

## A Basic Introduction to Contract Law

Although contract law can become extremely complicated, at heart it is really very simple. A contract is nothing more than an agreement between two or more people that each will do something in exchange for receiving something. Regardless of whether a contract has hundreds of pages of fine print or consists of a few words and a handshake, there are four broad categories of legal issues that come up again and again.

### Contract Formation

More often than one might think, fact situations may raise an issue about whether the parties actually have entered into a contract. The critical factors are (1) that the parties each agreed to a deal in which (2) each of them gives something up and gets something in return. See what you think about the following fact situations: contract or no?

1. I promise to give my daughter a pony for her birthday.  
Contract? Yes No
2. Luna and I agree that I will pay her \$35 if she will cut my grass, and she agrees to do so.  
Contract? Yes No
3. I make an appointment to see my doctor, and she diagnoses a cold.  
Contract? Yes No
4. I put an ad in the paper saying “sofa for sale—best offer.” Before Phil shows up at my door saying he’d like to buy it, though, I change my mind.  
Contract? Yes No
5. I agree to pay Samantha \$1500 for her gently-used computer, but decide on the way to pick it up that I’d be better off buying a new one.  
Contract? Yes No
6. I agree to pay Samantha \$1500 for her gently-used computer, but discover after I get home with it that the same computer costs \$400 if I buy it new.  
Contract? Yes No

### **Answers and Explanations:**

**1. No contract.** I promised to make a gift, but my daughter didn’t give up anything—there was no agreement or bargain here. It would be different, though, if I had said, “If you do all the work in the garden this summer, I’ll buy you a pony” and my daughter said, “Deal!”

**2. Contract.** I agreed to give up money for the benefit of getting my grass cut, and Luna agreed to do the work for the benefit of being paid.

**3. Contract.** Even though there was no negotiation between me and my doctor, it is common knowledge throughout our society that when you seek out treatment by a doctor, you will be charged a reasonable fee. There was agreement here, but it was *implied* from our behavior, rather than being a verbal agreement.

**4. No contract.** By putting an ad in the paper, I indicated my willingness to consider offers for the sofa, but I didn't enter into an agreement with Phil. The result might be different, though, if my ad said, "I'll sell my sofa to the first person who shows up at my door with \$150 cash." In that case, I've made an offer, and indicated that a contract will come into existence if Phil shows up at my door with \$150. If I change my mind, I will have to withdraw my offer before Phil accepts—I may need to put a sign in my front yard saying, "I withdraw my offer. Keep your money. I love my sofa."

**5. Contract.** Because Samantha and I have entered into an agreement, in which I give up money and get a computer, and she gives up her computer and gets money, I've lost the right to change my mind. Even though the actual performance of the contract has not yet occurred, *the agreement has*, and so a contract has been formed. Quite often a contract consists of an exchange of promises to perform, with performance occurring at a later date.

**6. Contract.** Whether a bargain is a good one or a bad one doesn't affect whether a contract has been formed. (Although in some extreme cases, it may affect whether the law will enforce that contract.) Freedom of contract means that we are all free to make a bad bargain.

Be sure to note the questions you missed and pay particular attention to the rule in those situations. Be sure to ask the instructor if you're puzzled.

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*Note:* An important step in analyzing contract cases is determining WHO is liable under the contract. One common situation involves spouses who together enter into a contract, promising to pay the amount owed.

*Example:* Luna and Jane have been married for a little over a year, and they've decided it's time to buy furniture. They both sign an installment sales contract provided for 12 easy monthly payments of \$135. If they fail to pay the amount owed, the furniture store has a choice under the legal principle of *joint and several liability*. It can sue Luna and Jane together, or either of them separately. If the store sues one of them separately, it can sue for the entire amount due—each of them has promised to pay the entire amount due.

Change the facts: Luna buys the furniture, signs the agreement, gets tired of Jane, and moves to Canada. Can the furniture store sue Jane? [See p.9 for answer and explanation.]

### **Determining the Terms of the Contract**

Before you can decide whether a contract has been breached, you have to know what the contract requires each party to do. The details about the agreement between the parties are called the *terms* of the contract.

