Chapter 1

Getting the Lowdown on Contract Law

In This Chapter

- Wrapping your brain around the concept of contract law
- Grasping the fundamental rules and principles that govern contracts
- Understanding contract formation, defenses, and interpretation
- Getting up to speed on performance, breach, and remedies

Contract law may feel overwhelming, especially when you're in a class that reads and analyzes case after case after case. Adding to that load are the many sources of contract law, including the common law, the Restatement of Contracts (Restatement), the Uniform Commercial Code (UCC), federal and state statutes, and rules that govern when parties are allowed or prohibited from coming up with their own contract terms.

Although all the details swirling around the topic of contract law are important, placing those details in context makes them more manageable and enables you to see the big picture. That's what this chapter is all about. Here, you get the eye-in-the-sky view of contract law and a framework on which to hang the rich tapestry of policies, principles, and rules collectively referred to as *contract law*.

Grasping the Concept of Contract Law

Contrary to popular belief, contract law isn't just a bunch of rules and regulations that govern agreements between people. It's not developed and imposed from above by some rule-making authority. It developed naturally over the course of thousands of years through the interactions and transactions between people like you and me — the parties who form contracts.

In this section, I explain what a contract is, present a few different perspectives on the principles that should drive the formation of contract rules, and briefly explore how contract law developed into what it is today.

From coconuts to contracts: Grasping the purpose of contracts

To begin to grasp what contract law is all about, imagine a group of people on a desert island trying to figure out ways to govern their relationships. They want to be a community, but they also want each person to have autonomy. Collectively, they decide that each person may own property and make agreements about what to do with that property. They discover that the free exchange of property increases the wealth and well-being of both parties; for example, if one person has a surplus of coconuts and a shortage of fish and another person has a surplus of fish but no coconuts, the two may exchange goods for their mutual benefit.

If the parties take the next step and decide that they can promise in advance to perform such exchanges, their agreement indicates the beginnings of contract law. As certain issues arise, the islanders form rules that address those issues, such as how quickly the parties must perform, the acceptable quality of the coconuts and fish, and the consequences for nonperformance. Their system of contract law grows organically from the ground up, not from the top down.

Defining contract

A *contract* is simply a promise or set of promises enforceable by law. Which agreements are enforceable by law varies from culture to culture — what's acceptable in one culture may not be acceptable in another. If I agree to sell you my house, for example, the house-selling culture says that I can't make any untruthful statements about the house. But if I agree to play a hand in the World Series of Poker, then the poker culture says that I can't make any *truthful* statements about my hand.

The United States doesn't have a monolithic contract law with uniform rules. Contract law is nuanced and fact intensive. A "rule" may differ, for example, depending on whether the parties are two giant corporations having their lawyers negotiate an agreement or family members making an agreement over the dinner table.

Comparing different schools of thought on contract rules

The overriding principles that guide the formation of contract rules vary according to different schools of thought. Depending on your perspective, you may think that the rules should be based on what is

- **Customary and reasonable:** In most systems of contract law, the rule that develops is usually based on what's customary and reasonable. With nearly every issue that arises in contract law, just think about what's reasonable, and you'll usually discover the "rule."
- **Economically efficient:** My economist friends think that rules should be based on what's most economically efficient. According to the economists, people enter contracts for their mutual financial benefit; for example, you agree to sell and I agree to buy your car for $7,000, because right now, the $7,000 is worth more to you than the car, and the car is worth more to me than the $7,000 I have in my piggy bank. Throughout this book, I sometimes share the economist's perspective, but if you haven't studied Econ (or read *Economics For Dummies* [Wiley]), stick with asking what's reasonable and you'll come up with the rule most of the time.
- **Fair for the little guy:** According to my friends in the Critical Studies movement, the people in power, who happened to be rich white men, made the rules. The rich guys came up with rules that are favorable to them, so contract law needs to watch out for the little guy, who gets the worst of it in contracts.

