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# Chapter 6

## Contracts

### LEARNING OBJECTIVES

After reading this chapter, you should understand what a contract is, how a contract is formed, the types of law that govern contracts, the elements of common-law contract formation, and defenses to contracts. You will learn about performance and discharge, breach, and remedies. You will also understand important differences between common-law contracts and contracts between merchants under the Uniform Commercial Code (UCC). You will recognize commonly used clauses in contracts and their importance. You will also learn about assignment, delegation, and parol evidence. At the conclusion of this chapter, you should be able to answer the following questions:

1. What is a contract?
2. How is a contract formed?
3. When does common law govern contract formation, and when is the UCC relevant?
4. What are the defenses to performance of a contract?
5. What does it mean to breach a contract, and what are the consequences of breach?
6. What are remedies for breach of contract?
7. What common clauses can be used to accomplish certain goals, such as ensuring expediency, limiting liability, or restricting assignment?

Clint Eastwood had a long-term relationship with Sondra Locke. Sadly, the relationship deteriorated and, allegedly, ended on unfriendly terms. The couple never married, but they shared a household for many years, and they worked on many professional projects together. When the relationship ended, Locke sued Eastwood for various causes of action. To settle the case, Eastwood proposed, among other things, that if Locke dropped the lawsuit against him, he would secure a development deal for Locke at Warner Bros. Inc. Locke was not only an actress; she was also a director. No doubt assuming that this deal would advance her professional interests and, at the same time, bring a long-standing personal dispute to an end, Locke agreed. Locke entered into a settlement agreement with Eastwood, and as promised, she contemporaneously entered into an agreement with Warner

Bros. The agreement with Warner Bros. had two components. First, it required Locke to submit work that she was interested in developing, before she submitted it elsewhere. Warner Bros. was to accept or reject the work within thirty days. For this part of the contract, Locke would receive \$250,000 per year for three years. Second, the contract was a \$750,000 “pay or play” deal, which gave Warner Bros. a choice between using Locke’s services as a director and paying Locke a fee. Though Locke did not know this, Eastwood agreed to reimburse Warner Bros. for the cost of this contract if she did not have success in developing her projects or using her director services. Warner Bros. paid the \$1.5 million contemplated under the contract, but it did not develop any of Locke’s thirty proposed projects, and it did not hire her to direct any films.

Locke argued that the agreement had been a sham, because Warner Bros. had never intended to make films with her. She also argued that its only motivation for entering into the contract with her was to help Eastwood in settling her earlier claims against him. Locke sued Warner Bros. for a number of claims, including a breach of the **implied covenant**<sup>1</sup> of **good faith**<sup>2</sup> and fair dealing, and fraud. She alleged that she was deprived of the benefit of the bargain and that Warner Bros. had no intention of honoring its agreement with her. Warner Bros. won at trial, and Locke appealed.

The California Court of Appeals found that while the creative decisions of Warner Bros. were not appropriate for judicial review, acting in bad faith by refusing to consider the merits of Locke’s proposals was a matter for the courts. The court also noted that even though the contractual sum of money was paid, that alone did not constitute performance under the contract. Part of the value of the contract for Locke was the opportunity to work on projects that would earn additional money and promote and enhance Locke’s career. Moreover, the appellate court found that if Warner Bros. never intended to work with Locke but had entered into the contract solely to accommodate Eastwood, then a lack of good faith might be inferred. *Locke v. Warner Bros. Inc.*, 57 Cal. App. 4th 354 (1997).

What do you think about this case? After all, Locke was compensated the amount of money explicitly contemplated under the contract. Should it matter whether one party acts in good faith or not? We might say that this contract contains all necessary elements to be enforceable, and it looks on its face as if it has been performed. However, a lack of good faith by one party could lead to damages. After the court’s decision, the parties settled for an undisclosed amount.

1. A promise the law requires in all contracts, regardless of whether the parties state it or not.
2. Without deception; honest.
3. A legally enforceable promise.

Contracts are a fundamental part of doing business. A **contract**<sup>3</sup> is a legally enforceable promise. As you know, breaking promises is a big deal. Ethical questions arise when promises are broken. For example, what if you promised to

mow your elderly neighbor's lawn because you wanted to help him, but then you never got around to doing it? Wouldn't you feel guilty about watching his grass grow into tall weeds?

When the promise is a legally enforceable promise, feeling guilty about breaking the promise is not the only fallout. When a legally enforceable promise is broken, the injured party can seek **damages**<sup>4</sup>. In contracts, this usually means that the party who breaches the contract must pay the injured party an amount that would make that party whole again. Also, some people disagree about whether breaching a legally enforceable promise—that is, a contract—carries any ethical implications. For instance, if a company decides that it is less expensive to pay damages than fulfill its promise by performing under a contract, it might make the decision to breach based on rational decision making. That is, since it will be less expensive to **breach**<sup>5</sup>, it makes sense to breach. Others disagree with this approach, pointing out that reliance on promises is an important part of business that provides necessary stability, regardless of whether keeping the promise makes economic sense or not.

If you had a business, would you breach a contract to save money? Why or why not?

Contracts are agreements between two or more parties. Generally speaking, contracts are a form of **private law**<sup>6</sup>, because the **terms**<sup>7</sup> of the contract are binding on those parties but not on everyone. The contract represents **mutual assent**<sup>8</sup> to a bargained-for exchange between parties.

Generally speaking, in the United States parties may enter into contracts for whatever they wish and under any terms that they agree on. In other words, parties may assent to agreements even if those agreements represent bad bargains.

However, there are certain external restrictions on our abilities to form contracts. Additionally, certain internal (to the contract) restrictions may exist on our abilities to exercise rights or to engage in other contracts.

Legal restrictions, external to the contract, limit our ability to bargain. For example, if you wanted to hire someone to work for your company, you could not contract with that person to work one-hundred-hour workweeks at twenty-five cents per hour. Even if you could find someone to work under those conditions and even if you both agreed to those terms of the contract, our statutory and regulatory laws prohibit you from entering into a contract with those terms. Such wages would violate minimum wage laws.

There may also be restrictions that are internal to the contract. Imagine that you entered into an employment contract with a company to work for \$55,000 per year,

4. Compensable loss.
5. The failure to perform duties and obligations required by contract.
6. A legally binding agreement between consenting parties that does not apply to the public at large.
7. Elements of contracts that specify important matters, such as quantity, price, and time for performance.
8. In common-law contracts, comprises offer and acceptance.

plus benefits, and for a term of two years. You might be pretty happy about that. But what if, one month later, another company offered you the same position at its company, but for a salary of \$65,000 per year, plus benefits. The better offer does not invalidate your first contract. In fact, in such a case, your first contract would probably contain a **noncompete clause**<sup>9</sup> that would prohibit you from working in a similar capacity for a specified length of time and geographic area. So even if you decided to breach your first contract to enter into the second, you would be prohibited from doing so under the noncompete clause.