Judges are happiest when the terms of a contract are clear: preferably written and with enough detail, but without being so complicated that it's hard to understand. All too often, though, it's not easy to determine exactly what the parties agreed to. In trying to figure that out, says the law, judges should have as a guiding beacon the question of what the parties **intended**. [*But note*: When the terms of an agreement are clear, the law will not rewrite a contract even if the evidence shows that one of the parties intended something different.]

Sometimes it is difficult to identify the terms of a contract because the agreement between the parties was oral, and the evidence is conflicting about what the agreement was. In these cases, an important legal principle helps you as the judge decide what to do: The party who has the burden of proof (usually the plaintiff) has the responsibility of producing enough evidence to persuade you that the terms of the contract were most likely what s/he says they were. If you believe that the version offered by that party is the more likely version (i.e., "by the greater weight of the evidence"), then that term is treated as part of the contract. What if you conclude instead that his contention is possible? That term does not become a part of the contract unless you conclude that it is not only possible, but in fact more likely than not.

**Try it out:** Joanna is suing for money owed, saying that she lent Tom \$50 three months ago, and that Tom promised to pay her back "within the next couple of months" with interest but has never done so. Tom says he borrowed the money to buy textbooks for college, and that he and Joanna agreed he would repay the loan at the end of this semester, when Tom begins working at his summer job. You're not sure who to believe. What do you do? *Check p. 9 for answer and explanation.*)

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Sometimes the problem is not that the evidence about the terms is conflicting, but instead that there was no discussion about a term at all. In this case, the law sometimes fills in the blanks, and sometimes it does not. The rules about this are complicated, and a specific case may present a situation in which you need to consult reference material or ask for help. In many instances, though, your common sense will lead you to a correct result. When it is

obvious to you from the evidence that a term was not important to either party, or was obvious to both parties, the legal solution is usually to fill in the blank.

Example: I walk by a store and see a black sweater on a mannequin in the window. The mannequin is on a table containing many identical sweaters. The clerk notices my interest and asks if I would like to buy a sweater. I answer, “Yes—that’s a great looking sweater.” He boxes it up for me, and I pay for it, but when I open the box at home, I discover a polka-dot sweater. The salesclerk and I did not explicitly state that a term of the contract was that the sweater in the box would be identical to the sweater on the table. Nevertheless, that was an *implied* term of the contract.

Problem: Same facts, except this time the folded sweaters on the table are variously colored and patterned. The clerk says, “Would you like to pick one out?” and I respond, “No, thanks. Just box one up for me.” Can you conclude from this evidence that one term of the contract was that the sweater would be black? (Check p.10 for answer and explanation.)

There is a special legal rule called the *parol evidence rule* about deciding what the terms of a contract are. [*Parol* is an old French word meaning “spoken words.” The similar French word *parole* meant “word of honor.” Cool, huh?] The legal name for this rule makes it sound very technical, but it actually amounts to common sense. The rule simply says that if a written contract is clear, but one party wants to introduce evidence that the actual verbal agreement between the parties was different from what is written down, the judge will base the decision on what is written down. The logic, of course, is that what is written down is more reliable evidence than recollections about what people said. Also, the law wants to encourage people to write their agreements down, so part of the reason for this rule is to support that encouragement. There are a couple of exceptions to the parol evidence rule, though. See if you can figure them out, based on the fact situations below:

Sol and Luna sign a written agreement that says, “I, Sol, will pay Luna \$75 for performing yard work on my yard. Luna will complete this work between the 1<sup>st</sup> and the 5<sup>th</sup> of this month, and I will pay her upon completion.”

Question #1: Luna has brought an action for money owed against Sol after Sol refused to pay her. Sol says that’s because Luna didn’t trim the shrubbery. Luna wants to introduce evidence that, at the time they were negotiating the agreement, she asked Sol what he meant by “yard work” and Sol said, “Mowing and raking the grass, edging the lawn, and using the weedeater in places where you can’t get the mower.” Based on this part of their negotiation, Luna says, trimming the shrubbery was not actually included in their agreement, and thus she did not breach by failing to do so. In this case, the judge can consider Luna’s testimony. Can you figure out why?