Regardless of view, everyone would probably agree that one of the most difficult problems facing contract law today is the ease with which consumers can bind themselves to contracts by clicking I AGREE to the "terms and conditions" that nobody reads. This is quite different from the contract created by a carefully negotiated exchange of drafts. Or is it? Throughout your career in contract law, you'll struggle to determine whether the same rules apply to both situations.

Tracing contract law's roots

Most contract law in the United States comes from England, where it was largely based on the tradition commonly referred to as the *common law,* meaning the law made by judges. Many of the rules of commercial law that govern buying, selling, and financing come from medieval times. Anytime parties traded, they had to have an understanding of the deal they were making. They made their own rules, called the *law merchant,* to govern their situation.

As the law became more specialized, various areas of contract law were spun off and now stand on their own. Insurance law, banking law, and government procurement law are all areas of contract law that you don't study in a standard Contracts course. One authority has called contract law "the law of leftovers" — general principles that remain irrespective of the substance of the transaction.

Meeting the Key Players: Common Law, the Restatement, and the UCC

Although you'll find no definitive collection of the rules and regulations that govern contracts, you can find guidance from three primary resources: the common law, the Restatement of Contracts, and the Uniform Commercial Code (UCC, or the Code). I refer to these resources throughout the book, so you need to have a general understanding of how each resource contributes to contract law.

Exploring the common law: Tradition and precedent

In the Anglo-American (meaning English and American) tradition, contract law was *common law* — judges decided each dispute on the basis of tradition and recorded precedent. Imagine yourself the lord of the manor in Merrie Olde England, and the parties to a dispute look to you for wisdom. You'd likely ask, "What have we done in the past? Does it make sense today?" — the same questions today's judges ask!

In a common-law system, if you want to find out what the outcome is likely to be under a particular fact pattern, you have to read all the applicable cases (the reported court decisions) and synthesize them. That's what you do in your legal research and writing class and you sometimes do in your Contracts class when you have a string of cases to read. You don't read them in isolation; you try to see the connections and be prepared to say why one case came out one way and one came out another way.

Because of the common-law rule of *stare decisis* ("let the decision stand"), courts generally follow precedent. Therefore, you can fairly accurately predict what a court will do in the future based on what courts have done in the past. Because that predictive power is important to businesses entering transactions, contract law is slow to change.

Capturing general rules in the Restatement

Although the common-law approach is effective, sometimes you just want to know what the general rule is, devoid of any particular fact situation. Having to read all the cases on point to find a rule would be a pain. Fortunately, someone has always been willing to read all those cases and try to synthesize them into *black-letter rules* — attempts to capture the essence of each rule. In the 18th century, that someone was Sir William Blackstone, who wrote *Commentaries on the Laws of England* (1765–1769). In those days, lawyers,

including many of our Founding Fathers, relied on Blackstone for this purpose. Now contract law has the Restatement.

The *Restatements of Law* are an effort by the American Law Institute (a group of law professors, lawyers, judges, and other interested parties) to reduce the law to workable sets of black-letter rules. The First Restatement of Contracts came out in 1932. The principal reporter was Samuel Williston, who wrote one of the great multivolume treatises on contract law. The rules in this Restatement are somewhat rigid and don't always reflect modern legal thinking, which often takes into consideration a number of mushy factors instead of drawing bright lines.

A Second Restatement of Contracts was promulgated in 1981, with Allan Farnsworth as reporter. When I refer to "the Restatement," I mean the Second Restatement.

Although the Restatement is a great resource, recognize its limitations:

- **It's not enacted law, so it has only persuasive authority.** If you're citing law to a judge, the judge wants to know what the higher courts in that jurisdiction have held, not what the Restatement says.
- **It represents a limited number of views.** People hold conflicting views of what should be the rule, with some jurisdictions following one line of reasoning and others following another. The Restatement generally chooses the majority view in this situation, so you may get the misimpression from its statement of a rule that the law is more settled than it is. And on a few occasions, the Restatement states the minority view because the drafters thought it represented the better view.

  Many publications of the Restatement for students contain only the rules. The complete edition includes commentaries and illustrations to help you more fully understand each rule.

