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

11

In this chapter, which continues our examination of contract law, we are going to study what are commonly called **risk of loss rules**. These are the rules that apply to transactions between sellers and buyers when goods are lost, damaged, or destroyed between the time of purchase and actual receipt by the buyer. The question always is: Who will pay the cost of the goods—the seller, the buyer, or someone else—in the event that the parties suffer a loss? We will also discuss the role of a manager in entering contracts and working with an attorney.

11.1 Risk of Loss Rules and Contracts

Before a risk of loss problem can arise, the buyer must have enough ownership in the goods that he or she has *rights* in their loss. Such rights are often described as an **insurable interest**, that is, one that is worthy of financial remuneration in the event that the goods are lost, stolen, or damaged. To have an insurable interest, the goods must first be picked out of the larger mass, or **identified to the contract**. If you actually went into a large appliance store, chose a particular flat-screen television, and paid for it, the employees would go back into the warehouse and pull your set off the shelf. At the moment it was pulled off the shelf, it would be *identified to the contract* as being your television.

A buyer obtains an insurable interest in goods that exist at the time of entering into the contract, like the television described above. But if **future goods** are involved (goods that are not in existence at the time of entering into the contract, such as those to be manufactured or ordered by the seller for the buyer), the buyer obtains an insurable interest as soon as the goods are "shipped, marked, or otherwise designated by the seller as goods to which the contract refers" (UCC §2[501]). If the future goods are crops or the unborn young of animals, for example, the buyer obtains an insurable interest as soon as the crops are planted or the animals conceived. Sellers, on the other hand, retain an insurable interest in goods for as long as they have title in the goods or for as long as they retain a **security interest** in them, which is a right by a creditor to have specific property sold to satisfy the debt.

When goods are damaged, lost, or destroyed between the time that the buyer gains an insurable interest in them and actually receives them, we say there is a *risk of loss problem*. The easiest way to settle any dispute concerning a loss of goods is to negotiate a contract about the issue ahead of time, while purchasing the goods. The contract could say something like "In the event the automobile is damaged on the way to the dealership, the manufacturer agrees to bear all the costs of any such

damages." This is, of course, the safest and simplest way to avoid any disagreements about damage or loss of the goods (personal property).

In the event that the parties do not have the foresight to agree about risk of loss before it occurs, the courts will look to see whether either party breached the contract. As a general rule, the party who breaches the contract will bear the risk of loss, as illustrated below:

> ***A seller agreed to sell 1,000 pounds of beans to the buyer with delivery to be on or before May 15. However, the seller failed to deliver the goods on that date, and that night, the seller's factory burned down. Since the seller breached the contract, the seller would incur the risk of loss.***

In the event that the parties do not agree ahead of time who has the risk of loss, and if neither party breached the contract, then the courts next look at whether or not one of the parties is a merchant. Suppose, for example, that when you purchased your flat-screen TV from a big-box store, you could not take it home that day but planned to return the next day with a truck to transport it. If the store burned down that night, the loss would be incurred by the merchant (store). If you purchased the same TV at a garage sale, however, or from a nonmerchant, then the loss would be borne by you (the buyer), as soon as you paid for the goods.

Common Carrier Contracts

With the advent of the Internet, much more commerce is being conducted via shipping companies, or **common carriers**. A common carrier is a company that offers transportation services to the general public, such as UPS; Federal Express; air, train, and bus transportation companies; and the U.S. Postal Service. The type of method chosen for delivering goods can have an effect on such factors as the risk of loss of goods in transit and the time when the buyer obtains an insurable interest in them.

A common carrier is a company that transfers goods for the general public, such as the U.S. Postal Service.

Elaine Thompson/Associated Press

There are two basic types of arrangements one can make with a common carrier: a **shipment contract** or a **destination contract**. Whether the contract is designated as a shipment or destination contract has important legal ramifications for who bears the risk of loss between the buyer and the seller.

sea80373_11_c11_167-176.indd 2 10/4/12 3:23 PM

Shipment Contracts

In a shipment contract, the risk of loss passes from the seller to the buyer when the goods are placed on the carrier in the seller's city. Suppose, for example, that the seller is located in Maryland and that the buyer is located in California. The seller is responsible for shipping the goods to the buyer, so the seller makes arrangements to place the goods onto the carrier in Maryland. The shipping terms are "FOB Baltimore, Maryland," the seller's city. This scenario is illustrated in Figure 11.1.

