19.2 Contract Formation

Terms. Generally speaking, in order to create a contract, the parties must make clear their intent to be bound by their agreement, and the agreement must be specific and definite enough for a court to enforce. The contract must contain terms that are specific enough to allow the court to determine what was promised. In addition, the contract must allow some mechanism of enforcement, or a way for the court to ensure that the parties honor their respective obligations. The parties do not need to foresee every contingency or set forth every possible term, but at a minimum, the contract must specify: (1) who the parties are; (2) what each party is promising, if anything; and (3) the price for each party's performance of the contract. The parties may also wish to specify the time for performance, i.e., set a limit on how long each party has to fulfill its obligations. If they fail to include such a provision, the court may, if reasonable, impose such a time limit as it finds reasonable under the circumstances.

Parties. The parties to a contract are the persons or organizations who are offering or accepting a transfer of rights. Generally, only the parties who are named in a contract may sue or be sued to enforce it. Thus, Party A may not sue to enforce a contract between Party B and Party C. There are two main exceptions to this principle.

The first exception is where a party to a contract has transferred his, her, or its rights or obligations to a person or organization not originally part of the deal. This is known as "**assignment**." A party to a contract can generally assign its rights or obligations without the permission of other parties; the other parties may object only where: (1) the contract forbids such an assignment; (2) the assignment would cause the duties of the parties to change in a significant way; (3) the risk of return performance (i.e., being paid back) is materially reduced; or (4) the value of performance is significantly reduced. In most cases, an assignee steps into the shoes of a party, and can sue and be sued as if he had originally been a party to the contract. Generally, however, a party's *duties*, as opposed to its *rights*, cannot be assigned without the agreement of other parties. Such an agreement creates a **novation,** and the delegate becomes a party for all intents and purposes.[1]

The second exception is where an agreement provides benefits to a person or organization that does not sign or otherwise indicate agreement to the terms of the contract. Such a **third party beneficiary** can sue to enforce the contract if he was intended to have enforceable rights. An example would be if Party A promised, in return for a payment of $200 by Party B, to give his car to Party C. Party C, who has no obligations under this agreement, would be a third party beneficiary. A person or organization that derives benefit from a contract, but was not intended to have enforceable rights (such as a property owner whose property value is enhanced by the construction of a road or railway), is an **incidental beneficiary**, and has no right to sue to enforce the terms of the agreement.

Assent and the "meeting of the minds." A contract requires, at a minimum, that the parties give a clear indication of their agreement, or **assent**, to the same bargain. This is usually done in the form of an offer and acceptance, discussed below. Courts call the manifestation of an agreement between the parties a "**meeting of the minds**," and the test is an objective one. Generally, there has been a "meeting of the minds" if a court finds that a reasonable person in the position of each of the parties would have been led to believe by the actions or words of the other party that a contract had been created between them, and that each had the same understanding of its terms. Assent to a common understanding of the contract's goals is such a crucial element that courts have been known to override the express terms of a contract when those terms interfered with the "manifest objectives" to which all parties had agreed.[2] This is known as **reformation**.

Offer, revocation, and acceptance. Creation of a contract, at a minimum, also generally requires an offer by one party and acceptance by another. An **offer** is a demonstration of one's willingness to be bound by a contract, and must be such that a reasonable person would think that responding in a certain way (by accepting the

[1] *See, e.g.*, Restatement (Second) of Contracts §§ 317-318.
[2] *Spaulding v. Morse*, 76 N.E.2d (Mass. 1947).

offer or performing a requested act) will create a contract. Entering into preliminary negotiations (e.g., "I'd like for you to cut my lawn, and I'd be willing to pay for the service") does not create an offer. An offer must usually be a definite statement (e.g., "I will pay you $50 to cut my lawn"). The offering party (the "**offeror**") can generally take back, or **revoke**, the offer at any time until someone accepts it. There are a few exceptions to this rule, as in the case of an **option contract** (where the offeror accepts a payment in exchange for keeping the offer open for a specified time) or where a statute such as the Uniform Commercial Code makes a particular type of offer irrevocable.[3]

