Unit III

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Contracts

Chapter 9 Contracts, Part I: Introduction and Formation

In this chapter you will:

- Distinguish between the two bodies of law that govern contracts.
- Identify the five elements of a contract.
- Identify defenses to contracts.

Chapter 10 Contracts, Part II: The UCC

In this chapter you will:

- Explain the rule of acceptance under common law and under the UCC.
- Understand the various types of contracts used in transactions between buyers and sellers.
- Identify which contracts must be made in writing and explain what constitutes "in writing."

Chapter 11 Contracts, Part III: Risk of Loss Rules, Negotiating Contracts, and Working With an Attorney

In this chapter you will:

- Name and define the types of damages available for breach of contract.
- Understand the role of a manager when entering into contracts.

Contracts, Part I: Introduction and Formation

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As a manager, you may find yourself dealing with contracts on a regular basis. For instance, contracts may be presented to you for signature or you may be asked to hire an employee. Perhaps you will enter into contracts to purchase goods for the business or to arrange insurance coverage. In any event, understanding the mechanics of contract law is essential to effectively carry out your obligations.

This chapter presents an overview of contract law. It is not meant to take the place of legal advice, nor will it make you an expert in contract law. What you should derive from these materials is an appreciation of the complexities of contract law and a mindset for acting preventively and strategically in your business dealings. Warding off the possibility of a contract lawsuit is a cost-saving measure. Furthermore, you should acquire an understanding of **black letter law**, that is, the theories of law in the context of business and employment contracts.

9.1 What Law Governs Your Contract?

Contract law is governed by either the common law or the Uniform Commercial Code (UCC). As a student, the first question you should ask yourself when contemplating a contract problem is: What body of law is this contract under? Fortunately, the answer is relatively simple:

- If the contract involves the sale of goods, it is governed by the Uniform Commercial Code (whether the people involved are merchants or nonmerchants); and
- If the contract deals with anything other than sales of goods (e.g., real estate, insurance, or personal services), then it is governed by the common law.

As a manager, you will need to know which body of law applies to a particular contract. For example, **warranties** apply to goods sold pursuant to the UCC but do not apply to contracts under the common law. When you hire an employee to join your staff, you enter into a contract that is governed by principles of common law. Selling food in your restaurant, however, creates a contract governed by the UCC. What difference does it make which set of rules applies? In the restaurant example, the UCC covers a warranty about the quality of goods, whereas the common law does not. An employee could not sue for breach of warranty for the quality of his or her office, for example, but could for the quality of the food in your restaurant. Table 9.1 provides some examples of types of contracts covered under each body of law. Many other differences between the two regimes will be examined throughout this chapter.

Table 9.1: Contracts governed by common law or the Uniform Commercial Code	
Examples of Common Law Contracts	**Examples of Uniform Commercial Code Contracts**
Real estate (e.g., selling a house)	Sale of goods (e.g., purchasing an automobile or office equipment) between merchants or nonmerchants
Insurance	
Personal services (e.g., hiring an employee or professional)	

Sometimes a contract comprises both goods and services. For example, if you hired people to build your house, they would need to supply material goods, such as the bricks, cement, wiring, and wood, as well as services, that is, constructing the building. What law governs such a contract? The answer lies is the **predominant test**, which asks: Which is greater, the cost of the goods (UCC) or the cost of the services (common law)? If the cost of the goods is greater, then the contract is governed by the UCC; if the cost of the services is greater, then the contract is governed by the common law. For example, suppose that a buyer hires a contractor to construct a new factory. The goods to build the new plant cost $450,000 and the cost of the contractor's services total $1 million. Under the predominant test, the cost of the services is greater, and therefore, the contract is governed by the common law.

9.2 Elements of a Contract

Although all contracts contain promises that are enforceable, not all promises rise to the level of a contract. Rather, only promises that meet certain criteria are considered to be valid contracts. For a valid contract to be formed that is enforceable by a court, each of the following criteria must be present:

1. Offer
2. Acceptance
3. Consideration (something of legal value given and received by each party to the contract)
4. Capacity (mental capacity or legal ability)
5. Legality (of purpose)

We will discuss each one of these elements in the following sections. The phrase *enforceable by a court* is significant because it means that a court can assess monetary damages against a party who does not comply with the terms of the agreement. Thus, it is important to recognize these defining elements, for example, when a seemingly innocent statement becomes a binding statement leading to contract formation.

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Because an offer and acceptance are sent over electronically by email, or in a Tweet or text message, they are in a tangible form or in writing. As such, the fact that it is an electronic form does not affect contract formation. What matters is that it is in writing—clearly an advantage over contracts made by the parties that are oral, for a writing, that means the terms are stated in the correspondence itself.

What has changed with regard to electronic contract formation is the signature. All states but three (New York, Illinois, and Washington) have adopted the Uniform Electronic Transactions Act. Although each state's law as adopted has different components, the following is an example of Montana's law:

> **30-18-104. Use of electronic records and electronic signatures—variation by agreement.**
>
> (2) This part applies only to transactions between parties[,] each of which has agreed to conduct transactions by electronic means. Whether the parties agree to conduct a transaction by electronic means is determined from the context and surrounding circumstances, including the parties' conduct.
>
> (3) A party that agrees to conduct a transaction by electronic means may refuse to conduct other transactions by electronic means. The right granted by this subsection may not be waived by agreement.
>
> (4) Except as otherwise provided in this part, the effect of any of its provisions may be varied by agreement. The presence in certain provisions of this part of the words "unless otherwise agreed," or words of similar import, does not imply that the effect of other provisions may not be varied by agreement.
>
> (5) Whether an electronic record or electronic signature has legal consequences is determined by this part and other applicable law.
>
> **30-18-106. Legal recognition of electronic records, electronic signatures, and electronic contracts**.
>
> (1) A record or signature may not be denied legal effect or enforceability solely because it is in electronic form.
>
> (2) A contract may not be denied legal effect or enforceability solely because an electronic record was used in its formation.
>
> (3) If a law requires a record to be in writing, an electronic record satisfies the law.
>
> (4) If a law requires a signature, an electronic signature satisfies the law.

