely descriptive, and the product need not be actually sold if it has been injected into the stream of commerce by other means. The test is not the sale, but rather the placing in commerce."[66]

Precisely because strict products liability is based on tort and not contract law, the requirements of sale and privity are eliminated. Public policy[67] and humanitarian concerns[68] predominate in the law of torts. In contract law, however, parties are generally left to determine the terms of their own bargains.[69] Contract law protects the right of individuals to limit the

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61. *See* Ridge Co., Inc. v. NCR Corp., 597 F. Supp. 1239 (S.D. Ind. 1984); Neofes v. Robertshaw Controls Co., 409 F. Supp. 1376 (S.D. Ind. 1976) (denying recovery under U.C.C. warranties to lessee). *Cf.* Gilbert v. Stone City Constr. Co., 171 Ind. Ct. App. 418, 357 N.E.2d 738 (1976) (granting recovery under tort warranties to a lessee).

62. Moridge Mfg. Co. v. Butler, 451 N.E.2d 677 (Ind. Ct. App. 1983).

63. Lane v. Barringer, 407 N.E.2d 1173, 1175 (Ind. Ct. App. 1980).

64. Baker v. Compton, 455 N.E.2d 382 (Ind. Ct. App. 1983) (contract for sale and installation of equipment was within the scope of Article 2 where services were incidental to sale of goods); Stephenson v. Frazier, 399 N.E.2d 794 (Ind. Ct. App. 1980) (modular home is "goods"), *trans. denied*, 425 N.E.2d 73 (Ind. 1981); Helvey v. Wabash Co. REMC, 151 Ind. App. 176, 278 N.E.2d 608 (1972) (electricity is "goods"). *But cf.* Data Processing Servs., Inc. v. L.H. Smith Oil Corp., 492 N.E.2d 314, *aff'd*, 493 N.E.2d 1271 (Ind. Ct. App. 1986) (development of computer software program was service and not goods).

65. IND. CODE § 22-1-1.5-3 (1982).

66. Link v. Sun Oil Co., 160 Ind. App. 310, 312 N.E.2d 126, 130 (1974) (citing Perfection Paint & Color v. Konduris, 147 Ind. App. 106, 258 N.E.2d 681 (1970)).

67. Greeno v. Clark Equip. Co., 237 F. Supp. 427, 431 (N.D. Ind. 1965) (implied warranty liability in tort is a matter of public policy).

68. Citizens Gas & Coke Util. v. American Economy Ins. Co., 486 N.E.2d 998, 1000 (Ind. 1985).

69. Most provisions of the U.C.C. are not mandatory and do not supplant the common law of contracts unless so specified in the relevant section, thus leaving parties free to shape

scope of their liability for economic and property losses to those with whom they are in contractual privity.[70]

V. U.C.C. WARRANTY PROVISIONS

Article 2 of the U.C.C. provides for three types of product warranties:[71] express warranties between the parties,[72] an implied warranty of merchantability,[73] and an implied warranty of fitness for a particular purpose.[74] As the Official Comments to each of these actions explain, all three warranties were derived from the Uniform Sales Act and had a required privity element.[75]

An express warranty is a specific affirmation, promise, or representation with respect to the subject goods which becomes part of the basis of the bargain between the parties.[76] An express warranty must become part of the contract, even if it is by tacit agreement, because it is part of the basis of the bargain between the parties.[77] Whether given by agreement between the parties, description, or sample, an express warranty may be given in any sales or nonsales transaction.[78] If a vendor lessor or finance lessor gives an express warranty to the lessee, this will be enforced as part of the contract between the parties, but will not be enforced under the U.C.C.[79] Privity is required to bring an action on the contract because express warranties are part of the bargain between the buyer and seller or between the lessee and lessor.[80]

The implied warranty of merchantability applies to every sale of goods

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their own bargains. U.C.C. § 1-103 (1977); IND. CODE § 26-1-1-103 (Supp. 1986).

70. Hixon v. Sherwin-Williams Co., 671 F.2d 1005, 1010 (7th Cir. 1982) (Indiana law requires privity of contract for enforcement of warranties in order to protect the contractual rights of parties to bargain for a limited scope of liability).

71. U.C.C. § 2-312 (1977) and IND. CODE § 26-1-2-312 (1982) provide for a warranty of title, i.e., that the transfer of goods is rightful and good title is being conveyed. Warranty of title issues are not relevant to this discussion.

72. U.C.C. § 2-313 (1977); IND. CODE § 26-1-2-313 (1982).

73. U.C.C. § 2-314 (1977); IND. CODE § 26-1-2-314 (Supp. 1986).

74. U.C.C. § 2-315 (1977); IND. CODE § 26-1-2-315 (Supp. 1986).

75. U.C.C. §§ 2-313 Official Comment 1, 2-314 Official Comment 1, 2-315 Official Comment 1 (1977).

76. Royal Business Machines v. Lorraine Corp., 633 F.2d 34, 41 (7th Cir. 1980).

77. J. WHITE & R. SUMMERS, *supra* note 25, § 9-2, at 327-38. *See also* Nimet Indus., Inc. v. Joy Mfg. Co., 419 N.E.2d 779, 782 (Ind. Ct. App. 1981) (limitations of warranties must also be express or they are not part of the contract because they were not made part of the basis of the bargain).