Question #2: In this situation, Luna and Sol have entered into the same written agreement, but this time Sol wants to testify that, two weeks after they signed the contract, he asked Luna to include trimming the shrubbery, and Luna agreed, with the understanding that she would have five extra days to do the work. The judge can consider this testimony. Can you figure out why? [See p.10 for answers.]

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There's another situation in which a contract may have important terms even though the parties didn't discuss them, much less agree to them. *These terms* are automatically part of contracts involving the sale of goods under a comprehensive statute known as the Uniform Commercial Code. These special terms are called *implied warranties*, and there are two of them:

The *implied warranty of merchantability* is a term automatically inserted in a contract for the sale of goods to the effect that the seller promises (or "warrants") that the product it will do what it is ordinarily expected to do. An iron will get hot; a refrigerator will get cold. It doesn't matter that the contract doesn't say that explicitly (although often the contract will, and that's called an express warranty, or guarantee). If a person buys a a new television set that doesn't work, he has a legal claim that an implied term of the contract has been breached—the term that says the TV set I'm buying from you will work. Note that this implied term applies only when the seller is a merchant. If you buy an iron at a yard sale, you're on your own!

The *implied warranty of fitness for a particular purpose* is another term that makes good sense. That term says that if I consult a merchant who is in a specialized business or otherwise purports to be someone who has some expertise about which product is best for some particular purpose, there is an implied promise that the goods I buy based on that advice will be suited to that particular purpose. Let's say I go to a store that sells running shoes and tell the clerk I'm going to run the Boston Marathon, and I buy a pair of running shoes based on the advice of the salesman. Two weeks into my training, the shoes start to fall apart. I now have a legal claim that an implied term of the contract has been breached—the term that says these shoes will be suited for marathon running.

The rules about warranties are the first examples we've discussed of an important aspect of contract law: consumer protection legislation. This is a subject we'll return to in a few pages. For now, just notice that the law sometimes inserts or deletes a contract term, despite our society's commitment to the ideal of freedom of contract, in order to protect consumers.

There are exceptions and qualifications to the rules about implied warranties. One of the best known is that, when a seller sells something "as-is," the seller makes no warranty about the condition of the goods. If you are confronted with a case involving a technical

legal dispute about a question such as whether an attempted waiver of warranty was legally effective, or some similar complex question, it would be best to reserve judgment and consult reference material or otherwise seek assistance.

### **Is the Contract One That the Law Will Enforce?**

So far, I have indicated several times that common sense is a generally reliable guide in arriving at a correct legal answer in contract cases. That statement is much less true when it comes to the rules about legal enforcement of contracts. While there are sound reasons for the legal principles to which we will now turn our attention, sometimes the result of their application in particular cases may seem to contradict common sense. The usual reason for this is that the principle is based on a policy decision made by our society that works well most of the time but may yield surprising or unfair results in a particular case.

*Remember:* This situation comes up after you have decided that the parties have entered into a contract, you have ascertained its terms, and you have determined that one party has breached the contract. Under what circumstances might the court, in this situation, nevertheless refuse to give the complaining party a remedy?

First, the law will usually refuse to enforce a contract in which one of the parties was not able (i.e., *lacked capacity*) to give legal consent. Stop here and ask yourself: what is an example of a party not able to give legal consent to a contract?

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If you said minors or persons who are mentally incompetent, you were correct. The general rule is that a contract by a minor or mentally incompetent person is not enforceable **against that person**. [Note that the law is perfectly willing to enforce a contract against another person on behalf of a minor or incompetent—we don't worry about protecting the interests of those who can protect themselves.] Similarly, a person who contracts because he has been tricked or misled, or who has been coerced in an illegal way, does not truly consent to the contract, and the law will not hold him to it. This is one of those general principles that have a lot of exceptions. Let's look at the rule, and at some of the exceptions, in the examples below.

#### **Example #1:**

Luna is 17 and looks 22. When she bought a car from Fast Eddie, she assured him she was 21. After she wrecks the car, she wants to return it and get a complete refund of her money. Can she?

#### **Example #2:**

Jane is a quiet woman with a sweet smile who gives no outward sign that she suffers from Alzheimer's and has been declared mentally incompetent. She goes to Sears and buys a

refrigerator for \$900. She has purchased 3 other refrigerators this week. Sears wants to enforce its contract against Jane. Can it?