Some states make the law expressly apply to commercial as applied to personal transactions. Others also state that an electronic signature is not applicable to documents such as wills.

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ESIGN is a federal version of the same law that was enacted by Congress to facilitate the use of electronic records and signatures in interstate or foreign commerce. It holds that a contract relating to such a transaction may not be denied legal effect, validity, or enforceability solely because an electronic signature or electronic record was used in its formation. (See U.S. Government Printing Office (GPO), Public Law 106-229—Electronic Signatures in Global and National Commerce Act at http://www.gpo.gov/fdsys/pkg/PLAW-106publ229/content-detail.html.)

Offers

The two parties to a contract are the **offeror** (the person making the offer) and the **offeree** (the person who has the power to accept the offer). Suppose an offeror says, "I will sell you a basset hound puppy." This offer creates in the offeree the **power of acceptance**. Therefore, one can say that the offeror is the party who makes the offer, and the offeree is the party who has the power of acceptance. Imagine that you wish to purchase a new copier machine for your business and that you have been instructed to contact a particular supplier, which we will call Acme Business Supply Company. You would most likely begin by calling and inquiring about machine types and prices. Information would be exchanged about your business needs and what machines would meet those needs. Although informal, these discussions are called **preliminary negotiations**. Preliminary negotiations are the conversations, e-mails, telephone conversations, and other dialogue that occur before a contract is created. Note that these talks are completely unenforceable between the parties.

How, then, does one distinguish a preliminary negotiation from a legally binding **offer**? An offer has three characteristics that set it apart from a preliminary negotiation. First, the language of an offer is *definite and certain*. If you say to Acme Business Supply Company, "I offer to buy the 123C Machine for $5,000," that language is considered definite and certain and constitutes an offer because it clearly expresses the intent to purchase the goods. Second, the transaction between the parties must *look like* a contract and not something else. This is called the **objective test**. "Objective" means how it appears to a hypothetical reasonable third party. Third, the offer must be *communicated* to the offeree (see Table 9.2).

Table 9.2: Distinctions between a preliminary negotiation and an offer

	PRELIMINARY NEGOTIATION	OFFER
Language	"I am thinking about . . ."	"I offer . . ."
	"I might sell my goats . . ."	"I agree to sell you my goats . . ."
	"I am thinking about buying that car . . ."	"I will buy that car from you."
Objective Test	Does not look like the two parties are entering into a contract.	Appears to a reasonable third party that the two parties are entering into a contract.
Communication to the Offeree	No offer is communicated.	Offer is communicated.

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Consider the following example: You opened your mail at work today and received this offer letter.

> ***Carl Beethoven Real Estate***
>
> ***Dear Customer:***
>
> ***As you are aware, I am the owner of a substantial amount of real estate in the Pocono Mountains. I am thinking about retiring next year and need to sell off a substantial portion of my holdings. If you are interested, please contact me.***
>
> ***Sincerely,***
>
> ***Carl***

If you wrote back and said, "I accept," would you have a contract with Carl? The answer is no. To have a contract, you must first have an offer, and to have an offer, the language must be definite and certain. The language in Carl's letter "If you are interested" and "I am thinking about" is instead vague and noncommittal. Therefore, this dialogue opening is a preliminary negotiation only.

Offers in Large Communicating Media

Sometimes, the language of an offer appears in a **large communicating medium**. This is a site like a newspaper, webpage, Tweet, or television advertisement, which potentially has thousands of people hearing or seeing the "offer." The problem is that when thousands of people hear an offer simultaneously, no one has the power of acceptance. And, if no one has the power to accept, then it is not considered an offer but rather a preliminary negotiation, even if it is couched in language that is definite and certain.

There is an exception to this rule, however. In these situations, a message in a large communicating medium does constitute an offer because the number of potential offerees is *limited*. For example, if the offer states, "First come, first served!" then only the first person has the power of acceptance. Or, if the offer limits the class of offerees to the first 100 callers, then only 100 people have the power of acceptance. Another example would be if it is a reward contract offered by a local police department; then only the person giving information leading to the arrest of the fugitive would have the power of acceptance.

Once it has been established that an offer has been made, four events may then take place, as illustrated in Figure 9.1.