The party to whom the offer is made (the "**offeree**") has a number of options available. The offeree may **reject** the offer, in which case the offer is terminated and the offeror is under no further obligation, even if the offeree later changes his mind and decides that he would rather accept. To create a binding contract, the offeree must **accept** the offer, in which case a contract has been created. Acceptance must be unconditional and must completely correspond with all of the terms of the offer. The requirements for a valid acceptance often depend on the type of contract being offered. In a unilateral contract, the offeree may usually accept the offer by **performance**, or by carrying out the actions specified in the offer. Thus an advertisement offering a reward for performance of a certain act may be accepted merely by doing what the ad invites.[4] A bilateral contract, on the other hand, is usually accepted by giving a return promise, communicated by the offeree to the offeror. This **notice of acceptance** must be made in a timely manner, but what counts as "timely" will often depend on the specific nature of the offer and the circumstances surrounding it. Notice of acceptance must be given in the manner specified by the offeror, but if the offeror does not specify a means of notice, then no specific form of notice is generally required.[5] Acceptance generally eliminates the ability of the offeror to revoke his offer. In other words, an offer that has been accepted is a valid, legal contract, and any revocation would be a breach of contract.

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[3] *E.g.,* Restatement (Second) of Contracts §§ 87-88.
[4] *Carlill v. Carbolic Smoke Ball Co.*, 1 Q.B. 256 (1893).
[5] *International Filter Co. v. Conroe Gin, Ice & Light Co.*, 277 S.W.2d 631 (Tex. 1925).

Counter-offer. Instead of either accepting or rejecting a contract, an offeree may choose a third option, that of **counter-offer**. A counter-offer functions as a rejection of the terms of the original offer and a simultaneous offer of similar but modified terms. For example, if Party A offers to buy Party B's car for $1000, and Party B counter-offers with a sale price of $1500, the original offer is considered rejected and Party A is under no further obligation. Party A, however, may accept Party B's counter-offer, creating a contract and obliging Party B to sell his car at the new agreed-upon price of $1500. Because acceptance must be unconditional, any response styled as an acceptance with additional conditions, or a **conditional acceptance**, is in fact no acceptance at all, but rather a counter-offer.[6]

Consideration. A contract must be the result of **bargain**; as such, **consideration** is required to form a valid, enforceable contract. "Consideration" is a legal term that refers to anything of value, tangible or otherwise, received from a recipient of the promise. Any enforceable contract requires consideration; in other words, every party to a contract must receive something of value. Thus, a **donative promise** (a promise to make a gift in the future, with no bargain or return obligation), such as a charitable pledge, is not an enforceable contract.[7] There are different ways, however, in which this requirement can be satisfied.

Courts in the United States are reluctant to be involved in determining whether a deal is "fair." In the absence of fraud, a court will generally leave parties to their contract, and will not interfere with "bad" deals. As a result, courts will not generally weigh the respective benefit provided to each party. Instead, the focus is on whether each party passed some obligation or duty to the other. A contract where Party A promises to pay $200 for Party B's Lamborghini is generally enforceable, even though the consideration ($200) is far less valuable than the item being transferred (the Lamborghini, which may be worth a thousand times the value of the consideration).[8]

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[6] *Ardente v. Horan*, 366 A.2d 162 (R.I. 1976).
[7] *Dougherty v. Salt*, 125 N.E. 94 (N.Y. 1919).
[8] *Hancock Bank & Trust Co.*, 309 N.E.2d 482 (1974).

Traditionally, consideration could be **nominal**; the test under old English law was the "value of a peppercorn," i.e., a negligible or insignificant amount. This is why you have probably seen licensing agreements that include phrases such as "for a sum of $1.00 and other good and valuable consideration." Courts in some states, however, have found that such nominal consideration is not enough to create a contract.[9] Contracting parties must investigate the laws of the state under which the contract is created to make sure that sufficient consideration is being provided. Consideration usually takes the form of money or other valuable items provided by one party to another. But under the common law, a promise to abstain from doing something that one had a right to do was enough consideration to create a valid contract.[10] Thus, if Party A promised Party B to pay him $500 in exchange for Party B's promise to stop smoking, that promise would be enforceable, even though Party B's abstention is arguably not valuable to Party A in a material sense.

