American Contract Law in a Comparative Perspective

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The Effect of Bargaining Misconduct and the Relationship between Contract and Tort

I. Fraud and Nondisclosure

II. Unconscionability

III. Good Faith

I. Fraud and Nondisclosure

Leading Case

Hill v. Jones, (Arizona 1986)

Facts

- The case involved a contract to buy a home entered into after the buyers, the Hills, visited the home on several occasions.
- The contract required the sellers to submit a termite inspection report showing that the home was free from evidence of termite infestation.

Facts (2)

- One of the features of the home was a parquet teak floor covering a large part of the house.
- On a visit after the contract was signed, the buyers noticed a ripple in the floor in a step leading from the sunken living room up to the dining room.

Facts (3)

- Mr. Hill asked if the ripple could be caused by termite damage.
- Ms. Jones said that it was caused by water damage.
- In fact, a few years before, a broken hot water heater had caused damage in that area.

Facts (4)

- The parties had no further discussion about the matter.
- The termite inspection report stated that there was no visible evidence of termite infestation.
- The report did not mention
  - Existence of previous termite damage
  - Evidence of previous treatment
- The broker informed the parties the property had passed the termite inspection.

Facts (5)

- After moving into the house, the Hills learned that the home had been infested with termites and that the defendants knew about the infestation, but never revealed this information to them, to the termite inspector, or to the broker.
- The Jones may have placed boxes on some termite holes to prevent the inspector from seeing the damage.

Facts (6)

- The Hills had unrestricted access to the property before they signed a contract.
- Both of the Hills had seen termite damage before.
- Mr. Hill was familiar with termite damage from his job as a maintenance supervisor at a school.
- Neither of them asked any questions about termites except for the question about the ripple.

Facts (7)

- The contract had the following clause:

  “That the Purchaser has investigated the said premises, and the Broker and the Seller are hereby released from all responsibility regarding the valuation thereof, and neither Purchaser, Seller, nor Broker shall be bound by any understanding, agreement, promise, representation or stipulation expressed or implied, not specified herein.”

Decision

- The buyers sued to rescind the contract for misrepresentation and nondisclosure.
- The trial court dismissed the case because of the integration clause in the contract.
- The appellate court reversed and remanded.

Decision (2)

- The court held that a contract provision cannot protect a party from its own fraud.
- The court referred to the traditional rule of caveat emptor—let the buyer beware---but stated that the rule has "waned during the later half of the 20th century".
- The modern view is that a duty to disclose arises in a number of situations, including when >>>>

Decision (3)

Disclosure would correct a mistake of the other party as to a basic assumption on which that party is making the contract and if nondisclosure amounts to a failure to act in good faith and in accordance with reasonable standards of fair dealing.

Restatement (2d) of Contracts §161.

Comments on *Hill*

- The case was a contract case seeking rescission for nondisclosure.
- The Jones had a number of good arguments against liability, but these were for the jury to decide.

Comments (2)

- If the Hills wanted to keep the property, they could have sued in tort for the damages suffered as a result of the defendants' nondisclosure.
  - See Restatement (2d) of Torts §551.
  - Punitive damages might have been recoverable as well.

Comments (3)

- *Hill* deals with nondisclosure of basic facts when required by good faith and fair dealing.
- US law provides that a duty to disclose exists in other situations as well:
  - When necessary to prevent a previous assertion from being a fraudulent or material misrepresentation;
  - When necessary to correct a mistake as to the contents of a writing;
  - When a relationship of trust or confidence exists between the parties.
- Restatement (2d) of Contracts §161.

Comments (4)

- Under US law a contract may also be avoided for material misrepresentation as well as nondisclosure. See Restatement (2d) of Contracts §164.
  - The misrepresentation need not be fraudulent.
  - Fraudulent misrepresentation is also actionable in tort.

International and European Law

- CISG, Art. 4, 7(2), 7.1, 40
- UNIDROIT Principles, Art. 3.8
- European Principles Art. 4:07

CISG Art.4

This Convention governs only the formation of the contract of sale and the rights and obligations of the seller and the buyer arising from such a contract. In particular, except as otherwise expressly provided in this Convention, it is not concerned with:

(a) the validity of the contract or of any of its provisions or of any usage;

(b) the effect which the contract may have on the property in the goods sold.

CISG Art. 7(2)

- Under Art.7(2), when CISG is silent, questions are to be "settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law."