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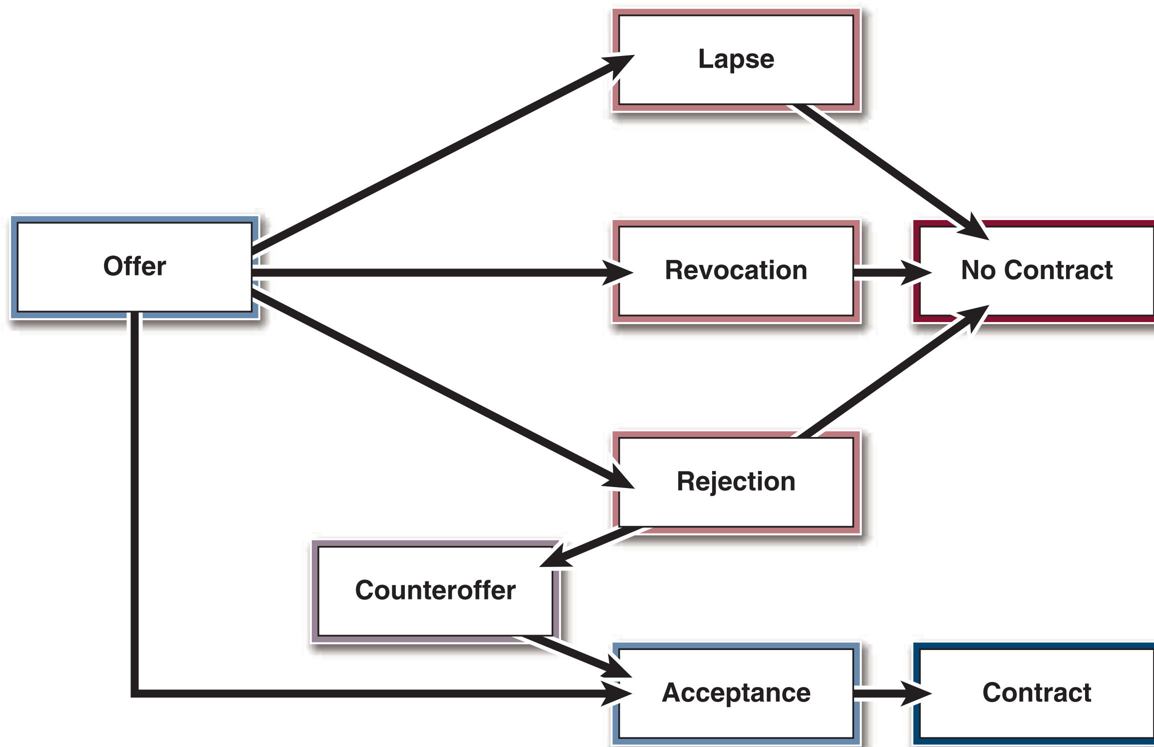
Figure 9.1: Four events that can happen after an offer



In order for a contract to be made, an offer must be accepted. If an offer is initially rejected, a counteroffer can then be made and, if accepted, lead to a contract.

Lapse

Lapse is the outcome that simply refers to the fact that an offer does not last forever. After a certain amount of time, the offer expires. How much time is that? The answer is, it depends on the situation. In most businesses, an offer is open for a reasonable amount of time, say, two weeks. However, if the business is a **wildly fluctuating market**, such as stocks or commodities, the offer can lapse after only a few seconds. An important exception to this rule is the **option contract**, a frequently used and highly valuable business tool. In an option contract, the offeree will pay money to hold the offer open for a certain amount of time.

Consider, for example, that the offeror agrees to sell the offeree a $10 million printing press. The offeree is not sure whether financing for the press is available and needs to meet with bankers to determine if he can obtain a loan. At the same time, the offeree does not want the offeror to sell the press to anyone else. In such a case, the offeree could pay a certain sum, e.g., $1,000, to the offeror to hold the offer open for 30 days contingent on getting a bank loan. If the bank does make the loan, the offeree still has the power of acceptance, but if the bank says no, then all the offeree has lost is the $1,000.

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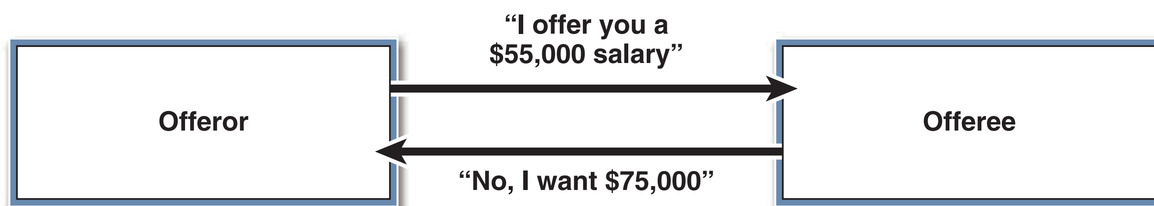
Rejection and Counteroffer

In **rejection**, the offeror makes an offer to the offeree. The offeree then either says "no," which is an *express rejection*, or the offeree makes a **counteroffer**, which is also a rejection of the original offer. In either case, both responses negate the original offer and make the offeree the offeror, as illustrated in Figure 9.2.

Figure 9.2: Rejection and counteroffer

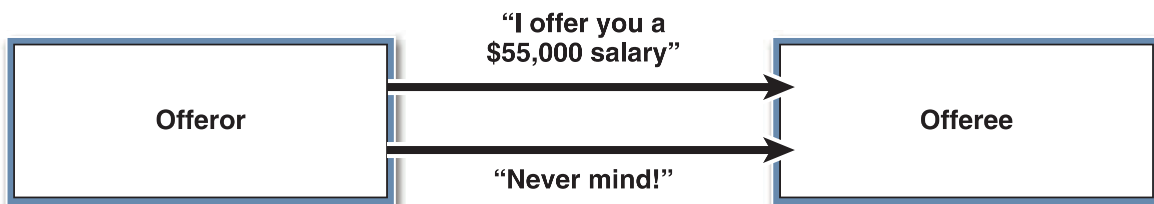


This response by the offeree kills the original offer. Now the original offeror becomes the offeree and has the power to accept the offeree's offer of $75,000.

Revocation

In **revocation**, the offeror takes back the offer before the offeree has time to accept. See Figure 9.3.

Figure 9.3: Offer revocation



Acceptance

Acceptance is one of the four events that can happen after a valid offer, but it is the only one that leads to *contact formation* (the second element). Suppose the offeror said, "I will sell you a puppy for $200." If the offeree says, "I'd love a puppy! I'll take it!" then he or she has assented to the terms of the offer and contract formation has begun.