78. J. WHITE & R. SUMMERS, *supra* note 25, § 9-3, at 328; Carmichael v. Lavengood, 112 Ind. App. 144, 44 N.E.2d 177 (1942).

79. J. WHITE & R. SUMMERS, *supra* note 25, § 9-2, at 327-28.

80. Hixon v. Sherwin-Williams Co., 671 F.2d 1005, 1010 (7th Cir. 1982).

where the seller is a "merchant with respect to goods of that kind."[81] Even if the U.C.C. is applied to lease transactions, section 2-314 will presumably apply only to merchant lessors who deal in goods of the kind being leased. Arguments in favor of applying warranty liability to lessors are appropriate for vendor lessors such as car rental agencies and short-term equipment lessors who can be characterized as "merchants with respect to goods of [the] kind" being leased.[82]

"Merchant" as defined by the U.C.C. is one who "deals in goods of the kind or otherwise by occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction or to whom such knowledge and skill may be attributed by his employment as an agent or broker or other intermediary who by his occupation holds himself out as having such knowledge or skill."[83] Most vendor lessors will fit the definition of merchant by either dealing in goods of the same kind or by making representations of particular skill or knowledge relevant to the leased goods.

Finance lessors, who are likely to have had little or no contact with the leased goods, may in fact have significantly less skill or knowledge of the leased goods than the lessee and will rarely hold themselves out as ones who are skilled or knowledgeable about the goods. It appears that Indiana courts construe the "merchant" requirement strictly, holding that there is no liability unless one "is a merchant or manufacturer engaged in the business. There is no warranty or strict liability for occasional sales by nonmerchants or nonmanufacturers."[84]

Whether the finance lessor is an agent, broker, or intermediary for the merchant who supplies the leased goods will be a question of fact in each case. Agency has been recognized in Indiana as a basis for warranty liabil-

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81. U.C.C. § 2-314 (1977); IND. CODE § 26-1-2-314 (Supp. 1986). This warranty provides, in essence, that goods shall be fit for their ordinary purpose and use. Privity remains an element of a cause of action for breach of implied warranties based on contract, but not based on tort. Corbin v. Coleco Indus., Inc., 784 F.2d 411 (7th Cir. 1984). To the extent that an action is based on a claim of tortious breach of implied warranties, it is subsumed by and merges into a claim based on strict liability. Styron v. State Farm Mutual Ins. Co., 644 F. Supp. 713 (E.D. Pa. 1986) (construing Indiana law).

82. Fraser, *supra* note 7. *See also* Price v. Shell Oil Co., 2 Cal. 3d 245, 466 P.2d 722, 85 Cal. Rptr. 178 (1970) (where leasing activity was an organized and continuing activity, lessor was found to be in the business of leasing). *Cf.* All-States Leasing Co. v. Ochs, 42 Or. App. 319, 600 P.2d 899 (1979) (where a finance lessor was in the business of leasing various kinds of goods and equipment, but had only leased computer systems on a few occasions, the lessor was not a merchant with respect to the lease of computer systems).

83. U.C.C. § 2-104 (1977); IND. CODE § 26-1-2-104 (Supp. 1986).

84. Zimmerman v. Moore, 441 N.E.2d 690, 695 (Ind. Ct. App. 1982), *citing*, Royal Business Machines v. Lorraine Corp., 633 F.2d 34 (7th Cir. 1980); Stapinski v. Walsh Constr. Co., 272 Ind. 6, 395 N.E.2d 1251 (1979); Richards v. Goerg Boat & Motors, Inc., 179 Ind. App. 102, 384 N.E.2d 1084 (1979).

ity in the absence of privity.[85]

The implied warranty of fitness for a particular purpose is codified at section 2-315 of the U.C.C. and arises where the buyer communicates a specific intended purpose or use to the seller.[86] It is necessary that the buyer communicate the specific need to the seller[87] and that the buyer is in fact relying on the skill or knowledge of the seller to provide goods which will meet the stated need.[88] The course of dealing between the parties will affect the warranty of fitness for a particular purpose because over the course of dealing, the buyer will come to know the product and will rely more and more on first-hand experience with the product and less on the experience and expertise of the seller.[89]

If the communication of specific purpose can be shown, and if the necessary element of reliance is present, the warranty of fitness for a particular purpose will be implied even if it was not part of the express agreement between the parties.[90] The reliance element and opportunity for fraud or misrepresentation underlie the public policy of implying warranty liability for particular purposes even when not part of the express bargain between the parties.[91]

This warranty was also found at common law, and to the extent that U.C.C. provisions do not apply to leases, common law warranty liability may still apply. "It is the rule in Indiana, and it is well settled, that where a person hires or leases out a chattel which is to be used for a particular purpose, a warranty will be implied that the chattel is reasonably fit for the purpose for which it is leased or hired."[92] This common law warranty can be overridden by the express terms of the bargain between the lessor and the lessee. It does not extend to the equipment seller where there is no privity between the lessee and the seller.

