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Vendors, Keep Your Promises

Minnesota Supreme Court Upholds Vendor Warranty

By Debra Devassy Babu

A recent decision by the Minnesota Supreme Court addressed the enforceability of a provision commonly found in vendor program agreements — that a transaction presented by the vendor to the lessor/financier is valid and enforceable. The Minnesota Supreme Court upheld the clause under Minnesota law, creating important precedent for vendor liability under longstanding principles of contract law.

Background

Under the contract (the "Agreement") between Lyon Financial Services, Inc. ("Lyon") and Illinois Paper and Copier Company ("Illinois Paper"), Lyon obtained the right to finance transactions for Illinois Paper's commercial customers, with Illinois Paper supplying the copying equipment that was financed, and providing maintenance on the equipment. In the Agreement, Illinois Paper represented that "all lease transactions presented to [Lyon] for review are valid and fully enforceable agreements." Pursuant to the Agreement's terms, transactions submitted to Lyon under the Agreement are non-recourse to Illinois Paper, unless the latter breaches its representations and warranties.

Illinois Paper provided Lyon with an equipment lease transaction with the Village of Bensenville (the "Village") pursuant to the Agreement. The Village, as lessee, and Lyon, as lessor, entered into 72-month equipment lease agreement (the "Lease"), with Illinois Paper supplying the equipment subject to the Lease. After making payments under the Lease for nearly two years, the Village defaulted, contending that the Lease was void and unenforceable, because its term was longer than 60 months in violation of the Illinois Municipal Code, 65 ILCS 5/11-76-6. Lyon, having no remedy against the Village, filed suit against Illinois Paper for breach of contract in the United States District Court for the Northern District of Illinois, for Illinois Paper's breach of representation under the Agreement regarding the Lease's validity and enforceability.

District Court Ruling

In the district court, Illinois Paper filed a Motion for Judgment on the Pleadings, claiming that Illinois Paper's representation was an unenforceable representation of law, such that Lyon could not rely on the representation. Lyon filed a Cross-Motion for Judgment on the Pleadings, arguing that Illinois Paper's representation under the Agreement was enforceable. The court granted Illinois Paper's Motion and denied Lyon's Cross-Motion. Analyzing the Agreement under Illinois law (rather than Minnesota law, which applied under the Agreement's choice-of-law clause), the court concluded that Lyon's breach of contract claim was really a breach of warranty claim, because Illinois Paper "represented and warranted" that a given condition was true, rather than promising performance. *Lyon Fin. Servs., Inc. v. Illinois Paper & Copier Co.*, Case No. 10 CV 7064, Docket No. 63 (N. D. Ill. Feb. 6, 2012).

The district court held that Illinois Paper could not be liable for breach of warranty, because the representation contained in the Agreement allegedly was one of law, not fact. *Id.* The court reasoned that because both parties are presumed to know the law or are equally capable of determining the law, Lyon could not rely on Illinois Paper's representation. *Id.* Under the court's rationale, Lyon could have researched the Illinois Municipal Code for itself and determined the Lease's unenforceability, and thus could not rely on Illinois Paper's representation of law regarding the Lease's enforceability. *Id.* Because the district court concluded that reliance is an element of breach of warranty under Illinois law and Lyon could not have relied on the representation, the court held that Illinois Paper's "pure representation of law" was not actionable. *Id.* Lyon appealed the district court's judgment to the United States Court of Appeals for the Seventh Circuit.

Seventh Circuit Ruling

The Seventh Circuit expressed skepticism over the district court's holding, but ultimately certified various questions to the Minnesota Supreme Court, because it was uncertain how that court would resolve the questions of Minnesota law presented. Finding that Minnesota law applied to the Agreement under the choice-of-law clause, the Seventh Court characterized Illinois Paper's representation in the Agreement as one of law, to highlight the unsettled nature of the legal issue. *Lyon Fin. Servs., Inc. v. Illinois Paper & Copier Co.*, 732 F.3d 755, 759, 760 (7th Cir. 2013).