CISG Art. 7.1 on good faith

(1) In the interpretation of this Convention, regard is to be had to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade

CISG Art. 40

The seller is not entitled to rely on the provisions of articles 38 and 39 [dealing with the buyer's obligation to give reasonable notice of nonconformity] if the lack of conformity relates to facts of which he knew or could not have been unaware and which he did not disclose to the buyer.

UNIDROIT Art. 3.8

Fraud

A party may avoid the contract when it has been led to conclude the contract by the other party's fraudulent representation, including language or practices, or fraudulent non-disclosure of circumstances which, according to reasonable commercial standards of fair dealing, the latter party should have disclosed.

European Pr. Art. 4:07(1), (2)

Fraud

(1) A party may avoid a contract when it has been led to conclude it by the other party's fraudulent representation, whether by words or conduct, or fraudulent non-disclosure of any information which in accordance with good faith and fair dealing it should have disclosed.

(2) A party's representation or non-disclosure is fraudulent if it was intended to deceive.

European Pr. Art. 4:07(3)

(3) In determining whether good faith and fair dealing required that a party disclose particular information, regard should be had to all the circumstances, including:

(a) whether the party had special expertise;

(b) the cost to it of acquiring the relevant information;

(c) whether the other party could reasonably acquire the information for itself; and

(d) the apparent importance of the information to the other party.

Comments on US and International Law

- While the UNIDROIT and European Principles refer to fraudulent misrepresentation or nondisclosure, these principles also allow for avoidance of a contract based on mistake arising from incorrect information supplied by the other party. UNIDROIT Principles Art.3:05, European Principles Art. 4:06.

Comments (2)

- Would International law allow for relief for non-disclosure that was not fraudulent, that is where there was no intention to deceive?
  - US law does not require non-disclosure to be fraudulent, only material, to provide relief, but does require a showing of knowledge, which may be very close to an intention to deceive.

II. Unconscionability

Leading Case

Williams v. Walker-Thomas Furniture Co.,

(United States Court of Appeals for the District of Columbia 1965)

Facts

- Ms. Williams was a low-income resident of Washington, DC.
- She purchased a number of household items form the defendant furniture store from 1957-1962.

Facts (2)

The contracts had the following features

- standard form documents prepared by the defendant.
- payments in installments
- title retention to each of the items with the defendant until all of them were paid for.
- payments were to be credited pro rata to each of the items.

Facts (3)

- As a result
  - Ms. Williams did not own any of the items until she paid for them all.
  - The company could repossess all items if she failed to make payment on any of them.
  - Whenever she bought a new item, it became subject to repossession for the debt of all others.

Facts (4)

- In 1962 Ms. Williams purchased a stereo system at a cost of $514.95.
- Shortly thereafter she defaulted and defendant attempted to repossess all items she had purchased since 1957.
- At that time her account balance was $164; she had purchased items totaling $1800.

Decision

- The lower court condemned the defendant's conduct, but concluded that it lacked the power to refuse enforcement.
- The court of appeals disagreed, holding that a court could declare a contract unenforceable if it was unconscionable.

Decision (2)

- The court defined unconscionability as follows:

  "Unconscionability has generally been recognized to include an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party."

Decision (3)

- To determine whether a lack of meaningful choice exists, the court will examine factors, including
  - Whether gross inequality of bargaining power exists
  - Manner in which contract was entered into, such as use of fine print and sales practices.
- To determine whether contract terms are unreasonably favorable, the court will consider those terms in light of general commercial background and the needs of the particular trade or industry.

Current US Law

- Current US recognizes unconscionability as a defense against enforcement of a contact.
  - Restatement (2d) of Contracts §208
  - UCC §2-302

UCC §2-302(1)

Unconscionable Contract or Term

(1) If the court as a matter of law finds the contract or any term of the contract to have been unconscionable at the time it was made, the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable term, or it may so limit the application of any unconscionable term as to avoid any unconscionable result.

UCC §2-302(2)

(2) If it is claimed or appears to the court that the contract or any term thereof may be unconscionable, the parties shall be afforded a reasonable opportunity to present evidence as to its commercial setting, purpose, and effect to aid the court in making the determination.

- The Restatement section is substantially identical to UCC 2-302(1).

Comments about US unconscionability doctrine

- In consumer cases, various statutes provide substantive and disclosure protection to consumers, although the unconscionability doctrine remains available if statutory protection is not available.
- In commercial cases use of the doctrine is rare because the factors showing unconscionability are more difficult to establish.