Example #3:

Susan signed a contract with Better Bodies as part of her New Year's resolution to finally knock off some weight, but she's thought better of it now. Better Bodies has sued Susan in small claims court for money owed on the contract, but Susan claims that Better Bodies should not be allowed to enforce the contract. She says they used glitzy machinery and a cool smoothie bar to talk her into signing a contract when they know very well that 9 out of 10 people who sign up stop coming within 6 weeks. Susan says she was tricked. Can Better Bodies enforce the contract?

Example #4:

Robbie Robber kidnapped Abe's sweet Petunia pug dog and demanded \$1,000 for ransom. Not only did Abe pay, but he also solemnly swore that he wouldn't cooperate in any prosecution of Robbie. Robbie says that because Abe breached the contract by going to the police after recovering Petunia, Robbie has been severely injured—he's out dog and money, and in jail! Abe doesn't dispute that he broke his promise to Robbie. Does Robbie have a good case?

Example #5:

After showing Miranda several sheets of fine print and explaining them to her, Snidely closes the deal on a rental agreement by asking her to sign a rental contract that he has kept concealed until now that contains a very high rental fee, covering the contents with other papers and talking quickly so Miranda doesn't notice. Snidely has filed an action against Miranda, but she says she never laid eyes on the contract that bears her signature, and you believe her. Is the contract enforceable?

*[Look at pp. 10-12 for answers and discussion.]*

There are three other common reasons for a court to refuse to enforce a contract. Although they have legal-sounding names, they're pretty straightforward. As a general rule, these reasons are *affirmative defenses*, which means the defendant is responsible for bringing them to the attention of the judge and persuading the judge of their validity.

*The Statute of Frauds.* Some contracts are required to be written, dated, and signed by the debtor to be enforceable. The ones you are likely to see most often are retail installment sales contracts when the seller is furnishing the buyer credit so that he can buy the goods or services.

*The Statute of Limitations.* There are legal time limits within which a person must bring a lawsuit or else lose the right to do so. There are three important rules that come up frequently in this defense:

1. The statute of limitations for contracts for services or money lent is three years.
2. The statute of limitations for contracts for the sale of goods is four years.
3. In an action on an account, a part payment starts the statute of limitations all over again on the balance due.

*Unconscionability.* Remember when I said earlier that freedom of contract includes the right to make a bad deal? Sometimes a deal is SO bad, and the circumstances surrounding it are so troublesome, that the law refuses to enforce a contract. One judge described this kind of contract as one that “shocks the conscience.” When a contract is made between two parties who are very unequal in terms of their bargaining power and sophistication, and the contract itself strikes almost everyone as extremely unfair, the law simply refuses to lend its support and approval by enforcing it. Instead, the contract—or often one or more of the terms of the contract—is labeled “unconscionable” and not enforced.

### **What Are the Damages?**

Assume that you’ve determined a contract exists, identified its terms, and decided that the contract has been breached. How do you decide what to award the plaintiff? What is the measure of damages?

General rule: Amount of money owed plus interest from date of breach.

Special measure of damages in actions for breach of warranty term: Difference between fair market value of goods received and goods as warranted.

Interest: In all breach of contract actions, the law awards interest for the time period between the date of breach and the date of judgment. If the contract itself contains a rate of interest, that interest rate will apply (so long as it does not exceed the allowable rate under the law.) If the contract does not contain an interest rate, the rate is set by statute at 8% (sometimes referred to as “the legal rate.”)

Attorney fees are not usually allowed as part of damages. In the case of contracts, a notable exception includes action on a note or other evidence of debt. Amount is at contract rate up to maximum of 15% of outstanding balance, and there is a notice provision that allows debtor to avoid attorney fees by paying off debt.



Example: I buy a pure-bred puppy from Super Intelligent Pets. I tell the salesperson I want the smartest dog in the store, and he tells me about the special Doggy IQ Test that all their dogs must take before being matched with an equally smart owner. I agree to pay \$500 over a one-year period, with interest at 10%. I also agree that if SIP has to take me to court, I will pay an attorney fee of \$200. After I take Einstein home, I discover he's dumb as dirt and I stop paying SIP. SIP sues me for breach of contract, and I counter-sue for breach of implied warranty of fitness for a particular purpose.