### Key Takeaways

Contracts are legally enforceable promises that, if breached, result in compensable damages. Contracts are a fundamental part of doing business, which require not only performance of the terms of the contract but also good faith in dealing. Parties may enter into a contract for any agreement with terms, providing the agreement is legal. Also, restrictions on ability to contract may be external, such as those imposed by law, or they may be internal, such as those imposed by clauses like noncompete agreements.

9. A contract clause that restricts competition for a specified period of time, within a certain geographic region, and for specified activities.

## 6.1 Formation

### LEARNING OBJECTIVES

1. Find out when the Uniform Commercial Code (UCC) is the appropriate law to apply and when the common law is the appropriate law.
2. Learn the elements of common-law contracts.
3. Identify the difference between common-law contracts and contracts between merchants.

A contract is a legally enforceable promise. Therefore, it is important to know whether promises made are legally enforceable. You certainly have made many promises in your life. You have probably broken a few promises, too. For example, if you promised your best friend that you would be best friends forever, but then your relationship changed, we might say that is a broken promise. However, you would not be held legally liable to pay damages for breaking that promise. On the other hand, if you promised your bank that you would make payments to it in exchange for the bank loaning money to you to purchase a car, and if you broke that promise by failing to pay as scheduled, then you have broken a legally enforceable promise. The bank could seek damages from you to make itself whole again. What is the difference between these two promises? Why would you have to pay damages to the bank but not to your former best friend? More specifically, why is one considered a breach of contract and the other simply a broken promise?

This section explores contract **formation**<sup>10</sup>. We can examine the elements of formation to determine whether the contract is valid or whether it suffers some deficiency that renders it not legally enforceable.

In the United States, two primary sources of law govern our contracts: the common law and the Uniform Commercial Code. The **Uniform Commercial Code (UCC)**<sup>11</sup> article 2 governs contracts between a merchant and the sale of goods. Essentially, the UCC contains two sets of rules for contracts. One set involves rules for everyone, and the other set involves rules for merchants. In this section, we will explore the UCC as it applies to merchants. Chiefly, we will examine how the UCC requirements differ from common law in contract formation

However, we will first address common-law contracts. Common law governs contracts for services as well as contracts not otherwise governed by the UCC. It is important to recognize the elements of common-law contract formation because

10. In common-law, this refers to offer, acceptance, and consideration.

11. A model statute that seeks to provide uniformity to contracts law among the different states. It is not a law until state legislatures adopt it as law.

they are more stringent than the requirements for formation between merchants under the UCC. If all elements of common-law contract formation do not exist, then the contract may be **void**<sup>12</sup> or **voidable**<sup>13</sup>.

The elements of common-law contract formation include **offer**<sup>14</sup>, **acceptance**<sup>15</sup>, and **consideration**<sup>16</sup>. Offer and acceptance together form mutual assent. Additionally, to be enforceable, the contract must be for a legal purpose and parties to the contract must have **capacity**<sup>17</sup> to enter into the contract.

An offer gives power of acceptance to another party, and it includes the agreement's essential elements, which must be definite and certain. For example, if an offeror says to you, "I offer to sell you my scooter for four hundred dollars," then that offer is valid. It contains the price, the person to whom the offer is made, and the object of the offer (i.e., the scooter). It creates a power of acceptance in you, the offeree.

12. Refers to a contract that is not valid on its face because it suffers from some fatal flaw.

13. Refers to the status of a contract that may be terminated due to some defect.

14. In common law, it creates the power of acceptance in another party and includes the agreement's essential elements, which must be definite and certain.

15. In common law, it must be a mirror image of the offer.

16. A bargained-for exchange.

17. The legal ability to enter into a contract.

18. The requirement for acceptance in common-law contracts; it means that the acceptance must be precisely the same as the offer.

19. A rejection of an offer. It is a new offer.

20. The retraction of an offer before it is accepted.

Importantly, in common-law contracts, the acceptance must be a **mirror image**<sup>18</sup> of the offer to constitute valid acceptance. This means that the acceptance must be precisely the same as the offer. If the acceptance is not precisely the same, then it will fail to meet the requirements of an acceptance, and it will not constitute a valid element of formation in contract. To accept the offer, the offeree could say something like this: "I agree to buy your scooter for four hundred dollars." If a **counteroffer**<sup>19</sup> is made, then that would not be acceptance, because the counteroffer would not be a mirror image of the offer itself. So, for example, if the offeree said, "I agree to buy your scooter for three hundred dollars," that would not be an acceptance. In fact, a counteroffer is a rejection of the offer. Once an offeree rejects an offer—either outright (e.g., by declining to accept) or through counteroffer, the offeror is free to walk away from the failed negotiation. In this example, he no longer has to sell his scooter at all, not even if the offeree changes his mind and agrees to pay four hundred dollars. Likewise, if the offeror revokes an offer before the offeree accepts, then the power of acceptance has been withdrawn by that **revocation**<sup>20</sup>. The offeror would no longer have to sell the item originally offered. If the offeror wished to limit the time that an offer was valid, he could do so by limiting the time that the offer may be accepted. If the offer is not accepted during that time, then the offeror is not required to honor any acceptance that is made after expiration of the offer.

What if you saw an advertisement for a scooter for sale at a local shop? Perhaps the advertisement looked like this:

Figure 6.1



Do you think that this advertisement should create the power of acceptance in you, a potential customer? The fact is that an advertisement is not an offer. It is simply an **invitation to bargain**<sup>21</sup>. Advertisements are requests for people to make offers. This places the power of acceptance on the merchant, who is free to reject offers or to choose to whom he sells. Of course, certain statutory protections exist today to protect consumers against unscrupulous merchants who might engage in unethical behavior, such as bait-and-switch or false advertising, or race-based denial of services or refusal to contract. Specifically, consumer protection statutes and civil rights statutes, respectively, would protect consumers in such circumstances.

If an offer is valid, then the acceptance must be a mirror image, as mentioned previously. A **bilateral contract**<sup>22</sup> is a contract in which both parties make a promise. The previous example is an example of a bilateral contract. The following is a promise for a promise:

21. When a party invites others to make offers to buy; advertisements are a prevalent example.

22. A contract in which both parties make a promise.

The offeror says, "I offer to sell you my scooter for four hundred dollars."

The offeree replies, "I agree to buy your scooter for four hundred dollars."

Specifically, it is a promise to sell the scooter in exchange for a promise to buy the scooter for four hundred dollars. Since this is a promise for a promise, then this is a bilateral contract.

A **unilateral contract**<sup>23</sup> is one in which the accepting party may only accept through an action. Here is an example:

The offeror says, “I will sell this scooter to the first person who puts four hundred dollars cash in my hands.”

The offeree says nothing but places four hundred dollars cash into the offeror’s hands.

This is a promise for an action. Specifically, it is a promise to sell the scooter in exchange for the action of placing four hundred dollars cash into the offeror’s hands.

Common-law contracts can be either bilateral or unilateral.