Comments (2)

- A recent area of litigation involves clauses requiring disputes to be submitted to arbitration. On occasion courts have declared such clauses unconscionable when the costs of arbitration imposed on the consumer or employee effectively deprive that person of a hearing before a tribunal.
- According to most courts, unconscionability is not the basis of a tort action (unlike fraud or nondisclosure) although it might be the basis of a statutory claim for unfair trade practices.

International and European Law

- CISG (does not cover contract invalidity, see above)
- UNIDROIT Principles, Arts. 3.10, 2.1.20. See also 7.1.6 (exemption clauses)
- European Principles Arts. 4:109, 4:110

UNIDROIT Principles Art. 3.10 (1)

Gross disparity

(1) A party may avoid the contract or an individual term of it if, at the time of the conclusion of the contract, the contract or term unjustifiably gave the other party an excessive advantage. Regard is to be had, among other factors, to >>>

UNIDROIT Principles Art. 3.10 (1)(a), (b)

(a) the fact that the other party has taken unfair advantage of the first party's dependence, economic distress or urgent needs, or of its improvidence, ignorance, inexperience or lack of bargaining skill, and

(b) the nature and purpose of the contract.

UNIDROIT Principles Art. 3.10 (2), (3)

(2) Upon the request of the party entitled to avoidance, a court may adapt the contract or term in order to make it accord with reasonable commercial standards of fair dealing.

(3) A court may also adapt the contract or term upon the request of the party receiving notice of avoidance, provided that that party informs the other party of its request promptly after receiving such notice and before the other party has reasonably acted in reliance on it. The provisions of Article 3.13(2) apply accordingly.

UNIDROIT Principles Art. 2.1.20

Surprising Terms

(1) No term contained in standard terms which is of such a character that the other party could not reasonably have expected it, is effective unless it has been expressly accepted by that party.

(2) In determining whether a term is of such a character regard shall be had to its content, language and presentation.

European Principles Art. 4:109 (1)

Excessive Benefit or Unfair Advantage

(1) A party may avoid a contract if, at the time of the conclusion of the contract:

(a) it was dependent on or had a relationship of trust with the other party, was in economic distress or had urgent needs, was improvident, ignorant, inexperienced or lacking in bargaining skill, and >>>

European Principles Art. 4:109 (1)(b)

(b) the other party knew or ought to have known of this and, given the circumstances and purpose of the contract, took advantage of the first party's situation in a way which was grossly unfair or took an excessive benefit.

[(2), (3) provide for judicial adaptation similar to the UNIDROIT Principles.]

European Principles Art. 4:110 (1)

Unfair Terms Not Individually Negotiated

(1) A party may avoid a term which has not been individually negotiated if, contrary to the requirements of good faith and fair dealing, it causes a significant imbalance in the parties' rights and obligations arising under the contract to the detriment of that party, taking into account the nature of the performance to be rendered under the contract, all the other terms of the contract and the circumstances at the time the contract was concluded.

European Principles Art. 4:110 (2)

(2) This Article does not apply to:

(a) a term which defines the main subject matter of the contract, provided the term is in plain and intelligible language; or to

(b) the adequacy in value of one party's obligations compared to the value of the obligations of the other party.

Comments on US and International Law on Unconscionability

- In form at least, US and International Law are significantly different.
- US law has a single doctrine of unconscionability. Most courts require a combination of defects in the bargaining process and unfair terms for the doctrine to apply.

Comments (2)

- International and European law appears to recognize two distinct situations:
  - Substantive disparity in the bargain
  - Unfair or surprising terms
- By providing relief in either situation, rather than requiring a combination as under US law, relief is probably more readily available under International and European Principles.

III. Good Faith

Leading Case

Locke v. Warner Bros. Inc.,
(California Court of Appeals 1997)

Facts

- In 1975 Sandra Locke and Clint Eastwood began a romantic relationship during the filming of the movie *Outlaw Josey Wales*.
- In 1988 the relationship deteriorated, and in 1989 Eastwood ended it.
- Locke brought a palimony suit against Eastwood, which was settled in 1990.

Facts (2)

- In connection with the settlement Eastwood agreed to assist Locke in obtaining a development deal with Warner Bros.
- In 1990 Locke entered into a development contract with Warner Bros.

Facts (3)

- The contract had two parts.
  - Part 1 called for Warner to pay Locke $250,000 per year for three years for a "non-exclusive first look deal" on any films she was interested in developing before submitting them to another studio.
  - Part 2 called for a $750,000 "pay or play" directing deal.

