TOPIC 10: CONTRACT LAW

Overview

Contract law concerns the legal principles governing the exchange of goods or services between individuals or businesses. This chapter will explore the sources of contract law applicable to the sale or exchange of goods or services. It will lay out the elements necessary to form a contract and each party's duty of performance under the contract. It will examine key contract principles, such as performance, breach, enforceability, voidability, etc. It will lay out the generally applicable rules that courts employ when interpreting contracts. This includes rules about what terms or communications are considered to be part of the contract. Lastly, it explores the remedies available to parties who suffer harm as a result of another party's breach.

VIDEO LESSON - INTRODUCTION

VOCABULARY & CONCEPTS

- Contract
- Restatement of Contracts & Uniform Commercial Code
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- Interpreting a Contract (Rules)
- Parol Evidence Rule
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  - Complete
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- Extrinsic Evidence - Exceptions
- Patent & Latent Ambiguity

TOPIC 10: CONTRACT LAW - QUESTIONS & ANSWERS

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1. What is a "contract"?

A contract is a legally enforceable promise or an exchange of promises. To be enforceable, the contract must meet certain elements. There must be an offer, acceptance of that offer, and then an intended exchange of value between the parties. These elements demonstrate a "meeting of the minds" between the parties. That is, the parties have a common understanding of the material terms of the agreement. A contract does not have to be a formal, written document. It can be a verbal agreement or it can arise through the conduct of the parties. Those who make a contract do not have to use the word contract or even recognize that they have made a legally enforceable promise. Each state develops its own contract law. Contract law provides confidence and promotes productivity by making private agreements between individuals legally enforceable. Plainly stated, it helps make buyer and seller willing to do business together.

- *Example*: One individual offers to purchase a widget from another person for $1. The other person agrees. This is an contract, as there is an offer and acceptance of that offer, a planned exchange of value, and a meeting of the minds as to these primary terms of the agreement.

- *Note*: As you can see, a contract does not necessarily have to be formal or in writing. A simple conversation or even actions of two or more individuals can be a contact.

- ***Discussion***: Does it surprise you how easy it is to form a contact? Why or why not? Why do you think it is so easy to form an enforceable contract? Are there any negatives to this? How do you judge whether there is a meeting of the minds between the parties? How do you account for the subjective nature of one person's understanding?

- ***Practice Question***: Mark goes to an antiques auction. A nice painting comes up for auction and Mark love it. The auction provides extensive background on all of the items being offered. The auctioneer begins taking bids and Mark the winning bidder. Has a contract been formed in this situation?

- ***Resource Video***: http://thebusinessprofessor.com/what-is-a-contract/

2. What are the sources of contract law?

States create their own contract law. They pass statutes and allow courts to develop common law. In doing so, state legislators and judges rely upon model laws in developing the statutory and common law. These model laws are known as the Restatement of Contracts and the Uniform Commercial Code. These model laws influence judges who interpret contract law and legislators who draft statutes that resemble (or copy exactly) these model laws. As such, you can study model laws to acquire a broad understanding of how contract law works. You can then look to the specific laws of your state to determine the exact law that applies to a given situation.

- *Restatement of Contract* - The Restatement of Contracts (Restatement) is a model law that deals primarily with contracts that do not involve the sale of goods or when goods are not the primary subject of the contract. Most state common law generally tracks closely the provisions of the Restatement.

- *Article 2 of the Uniform Commercial Code* - Article 2 of the Uniform Commercial Code (UCC) governs contracts for the sale of goods. It has been uniformly accepted by nearly every state in the United States. A sale of goods includes any manufactured product, crops, timber, livestock, attachments to land, exchanged currencies, mined minerals, etc. It does not include intellectual property, securities, non-commodity currencies, and un-mined minerals.

To be subject to the provision of the UCC, goods must be the primary purpose of the contract. If services are the primary purpose of the agreement, the incidental inclusion of goods is not covered by the UCC or corresponding state statutes.

- ***Discussion***: What are some of the advantages and disadvantages of model codes of laws? Why do you think states more readily adopt a uniform code of contracts covering the sale of goods, but are less apt to adopt a uniform code covering services?

- ***Practice Question***: Jill approaches an interior designer about designing and purchasing furniture for her home. Jill owns a large mansion. The designer quotes Jill a price of $10,000 for her services and $1 million for all of the furniture. If Jill's state adopts the Restatement of Contracts and UCC, which model law will primarily govern the contract?

- ***Resource Video***: http://thebusinessprofessor.com/influential-sources-contract-law/

3. What are "unilateral contracts" and "bilateral contracts"?

Contracts are divided into unilateral and bilateral agreements based upon the duty of performance and how an offer to contract is accepted.

- *Bilateral Contract* - A bilateral contract consists of two promises between individuals that form a contract. Specifically, one party makes a promise to another party that she will do something (or forgo doing something) in exchange for the other party's promise to do something (or promise to forgo doing something).

    - *Example*: Eric promises to wash Julia's car if she promises to pay him $20. The both activities will occur at some point in the future, so you have two promises of future performance.

- *Unilateral Contract* - A Unilateral contract is an agreement with only one promise. That is, one party promises a future action if the other party performs whatever is requested of her. The promising party does not want a return promise. As such, a contract is formed or comes into exists once the other party begins to perform the requested services.

    - *Example*: Suppose Eric tells Julia that he will pay her $20 if she washes his car. Eric does not want a promise to wash the car. Julia can accept Eric's offer by beginning to wash his car. Julia is not obligated to wash the car unless or until she begins doing so. Further Eric is not obligated to pay Julia until she begins washing the car.

- *Note*: The common characteristic between unilateral and bilateral contracts is that it entails a promise of

performance and a demand from the offeree. This is critical to the requirement that a contract contain an offer, acceptance, and exchange of value.

- ***Discussion***: Why do you think it is important to distinguish and recognize these two types of contracts? Do you think each type of contract is more applicable in either sales of goods or services? Why or why not?

- ***Practice Question***: Jennifer is looking for someone to paint her house. She sends out an email to several painters in the neighborhood that she has purchased the paint and will pay $3,000 to anyone who paints her house. She also includes some detailed requirements for the painting process and states that project must be completed by the coming weekend. Rob shows up the next morning with all of his equipment and ready to paint. Is there a contract in this situation? Why or why not?

- ***Resource Video***: http://thebusinessprofessor.com/unilateral-and-bilateral-contracts/

4. What are "express contracts", "implied-in-fact contracts", and "implied-in-law contracts"?

- *Express Contract* - An express contract arises from interactions in which parties actually discuss the agreement and the promised terms. The contract does not have to be formal or in writing, but it requires that the parties express their intentions in an agreement.

    - *Example*: One person expressly offers to sell a widget to another person. The other person accepts the offer by saying the she will buy it. The parties have an expressed contract because they have stated an offer, stated an acceptance, and identified consideration. These expressions can be verbal, as in this situation, or written.

- *Implied-in-Fact Contract* - An implied-in-fact contract arises from the conduct of the parties, rather than from words. That is, the parties interact in a manner that constitutes a legally enforceable contract. This means that all of the elements of an enforceable contract can be inferred from the actions of the parties.

    - *Example*: Ellen asks Albert, an attorney, for professional advice. Ellen knows that Albert is an attorney and charges for his advice. Asking Albert for his professional advice implies a promise from Ellen to pay the going rate for that advice. This is true even though Ellen and Albert did not make an express promise to pay for it.

- *Implied-in-Law or Quasi-Contracts* - An implied-in-law contract is a contractual relationship ordered by the court. It lacks the mutual asset element of a contract, but the court deems the interactions between parties to be a contract under the law. This court action is generally taken to avoid an unjust result, such as when one party is unjustly enriched at the expense of another. The court will hold that the law implies a duty on the first party to pay the second, even though the elements to find a legally enforceable contract between the two parties are absent.

    - *Example*: Bell routinely rakes leave in the neighborhood for extra money. She rakes leaves for lots of houses and sometimes forgets which houses have requested her services. She begins raking James's yard, having forgotten that she never worked out an agreement to do so. James often pays individuals to rake his yard and has plenty of money to do so. At the end of the job, Bell asks James for $20 for her effort. If

James refuses to pay the court may hold that it would be unfair for James to receive this value and not pay something for it. As such, the court could hold that an implied-in-law contract to pay for Bell's services.

- ***Discussion***: How do you feel about implied contracts? Should all contracts be required to be expressed? What are some arguments for and against this approach? What do you think is the justification for recognizing implied contracts?

- ***Practice Question***: Kyle agrees to purchase building material from Anna, a new employee of a construction materials company. Anna executes a contract but makes an error when pricing the material. Per the terms of the agreement, Kyle will pay far less than the cost of the material. Kyle realizes this, but he stays quiet. Kyle uses the material before Anna catches the error. She sends Kyle an additional bill to cover the cost of the material, but not profit. Kyle refuses to pay the additional amount. What might a court do in this situation?

- ***Resource Video***: http://thebusinessprofessor.com/express-vs-implied-contracts/

5. What are "valid contracts", "enforceable contracts", "void contracts", and "voidable contracts"?

There are several common characteristics of contracts that dictate whether a contract actually exists and whether it is enforceable in a court of law. The following vocabulary is important for characterizing these aspects of a contract.

- *Valid and Invalid* - A contract is valid when all of the elements essential to forming a legal contract are present. Conversely, a contract is invalid (or rather, there is no contract) if any of the essential elements of a contract are missing. The elements to forming a valid contract (offer, acceptance, consideration, and a meeting of the minds) are discussed further below.

    - *Example*: One person announces that she will sell her cell phone for a reasonable price. Another person quickly says, "I will buy it". In this case there is not a valid contract because there is not enough specificity in the consideration. As such, a critical piece of the contract is missing. While the parties might think they have a contract, if a challenge to the contract arises, a court is likely to hold it to be invalid.

- *Enforceable and Unenforceable Contract* - An enforceable contract is one that can be enforced in court of law. That is, the law allows for enforcement of the contract. An enforceable contract must always be valid. A valid contract may, however, be unenforceable. That is, even though all of the essential elements of a contract are present, a court will not enforce the contract.

    - *Example*: An oral contract may be valid, but the court will not enforce it because that specific type of contract is required to be in writing under the state's law. Contracts that are required to be in writing are discussed further below.

    - ***Discussion***: Why do you think there is a distinction between a invalid contract and contract that is unenforceable against a party? Are there any reasons or justifications for treating them as one in the same?

- ***Practice Question***: Gayle arrives at work one morning and says to all of her colleague, "I am tire of my piece of junk car. I would sell it right now for $500." Bert thinks about Gayle's statement and determines that it would be a good buy. After lunch, Bert approaches Gayle and says, "I will buy your car" and extends $500 in cash. Gayle, surprised by Bert's actions, replies that she is not willing to sell her car. If Bert sues Gayle for breach of contract, what will be the likely result?

- ***Resource Video***: http://thebusinessprofessor.com/enforceable-vs-valid-contracts/

- *Void and Voidable Contracts* - An otherwise valid contract may be void pursuant to the law. That is, state law identifies certain types of contracts that are deemed void from the outset. These include contracts that violate public policy or have an illegal purpose. A voidable contract is an agreement where either one or both parties has the right to make the contract void. That is, the contract is valid and enforceable until one party elects to void it.

