



Business Law I (BMGT 380)

Week 5

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Business Law I

Contracts (Continued...)

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Contracts - Recap of basics

- Contracts are an exchange of mutually enforceable promises--consideration
- A contract requires a clear offer and acceptance, with an intent to be bound to a set of obligations.
- A failure by one or both parties to perform its promises (obligations) is a breach of contract
- Consequences for breach of contract can be damages paid to the non-breaching party--
 - compensation to make them whole including the benefit of the bargain (e.g., lost profit)
 - incidental and consequential damages
 - not penalties, but late fees may be allowed (liquidated damages).
- Contracts are governed by UCC Art 2 for the sale of goods, and by common law (Restatement) for services and real estate.

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Contracts - Recap of basics

- Parties to a contract create “private law” - legal obligations applicable to the parties with consequences enforceable by the courts.
- Contracting parties creating private law bind each other, but not third parties.
 - Contracting parties cannot limit rights of third parties (persons that are not parties to a contract)
 - However, third parties may be able to enforce contractual provisions if the contracting party intended that third party to be a beneficiary.

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Contracts - Freedom of contract

- The law permits great latitude to parties to establish contractual terms
- The law does not look at sufficiency of consideration--the contract may be a bad bargain for one side.
- The law does impose limitations on what parties can agree or enforce.
 - It cannot be for an illegal purpose
 - One party cannot impose penalties on another, or waive certain types of liability.
- Contracts are easy to enter into...and easy to get out of
 - The law looks for evidence of agreement, not formalities, to find contractual obligations.
 - The law does not penalize a party for breach. It only requires compensation for harm caused and loss of expectation.
 - Contractual liability is a form of strict liability. Fault does not need to be proven, only that a party failed to perform its obligation.

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Contracts - Freedom of contract

- **Transfer** - Parties can generally transfer their contractual rights and obligations to third parties.
 - A party may **assign** of all or some rights
 - A party may also **delegate** of all or some obligations (though many use “assignment” to mean assignment and delegation)
 - However, a transferring party may be liable for transferee’s non-performance.
 - Requires notice to non-assigning party
 - Some also call this “novation” - substitution of one party for another.
 - Releases the transferring party from further liability.
 - Requires agreement by transferor, transferee and other party.
 - The third party assignee steps into the shoes of the contracting party (assignor).
 - The ability to transfer contractual rights may be restricted within the contract.

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Contracts - Statute of Frauds

- To be enforceable, **executory obligations** in certain contracts must be in writing
 - *Signature by the defendant* normally required, though now courts will consider other evidence of agreement.
 - Includes contracts for:
 - Sales over \$500
 - Interest in real estate
 - Long term contracts (performance over 12 months)
 - Surety -- covering debt obligations of another
 - However, once performed, the obligations are no longer subject to a writing requirement to be enforceable.

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Contracts - Statute of Frauds

- Mirror image rule - Offer and acceptance must be the same.
 - Traditional common law requirements, captured in the Restatement
 - UCC Art 2 has relaxed this to allow for some gaps
 - Battle of the forms -- competing/inconsistent terms between *merchants* are not fatal
 - Look at last set that the parties performed against
 - May be limited by terms in a written agreement--parties agree to ignore other terms outside the main agreement.
 - Contractual provisions take precedence over UCC, but UCC will fill in gaps.
 - Price may be left open when creating a contract, but product and quantity will normally need to be defined.
 - Be mindful of the requirement for a writing (Statute of Frauds) and the significance of expressions outside the contract (*parol evidence*)

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THE PAROL EVIDENCE RULE, in general, prevents the introduction of evidence of prior or contemporaneous negotiations and agreements that contradict, modify, or vary the contractual terms of a written contract when the written contract is intended to be a complete and final expression of the parties' agreement.

However, there are some exceptions to the parol evidence rule. Evidence of the following is admissible:

1. *Defects in the formation of the contract (such as fraud, duress, mistake or illegality).*
2. *The parties' intent regarding ambiguous terms in the contract.*
3. Problems with the consideration (e.g., the consideration was never paid).
4. A prior valid agreement that is incorrectly reflected in the written instrument in question.
5. A related agreement, if it does not contradict or change the main contract.
6. A condition that had to occur before contract performance was due.
7. Subsequent modification of the contract.

(<http://jec.unm.edu/education/online-training/contract-law-tutorial/the-parol-evidence-rule>)

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Contracts - Interpretation

- Courts attempt to understand what the parties agreed to in the contract by using these tools:
 - Specific terms are more important than general terms.
 - Terms are interpreted in the context of the entire contract, not in isolation.
 - Will look at defined terms (usually capitalized). Otherwise, common words will be given common meaning, and technical terms will be given technical meaning as understood in the industry.

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Contracts - Interpretation

- Courts attempt to understand what the parties agreed to in the contract by using these tools (continued):
 - Will look at :
 - express terms,
 - course of performance (the parties have applied the contract terms),
 - course of dealing (how parties deal with each other), and
 - usage of trade (common business practice).
 - If an amount is given in words and figures that differ, the words control.
 - Handwritten language controls over typed language; typed controls over standard forms.
 - Ambiguities are construed against the party that wrote the contract.