Figure 11.1: Shipment contract

In a shipment contract the risk of loss passes from the seller to the buyer when goods arrive at their place of shipment, in this case when the goods are placed on the carrier in Baltimore.

You can recognize this as a shipment contract because the seller is located in Baltimore and the **FOB** (free on board) location is also Baltimore. (Some students remember this rule by the device "S and S": Shipment/Seller. Both begin with the letter *S*.). Accordingly, because it is a shipment contract, when the seller places the goods on the carrier in Baltimore, the risk of loss passes to the buyer. Therefore, if the goods are damaged or destroyed between Baltimore and Los Angeles, the buyer will have to pay for the goods anyway.

How do you know whether a contract is a shipment or destination contract? Contracts with carriers have *shipping terms*. As noted above, the buyer and the seller entered into a contract "FOB Baltimore, Maryland." Since it specifies FOB *Baltimore*, which is the *seller's city*, it is a *shipping contract*. If it had said "FOB Los Angeles," we would recognize it as a destination contract, because Los Angeles is the buyer's city, as discussed in more detail below. Thus, the shorthand FOB [*seller's city*] is part of a shipment contract in which the risk of loss is on the buyer once the seller places the goods on the carrier in the seller's city.

Destination Contracts

In a destination contract, the seller must, at his or her own expense, deliver the goods to the buyer's city and make the goods available for pickup there. You can recognize a destination contract by looking at the city designated after the shipping terms. In Figure 11.2 the city designated is Los Angeles, where the buyer lives, so it is a destination contract. In a destination contract, the risk of loss is on the seller until the goods are tendered to the buyer. **Tendered** means that the seller has notified the buyer that the goods are available for pickup.

sea80373_11_c11_167-176.indd 3 10/4/12 3:23 PM

Figure 11.2: Destination contract

In a destination contract the seller bears the risk of loss until a shipment of goods reaches its destination, in this case Los Angeles.

Shipping terms are shorthand initials that designate what type of contract is involved and various details regarding cost and insurance of the goods. For example, FOB and **FAS** are shipping terms that mean *free on board* and *free alongside a vessel*, respectively. When FOB and FAS, combined with the seller's city, are involved, the seller bears the responsibility (and cost, if any) of transferring the goods into the possession of the carrier. However, once delivered, the risk of loss is on the buyer. If the contract calls for FOB or FAS at a specific destination or the buyer's city (e.g., FOB buyer's plant or FAS buyer's port), then the seller bears the cost and risk of loss of getting the goods to the named destination.

The acronyms **CIF** and **C&F** stand for *cost, insurance, and freight* and *cost and freight*, respectively. In a CIF contract, the cost of shipping and the cost of insurance are included in the sale price, whereas in a C&F contract, the cost of shipping (freight) is included in the sales price but not the cost of insurance, which the buyer must pay for and procure on his or her own, if desired.

Sale on Approval Contracts

Another type of contract used frequently in business is a **sale on approval contract**. In this type of contract, the seller ships goods to the buyer so that the buyer can try the goods and then decide whether or not to keep them; if the buyer decides not to keep them, the buyer ships the goods back to the seller. Throughout the transaction, all the costs and risk are borne by the seller, including shipping to and from the buyer. If, however, the buyer decides to keep the goods, the buyer has to pay for them.

Why would a seller enter into such a contract? In many instances, it is just good business. If buyers are reluctant to try out a product, the seller may be willing to pay the expenses to get the goods into their hands, confident that once they have enjoyed the products, they will want to purchase them.

In some instances, the seller will offer the goods for something like a "15-day trial period." In this scenario, if the buyer keeps them for more than 15 days without shipping them back, the buyer will have accepted the goods, and the risk of their loss will shift to him or her.

sea80373_11_c11_167-176.indd 4 10/4/12 3:24 PM

Sale or Return Contracts

In a **sale or return contract**, the seller ships goods to a buyer who is also a seller, as illustrated below:

> ***A music manufacturer ships CDs to a gas station to sell. The gas station is buying the CDs from the manufacturer and selling to the general public. If the gas station does not sell the CDs, then under the sale or return contract, the gas station can return the goods, but only at its own (the buyer's) risk and expense.***

As you can see from this illustration, the gas station is a buyer because it is purchasing the goods from the manufacturer; but the gas station is also a seller since it is then offering the CDs for sale to the general public. In cases such as these, the manufacturer is providing the CDs to the gas station for sale, and the gas station is taking the business risk that its customers will be interested in purchasing music at a gas station. The gas station is willing to try selling the CDs because if it does not sell them, it can return the CDs without paying for them. In the event of returning the goods, however, if they are lost, stolen, or accidentally destroyed in transit or while in the buyer's (gas station's) possession, the buyer (gas station) must pay for them, since the risk of loss for goods in a sale or return rests with the buyer (gas station).