    - *Example:* A contract to purchase illegal drugs is void. A party to a contract who is below the legal age of mental capacity may void the contract at any point before she reaches the age of mental capacity. Various situations where contracts are deemed valid, enforceable, void, or voidable are discussed further below.

    - ***Discussion***: What do you think are the justifications for deeming a contract voidable? Can you think of scenarios where you think one party should be allowed to get out of the contract, but not the other party? Can you think of scenarios where both parties should be allowed out of the contract?

    - ***Practice Question***: Amy is extremely angry at David. She hires Laura to pour sugar into the gas tank of David's car. Laura loses her nerve and backs out of their agreement? Can Amy enforce her agreement with Laura?

    - ***Resource Video***: http://thebusinessprofessor.com/voidability-of-a-contract/

CONTRACT FORMATION

6. What elements are required to form a valid contract?

As previously discussed, a contract is a specific promise to another and also a specific demand of that person. The demand could be a promise of future action (bilateral contract) or immediate performance of an act (unilateral contract). The promise and demand is an **"offer"**. Meeting with the offeror's demand is known as "**acceptance**". Both parties must give or exchange something of value with the other. The thing of value is known as "**consideration**". Consideration is the promise to give, or actual giving, of a requested benefit or the incurring of a legal detriment (i.e., doing something one does not have to do.). Both parties must be of a legal age and sound mind, and the purpose of the agreement cannot be illegal or against public policy.

- *Example*: One person offers to sell a product, service, or offers something of value (money, goods, etc.) in exchange for someone else's product, service, or other thing of value. This constitutes a valid offer. The things of value constitute consideration. A second person accepts the offer by either agreeing to the offeror's request to trade things or actually trading those valuables.

- *Note*: An important thing to remember is that each party must provide something of value to the other. It does not matter how much value or even whether anyone else in the world would consider it valuable.

- ***Discussion***: Why do you think that the law requires an agreement to have all of the elements to be enforceable? Can you think of situations where any of these elements are not present, but you believe the agreement should be enforceable anyway?

- ***Resource Video***: http://thebusinessprofessor.com/requirements-to-form-a-contract/

7. What constitutes an "offer" to contract?

The following elements must be present to establish a valid offer to contract.

- *Offeror and Offeree* - An offer to contract must contains a specific promise from the the person making the promise (offeror) and a specific demand of the individual receiving the offer (offeree).

    - *Example*: I tell you that I will sell you a product for $5. I am the offeror and you are the offeree. My offer is to transfer ownership of a product and my demand is that you transfer ownership $5.

- *Intent to Make an Offer* - The offeror must intend to make the offer. Whether there is intent to make an offer is judged from the position of the offeree. If a reasonable person in the position of the offeree would believe the offeror's words or actions constitute an offer, it is an offer. This is an objective, rather than subjective, standard for determining whether the intent to make an offer exists.

    - *Example*: I shout out loud in frustration that I would sell my piece-of-junk care for a $100. The words look like an offer to sell my car. In reality, I am simply espousing my frustration. I do not have the intent necessary for my statement to constitute an offer and no reasonable person would interpret my statement as truly demonstrating that intent.

- *Definite Terms* - An offer to contract must be sufficiently definite. That is, the terms of the offer must be sufficiently specific to allow the offeree to understand and accept the offer. The offeree must understand that she is the intended recipient of the offer and may accept it. Also, the terms of consideration must be stated.

    - *Example*: Simply stating that I will sell you an item "for a reasonable price" is not sufficient to constitute a definite offer. Most advertisements, catalogs, and web page price quotes are considered too indefinite to form the basis for a contract. To be sufficiently definite, the advertisement must be specific about the quantity of goods being offered and who is the intended offeree.

    - *Note*: There is an exception to this rule for the sale of goods pursuant to the terms of the UCC. Some contracts for the sale of goods can leave open non-quantity terms to be decided at a future time.

Remember, the above elements do not have to be in writing or formal. Further, the parties do not have to realize that their words or actions constitute a valid contract; rather, each element is judged by an objective standard. That is, how would a

reasonable person perceive the actions potentially constituting an offer?

- ***Discussion***: How do you feel about the requirement that a contract meet this level of formality? Should it be more or less formal, and why? How do you feel about the fact that individuals can form a contract without fully realizing that their agreement is legally enforceable?

- ***Practice Question***: Ashton is reading looking at the merchandise for sale on Smart Clothes Corp's website. He places an order for a new shirt and goes through the process of setting up an account and attempting to pay. At the end of the process, he gets notification that his purchase is discontinued and cannot be purchased. Ashton is furious and wants to sue Smart Clothes for breach of contract. If he does, what is the likely legal result in this situation?

- ***Resource Video***: http://thebusinessprofessor.com/what-is-a-valid-offer/

8. When does an offer to contract terminate?

An offer to contract terminates at the following times or under the following conditions:

- *Specific Provision* - An offer may include a specific provision detailing how long an offer will stay open and the conditions under which it terminates.

- *Lapse of Time* - Unless the offer states otherwise, an offer terminates after a reasonable period of time. A reasonable period of time will vary depending upon the type of contract.

    - *Example*: An offer to sell bananas will terminate more quickly than an offer to sell cement.

- *Offeree's Rejection* - An offer terminates if the offeree receives the offer and rejects it. Once the offeree rejects the offer, she cannot come back later and accept the offer. Any attempt to do so may constitute a new offer to the original offeror.

- *Counter Offer* - If an offeree makes a counter offer or counter proposal in response to an offer, the original offer terminates. This is the case with negotiations. If a party attempts to negotiate new or additional material terms to the offer, the original offer terminates. Attempting to offer ancillary or non-material terms may not terminate the offer.

- *Revocation by Offeror* - Generally, the offeror may revoke an offer at any time before the offeree accepts it. If the offeree has already accepted the offer, a valid contract exists and an attempt to revoke the offer may constitute breach of the contract.

    - *Note*: There are certain offers, known as "firm offers", that state that the offer cannot be revoked for a certain period. This type of offer is a form of contract in itself.

- *Destroy Subject Matter of Contract* - An offer terminates if, before the offer is accepted, the property that is the subject of the offer is destroyed. If the offer has already been accepted, this could serve to void the contract.

- *Death or Mental Incapacity* - If the offeror dies or loses mental capacity at any time before an offer is accepted, the offer is revoked.

    - *Note*: The offer does not become effective again if the offeror regains mental capacity.

- *Illegality* - An offer terminates if the subject of the offer (the activity or product) becomes illegal. If the offer has been accepted, the subject matter becoming illegal will void the contract.

Some of the methods of contract termination are voluntary, while others others are a result of circumstances beyond the control of the parties.

- ***Discussion***: Do any of the common methods by which an offer terminates surprise you? What factors should a court consider when determining whether a "reasonable time" has passed? What factors should the court consider in determining whether an offeree has been rejected? Does the rule regarding counter-offers discourage negotiation? Why or why not?

- ***Practice Question***: Dudley is interested in purchasing an ownership interest in Sarah's business. Sarah sends over a term sheet that places a specific value on her business and offers a specific number of shares. Dudley reviews the sheet and sends back a sign subscription agreement that lists a lower valuation, but agrees to buy a larger number of shares. The total purchase price for all shares would equal the amount indicated in Sarah's term sheet. Sarah writes back and says that she will work with other investors. Dudley is angry and wants to sue for a breach of contract? What is the likely outcome?

- ***Resource Video***: http://thebusinessprofessor.com/terminating-an-offer/

9. What is "acceptance" of an offer?

Acceptance of a contract is the assent of the offeree to the demands contained in the offeror's offer. Acceptance of the contract varies depending upon whether the contract is unilateral or bilateral. An offeree accepts a bilateral contract by making the return promise demanded by the offeror. An offeree accepts a unilateral contact by undertaking the performance demanded by the offeror. The acceptance of an offer must meet a specific standard based upon the type of contract and the governing law. The standards that a specific type of contract must meet are as follows:

- *Mirror-Image Rule (Restatement)* - Contracts that are not primarily for the sale of goods may be governed by rules derived from the Restatement of Contracts. The Restatement proposes the "mirror-image rule" for acceptance of an offer. This rule states that the acceptance of an offer must be exactly as demanded by the offeror. That is, the acceptance must "mirror" the offer. If the offeree adds new terms to the acceptance, it is not really an acceptance. Acceptance with different or additional terms constitutes a counteroffer.

    - *Example*: I offer to perform a service for you at a given fee. You reply that my prices are too high and that you want a 15% discount. You changed the terms of the consideration (the price), which is a material aspect of the offer. As such, you have effectively rejected my offer, as your attempted acceptance was not the mirror image of my offer.

- ***Discussion***: Why do you think about the mirror-image rule? Does it concern you that a minor deviation in an acceptance can effectively reject a contract? Why or why not? What if this was not the intent of the parties at the time of entering into the agreement?

- ***Practice Question***: Kate offers to paint Roger's house for $2,500. Roger attempts to accept the offer by saying, "Great. But, you have to paint the storage shed in the backyard as well." Kate does not respond and decides to take a different painting job. Roger is angry, particularly when he learns that the next closest offer is twice as expensive. He wants to sue Kate for her failure to perform. What is the likely result?

- ***Resource Video***: http://thebusinessprofessor.com/mirror-image-rule/

- *Rule for Sale of Goods (UCC)* - The mirror-image rule does not apply to sales of goods under the UCC. The UCC recognizes that a contract is formed if the acceptance of the offer is unequivocal. That is, if it is obvious the parties agree on the primary or material terms of the agreement, an acceptance that changes or adds additional terms is a valid acceptance. The effect of different or additional terms depends on whether the parties are merchants. If either party is not a merchant, any additional or different terms are deemed suggestions for addition and do not become part of the contract. If both parties are merchants, the additional terms become a part of the contract, unless:

  - they materially alter the contract,

  - acceptance is conditioned on the specific terms of the offer, or

  - the offeror specifically rejects the additional or different terms.

    - *Example*: I am a merchant and I offer to sell you goods. You respond that you are willing to purchase the goods, but I must provide you with a warranty. I send the goods and you accept them. If you are not a merchant, there is no warranty. That was simply a recommendation to be part of the contract. If you are a merchant, the warranty is a part of the contract.

    - *Note*: In the above example, if we are both merchants, I could have excluded the warranty from the contract be expressly rejecting the warranty. If I sent the goods and you accepted them, you have agreed to the terms of my original offer.

  - ***Discussion***: Why do you think the sale of goods employs a different rule than contracts to provide services? Can you think of any reasons for differentiating between the rules that apply to merchants of goods and non-merchants?

  - ***Practice Question***: Darla is purchasing consumer goods from Isaac's business. Darla sends in a purchase order and the payment for the goods. Isaac sends the goods and a receipt that includes a clause stating that any disputes about the goods must be submitted to arbitration. Darla is not happy with the quality of the

goods and she asks Isaac to return her money. When Isaac refuses she seeks to sue Isaac. What is the result in this situation?

- ***Resource Video***: http://thebusinessprofessor.com/battle-of-forms-ucc-acceptance-of-contract/

- *Silence with Regard to Offer* - Failing to reply to an offer is not acceptance in most cases. This is true even if the offer says silence will be considered acceptance. There are, however, exceptions to this rule. If the relationship between the parties is such that it is not expected that the offeree reply, silence by the offeree may constitute acceptance. Another exception would be where the offeree readily understands that silence or a failure to respond means acceptance of the offer. This generally only arises in situations where the offeror and offeree have a history of prior dealings. Lastly, in the case of contracts between merchants under the UCC, silence may constitute acceptance of an offer. In some instances, a merchant is required to expressly reject goods that are delivered; otherwise, her silence constitutes acceptance of the contract.