Statutes: Supplanting common law with codes

Although contract law is traditionally common law, statutes enacted by legislatures are increasingly taking over the role of common law. The courts have to follow the laws enacted by the legislature, so if the law has a statute on point, that should be the starting point for a court.

As you're probably aware, many European countries have civil law systems based largely on systematic arrangements of statutes called *codes.* Such systems have an authoritative source to go to in order to find the governing contract law. Louisiana, because of its French origins, has a civil code of Contracts, and so do many other states.

In the mid-19th century, a "codification" movement in England and the U.S. sought to codify the law in order to make it more accessible, and the codifiers won out in a number of states, including California, which has codified the law of Contracts in its Civil Code. But these codes often just state common-law rules and principles, leaving the courts plenty of room to interpret the statute and apply it to a particular situation.

Contract law is mostly state law rather than federal law. Although no federal common law of contracts exists, a number of federal statutes govern contracts. Most of these are in the consumer and credit areas, so when you have a transaction in these areas, check for any relevant federal statutes.

Brushing up on the Uniform Commercial Code (UCC)

If each state had the same statutes governing contracts, then the law would be easier to find and more predictable, which is especially important in commercial law that applies to many interstate transactions. Congress could probably enact an American Commercial Code based on its authority to regulate interstate commerce, but Congress has left this project to the states. The states have turned to the assistance of the Uniform Law Commission (ULC) — a private group with representatives from every state that aspires to write model statutes that get the law right and that are enactable.

When the ULC agrees on a model statute, the process is only just beginning, because the model statute isn't yet law. State legislatures must enact the statutes for them to become law.

The ULC, with the assistance of the American Law Institute (the folks responsible for the Restatements) has had great success getting states to enact the Uniform Commercial Code (UCC), which contains a number of Articles addressing various aspects of commercial law. Karl Llewellyn first drafted this model statute in the 1940s, and states began to enact it in the 1960s. Article 2, which deals with the sale of goods, is the Article most relevant to contract law.

Varying the model statutes in state laws

The ULC is frequently unable to achieve its goal of uniformity, because states can and often do alter the Uniform version. So although every state has enacted the UCC (Louisiana has not enacted Article 2), they've all enacted slightly different versions. In this book, I generally cite the North Carolina version, not out of some love for the First-in-Flight state but because the Uniform version is under copyright, whereas an enacted statute is in the public domain.

In your law studies, you'll probably be working with the Restatement and the Uniform version of the UCC as promulgated by the ULC. But remember, when

you have a research question in a certain jurisdiction, you need to look up the law in that state to make sure that it's the same.

Note: Attempts to revise UCC Article 2 have come to an end, but Article 1 underwent a revision process in 2001. Most states have enacted Revised Article 1, which is also used on the Multistate Bar Exam, so that's the version of Article 1 that I refer to. Again, when doing research in a jurisdiction, you must find out which is the applicable law in your jurisdiction.

Looking at some important UCC principles

Although UCC Article 2 gets the most press in this book, you also encounter references to UCC Article 1, which deals with basic principles and definitions that apply throughout the Code, including Article 2.

Some of the basic principles found in Article 1 are so important that I cite them repeatedly. I discuss two of the most significant provisions next.

Freedom of contract: Letting parties agree to a different rule

One important principle of UCC Article 1 is what I call the *freedom of contract provision.* Section 1-302(a), as enacted in North Carolina at 25-1-302(a), provides the following:

> § 25-1-302. Variation by agreement.
>
> (a) Except as otherwise provided in subsection (b) of this section or elsewhere in [the Uniform Commercial Code], the effect of provisions of [the Uniform Commercial Code] may be varied by agreement.

This important rule offers guidance on how to think of "the law." Contract law is not a bunch of regulations that parties to a contract must follow. Often, contract law facilitates a transaction by providing a rule that kicks in if the parties neglect to provide their own rule. These rules are often called *default rules* because, like the default settings on your computer, they apply unless you change them. But very often, as UCC § 1-302(a) states, contract law gives the parties the freedom of contract to come up with their own rule. Some of the rules are regulatory, and unfortunately the Code isn't always helpful in identifying whether a particular rule is regulatory (can't be changed) or facilitatory (can be changed by the parties' mutual agreement).