Facts (4)

- Unknown to to Locke, Eastwood had agreed to reimburse Warner Bros. for its payments to Locke.
- Warner Bros. did not develop any of Locke's films or use her directing services.
- Locke subsequently learned about the side agreement between Eastwood and Warner, and she brought suit against Warner.

Decision

- On Locke's tort claim for breach of the duty of good faith and fair dealing,
  - The trial court found no liability because the contract gave Warner the right not to use Locke's services.
  - The court of appeals reversed.

Decision (2)

- The court held that when a contract confers a discretionary right on a party, the party must exercise that right in good faith.
- Locke's evidence showed the Warner had failed to exercise its discretion but had made up its mind to categorically reject her proposals.

Good Faith under US Law

- Restatement (2d) of Contracts §205
- UCC §1-304, 1-201(20)

Restatement (2d) of Contracts §205

Duty of Good Faith and Fair Dealing

Ever contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.

UCC §1-304 (rev. 2001)

Obligation of Good Faith

Every contract or duty within [the Uniform Commercial Code] imposes an obligation of good faith in its performance and enforcement.

UCC §1-201(20) (rev. 2001)

Definition of good faith

(20) "Good faith," except as otherwise provided in Article 5, means honesty in fact and the observance of reasonable commercial standards of fair dealing.

International and European Law

- CISG, Art. 7
- UNIDROIT Principles, Art. 1.7
- European Principles, Arts. 1:201, 1:102, 1:106

CISG Art. 7(1)

(1) In the interpretation of this Convention, regard is to be had to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade.

UNIDROIT Principles Art. 1.7

Good Faith and Fair Dealing

(1) Each party must act in accordance with good faith and fair dealing in international trade.

(2) The parties may not exclude or limit this duty.

See also Art. 1.8 on inconsistent behavior and Art.4.8 on supplying an omitted term.

European Principles Art. 1:201

Good Faith and Fair Dealing

(1) Each party must act in accordance with good faith and fair dealing.

(2) The parties may not exclude or limit this duty.

European Principles (2)

- Good faith is mentioned in numerous other European Principles, such as the following:
- Arts. 1:102 and 1:106, good faith in interpretation,
- 1:202, duty to co-operate
- 2:301, negotiations contrary to good faith

Comments on US and International Law

- Both US and international law clearly recognize a concept of good faith.
- Both would look to general commercial standards in determining whether the duty has been breached.
- Whether there are significant differences in application of the concept requires detailed comparative study.
- However, the European concept of liability for failure to negotiate in good faith probably goes beyond current US law.

Changed Circumstances

I. Mistake

II. Impracticability

III. Failure of Condition

I. Mistake

Leading case

Lenawee County Board of Health v. Messerly, (Michigan 1982)

Facts

- The Pickles purchased from the Messerlys a 600 square foot tract of land on which was located a three-unit apartment building.
- Unknown to any of parties, a prior owner had installed a septic tank without a permit in violation of the health code.

Facts (2)

- Five or six days after the contract was signed, the Ps discovered raw sewage seeping from ground.
- Subsequently, the County brought suit to obtain an injunction to prevent habitation.

Facts (3)

- The contract had the following clause: "Purchaser has examined this property and agrees to accept same in its present condition. There are no other or additional written or oral understandings."

Decision

- The court granted the injunction to the county.
- The Ms filed a cross-claim for foreclosure and Ps counterclaimed for rescission.
- The court denied rescission on ground that the Ps bore the risk of mistake because of disclaimer clause in contract.

Current US Law

- *Lenawee County* reflects current US law.
- The court relies on the Restatement (2d) of Contracts §§152 and 154 dealing with mutual mistake.

Restatement (2d) §152(1)

When Mistake of Both Parties Makes a Contract Voidable

(1) Where a mistake of both parties at the time a contract was made as to a basic assumption on which the contract was made has a material effect on the agreed exchange of performances, the contract is voidable by the adversely affected party unless he bears the risk of the mistake under the rule stated in §154.

Restatement (2d) §154

When a Party Bears the Risk of a Mistake

A party bears the risk of a mistake when

(a) the risk is allocated to him by agreement of the parties, or

(b) he is aware, at the time the contract is made, that he has only limited knowledge with respect to the facts to which the mistake relates but treats his limited knowledge as sufficient, or

(c) the risk is allocated to him by the court on the ground that it is reasonable in the circumstances to do so.