  - *Example*: I offer to paint your house for $100. If you do not respond to my offer, there is no acceptance. If, however, I specifically state that, "If I do not hear anything from you by Friday, I will assume you agree to my offer." You reply, "That sounds good." You now realize that silence become acceptance on Friday. Changing the scenario a bit, you are a contractor and I routinely provide you quotes on houses. You expect me to paint all of your houses. If our routine practice is that I provide a quote and am expected to paint the house if you do not object, silence may be acceptance.

  - *Example*: If we are both merchants dealing in expensive bicycles. You make a monthly order with me for the same inventory. One month, I send a shipment of inventory without receiving an order from you. If the goods arrive and you do not reject them for two weeks, your silence constitutes acceptance.

  - ***Discussion***: How do you feel about the idea that, in some instances, an individual can accept and offer simply by failing to respond? Are you convinced that the applicable exceptions are justified? Why or why not?

  - ***Practice Question***: Eric enters his email address to receive offers from a CD of the month club. The next week, Eric receives a CD in the mail with instructions state that he must return them within 10 days or he incurs an obligation to purchase the CD. What is the likely result?

  - ***Resource Video***: http://thebusinessprofessor.com/silence-is-not-acceptance-of-an-offer/

- *Mailbox Rule* - The mailbox rule is a default rule that applies when the offeror does not place specific requirements on the manner of acceptance. Under this rule, the offeree accepts the offer when it is sent to the offeror. This could include dropping it in the mail or sending it with a courier. This may also include providing notice of acceptance *via* email or other electronic communication (regardless of whether the offeror actually checks or reads the email). As such, if an offer is made to multiple offerees, the first offeree to accept in any manner (including by dropping the acceptance in the mail) has a binding contract.

  - *Example*: You offer to sell me your car for $500. I immediately send you a letter accepting your offer and

a $500 check. We have a contract as soon as I drop the letter in the mail.

- ***Discussion***: What do you think about the mailbox rule? Should it be the default rule in contracts? Why or why not?

- ***Practice Question***: Pamela is a musician and writer. She offers to sell her copyright to a popular song to Devon and Mark. Devon drops his acceptance of the offer in the mail on Friday evening. On Saturday morning, Pamela meets with Mark and signs an agreement transferring the copyright to him. What is the likely result in this situation?

- ***Resource Video***: http://thebusinessprofessor.com/mailbox-rule-for-contracts/

10. What is "consideration" in the context of contract formation?

Consideration is anything of value. Recall that a valid contract must include an exchange of value between the offeror and offeree. The value should be the inducement or incentive for the other party entering into the agreement. That is, it must be the subject of the bargain between the parties. A promise to make a gift is not binding because the party receiving the gift gives no value in return for the promise. When the existence of consideration is not clear, the court will examine the transaction as a whole to determine if consideration exits and the contract is enforceable.

- *Types of Consideration* - The amount or value of the consideration present does not matter. It need not be money or goods. Acceptable types of consideration include:

  - *Agreement to Refrain*: An agreement to refrain from doing something that you have the right and ability to do may constitute consideration.

    - *Example*: I really want to stand up and sing in the middle of a crowded restaurant. You would be very embarrassed if I do so. You offer me $5 to not stand up and start singing. My refraining form doing this may constitute consideration.

  - *Agreement not to Sue*: An agreement not to sue the other party may be sufficient consideration when reasonable grounds exist to make a lawsuit possible.

    - *Example*: You claim that I owe you additional funds under a contract. I disagree and argue that all accounts are settled. You threaten to sue me. I offer to pay you a small sum of money in exchange for your agreement not to bring a legal action against me. Forgoing your right to sue me in exchange for money is a valid exchange of consideration.

  - *Prior Consideration* - Generally, consideration in a prior agreement is not valid consideration in a new agreement, except in very limited circumstances. The reason is because the individual is already obligated under the old agreement. Trying to promise to do the same thing does not provide a new form of value. Under the UCC, however, a preexisting obligation can constitute valid consideration if the offeror is a purchaser of $500 or more in goods, and she offers to pay more than an additional $500 for the same goods. This exception exists to protect certain business arrangement from failing.

- *Example*: We are both merchants. You enter into a contract to purchase goods from me for $5,000. In the pendency of the contract, you realize that I am likely breach the contract. You really do not want to find another seller, so you offer to pay an additional $1,000 for me to perform the contract. May agreement to perform my existing contractual obligation (sell you the goods) is valid consideration - even though it is the consideration for a prior agreement.

- ***Discussion***: How do you feel about the requirement for consideration? Should there be a value requirement for the consideration? Why or why not? What do you think is the purpose or objective behind requiring any form of consideration, regardless of the nature or value?

- ***Practice Question***: Donna is merchant and enters into a contract with Ashley to purchase bricks from me for $10,000. In the pendency of the contract, the cost of bricks rises dramatically. Ashley will lose money by selling the bricks to Donna for $10,000. Donna realizes that Ashley is going to lose money and will likely breach the contract. Donna really needs the bricks and it is most convenient to purchase from Ashley. She offers to pay an additional $1,000 for the bricks. If, after Ashley ships the bricks, Donna decides not to pay the additional $1,000, what is the probable result?

- ***Resource Video***: http://thebusinessprofessor.com/what-is-consideration/

- *Promissory Estoppel Exception to Consideration Requirement* - A doctrine known as "promissory estoppel" may serve as a substitute for consideration to make an agreement into a valid contract. Promissory estoppel is an equitable doctrine. If the offeree reasonably relies on the offeror's promise to her detriment, the doctrine of promissory estoppel may make the contract valid despite the absence of consideration. The two key elements are:

  - that the reliance must be reasonable in light of the situation, and

  - the relying party must suffer a tangible detriment.

    - *Note*: The court may also consider whether performance causes a hardship on the promising party.

    - *Example*: You are having erosion problems in your hard. You cannot afford to pay to have it fixed, so I offer to give you the materials necessary to build a retaining wall. You spend your available money grading out the ground and digging the dirt where the wall will go. After all of this, I back out of my promise. You have now spent your available money and, without installing the wall, made the situation far worse than it was before. A court may deem my promise to be an enforceable contract because you relied to your detriment on my promise.

- ***Discussion***: How do you feel about the idea that a person's reliance on another person's promise can substitute for consideration? How much of a detriment must the relying party suffer before you think a court should enforce the agreement? Should the promise be enforced if it would result in a significant hardship for the promising party?

- ***Practice Question***: Tina says that she will give Sam her car to drive across the country from Georgia to California. Sam relies on Tina's promise by not purchasing a plane ticket. Tina fails to follow through with her promised gift. Sam has to purchase a plane ticket that is dramatically more expensive that it would have been if he had purchased the ticket at the time that Tina made her promise. If Sam wants to sue Tina for breach of contract, what is the likely result?

- ***Resource Video***: http://thebusinessprofessor.com/promissory-estoppel/

- *Other Exceptions to Consideration Requirement* - There are two very broad, common exceptions to the requirement that a contract be supported by consideration.

  - *Option Contracts* - An option contract is an agreement between parties that allows one party a specific period of time to purchase a particular asset at a given price.

    - *Example*: Mark believes that the price of Apple, Inc., stock is going to rise. He purchases an option contract from Tom that allows him to purchase the Apple stock at the current price at any time within the next 30 days. Tom believes that the price is going to go down, so he is happy to sell the option to Mark.

  - *Firm Offers* - The UCC recognizes the enforceability of a promise to keep open (not retract or cancel) the offer to purchase or sell a good for a specific period of time.

    - *Example*: Agnes offers to sell a piece of equipment to Maria. She states that the offer is good for 30 days. Agnes and Maria now have an enforceable agreement for the next 30 days, despite the absence of consideration in the agreement to keep the offer open.

- ***Resource Video***: http://thebusinessprofessor.com/options-contract-and-firm-offers-exception-to-consideration-requirement/

ENFORCEABLE, VOID, & VOIDABLE AGREEMENTS

11. What is "mental capacity" to contract?

To enter into a contract, a person must have mental capacity sufficient to understand the nature and consequences of her actions. If mental capacity is absent, the contract is voidable by the person lacking capacity. There are three classes of persons commonly understood to lack capacity to be bound by contractual promises:

- *Minors* - A minor is someone below the statutory age of mental capacity within a jurisdiction. Generally, a person must be 18 years old or older to have the requisite mental capacity to contract. As such, a minor who enters into a contract can void the contract at any time prior to reaching the age of majority. The exception to this rule is when the contract involves goods or services necessary for the child's survival. This could include food, water, shelter, etc. In the case of necessities, the child will be obligated to pay the reasonable value of the goods or services received. If the child fails to disaffirm the contract by this time, she thereby ratifies the contract and is bound

going forward.

- *Example*: Jane is 17 years old. She goes to a local gym and signs up for a year-long membership. This is not a contract for a necessity. Jane will be able to void the contract at any time before she turns 18 years old. She will, however, have to pay the reasonable cost of any value she receives from the gym.

- *Intoxicated Person* - An intoxicated person may lack the mental capacity necessary to contract. Generally, this will require extreme intoxication. If the intoxicated person enters into a contract, she must disaffirm the contract within a reasonable time of regaining capacity and learning of the contract. If she fails to do so within a reasonable time, she has ratified the contract and will be bound.

    - *Example*: Don gets incredibly drunk in a bar. He does not know where he is and asks a stranger for a ride home. He offers to give the stranger, Gary, his Rolex watch in exchange for a ride home. Gary takes him home and takes the Rolex. When Don sobers up, he can immediately demand return of the Rolex. He was too intoxicated to appreciate the nature of his actions. As such, he can void the contract. He must act within a reasonable period to void the contract upon becoming sober.

- *Mentally Incompetent Person* - A mentally incompetent person generally lacks the ability to enter into a contract. If the mental incompetency is temporary, the individual must disaffirm any contract entered into during incapacity within a reasonable time of regaining capacity. If the person is permanently incapacitated, the contract is either void or voidable at the insistence of a legally appointed guardian.

    - *Example*: Ernie is having psychotic delusions. He goes to a security firm and hires a private security guard. Ernie's legally appointed caretaker will be able to void the contract based upon Ernie's lack of mental competence to enter into the agreement.

Each state may pass additional situations in which it deems an individual mentally incompetent to enter into contractual relations.

- ***Discussion***: How do you feel about the requirement for mental capacity to contact? Do you agree with arbitrarily setting an age at which a person is deemed to have mental capacity? Why or why not? How should a person's level of intoxication be measured to determine whether she has mental capacity to contract?

- ***Practice Question***: Phyllis is in a bar and drinking heavily. She realizes that she cannot drive in her state, so she solicits a ride from Harriet. She does not have any money, so she offers Harriet her new Rolex watch in exchange for a ride. Harriet accepts and drives Phyllis 3 miles to her home. The next morning Phyllis realizes that she traded a very expensive watch for a 3-mile ride. What are Phyllis' options?