Additionally, all common-law contracts must contain valid consideration. This means that there must be a bargained-for exchange of acts or promises, and both parties must incur new **legal detriment**<sup>24</sup> or obligations as a result of the contract. Imagine that you have accepted a new position with a company. You have a valid employment contract that you’ve successfully negotiated prior to beginning work. All terms of the contract are valid, and both parties are bound to the contract. Basically, this means that you have agreed to work for a specified period of time, and your employer has agreed to compensate you with a specified salary and benefits in exchange for your work. So far, so good, right?

Now, imagine that during your first week, your boss appears in your office and asks you to sign a new contract that, in essence, is a **noncompete agreement**<sup>25</sup>. This means that your employer now wants you to sign a new contract agreeing not to compete with the company if you decide to terminate your employment arrangement. The employer wants you to make this promise, but the employer does not offer anything additional in return. For the purposes of this example, let’s say that you sign the new agreement. Is this new agreement valid and binding on you? Probably not. Why? Because the company has not suffered any new legal detriment or obligation as a result of the contract. You have agreed to refrain from competing with the company if you leave, but the company itself has not given you anything in return for your promise. To make this contract binding against you, your employer should have provided consideration. For example, it could have asked you to sign

23. A contract in which the accepting party may accept only through an action.

24. An obligation or a duty enforced by law.

25. A contract or clause in a contract limiting the time, place, and scope of future competition.

the noncompete agreement in consideration of an additional one thousand dollars of salary per year. Then, the contract would have consideration and it would have a much greater chance of being found to be valid. Better yet, the company should have negotiated the noncompete agreement along with your original contract before you assumed your new position.

Let's continue our example of an offeror who offers to sell his scooter for four hundred dollars. He says, "I offer to sell you my scooter for four hundred dollars." If you reply, "I agree to buy your scooter for four hundred dollars, if I don't find one that I like more," then that does not constitute valid consideration. This is because you have placed a condition on the consideration. In essence, you have made what appears to be a promise to do something, but instead of being a promise, it is only an illusion of a promise. This is called an **illusory promise**<sup>26</sup>, and it does not constitute valid consideration. There is no legal detriment to you here, because you might find a scooter that you like more than the one offered by the offeror. You have a way out. A legal detriment is a detriment (or burden or obligation) that is legally enforceable. You cannot "get out" of the promise without suffering legal detriment. The other party must be able to rely on the promise for it to constitute valid consideration. The thing bargained for can be an act or a promise (either to do something or to refrain from doing something.)

Additionally, for a contract to be valid, the subject matter of the contract must be for a legal purpose. If a distributor of illegal drugs hires a pilot to fly his illegal cargo to a particular place in exchange for payment, this is a contract for an illegal subject matter. If the drug dealer fails to honor his agreement to pay, or if the pilot fails to honor his agreement to transport the cargo, neither aggrieved party will find a remedy in our courts, even if the elements of contract are all present and perfectly formed.

Moreover, the parties to contract must have capacity to enter into the contract for its terms to be enforceable against them. Adults of sound mind have capacity. Minors lack legal capacity, but they may enter into contracts that they may cancel at their sole option. In other words, a minor who enters into a contract with a party who has capacity may void the contract, but the other party may not. This means that any contract with a minor is voidable by the minor under the **infancy doctrine**<sup>27</sup>.

Let's compare common-law contract formation with UCC contract formation. Recall that common law governs contracts for services and contracts not governed by the UCC. Article 2 of the UCC governs the sale of **goods**<sup>28</sup>, which is defined by §2-105 and includes things that are moveable, but not money or securities. It does not include land or houses. Contracts between merchants are also governed by article 2

26. A statement that looks like a promise but is actually only an illusion of a promise due to its conditional nature or its otherwise lack of a firm commitment.

27. A legal doctrine that allows minors to disaffirm contracts.

28. As defined in §2-105 of the Uniform Commercial Code (UCC), things that are moveable, but not money or securities. It does not include land or houses.

of the UCC. Generally speaking, §2-104 defines a merchant as a person who deals in goods or holds himself out as having special knowledge or skill regarding the practices or goods that are the subject of the transaction. Since contracts law is a state law issue, each state can have different laws related to contracts. The UCC seeks to provide uniformity to contracts law among the different states. However, like other uniform laws, the UCC does not become a law until state legislatures adopt it as law. All fifty states have adopted some version of the UCC.

As you can imagine, contracts between merchants do not always contain offers that include definite terms, and acceptances are not always mirror images. Merchants typically place a purchase order when they wish to purchase materials, and the seller often sends an invoice with the order when it ships. Merchants frequently use **boilerplate language**<sup>29</sup> in their individual purchase orders and invoices. Obviously, not every merchant's contract will contain the same language as those of other merchants. This can lead to discrepancies between terms that would be fatal in common-law contract formation, otherwise known as **battle of the forms**<sup>30</sup>. However, the UCC provides more flexibility in contract formation than exists in common-law contracts, thereby accommodating the reality of business practices. The requirements for common-law contract formation would be too burdensome for merchants. Can you imagine if every merchant had to issue offers with definite terms and receive mirror image acceptances for every item that it sold or purchased to have valid, enforceable contracts? Such a burden might cause commerce to come to a screeching halt. Or it might lead to many contracts disputes.

The UCC also embodies some elements of the **Statute of Frauds**<sup>31</sup>. The Statute of Frauds requires certain types of contracts to be in writing to be enforceable. Specifically, it requires contracts to be in writing for goods priced at five hundred dollars or more *and* signed by the defendant, for those contracts to be enforceable. Other important types of contracts relevant to business that must be in writing and signed by the defendant to be enforceable include contracts for any interest in land, promises to pay the debts of another, and contracts that cannot be performed within one year. The types of contracts that are contemplated by the Statute of Frauds but are not captured by the UCC are often embodied in state statutes. The peculiar name—the Statute of Frauds—is derived from its early incarnation in seventeenth-century England, when a statute was passed by parliament to reduce or prevent fraud in property transactions and other important civil matters.

Of primary concern to students of business are the differences between common-law contracts and the UCC. When analyzing a contracts issue, identification of the type of law that governs the contract should be addressed first. This is because you cannot know which rule applies unless you know which type of law is applicable.

29. Standard legal language used in contracts or other legal documents.

30. A term that describes inconsistent elements of an agreement between merchants.

31. A statute that requires certain types of contracts to be in writing to be enforceable.

The primary differences between common-law contracts and the UCC are in the UCC’s relaxation of various common-law contract formation requirements. See Table 6.1 "Differences between Contract Formations by Type of Law" for a comparison between common-law and UCC contract formation requirements. When a battle of the forms ensues between merchants, for example, the conflicting terms are not fatal to the contract. This is a major departure from the mirror image rule required by common-law contracts. For the UCC, the primary issue is whether the parties intended to enter into a binding agreement. New or additional terms included in an offer will become part of the contract on acceptance. Terms that conflict with each other will “fall out” of the contract and be replaced by UCC **gap fillers**<sup>32</sup>, which can create the terms of the contract. Likewise, terms that are left open will be filled in. Gap fillers are terms provided by the UCC, and they can be inserted into a contract when those terms are not definite. While prices, delivery dates, warranties, and other terms can be “filled in” by the UCC gap fillers, quantity cannot. Quantity, therefore, is an essential term that must be specified in the contract for it to be binding.