On the other hand, a promise to perform a **preexisting legal duty**, an act a party *already* has a duty to do (or refrain from doing) under the law, is not sufficient consideration to create a contract. In other words, if Party A is a firefighter, a promise by Party B to pay him $500 to put out a fire is probably *not* enforceable, because a firefighter has a legal duty to put out fires.[11] **Past consideration**, a past event that inspires a promise, is also generally not sufficient consideration to create a present contract. Such past performance is regarded by courts as a "mere" **moral obligation**, one that should make an obligor *want* to pay back his benefactor, but does not create a legal duty to do so.[12] Suppose, for instance, that Party A gave Party B $1000 a year ago, with no requirement of repayment. Party B now says "out of gratitude, I will pay you $2000 next week." No contract has been created, because Party B's promise was not bargained for with any present consideration. There are a few exceptions to this principle. A promise to pay (either in whole or in part) a debt that is otherwise barred

[9] *Schnell v. Nell*, 17 Ind. 29 (1861).
[10] *Hamer v. Sidway*, 124 N.Y. 538 (1891).
[11] *Gray v. Martino*, 103 A. 24 (N.J. 1918).
[12] Note, however, that some courts have rejected this tradition, and will enforce a promise based on moral obligation under certain circumstances. *See, e.g.*, *Webb v. McGowin*, 168 So. 196 (Ala. App. 1935).

by an applicable statute of limitations is enforceable, even if no new consideration is provided.[13] Similarly, a promise to perform a voidable obligation is enforceable.[14]

In many states, bundling a valueless term (such as an existing legal duty) with a valuable one (i.e., one that would, by itself, provide consideration sufficient to create a contract) *will* be enough to create consideration.

Detrimental reliance / promissory estoppel as consideration. Consideration can be created in the absence of a bargain under the doctrine of **detrimental reliance**, also known as **promissory estoppel**. Where one party makes a promise to another that a reasonable person would expect to cause the recipient of the promise to act or fail to act, and where the recipient does act in the expected manner, the promissor is *estopped*, or legally barred, from refusing to honor his promise on the grounds that there was no consideration.[15] For example, Party A tells Party B, an employee, that Party A will pay Party B an annual stipend for life if Party B retires. Based on this expectation, Party B retires. Party A has entered into a valid, enforceable contract even though Party B has not offered any return consideration for the promise.[16]

Writing requirement and the statute of frauds. A contract may usually be oral or written, and the lack of a writing is not generally a bar to enforcement. English law, however, recognized that oral contracts were subject to fraudulent claims by unscrupulous parties, and so developed the **Statute of Frauds** requiring that certain types of contracts be put into a signed writing.[17] Most states of the United States have adopted similar provisions. While there are many local variations, the following types of contracts must generally be in writing under relevant statutes of frauds: (1) a contract which cannot, under any circumstances, be performed within one year (e.g., a promise to deliver certain goods in 15 months); (2) sale or other transfer of real

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[13] Restatement (Second) of Contracts § 86.
[14] Restatement (Second) of Contracts § 89.
[15] Restatement (Second) of Contracts § 90.
[16] *Feinberg v. Pfeiffer Co.*, 322 S.W. 2d 163 (Mo. 1959).
[17] Originally passed as An Act for Prevention of Frauds and Perjuries, 29 Chas. II c. 3 (1677).

property and interests therein; (3) leases and brokerage agreements with a duration of one year or more; (4) promises to pay time-barred debts or debts discharged in bankruptcy; and (5) agreements to guaranty another's debts. The Uniform Commercial Code, applicable to some types of contracts (as more fully described below), imposes additional statute of frauds restrictions; under its terms, contracts for: (1) sale of intangibles valued over $5000; (2) the sale of goods worth $500 or more;[18] (3) the sale of securities; and (4) granting security interests in personal property or fixtures must all be in writing.[19]