- ***Resource Video***: http://thebusinessprofessor.com/mental-capacity-to-contract/

12. What is the requirement that a contract have a "lawful purpose"?

A contract must have a lawful purpose to be enforceable. That is, the contract cannot violate or cause others to violate the law or public policy.

- *Crimes and Torts* - Contracts that require commission of a crime or tort or violate accepted standards are void. If a contract has both legal and illegal provisions, a court will often enforce the legal provisions and refuse to enforce the illegal ones.

- *Unconscionable Contracts* - An unconscionable contract is one that is so unfair that it is said to "shock the conscience". Unconscionability is broken down into "substantive unconscionability" and "procedural unconscionability".

    - *Substantive Unconscionability* - This means that the terms of the agreement are so extremely unfair or one-sided in favor of a party that it is unlikely that the other party to the agreement understood its terms.

    - *Procedural Unconscionability* - This refers to the conditions under which the contract was formed. The terms of the contract may indicate that one party was taken advantage of by another party with greater bargaining power. Such a contract may be void as against public policy if the circumstances indicate that a reasonable person would not have entered into the agreement without the existence of an undue hardship. In some situations, the undue hardship must have been brought on by the party unduly benefited by the contract.

- *Contracts that Restrain Trade* - Contracts that restrain trade may be illegal and thus void. This is true for contracts that create a monopoly, fix prices, and divide up markets. This is generally the area of antitrust law. A court may also find a contract void if it serves to frustrate economic activity in a manner not covered by antitrust law or it intentionally interferes with contractual relations or unfairly competes.

    - *Example*: An example of a contract that directly prohibits competitive business activity is a "covenants not to compete". This type of contract restricts an individual from carrying on a trade or practice. These contracts are held to be void when they are unduly burdensome in their restrictions regarding the time and geographic locations for doing business. A covenant not to compete that has a limited time frame (3-6 months) and a limited jurisdiction (up to 50 miles) is generally enforceable if there is good reason for the restriction.

States are free to pass statutes or develop common law that protects the public interest. A contract that runs afoul of what is deemed necessary for the public good may also be void.

- ***Discussion***: How do you feel about the requirement that a contract have a lawful purpose? Can you think of any situations where this requirement may cause an unfair result for parties? Should there be a sliding scale for determining enforceability of contracts that violate public policy or are illegal? Why or why not?

- ***Practice Question***: Carter lives in New Orleans, Louisiana. The state is in a state of emergency based upon an approaching hurricane. Carter, along with thousands of other people, attempts to flee the city. The traffic is horrible and folks are running out of gas on the roadway. Carter is low on gas and pulls into a gas station. The gas station is charging $250 per gallon of gas. Carter is outraged, but purchases the gas and continues to flee the city. What are his legal options?

- ***Resource Video***: http://thebusinessprofessor.com/lawful-purpose-for-contracts/

13. What common situations give rise to a voidable contract?

- *Fraud* - Fraud involves an intentional misstatement of the material (important) fact that induces one to rely justifiably to his or her injury. If a person is defrauded into entering a contract, the defrauded party may void the contract upon learning of the fraud. Voiding the contract is at the option of the defrauded party, as she may wish to remain in the contract. The party committing fraud may not void the contract. If the defrauded party fails to void the contract upon learning if the fraud, she is deemed to have ratified it and is bound.

- *Misrepresentation* - Misrepresentation is a material misstatement of fact that induces one to rely on the statement. The difference with misrepresentation and fraud is that misrepresentation does not involve the intent to mislead. As in the case a fraud, a party who enters a contract as a result of a material misrepresentation may void the contract upon learning of the false representation. The misrepresenting party may not void the contract. If a party fails to void the contract upon learning of the misrepresentation, she is deemed to ratify the agreement.

- *Duress* - Duress means the use or threat of force to convince a person to act according to one's wishes. If a party enters into a contract due to the physical or economic duress imposed by the other party, the contract is voidable at any time by the party subject to duress.

- *Undue Influence* - Undue influence arises when one party unfairly takes advantage of another party by using a position of trust, influence, or confidence.

    - *Example*: A psychiatrist who enters into a contract with her patient that is not related to medical services may be deemed to have exercised undue influence. The influenced party may have been pressured to enter into the agreement or felt unduly obligated to enter into the agreement for fear of destroying the doctor-client relationship.

- *Mutual Mistake* - A mistake by both parties regarding "material" facts or circumstances relevant to the contract may make a contract voidable. In such a situation, either party may void the contract upon learning of the mutual mistake. The standard for whether the mistake of fact is material is whether a reasonable person would have entered into the agreement if the true facts were known. A mutual mistake of law may make a contract voidable if it caused the parties to not have a "meeting of the minds" with regard to the core aspects of the contract. If no meeting of the minds exists, there is never a valid agreement between the parties.

- *Unilateral Mistake* - Generally, unilateral mistake by one party to the contract does not make the contract voidable. A unilateral mistake about the basic assumptions of the contract will only make the contract voidable when the non-mistaken party knew or had reason to know of the other party's mistake. In such a case, the effect of enforcing the contract against the mistaken party must be unconscionable and the non-mistaken party would not suffer a substantial hardship by voiding the contract. If the non-mistaken party did not know about the other party's mistake, the standard for voiding the contract is even higher. In such a case, the contract must not yet have been performed or the parties must be easily restored to their pre-performance positions. The mistake must be substantial, and the mistake must directly relate to some computational or clerical error in the construction of the terms of the agreement.

    - *Note:* No defense exists if the mistaken party knowingly assumed the risk of the mistake; is grossly

negligent in making the mistake; violates a legal duty; fails to act within her duty of good faith and fair dealing; or intentionally fails to read the contract.

- ***Discussion***: How do you feel about the idea that both parties may hold the right to void a contract? Is there any justification for holding that the contract is void rather than voidable? Do you agree with the scenario under which a unilateral mistake if voidable? Why or why not?

- ***Practice Question***: Constance enters into an agreement to purchase Gerald's business. The contract contains a calculation for the business's cash on hand at the time of sale to be added to the purchase price. Constance and Gerald did not pick up on the calculation error at the time of signing the agreement. The week prior to closing, Constance's attorney caught the error, which causes a huge increase in the calculated value of the business. Gerald wants to hold Constance to the dramatically increased price, as she signed the contract containing the calculation error. What are Constance's options?

- ***Resource Video***: http://thebusinessprofessor.com/voidable-contract-scenarios/

14. When is a contract required to be in writing?

Some valid contracts are required to be in writing to be enforceable by a court of law. The requirement that a contract be in writing is generally dependent upon the subject matter of the agreement. A statute requiring that a contract be in writing is known as a "statute of frauds". These statutes are designed to prevent fraud in the formation of contracts. Most statutes do not require that the entire contract be in a formal writing; rather, there must be sufficient writing (in any form) to demonstrate the core aspects of the agreement.

The following types of contract are generally required to be in writing in all jurisdictions:

- *Sale of an Interest in Land* - Contracts concerning the transfer of an interest in land must be in writing to be enforceable. An "interest in land" includes contracts for mortgages, mining rights, easements, etc.

    - *Example*: I agree to sell you an easement to cross my land. Our contract must be in writing to be enforceable.

    - *Note*: A construction agreement is not a transfer of an interest in land.

- *Collateral Promise to Pay Another's Debt* - Debt surety or guarantee agreements are required to be in writing to be enforcement. These instruments document when one person promises to repay the debt of another. This includes situations where business owners guarantee the debts of their business.

    - *Example*: You approach your rich uncle and ask that he loan you money to buy a car. I am your friend and I promise to repay the loan if you are unable to do so. If you default, your uncle may not be able to recover against me because our agreement is not in writing. That is, your uncle and I do not have an enforceable contract.

- *Cannot Be Performed within One Year* - A contract must be in writing to be enforceable if the duties under the

contract cannot possibly be performed within one year after its making. The ability to carry out the contract must be impossible to a certainty.

- *Example*: You and I enter into an oral contract for services that lasts for twenty months. This is not enforceable, as any service contract or a lease of longer than one year are generally not enforceable.

- S*ale of Goods of $500 or More* - Sales of goods fall under the provisions of the UCC. The UCC requires that any contract for the sale of goods for $500 or more must be in writing to be enforceable. Modifications to any such agreement must also be in writing.

    - *Example*: I verbally agree to sell you a piece of equipment for $750. If I back out of our agreement, you may not be able to enforce our agreement through the courts because the agreement is not in writing.

States may establish other contracts that are required to be in writing to be enforced in that jurisdiction. For example, most states require insurance policies to be written.

- ***Discussion***: Why do you think that certain contracts are required to be in writing to be enforceable while others are not? Can you think of any other types of contract that you believe should be in writing to be enforceable? What is your reasoning?

- ***Practice Question***: Todd enters into a verbal agreement with Ashley to provide lawn serves at her rental property for the next two years. After performing his obligations for one month, he realizes that it is a very difficult property to service and he drastically underbid the job. What are his options?

- ***Resource Videos***: http://thebusinessprofessor.com/statute-of-frauds-explained/

15. What type of writing is required to satisfy the "statute of frauds"?

To meet the requirements of the statute of frauds, there must be a sufficient writing to demonstrate that a contract exists. The writing can be typed, handwritten, or electronic. The agreement must generally be signed by the party against whom it is being enforced. A signature may be a mark, seal, stamp, electronic signature, or a handwritten agreement. Between merchants, a confirmation regarding the contract by one merchant that is not objected to by the other merchant will be sufficient, even though it is not signed by the other merchant.

- ***Discussion***: Why do you think that the definition of a writing is construed so broadly? Is this broad interpretation justified or does it unduly detriment a party? Why?

- ***Practice Question***: Frank agrees to sell Amy his collector-edition, signed baseball card. Frank writes on the back of the a napkin, "I agree to sell Amy my Mickey Mantle rookie card for $2000." Will this be a sufficient writing to satisfy the statute of frauds?

- ***Resource Videos***: http://thebusinessprofessor.com/types-of-writing-to-satisfy-statute-of-frauds/

16. What exceptions exist to the requirement that a contract be in writing to be enforceable?

Jurisdictions recognize a number of exceptions to the requirement that certain contracts be in writing to be enforceable. Common exceptions to the writing requirement are as follows:

- *Admission Under Oath* - If a party admits under oath (such as in a deposition or in a court proceeding), the contract may then be deemed enforceable.

- *Part Performance* - A court may deem an oral contract enforceable if the parties (or one party) has partly performed the contract. This principle generally applies to oral agreements to sell or transfer real property (land).

    - *Example*: If the buyer has paid part of the purchase price and taken possession of the land, the court may hold the oral agreement enforceable. This would generally entail a court order to complete the contract performance by signing a deed legally transferring the property.

- *Promissory Estoppel* - The equitable doctrine of promissory estoppel applies in situations where one party relies to her detriment on another party's promise. It arises in a situation where a party believes that her exchange of promises with the other party is a legally enforceable contract. That party puts herself in a position where she would suffer a loss if the other party does not perform.

    - *Example*: Tom promises Jane that he will sell her land to build a house. Jane, relying on the promise, hires individuals to begin grading the land and laying a foundation for the house. Later, Tom refuses to transfer a deed to Jane and claims that the contract is not enforceable because it was not in writing. Jane has spent significant money and time under the belief that the contract was enforceable. As such, a court will probably hold the contract to be enforceable under the doctrine of promissory estoppel.