Unilateral Mistake under US Law

- US law also recognizes relief from a contract on basis of unilateral mistake—by one party rather than both. Restatement (2d) §153.
  - The party seeking relief must show that enforcement of the contract would be unconscionable, that the other party had reason to know of the mistake, or that party's fault caused the mistake.
- The risk allocation analysis also applies to claims of unilateral mistake.

UCC

- UCC does not have specific sections on mistake.
- In the absence of a specific section, general common law principles apply, UCC §103 (b).

International and European Law

- CISG, Art. 4
- UNIDROIT Principles, Arts. 3.4, 3.5
- European Principles, Art. 4:103

CISG Art. 4

This Convention governs only the formation of the contract of sale and the rights and obligations of the seller and the buyer arising from such a contract. In particular, except as otherwise expressly provided in this Convention, it is not concerned with:

(a) the validity of the contract or of any of its provisions or of any usage;

(b) the effect which the contract may have on the property in the goods sold.

Comments on CISG

- No provision on mistake or other invaliding grounds.
  - But see Art. 35 on implied warranties.
- Under Art.7(2), when CISG is silent, questions are to be "settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law."

UNIDROIT Principles Art. 3.4

Definition of mistake

Mistake is an erroneous assumption relating to facts or to law existing when the contract was concluded.

UNIDROIT Principles Art. 3.5

Relevant Mistake

(1) A party may only avoid the contract for mistake if, when the contract was concluded, the mistake was of such importance that a reasonable person in the same situation as the party in error would only have concluded the contract on materially different terms or would not have concluded it at all if the true state of affairs had been known, and >>>

UNIDROIT Principles Art. 3.5

(a) the other party made the same mistake, or caused the mistake, or knew or ought to have known of the mistake and it was contrary to reasonable commercial standards of fair dealing to leave the mistaken party in error; or

(b) the other party had not at the time of avoidance reasonably acted in reliance on the contract.

UNIDROIT Principles Art. 3.5

(2) However, a party may not avoid the contract if

(a) it was grossly negligent in committing the mistake; or

(b) the mistake relates to a matter in regard to which the risk of mistake was assumed or, having regard to the circumstances, should be borne by the mistaken party.

Comments on UNIDROIT Principles

- Has many similarities to US law, particularly risk allocation analysis.
  - Importance = basic assumption and material effect
  - Risk allocation = risk allocation
- The principles do not use terms mutual and unilateral mistake, but they reflect that distinction
  - Made the same mistake = mutual mistake
  - Knew or ought to have known = unilateral mistake

Other UNIDROIT Principles on Mistake

- 3.6 Error in Expression or Transmission
- 3.7 Remedies for Non-performance
- 3.13 Loss of Right to Avoid
- 3.19, Mandatory Character of Provisions, excludes mistake so can eliminate by contract.

European Principles Art. 4:103

Fundamental Mistake as to Facts or Law

(1) A party may avoid a contract for mistake of fact or law existing when the contract was concluded if:

(a) (i) the mistake was caused by information given by the other party; or

(ii) the other party knew or ought to have known of the mistake and it was contrary to good faith and fair dealing to leave the mistaken party in error; or

(iii) the other party made the same mistake,

European Principles Art. 4:103

and

(b) the other party knew or ought to have known that the mistaken party, had it known the truth, would not have entered the contract or would have done so only on fundamentally different terms.

(2) However a party may not avoid the contract if:

(a) in the circumstances its mistake was inexcusable, or

(b) the risk of the mistake was assumed, or in the circumstances should be borne, by it.

Comments on European Principles

- While the language is different, the basic principles seem very similar to US law and the UNIDROIT principles:
  - Recognizes types of mistake that are equivalent to unilateral and mutual mistake. Section 1(a).
  - Requires mistake to be of sufficient importance. Section 1(b).
  - Provides for risk allocation. Section 2.

Other European Principles on Mistake

- 4:105: Adaptation of Contract
- 4:106: Incorrect Information
- 4:117: Damages
- 4:118: Exclusion or Restriction of Remedies —May exclude or restrict remedy for mistake unless contrary to good faith and fair dealing.

II. Impracticability

- The common law developed the concept that a party to a contract could avoid enforcement if performance was impossible because of
  - Death of person necessary for performance
  - Destruction of subject matter of contract
- Over time English and American courts expanded the impossibility doctrine to situations in which the goal of the contract was frustrated even though performance was not impossible.