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Contracts - Mistakes and Misrepresentation

- **Mistake** refers to an essential provision of a contract, not a bad deal.
 - The law will not prevent you from making a bad deal
 - Mistake as a defense is rarely granted, but may still be successful depending on facts and circumstances.
 - May be by one or both parties.
 - Unilateral mistakes are rarely enforced, except if the other party knew or should have known of the mistake that induced the defendant to enter into the contract (bad faith behavior).
 - Mutual mistakes - there is a meeting of the minds on an erroneous fact. May make the contract voidable if the mistake is material to the contract (not collateral).

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Contracts - Mistakes and Misrepresentation

- **Misrepresentation** is when a party makes a false statement to induce the other to enter into the contract.
 - **Fraud** is when one party has used deception to acquire money or property.
 - Intentional act by one party to induce the other party to act.
 - Cause of action in tort, and may render the contract **void**.

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Contracts - Miscellaneous Concepts

- **Bankruptcy** provides statutory protection of a debtor that is insolvent.
 - Debtor owes more than he can pay for.
 - Creditor claims (secured and unsecured) are ranked
 - During bankruptcy case, payment obligations to creditors are “stayed”, creditors are not permitted to pursue collection.
 - When a bankruptcy plan is confirmed, it will replace all prior debt obligations.
 - Explored in more detail in Business Law II (BMGT 381)
- **Remedies** for breach of contract are typically monetary damages.
 - Expectation damages, including compensatory and consequential damages.
 - However, consequential damages must be foreseeable to both parties at the time of the contract and not speculative.
 - These can be limited by the parties, if provided expressly in the contract.

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Contracts - Miscellaneous Concepts

- **Remedies** (continued).
 - **Specific performance** is provided when monetary damages are not adequate. It is rare.
 - Might apply to contracts for land (considered unique). Therefore, monetary damages are not adequate, because “replacement” land cannot be found that would be exactly like the land that is the subject of the contract.
 - Specific performance is not appropriate for service contracts, due to prohibition against involuntary servitude in the Thirteenth Amendment to the U.S. Constitution.

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Contracts - Miscellaneous Concepts

- **Remedies** (continued).
 - A **breach of contract** is a failure by one party to perform a contractual obligation.
 - A breach of contract will normally entitle the non-breaching contract to seek remedies for harm that it suffers as a result of the breach.
 - If it is for a “material obligation” (an obligation that was essential for the other party to enter into the contract), then the non-breaching party may terminate the contract.
 - In the event of breach, the injured party has a **duty to mitigate** their damages.
 - Must make reasonable efforts to limit the harm caused by the breach by the other party.
 - A party alleging breach has the burden of proving that the breach occurred, then the burden shifts to the other party to assert defenses.

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Contracts - Miscellaneous Concepts

- **Common provisions**
 - **Non compete clauses**
 - Intended to restrict competition for (i) a specified period of time, (ii) within a certain geographic area, and (iii) for specified activities (scope).
 - Must be reasonable on all three points to be valid.
 - Often seen in employment contracts and contracts for the sale of a business.
 - **Mandatory arbitration** - seen in employment and form contracts, requires parties to waive right to take their dispute to court, and instead litigate in arbitration.
 - **Acceleration** - common in financing contracts, allows a lender to require that the full balance is paid immediately if the borrower is in breach.

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Contracts - Miscellaneous Concepts

- **Common provisions**
 - **Liquidated damages**
 - Parties may pre-agree certain damages, especially if actual damages may be difficult or impossible to determine.
 - May apply to late performance
 - E.g., if Seller is late delivering the Product, then Seller will compensate Buyer \$100/day for each day of delay until delivered.
 - Must be reasonable--if too high or too low it may be deemed penalty and void
 - Liquidated damages are in lieu of actual damages. The non-breaching party cannot claim both liquidated damages and actual damages.
 - It may look like a penalty, but it is not (if drafted correctly).
 - See UCC § 2-718

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Contracts - Miscellaneous Concepts

- **Common provisions**
 - **Warranty**
 - Seller agrees to repair or replace defective product that fails within a specified period of time. May also cover compensation to Buyer for foreseeable resulting damage.
 - Buyer must report failure promptly, and normally return defective product.
 - Seller's promise will typically exclude:
 - Buyer's modification of the product
 - Buyer's misuse or abuse of the product
 - Buyer's failure to maintain the product
 - Normal wear and tear.
 - Warranty for services would entitle buyer to repeat or correct faulty service
 - Buyer waives right to sue for failure of the product in exchange for the warranty.

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Contracts - Miscellaneous Concepts

- **Common provisions**
 - **Limitation/Exclusion of Liability**
 - Parties agree to exclude liability of one or both for certain types of damages (incidental, consequential) resulting from its actions or failures to act
 - May cover negligence but not wilful or grossly negligent acts
 - Liability may be capped at a specific value.
 - Strictly construed. Always consult a lawyer.
 - **Indemnification**
 - One party agrees to cover the costs and liability (and sometimes the defense) of the other party resulting from use of the product, or by the acts of the indemnifying party.
 - Applies to third party claims.
 - Consult a lawyer.

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Contracts - Miscellaneous Concepts

- **Common provisions**
 - **Integration**
 - Many contracts will provide that it contains the full and complete agreement between the parties (integrating all promises).
 - Will exclude all prior communications, offers, representations, proposals, agreements, etc. on the subject matter of the contract.
 - Parties agree to not rely on prior representations or anything outside of the “four corners” of the contract.
 - Courts will generally exclude extrinsic evidence on the obligations of the parties (parol evidence), but in some cases it may be allowed to resolve inherent ambiguities in the terms.