A leading case on warranty liability of lessors, *Cintrone v. Hertz Truck Leasing, Inc.*,[93] was based on the common law implied warranty of fitness for ordinary use.

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85. *See* discussion of Thompson Farms, Inc. v. Corno Feed Products, *infra* text accompanying notes 126 and 156.

86. Jameson Chemical Co. v. Love, 401 N.E.2d 41, *modified as to att'y fees*, 403 N.E.2d 928 (Ind. Ct. App. 1980).

87. Auto-Teria, Inc. v. Ahren, 170 Ind. App. 84, 352 N.E.2d 774 (1976).

88. Woodruff v. Clark County Farm Bureau Coop. Ass'n, 153 Ind. App. 31, 286 N.E.2d 188 (1972).

89. *Royal Business Machines*, 633 F.2d at 46.

90. *Id.*

91. Filler v. Rayex Corp., 435 F.2d 336 (7th Cir. 1970).

92. Pointer v. American Oil Co., 295 F. Supp. 573, 577 (S.D. Ind. 1968). *See also* Bass v. Cantor, 123 Ind. 444, 24 N.E. 147 (1890).

93. 45 N.J. 434, 212 A.2d 769 (1965).

> To illustrate, if a traveler comes into an airport and needs a car for a short period and rents one from a U-drive-it agency, when he is put in the driver's seat his reliance on the fitness of the car assigned to him for the rental period whether new or used usually is absolute. In such circumstances the relationship between the parties fairly calls for an implied warranty of fitness of use, at least equal to that assumed by a new car manufacturer. The content of such warranty must be that the car will not fail mechanically during that period.[94]

Although the nature of this common law warranty has been found to be no different in sales or bailments (leases), it does not protect the lessee's expectation interests for a specific use.[95] The lessee who suffers economic loss without property damage or personal injury gains no remedy against the lessor other than the remedy to sue on the contract. Likewise, the lessee gains no remedy outside the contract to seek recovery from the remote equipment supplier or manufacturer.[96]

VI. Privity Requirements Under Indiana Law

The right to enforce a contract or bring an action based on breach of warranty in contract is generally limited to those parties who are in privity with the defendant.[97] Furthermore:

> [R]esearch discloses not one decision under Indiana law in which a plaintiff brought a personal injury action against a defendant with whom he was not in privity of contract that reached a result favorable to the plaintiff on the theory of breach of implied warranty sounding in tort.[98]

Indiana has abolished the privity requirement for personal injury actions based on negligence or strict liability in tort:

> The requirements of privity have been abolished by this Court and the Court of Appeals for products liability and contractor

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94. *Id.* at 449, 212 A.2d at 777.

95. *Id.* at 453-54, 212 A.2d at 777, 779 (citing Delaney v. Towmotor Corp., 339 F.2d 4, 6 (2d Cir. 1964), wherein the court held that reference to "sales" was descriptive of the situation rather than determinative of the scope of available remedies).

96. Richards v. Goerg Boat & Motors, Inc., 179 Ind. App. 102, 112, 384 N.E.2d 1084, 1092 (1979) (citing Gregory v. White Truck & Equip. Co., Inc., 163 Ind. App. 240, 323 N.E.2d 280 (1975)).

97. Citizens Gas & Coke Util. v. American Economy Ins. Co., 486 N.E.2d 998, 1001 (Ind. 1985); Essex v. Ryan, 446 N.E.2d 368, 372 (Ind. Ct. App. 1983). Two exceptions to the privity requirement in addition to the special case of the implied warranty of habitability will be discussed below.

98. Theile v. Faygo Beverage Inc., 489 N.E.2d 562, 577 (Ind. Ct. App. 1986).

> liability involving personal injury caused by a product or work in a condition that was dangerously defective, inherently dangerous or imminently dangerous such that it created a risk of imminent personal injury.[99]

Even where personal injury occurs, an action brought under a claim of breach of warranty based in contract must show that the plaintiff was a party to the contract, in privity with the defendant, or within the class protected by section 26-1-2-318 of the Indiana Code as a third party beneficiary to a warranty.[100] Indiana has adopted Alternative A, the most restrictive version of the three choices under U.C.C. § 2-318 for Third Party Beneficiaries Under Warranties, Express or Implied.[101] Alternative A limits protection to members of the buyer's household or family and guests in the home of the buyer.[102]

The Indiana Supreme Court refused to abolish the privity requirement where property damage without concomitant personal injury was involved.[103] In *Citizens Gas & Coke Utility v. Economy Insurance Co.*, a water heater was installed without the floor drain necessary to carry away excess water if the heater overflowed, became overpressurized, or leaked.[104] Property injury resulted when the heater overflowed while the home occupants were away. Because the parties had stipulated that only property damage was involved, the court did not consider whether the escaping hot water in the absence of a proper drain might have caused personal injury from scalding or falling on a wet floor.[105]

Although the difference between personal injury and property damage[106] was recognized as the result of fortuitous circumstances in *Barnes v. Mac Brown & Co.*,[107] and might well have been so in the *Citizens Gas* case,

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99. *Citizens Gas*, 486 N.E.2d at 1000.