Table 6.1 Differences between Contract Formations by Type of Law

UCC	Common Law
Any manner that shows agreement to contract (e.g., words, actions, writing)	Mirror image acceptance required
Quantity term required; other terms may be filled in with gap fillers	Essential terms must be definite
Contracts between merchants; contracts for sale of goods priced at \$500 or more	Contracts for services and for interest in real property

### KEY TAKEAWAYS

A contract is a legally enforceable promise. Common law and the UCC are different sources of contract law. Common law is the appropriate type of law for service contracts and contracts that do not fall under the UCC, like real estate contracts. The UCC governs contracts involving the sale of goods with a price of five hundred dollars or more and in contracts between merchants. Common-law contract formation requires a valid offer, acceptance, and consideration. The parties must have capacity, and the subject matter must be a legal purpose. The UCC relaxes formation requirements by allowing the use of gap fillers for undefined or conflicting terms and by allowing a contract to be formed by any manner that shows agreement to contract. Quantity is a required term for contracts governed by the UCC.

32. In contracts governed by the Uniform Commercial Code (UCC), terms that can be inserted into a contract when those terms are not definite and certain.

## EXERCISES

1. If a contract was not entered in good faith, do you think that fact alone should matter? Consider *Locke v. Warner Bros. Inc.*, which was discussed in the introduction to this chapter. All essential elements of the contract appear to have existed, and the parties performed as required by the wording of the contract. How can lack of good faith be shown?
2. Has anyone ever broken a promise to you? Were those promises legally enforceable promises? Why or why not? Be sure to analyze the agreement by checking to see if all elements of contract formation were present. Remember to first determine whether the promise was one governed by the UCC or by common law.
3. What are the dangers inherent to making a counteroffer? Imagine that you really wanted to sell your house. You receive an attractive offer, but you wondered whether you might be able to sell the house for a little more money. What types of things should you think about before submitting a counteroffer?

## 6.2 Performance and Discharge, Breach, Defenses, Equitable Remedies

### LEARNING OBJECTIVES

1. Learn what constitutes performance.
2. Understand what it means to discharge obligations in a contract.
3. Explore different standards of performance.
4. Examine breach.
5. Explore defenses to breach.
6. Learn about equitable remedies.

A contract is an enforceable promise. When the promise is fulfilled, then the contract terms have been satisfied. This means that the parties are **discharged**<sup>33</sup> from the contract, because they have already fulfilled their legal duties under it. That is, they have satisfactorily performed their obligations under the contract. **Performance**<sup>34</sup> simply means undertaking the legal duties imposed on us by the terms of the contract. This is certainly what parties hope for when they enter into a contract—the successful execution of the terms of the contract and subsequent discharge from it.

But how do we know whether the contract terms have been performed? Sometimes it's easy to determine. For instance, if I offer to sell you my scooter for four hundred dollars, you agree to buy my scooter for four hundred dollars, and we exchange those items, then we have fulfilled our obligations under the terms of the contract. We formed a contract, we fully performed our obligations under it (known as **complete performance**<sup>35</sup>), and we are subsequently discharged from further duties arising under that contract.

33. When parties to a contract have fulfilled their duties under the contract and they are released from further requirements to perform under the contract.

34. Undertaking the legal duties imposed on us by the terms of the contract.

35. Full and perfect performance of the promises, obligations, and duties contained in a contract.

In other cases, whether a party has performed can be trickier to determine. For example, imagine that you hire a builder to construct a new home for you. You specify all dimensions of the home, as well as your chosen building materials. Certainly this would be a very detailed contract. Imagine that all essential elements have been determined and that the contract is valid. In short, the builder agrees to build your specified home, and you agree to pay the builder the agreed on price. Imagine that everything goes according to plan. When your home has been constructed, you visit it for the first time. To your dismay, you see that the foyer has been tiled in red ceramic, even though you clearly specified—and the contract clearly reflected—that the foyer should be tiled in blue ceramic. However, on your further inspection, every other item specified in the contract has been completely

performed. Would we say that the builder has performed his duties under this contract? The item at issue is the problem with the foyer tile. Does this error rise to breach? More importantly, does this excuse your obligations under the contract to pay the builder for his work?

When a party fails to perform under the terms of the contract without a legally justifiable reason, the party is said to be in **breach**<sup>36</sup> of the contract. However, in a service contract—such as a service to build a house—the standard of performance is **substantial performance**<sup>37</sup>. This means that the performing party acted in good faith and conveyed enough benefit of the contract to the other party so that the other party can use the benefit for its intended purpose, and the defects arising under the contract may be remedied by money damages. A material breach in a service contract is when a party has not substantially performed under the terms of the contract. A minor breach is when the party has substantially performed but has not *strictly* performed. In our example, installation of the red tile in the foyer would not rise to material breach, because presumably the builder acted in good faith, he produced a house that is capable of being used for its intended purpose, and the defects (the red tile) can be remedied through monetary damages. They simply need to be replaced by blue tiles. This was a minor breach. If this were your contract, you would have to pay the builder as required under the contract, less the cost of replacing the tile.

Consider the firing of Texas Tech’s head football coach, Mike Leach, in [Note 6.47 "Hyperlink: Coach Mike Leach"](#) to practice your analytical skills. Try to identify what additional information you would need to determine whether substantial performance exists, or whether the contract has been materially breached.

Figure 6.2



*A Promise Kept? Or a Promise Broken?*

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- 36. The failure to perform duties and obligations required by contract.
- 37. The standard for service contracts. It means that the performing party acted in good faith and conveyed enough benefit of the contract to the other party so that the other party can use it for its intended purpose and that the defects arising under the contract may be remedied by money damages.
- 38. A standard of performance in a contract that requires perfect performance.

Sometimes, substantial performance is not adequate. Adherence to a **strict performance**<sup>38</sup> standard requires express terms in the contract to that effect and circumstances where such a high standard is reasonable. In our scooter example, if you tried to give the offeror three hundred dollars in cash and one hundred dollars in postage stamps, then that would most likely not satisfy the terms of the contract. You might recall that the contract was a bargain for a scooter in exchange for four hundred dollars. Here, strict performance makes sense and is reasonable.