Legal capacity. To be bound under contract, a party must have the **legal capacity** to enter into a contract. One must be of sufficient age (usually 18 years old) to enter into a contract. In most jurisdictions, contracts entered into by minors, except contracts for necessities (such as food) are voidable by the minor or his guardian after the minor becomes an adult. The minor may, however, choose to **reaffirm** the contract upon reaching adulthood, in which case it is valid even for the period of minority. Adults must also meet the requirements of legal capacity, although the threshold is quite low. Adults impaired by drugs, alcohol, developmental disability, mental illness, or senility may still have sufficient capacity to enter into a contract. The test is whether the impaired party had the ability to understand the nature of the transaction and its implications.

A promise by an incapacitated person or minor is sufficient consideration for creating a contract; what this means is that an incapacitated person or minor can enforce a contract against another party that might not be enforceable against themselves.

Most jurisdictions now require that a party choosing to avoid a contract on the grounds of incapacity or minority reimburse the other party for losses as a result of canceling such contracts.

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[18] Recent revisions to the UCC have raised this limit to $5000. However, the vast majority of states have not adopted this revision and have kept the previous, lower limit.
[19] UCC §§ 1-206; 2-201; 8-319; 9-203(1)(A).

Conditions. Contracts may contain **conditions precedent**, or require that certain events take place or certain actions be performed before one of the parties is required to carry out its part of the contract. The occurrence of the condition precedent creates the duty to perform a contractual duty. For example, Party A promises to pay Party B $100 *if* Party B delivers certain goods by a specified date. Party B's delivery by that specific date is a condition precedent to Party A's duty to pay the $100. If Party B fulfills the condition precedent, Party A is bound by the contract. If not, neither party is bound and there is no breach by anyone. Another type of condition is a **condition subsequent**, where the occurrence of a particular specified event removes a duty to perform. For example, Party A promises to mow Party B's lawn all summer *unless* Party A wins the lottery by the end of the summer. If Party A then wins the lottery, that condition subsequent has extinguished his duty to perform the lawnmowing services. **Conditions concurrent** are mutually dependable actions that can be performed more or less simultaneously by the parties.

19.3 Contract Interpretation

When considering whether to enter into specific contract terms, it is important to analyze how a court will interpret the contract, if the parties end up litigating over its enforcement. Courts in different jurisdictions have adopted different rules of contract interpretation, and apply them differently under different circumstances. But there are broad commonalities that are set forth below.

Objective theory of contracts. Courts in the United States adhere to the **objective theory of contracts**—essentially, a contract means what a reasonable person in the position of each party would have believed it meant based on the words or actions of the other party. Thus, if Party A makes an offer to Party B, and Party B accepts only in jest (without Party A having any reasonable way of knowing that it was a joke), a court will likely find that an enforceable contract exists. Party B should have known that Party A would believe that his acceptance was genuine.[20]

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[20] *Lucy v. Zehmer*, 84 S.E.2d 516 (Va. 1954).

Four corners. Most courts in the United States are reluctant to interfere with the bargains of private parties. Because of this, most jurisdictions apply a **"four corners" rule**; if the terms of the contract are not ambiguous (i.e., can only be reasonably interpreted one way), courts will generally not look beyond the "four corners" of the agreement (e.g., by hearing testimony about prior discussions between the parties). Generally, the court will only look at the surrounding circumstances and hear testimony on matters beyond the express terms of the contract where such **extrinsic evidence** is needed to interpret contract terms that are **ambiguous**, or susceptible to more than one reasonable interpretation.

Parol evidence rule. Where the parties have signed a written contract that the parties intend to fully express the terms of their agreement, they are said to have entered into an **integrated contract.** In most cases, a court will refuse to hear evidence of any earlier or contemporaneous oral or written statements (called **parol evidence**) to add to, contradict, or change the terms of such a written contract.[21] This **parol evidence rule** applies only to statements or expressions dating to before or to the same time that the contract was signed. Evidence from the period after the signing of a contract is *not* parol evidence and is admissible.