- *Rules Involving Goods* - The UCC provides several exceptions to the rule that contracts for the sale of goods for $500 or more be in writing. For example:

    - *Specialty Goods* - If a manufacturer agrees to manufacture specialty goods for a client, once the manufacturer begins production of the goods, the contract may be enforceable without a written agreement.

    - *Partial or Complete Performance* - If goods have been accepted and payment for the goods has been made, the parties cannot later claim that the contract was unenforceable and demand return of the money or property. This may also be true for partial payment or delivery of a portion or installment of the goods.

    - *Contract Between Merchants* - An oral contract between merchants is enforceable when one party delivers goods and the other party either delivers goods or sends written notice confirming the terms of the agreement and the other party does not object to that notice within 10 days.

The justification for the above exceptions to the statute of frauds is that each situation provides an additional level of proof regarding the existence of a contract. It reduces the need for a writing to prove that the contract exists and its terms.

- ***Discussion***: Why do you think each of these exemptions from the statute of frauds exists? What standard do you think should apply to determining what is "part performance"? How far should an individual go in relying on a promisor before it exempts the agreement from the statute of frauds? Why do you think these special provisions exist for sales of goods between merchants?

- ***Practice Question***: Chris is a professional musician and celebrity. He walks into Grey's jewelry store and request that Grey make him a custom necklace. Grey agrees, but they do not execute a contract. The necklace is very ornate and will cost about $150,000. It will contain the musician's initials and symbol. When Grey finishes the necklace, Chris decides that he does not want it. What are Grey's options?

- ***Resource Video***: http://thebusinessprofessor.com/exceptions-to-statute-of-frauds/

INDIVIDUALS WITH RIGHTS UNDER THE CONTRACT

17. Who are the beneficiaries of the contract?

The parties to the contract are the primary beneficiaries. In general, individuals who are not parties to a contract have no rights to sue to enforce the contract or to get damages for a breach of contract. There are, however, exceptions to this rule. It is possible for third parties to have rights in a contract. A third-party beneficiary may have rights under a contract if the original parties to the contract intend for the agreement to benefit the third party and that intent is demonstrated in the agreement. This may happen at the time of the contract, or a third party may also acquire rights in an already executed contract if one party to the contract validly transfers those rights to the third party.

- *Example*: I enter into a contract with ABC Corp to provide them consulting services. As part of the agreement, ABC Corp is to make payments for those services directly to XYZ Corp. Because XYZ Corp is a named (intended) beneficiary, it has rights under the contract that are enforceable against ABC Corp.

The extent of the third party's rights is determined by her status as either a donee beneficiary or creditor beneficiary.

- *Donee Beneficiary* - A donee beneficiary is a third party who receives contractual rights as a gift from the promisee. If a promisee makes a contract for the benefit of a donee beneficiary and the promisor fails to perform, the third-party may not bring an action against the promisee (individual transferring the contract), but may bring an action against the promisor (individual obligated under the contract). Since the transfer to the beneficiary is a gift, there are no grounds for recourse against the promisee.

    - *Example*: ABC Corp has an obligation to pay me. I instruct ABC Corp to make the payments directly to you. The payments to you are a gift to help your business get started. If ABC Corp refuses to pay you, you may enforce your right to payment against ABC Corp. You cannot, however, sue me if ABC fails to pay.

- *Creditor Beneficiary* - A creditor beneficiary is a third party who receives contractual rights from the promisee as satisfaction of a debt. When a promisor fails to perform under the subject contract, the creditor beneficiary can bring an action against the promisee, as the value of the consideration transferred is gone. The promisee may also bring an action against the promisor, as her rights have been harmed by the promisor's failure to perform.

    - *Example*: ABC Corp has an obligation to pay me. I instruct ABC Corp to make the payments directly to

you. The payments to you are in satisfaction of a debt I owe to you for services you have already performed. If ABC Corp refuses to pay you, you may enforce your right to payment against ABC Corp. You can also sue me if ABC fails to pay.

- ***Discussion***: Why do you think that the rules change depending on whether the beneficiary is intended vs unintended? Donee vs creditor beneficiary?

- ***Practice Question***: Big Corp does business with Town Corp. Town Corp is the lifeblood of many smaller businesses in its town. These businesses exist to provide goods and services to Town Corp. Big Corp has a dispute with Town Corp which results in Big Corp breaking off relations with Town Corp and, in turn, breaching a major purchasing contract. The loss of Big Corp as a purchaser is detrimental to Town Corp and they are forced to reduce their output. This affects all of the businesses in Town Corp's town. What legal options exist for the small businesses in Town Corp's town?

- ***Resource Video***: http://thebusinessprofessor.com/third-party-beneficiaries/

18. What is "assignment" and "delegation" of contracts?

Assignment is the transfer by one party of her right to receive performance from the other party to the contract. Delegation is the transfer by one party of her duties to perform under a contract.

- *Methods of Assignment or Delegation* - The rights under a contract can be assigned or the duties delegated through agreement between the assignor and assignee. Assignments/delegations can be a gift or an exchange for other value. In general, unless the contract deems otherwise, obligees may assign their rights or delegate their duties under the contract to third parties.

    - *Note*: The assignor/delegator must give notice to the other party immediately upon assignment/delegation.

- *Writing Requirement* - Assignments and delegations of common law contracts do not have to be in writing. Assignments of contracts for the sale of goods, however, must be in writing if the original contract was subject to the statute of frauds.

- *Non-Assignable/Delegable Contracts*: Unless the agreement limits assignment of rights, most contracts are assignable. Delegation of duties pursuant to contract is more limited. The following contracts are not capable of delegation:

    - *Material Changes of Responsibility* - A contract that materially alters the obligor's duties under the agreement is not transferable. Particularly, an assignment that greatly increases a party's delivery requirements cannot be assigned. Doing so may detriment the obligor who has to meet a new (and possibly more taxing) delivery schedule.

        - *Example*: I sign a contract to supply all of the cement that your company needs. You are a small construction business with about $1 million per year in revenue. You attempt to assign the contract to ABC Corp, which is a large company with $10 million per year in revenue. If this will

dramatically increase my supply requirements, it cannot be assigned without my consent.

- *Increases Burden or Risk* - Generally, any contract that materially increases the other party's burden, risk, or ability to receive return performance is not delegable. As such, requirement contracts generally cannot be delegated because the producer's duty depends on the individual output requirements of the purchaser.

    - *Example*: I sign a contract to supply all of the cement that your company needs. You signed the contract with my company because of my reputation and ability to perform. I cannot then delegate the duties under the contract to another company without your consent. This could increase your risk of not receiving performance.

- *Special Skills* - A party to a contract cannot delegate performance of duties under a contract when performance depends on the character, skill, or training of that party.

    - *Example*: One singer cannot transfer her obligations under a contract to another singer if the other party depended upon the skill of that particular vocalist.

- *Multiple Assignments* - A party can partially assign a contract or assign the same contract to multiple parties. Different jurisdictions follow different rules regarding the priority of the assignees. Some jurisdictions allow that the first assignee of a contract who gives notice to the obligor has priority over other assignees. Other jurisdictions follow the rule that the first assignee to receive assignment of a contract has priority to performance by the obligor. Still other jurisdictions follow the rule that the first assignee has priority, unless:

    - *Purchaser in Good Faith for Value* - If an assignee pays value for the assignment in good faith without notice of a prior assignment (and the prior assignee did not receive the assignment in good faith and for value), she has priority over prior assignments.

        - *Example*: ABC Corp has a duty to deliver goods to me. I assign the right to receive the goods to 123 Corp as a gift. I later decide to assign the right to receive goods to XYZ Corp in exchange for $1,000. XYZ Corp has no knowledge of my prior assignment to 123 Corp. ABC Corp will have priority over 123 Corp, as 123 Corp did not pay anything for receiving the assignment.

    - *Court Action* - If an assignee receives a judgment against the obligor. If a court adjudicates the matter, the assignee winning at court may be vested with the authority to establish priority in performance of assigned rights.

        - *Example*: I am a party to a contract with ABC Corp. I assign my rights under a contract to Tammy and later to June. Tammy sues me and ABC Corp to establish her priority regarding performance of the contract. The court may award priority to Tammy or June.

    - *Novations* - If the assignee executes a novation, the novation establishes priority. A novation is a new contract between individuals that replaces a party to the contract or obligations or rights under the agreement.

        - *Example*: I am a party to a contract with ABC Corp. I assign my rights under a contract to Tammy and later to June. June enters into a novation agreement with ABC Corp that replaces me under

the contract and establishes her as the obligee. June will have priority of performance above Tammy.

- *Written Assignment* - If a later assignee receives a written assignment capable of transfer that is not in writing, she will have rights superior to those of an earlier assignee. Some agreements, such as assignments that are subject to the statute of frauds, are only capable of being assigned *via* a valid writing. If a prior assignment does not satisfy the statute of frauds, a subsequent transfer could take precedent. It is important to review the specific rules applicable to the specific jurisdiction when determining one's rights under an assigned contract.

    - *Example*: I am party to a written contract to sell goods to ABC Corp. I verbally transfer my right to receive payment to Amy. I later transfer the right to receive payment to Zora in a written agreement. Zora may have priority over Amy.

- *Revoking an Assignment* - A gratuitous (gift) assignment cannot be revoked if the assignment is made pursuant to a written document signed by the assignor. If no writing exists, revoking a gratuitous assignment that has not been performed is extremely easy (because no physical transfer has taken place). It can be revoked by an assignor later assigning the same right (the last assignment controls), the death or incapacity of the assignor, or by the delivery of notification of revocation to the assignee or obligor.

    - *Example*: I verbally assign to you my rights to receive payment under a contract. I later tell you that I am revoking the assignment. This is effect to revoke the assignment because the original assignment was a gift and I did not make the assignment in writing.

- *Modification after Assignment* - Generally, a contract cannot be modified after assignment. As previously discussed, once a contract has vested, the parties generally cannot modify the contract in a way that impairs the assignee's rights. If, however, a modification does not affect the assignee's rights, it may be modified.

    - *Example*: I have the right under a contract with ABC Corp to receive payment. I transfer the right to receive payment to you. I later approach ABC Corp and alter my obligation to deliver goods on a specific date. If the alteration of my duties does not affect your rights as assignee, the alteration is not prohibited.

    - *Note*: There is an exception in commercial contracts under the UCC that allows for modifications or substitutions in accordance with commercially acceptable standards. This allows for slight modifications that are within the expectations of the parties.

- *Continued Delegator Responsibilities* - The party delegating the contract is still potentially liable under the contract if the delegatee fails to perform. If, however, the delegatee and the obligee under the contract enter into a novation, the delegator is relieved of responsibility.

    - *Example*: I am obligated to perform services to ABC Corp. I delegate my responsibilities to you. If you fail to perform the consulting duties, ABC Corp can still sue me. If, however, you enter into a novation with ABC Corp that substitutes you for me in the original contract, your failure to perform does not affect me.

    - *Note*: If the delegator expresses her intent to repudiate the contract upon assignment to the delegatee,

there is an implied novation if the obligee does not object. Also, the delegatee will be liable under the contract if she expressly or impliedly accepts responsibility for performance.

Most of the above rules regarding assignment and delegation are capable of modification in a contract between the parties.