Assume you rule in favor of SIP and against me on my counterclaim. What will the damages consist of? [I'm not looking for a specific amount of money—just tell me in words what you'd be thinking about.]

Assume you rule against SIP and for me. How will you determine damages? [Answers on p. 12.]

### **Answers and Explanations**

**Page 3** [*Joint and several liability*]: Luna buys the furniture, signs the agreement, gets tired of Jane, and moves to Canada. Can the furniture store sue Jane?

Answer: No. Jane did not enter into the agreement with the furniture store, so she was not a party to the contract. Just being married to Luna doesn't mean Jane is legally responsible for all her agreements.

**Page 3** [*Conflicting evidence of terms of contract*]: Joanna is suing for money owed, saying that she lent Tom \$50 three months ago, and that Tom promised to pay her back "within the next couple of months" with interest but has never done so. Tom says he borrowed the money to buy textbooks for college, and that he and Joanna agreed that he would repay the loan at the end of this semester, when Tom begins working at his summer job. You're not sure who to believe. What do you do?

Answer: Dismiss the case. When both parties are credible and the versions offered by each are plausible, the party with the burden of proof loses. Before you become too concerned that this result may be unfair to Joanna—since she might be telling the truth, remember that she could have insisted on putting their agreement in writing.

**Page 4** [*Determining contract terms*]: This time the folded sweaters on the table are variously colored and patterned. The clerk says, "Would you like to pick one out?" and I respond, "No, thanks. Just box one up for me." Can you conclude from this evidence that one term of the contract was that the sweater would be black?

*Answer:* No. Since the display was varied, and I refused to select a particular sweater, there is no evidence to support a finding that the color of the sweater was a term of this particular contract.

**Pages 4 & 5** [*Parol evidence rule*]: Luna and Sol sign a written agreement that says, “I, Sol, will pay Luna \$50 for performing yard work on my yard. Luna will complete this work between the 1<sup>st</sup> and the 5<sup>th</sup> each month, and I will pay her upon completion.”

**Question #1:** Luna has brought an action for money owed against Sol after Sol refused to pay her. Sol says that’s because Luna didn’t trim the shrubbery. Luna wants to introduce evidence that, at the time they negotiated the agreement, she asked Sol what he meant by “yard work” and Sol said, “Mowing and raking the grass, edging the lawn, and using the weedeater in places where you can’t get the mower.” In this case, the judge can consider Luna’s testimony. Can you figure out why?

*Explanation:* The term in the contract that refers to “yard work” is not clear—we don’t know what the parties meant when they included that in the contract. Evidence about discussions they had before or at the time they negotiated the agreement may be considered by the judge in deciding what the term means. The judge may or may not believe Luna’s testimony, of course, but this is an example of a case when the parol evidence rule does not apply to prevent the judge from even hearing the evidence. *Rule:* Parol evidence is properly admitted to explain a term in the contract that is ambiguous.

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**Question #2:** In this situation, Luna and Sol have entered into the same written agreement, but this time Sol wants to testify that, two weeks after they signed the contract, he asked Luna to include trimming the shrubbery, and Luna agreed, with the understanding that the time for her performance would be increased from 5 days to 10. The judge can consider this testimony. Can you figure out why?

*Explanation:* This evidence is not about the original agreement, but about a change in the agreement that happened **later**. Obviously, we can’t expect later agreements (called *modifications*) to be included in the original writing. The parol evidence rule applies only to evidence about events that happened before or at the same time as the contract.

**Pages 6 & 7** [*Reasons not to enforce a contract*]:

**Example #1:** Luna is 17 and looks 22. She bought a car from Fast Eddie, and she assured Fast Eddie that she’s over 18. After she wrecks the car, she wants to return it, and get a complete refund of her money. Can she?

*Answer:* Yes. Luna is a minor and had no legal ability to enter into this contract—as far as the law is concerned, Luna can enforce it against Fast Eddie if she wants to, but she can also

change her mind and cancel the contract at any point. If this seems unfair to you, remember that one purpose of this law is to encourage adults like Fast Eddie think twice before entering into a contract with a young person who may not be mature enough to make a good business decision.