100. Wilson v. Studebaker-Worthington, Inc., 582 F. Supp. 383, 388 (S.D. Ind. 1983). Usually a contract warranty claim is brought in a case involving personal injury where the two-year tort claim statute of limitations has run. *See, e.g.*, Whittaker v. Federal Cartridge Corp., 466 N.E.2d 480 (Ind. Ct. App. 1984); Lane v. Barringer, 407 N.E.2d 1173 (Ind. Ct. App. 1980).

101. IND. CODE § 26-1-2-318 (1982).

102. Corbin v. Coleco Indus., Inc., 748 F.2d 411 (7th Cir. 1984) (does not include remote or second-hand buyers); *Lane*, 407 N.E.2d at 1178 (does not include relatives who are not members of the buyer's household).

103. *Citizens Gas*, 486 N.E.2d at 1000.

104. *Id.* at 999.

105. *Id.*

106. Property damage as used herein refers to actual damage to the goods as a result of their defective condition and is to be distinguished from economic loss of bargain. *See supra* notes 25-45 and accompanying text.

107. 264 Ind. 141, 342 N.E.2d 619 (1976). Perhaps this is a further indication that Indiana courts view the implied warranty of habitability as a distinct area of the law with little

the court refused to abolish the privity requirement in the case of negligence involving only property damage.[108] The *Citizens Gas* court did not cite *Barnes*,[109] but did cite *Essex v. Ryan* as supportive of its position.[110]

Essex v. Ryan[111] further complicates the privity issue. The case involves a claim by heirs against a surveyor for negligence in carrying out a land survey under the terms of a personal service contract between the surveyor and the deceased. The precedential value of *Essex* is difficult to assess because (1) it involves a personal services contract which is clearly not within the scope of the U.C.C., (2) there is no privity of contract between the heirs and the surveyor or between the heirs and the deceased, and (3) the heirs had no expectation interest or any other nexus with the surveyor which could be recognized as forming a basis for recovery. The court rightfully protected the surveyor's interest to be free from liability to those with whom he did not bargain and to those whom he could not reasonably foresee that a duty of care would be owed.[112]

Where economic loss in the nature of loss of bargain is claimed, the general rule in Indiana and the majority of jurisdictions requires privity of contract in order to maintain a cause of action.[113] The same conclusion was reached by federal courts interpreting Indiana law in *Sanco, Inc. v. Ford Motor Co.*,[114] where both the District Court for the Southern District of Indiana and the Seventh Circuit Court of Appeals held that there is no negligence-based cause of action, that is, a cause of action which does not require privity of contract between the parties, that grants a remedy for purely economic loss.

> [I]f a negligence cause of action were available, Sanco could recover despite any effective disclaimer of warranty under Ind. Code 26-1-2-316, or any failure of Sanco to adhere to the notice requirements of Ind. Code 26-1-2-316. [T]his result would represent an unwarranted extension of the traditional boundaries of tort law into an area that [the] legislature, by enacting the Uniform Commercial Code, has provided with a finely tuned mechanism for dealing with the rights of the parties to a sales transaction with respect to economic losses. We are confident

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bearing on other types of warranty claims.

108. 486 N.E.2d at 1001.

109. *Id.*

110. *Id.*

111. 446 N.E.2d 368 (Ind. Ct. App. 1983).

112. Richards v. Goerg, 179 Ind. App. 102, 120, 384 N.E.2d 1084, 1092 (1979); Dagley v. Armstrong Rubber Co., 344 F.2d 245 (7th Cir. 1965).

113. Sanco, Inc. v. Ford Motor Co., 579 F. Supp. 893; (S.D. Ind. 1984), *aff'd*, 771 F.2d 1081 (7th Cir. 1985).

114. 771 F.2d at 1085 (quoting *Sanco*, 579 F. Supp. at 897-98).

that the Supreme Court of Indiana would view unfavorably any encroachment of tort law on the sales scheme of the Uniform Commercial Code.[115]

Where pure economic loss in the nature of loss of bargain, lost profits, or lost business opportunity is the subject of an action, privity remains firmly entrenched as a prerequisite to the pursuit of warranty remedies.[116] While this is generally not a problem in a sales transaction, the privity requirement leaves the lessee with inadequate remedies. A lessee faced with a defective telephone system which has failed to perform as promised by the vendor may discover that the finance lessor made no warranties for the equipment and therefore is not liable and that lack of privity precludes an action against the vendor of the equipment.

Although the difference between personal injury and property damage may be the result of fortuitous circumstances which does not warrant different treatment in the law, the reasoning of the court outside the context of the implied warranty of habitability[117] has consistently emphasized "humanitarian principles,"[118] public health and safety,[119] and concern for the innocent injured bystander,[120] implying an analysis under tort rather than contract theories. Where there is only loss of bargain, in the case where leased equipment fails to perform as expected, contract theory, with its attendant requirement of privity and express or implied warranties, offers the only remedy. Indiana courts have given no indication that this distinction will be obviated.