Leading Case

Mineral Park Land Co. v. Howard (California 1916)

Facts

- The defendant contractor had agreed to purchase and extract from plaintiff's land, at fixed prices (varying with the amounts taken), all the gravel required for the construction of a concrete bridge.
- The defendant procured some of the gravel used in the bridge from another source.
- The plaintiff sued for defendant's failure to take all of its gravel requirements from plaintiff's land.

Facts (2)

- The defendant showed that it had removed from plaintiff's land all the gravel that was above water-level.
- Removal of that which lay below water-level would have entailed not only a different means of extraction, but 10 to 12 times as great a cost.

Decision

- The court held that the extreme increase in the cost of extraction justified the defendant's nonperformance.
- Even though performance clearly was not literally impossible, it was sufficiently different from what the parties had both contemplated at the time of contracting as to be "impracticable."

Current US law

- Current US law recognizes a number of related doctrines
  - Impossibility because of death of a specific person or destruction of a specific thing necessary for performance of the contract. Restatement (2d) §§262, 263
  - Frustration of purpose, Restatement (2d) §264
  - Impracticability of performance, Restatement (2d) §261.

Restatement (2d) §261

Discharge by Supervening Impracticability

Where, after a contract is made, a party's performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged, unless the language or the circumstances indicate the contrary.

UCC §2-615

Excuse by Failure of Presupposed Conditions

Except to the extent that a seller may have assumed a greater obligation and subject to Section 2-614:

UCC §2-615(a)

(a) Delay in performance or nonperformance in whole or in part by a seller that complies with paragraphs (b) and (c) is not a breach of the seller's duty under a contract for sale if performance as agreed has been made impracticable by the occurrence of a contingency the nonoccurrence of which was a basic assumption on which the contract was made or by compliance in good faith with any applicable foreign or domestic governmental regulation or order whether or not it later proves to be invalid.

UCC §2-615(b)

(b) If the causes mentioned in paragraph (a) affect only a part of the seller's capacity to perform, the seller must allocate production and deliveries among its customers but may at its option include regular customers not then under contract as well as its own requirements for further manufacture. The seller may so allocate in any manner that is fair and reasonable.

UCC §2-615(c)

(c) The seller must notify the buyer seasonably that there will be delay or nonperformance and, if allocation is required under paragraph (b), of the estimated quota thus made available for the buyer.

International and European Law

- CISG, Art. 79
- UNIDROIT Principles, Arts. 6.2.2, 6.2.3, 7.1.7
- European Principles Arts. 4:102, 6:111. See also 8:108 (Excuse due to an Impediment)

CISG Art. 79(1)

(1) A party is not liable for a failure to perform any of his obligations if he proves that the failure was due to an impediment beyond his control and that he could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences.

CISG Art. 79(4), (5)

- (4) The party who fails to perform must give notice to the other party of the impediment and its effect on his ability to perform. If the notice is not received by the other party within a reasonable time after the party who fails to perform knew or ought to have known of the impediment, he is liable for damages resulting from such nonreceipt.
- (5) Nothing in this article prevents either party from exercising any right other than to claim damages under this Convention.

UNIDROIT Principles Art. 6.2.2

Definition of Hardship

There is hardship where the occurrence of events fundamentally alters the equilibrium of the contract either because the cost of a party's performance has increased or because the value of the performance a party receives has diminished, and

UNIDROIT Principles Art. 6.2.2

(a) the events occur or become known to the disadvantaged party after the conclusion of the contract;

(b) the events could not reasonably have been taken into account by the disadvantaged party at the time of the conclusion of the contract;

(c) the events are beyond the control of the disadvantaged party; and

(d) the risk of the events was not assumed by the disadvantaged party.

UNIDROIT Principles Art. 6.2.3 (1), (2)

Effects of Hardship

(1) In case of hardship the disadvantaged party is entitled to request renegotiations. The request shall be made without undue delay and shall indicate the grounds on which it is based.

(2) The request for renegotiation does not in itself entitle the disadvantaged party to withhold performance.

UNIDROIT Principles Art. 6.2.3 (3), (4)

(3) Upon failure to reach agreement within a reasonable time either party may resort to the court.

(4) If the court finds hardship it may, if reasonable,

(a) terminate the contract at a date and on terms to be fixed, or

(b) adapt the contract with a view to restoring its equilibrium.

UNIDROIT Principles Art. 7.1.7

Force Majeure

(1) Non-performance by a party is excused if that party proves that the nonperformance was due to an impediment beyond its control and that it could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences.