Example #2: Jane is a quiet woman with a sweet smile who gives no outward sign that she suffers from Alzheimer's and has been declared mentally incompetent. She goes to Sears and buys a refrigerator for \$900—one of the less expensive ones on the sales floor. She has purchased 3 other refrigerators this week. Sears wants to enforce its contract against Jane. Can it?

*Answer:* Maybe. We have a slightly different rule for contracts by people who are mentally incompetent, perhaps because the law realizes that, unlike young people, there may be no way for a merchant to tell if Jane is capable of giving legal consent. If Sears had no reason to know that Jane was incompetent, and there's no evidence that the contract was unfair or that Sears was taking advantage of Janet, courts will enforce the contract.

Example #3: Susan signed a contract with Better Bodies as part of her New Year's resolution to finally knock off some weight, but like most of us, she's thought better of it now. Better Bodies has sued Susan in small claims court for money owed on the contract, but Susan claims that Better Bodies should not be allowed to enforce the contract. She says they used glitzy machinery and a cool smoothie bar to talk her into signing a contract when they know very well that 9 out of 10 people who sign up stop coming within 6 weeks. Susan says she was tricked. Can Better Bodies enforce the contract?

*Answer:* Yes. This is the classic example of a bad bargain. Susan was not deceived by Better Bodies; the company may not have provided her with facts about how many customers change their minds, but it is under no duty to do so. The law distinguishes between active deception and a passive failure to inform. This situation reminds us of the old saying: Let the buyer beware.

Example #4: Robbie Robber kidnapped Abe's sweet Petunia pug dog and demanded \$1,000 for ransom. Not only did Abe pay, but he also solemnly swore that he wouldn't cooperate in any prosecution of Robbie. Robbie says that because Abe breached the contract, he's been severely injured—he's out dog and money, and IN jail! Abe doesn't dispute that he made the promise to Robbie, and agrees as well that he broke it. Does Robbie have a good case?

*Answer:* I sure hope you said no. There are several problems with this contract, in addition to the main point of the question, which is that contracts made as a result of coercion or extortion are not enforceable. Neither are illegal contracts, of course. Finally, there was no real exchange here. Robbie gave up Petunia, but he had no right to her to begin with—she belonged to Abe!

Example #5: After showing Miranda several sheets of fine print and explaining them to her, Snidely closes the deal on a rental agreement by asking her to sign a rental contract that he has kept concealed until now that contains a very high rental fee, covering the contents with other papers and talking quickly so Miranda doesn't notice. Snidely has filed an action against Miranda, but she says she never laid eyes on the contract that bears her signature, and you believe her. Is the contract enforceable?

*Answer:* No. This is an example of a contract in which there was no real consent—Miranda's signature was obtained by a trick, and so it is not a meaningful sign that she agreed to this contract.

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Page 9 [Determining damages]: I buy a pure-bred puppy from Super Intelligent Pets. I tell the salesperson I want the smartest dog in the store, and he tells me about the special Doggy IQ Test that all their dogs must take before being matched with an equally-smart owner. I agree to pay \$500 over a one-year period, with interest at 10%. I also agree that if SIP has to take me to court, I will pay an attorney fee of \$200. After I take Einstein home, I discover he's dumb as dirt and I stop paying SIP. SIP sues me for breach of contract, and I counter-sue for breach of implied warranty of fitness for a particular purpose.

Assume you rule in favor of SIP and against me on my counterclaim. What will the damages consist of? [I'm not looking for a specific amount of money—just tell me in words what you'd be thinking about.]

*Answer:* SIP is entitled to whatever portion of \$500 I haven't yet paid, with 10% interest up to the date of judgment. In addition, assuming SIP properly gave me notice of its intent to seek attorney fees, I will have to pay attorney fees, but only up to 15% of the outstanding balance.

Assume you rule against SIP and for me. How will you determine damages?

*Answer:* Damages on a breach of warranty claim are determined based on the difference between the fair market value of Einstein as warranted and as she actually is. It will be my burden to prove to you the current fair market value of a super-intelligent puppy of Einstein's breed and the FMV of an ordinary dog of that breed. I will be entitled to that amount, plus interest of 8% (the legal rate, which applies unless a contract specifies a different rate) from the date of breach (which in this case would be the same as the date of sale).