Privity remains firmly entrenched in Indiana law as a prerequisite to recovery for any kind of personal, property, or economic damage claimed in an action brought on a contract. Where personal injury is involved, tort law will allow recovery for the plaintiff in either a negligence or strict products liability action without privity of contract.[121] As a result, the lessee is faced with a particularly narrow range of options. If the lessee is injured and falls within the class protected by section 402A, the lessee may recover.[122] But if

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115. *Id.*

116. Citizens Gas & Coke Util. v. American Economy Ins. Co., 486 N.E.2d 998, 1001 (Ind. 1985); Ridge v. NCR Corp., 597 F. Supp. 1239, 1243 (N.D. Ind. 1984); Candlelight Homes, Inc. v. Zornes, 414 N.E.2d 980, 982 (Ind. Ct. App. 1981).

117. Barnes v. Mac Brown, 264 Ind. 141, 342 N.E.2d 619 (1976).

118. *Citizens Gas*, 486 N.E.2d at 1000; J.I. Case v. Sandefur Co., 245 Ind. 213, 197 N.E.2d 519 (1965).

119. Hiatt v. Brown, 422 N.E.2d 736 (Ind. Ct. App. 1981).

120. Lane v. Barringer, 407 N.E.2d 1173 (Ind. Ct. App. 1980).

121. Thiele v. Faygo Beverage, Inc., 489 N.E.2d 562, 577 (Ind. Ct. App. 1986).

122. IND. CODE § 33-1-1.5-3(a) (Supp. 1986) limits the class of potential plaintiffs to users and consumers whom the defendant could reasonably foresee might be subject to harm from the defective product. *Thiele*, 489 N.E.2d at 585. *See* Neofes v. Robertshaw Controls

the lessee suffers no personal injury, privity leaves only the lessor as a possible defendant for an action brought on the lease contract or based on common law implied warranty for a particular purpose. The lessee whose computer does not work or whose truck is a "lemon" will probably find that the financial institution which funded the lease disclaimed all warranties and that the lessee is left with the property "as is."

In addition to the exception carved out in the area of the implied warranty of habitability,[123] Indiana courts have recognized two exceptions to the privity requirement in sales contexts: (1) an exception based on traditional concepts of agent and principal which allow extension of the status of buyer or seller to more than one individual or entity[124] and (2) an exception based on actual participation in the transaction to such an extent that equity absolves the privity requirement.[125]

Indiana maintains a clear distinction between contract and tort actions, requiring the plaintiff to establish substantially different elements in order to establish a prima facie case in each kind of action. The exceptions which allow a plaintiff to bring an action sounding in contract without proving privity of contract are narrowly defined. Most significantly, the exceptions to privity do not eliminate privity, but recognize circumstances where the plaintiff is brought within the privity framework on the basis of agency or actual participation.

VII. The Agency Exception to the Privity Requirement

Traditional concepts of principal and agent have been used to extend U.C.C. warranty remedies from a remote manufacturer to an injured buyer. *Thompson Farms, Inc. v. Corno Feed Products*[126] is a 1977 Indiana Court of Appeals decision where an implied agency relationship between the dealer, Triple T Grain and Fertilizer, Inc., and the manufacturer, Corno Feed Products, was held to bestow the status of "seller" on both the dealer and the manufacturer, thereby bringing both into the transaction as parties liable on the warranties made to the buyer, Thompson Farms.

Thompson Farms is particularly instructive for the typical tripartite lease situation because Corno, the dealer and financing agent for the sale, brought an action against the buyer for default under the terms of the fi-

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Corp., 409 F. Supp. 1376, 1379 (S.D. Ind. 1983) (denying the claim of a lessee brought on a contract warranty due to lack of privity between the lessee and a component manufacturer).

123. Barnes v. Mac Brown, 264 Ind. 141, 342 N.E.2d 619 (1976).

124. Thompson Farms, Inc. v. Corno Feed Products, 173 Ind. App. 682, 366 N.E.2d 3 (1977).

125. Richards v. Goerg Boat & Motors, Inc., 179 Ind. App. 102, 384 N.E.2d 1084 (1979).

126. *Thompson*, 173 Ind. App. at 682, 366 N.E.2d at 3.

nance and security agreements, which granted no warranty rights to Thompson.[127] The buyer brought a counterclaim based on breach of express and implied warranties as well as a tort claim for negligent design and manufacture of hog houses and a feeding system.[128] Although it was the dealer, Triple T, which constructed and sold the hog houses and feeding system to Thompson, Corno was the designer, component manufacturer, and promoter of the complete hog feeder program.[129] Notwithstanding the fact that the products bore Triple T's logo, the court found an agency relationship existed sufficient to impose warranty liability on Corno based on these facts: (1) Corno promoted the hog feeding system in its own name, (2) placed its name on promotional materials and product packaging, (3) paid for Triple T's advertising expenses, (4) required the dealer to submit all contracts for financing to Corno for Corno's approval, and (5) made direct contact with the buyer when design problems developed.[130] In addition, the dealer and the manufacturer had a course of dealing with respect to the hog feeder system which indicated that Triple T was acting as a special agent for Corno in the promotion and sale of the product.[131]

The court defined agency as "a relationship which results from a) the manifestation of consent by one person to another, to undertake some business b) on his behalf or in his name, and subject to his control, and c) the authority and consent of the other for such person to so act."[132] As a general rule, agency may be inferred from the circumstances, including course of dealing between the parties or creation or assent to circumstances or conditions which give rise to the reasonable expectation that one is acting as the agent for another.[133] "An agency will, at times, be implied from the circumstances, in order to protect the rights of innocent parties, even where no contract of agency in fact exists."[134]

Corno contended it was not a seller because its role in the transaction was that of financing agent.[135] Unlike other jurisdictions, the Indiana court held that Corno could be both a seller and a financing agent in the same transaction.[136] The court recognized that complex transactions may involve

127. *Id.* at 684, 366 N.E.2d at 5.