11.2 The Role of Managers Entering Into Contracts

Employees' duties regarding entering into contracts run the gamut. They can range from an entire office that procures goods for the business, and therefore enters into multiple contracts every day, to those who are involved in one contract during their entire employment, which might be their hiring contract. With the wide range of activities in mind, the purpose of this chapter is to address some concerns that might arise for you as a manager if you are asked to become involved in the contract process.

Recommendation number one is to get legal advice and make your contract subject to such review. Based on what you learned in Chapters 9 and 10 about contracts, it should be clear that entering into a contract can be fraught with peril. The cost of hiring an attorney up front is well spent when you form a contract. Nevertheless, there is a great deal you can do without an attorney. For example, you can negotiate a contract and then make it subject to attorney approval. That way, if you made any mistakes, the **escape clause** of attorney review will allow you to get out of the contract, or have your attorney correct any errors, before implementing the contract. For example, an employee could add a phrase like this to an employment contract: "This contract is subject to attorney approval and, in the event such attorney approval is not obtained, this contract will be considered null and void."

Many people think that informal conversations on the telephone or by e-mail are completely harmless, but they are not. Oral conversations can become contracts, as can e-mails. In addition, even if they don't rise to the level of an enforceable contract, such written documents, voice mails, or text messages may be admissible in court as exhibits. When dealing in business, it is best to remember that joking around, using profane language, or

sea80373_11_c11_167-176.indd 5 10/4/12 3:24 PM

making discriminatory remarks may all come back to haunt you in a court case. Think of every Tweet or Facebook posting as possibly "going viral" and being embarrassing, at the least, or evidence that can be used against you in court, at the worst.

A Closer Look: Contract Best Practices

Entering into a contract is a serious business, and if you have been given this responsibility by your employer, you may be entering into a binding agreement to which your employer must comply. Obviously, you need to apprise your employer of all conversations and tentative agreements you are making. Phrases such as "subject to my employer's approval," "I will have to get permission to agree to that," or similar language that makes the contract *provisional* will release you if there is a problem with the agreement or the specific language. Keep in mind that the best written contracts are plain and simple, and never be fooled by anyone involved in the contract process who asks you to "just initial this—it's not the same as a signature." Or by anyone telling you, "this is just between you and me," "This doesn't count, it is just preliminary," or similar language. Initialing is the same as a signature, and no agreement is just between "you and me." It is always better to check any agreements with your supervisors and to make any agreements subject to another's approval. The following website offers a number of tips for writing contracts: http://smallbusiness.findlaw.com/business-contracts-forms/how-to-write-a-business-contract.html.

Working With an Attorney

Prudent business practice recommends that you work closely with an attorney when entering into a contract. This section is not meant to take the place of legal advice, but it will show you steps you can take that will be helpful and cut costs:

- Keep all written material that pertains to the contract in an orderly folder for easy reference.
- Make sure your attorney knows about all paper, tangential agreements, and conversations that have taken place with regard to the transaction.
- Save all e-mail and cell phone texts or any other transmissions. At the very least, the attorney can sort through what he or she believes to be important correspondence.
- Read all contracts carefully and thoroughly. It is surprising how many people in business fail to do so. Treating a contract with such utter disregard will only present problems later on.
- As you carefully and thoroughly read any contracts presented to you, make notes in the margin about any changes you want to make or questions you have about the language.
- Strive to understand every single part of the contract, and insist on a clearly written document. There is no need for any obscure or confusing language in a document, and you should insist that any ambiguous language be explained to you.

