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I.A Contract Law in the United States

by Alexander Quest revised and updated by Richard Kaye

Contract law in the United States is governed by a combination of various authorities including jurisdictional common law, state and federal statute, and the law of the contract itself. Unless otherwise modified by state or federal statute, the common law will interpret the rights and obligations the parties have agreed to under the specific terms of the contract, often referred to as the **private law of the parties**. An especially important source of contract law in the United States is the Uniform Commercial Code (U.C.C.) The U.C.C. is a codified body of uniform laws established by a **non-governmental authority** that has been adopted, usually with minor modification, in every U.S. jurisdiction. The U.C.C. most importantly governs transactions between merchants for the sale of goods, personal property, financial transactions and securitization, banking transactions and commercial paper transactions such as letters of credit. Many of the U.C.C. sections require strict compliance, emphasizing form over substance. For example, disclaimers of warranties require specific language and must meet conspicuousness requirements such as bold face or font size within the body of a contract or terms and conditions of sale to be valid. The legal practitioner is strongly advised to consult the individual state U.C.C. statutes that apply to a transaction as each state's nuanced differences may affect the legal rights of the parties.

While a number of **mandatory** contract principles cannot be modified by the parties, e.g., the **duty of good faith** and fair dealing, the bulk of authority is generally considered to be **default rules**, applicable only when the agreement is insufficient to determine the rights and obligations of the parties. While the **freedom of contract** approach has both strengths and weaknesses, the primary result is that greater weight is placed on **interpretation** of the agreement itself and the process by which it was reached than on the **application** of broad contract principles. The following discussion outlines general principles of contract law, starting with the four basic elements that are required for an enforceable contract: (i) the **mutual assent** of the parties; (ii) the presence of **consideration**; (iii) the **capacity to contract**; and (iv) **legality** of the contract terms.

1. Mutual Assent

Contract law in the U.S. follows an 'objective' theory of **assent** where the external or objective appearance of the parties' intentions, as manifested by their actions, determines whether a valid contract is formed, not the actual or subjective intentions of the parties. Under this approach the opposing party must reasonably believe that the other party intended to be bound, thus, any **manifestation** of assent must be objectively reasonable.

Offer and Acceptance

The manifestation of mutual assent is generally characterized by an **offer** and **acceptance**; however, mutual assent may be found without it. An 'offer' is the manifestation of a willingness to enter into a **bargain** that causes the **offeree** to reasonably believe his or her assent to the bargain will create an **enforceable** contract. Generally, an offer need not be in any particu-

lar form and can be implied from words or conduct. An offer is valid when received and may be accepted by the offeree for a reasonable time thereafter so long as it has not been **revoked**.

An 'acceptance' is defined as the action of the offeree which has the **legal effect** of making the offeror's promise enforceable and is valid only when made in accordance with the terms of the offer. An offer grants the offeree the 'power of acceptance' that may be terminated by a **revocation** of the offer including taking action inconsistent with assent, **lapse of time**, rejection of the offer, or the death or **incapacity** of either party. An acceptance cannot change the terms of an offer in any way; otherwise, it acts as a rejection and return offer, or '**counteroffer**', transferring the power of acceptance to the other party. Either party may withdraw from **negotiations** until the time at which both parties are bound through their mutual assent. However, it is well settled law that acceptance of an offer by part performance in accordance with the terms of the offer is sufficient to complete the contract.

Implicit in the element of assent is the requirement that the agreement is defined with sufficient clarity that the parties are aware of what they are agreeing to so that their future expectations can be met. The concept of '**definiteness**' requires that the terms of a contract must be defined to the extent that they provide a basis for determining the existence of a **breach of the contract** terms and for allowing an appropriate **remedy**. Without sufficient definiteness of terms, mutual asset cannot be achieved and a contract will not be considered formed.

2. Doctrine of Consideration

In order for there to be an enforceable contract there must be '**consideration**', i.e., the exchange of something of value, economic or otherwise, in which the parties have bargained for. This can be a **return promise**, the performance of an act or the promise not to act; however, a pre-existing legal duty, gift or moral obligation cannot act as consideration. The sole inquiry concerns the process by which the parties arrive at the exchange and whether or not it was the product of a bargain. An exchange without a **bargain** will not suffice; however, the bargain need not be **contentious** or **adversarial**. Central to the determination of a bargain is the presence of **inducement** on the side of both parties. Not only must the **promisor** seek the consideration that is being given in exchange for the promise, but the **promisee** must reciprocally give it in exchange for the promise. There is no strict requirement in modern contract law that there be a benefit to the promisor and detriment to the promisee, or that the value exchanged be equivalent, so long as the element of consideration is otherwise met.