UNIDROIT Principles Art. 7.1.7 (2), (3), (4)

(2) [deals with temporary impediment]

(3) [requirement of notice]

(4) Nothing in this article prevents a party from exercising a right to terminate the contract or to withhold performance or request interest on money due.

European Principles Art. 4:102

Initial Impossibility

A contract is not invalid merely because at the time it was concluded performance of the obligation assumed was impossible, or because a party was not entitled to dispose of the assets to which the contract relates.

European Principles Art. 6:111 (1)

Change of Circumstances

(1) A party is bound to fulfill its obligations even if performance has become more onerous, whether because the cost of performance has increased or because the value of the performance it receives has diminished.

European Principles Art. 6:111 (2)

(2) If, however, performance of the contract becomes excessively onerous because of a change of circumstances, the parties are bound to enter into negotiations with a view to adapting the contract or terminating it, provided that:

European Principles Art. 6:111 (2)(a), (b), (c)

(a) the change of circumstances occurred after the time of conclusion of the contract,

(b) the possibility of a change of circumstances was not one which could reasonably have been taken into account at the time of conclusion of the contract, and

(c) the risk of the change of circumstances is not one which, according to the contract, the party affected should be required to bear.

European Principles Art. 6:111 (3)

(3) If the parties fail to reach agreement within a reasonable period, the court may:

(a) end the contract at a date and on terms to be determined by the court ; or

(b) adapt the contract in order to distribute between the parties in a just and equitable manner the losses and gains resulting from the change of circumstances.

In either case, the court may award damages for the loss suffered through a party refusing to negotiate or breaking off negotiations contrary to good faith and fair dealing.

III. Failure of Condition

Introductory comments on Conditions

- Condition is an event that must occur in order for a party to a contract to have a duty to perform that party's promises.
- Standard example:
  - Contract for purchase of real estate
  - Buyer's duty to purchase the property is conditioned on seller providing good title and buyer obtaining financing

Introduction on Conditions (2)

- US law draws a distinction between express and constructive (implied) conditions
- A condition is express if the language of the contract so provides:
  - "The buyer's duty to purchase the property is conditioned on the buyer obtaining a mortgage with the following terms…."

Introduction to Conditions (3)

- Promises made in a contract that are not expressly stated to be conditions of the other party's duty to perform are treated as constructive conditions.
- The following leading case illustrates the difference between express and constructive conditions.

Leading Case

Jacob & Youngs, Inc. v. Kent

(New York 1921)

Facts

- The plaintiff contractor, J&Y, agreed to construct a residence for Kent.
  - For $77,000 in 1914, it must have been a show place.
- The contract called for standard pipe "of Reading manufacture."
- The plaintiff inspected the first 1000 feet of pipe, which was of Reading manufacture, but failed to examine subsequent deliveries

Facts (2)

- Between 1000 and 1500 feet of non-Reading pipe was installed, much of it in the interior of the building.
- Kent occupied the building in June 1914, but he did not learn of the contractor's failure to use Reading pipe until March 1915.

Facts (3)

- Kent's architect was unwilling to issue a certificate of completion, and Kent refused to pay the balance of the contract price, $3,483.46, until the contractor replaced the pipe,
- The contractor declined this demand because of the expense involved in removing the pipe from the building.

Facts (4)

- Instead, the contractor brought suit for the balance of the purchase price, offering to show that the installed pipe was of the same quality as Reading pipe.

Decision

- The trial court refused to consider this evidence that the installed pipe was the same quality as Reading pipe.
- The Court of Appeals reversed with instructions to enter judgment for plaintiff.

Decision (2)

- Justice Cardozo held that the contractor's failure to use Reading pipe was a breach of the contract, but he refused to hold that this justified Kent in refusing to pay the balance of the purchase price.
  - In other words, the contractor's use of non-Reading pipe was a breach of promise but not a failure of a condition to Kent's duty to pay the purchase price.

Decision (3)

- Instead, he decided that only a substantial deviation from the contract would justify Kent's refusal to pay for the work done.
- He reasoned that considerations "partly of justice and partly of presumable intention" justified the court in refusing to decree a forfeiture for minor faults.

Decision (4)

- Cardozo also held that the measure of damages for the breach would be the difference in value between the home had the Reading pipe been installed and the home with the pipe that was actually used, rather than the cost of correcting the defects.
  - This produced an award of -0- damages.