Unfortunately, some attorneys can act impatient when asked questions. Remember that you, or your company, are paying legal fees and have hired the attorney to provide you with a service. Part of that service is to clearly explain what is going on in a way that is respectful of your concerns. It is usually not unreasonable to have explanations written

sea80373_11_c11_167-176.indd 6 10/4/12 3:24 PM

into the contract so that its clear meaning is spelled out. It is, after all, an agreement, and it should clearly enunciate the intentions of the parties. If anyone involved in the contract negotiations tells you, "Don't worry about that," then you need to be alarmed. In short, a contract should be a simply and clearly written statement of what each party is expected to do and when.

Negotiating a Contract and the Parol Evidence Rule

In Chapter 9, Contracts, Part I: Introduction and Formation, you learned about the elements of a contract, how to form one, and some of the defenses (how to get out of a contract). You will recall that to start contract formation, you must first have an *offer* and an *acceptance*. These can be made orally or in writing. For this reason, it is important to remember throughout your negotiations that both oral and written information is significant. At this point in your studies, you should be aware of the **parol evidence rule** (*parol* comes from the French for *word*). On its face, the rule seems daunting and difficult, but it actually makes a lot of practical sense. Here is the rule in a nutshell: *All prior or contemporaneous, oral or written agreements, that vary or contradict the final written contract, are inadmissible*.

Suppose that you entered into a negotiation with a seller to purchase a large, complex computer system for your offices. Table 11.1 illustrates the discussions that take place, leading to a contract.

Table 11.1: Sample purchase negotiations using the parol evidence rule

January 15	January 18	January 18	January 19	January 21
Telephone conversation in which you discuss "specs" for computer. Seller tells you the computer comes with a 12-month warranty. You agree that this is a good term.	Seller sends you an e-mail that says in part, "Also, this computer has an outer shell that is guaranteed against corrosion." You reply, "That's good, because that is a requirement of our office."	Telephone conversation in which seller tells you that the computer can be delivered "on or before February 1." You reply, "That's good, because we must have it by that date."	You send the seller an e-mail asking, "Will technical support be available after installation?" The seller sends back an e-mail that says, "Yes."	You sign the written contract, which describes a five-month warranty and a delivery date of March 15, on behalf of your company.

Note that, on January 21, the parties signed a contract that was supposed to memorialize or represent the entire agreement they made with one another. If they had read the contract before signing it, however, they would have noticed that the warranty in the final contract was for only five months (not the 12 months agreed to on January 15), nothing was said about the outer shell (which was discussed on January 18), and the computer would not be delivered until March 15, not February 1 (as requested on January 18).

sea80373_11_c11_167-176.indd 7 10/4/12 3:24 PM

The law assumes that when people enter into a final, written contract, as these parties did on January 21, they will incorporate all their understandings into that agreement. The law also assumes that if the parties have *not* agreed on a particular item, then this lack of agreement will also be represented in the contract by being absent. Note how the January 21 contract fails to include some of the oral and written agreements. These are *the prior oral or written agreements* referred to in the rule. Then note how the prior oral or written agreements vary or contradict the final written contract. For example, the parties "agreed" on January 18 that goods would be delivered on February 1, but the final written agreement stated a delivery date of March 15. The January 18 delivery date *varies* or *contradicts* the delivery date in the final agreement. Because the parties entered into a final written agreement, however, this contradiction is resolved because the parol evidence rule holds that those previous understandings of January 15, 18, and 19 are not part of the agreement and are thus **inadmissible** in court. "Inadmissible" means that the jury cannot hear any evidence about the previous agreements, rendering them useless: it is as though they had never taken place.

Why is the parol evidence rule a good one? This rule gives integrity to written contracts by preventing people from coming into court and saying, "Yes, I did sign that contract, but we also agreed to something else that should have been in the contract." If the parties agreed to it, it should be in the contract. The law challenges you to answer the question (if you agreed to something else): Why didn't you put it in the contract? It therefore keeps all previous understandings out of evidence unless one of the parties can show that fraud was involved and that one of the parties was duped. This rule is another important reason you should carefully read all contracts before you sign them and make sure they include *all* of the terms agreed upon between you and the other party.

Key Terms

C&F Cost and freight (a shipping term). The cost of shipping (freight) is included in the sales price but not the cost of insurance.