Note, for example, that § 1-302(b) states some obligations that the parties can't get out of by agreement. But that same provision goes on to say that you can "determine standards by which the performance of those obligations is to be measured." You can't, for example, agree not to be reasonable, but you can agree, "It is to be considered reasonable if we do A, B, and C." Figuring out the interplay between what is permissible in some circumstances and not permissible in others is one of the greatest challenges in studying contract law.

As you study Contracts, try to identify which are the regulatory rules that have to be followed and which are the facilitatory rules that the parties are free to change. Take a nuanced view. If the court doesn't let the parties change the rule, ask why — was it because the parties were in a particular state? Entered into a particular kind of transaction? Had an imbalance of power?

Supplementing the UCC with common law

Another important provision in Article 1 is § 1-103(b), which points out that the Code is not the exclusive law applicable to a transaction. As enacted in North Carolina at § 25-1-103(b), it provides the following:

> (b) Unless displaced by the particular provisions of this Chapter [the Uniform Commercial Code], the principles of law and equity [. . .] supplement its provisions.

This rule makes clear that the Code doesn't address every topic, and where it's incomplete, courts will fill in gaps in the Code with rules derived from the common law. For example, the Code says very little about the defenses to contract formation that I explain in Chapters 5 through 7 of this book. Section 1-103(b) says that in a case involving the sale of goods, those defenses apply, but you have to look to the common law to see what they are.

Applying state law in federal court

Many contracts cases are heard in federal court. Most of those cases got there on the jurisdictional basis of *diversity* — under federal law, parties who are citizens of different states are allowed to use the federal courts if the amount of money at issue is over a certain dollar amount set by Congress. In such cases, the federal court uses the principles of Choice of Law (as I explain in Chapter 18) to decide which state's law governs the transaction. The federal court is in effect sitting as the state's highest court and asking, "What would the judges on that court do in this situation?"

Whenever you see that a contracts case is in federal court, ask how that court got jurisdiction. If the answer is diversity, then identify the state whose law the court is applying. If the court got jurisdiction in some other way — for example, because it's a matter of *admiralty law* (law on the high seas) or because the United States is a party — then the court follows general principles of contract law rather than the law of any particular state.

Be careful when you research contract law questions, particularly online. Your search results for the decisions of a particular state often include federal court decisions from the circuit in which the state is located. But you have to read the federal court decision carefully to find out which state's law it's applying. If it's not applying the law of your state, the federal court isn't a very good authority. And even if the court applies your state's laws, remember that the federal court decision is only persuasive authority in your state.

Inferring a state rule that makes little sense

When federal courts take a contract case on the basis of diversity, the federal courts defer to state law, regardless of whether they agree with it. A good example of how this plays out in the real world is in the case of *Northrop Corp. v. Litronic Industries,* 29 F.3d 1173 (7th Cir. 1994).

In this case, Judge Richard Posner of the 7th circuit Federal Court of Appeals was given the task of ruling on a case where Illinois law applied. The rule in issue had three possible interpretations, but the Illinois courts had not yet expressed their opinion on the matter. Although Judge Posner preferred the view adopted only in California, his job was to try to figure out how the courts in Illinois would decide the case.

Judge Posner concluded that Illinois would probably not agree with his preferred view and said in effect, *We are hearing this case because of diversity, and Illinois law applies. Illinois would likely follow a rule that makes less sense, but I am going to have to hold my nose and go along with the state rule because that is what a federal judge has to do in a diversity case.*

You might think it would make more sense for the federal court judges to ask the state court judges what they would do, and many states have a procedure for doing that. Sometimes when the state has insufficient precedent, the state court takes a "certified question" from the federal court in order to assist the federal court in resolving a dispute.

Applying different sources of contract law

When you look at a contract case, you often need to consider several different sources of contract laws, including common law, the Restatement, the UCC, and federal and state statutes.