3. Invalid Contracts

3.1 Lack of Capacity

The **capacity to contract** is a fundamental element to a valid contract, the lack of which raises doubts as to whether an agreement has been formed. A minor lacks the legal capacity to contract in most jurisdictions until they have reached the age of 18, any contract made before then may be held voidable. Upon acquiring the **age of majority** the minor may avoid the contract altogether or ratify the contract by either words or conduct showing acceptance of the

terms. **Mental incompetency** of one party may also render a contract either **void** or **voidable** where the party lacked the capacity to understand the nature and consequences of the transaction. Some jurisdictions also require the ability to act in a reasonable manner with respect to such understanding or that the other party had reason to know of the other party's condition. Competency at the time of contract is determinative, thus, periods of **lucidity** can make an otherwise incompetent person competent to contract.

3.2 Fraud and Duress

Misrepresentation or **coercion** during the bargaining process can have an effect on the enforceability of promises. Misrepresentation, or 'fraud', must be both consciously false and intended to mislead. It can be in the form of an assertion or the non-disclosure of a material fact that the party knows would correct a mistake as to a basic assumption. In addition, the **injured party** must have relied on the misrepresentation in manifesting his or her assent. Coercion, or '**duress**', can render a contract void if the party's manifestation of assent was induced by an improper threat leaving the party with no reasonable alternative. The 'pre-existing duty' rule has been used to prevent enforcement of fraudulent or coercive modifications made after a contract has been formed; however, modern courts rely instead on the duties of good faith and fair dealing in policing such modifications.

3.3 Unconscionability

The equitable concept of '**unconscionability**' allows a court to **invalidate** an agreement where one party utilizes an **unfair bargaining position**, economic or otherwise, to impute unreasonable terms upon the other party. While superior bargaining power is generally present, it is usually not sufficient by itself to find unconscionability. The determination of unconscionability is made by the court as a matter of law. Factors that suggest unconscionability are the presence of unreasonably favorable terms or the absence of meaningful choice by one of the parties. The U.C.C. finds unconscionability if the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract.

3.4 Violation of Public Policy

Contracts can also be limited by interests of **public policy** that outweigh the rights of parties to freely enter into contracts. Absent a clear violation of statute or serious crime, a court will generally utilize a balancing test to determine whether a contract right or duty violates a public policy interest. Factors taken into consideration are: (i) the parties' justified expectations and any forfeiture that would result if the contract were not enforced; (ii) the strength of the public policy against enforcement; (iii) the likelihood of furthering the policy with non-enforcement; (iv) any misconduct of the parties; and (v) the connection of such misconduct to the contract terms. Examples of terms that violate public policy include exemptions from liability caused by intentional or reckless conduct, unreasonable restraints on competition and promises to interfere with the contracts of others.

4. Writing Requirement under the Statute of Frauds

All American jurisdictions have adopted some form of the English 'Statute of Frauds' and require a signed writing for certain agreements to be enforceable. The following contracts are generally covered: (i) contracts to answer for the duty of another (**surety contracts**); (ii) executor/decendent surety contracts; (iii) **marital agreements**; (iv) sales of interests in land; (v) contracts not performed within one year of execution; and (vi) contracts for the sale of goods of \$500 or more. Generally, the writing must identify the parties and show that a contract has been made or offered, indicate the nature of the contract and its subject matter, and state the essential terms of the promises to be performed. A contract that fails under the statute of frauds is unenforceable against the **non-signing party** and disallows the contract from being used as the basis of any action; however, an unenforceable contract may be admissible in evidence for any purpose other than to enforce the contract. The United States Electronic Signatures in Global and National Commerce (ESIGN) Act (Federal Law), and the Uniform Electronic Transactions (UETA) Act (State Law) were enacted to provide a framework for the legality of electronic signatures in both commercial contracts and government transactions. The UETA has been enacted in 47 states, the District of Columbia, Puerto Rico and the Virgin Islands. The states of Washington, Illinois and New York have enacted their own laws making electronic signatures valid. For electronic signatures to be valid under the UETA, the parties must agree to use electronic signatures, consent to the electronic form of the transaction, an electronic record must exist and both parties must have access to the electronic form of the document.