- ***Discussion***: How do you feel about treating assignments of rights and delegation of duties under contracts differently? Which of the assignment priority rules do you believe is most fair to the parties? Why? Should a party be able to modify a contract after assigning her benefits?

- ***Practice Question***: Cleo is a party to a contract with ABC Corp to provide consulting services. Cleo verbally assigns her rights to receive payment to Austin. Cleo later verbally assigns her rights to receive payment to Steve. Austin complains to Cleo about her subsequent assignment. What can Austin do to establish his priority to receive payment from ABC Corp?

- ***Resource Video***: http://thebusinessprofessor.com/assignment-of-a-contract/

CONTRACT PERFORMANCE

19. When is a party relieved from her obligations under a contract?

Parties to a contract have duties or obligations thereunder. There are generally three options to relieve these obligations:

- *Perform* - An individual is relieved from her duties under a contract once she has fully or substantially performed those duties. The individual is "discharged" from the contract.

- *Release from Contract* - Either party may be released from a contract by the other party. Alternatively, the person may be released if the contract becomes void.

- *Breach* - Once a party to a contract breaches that contract, she and the other party no longer have duties to perform. If the contract is enforceable, the other party then has the ability to enforce the contract against the other party by seeking damages.

Performance of the contract and release eliminate a person's liability under the contract. Breach exposes the breaching party to damages or losses suffered for the breach. None of these options relieve a party form tort liability if her actions with regard to the contract constitute a tort.

- ***Discussion***: Should a party pursue the method of relieve her obligation under a contract that is of greatest advantage to her? Why or why not?

- ***Practice Question***: Katie and Smith enter into a contract. Each has a duty to perform services for the other. Neither party ever takes action to act on the contract. What is the result?

- ***Resource Video***: http://thebusinessprofessor.com/duty-of-performance/

20. What are "executed contracts" and "executory contracts"?

An executed contract is one in which the parties have performed their duties under the contract. An executory contract is one in which the parties have not yet performed their obligations under the agreement.

- *Example*: I enter into a contract with you. Before I have fully performed the contract, it is executory. Once performed, the contract is executed.

- ***Discussion***: Why do you think it is necessary in business to characterize contracts are executory versus executed?

- ***Resource Document***: http://thebusinessprofessor.com/executory-vs-executed-contracts/

21. What is performance of a contract?

Performance of a contract relieves a person from further duties under the contract. There are three levels of performance:

- *Complete Performance* - Complete performance by a party means that the contracting party has fulfilled every duty required by the contract. A completely performing party is entitled to a complete performance by the other party.

    - *Example*: I enter into a contract to build a house for Ellen. I build the house and complete all of the material and non-material requirements of the contract.

- *Substantial Performance* - Substantial performance of a contract means less than complete performance; but, the level of performance is sufficient to avoid a claim of breach of contract. More specifically, it means that a party has performed all material elements of the contract, but there are non-material aspects left uncompleted.

    - *Note*: The other party may be entitled to seek offset or recovery from the substantially performing the party for the aspects of the contract not completed.

    - *Example*: I enter into a contract to build a house for Ellen. I build the house, but fail to paint the interior the color described in the contract. This contract is substantially performed and does not give rise to an action for breach. Ellen may, however, recover or offset the cost of painting the walls when paying me.

- *Breach of Contract* - Any performance that is not complete or substantial performance is a material breach. This entails performance at a level below what is reasonably acceptable. The materially breaching party cannot sue the other party for performance and is liable for damages to the other party for the breach.

    - *Example*: I enter into a contract to build a house for Ellen. I distracted by another contract and make material errors in laying the foundation. It causes the house not to meet standards and pass inspection by the building inspector. In this case, I have breached the contract by failing to perform a material duty under the agreement.

- ***Discussion***: How do you feel about the concept of substantial performance? Do you believe that failure to perform certain duties under a contract should not constitute a breach? Why or why not?

- ***Practice Question***: Missy enters into a contract to perform auditing functions for ABC Corp. She does reconciliation of many of the accounts, which takes substantial time. She is satisfied that the books are accurate, so she skips performing many of the key tasks required of external auditors. What is the status of Missy's duties under the contract?

- ***Resource Video***: http://thebusinessprofessor.com/performance-substantial-performance-breach/

22. What is performance of a "divisible contract"?

A divisible contract is one that has multiple parts or is divided up into segments. Each segment exists and can be completed independently. That is, each segment has duties that require completion. An installment contract is an example of a divisible contract. Each installment has duties or obligations that must be completed. Performance of one segment does not relieve a party from the obligation to perform the other segments. Further, breach of one segment does not excuse performance of the other segments by the parties.

- *Example*: I enter into a road construction contract that has three separate and distinct duties of completion. I complete the first phase by constructing a specific stretch of road that entitles me to compensation. I have significant delays in constructing the second stretch of road. I have materially breached this divisible portion of the contract. I still have the duty to complete and be compensated for the third divisible contract.

- ***Discussion***: Do you agree that the breach of any phase of a divisible contract should not constitute breach of the entire contract? Why or why not?

- ***Practice Question***: Clark's construction company wins the bid to build a large commercial building for the city. The contract is broken into multiple, divisible pieces. Clark completes the first phase consisting of laying the building foundation, which simultaneously working on the second phase. This second phase regards constructing a parking garage beside the building. Clark has some serious difficulties and is unable to complete this phase on schedule. What is Clark's legal status with regard to the third phase of the contract?

- ***Resource Video***: http://thebusinessprofessor.com/what-is-a-divisible-contract/

RELIEF FROM DUTIES UNDER THE CONTRACT

23. What situations relieve individuals from performing her duties under a contract?

An individual is relieved from her duty to perform a contract in the following scenarios:

- *Void Contract* - If a contract becomes void, both parties are relieved from their duty of performance.

- *Breach by Other Party* - If the other party materially breaches the contract, the non-breaching party is relieved

from the obligation to further perform the agreement.

- *Failure of a Condition* - A contract may contain any number of conditions that may materialize (or fail to materialize), which relieve the parties' obligation to perform under the contract.

- *Impossibility, Impracticability, of Frustration of Purpose* - Parties to a contract may be relieved from their obligation to perform if performance becomes impossible, commercially impracticable, or the underlying purpose of the contract is frustrated.

- *Waiver or Release* - A party may, per her own volition, sign a waiver or release relieving the other party's obligation to perform.

Any of the above situations may release one or both parties from their duties of performance.

- ***Discussion***: Do you agree that the above situations should relieve an individual from her obligations under a contract? Why or why not?

- ***Resource Video***: http://thebusinessprofessor.com/discharge-from-contract/

24. What are "conditions" upon the duty to perform a contract?

Conditions are facts or situations that must materialize (or fail to materialize) for either or both parties to have the duty to perform a contract. Conditions are generally divided as follows:

- *Condition Precedent* - A condition precedent is where something must take place or a situation must arise prior to or before a party has a duty to perform.

    - *Example*: Eric agrees to sell Fran one of his playoff seat tickets if the Atlanta Braves make it to the playoffs. The obligation to sell Fran a ticket only arises upon the occurrence of a specific event.

- *Condition Subsequent* - A condition subsequent excuses contractual performance if some future event takes place or situation arises.

    - *Example*: Frank agrees to cut Gina's grass today if it does not rain. If it rains, Frank is relieved from the obligation to cut the grass. Likewise, Gina is relieved from her duty to pay Frank.

A condition may be expressed between the parties or implied from the nature of the agreement. That is, the parties affirmatively discuss or include the conditions in the agreement or the language or nature of the contract may imply certain conditions on performance. The contract may also contain conditions that must take place concurrently before either party has a duty to perform. This is often the case when the contract requires simultaneous performance. Most point-of-sale purchases involve an implied concurrent condition of performance.

- *Example*: I give the cashier money and she sells me the groceries. My giving her money is a condition necessary for her to sell me the groceries.

- ***Discussion***: Should conditions precedent and conditions subsequent be treated the same? What is the justification for categorizing each type of condition?

- ***Practice Question***: Harold enters into an agreement to sell his house to Emily. The contract states that Emily is relieved from her obligation to purchase Harold's house if the home does not receive approval from a licensed home inspector. What type of condition is present in this agreement?

- ***Resource Video***: http://thebusinessprofessor.com/conditions-under-contract-precedent-and-subsequent/

25. What are the conditions regarding payment, delivery, and tender of performance?

Tendering performance means to offer or attempt to perform the agreement. Often a party's offer or attempt to perform is sufficient to satisfy the condition of performance and obligate the other party's performance. That is, a party cannot avoid her obligation under the contract by failing to accept the other party's tender of performance. One party offering or attempting to perform is a condition to the other party's obligation to perform. Unless a contract states otherwise, the default rules under the UCC and Restatement place conditions on the delivery of services and the delivery of a product by a party to a contract.

- *UCC Condition of Performance* - The UCC states the buyer tendering payment to the seller of a good is a condition that must be satisfied before the seller has the duty to deliver the good.

    - *Example*: I offer to purchase an expensive jacket from you. You accept. I must offer to give you the money before you are obligated under the contract to give me the jacket.

- *Restatement Condition of Performance* - The Restatement, in contrast to the UCC, requires that a service provider must tender performance before the other party has a duty to pay for those services.

    - *Example*: I offer to paint your house for $500. You accept. I must complete my obligation to paint your house before you are obligated to pay me $500. In this case, tendering performance is completing my duty to paint.

In either case, rejecting a party's tender of performance can constitute a breach of contract if the tender of performance conforms to the requirements of the contract.

- ***Discussion***: Why do you think tending performance as a condition is treated differently under the UCC versus the Restatement?

- ***Practice Question***: Herman offers to purchase machinery for his business from Jamie. The party is silent on who must perform first. Herman asks that Jamie ship the goods to his business location so that he can inspect it. If it meets inspection, he will pay for the machinery. Jamie refuses and asks Herman to pay first. If both parties refuse to perform first, who is likely legally liable for breach of contract?

- ***Resource Video***: http://thebusinessprofessor.com/tendering-performance-of-contract/

26. What are "impossibility", "impracticability", and a "supervening frustration of purpose" of a contract?

Impossibility of performance, commercial impracticability, and a supervening frustration may excuse a party's duty to perform a contract. Further, it will relieve the party from liability for the non-performance.

- *Impossibility of Performance* - A party may be excused from her duty to perform under a contract if performance becomes impossible. Events that make a contract impossible include:

    - Illegality of the subject matter;

        - *Example*: I enter into a contract with you to sell you cleaning chemicals. The sale of such chemicals becomes illegal. My duty to perform is excused.

    - The subject of the contract (property) is destroyed;

        - *Example*: I enter into a contract to sell you a car. Before I can sell it to you, a branch falls from a large tree and destroys the car. I am excused from my duty to sell an undamaged car.

    - One of the parties to the contract dies or becomes physically or mentally disabled;

    - Natural forces interrupt the contract;

        - *Example*: A tornado, earthquake, severe storms, flooding, etc., permanently interrupts a party's ability to perform her contractual obligations.

    - Performance would cause substantial risk of physical harm to one party.

        - *Example*: I enter into an agreement to replace the shingles on our house. Upon inspection, the roof of the house appears to be structurally unsound. Replacing the shingles would put me in an unreasonably dangerous situation. I did not anticipate this danger when entering the contract. As such, my duty to perform is relieved.