The court noted that pure representations of law are not actionable in tort under Minnesota law, because reliance is an element of fraud; therefore, a party cannot rely on a representation of law, because the law is presumed to be equally within the knowledge of both parties. *Id.* at 760. However, the Minnesota Supreme Court had yet to address whether a representation of law is actionable in a breach-of-contract or breach-of-warranty action. *Id.* at 760, 761. The Seventh Circuit noted that the legal dispute involved two questions: 1) whether reliance is an element of a breach-of-warranty claim in Minnesota; and 2) if so, what type of reliance is necessary: tort-like reliance (reliance on the substantive truth of the matter warranted), or contract-formation reliance (reliance on the warranty as a bargained-for part of the agreement as a whole, *i.e.*, reliance on the other party's promise to be liable if the matter turns out not to be as warranted). *Id.* at 761.

Reliance

The Seventh Circuit discussed at length the divide in the law between the two types

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of reliance — tort-like reliance and contract-formation reliance. Tort-like reliance invokes the type of reliance most practitioners would recognize — "a belief that the warranty will be fulfilled or warranted facts are true." *Id.* at 761. *See also CBS, Inc. v. Ziff-Davis Publishing Co.*, 553 N.E.2d 997, 1000 (N.Y. 1990) (defining tort-like reliance as "a belief in the truth of the representations made in the express warranty and a change of position in reliance on that belief"). Contract-formation reliance, by contrast, means that reliance is "satisfied simply by proving that the express warranty was relied on in contract formation — in other words, that the warranty was part of the bargained-for agreement." *Lyon*, 732 F.3d at 762. *CBS*, 553 N.E.2d at 1000-01 (contract-formation reliance considers whether a buyer "believed [it] was purchasing the [seller's] promise [as to its truth] of the warranted information," rather than whether the buyer actually believed the truth of the warranted information). In *CBS*, New York's highest court noted that this latter view of reliance as contract-formation reliance — "as requiring no more than reliance on the express warranty as being a part of the bargain between the parties" — reflects "the prevailing perception of an action for breach of express warranty as one that is no longer grounded in tort, but essentially in contract." *Id.* at 1001.

Warranties

The Seventh Circuit explored the history of warranties, observing that while warranty began as a tort embedded in the law of deceit (which is perhaps why tort-like reliance was required in breach of warranty actions), warranty eventually moved to the realm of contract. *Lyon*, 732 F.3d at 762. Because of warranty's shift from tort to contract, many courts have taken the modern view that contract-formation reliance, rather than tort-like reliance, is all that is required for breach-of-express-warranty claims. One of the leading opinions on the issue is *CBS, Inc. v. Ziff-Davis Publishing Co.*, 553 N.E.2d 997 (N.Y. 1990), referenced above, in which New York's highest court found that tort-like reliance was not required in a breach-of-warranty claim under New York law. Other courts similarly have held that contract-formation reliance, and not tort-like reliance, is required for breach-of-express-warranty claims. *See Pegasus Management Company, Inc. v. Lyssa, Inc.*, 995 F. Supp. 29 (D. Mass. 1998); *Glacier Gen. Assurance Co. v. Casualty Indemnity Exchange*, 435 F. Supp. 855, 860 (D. Mont. 1977); *C.R. Anthony Co. v. Loretto Mall Partners*, 817 P.2d 238, 238 (N.M. 1991); *Shambaugh v. Lindsay*, 445 N.E.2d 124, 127 (Ind. Ct. App. 1983). Under these decisions, tort-like reliance — "*i.e.*, a belief in the truth of the representations made in the express warranty and a change of position in reliance on that belief" — is not required. Instead, in an express-breach-of-warranty claim, the proper standard is contract-formation reliance: the plaintiff's belief that it was purchasing the defendant's promise as to the contractual term. In other words, because the express warranty is a written term in the contract, no tort-like reliance is required, and the warranty must be enforced like any other contractual term.