Suppose a client in Montana purchased a wheelchair for personal use and the seller refuses to fix it, even though it came with a warranty. Is she entitled to relief? At first glance, the case seems pretty simple, but it gets complicated in a hurry when you start to consider all sources of law that may come into play, which include the following:

- Federal consumer protection law, because the case involves a consumer
- The federal Magnuson-Moss Warranty Act, because it involves a warranty
- Montana UCC Article 2, because it involves the sale of goods
- The Montana Wheelchair Warranty Act, a statute that specifically addresses this transaction
- State consumer protection statutes and other relevant statutes
- General principles of contract law in Montana, found both in statutes and in cases

A word about international law and the CISG

Uniformity is helpful in governing both interstate and international transactions. More than 70 countries, including the United States, have adopted the United Nations Convention on Contracts for the International Sale of Goods (CISG). By default, the CISG applies to transactions for the sale of goods between businesses located in countries that have adopted it. You can find the text of the CISG at `www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG.html`.

Many U.S. lawyers contract around application of the CISG by putting in their international contracts a choice of law provision (see Chapter 18) specifying that the UCC of a particular state governs the agreement. Other lawyers, particularly in contracts that contain an arbitration clause (see Chapter 18), specify that the UNIDROIT Principles of International Commercial Contracts will apply. For the text of the UNIDROIT Principles, promulgated by the International Chamber of Commerce, visit `www.unidroit.org/english/principles/contracts/main.htm`.

- The parties' contract, because it's part of their own private contract law (You'd have to examine the contract terms carefully; the parties' agreement to a term doesn't necessarily make it enforceable. To the extent the federal and state law is regulatory, the contract would have to follow that law, but to the extent it's facilitatory, the parties would be free to provide their own rules.)

If you like solving puzzles like this, welcome to the world of contracts!

Forming, Defending, and Interpreting Contracts: The Basics

Knowing the rules that govern contracts is only half the battle. You have to be able to apply those rules to different situations. Because contract law is so fact dependent, it's always coming up with exceptions to the rules to deal with particular circumstances. No book covers all the possible variables and exceptions, but knowing the rules and the principles behind them gives you a firm foundation to build on. This section provides a framework for understanding Contracts.

Look at the big picture. Doing so may be difficult because no one agrees on a single best way to organize the study of Contracts. The topics are like a deck of cards that you can shuffle up and deal in various ways. Whether you start with remedies or with consideration, what's important is seeing how the pieces all fit together.

Understanding contract formation

Every contract starts at the point of formation. As I explain in Chapters 2 and 3, a *contract* is a bargained-for exchange that requires the following three ingredients:

- **Offer:** Party A's promise to Party B in exchange for something
- **Acceptance:** Party B's assent to Party A's offer
- **Consideration:** What each party offers in exchange for the other party's promise

If the parties didn't form a contract (because one of the essential ingredients was missing), that may not be the end of the story. Based on the theories of reliance and restitution (see Chapter 4), even in the absence of a contract, parties may be required by law to compensate another party because they made a promise or received a benefit:

- **Reliance:** If one person relies on another person's promise, the promise may be enforceable even in the absence of a bargain. For example, I promise to give you my car when you graduate, and you pass up another free-car offer as a result. I may be required to compensate you for your loss. Contract law uses reliance to restore the injured party to the position she was in before she relied on the promise.
- **Restitution:** If Party A confers a benefit on Party B without forcing it on her and without intending it as a gift, then even though Party B never offered consideration in exchange for that benefit, Party A may have a right to receive restitution. Contract law uses restitution to make the benefitted party give up the benefit, restoring her to the position she was in before the benefit was conferred.

Checking out attack and defense maneuvers

When a deal fulfills the requirements of offer, acceptance, and consideration, the agreement is presumptively an enforceable contract, but either party may challenge the contract via a *contract defense,* otherwise known as a *defense to formation.* A party may base its contract defense on different grounds, such as the characteristics of one of the parties (under the age of 18 or having impaired judgment), something one party did to the other (fraud, duress, or undue influence), or something wrong with the contract itself (mutual mistake, illegality, unconscionability, or an oral contract when the law requires the contract to be evidenced by a writing). Chapter 5 introduces contract defenses, and Chapters 6 through 8 discuss the specifics.