5. Failure of Basic Assumptions

Mistake, Impracticability and Frustration

Circumstances may exist which excuse one party from performing his or her contractual obligations. Under the doctrine of '**mistake**', a party maintains an erroneous assumption or belief that is not in accord with the facts and the adversely affected party must show that the mistake (i) goes to a basic assumption of the contract, (ii) has a material effect on the agreed upon exchange, and (iii) is not one of which that party bears the risk. A party bears the risk of mistake if s/he relies on insufficient information or knowledge of the facts, agrees to bear the risk in the contract or the court finds reason to allocate it to that party. If the mistake is unilateral, the mistaken party must also prove that the other party has not relied on the mistake and that it would be unduly burdensome to require the party to perform.

The excuses of '**impracticability** of performance' and '**frustration** of purpose' take their roots from the English doctrine of 'impossibility' and generally require that (i) an intervening event has either made the performance as agreed to impracticable or has substantially frustrated the party's principal purpose, (ii) the occurrence or nonoccurrence of the event was a basic assumption under the contract, (iii) the excused party was not at fault, and (iv) the excused party did not otherwise assume the obligation to perform. Courts have often held that parties assume the risk of potentially intervening events if the event was reasonably foreseeable.

6. Performance and Satisfaction

6.1 Nonperformance

Contract obligations are generally satisfied upon the strict compliance with the terms of the agreement, the occurrence of which discharges the party of its obligation. Usually, nothing short of full performance acts as a discharge and any **failure to deliver** is a **breach of contract**. The doctrine of '**substantial performance**' is one exception to this rule and has been used to prevent loss of forfeiture on the part of a substantially performing, yet breaching, party. Substantial performance is a question of fact and courts will generally focus on how much of the benefit did the injured party receive that was reasonably expected from the exchange. Alternatively, courts may also use the doctrine of '**divisibility**' to avoid forfeiture by allowing a pro rata recovery based on the proportion of the performance rendered.

6.2 Conditions

Contracts often incorporate the concept of '**conditions**' to determine the time at which a party's contractual duty arises, shifting the risk of **nonoccurrence** onto the other party. A condition may be expressly stated in the contract or implied from its terms. The nonoccurrence of an event may have the effect of suspending the **obligor's** duty to perform or wholly discharging the obligor's performance. Conditions are generally temporal in nature and, if written into the agreement, strict compliance applies with respect to the occurrence thereof. However, the requirement of a **condition** may be excused if the obligor commits a breach that causes the nonoccurrence of the **condition**.

6.3 Suspension and Termination

Where substantial performance has not yet occurred and the **nonperformance** of one party causes a breach, courts allow the **injured party** to limit its damages by terminating the contract or suspending further obligations thereunder. In order for such action to be justified, however, the **breach** must be **material**. The determination of '**materiality**' is made at the time of the breach and the court generally considers the extent to which the injured party will be deprived of the benefit it reasonably expected, the likelihood of a **cure**, the extent the injured party will otherwise be adequately compensated and the extent the **breaching party** will suffer a forfeiture. The breaching party usually is allowed the opportunity to cure a breach and, if it does so, the injured party is no longer justified in suspending further performance. After allowing a reasonable period of time for cure the injured party may terminate the contract and seek damages for total breach. A reasonable time period depends on the potential to deprive the injured party of its expected benefit and the breaching party's ability and willingness to cure.

A contract may also be terminated by mutual **rescission** so long as both parties have yet to fully perform under the contract. In the alternative, a substitute contract may be formed to replace the original. If satisfaction of the original contract depends on performance of the new contract, an accord and satisfaction results and both contracts act to bind the parties until performance under the new contract is satisfied.

6.4 Anticipatory Repudiation

A party may breach an agreement before a **contractual duty** arises through what is called an '**anticipatory repudiation**'. A repudiation is a manifestation through either words or conduct that the party cannot or will not perform at least some of its obligations under the contract. The nonrepudiating party may then treat the contract as terminated and claim damages for total breach, request adequate assurances from the repudiating party or ignore the repudiation and waive damages until performance is due. A repudiation may be nullified if retracted before the nonrepudiating party has acted in response to it.