128. *Id.*

129. *Id.* at 685, 366 N.E.2d at 6.

130. *Id.* at 695-96, 366 N.E.2d at 11-12.

131. *Id.* at 699, 366 N.E.2d at 12.

132. *Id.* at 694, 366 N.E.2d at 10 (citing Lincoln Nat'l Bank and Trust Co. of Fort Wayne v. Barker, 110 Ind. App. 1, 34 N.E.2d 190 (1941)).

133. *Id.* at 694, 366 N.E.2d at 12.

134. Foss-Schneider Brewing Co. v. McLaughlin, 5 Ind. App. 415, 418-19, 31 N.E. 838, 839 (1892).

135. *Thompson*, 173 Ind. App. at 699, 366 N.E.2d at 13.

136. *Id.* at 700, 366 N.E.2d at 13, distinguishing its holding from *In re* Sherwood Diversified Services, Inc., 382 F. Supp. 1359 (S.D.N.Y. 1974), and Atlas Industries, Inc. v. NCR

several parties and that individual parties may perform multiple roles in the same transaction.[137] Although it acknowledged that other courts have simply imposed additional responsibilities on finance agents, the Indiana court found no need to do so because it deemed Corno to be a seller and therefore fully accountable to the buyer under the express and implied warranty provisions of the sales contract.[138]

In holding that the hog houses and feeding system were goods under the terms of the U.C.C.,[139] the court noted that it was not applying the U.C.C. by analogy to this transaction.[140] It is a reasonable inference, therefore, that the court thereby intended not to extend Indiana's enactment of the U.C.C. beyond its terms.[141] This holding is significant in the tripartite lease situation because it is unlikely that the finance lessor would be found also to be a seller and therefore within the ambit of the *Thompson Farms* decision.

In *Candlelight Homes, Inc. v. Zornes*, the Court of Appeals affirmed Indiana's privity requirement in an action by a buyer to recover for economic loss to a mobile home from a remote manufacturer.[142] Where there was no evidence of any direct dealing between the buyer and the manufacturer, the court concluded that the mere existence of a manufacturer-dealer relationship did not establish an agency relationship sufficient to allow the buyer to recover for economic loss from the manufacturer.[143]

Thompson Farms[144] represents the use of agency principles to extend the status of seller to more than one entity. Agency may also be used to extend the status of buyer to more than one individual. A 1983 case, *Wilson v. Studebaker-Worthington, Inc.*, involving injury to an employee from an explosion in a turbine pump, was brought against various remote suppliers and manufacturers under both contract and tort theories.[145] Due to the expiration of the statute of limitations for the strict liability claims, the injured employee attempted to prove breach of contractual warranty.[146] The United States District Court for the Southern District of Indiana failed to find the requisite privity of contract, holding that the employer, but not the

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Co., 216 Kan. 213, 531 P.2d 41 (1975).

137. *Thompson*, 173 Ind. App. at 700, 366 N.E.2d at 13.

138. *Id.* at 701-02, 366 N.E.2d at 14.

139. *Id.* at 705, 366 N.E.2d at 14-15.

140. *Id.* at 701 n.9, 366 N.E.2d at 14 n.9.

141. *Id.*

142. 414 N.E.2d 980, 983 (Ind. Ct. App. 1981).

143. *Id.* at 982.

144. *Thompson*, 173 Ind. App. 682, 366 N.E.2d 3 (1977).

145. 582 F. Supp. 383 (S.D. Ind. 1983).

146. *Id.* at 385-87. *See also* Thiele v. Faygo Beverage, Inc., 489 N.E.2d 562 (Ind. Ct. App. 1986) (employee not considered user/consumer within § 402A).

employee, might bring a cause of action sounding in contract.[147]

In 1986, the United States District Court for the Northern District of Indiana relied on agency principles to supply the requisite privity to allow an employee of a corporation to bring a contract warranty action against a remote manufacturer.[148] Recognizing the role of the employee in the daily activities of the corporation, the court concluded, "[i]n essence, plaintiffs are the corporation."[149] The court relied heavily on the holding in *Hart v. Goodyear Tire & Rubber Co.* that:

> [M]ost businesses are carried on by means of the assistance of employees and that equipment or supplies purchased by employers will in actual use be handled by the employees, who in this respect may be said to stand in the shoes of the employer.[150]

The results in these two cases are not easily reconciled. Although the plaintiff in *Roberts*[151] was the sole shareholder in a small business operated much like a sole proprietorship, and the plaintiff in *Wilson*[152] was part of a large enterprise, both were employees of corporations. The emphasis on personal contact with the party whose nexus to the transaction is supplied by agency principles in *Thompson Farms*,[153] *Richards v. Goerg*,[154] *Ridge v. NCR*[155] and *Roberts v. Homelite*[156] is the only consistent thread running through these cases. Courts will imply an agency relationship, but appear to look to personal contact and direct dealing before they will do so.