Finding the terms of the contract and building contract-interpretation skills

A contract rarely contains a comprehensive list of terms the parties agreed to, nor does it provide for everything that might happen in the future. If the contract is indefinite or incomplete, contract law provides ways to clarify the terms and fill the gaps. If the agreement is part written and part oral, contract law uses the parol evidence rule to determine which unwritten terms to include. Some terms not included in the contract may need to be added due to *course of performance* (a history of how the parties acted under the present agreement), *course of dealing* (how the parties performed under other, similar contracts), or *trade usage* (how other parties in the industry perform). Finally, even after finding all the terms, the parties may have a disagreement regarding interpretation of unclear language in the contract. Chapters 9 through 11 address these issues.

Examining Contract Performance, Breach, and Remedies

After parties form a contract, the parties must *perform* (do what they promised to do). If a party doesn't perform and she's in breach, then contract law must determine a just remedy for the breach — usually an amount of money sufficient to compensate the non-breaching party for what he lost as a result of the breach. This section explores breach, remedies for breach, and the role of third parties.

Recognizing breach of contract

Breach of contract is a deceptively easy concept to grasp — it means that the party didn't keep his promise. Sometimes, however, a party who didn't keep his promise may actually not be in breach, as in the following situations:

- **The parties didn't actually have a contract.** One of the best and most common responses to an allegation of breach of contract is to launch a contract defense to try to prove that contract formation never happened. A party accused of breach may say, "Ha-ha! I can't be in breach because we never had a contract!"
- **The parties modified the contract, omitting the promise.** See Chapter 12 for details on making changes to a contract.

- **Performance was excused.** Performance may be excused because of an unanticipated event that prevented it or because performance was conditional and the condition never occurred. The most common condition is the other party's performance: The claim is that if you didn't perform, then I don't have to perform. See Chapters 13 and 14 for details on circumstances that excuse performance.
- **The other party repudiated prior to the performance deadline.** One of the other parties may have made an *anticipatory repudiation* — telling the other party in advance of the time for performance that he doesn't plan to perform the contract and thus letting the non-repudiating party off the hook. Chapter 15 covers anticipatory repudiation.

Formulating remedies and establishing losses

If parties have a contract and one party breaches, then the injured, non-breaching party is entitled to a remedy. The goal here is to give the injured party the *expectancy* — the position the party would've been in had the contract been performed. In addition to the expectancy, reliance and restitution come back as two additional remedies for breach. Chapters 16 to 18 cover the various remedies in greater detail.

In contract law, the principal remedy, the expectancy, puts the non-breaching party where she would've been had the contract been performed, not back where she was before the contract was formed.

Exploring the role of third parties in contract law

Third parties are people who aren't parties to the contract but who are affected by it in some way. They may be *third-party beneficiaries* of the contract (they stand to receive something), or they may have rights assigned or duties delegated to them by parties to the contract. Contracts classes rarely cover the role of third parties in contract law, but this is an important topic in the real world. Chapters 19 and 20 explain what you need to know.

Practicing in the Real World of Contracts

Getting lost in the study of Contracts or any legal subject is easy. The rules keep piling up, you can't keep them all straight, and pretty soon you're drowning under them. Take a deep breath and try to see the big picture as I present it in this chapter.

Most contract issues are solved through negotiation, not litigation, so contract lawyers, especially the most skillful of them, rarely see the inside of a courtroom. As you're studying case after case — the way Contracts is typically taught — fight the urge to become overly litigation-oriented and bogged down in minutiae.

Use your skills to see how you can use contract law in planning and drafting agreements. Contracts then becomes a matter of preventive law: Having read how people screwed up in past cases, you're going to get it right so you and your clients don't end up in court. When you think of Contracts as planning and drafting, you appreciate more the principle of freedom of contract. If you know the rules, then you're better able to draft around them.