Performance to the standard of **personal satisfaction**<sup>39</sup> can be enforced if the contract expressly requires it. This means that the performance under the contract is scrutinized subjectively, either by one party to the contract or by a third-party beneficiary specified in the contract. If the subject of the contract is something for which approval is dependent on someone's subjective opinion, like personal taste, then assessment can be made on a subjective standard providing this standard is clearly specified in the contract. For example, if you owned a piano bar, and you wished to hire a truly inspired pianist for entertainment, you might enter into a contract with a pianist subject to a personal satisfaction standard. Even if that person could tickle the ivory flawlessly, you might decide that his or her music is technically accurate but not truly inspired. Providing that your contract with the pianist allows for personal satisfaction to be the standard of performance, you may terminate that contract based on his or her failure to meet the personal satisfaction standard. This standard is unlike the substantial performance standard, which requires an objective assessment based on the **reasonable person standard**<sup>40</sup>. Referring again to [Note 6.47 "Hyperlink: Coach Mike Leach"](#), which standard appears to be controlling Texas Tech's decision to terminate Coach Leach's contract—personal satisfaction or substantial performance? Which standard is appropriate for a contract for coaching services?

39. A standard of performance in a contract that means that the performance under the contract is scrutinized subjectively, either by a party to the contract or by a third-party beneficiary specified in the contract.

40. An objective standard based on reasonableness, against which actions are measured to determine sufficiency.

## Hyperlink: Coach Mike Leach

Head football coach Mike Leach of Texas Tech was fired for breach of contract. He had recently signed a \$12.7 million contract for five years, and he had been named by the Associated Press as the Big XII Coach of the Year in 2008. However, that didn't stop Texas Tech from firing him, citing breach of performance as the reason for the termination. Under the terms of his contract, he was to "assure the fair and responsible treatment of student-athletes in relation to their health, welfare, and discipline." Allegedly, Coach Leach forced a student athlete to stand in a shed after the athlete was diagnosed with a mild concussion. Leach's supporters argue that the "shed" was a comfortable garage-like room with a cooler and a fan and that Coach Leach was simply having the player stand inside, out of the sun, in accordance with medical orders. Others argue that this was a sadistic punishment that was inappropriately levied against an injured player. Was Leach being cruel, or was he being protective of his charge in accordance with his contract terms?

Underlying this controversy are allegations that the firing occurred because Leach interviewed with another university unbeknownst to Texas Tech and because he has a colorful personality that might offend some people. For instance, he allegedly blamed his players' "fat little girlfriends" for distracting them to their defeat against Texas A&M.

Coach Leach was fired just before receiving an alleged \$800,000 contractual bonus.

Check out the story here:

<http://www.cnn.com/2009/US/12/31/texas.tech.leach/index.html?iref=allsearch>

Check out the video of the story here:

<http://sports.espn.go.com/ncf/bowls09/news/story?id=4781981>

Watch Coach Leach here:

<http://sports.espn.go.com/ncf/bowls09/news/story?id=4781981>

Watch speculation about Coach Leach's likelihood of being hired here:

<http://sports.espn.go.com/ncf/bowls09/news/story?id=4781981>

See the exercises in this section for related questions and discussion.

As mentioned previously, when the promises in a contract have been fulfilled based on the appropriate standard—substantial performance, strict performance, or personal satisfaction—then the parties are discharged. However, when a material breach occurs, the injured party may bring a claim for damages. But that isn't necessarily the end of the story. The breaching party may have a valid reason for breaching the contract. These valid reasons are known as defenses to contract. These defenses include formation problems, lack of capacity, illegality of subject matter, impossibility, duress, unconscionability, undue influence, violation of the Statute of Frauds requirement that certain types of contracts must be in writing to be enforceable against the defendant, exceeding the statute of limitations, mistake, misrepresentation, fraud, commercial impracticability, and frustration of purpose. Bankruptcy discharge is a permanent legal excuse from performance, and it will discharge obligations that are dischargeable by law if the debtor successfully fulfills his obligations under the bankruptcy. Obligations that are not dischargeable by law will not be permanently discharged by a bankruptcy. However, during the bankruptcy, the performance of contract terms requiring payment of debt incurred prior to filing the bankruptcy petition is suspended by the court until the bankruptcy is terminated either by successful completion of the bankruptcy or by dismissal of the case.

Formation problems in common-law contracts relate to whether the offer, acceptance, and consideration were valid. For example, if the offer did not contain the essential terms in definite and certain form, then that offer will not be valid. If I offered to sell you my house for a fair price, it would not be a sufficient offer because the price term is an essential element, and in this offer it is vague. To say that a house will be sold "for a fair price" is not specific. Likewise, in a common-law contract, if the acceptance is not a mirror image of the offer, then the acceptance will not be valid. Similarly, if consideration does not firmly commit the parties to the deal, then consideration will fail, as is the case with an illusory promise. For example, if I offered to sell you my house for \$150,000, and you agreed to buy it "if you like it," then that is not a firm commitment. Consideration will fail, and the

contract has not formed. As a practical matter, how can this defense be used? The defendant simply needs to show that the contract was never formed in the first place, due to one or more deficiencies in formation. Keep in mind, however, that if the Uniform Commercial Code (UCC) is the relevant type of law, formation is much simpler than in common law. For example, all essential elements do not need to be stated in definite and certain terms (but quantity must be stated), and acceptance does not need to be a mirror image of the offer. Accordingly, in contracts in which the UCC is the relevant type of law, this defense can be more challenging to successfully mount.

Sometimes when all elements of the contract are not present, the court will enforce the promise through an **equitable remedy**<sup>41</sup> to avoid a perceived injustice that would occur if the contract failed based on a formation defect. **Quasi-contract**<sup>42</sup> and **promissory estoppel**<sup>43</sup> are two types of equitable remedies that a court may impose. When detrimental reliance is found, an equitable remedy can substitute for consideration. This allows the court to enforce the terms of the “contract,” even though, technically speaking, there was no contract to begin with.

Quasi-contract is determined when one party will receive a benefit from the other unjustly (**unjust enrichment**<sup>44</sup>), and the party who tendered the benefit reasonably expected to be paid for it. The party who received the benefit knew that the other party reasonably expected to be paid. For example, imagine that your neighbor hired painters to paint his house, but the painters accidentally appeared at your house to work. Instead of sending them away, you decided to let them paint your house, but you did not tell them that they were at the wrong house. At the end of the job, they demanded payment. You point out that they never had a contract with you. While this would be true in fact, the issue is that you would be unjustly enriched by their painting of your house if you were not made to pay. Additionally, you knew that the painters would reasonably expect to be paid for their services, and you did nothing to stop them. This would be a good case for a court to impose the equitable remedy of quasi-contract. The damages awarded in such case are called **quantum meruit**<sup>45</sup>, which means “as much as is deserved.” The painters will receive the value of their services in damages. Compare this situation with one in which you were on vacation when the painters painted your house. You knew nothing of their presence. In such a case, quasi-contract would not be imposed as an equitable remedy because you were not aware of their presence. In fact, you would have a potential claim against the painters for interfering with your property and entering your land without your permission. Promissory estoppel is another equitable remedy. It is imposed on parties when one party detrimentally relied on another’s promise, and to avoid injustice, the enforcement of the promise is required. Like quasi-contract, when promissory estoppel is used, there is some formation problem with the contract so, technically speaking, no contract exists.