Where there is an actual or implied agency between the seller and the manufacturer, despite lack of privity between the buyer and the remote manufacturer, Indiana courts have found sufficient basis to apply U.C.C. warranty remedies directly between the buyer and the manufacturer. The agency exception eliminates the inequity of allowing a remote party such as the manufacturer to avoid warranty liability when it has as principal reaped the benefit of its agent's tripartite finance lease where the equipment vendor has supplied goods to the lessor who is acting for the lessee.

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147. *Wilson*, 582 F. Supp. at 388.

148. Roberts v. Homelite Div. of Textron, 649 F. Supp. 1440 (N.D. Ind. 1986).

149. *Id.* at 1443.

150. 214 F. Supp. 817, 819 (N.D. Ind. 1963) (quoting Peterson v. Lamb Rubber Co., 54 Cal. 2d 339, 353 P.2d 575, 5 Cal. Rptr. 863 (1960)).

151. *Roberts*, 649 F. Supp. at 1443-44.

152. Wilson v. Studebaker-Worthington, Inc., 582 F. Supp. 383 (S.D. Ind. 1983).

153. Thompson Farms v. Corno Feed Products, 173 Ind. App. 682, 366 N.E.2d 3 (1977).

154. Richards v. Goerg Boat & Motors, Inc., 179 Ind. App. 102, 384 N.E.2d 1084 (1979).

155. Ridge Co. v. NCR Corp., 597 F. Supp. 1239 (N.D. Ind. 1984).

156. *Roberts*, 649 F. Supp. at 1440.

VIII. THE PARTICIPATION EXCEPTION TO THE PRIVITY REQUIREMENT

Even where an agency relationship cannot be found, participation in the sales transaction can be sufficient to bring the parties within the privity parameter. In *Richards v. Goerg Board and Motors, Inc.*,[157] a buyer of a houseboat brought an action against the dealer and the manufacturer of the boat for breach of express and implied warranties under the U.C.C. The lower court granted summary judgment in favor of the manufacturer based on a finding of no privity between it and Richards. The court of appeals reversed, finding there were sufficient factors to bring the manufacturer into the transaction.[158] The court held that both the dealer and the manufacturer of the boat "must be considered sellers under the [Uniform Commercial] Code."[159] Factors which the court identified included (1) that the buyer and the manufacturer talked about the potential purchase at a boat show, (2) that the buyer inspected the goods and received a demonstration at the manufacturer's plant, (3) that the buyer discussed repair problems directly with the manufacturer, and (4) that the carpenter's certificate and warranty were mailed directly from the manufacturer to the buyer.[160] The court noted that "[e]xcept for the direct exchange of payment, the relationship between [the buyer] and [the manufacturer] involved all the attributes of a sales transaction relevant to the warranty."[161]

The significance of the decision in *Richards*[162] is that only economic loss was involved. There was no personal injury or other property damage claimed which might lead the court, based on policy or humanitarian concerns, to try to fashion a remedy for the plaintiff. Nevertheless, the court used the agency principles discussed in *Thompson Farms*[163] to find sufficient privity to allow the plaintiff to enforce the implied warranty provisions found in the U.C.C. The level of personal involvement in the sale between Richards and the boat manufacturer was significant.

The *Richards* decision expands the agency exception in two ways: by finding an exception based on participation without the formal attributes of an agency relationship and by applying the exception where only economic loss was involved. Both of these dimensions are applicable to tripartite finance leases. In the case of the typical tripartite finance lease, the lessor will usually go to the premises of the equipment seller and talk with the seller directly about the goods. The lessee may have a demonstration of the

157. *Richards*, 179 Ind. App. at 102, 384 N.E.2d at 1084.
158. *Id.* at 112, 384 N.E.2d at 1085.
159. *Id.* at 113, 384 N.E.2d at 1092.
160. *Id.* at 104-06, 384 N.E.2d at 1088-89, 1092.
161. *Id.* at 112, 384 N.E.2d at 1092.
162. *Id.* at 102, 384 N.E.2d at 1084.
163. *Thompson*, 173 Ind. App. 682, 366 N.E.2d 3 (1977).

equipment's operation or may inspect the goods, but the lessor who is the buyer will rarely do so. In some cases, the lessee may address questions or problems directly to the seller, depending on maintenance and service arrangements.

The difficulty in enforcing warranty liabilities in this situation is that while express representations about the nature, capacity, or qualities of the goods may have been made, they were not made by the seller to the buyer. Likewise, any implied warranties flow from the seller to the buyer and not to the user/lessee. When the product fails, resulting in economic loss to the lessee, privity requirements preclude any direct action against the equipment supplier. The fact that the transaction is characterized as a lease, in addition to any warranty disclaimers made by the lessor, usually precludes recovery against the lessor. As in *Richards v. Goerg*,[164] both the supplier and dealer/lessor in the tripartite lease situation seek to avoid the status of seller.