The Mirror Image Rule

In the acceptance phase, it is significant whether the contract is governed by the UCC or by common law. Under the common law, acceptance must mirror the offer. For example, if you offer to sell me a house for $450,000, I must use those exact terms in my acceptance. Any deviation from the terms of the offer in the terms of my acceptance constitutes a

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counteroffer, not an acceptance. Under the common law, the rule for acceptance is called the **mirror image rule**. This means that all the terms in the offer must match (mirror) all the terms in the acceptance. If the terms do *not* match, the parties are still engaged in preliminary negotiations. This is illustrated in Table 9.3 and in the examples that follow.

Table 9.3: Offer and acceptance

OFFER	ACCEPTANCE	
"I offer *A* and *B* and *C*."	"I accept *A* and *B* and *C*."	This is a mirror image acceptance.
"I offer *A* and *B* and *C*."	"I accept." (It is implied that *A* and *B* and *C* are included in the acceptance.)	This is a mirror image acceptance.
"I offer *A* and *B* and *C*."	"I accept, but I want *D*, too."	This is *not* a mirror image acceptance but a counteroffer; there is no contract formation.
"I offer you employment for six months at a salary of $50,000."	"I accept, but I want health insurance, too."	This is not a mirror image acceptance but a counteroffer; there is no contract formation.

Acceptance Under the UCC

Recall that the Uniform Commercial Code applies to contracts involving the sale of goods. This is a law that was adopted by all 50 states to make the sale of goods from people in one state to another relatively uniform.

Under the UCC, no mirror image acceptance is required. If the offeree changes the terms of the offer, there may still be a contract. If the parties are *not* both **merchants**, the new terms in the acceptance become a proposal that the offeror may accept or reject. If the parties are both merchants, the new terms automatically become part of the contract unless the offeror objects or states that the offer can be accepted only in mirror image fashion. We will look at this rule in much more detail in Chapter 10, Contracts, Part II: The UCC.

Consideration

Consideration is the third element required of all contracts. Despite its importance to contract law and its long and deep history, it has really become quite archaic. As a result, we will discuss it only briefly. The concept of consideration is what makes a **gift** different from a contract.

To have consideration means that the promise by the promisor gets the promisee to do something he or she was not previously legally bound to do. For example, if Glenda says to Bill, "I will give you $1,000 if you find my lost dog," the offer of $1,000 is causing Bill to do something he has no legal obligation to do. When Bill finds the dog, his action is what causes Glenda to promise the $1,000. We say that the promise of the $1,000 caused Bill to find the dog, and conversely, Bill finding the dog is what caused Glenda to promise the $1,000. A shorthand way to say this is, the promise (of $1,000) induced the **detriment** (finding the dog), and the detriment (finding the dog) induced the promise (of $1,000).

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Compare this scenario with the following: Suppose Glenda said to Bill, a police officer, that she would give him $1,000 to find her dog. Did the promise of the $1,000 cause Bill to do anything he was not already previously, legally bound to do? No. As a police officer, he is already obligated to do many things, including finding lost dogs, so her promise did not cause him to do something he wasn't already obligated to do; thus, there is no consideration. Her promise to give him the $1,000 is completely unenforceable.

In a *gift*, the bestower might announce, "I am getting you a new car for your birthday!" That statement is another example of a completely unenforceable promise. While the promise to get you a new car for your birthday might cause you to do something that you were not previously legally bound to do, such as sell your current car (the promise caused the detriment), selling your car is not why the promisor said he would get you a new car, and so the detriment did not cause the promise. Therefore, there is no consideration, so if you sued your would-be benefactor when your birthday came and went and no car arrived in your driveway, you would lose in court because a gift is not a contract. If that same person, however, had promised, "I am getting you a new car for your birthday if you get an A in your law class," then you *would* have a contract. What is the difference? The promise to get you a car induced or caused you to do something you were not previously, legally bound to do (work for an A). And your getting the A is what caused the gift giver to promise the car: The car caused the A, and the A caused the car. Or stated another way, the promise (of the gift of a car) induced the detriment (earning an A), and the detriment (earning an A) induced the promise (of the gift of a car).

Capacity

The fourth element of a valid contract is **capacity**. This relates to the mental state of the parties to the contract. A party who *lacks capacity* does not have the ability to understand the consequences of entering into a contract.

Mental Competence

With regard to lack of mental capacity, people generally fall into two different categories. First, some people are deemed mentally incompetent by a court because they may have a disease such as Alzheimer's, or they may be acting in such a way that their family members ask the court to appoint a guardian. In either scenario, the fact that someone has gone to court and been adjudicated insane is a finding that a person is ***non compos mentis***, or lacking mental capacity. As a general rule, a person lacks capacity if he or she is judged by the courts to be so mentally ill that he or she can no longer handle personal business, and thus is assigned a legal guardian. Other categories of persons who may be assigned a guardian by a court are "habitual drunkards," another special type of category lacking mental capacity, and **minors** (those under the age of 18).

Persons who have been adjudicated insane can enter into a contract only through their guardians; if the insane person enters into a contract on his or her own, it is void. As a result, the insane person would have no liability for any damages to the goods and would be entitled to his or her money back.

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Minors

Businesses more often deal with minors since they may constitute a large segment of their consumers, in retail sales, for example. Contracts with minors are not void, but rather **voidable**.

The law confers special protection on minors when it comes to disaffirming contracts. This attitude stems from the common law notion that children need special protection because, compared with adults, they are innocent, gullible, and easy to be taken advantage of. Thus, a minor who enters into a contract may choose to escape his or her contractual liability, which is why contracts with minors are called voidable; they may be **avoided** by the minor. Such avoidance is called **disaffirmance**. A person may exercise this right only before reaching the age of 18 or for a reasonable time thereafter. Suppose that a 16-year-old purchases a car on credit, pays for two months, and then decides to return the car. The minor may disaffirm the contract but must return the car. Then the seller must return to the minor his or her payments to date. In short, the minor is completely protected from liability when entering into a contract. Needless to say, few merchants are willing to enter into a contract with a minor.