CIF Cost, insurance, and freight (a shipping term). In a CIF contract, the cost of shipping and insurance are included in the sale price.

common carrier A form of transportation for goods or people that is available to the public.

destination contract A type of contract for the sale of goods in which the risk of loss is on the seller until the goods are tendered at the buyer's city or destination.

escape clause Contract language that says, if you made any mistakes before the contract has been reviewed by an attorney, you can be released from the contract.

FAS Free alongside a vessel (a shipping term). The seller bears the responsibility (and cost, if any) of transferring the goods into the possession of the carrier or to a named destination.

FOB A shipping term that means "free on board." The seller bears the responsibility (and cost, if any) of transferring the goods into the possession of the carrier or to a named destination.

sea80373_11_c11_167-176.indd 8 10/4/12 3:24 PM

future goods Goods that are not in existence at the time of entering into a contract, such as goods to be manufactured or ordered by the seller for the buyer.

identification of goods to the contract The moment at which a buyer's goods are selected and picked out as that particular buyer's.

inadmissible Evidence that a jury cannot hear because it is not part of the final contract. Under the parol evidence rule, a previous but unwritten agreement between two parties to a contract.

insurable interest Sufficient property interest in goods so that one can obtain insurance against his or her loss.

parol evidence rule Holds that all prior or contemporaneous oral or written agreements that vary or contradict the final integrated contract are *inadmissible* in court.

risk of loss rules Guidelines for determining who must pay for damages or loss of goods in a contract or exchange.

sale on approval contract A contract in which the buyer may try the seller's goods and keep them or send them back at the seller's expense.

sale or return contract A contract in which the buyer sells the goods to a third party and returns whatever goods are not sold at his or her own expense to the original seller.

security interest The right of a creditor to have specific property sold to satisfy a debt.

shipment contract A type of contract for the sale of goods in which the risk of loss is on the buyer once the seller places the goods on a carrier in the seller's city.

tendered As part of a shipping agreement, the seller has notified the buyer that the goods are available for pickup.

Critical Thinking and Discussion Questions

1. What are the differences between shipment contracts and destination contracts?
2. In what situation would a sale on approval contract be used?
3. What protection does the parol evidence rule offer?
4. Stephanie went to a hair salon for a wash, cut, and perm. While performing these services the hairstylist used a variety of products on Stephanie's hair, including shampoo, conditioner, and permanent solution. Does the contract between Stephanie and the hair salon fall under the UCC or the common law? What test would the court use to determine this? Suppose that Stephanie was severely injured by the solution and wanted to sue the hair salon for breach of warranty. Why would it make a difference if the contract was under the UCC or the common law?
5. Blake decided that he needed to purchase a new automobile. He went to a dealership and looked at a new car. "How much is the car?" he asked. The salesperson told him. "Does it come with torsion bar suspension?" Blake asked. "No, but we can order it installed on the car for you," the salesperson responded. "Can I have it delivered on August 15?" Blake asked. "Yes," the salesperson said. After concluding their conversations, Blake met with the salesperson and signed a written contract that he did not read. The car could not be delivered until December 1

due to manufacturing problems, and when it did arrive, it did not have torsion bar suspension. Blake was furious, and he actually sat down and read the contract. He noticed that there was no mention of adding the torsion bar suspension and that the delivery date in the written contract was September 2. Discuss the application of the parol evidence rule to this problem.

6. Lindsay owns a gift shop where she sells all sorts of new and used products to customers. Business is good, but she needs to be cautious in terms of what products she offers, so as not to be stuck with inventory that does not sell. Alicia approaches Lindsay with a new line of products that she thinks will sell very well in Lindsay's store. Lindsay is not sure and is worried about taking on the new line of inventory. Advise Lindsay on what type of contract she could enter into with Alicia to sell the goods with the lowest risk.
7. You are the manager for a large appliance big-box store and have many customers who purchase goods and return later to pick them up. On the night in question, a customer purchased a washer and dryer set and agreed to return the next day with a truck. The customer paid in full for the purchase. That night, the store burned down and all the inventory was destroyed.
   a. Who has the risk of loss in this situation? Why? What rule applies?
   b. Assume the same set of facts as above, but this time the buyer purchased the washer and dryer at a garage sale and agreed to return the next day to pick them up. The buyer paid in full for the washer and dryer. That night, the seller's garage burned down. Who has the risk of loss in this situation? Why? What rule applies?

sea80373_11_c11_167-176.indd 10 10/4/12 3:24 PM