    Impossibility of performance will only excuse a party's performance if the impossibility is not the fault of the non-performing party. Further, impossibility will not excuse liability for non-performance if the contract expressly contemplated the risk of conditions making performance impossible and specifically placed those risks upon the non-performing party.

    - *Example*: I enter into a contract to sell you a piece of machinery. In the contract, we expressly state that I must repair any malfunction of the machine that occurs prior to sale. The machinery breaks before the sale date. In this situation, the contract anticipates a risk and places it on me. I must repair the machine prior to sale.

- ***Discussion***: What do you think is the justification for allowing the above situations to excuse a person's duty under a contract? Can you think of any other situations that you believe should excuse a person's duty?

- ***Practice Question***: Derek agrees to sell Artem sheet rock for a construction job. Derek leaves the sheet rock outside and it rains. The sheet rock is ruined. Artem has to purchase sheet rock from another source at a much higher price. If Artem decides to sue Derek, what will be the likely outcome?

- *Commercial Impracticability* - Commercial impracticability arises when performance of a contract by a party has become unfeasibly difficult or costly to perform. The difference between impracticability and impossibility is that impracticability is still physically possible; however, performance will result in a substantial hardship to the performing party. Impracticability will excuse performance where the excused party did not have control over (or was not at fault for) the condition that made performance impracticable. Further, the excused party must not have expressly or impliedly assumed the risk of the duties becoming impracticable. Generally, impracticability is only found in extreme circumstances.

    - *Example*: I enter into an agreement with you to sell goods or perform services. The cost of performing the contract spikes because of a government tax, regulatory hurdles, raw material rates, etc. When entering the contract, we did not contemplate the price of goods or the cost of performing services to go up. If performing the contract would result in a serious financial burden to me, I may be able to get out of the contract by claiming that commercial impracticability excuses my performance.

    - ***Discussion***: How do you feel about the doctrine of commercial impracticability? How unforeseeable must the intervening event be to make the contract impracticable? How severe must the damage suffered by the performing party be?

    - ***Practice Question***: Tom agrees to sell lobsters to Suzie for resale in her restaurant. Tom sets the price at a specific dollar value per pound. Later, the government imposes a large tax on sales of lobsters. If Tom continues to sell at the contract price, he will go out of business. What are Tom's options?

    - ***Resource Video***: http://thebusinessprofessor.com/impossibility-and-impracticability/

- *Supervening Frustration of Purpose* - This is when circumstances arise that fundamentally frustrate a party's reason or purpose for entering a contract. The doctrine is similar to impracticability, but it does not relate to a party's hardship; rather it focuses on her expectation and purpose in entering the agreement. For a frustrating circumstance to relieve or excuse an obligation under a contract, the party cannot have assumed the risk of the circumstance (in the contract) or be at fault for the occurrence or the non-occurrence of the event or circumstance. Further, the occurrence or non-occurrence must have been a basic assumption on which the contract was made.

    - *Example*: John signs up for piano playing lessons from Tara. John suffers a horrible accident that causes him to lose dexterity in his hands. This is a frustration of purpose that was unforeseeable and substantially

frustrates the purpose of learning to play the piano. As such, John will be excused from performance of the contract. Suffering an economic loss is not a frustration of purpose.

- ***Discussion***: How do you feel about allowing an unforeseen event relieving a person's duty for performing a contract? How fundamental must the assumption be to the purpose of the contract? To what extent must each party understand this to be the fundamental purpose of the agreement?

- ***Practice Question***: Donald bids for and wins a government contract to construct a dam. The contract is subject to legislative approval. He begins preparing by entering into contracts with Lizzie for the purchase of cement. The cement supplier knows that the cement purchase is in preparation for the dam-building project. The legislator ultimately disapproves the dam project, which causes Donald to lose the contract. What is the possible result?

- ***Resource Video***: http://thebusinessprofessor.com/frustrating-purpose-in-a-contract/

27. What is "waiver" or "release" from a contract?

A waiver and a release serve to excuse one or both parties' duty of performance.

- *Waiver* - When a party intentionally relinquishes a right to enforce the contract. A waiver is generally employed after a party fails to perform.

    - *Example*: Per our contract, I am supposed to paint your house, but I fail to do so in the allotted time. You grant a waiver excusing my liability for failure to perform.

- *Release* - When one party is relieved from her promise of performance. A release generally occurs before a contracting party has to perform.

    - *Example*: We sign a contract where you agree to pay me to paint your house by the end of the month. Before my performance is due, I explain that I do not have time to paint your house. You sign a release that frees me of my duty to paint your house.

Waiver and release are often used synonymously to refer to a single document that simultaneously relieves a party from her duty to perform and excuses a non-performance or breach.

- ***Discussion***: What do you think is the justification for categorizing a release and waiver differently? Should the content of a release agreement be treated differently than the content of a waiver?

- ***Practice Question***: Pam enters into a contract with Lia to perform consulting services for her business. Pam has a great deal of work and is too busy to perform the contract. She asks Lia to let her out of the contract. What is Pam asking of Lia?

- ***Resource Video***: http://thebusinessprofessor.com/waiver-or-release-from-contract/

BREACH OF CONTRACT

28. What is a "breach of contract"?

A party who is not relieved from her duty of performance and fails to perform her obligations under a contract is said to breach the contract. Breach entails a failure to perform material duties in accordance with the agreement. This can include a complete lack of performance, partial performance of the material duties, or performance that fails to meet the demanded standard. A breach by one party relieves the other party's duty of performance.

- ***Discussion***: Should different types of breach be treated differently? Why or why not?
- ***Practice Question***: Joseph enters into a contract with Eric to build a deck on Eric's house. Joseph builds a deck that is weak, flimsy, and drastically varies from the design plans. Under what grounds might Joseph allege breach of contract against Eric?

29. What methods exist for resolving a breach of a contract?

There are several remedies or solutions available for a breach of contract:

- *Negotiated Settlement* - The parties may work out a satisfactory solution to most breaches of contract is resolved by the parties themselves through voluntary negotiated settlements.
- *Arbitration* - The parties may agree to submit their dispute to a neutral third party or parties to resolve the dispute.
- *Litigation* - The parties seek to enforce their contract rights in a court of law.

All of these methods are discussed in greater detail in other chapters of this text.

- ***Discussion***: What are the benefits of pursuing each of the available methods of resolving a breach of contract?

30. What remedies exist for breach of a contract?

A breach of contract action may result in any number of damages:

- *Compensatory Damages* - Compensatory damages are court-awarded damages to put the plaintiff in the same position as if the contract had been performed. It includes lost profits on the contract and the cost of substitute performance. A party's lost profits from the other party's breach of contract are the expected gains from performance of the contract. This would generally mean the value received minus the costs incurred in performing. This calculation is known as the "expectation damages".

- *Example*: You sign a contract to sell me supplies for my business. You back out of the contract and I have to purchase my supplier from another vendor. The cost to me to purchase the supplies from a new vendor is 15% higher than pursuant to our agreement. I have suffered damages of 15% of the contract value. Alternatively, if I backed out of the contract and my duties to purchase your supplies, you would have suffered expectation damages equal to the price of the goods minus your cost of supplying them to me.

- *Consequential Damages* - These are court-awarded damages arising from unusual losses which the parties knew would result from breach of the contract.

  - *Example*: I order cement from you to complete a large contract. I express to you that I intend to use the cement for the large construction contract and that time of deliver and quality of the goods is of utmost importance. You fail to deliver the cement and I am forced to purchase from another vendor. The cement arrives late and causes delays. I incur substantial penalties under the larger contract. Your breach of contract may have cost me compensatory damages equal to the price difference between our contract and the replacement vendor. The consequential damages, however, are the penalties incurred and any lost business as a result of your breach.

- *Liquidated Damages* - Liquidated damages are damages specified in the contract in the event of non-performance by either party. Liquidated damages are appropriate where real damages for breach of contract are likely to be uncertain. In such a case, the parties decide to specify in the contract the damages in the event of breach. Courts will enforce these liquidated damage clauses unless they seem to penalize the defendant instead of merely compensating the plaintiff for uncertain losses.

  - *Example*: I sign an agreement to provide you with consulting services. It is difficult to estimate the damage to your business if I fail to adequately perform. In the agreement we indicate that my failure to perform will result in damages of $1,000 to you. This liquidated damages clause is likely enforceable.

- *Nominal Damages* - Nominal damages include a small amount awarded by the court to the plaintiff for a breach of contract, which causes no financial injury to the plaintiff.

  - *Note*: In a tort action, a court may only award punitive damages if there is some finding of liability of the defendant. The court may not be able to find liability based upon tort theory in the absence of identifiable harm suffered by the plaintiff. If, however, the tort action is accompanied by a contract cause of action for the same conduct, the award of nominal damages for breach of contract may support a finding of punitive damages in the related tort action.

  - *Example*: I enter into a contract to provide you with consulting services. I fail to perform and you hire someone else. In this situation, it is difficult to determine if your business incurred any damages. If you sue me, a court may award nominal damages against me indicating that I was legally wrong in failing to perform my contractual duties. A common nominal damages amount is between $1 - 100.

- *Specific Performance* - Specific performance is a court-ordered, equitable remedy available when the subject matter of the contract is unique. A court order for specific performance directs a party to perform her duties under the contract. The court will only apply this remedy when the subject matter of the agreement is truly unique and irreplaceable. Specific performance is not available for service obligations.

- *Example*: You agree to sell me a Picasso painting that you inherited. At the last minute, you back out of the contract. I sue you to force you to sell me the painting. A court may order specific performance of the contract by ordering you to sell me the painting.

- *Rescission* - Rescission means to undue a contract and return the parties to the position they were in prior to entering the contract. This generally means returning property sold in the condition it was transferred and a return of the purchase price. This remedy is not available for executed services contracts.

- ***Discussion***: How do you feel about the concept of consequential damages? Is it fair to impose that extent of liability on a party if it is not part of the subject matter of the contract? Why or why not?

- ***Practice Question***: Taylor enters into a contract with Winnie to supply her with reinforced steel. Winnie is going to use the steel in the construction of a new manufacturing facility for her business. Winnie backs out of the contract when she realizes that she can get the steel 10% cheaper from a competitor. If Taylor sues Winnie, what are his options for damages?

- ***Resource Video***: http://thebusinessprofessor.com/damages-in-a-breach-of-contract-action/

31. What is "efficient breach"?

Efficient breach occurs when a party makes a conscious decision to breach a contract after balancing the costs of complying against fulfilling the contractual obligation. This normally arises in situations where a party will incur fewer losses or make more money by breaching the contract than the party would suffer in compensatory or consequential damages if sued.

- ***Discussion***: How do you feel about the concept of efficient breach? Should the decision of whether to breach a contract simply be an economic consideration or is there a moral consideration involved? Should morality or ethics play a role in business transactions? If so, to what extent and why?

- ***Practice Question***: Wendy enters into a contract to sell a piece of equipment to Laura. Before the sale is finalized, Erwin offers to purchase the equipment from Wendy at a much higher price. Wendy evaluates whether to breach the contract with Laura and sell the equipment to Erwin at the higher price. What might Wendy consider in making her decision?