41. A remedy imposed by the court to prevent injustice, which allows the court to enforce the terms of a “contract,” even though, technically speaking, there was no contract to begin with. An equitable remedy can substitute for lack of consideration.
42. A type of equitable remedy that may be imposed on parties to avoid unjust enrichment to one party at the expense of the other.
43. A type of equitable remedy that may be imposed on parties to avoid injustice, when one party detrimentally relied on another party’s promise.
44. A benefit that is conferred or expected to be conferred unjustly.
45. The name for damages awarded in quasi-contract cases, which means “as much as is deserved.”

The remaining defenses discussed in this chapter are relevant if the contract is valid. That is, there are no formation problems. For example, if a party lacks capacity to enter into a binding contract, that can be used as a defense. When people lack the mental ability to understand, they lack capacity. Sometimes, it may *seem* that someone understands, even though he or she might actually lack legal capacity. This is the case with minors. Though some may certainly understand the terms of a contract, they lack the legal capacity to be bound to it. That means that they can **disaffirm**<sup>46</sup> the contract if they wish. Likewise, someone who suffers from a temporary or permanent cognitive defect lacks capacity to be bound to a contract. This may be the case with an infant, a person who suffers from dementia, or a person who has other profound cognitive or mental impairment. Use of alcohol or drugs may impair capacity, but the courts are reluctant to find this as a convincing defense, particularly if the person voluntarily imbibed in the alcohol or drug use themselves. If they were involuntarily drugged, however, then lack of capacity can be a good defense. If someone does not read or speak the language in which the contract is written, that can also indicate a lack of capacity.

If the subject matter of a contract or the terms of the contract are illegal, then the contract may be void at the outset, or it may become void if the subject matter or the terms of the contract become illegal after the contract is formed. The former case can be illustrated by imagining a contract for the production of illegal drugs. A defense to performance is that the contract itself concerns an illegal subject matter. A court will not step in to such a contract to enforce its promises.

The latter case of illegality of the terms of the contract is an example of impossibility as a defense. Impossibility is a defense that can be used when performing the contract has become truly impossible. For example, if you entered into a contract to do business in a country that was subsequently placed on a no-trade list by the federal government, then you would be excused from performing your obligations under that contract, because it would violate federal law for you to perform as promised. It would be impossible, and impossibility would be a valid defense. Sometimes impossibility does not involve the legality of the subject matter or the terms of the contract. Instead, it might simply be a matter of the destruction of the subject matter of the contract. In our scooter example, imagine that before the transaction was completed, the scooter was crushed by the trash collector by accident. The subject matter of the contract was destroyed, and so it would be impossible for the offeror to perform. The offeror would not need to find another scooter to sell to fulfill the obligations under the contract. Instead, he or she would use the defense of impossibility.

46. An option that may be exercised by a minor who is a party to a contract to render the contract void.

Another defense to contract performance is duress. If a party suffers from duress when entering the contract, that party will have a valid defense. Duress means that the party had no other reasonable alternative but to enter into the contract. The

party was coerced into entering into the agreement. For example, imagine that you entered into a contract for automobile insurance. Part of your insurance contract requires your insurance company to defend you in the event of a lawsuit arising from a traffic accident. Imagine that you are involved in a traffic accident and your insurance company refuses to defend you. This is bad news, because you will still need to mount a defense. You will probably expend a great deal of money defending yourself, not to mention trying to launch a complaint against your insurance company for breach of contract. After spending all of your savings and borrowing just to pay your bills, imagine that your insurance company comes to you with an offer to pay you fifty thousand dollars if you sign a waiver that it has no liability to you. You will probably sign that waiver and take the money. Why? Because you have no reasonable alternative. This is an example of **economic duress**<sup>47</sup>, and it is likely that no court would enforce the waiver for the benefit of the insurance company given such facts. The insurance company forced you into signing an agreement with it that you would not have signed if you had any other reasonable alternative.

Unconscionability is a defense used when the contract contains markedly unfair terms against the party with less bargaining power or sophistication than the party who created the terms and induced the other party to sign it. For example, imagine a biotech company discovering a cure for cancer from a plant growing on the private lands of an indigenous people. Imagine that the indigenous people did not understand the importance of the discovery, and they did not understand the value of it. If the biotech company offered to pay for the absolute and complete rights to the plant with ten dollars and a bag of flour, that contract might be said to be unconscionable.

Undue influence is a defense that can be used when one party ceases to be able to exercise his or her free will due to the superior power and influence exerted over that party by the other. For example, imagine an elderly person who is completely isolated from social contact due to poor health and remote living conditions. That person might be quite lonely and eager for company. Say that an unscrupulous person entered that elderly person's life and exerted influence over that person so that the elderly person really could not exercise his free will any longer. If, consequently, the elderly person entered into a contract with the other party to transfer all of his wealth to that person, we might say that this is a case of undue influence. How might this happen? Maybe the unscrupulous intruder is the only human contact that the elderly person has, and maybe he or she led the wealthy elderly person to believe that the only way to salvation is by handing over his assets.

Remember, too, that the Statute of Frauds requires certain contracts to be in writing and signed by the defendant to be enforceable against the defendant. If

47. A defense to contract that can be exercised when one party had no other reasonable alternative but to enter into a contract due to economic threat or pressure.

those types of contracts are not in writing, that can be used as a defense to performance. Contracts for any interest in land, in consideration of marriage, and to pay the debts of another that cannot be performed within one year and contracts for the sale of goods with a price of five hundred dollars or more are all examples of contracts that are required to be in writing to be enforceable according to the Statute of Frauds. If a contract exists for these items, but the contract is not in writing, it may be performed. However, if there is a dispute arising under the contract, it will not be enforced because it violates the Statute of Frauds requirement for a writing.

The statute of limitations is an affirmative defense that can be raised by a defendant to argue that the complaint is being brought too late, by law, to do anything about it. This means that if a dispute arises under a contract, then the plaintiff must bring a complaint concerning that dispute within a certain time period. Every state has different statutes of limitations for different types of disputes. Contracts statutes of limitations range from three to ten years, depending on whether the contract was oral or written, and depending on the jurisdiction.

Mistake is rarely a successful defense to contract, but it is a defense nonetheless. Mistake does not mean bad bargaining. After all, we have the freedom to bargain badly, and the courts will not step in to save us if we do so. For instance, if you agree to buy a house for \$170,000, but the house is only worth \$150,000, you may have bargained badly, particularly if the seller did not deceive you in any way. The court will not step in to rewrite the contract or allow you to use mistake as a defense to excuse your performance. Indeed, the court will enforce the terms of the contract if it is a valid contract. Mistake refers to something that is truly a mistake either by one party or by both. If the parties to a contract truly make a mistake with respect to essential terms of the contract, then that can be used as a defense to performance.

Misrepresentation and fraud are also defenses to contract. Misrepresentation is when a party makes a false statement that induces the other party to enter into the contract. Fraud is a closely related concept, and it simply means that one party has used deception to acquire money or property. Often, unscrupulous salespeople will commit fraud or misrepresent the subject matter of the contract in such a way that the other party will enter into the contract. However, fraud and misrepresentation both may be used as successful defenses in such circumstances.