Once a minor reaches 18, the minor reaches **majority** and may want to continue, rather than disaffirm, any contracts entered into before the age of 18. In this case, the person now of majority is said to ratify the contract. **Ratification** can be *implied* (by retaining the goods, for example) or *express* (e.g., by agreeing orally or in writing to continue the contract). Either way, the person is now liable for **performance** of the contract (to fulfill one's obligations under its terms) he or she entered into as a minor, just as any other adult would be.

But are minors liable for anything? Yes, in some instances, they are liable for their contracts. Specifically, the courts have ruled that minors are liable for **necessaries**, which comprise food, drink, clothing, shelter, medical care, and education. In evaluating whether an item is a necessary or a luxury (and therefore not exempt from disaffirmance), courts generally look at the minor child's needs in relation to his or her upbringing and the relative wealth of the minor's parents. The minor is liable, however, only for the fair market value of such services, which may be considerably less than the price charged by the provider.

Business contracts entered into by *nonemancipated minors* (minors who are still dependent on their parents or guardians) are also exempt from disaffirmance. The rationale here is clear: a minor who is mature enough to run his or her own business is also mature enough to be held responsible for contracts entered into on behalf of that business. However, that same minor is still free to disaffirm personal contracts he or she enters into that are unrelated to the business.

If a minor lies about his or her age in order to induce an adult to enter into a contract, legal opinion is split among the states. Some states allow the adult to recover damages from the minor for the tort of fraud, while others allow the minor to disaffirm the contract, even when the minor offered fraudulent proof of age to induce the adult to enter into the contract.

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So how can a business protect itself from the impact of minors' disaffirmance? By either requiring minors to obtain an adult cosigner for any contract they enter into, or by refusing to deal with minors altogether. The second option is seldom exercised, because minors represent a very important market for most vendors. And, with the exception of large-ticket items, the first option is also often impractical. Why then do merchants deal with minors? Because the benefit of courting this profitable consumer segment far outweighs the potential cost of disaffirmance. As a businessperson, it is essential that you are aware of those persons with whom you are contracting and their potential for reneging on their contracts with you.

Legality

The fifth and final element of a contract is the requirement that the contract be legal. So even if it fulfills all other four elements, if it is for the transfer of goods or services that are illegal, it is invalid.

An illegal contract is one that is defined by the law of its state as being illegal. Each state has different laws on this topic, but all states agree, for example, that hiring someone to commit murder is an illegal contract, since the purpose of the contract is illegal. Similarly, if Bob orders "100 grams of cocaine" from Harriett, that too is an illegal contract and unenforceable by the courts.

Sunday Contracts

In some states, entering into a contract on a Sunday renders the contract void. These laws originated from the religious belief that entering into business transactions on Sunday (when one should be observing the Sabbath and attending church) is immoral. These beliefs were codified into legislation known as **Blue Laws** and are still in force to varying degrees in some states.

Overly Broad Noncompetition Contracts

Suppose that the Fabulous Hotel hires you as head chef under a two-year employment contract. After two years, another hotel wants to hire you. However, in the original employment contract you signed with the Fabulous, the following paragraph appears:

> 22. The below-signed agrees not to work as a chef for another hotel in the same metropolitan area for a period of two years after leaving our employ.

This is called a *covenant not to compete*, or a **noncompetition clause**. As a general rule, these clauses have been held valid in court. Does this mean that you cannot work for another hotel? That depends on certain factors that a court will consider to determine whether the clause is enforceable. These include:

- Whether the agreement stood alone or was contained in an employment contract. If alone, the agreement is void;
- The length of time involved. If too great, the contract is void; and

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- The location or distance involved. If the contract prohibits you from working in the Western Hemisphere, that scope is too great, but the same county may be small enough to consider the agreement enforceable.

If you agreed never to be a chef on the entire East Coast for the rest of your life, a court would most likely find that agreement illegal because it is in force for too much time and over too great a distance. In contract law, a clear dividing line between reasonable and unreasonable terms does not exist but is a matter of judicial discretion, so a court will study each case individually. As an employee, you should be aware of the implications of signing such an agreement, and as a manager, you should make sure the language of your employment contracts is carefully drafted.

You may see this type of clause not only as an employee or manager but also when you sell a business. Part of the selling contract of your restaurant may include the requirement that you not open another restaurant in the same city. Here, too, the courts will look at the same factors mentioned above to determine whether the clause is enforceable.

Exculpatory Agreements

Suppose that you have been injured while skiing. On the back of the lift ticket, the resort printed a clause stating, "In the event of injury, the resort assumes no responsibility." Such an **exculpatory clause**, or *waiver of liability*, states in writing that the owner is not liable for injury or harm to users of the facilities. Can you sue for your injuries nevertheless?

The good news is that, in many states, an exculpatory clause or waiver of liability is void. In New York State (and many others), these clauses are illegal in specific settings. For example, an exculpatory clause given to attendees at a place of amusement is void. Thus, the owner can be sued even if the customer signed an agreement saying the owner would not be liable.

Failure to Follow Licensing Requirements

At law, there exist two types of licenses: One type is for the purpose of ensuring competency, and the other type is a government device for collecting revenues.

Doctors, lawyers, and other professionals must pass a test before the state will award them a license to practice. If these professionals do not obtain a license but nevertheless enter into a contract, that contract is voidable by the other party. For example, Dr. Jones never passed his medical examinations, but set up his own practice anyway. He sees a patient and sends the patient a bill for his services. That patient may avoid the contract. This means that the patient may choose not to pay because Dr. Jones is unlicensed. Economically, this is a powerful incentive to obtain a license.