Participation in the transaction, and in some cases an agency relationship between two of the three parties, can be demonstrated in most tripartite lease situations. The difficulty for the typical lessee is that lack of privity with the equipment supplier is only half the problem. Unless the lease is brought within the scope of the U.C.C., any recovery is limited to common law warranty. Allowing the lessee to use the exceptions to privity based on agency or participation in the transaction might bring the equipment supplier into the lease transaction. It does not change the nature of the transaction from a lease to a sale.

On the other hand, if the lessor is viewed as the agent of the lessee in transacting the sale with the equipment supplier, the lessee then is brought into the sales transaction and U.C.C. remedies are available to the lessee. The *Richards*[165] exception could be applied to qualify both the lessee and the lessor as buyers for the purposes of U.C.C. warranty remedies. Particularly where the lessee has personally selected the equipment, has dealt directly with the supplier prior to the execution of the sale documents with the financing agent, and has arranged for delivery directly to the lessee's place of business, the requirements for participation in the transaction sufficient to categorize both the lessor and lessee as buyers might be found.

Precisely these elements were missing in *Ridge v. NCR*,[166] which prevented the court from applying the theories of agency and participation to the component part manufacturers. Because the lessees (1) had no direct contact with the component part manufacturers, (2) thought they were purchasing NCR equipment and not equipment made by the component

164. *Richards*, 179 Ind. App. at 102, 384 N.E.2d at 1084.
165. *Id.*
166. Ridge Co. v. NCR Corp., 597 F. Supp. 1239 (N.D. Ind. 1984).

part manufacturers, and (3) did not involve the component part manufacturers in the transaction negotiations, the exceptions founded on the law in *Thompson Farms* and *Richards v. Goerg* could not be applied.[167]

The counter argument is that to include two parties as buyers, therefore placing them within the scope of warranty protection, might be outside the scope of the bargain. Indiana courts have long been protective of the parties' own allocation of economic risk and benefit and will not set aside a bargain merely because the parties are of unequal bargaining power.[168] Further, because it is presumed that the lessee, lessor, and equipment supplier are all business entities and not individual consumers, they ought to be left to vagaries of their own bargains and not look to the courts for protection from bad contracts.

The reality is that leasing is a business transaction that has outgrown its legal underpinnings.[169] Just as courts and legislatures in the 1960s and 1970s recognized that the modern marketplace did not compound with traditional concepts of privity between buyer and seller and therefore developed strict products liability, now it is time to re-examine the laws of sales and bailments. *Carte blanche* application of the U.C.C. to lease transactions is one solution, but does more than is needed. Rather, a more efficient solution is to grant to lessees in tripartite lease situations a remedy against the equipment supplier with whom the lessee had direct contact. Where the participation elements set forth in *Richards v. Goerg*[170] (such as personal contact, inspection or demonstration of the goods, or participation in service and repair arrangements) can be shown, equity requires that the lessee who suffers economic loss be allowed to seek a remedy from the equipment supplier. By leaving the finance lessor out of the picture, the lessor's role as financing agent is not obfuscated, and unnecessary anxiety over potential liability does not drive up the cost of credit.

Because the law of implied warranties is largely a matter of public policy, changes in commerce and industry may dictate changes in the law.[171] Granting implied warranty protection for economic and property loss, as well as personal injuries to the commercial lessee, comports with notions of fairness and justice. Parties are still free to make their own bargains; the lessee and the equipment supplier may negotiate the allocation of risks and benefits in the transaction. The difference is this: where there is direct dealing between the parties, the lessee may, within the terms of the

167. *Id.* at 1242.

168. *Id.*

169. Carlin, *supra* note 8, at 850.

170. *Richards*, 179 Ind. App. at 102, 384 N.E.2d at 1084.

171. Greeno v. Clark Equip. Co., 237 F. Supp. 427, 431 (N.D. Ind. 1965) (indicating that the change in strict products liability law was due in part to the court's recognition that changes in commerce and industry should result in changes in public policy).

sale agreement between the lessor and the equipment supplier, directly enforce whatever warranty remedies would be available from the seller to the buyer. The equipment seller is still free to disclaim and limit warranties within the confines of U.C.C. § 2-318 and the requirements for good faith and fair dealing.[172] The lessee, however, ought to be able to enforce the sales contract in lieu of the lessor and without the need to establish privity of contract directly with the equipment seller.

The advantage of allowing this exception to privity in a nonsales transaction is that it preserves the intent of the parties as to the respective roles: the seller provides the goods or equipment to a lessee/buyer not a financier/buyer; the lessor provides financing and avoids involvement in the underlying procurement transaction; and the lessee/buyer obtains the needed item without having to sacrifice warranty protection or performance expectations for credit financing. Such a change does no more than is necessary. Not all lease transactions would be brought within the scope of the U.C.C. Where lessees stand in the role of buyer, the application of U.C.C. remedies on behalf of the lessee rather than the lessor is an equitable solution.

172. U.C.C. § 2-313 (1977); IND. CODE § 26-1-2-318 (1982).