Commercial impracticability is a defense that can be used when fulfilling a contract has become extraordinarily difficult or unfair for one party.

Frustration of purpose is when the contract has become essentially worthless to one party, though the event giving rise to that state was nonexistent or unknown to both parties to the contract at formation.

Finally, sometimes a party to a contract files for bankruptcy protection. When that party is required to pay a debt that was incurred before the bankruptcy was filed, that duty is suspended temporarily or permanently when the bankruptcy is filed through the court's **automatic stay**<sup>48</sup>. In other words, the debt does not have to be paid during the course of the bankruptcy. At the conclusion of the bankruptcy, if the debtor is successful in bankruptcy and if the contract obligation is a dischargeable debt, then the debt will never have to be paid. The debt is, in fact, discharged. Bankruptcy is a defense to performance of contract for debtors who file for bankruptcy protection.

Remedies for breach of contract are typically monetary damages. Expectation damages, including compensatory and consequential damages, can be recovered. However, consequential damages may not be speculative. Indeed, they must be foreseeable to both parties at the time of the contract formation to constitute damages by breach. **Specific performance**<sup>49</sup> might be required under certain types of contracts, such as in contracts for land. For example, in contracts for real property, the assumption is that land is unique. Therefore, monetary damages are not adequate, because “replacement” land cannot be found that would be like the land that is the subject of the contract. Importantly, specific performance is not an appropriate remedy for service contracts, given the prohibition against involuntary servitude in the Thirteenth Amendment to the U.S. Constitution. Finally, it is important to note that on breach, the injured party has a **duty to mitigate**<sup>50</sup> his damages. This means that he must avoid damages by making reasonable efforts to do so. If a tenant breaches a contract by moving out of his apartment before the lease is over, the landlord will be able to recover damages from that tenant for breaking the lease (i.e., breaching the contract). However, the landlord also has a duty to mitigate those damages by trying to find another tenant.

48. An order by the court to stop all collection activities of prepetition debts owed by a debtor in bankruptcy.

49. A remedy that requires complete performance in a breach, rather than (or in addition to) monetary damages.

50. A duty placed on a party injured by breach, requiring that party to avoid damages by making reasonable efforts.

### KEY TAKEAWAYS

A contract is an enforceable promise. Parties to the contract must perform according to the relevant standard—substantial performance for most service contracts, personal satisfaction, complete performance, or strict performance. Once parties have performed, they are discharged from further obligations under the contract. Failure to perform according to the requisite standard is a breach, which is a compensable injury. A breach may be minor or major. Several defenses exist to breach of contract.

## EXERCISES

1. Referring to [Note 6.47 "Hyperlink: Coach Mike Leach"](#), what additional information would you need to determine whether Coach Leach's services fell below substantial performance and were a material breach or whether he substantially performed his contract so that he did not materially breach it? Should coaching services be evaluated based on substantial performance or personal satisfaction? Why?
2. In international business, it is very common for parties to contract not to read or speak the same language. If someone sought to enter into a contract with you, but that party could not read the language in which your contract was written, should you enter into that contract with that person? How can this problem be overcome so that both parties can form a legally binding contract with each other?

## 6.3 Assignment, Delegation, and Commonly Used Contracts Clauses

### LEARNING OBJECTIVES

1. Learn about assignment and delegation.
2. Examine novation.
3. Explore restrictions on assignment, exculpatory clauses, noncompete clauses, mandatory arbitration clauses, acceleration clauses, and liquidated damages clauses.
4. Explore the parol evidence rule.

What if you formed a contract with a rock 'n' roll band for its services? Specifically, you wanted the band to play at your nightclub, because you thought that your customers would enjoy the band enough to pay to see it perform. You hired this specific band because you heard that it drew large crowds of paying customers. Imagine your surprise when, as you anticipate the band's performance, you discover that another band—one you have never heard of—has come to play instead of the original contracting band. On inquiry, you learn that the original band transferred its duties to perform to a lesser known band. Can it do that?

Figure 6.3



*Let's do business.*

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Contract elements—the terms of the contract—are important. They may, among other things, foreclose your ability to bring a complaint in court, they may render you unable to be hired in your profession (at least within certain boundaries), or they may limit liability to a party that had a role in causing injury to you. If you are not aware of these elements, then you may face an unpleasant surprise if you act in a way contrary to the restrictions imposed by those terms. Likewise, contracts possess certain qualities that prohibit parties from acting in certain ways, unless those qualities are expressly waived. This section identifies common properties of contracts, as well as commonly used elements of contracts. If you are negotiating a contract and you do not like a term, then you should not agree to it. In law, there is a presumption that you have read, understood, and agreed to each and every term of any contract to which you are a party. Arguing that you did not understand or that you did not approve of a particular term in the contract will not be a valid excuse to performance. You should know what you can expect when you enter into a contract. Are you getting the band that you wanted to

hire to play in your nightclub, or are you really getting any band that the original band happens to transfer its duties to?

As a preliminary matter, it is important to realize that contracts are, by law, assignable and delegable. This means that the rights conveyed by the contract may be transferred to another party by **assignment**<sup>51</sup>, unless an express restriction on assignment exists within the contract, or unless an assignment would violate public policy. Likewise, the duties imposed on a party may be transferred to another party by **delegation**<sup>52</sup>, unless the contract expressly restricts delegation, or there is a substantial interest in personal performance by the original party to the contract, or if delegation would violate public policy. In the case of a band hired to perform at a nightclub, an argument could be made that the original band cannot delegate its duties under the contract because there was a substantial interest in personal performance by the original band. This would render the contract nondelegable. To be on the safe side, your contract with that band should have had a clause expressly prohibiting delegation.

Many students have seen restrictions on assignment in the form of no-sublease clauses in leases with landlords. Do you have a no-sublease clause in your lease? If so, that is a **restriction on assignment**<sup>53</sup>. This clause is necessary to prevent you from assigning your rights under the lease—your rights to inhabit the premises—to another party. It is necessary for the landlord to include that provision expressly if she wishes to prevent you from subleasing the unit, because there is a presumption in law that assignment is permitted unless it is expressly prohibited by the contract or unless the assignment would violate public policy. Since it is unlikely that letting someone else live in your housing unit in your absence would violate public policy, then the landlord must expressly prohibit the assignment within the original contract if she wishes to prevent tenants from subleasing. A landlord may have a very good reason to wish to prevent subleasing; she may wish to ensure that each tenant is creditworthy prior to allowing the tenant to live in the property.

- 51. The ability to transfer rights conveyed by a contract to another party.
- 52. The ability to transfer duties imposed on a party by a contract to another party.
- 53. A clause that prohibits parties from transferring the rights conveyed by a contract to another party.
- 54. An agreement that transfers all rights and duties to a new party to the contract and releases the previous party from any further obligation arising from the original contract.