The second type of license is one established for the purpose of raising revenue for the state. Suppose you want to start a business, such as a bar. As part of the process of setting it up, you would need to obtain, in this case, a liquor license. A liquor license is an example of the type of license the state uses to collect money rather than to establish competency. If a person subject to this type of licensing requirement fails to obtain a license, his or her contracts are still enforceable. Thus, a patron of your restaurant could not argue that your failure to obtain a liquor license excuses him or her from paying for a pitcher of beer.

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9.3 Defenses to Contracts

Sometimes one party to a contract has a legal reason for being excused from contractual liability. This reason is called a **defense to contracts**. While we cannot study all the various defenses, we will examine the four most common ones: fraud, **undue influence**, **duress**, and **impossibility**.

Fraud in the Inducement and Fraud in the Execution

Fraud in the inducement occurs when one party enters into a contract because the other party knowingly lied. Suppose I come to look at your house, which is listed for sale. I ask you whether the creek in the back ever floods. You say no. In reliance on your statement, I buy the house. The next spring, the creek floods, causing extensive damage. Can I get out of the contract? Yes.

A case of fraud requires one to prove the following:

- One party intended to deceive the other, that is, knowingly lied;
- The innocent party relied on the lie; and
- Reliance was justified.

If all those elements are proven, the innocent party can withdraw from the contract in an act called **recission**. Fraud in the inducement makes the resulting contract voidable at the option of the defrauded party. In our example, I (the innocent party) would normally get back my money, and you (the guilty party) would get back your house. In other words, the parties would be restored to their precontract positions. However, if the defrauded party wishes to go through with the agreement even after learning about the fraud, he or she has the right to fully enforce the contract.

When **fraud in the execution** of a contract is involved, the defrauded party has been intentionally encouraged to execute a legal instrument by misrepresenting the nature of the instrument being signed. This is a different situation than fraud in the inducement, where one party is induced to enter into an otherwise valid agreement through the intentional misrepresentation of a material fact. Whenever fraud in the execution is involved, the victim does not intend to enter into an agreement at all. Thus, the agreement that appears to result from the fraud is completely void and unenforceable by either party, not only the victim.

Undue Influence

Parties to a contract sometimes have a special relationship to one another because of a state statute that defines their relationship as fiduciary. A **fiduciary relationship** is a relationship of special trust. Examples include the relationship between attorney and client or doctor and patient. In these relationships, the law recognizes that there is one party in a position of special trust and another party who is more vulnerable. As a result, the courts have held the fiduciary to a higher standard of care than an ordinary person.

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For example, a trustee who manages the monies of a young beneficiary is a fiduciary and will be held liable if he or she does anything unethical or illegal with the beneficiary's money. If the trustee uses his or her influence to overcome the will of the other party, that is *undue influence*. Suppose a trustee talks a beneficiary into investing in one of the trustee's enterprises, which is in fact a high-risk investment, and the beneficiary agrees to the arrangement only because she trusts his judgment. This agreement could be voided if the court found that the trustee overcame the "will" of the beneficiary. A party seeking to avoid a contract based on undue influence needs to show that the assent given to enter into the contract was not genuine, but rather was clouded by the other party's taking unfair advantage of the fiduciary relationship in inducing her to enter into the contract. As with contracts where there was fraud in the inducement, contracts involving undue influence by one of the parties are voidable only by the victim.

Duress

Duress consists of forcing a party to enter into a contractual relationship under threats. Generally, being threatened with physical or mental harm or with criminal prosecution constitutes a valid defense to the contract. Courts generally apply an objective test in determining whether a threat constitutes duress. Under an objective standard, a threat constitutes duress only if a reasonable person under the same circumstances would have deemed the threat believable and would have been motivated to act in order to avoid the consequences of the threat.

Some types of threats are not considered duress, however. For example, being threatened with a civil lawsuit or with economic need is not a valid defense. A contract entered into under those types of threats would still be enforceable.

Impossibility

Suppose a family made reservations at the Fabulous Hotel and then, because of illness, canceled. Or suppose a famous rock group did not show up for a concert you were managing because their bus broke down. Are these excuses for reneging on a contract recognized by the courts? The answer is—sometimes. *Impossibility* means, as a general rule, that the contract could be performed only at an "excessive or unreasonable cost," that is, that it would be impractical. For example, an earthquake, flood, or emergency that interrupted electrical power at the hotel might make the performance of the innkeeper's contract with a guest impractical and, therefore, serve as an excuse for nonperformance.

9.4 Contracts That Must Be in Writing to Be Enforceable

Many students are surprised to learn that most oral contracts are enforceable. Of course, the problem with enforcing an oral contract is proving its existence. Even so, if this burden can be overcome in court (that is, if the court finds that a contract existed), then an oral contract may be enforced.

With that said, there are six contracts that *must be in writing to be enforceable,* of which we will discuss three. Collectively, laws requiring certain contracts to be in writing fall under the category of the Statute of Frauds, a common law concept dating back to 1677.

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Before we address the three contracts that must be in writing to be enforceable, it is useful to first study what it means to "be in writing." The phrase *in writing* does not necessarily mean written on a piece of paper. For contracts under the common law, it simply means that the contract has all of the following characteristics:

- Identifies the parties;
- Describes the subject matter;
- Sets forth terms and conditions;
- Sets forth the consideration; and
- Contains the signature of the party to be charged ("charged" in this context means the party "to be sued, or the defendant." Thus, a breach of contract lawsuit will not be "winnable" unless the defendant has signed the contract—that is, if it is one of the types of contracts that must be in writing to be enforceable.)