The court noted that the modern view requiring contract-formation reliance, not tort-like reliance, in express-warranty claims makes sense, in light of the distinct differences between contract law and tort law and the interests each protects. *Lyon*, 732 F.3d at 764. However, after considering Minnesota cases, the history of warranties, and other authorities, the Seventh Circuit concluded that it was genuinely uncertain as to how the Minnesota Supreme Court would resolve the questions of state law presented. *Id.* at 766. Accordingly, the court certified various questions to the Minnesota Supreme Court pursuant to Minn. Stat. § 480.065.

The Minnesota Supreme Court

The Minnesota Supreme Court accepted the certification as requested and issued its opinion on the certified questions, as reformulated, holding that *Lyon* stated an actionable claim for breach of contract under Minnesota law. *Lyon Fin. Servs., Inc. v. Illinois Paper & Copier Co.*, 2014 WL 2965404, *6 (Minn. July 2, 2014). The court reformulated the questions to hold that "A breach of contract claim based on an alleged breach of a contractual representation of future legal compliance is actionable under Minnesota law without proof of reliance." *Id.* at *1. Rather than characterizing Illinois Paper's representation to Lyon as a "representation of law" — because that label created more confusion than clarification — the Minnesota Supreme Court identified the representation as a "representation of future legal compliance." *Id.* at *3.

Analyzing Lyon's claim as a breach of contract cause of action, rather than a breach of warranty claim, the Minnesota Supreme Court held that "Minnesota law does not require reliance to be pleaded in a contract action based on an alleged breach of a representation of future legal compliance. Although detrimental reliance may be an element of certain tort claims, we have recognized and preserved the distinction between tort actions and contract actions. … Accordingly, even though we have required reliance in warranty actions, we decline to require reliance in a breach of contract action based on representation of future legal compliance." *Id.* at *4 (citations omitted).

The court further noted that "the representation of future legal compliance in this case was much more than a mere expression of opinion. Illinois Paper specifically agreed to indemnify and hold Lyon harmless from any loss resulting from Illinois Paper's breach of the representation that all lease transactions presented to Lyon would be valid and enforceable." *Id.* at *5. The court indicated that it has "never held that representations of future legal compliance are not actionable in contract," and it declined to do so now, finding that Illinois Paper's representation is actionable. *Id.* at *5. Noting that Minnesota public policy favors freedom of contract, the court held, "Under freedom of contract principles, parties are generally free to allocate rights, duties and risks. In this case, the parties agreed to allocate the risk of legal noncompliance to Illinois Paper. Holding parties to their promises, without requiring separate reliance on those promises, furthers freedom of contract principles, and there is no reason to refuse to enforce the terms of those parties' bargain here." *Id.*

The Minnesota Supreme Court did not address whether state law requires reliance in breach of warranty actions, or, if reliance is required, whether a party needs to prove tort-like reliance or contract-formation reliance. *Id.* at *4, *6, fn. 6. At press time, the parties were awaiting decision from the Seventh Circuit, in light of the Minnesota Supreme Court's answer to its certified questions.

Conclusion

The Minnesota Supreme Court's opinion establishes favorable precedent for lessors and financing companies relying on a vendor's representations and warranties in a vendor program agreement. Under the court's decision, a vendor cannot claim that its representation that an underlying transaction is "valid and enforceable" is an unenforceable representation of law. Both parties may be equally capable of determining the law, but if one party contractually undertakes the task of determining a contract's enforceability, that party rightfully will be held to its contractual obligations. While the Minnesota Supreme Court sidestepped the complicated academic battle surrounding tort-like reliance and contract-formation reliance, it reaffirmed the principles behind the plain meaning rule of contract interpretation and contractual allocation of risk. The court's opinion is of significance outside the leasing industry as well, particularly because a countless number of contracts, including contracts common in the mortgage industry, contain representations as to legal compliance.

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