Note that in delegation and in assignment, the original contracting party is not “off the hook” if it transfers its duties or rights to another party. For instance, if subleasing was not prohibited, and the new tenant assumed the rights and duties imposed by the original contract, the original party to the contract is still liable for the payment of rent. If the subleasing tenant does not pay the rent, the original party to the lease is still liable. The way to excuse oneself from this liability is to form a three-way **novation**<sup>54</sup> with the original party and the new party, thereby excusing the exiting party from future liability arising under the contract. A novation is essentially a new contract that transfers all rights and duties to the new party to the contract and releases the previous party from any further obligation arising from the original contract.

Restrictions on assignment or delegation are not the only common elements that can be found in contracts. For example, you have probably encountered exculpatory clauses. An **exculpatory clause**<sup>55</sup> is an express limitation on potential or actual liability arising under the subject matter of the contract. In short, exculpatory clauses are often employed when risk of injury exists. They seek to limit one party's liability to another. You most certainly have signed exculpatory agreements or contracts containing exculpatory clauses if you have participated in any potentially dangerous activity at a club or with an organized group that could incur liability from injuries suffered by its patrons or members. For example, if you join a kayaking club, you will most likely be asked to sign such an agreement to "hold harmless" the club in the event of any accident or injury. However, despite the existence of an exculpatory clause, liability will not be limited (that is, the liability limitations will be unenforceable) when the party who would benefit from the limitation on liability acted with gross negligence, committed an intentional tort, or possessed greatly unequal bargaining power, or if the limitation on liability violates public policy. Imagine that you signed an agreement to engage in kayaking activities with a kayaking group, but the leader of the group battered you with her oar because she was angry with you for mishandling your kayak. Since battery is an intentional tort, the exculpatory clause will not protect the kayaking organization from liability it incurred through the actions of its employee.

Another common contract element that you may have encountered is a noncompete clause. A **noncompete clause**<sup>56</sup> attempts to restrict competition for a specified period of time, within a certain geographic region, and for specified activities. Noncomplete clauses are generally valid against the party who signed it if the time, place, and scope are reasonable. These are very common clauses in employment contracts, particularly where the duties involved in employment are likely to involve trade secrets or other proprietary information that the company wishes to protect.

A **mandatory arbitration clause**<sup>57</sup> is very common in consumer contracts and employment contracts. You have certainly subjected yourself to the restrictions imposed by these clauses if you have signed a contract for a credit card. Mandatory arbitration clauses require parties to a contract that contains such a clause to submit to mandatory arbitration in the event of a dispute arising under the contract. Mandatory arbitration clauses frequently foreclose any possibility of appealing arbitration awards in court.

An **acceleration clause**<sup>58</sup> commonly exists in contracts where periodic payments are contemplated by the agreement. For example, if you signed a lease for your housing unit, then you most likely pay rent on a month-to-month basis. If you breached your lease, you would still owe rent for each subsequent month contemplated by the lease agreement. This means that your landlord would have

- 55. An express limitation on potential or actual liability arising under the subject matter of the contract.
- 56. A contract clause that restricts competition for a specified period of time, within a certain geographic region, and for specified activities.
- 57. A contractual clause that requires the parties to a contract that contains such a clause to submit to mandatory arbitration in the event of a dispute arising under the contract. Mandatory arbitration clauses frequently foreclose any possibility of appealing arbitration awards in court.
- 58. A type of clause that accelerates all payments due under the contract on breach.

new injury every month that you did not pay. An acceleration clause accelerates all payments due under the contract on breach. This allows the injured party—in this case, the landlord—to sue for all damages due for unpaid rent under that contract at once, rather than having to bring a new suit each month to seek monthly unpaid rent.

A **liquidated damages clause**<sup>59</sup> allows parties to set the amount of damages in the event of breach. Agreeing to a damage amount before any breach occurs can save money and time spent litigating. Providing that the liquidated damages clause does not look like a penalty, the clause will be valid and enforced by a court that hears a dispute arising under the contract. For example, imagine that you entered into a contract for the sale of your car. If the liquidated damages clause provided for two thousand dollars of damages in the event of breach, that will probably be a valid liquidated damages clause, providing that your car is an “average” car. However, if the liquidated damages clause provided for one million dollars of damages payable by the breaching party, then that would not be enforceable by the court because it looks like a penalty. The proposed liquidated damages far exceed the value of the car that is the subject of the agreement.

Of course, there are additional common elements to contracts. This is not an exhaustive study of possible provisions, though it is a list of commonly encountered elements. For example, time of performance is often included as a separate provision. However, time for performance is an essential element in common-law contract formation, and without it, the contract may fail due to lack of definite and certain terms in formation.

A major assumption made about a written contract is that it is **integrated**<sup>60</sup>, which means that it contains the entire expression of the parties’ agreement. That means that any statements made before the parties signed the contract are not part of the contract, unless those statements are memorialized in the contract itself. In fact, any statements or actions that are not captured within the four corners of the contract are considered **parol evidence**<sup>61</sup>, and they will not be used to interpret the meaning of the contract.

59. A type of clause that sets the amount of damages in the event of breach.

60. The legal assumption made about contracts that they contain the entire expression of the parties’ agreement.

61. Statements or actions that are not captured within the four corners of the contract.

### KEY TAKEAWAYS

Parties to contracts must not only take care to form the agreement so that it is legally enforceable, but they must also be aware of the properties of contracts in general, as well as specific provisions contained within contracts to which they are a party. Properties of contracts include ability to assign, delegate, and exclude parol evidence. Several types of contracts clauses are commonly used to restrict rights and limit liability.

### EXERCISES

1. Think of an example of an exculpatory clause that you have signed. For what type of activity would you be unwilling to sign an exculpatory clause? If your refusal to sign the exculpatory clause or agreement prevented you from participating in that activity, would you still refuse to sign it?
2. Do you think that too many limitations and restrictions can be placed on parties in a contract? Should there be more government regulation and standardization of contract terms between private parties? Why or why not?

## 6.4 Concluding Thoughts

Contracts are an integral part of business. Without contracts, promises would not be enforceable, which would wreak havoc on our financial stability, both individually and professionally.

The law presumes that people who sign contracts have read the contract and understood its terms. Of course, contract language includes many terms of art, and simply reading a contract alone may not be enough to fully understand its implications. Contracts for important matters should be reviewed and explained by attorneys, so that parties who enter into contracts do not do so without understanding the agreement.

It's important to understand the implications of making promises. If those promises carry legal duties, then, barring a defense, the promise will need to be performed so that the obligation or duties arising under that promise can be discharged. If the promise is not performed, and if there are no defenses, then the contract has been breached. Breach is an actionable claim, with the goal of recovering the loss and placing the nonbreaching party back to the position that he or she would have been in if the contract had not been breached.

Recognizing fundamental elements of contracts and how to incorporate considerations important to you when entering into them can go far toward ensuring business success. Likewise, the failure to recognize the traps and tricks that can be incorporated into contracts can derail a good business idea.