7. Interpretation of Contracts

7.1 Law of the Contract and Parol Evidence

Because American contract law provides wide authority for parties to shape their own legal relationships, the interpretation of the private law created by the agreement carries much significance in the U.S. When the parties reduce their agreement to writing the **parol evidence rule** creates the presumption that the writing is the final expression of their agreement and any previous or extraneous communications during the negotiations process are not admissible. The application of the parol evidence rule depends on to what degree the parties intended the writing at issue to be their final and exclusive agreement. An agreement can be unintegrated (not final), partially integrated (partially final), or wholly integrated (final), the classification of which will determine to what extent the parol evidence rule will bar the admission of prior communications that can be used to interpret the intent of the parties. The parol evidence rule does not exclude evidence of subsequent negotiations that occurred after the contract was formed. Generally, the admission of parol evidence first requires a determination of an ambiguity in the contract.

7.2 Interpretation and Construction

Where parties have attached different meanings to language in the contract it is the role of the court to determine the most reasonable meaning taking into consideration all relevant circumstances surrounding the transaction. Rules of **interpretation** are utilized by the court in determining the meaning of language, for example, the entire agreement, including all writings, oral statements, and other conduct, are read together to determine the most common sense interpretation. If a principal purpose of the parties is ascertainable then it is generally given significant weight and, wherever reasonable, the manifestations of the parties' intent will be interpreted as consistent with each other and in accordance with any relevant course of performance/dealing or usage of trade. The following preferences among interpretations generally apply: (i) an interpretation that gives reasonable meaning to all terms is preferred to one that does not; (ii) specific terms and separately negotiated terms are given greater weight than general language or standardized terms; and (iii) express contract terms are preferred over a course of performance which are preferred over a course of dealing or **usage of trade**. The court will generally adopt an interpretation of language that favors the party that did not supply it. In the case of completely omitted terms, a court may impose implied con-

tractual terms based upon the actual expectations of the parties or, in the alternative, under basic principles of justice.

8. Third Party Rights

8.1 Intended and Incidental Beneficiaries

The modern rule determining whether a third party acquires rights under a contract depends on the third party's status as an **intended beneficiary** (does) or merely an **incidental beneficiary** (does not). To be an intended beneficiary, the party must show that the beneficiary's right to performance is appropriate to effectuate the intention of the parties, and either (i) performance of the promise satisfies the promisee's obligation to pay money to the beneficiary or (ii) circumstances suggest the promisee intended to give the benefit of the promised performance to the beneficiary. An intended beneficiary has a direct claim against the promisor and need not join the promisee to effectuate such action. The beneficiary also retains any right it originally had against the promisee and can seek judgment against both parties to the contract; however, only one complete **satisfaction** is allowed to the intended beneficiary.

8.2 Assignment

Most contract rights are freely **transferable**, subject to prohibitions on the grounds of public policy or where the rights of the obligor are adversely affected. The U.C.C. provides that an **assignment** is ineffective if it materially changes the duty of the other party, materially increases the burdens or risks under the contract, or materially impairs the other party's chance of obtaining return performance. Parties may agree in the contract to the assignability of contract rights, or later consent to such assignment. Courts generally hold that future contract rights or after-acquired rights are not assignable as well as rights in which the identities of the parties are of central importance to the performance under the contract. Generally, an **assignee** is considered to stand in the shoes of the **assignor** and acquires only those rights the assignor had against the **obligor**. In addition, an assignee will be subject to any and all **defenses** held by the obligor as to **enforcement** of the contract terms.

8.3 Delegation

Performance of a contractual obligation can generally be **delegated** to third parties under circumstances similar to that of an assignment. However, unlike an assignment, the delegating party remains liable under the contract until the **subsequent performance** by the **delegate**. A duty is generally nondelegable to the extent that the **obligee** has a substantial interest in having the original promisor either perform the obligation himself or control the performance thereof. **Personal service contracts** are the most common nondelegable duty where the basis of the performance relies on the reputation, skill or discretion of the party rendering the service. If a contract duty is delegable, the obligee must accept performance by the delegate and any refusal by the obligee would effect a repudiation.