For contracts under the Uniform Commercial Code, "in writing" means that the contract has the parties, quantity, and enough information for a reasonable person to conclude it is a contract. Note that if a contract is missing any of these requirements, it will be considered oral, even if it is written on a piece of paper. For example, under the common law, a contract to sell real estate that is printed on a form but is not signed by the party to be charged is oral, and therefore unenforceable.

What contracts must be in writing to be enforceable? We will look at the three most important and common ones in the sections that follow.

Contracts for the Sale of Real Property

Real property is land and all things attached to the land (**fixtures**). Personal property is all other property. If you enter into a contract to sell land, a building, or a house, that contract must be in writing to be enforceable. Are there any exceptions? Yes.

Suppose that the buyer and seller enter into an oral contract for the sale of a building. The buyer moves in and makes substantial improvements to the property. Although the agreement is oral, the courts will usually find that a contract exists, because people do not usually make improvements unless they own real property. Likewise, a seller would not normally allow such improvements unless the alleged buyer owned the property. This situation is called **part performance**, and it may be sufficient proof of the contract's existence to make the oral contract enforceable.

Contracts for the Sale of Goods Greater Than $500

Under the Uniform Commercial Code, Article 2 (discussed further in Chapter 10), a contract to sell goods valued at $500 or more must be in writing to be enforceable. Exceptions include those with part performance. Suppose I agree over the telephone to sell you widgets worth $4,000. I deliver $2,000 worth of the devices, which you accept. You then become liable for the payment of $2,000, even though the contract should have been in writing.

Another important exception that is used frequently in businesses is the *confirming memorandum*. Suppose the Fabulous Hotel calls a supplier and orders 1,000 luxury terry-cloth robes at $50 each. The contract is for more than $500 and therefore should be in writing.

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But the telephone call is, of course, oral. Such a contract may be enforceable if one of the parties sends a confirming memorandum and the receiving party does not object to it within 10 days. The parties then have a contract even though it is not "in writing." (Remember that "in writing" under the UCC means, in part, that the quantity is stated.) If the seller sends a fax reading, "Order received. Will ship robes as per your order," even though the contract is not in writing by UCC standards (because the order to purchase the robes was oral and the confirmation does not contain quantity), under the confirming memorandum exception, it is enforceable. Note that, for this exception to apply, both parties to the contract must be merchants. That is, they cannot be private individuals, but must be businesspersons who "regularly deal in goods of this kind."

Contracts That Cannot Be Performed in a Year

The third contract that must be in writing is one that cannot be performed within a year. Suppose the Fabulous hires you on March 1, 2012, for one year. You will graduate in May 2012, but you want a little time off to see Europe before you start working. So you agree to begin your employment on August 1, 2012. Does this contract have to be in writing?

If you agreed to work for the Fabulous on March 1, the rule is that the time from which you start to count is the day after contract formation, or beginning on March 2. You agreed to work for a year from August 1, 2012, until August 1, 2013. However, March 2, 2012, through August 1, 2013, is almost 17 months—a period that exceeds one year. Therefore, this contract would have to be in writing to be enforceable.

9.5 Damages for Breach of Contract

If the parties to the contract perform all their obligations under the agreement and have no obligations remaining, they are said to be **discharged**. Unfortunately, not all parties perform. Failure of a party to perform is a **breach**. The nonbreaching party may institute a lawsuit and, if so, can choose what to sue for. **Damages** come in two forms: *monetary damages* and *nonmonetary damages*.

Monetary Damages

The nonbreaching party may sue for **compensatory damages**. These damages will replace the loss to the injured party. For example, suppose a seller fails to deliver a shipment of tomatoes to a hotel client, and purchasing replacement tomatoes would cost the hotel an additional $1,000. This amount is sufficient for compensatory damages, as $1,000 would compensate the buyer for the seller's breach.

Nominal damages are awarded when the court finds for the nonbreaching party in theory but does not find that the nonbreaching party suffered any actual money loss. Usually, token damages of $1 are awarded in these cases.

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Some types of monetary damages generally are not allowable for breach of contract. These include *punitive damages*, that is, damages whose purpose is punishment (also known as *exemplary damages*). Punitive damages are most often awarded in tort claims where there was malicious or willful misconduct, such as negligence actions, not for breach of contract cases.

Speculative damages are usually not allowed in breach of contract cases. These are damages remote from the actual agreement. Suppose that the tomatoes mentioned above were a special order and the chef now claims that because they did not arrive on time, the number of customers dining that evening fell by 10%. Damages for such a *speculative claim* are unlikely to be awarded unless the hotel had conveyed this possibility to the seller at the time the order was placed. However, it is highly unlikely that such a conversation ever took place. The point is, such damages would be considered too remote, that is, unless the buyer and the seller agreed otherwise about their liability at the time of contracting.

Nonmonetary Damages: Duty to Mitigate

Sometimes monetary damages are not sufficient compensation for a party's breach of contract. In those instances, the nonbreaching party wants to enforce *performance* of the contract and sues for the remedy called **specific performance**. Bear in mind that specific performance is not available when monetary damages would compensate the nonbreaching party; nor is it available to force a party to perform. You cannot sue in order to make someone do his or her part under the contract. That would be slavery, which of course is illegal. Let's say that you hire a famous band for the New Year's Eve party at the hotel you are managing. If the band cancels, you can sue for monetary damages, e.g., lost customers and loss of provable income. But you cannot sue the band to make them give a command performance at the hotel.

So when is specific performance available as a remedy? When the goods are unique, such as land, antiques, or paintings, you could sue to recover these specific goods rather than monetary damages.

Key Terms

acceptance When the offeree agrees to the offeror's offer.

avoidance In contract law, to annul, cancel, or make void. Also called *disaffirmance*.

black letter law Theories of law in the context of business and employment contracts.