Parol evidence is admissible for limited purposes, such as: (1) to demonstrate that there has been a forgery, fraud, mistake, or lack of consideration[22]; (2) to prove the existence of a condition upon which a written agreement depends (a **condition precedent**); or (3) to interpret or explain the written terms where these are ambiguous.[23] In some jurisdictions, parol evidence is allowed to limit a term so long as such evidence does not contradict the term.[24]

Rules of contract construction. Courts have adopted general rules over time to assist in contract interpretation, and to help determine the meaning of the language used by the parties. A few of the most important of these **rules of construction** are:

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[21] Restatement (Second) of Contracts §§ 209-216.
[22] *See, e.g.*, *Lusk Corp. v. Burgess*, 332 P.2d 493 (Ariz. 1958).
[23] *Pacific Gas & Electric co. v. G.W. Thomas Drayage & Rigging Co.*, 442 P.2d 641 (Cal 1968).
[24] *Hunt Foods and Industry, Inc. v. Doliner*, 270 N.Y.S.2d 937 (N.Y.A.D. 1966).

(a) Specific terms are given greater weight than general statements.
(b) Negotiated terms are given greater weight than standard, or **boilerplate**, terms.
(c) Words and the conduct of the parties are to be interpreted in light of all relevant circumstances.
(d) Contracts should be interpreted as a whole, with its clauses interpreted in a manner consistent with the general intent of the agreement.
(e) Words should be given the meaning that prevails in everyday use, unless the contract demonstrates a different intent.
(f) A contract can be interpreted in accordance with standard business custom within a particular industry if both parties knew or had reason to know of the custom, and neither party had reason to believe that the other party attached a different meaning.
(g) The meaning that operates against the interests of the party that drafted the contract is preferred.
(h) The general policy of the law is to uphold contracts, and interpretations that will make a contract lawful and enforceable are preferred over interpretations that render part or all of the contract unenforceable, illegal, or unreasonable.[25]

Extrinsic evidence. As noted above, if a contract term is ambiguous, a court may look to extrinsic evidence to determine which meaning was intended by the parties. Some of the types of extrinsic evidence that courts may consider include the course of conduct between the parties that may have established a common understanding for interpreting contract terms (**course of dealing** or **course of performance**), the **trade usage** (meaning of a term within a particular industry), and communications (written or oral) between the parties or with third parties.

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[25] *See generally* Restatement (Second) of Contracts §§ 228-229.

Warranties. In certain types of sales, the seller may give the buyer **express warranties**. A **warranty** is a guaranty that the good or service being sold meets certain criteria. Many home appliances, for example, come with warranties that they will function as advertised for a set period. But the law may also presume, in certain cases, that the seller has given **implied warranties** even if none are expressly stated. For example, a **warranty of merchantability** is a guaranty usually implied in a sale of goods that the goods reasonably conform to an ordinary buyer's expectations. A **warranty of fitness for a particular purpose** is a guaranty that goods meet the specific request of the buyer. Some types of implied warranties can be **disclaimed**; that is, a seller may expressly state that he is selling the goods "as is," or without implied warranties. Certain jurisdictions restrict the ability of merchants to disclaim some types of warranties. Failure to live up to the obligations of a warranty is considered a **breach of warranty**, which is, for all intents and purposes, a breach of contract.

Covenant of good faith and fair dealing. One type of guaranty similar to an implied warranty is the **covenant of good faith and fair dealing**. This covenant is an obligation between all parties of a contract that they act with good faith (i.e., that the parties will deal with one another honestly and fairly)[26] towards each other, and not seek to take unfair advantage of their contract partners. Under common contract law, the covenant of good faith and fair dealing attaches to *all* contracts, and cannot be waived or disclaimed under any circumstances.[27]

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[26] *Kirke La Shelle Company v. The Paul Armstrong Company,* 188 N.E. 163 (N.Y. 1933).
[27] Restatement (Second) of Contracts § 205; *see also* UCC § 1-203.