- ***Resource Video***: http://thebusinessprofessor.com/efficient-breach-of-contract/

INTERPRETING A CONTRACT

32. What rules or standards do courts apply when interpreting contracts?

Courts in different jurisdictions may employ unique standards when interpreting the meaning of contract terms. Common approaches include:

- *Plain Meaning* - The majority of jurisdictions interpret contract provisions based upon their "plain meaning." That is, if a contract term is unambiguous, the court will apply the meaning commonly applied to the term or provision.

- *Reasonable Person* - Other jurisdictions interpret contract provisions based upon how a "reasonable person" in the applicable circumstances would interpret the contract. This is known as the "objective standard."

- *Subjective Intent* - Some jurisdictions will look to any outside evidence to determine the subjective intent of the parties.

Some other common approaches to interpreting contract provisions are as follows:

- *Express Terms* - Afford the greatest weight to the contract's express terms.

- *Implied Terms* - Look to implied terms originating from the course of dealing, course of performance, or trade usage.

- *Specific Terms* - Give greater weight to specific terms than general terms.

- *Actively Negotiated Terms* - Terms that are actually negotiated between the parties are given greater weight than standard terms or boilerplate.

- *Totality of Circumstances* - The court will take into consideration the overall circumstances of the agreement.

- *Contract Purpose* - The purpose of the contract, if ascertainable, should be considered in interpreting the intentions of the parties.

- *All Writings* - Interpret all parts of the contract as a whole (including when the contract consists of multiple writings).

- *Context* - Words are given their prevailing meaning in the context of the contract.

- *Trade Terms & Course of Dealing* - Specific trade terms are to be interpreted in accordance with their meaning in the trade. The parties' intentions are interpreted consistently and in accordance with course of performance, dealing, and trade usage.

- *Interpret Against Drafter* - Ambiguous terms may be interpreted against the drafter.

Jurisdictions may employ any combination of these approaches when interpreting provisions or giving weight to conflicting terms.

- ***Discussion***: Do you agree with this hierarchy of contractual interpretation? Why or why not?

- ***Practice Question***: Ben and Jerry enter into a contract for the sale and purchase of goods. The contract is very short and is written in plain language. Soon after business dealings begin, Ben and Jerry argue of the extent of Ben's obligation to supply all of the goods that Jerry needs. Jerry sues Ben for breach of contract for failing to

meet his supply demands. Ben argues that the contract did not obligate him to meet this level of supply demand. In interpreting the terms of the contract, what are some of the rules that a court will employ?

- ***Resource Video***: http://thebusinessprofessor.com/role-of-state-in-interpreting-contract/

33. What is the "Parol Evidence Rule"?

This rule or doctrine concerns the evidence that parties may introduce to the court interpreting the disputed contract. Specifically, it addresses the introduction into court of any evidence of the parties' agreement that arose prior to the execution of the final agreement and is not included within the written document. This rule either allows or disallows a party from introducing that evidence to the court to modify or add terms to a contract. The purpose of this rule is to prevent confusion in the interpretation of the contract and fraud by any party against another.

- *Prior Communications* - The parol evidence rule primarily serves to exclude any evidence of prior negotiations (either before or contemporaneous with the signing of the contract) that has the effect of altering the express terms of the agreement. Information or communications contemporaneous with execution of the contract may be admissible in interpreting the contract, but are not admissible if they expressly contradict unambiguous, contract terms.

    - *Example*: You and I enter into a contract for the sale of goods. Later, we argue over the what goods are being sold under the contract. In a lawsuit over the matter, the parol evidence rule will cause the court not to consider our prior communications before we executed the contract if those communications contradict the contract.

- *Final Agreement* - For the parol evidence rule to apply, the contract must be the final agreement between the parties. This means the contract is an "integration". If the party is determined to be a final expression of the parties' agreement, the parol evidence rule is effective to limit what information outside of the writing the parties can introduce to the court in interpreting the agreement.

    - *Example*: In the above example, the court will determine whether the contract was meant to contain all of the terms of our agreement. If we specifically make reference to our prior communications in the contract, it would not be an integration. In determining whether the contract is the final agreement, the court will look to see if the contract includes an integration clause.

- *Integration Clause* - The best way to make certain that the contract is deemed a complete and final expression of the parties' intent is to include an "integration clause." An integration clause, also called a "merger clause," is a provision in a contract that says that the contract is a complete and final understanding of all the terms of the agreement. In other words, these clauses state that the contract is intended to be a complete integration. Some merger clauses will specifically state that any outside information or communications contemporaneous with the execution of the contract or prior thereto should not be considered a part of the contract. Other, more specific clauses, will specifically reference outside information, documents, or communications and state whether the terms of those items are included in the final agreement. These clauses are usually conclusive unless a contract defense applies (such as fraud, duress, etc.).

    - *Example*: In the above examples, the court finds a clause that states, "This contract is the complete and

final agreement of the parties". In that case, the court will not review our prior email communications to determine what goods are included under the contract. The court will only look at the provisions of the contract itself.

An agreement may appear on its face as simply a partial understanding of the agreement between the parties. In such as case, the contract is not an integration.

- ***Discussion***: Why do you think courts want to exclude prior communications that alter or contradict the terms of the contract? Can you think of any situations in which the court should certainly review prior communications, even if an integration clause is present?

- ***Practice Question***: Clayton enters into an agreement with Samson to provide consulting services. Clayton and Samson later sue each other over the extent of services Clayton is obligated to perform for Samson. Clayton argues that the contract only calls for him to do so preliminary business analysis. Samson argues that Clayton was obligated to perform far more services. He says that prior communications indicate the extent of Clayton's intended services. What do we need to know to determine whether the court will consider the prior communications in determining Clayton's obligations under the contract?

- ***Resource Video***: http://thebusinessprofessor.com/parole-evidence-rule/

34. What is a "complete integration" and "partial integration"?

The term integration determines the extent to which all provisions of the contract are included in the written document. It can either be completely integrated or partially integrated.

- *Complete Integration* - A complete integration is when the contract contains all of the facts or information regarding the parties' agreement. If the court determines that a contract is a complete integration, the parol evidence rule limits all prior or contemporaneous outside evidence that contradicts, modifies, or supplements the contract. A complete integration will generally contain a strong integration clause specifically excluding any outside information not specifically mentioned in the terms of the agreement.

    - *Example*: I enter into a contract to supply you with goods. If the court is called upon to determine the extent of our duties, the court will look to see if the document demonstrates an intent to include all of out terms in the agreement. Including a clause in the contract stating that this is the full and complete understanding of the parties will generally make the document a complete integration. As such, the court will not consider any communications prior to or contemporaneous with the execution of the contract.

- *Partial Integration* - The written document may contain only part of the information constituting the agreement between the parties. If a court determines that a contract is a partial integration, it will allow certain outside evidence that serves to supplement or explain provisions of the contract. Even with a partial integration, the parol evidence rule restricts outside evidence of prior or contemporaneous communications that specifically contradict the terms of the written contract. Partial integrations generally do not contain integration clauses. Often, the agreement itself will make reference to outside communications to clarify certain provisions of the agreement.

- *Example*: In the example above, the court determines if the contract is a complete or partial integration. In the agreement, if we make reference to prior communications or it is apparent that we intended for the agreement to include or incorporate prior communications, it is a partial integration. The court would consider any prior communications that appear to supplement or add to the written contract. The court will not consider communications that contradict the express terms of the contract.

- ***Discussion***: Why do you think the court disallows the consideration of contemporaneous and prior communications of the contract is a complete integration? Should the court consider prior communications to fully understand the intent and agreement of the parties? Why or why not?

- ***Practice Question***: Harold enters into a contract so supply Dana with manufacturing materials. The contract does not contain an integration clause. When a dispute arises between Harold and Dana regarding each party's duties under the agreement, Dana wants the court to consider a chain of emails between her and Harold to explain the extent of their duties. Under what conditions will the court consider the chain of emails?

- ***Resource Video***: http://thebusinessprofessor.com/contract-complet-and-partial-integrations/

35. When does the parol evidence rule not bar the consideration of extrinsic evidence to a contract?

Extrinsic evidence or information prior to or contemporaneous with the formation of the contract cannot be introduced to contradict the contract. Nonetheless, it may be necessary to employ extrinsic evidence or information from outside of the contract for the following reasons:

- to aid in the interpretation of existing terms (for example, when an ambiguity exists),

- to show that a writing is or is not an integration,

- to establish that an integration is complete or partial,

- to establish subsequent agreements or modifications between the parties (i.e., those arising after the contract is completed), or

- to show that the terms of the contract were the product of illegality, fraud, duress, mistake, lack of consideration or other invalidating cause.

These exceptions exist to reduce misunderstanding and fraud between the parties and to promote judicial efficiency in the interpretation of agreements.

- ***Discussion***: Do you agree with these rules for allowing prior communications in the interpretation of a contract? Why or why not?

- ***Practice Question***: Alice enters into a contract with Hannah. They end up in court pursuant to an argument over the terms of the agreement. The contract contains and integration clause, so the court will not consider prior

communications that contradict or add to the written agreement. Alice and Hannah are arguing over the type of goods described under the contract. Hannah argues that the description of the goods is ambiguous. Under what conditions will the court review prior communications between Alice and Hannah?

- ***Resource Video***: http://thebusinessprofessor.com/exceptions-to-the-parol-evidence-rule/

36. What is a "patent ambiguity" and "latent ambiguity"?

One important exception to the parol evidence rule is the use of extrinsic evidence to determine the meaning the parties attribute to certain terms or provisions. Generally, a court will give a term its common meaning or the meaning common in the context of the contract (such as a particular trade usage). Nonetheless, often a term or provision of the contract will be ambiguous. In such a case, ambiguities are broken into latent and patent ambiguities. Generally, outside evidence may be introduced to clear up an ambiguity that is obvious on the face of the document. This is known as a "patent" ambiguity. If a party claims that the contract contains an ambiguous term, but it is not obvious on the face of the contract, the party is claiming that a "latent" ambiguity exists. In such a case the party may be able to introduce outside evidence to show that an ambiguity exists. If the court determines that an ambiguity exists, it may consider extrinsic evidence to resolve the ambiguity. Many courts do not distinguish between patent and latent ambiguities. If an ambiguity exists, extrinsic evidence is allowed to the extent necessary to clear up the ambiguity. The parol evidence rule's prohibition on the use of evidence to change or add to the contract remains intact.

- *Example*: You and I enter into a contract. When a dispute arises, we ask the court to resolve the dispute. When interpreting the terms of the contract the court will use established rules for interpreting the meaning of words and clauses. If the court determines that a word or clause is ambiguous when reading it (a patent ambiguity), it may allow outside information to explain the term. If the court does not read a term as ambiguous, it may allow me to introduce outside evidence to demonstrate that it is ambiguous. If I am successful in demonstrating an ambiguity, the court will then consider outside information to explain the ambiguous term.

- ***Discussion***: Why do you think the court treats patent and latent ambiguities differently? Should the court consider all evidence and prior communications when determining the meaning or intent of the parties? Why or why not?

- ***Practice Question***: Alice enters into a contract with Hannah. They end up in court pursuant to an argument over the terms of the agreement. The contract contains an integration clause, so the court will not consider prior communications that contradict or add to the written agreement. Alice are arguing over the type of goods described under the contract. Hannah argues that the description of the goods is ambiguous. Under what conditions will the court review prior communications between Alice and Hannah?

- ***Resource Video***: http://thebusinessprofessor.com/patent-and-latent-ambiguities-in-a-contract/