Blue Laws Laws in some states, based on traditions of religious morality, that ban certain commercial activities on Sundays and render contracts entered into then invalid.

breach Failure of a party to perform part of a contractual agreement.

capacity The mental ability to understand that one is entering into a contract. Also, the ability of a person of average mental abilities who is above the age of 18 to enter into contracts.

compensatory damages Money awarded to the nonbreaching party to restore that person's position as though there had not been a breach of contract. The same as *restitution*.

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consideration When the offeree does something that he or she was not previously legally bound to do because of the offeror's promise. Distinct from a *gift*.

counteroffer An offer by the offeree that kills the original offer and creates the *power of acceptance* in the offeror.

damages Monetary loss that results from the breaching parties' actions.

defenses to contracts Legally valid excuses for not performing a contract.

detriment Doing something that one is not previously, legally obligated to do.

disaffirmance When a minor opts out of a contract before the age of 18.

discharged The parties to a contract have performed all their obligations under the agreement and have no obligations remaining.

duress A defense to a contract that involves a threat of physical or mental harm to force a party to enter into a contract.

exculpatory clause Also known as a *waiver of liability*, states in writing that the owner is not liable for injury or harm to users of the facilities.

fiduciary relationship A relationship of special trust, carrying with it increased responsibilities toward the other party.

fixtures Property that is firmly attached to land or buildings that is characterized as real property.

fraud in the execution Causing a party to enter into a contract by intentionally encouraging that party to execute a legal instrument and misrepresenting the nature of the instrument being signed.

fraud in the inducement Causing a party to enter into a contract under false pretenses, e.g., when one party enters into a contract because the other party knowingly lied. The resulting contract is voidable at the option of the defrauded party.

gift A freely given, voluntary transfer of property without consideration.

impossibility In contract law, being unable to fulfill the terms of the contract without undue hardship.

lapse The end of an offer; when too much time has gone by and the offeree has not accepted.

large communicating medium Means of broadcasting a message, e.g., television, the Internet, newspapers, webpage, Tweet, or radio advertisement.

majority Reaching the age of 18, at which time one's contracts are binding.

merchant A person who regularly deals in goods of a certain kind.

minor A person under the age of 18.

mirror image rule Required by the common law for contract formation; when the offeree's response to an offer matches every aspect of the offer and changes nothing.

necessaries What minors are liable for when entering into a contract: food, clothing, and shelter.

non compos mentis Not being of sound mind; insane. Deemed by a court to be legally incompetent and thus incapable of entering into contracts, for instance.

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noncompetition clause Part of a contract establishing that, after employment ends, the employee can work for a competing business in the same market only after a certain amount of time or beyond a certain distance from the employer.

objective test How an interaction appears to a reasonable third party and whether it appears that the parties involved in the interaction are entering into a contract.

offer A statement of intent to enter into a contract.

offeree The party to whom the offer is made.

offeror The party making an offer.

option contract In this contract, the offeree pays money to hold the offer open for a certain amount of time, pending acceptance.

part performance Sufficient proof of an oral contract's existence (i.e., a party begins to fulfill its terms) to make it enforceable.

performance Fulfillment of one's obligations under the terms of a contract.

power of acceptance The inherent power that resides in the offeree to accept the offer or not.

predominant test The test used to determine whether a contract is under the common law or the UCC by asking which is greater: the cost of the sale of goods or the cost of the services rendered (the common law component).

preliminary negotiations Discussions that take place before contract formation that might lead to contract formation.

ratification When the minor agrees to remain in the contract upon reaching the age of 18.

real property Land and all things attached thereto.

recission When the innocent party who has been the victim of fraud withdraws from a contract.

rejection A response by the offeree that kills the offer.

revocation When the offeror takes back the offer prior to acceptance.

specific performance A remedy in which the court orders the breaching party to perform the contract.

undue influence If the parties have a fiduciary relationship, when the fiduciary uses his or her influence to induce the other party to enter into a contract for the fiduciary's monetary benefit.

voidable Capable of being later annulled, as in a contract by a minor.

warranties Guarantees that apply to goods sold pursuant to the UCC but do not apply to contracts under common law.

wildly fluctuating market A commodities market in which the prices change very quickly, sometimes in seconds.

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Critical Thinking and Discussion Questions

1. What are the five elements that must be present in order for a contract to be formed?
2. What are the four most common defenses to contracts?
3. For contracts under the common law, what does the phrase “in writing” mean? For contracts under the Uniform Commercial Code?
4. As the manager of a small business, you receive a letter that says, “We are exploring our options in your market and wonder if you would be interested in purchasing our product for a low price.” Discuss whether you have the power of acceptance and why or why not.
5. Your business wishes to purchase a costly machine for which you need to obtain financing. The seller has only one such machine, and the bank tells you that approval for financing may take 20 days. What type of contract could you enter into to guarantee that if you receive the financing, the machine will still be available for purchase?
6. Your company purchased a machine with a three-year warranty that also came with a service plan. Does this contract fall under the purview of common law or the UCC? How could you prove it is under the UCC? If the machine broke down within the three-year period, why would you be anxious to show it was governed by the UCC?
7. Your company purchased a telephone system for $45,670. After a few months, the system completely failed, and the party that sold it to you refused to fix it. You seek bids from other companies willing to replace the system and provide you with equivalent services. The bids are as follows:
   Company A = $56,750
   Company B = $84,374
   Company C = $52,049
   If you sued the original telephone system in court and won, how would you determine your damages?
8. Your company sent out an offer to sell a complex machine for $403,093 and received back an acceptance, which one of your employees signed, binding you to the contract. The employee never bothered to read the acceptance, however, which stated, “This is our acceptance. We agree to all the terms of the contract and we add to this contract a 20-year warranty.” The machine broke down and the buyer sues you to enforce the warranty that they added to the contract. Who will win and why?

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