Comments on *J&Y*

- The case stands for the substantial performance doctrine.
- Under this doctrine a party's duty to performed is subject to an implied or constructive condition that the other party "substantially perform."

Comments on *J&Y*

- Cardozo also held that the doctrine would not apply if the breaching party had acted willfully or if the contract and made strict performance an express condition of the contract.

Current US Law—Constructive Conditions

- Current general US law recognizes the substantial performance doctrine of for constructive conditions *J&Y*. Restatement (2d) of Contracts §237.

Current US Law—Constructive Conditions (2)

- UCC §2-601 provides for a perfect tender rule, which allows the buyer to reject goods that fail to conform to the contract in any respect.
  - However, the perfect tender rule is subject to numerous exceptions so in practice it may not be that different from the substantial performance doctrine

Current US Law—Express Conditions

- Current US law in theory provides for strict performance (rather than substantial performance) of express conditions.
- Restatement (2d) of Contracts §225(1):

  "Performance of a duty subject to a condition cannot become due unless the condition occurs or its non-occurrence is excused."

- However, US law provides for excuse of express conditions on various grounds, including fairness to avoid forfeiture. Restatement (2d) §229.

International and European Law

- CISG Art. 49, 25
- UNIDROIT Principles Art. 7.3.1
- European Principles, Ch. 16, Art. 8:103

CISG Art. 49

(1) The buyer may declare the contract avoided:

(a) if the failure by the seller to perform any of his obligations under the contract or this Convention amounts to a fundamental breach of contract; or

(b) in case of non-delivery . . .

Art. 64 on seller's right to avoid the contract is similar.

See also Art. 48 on seller's right to cure.

CISG Art. 25

A breach of contract committed by one of the parties is fundamental if it results in such detriment to the other party as substantially to deprive him of what he is entitled to expect under the contract, unless the party in breach did not foresee and a reasonable person of the same kind in the same circumstances would not have foreseen such a result.

UNIDROIT Principles Art. 7.3.1

Right to Terminate the Contract

(1) A party may terminate the contract where the failure of the other party to perform an obligation under the contract amounts to a fundamental non-performance.

(2) In determining whether a failure to perform an obligation amounts to a fundamental non-performance regard shall be had, in particular, to whether>>>

UNIDROIT Principles Art. 7.3.1 (2)(a), (b), (c)

(a) the non-performance substantially deprives the aggrieved party of what it was entitled to expect under the contract unless the other party did not foresee and could not reasonably have foreseen such result;

(b) strict compliance with the obligation which has not been performed is of essence under the contract;

(c) the non-performance is intentional or reckless;

UNIDROIT Principles Art. 7.3.1 (2)(d), (e)

(d) the non-performance gives the aggrieved party reason to believe that it cannot rely on the other party's future performance;

(e) the non-performing party will suffer disproportionate loss as a result of the preparation or performance if the contract is terminated.

See also Art. 7.1.4 (cure by non-performing party).

European Principles on Express Conditions

- Chapter 16 deals with creation of conditions.
  - 16:101, Types of Conditions, distinguishes suspensive and resolutive conditions.
  - 16:102, Interference with Conditions
  - 16:103, Effect of Conditions
- Chapter 16 does not have provisions on excuse of conditions.

European Principles on Constructive Conditions

Art. 8:103 Fundamental Non-Performance

A non-performance of an obligation is fundamental to the contract if:

(a) strict compliance with the obligation is of the essence of the contract; or

(b) the non-performance substantially deprives the aggrieved party of what it was entitled to expect under the contract, unless the other party did not foresee and could not reasonably have foreseen that result; or

European Principles Art. 8:103(c)

(c) the non-performance is intentional and gives the aggrieved party reason to believe that it cannot rely on the other party's future performance.

See also Art.8:104 on Cure by Non-Performing Party

Comment on US and International Law

- International and European Law generally appear to require a breach to be fundamental before a contract can be avoided, unless strict performance is of the essence of the contract.
- US law requires substantial performance of constructive conditions and strict performance of express conditions, subject to excuse.
- While the formulation of the law of conditions is different, the substantive differences do not seem great.

Expectation Damages

I. Basic Principles

II. Limitations on Recovery

I. Basic Principles

Introductory Points

- Recovery of expectation damages is the normal remedy for breach of contract in the US, whether for breach of general contracts or sales of goods covered by the UCC.
- Specific performance is the purest form of expectation recovery, yet in the US a special showing is required to obtain specific performance.
  - Why? See Lecture 9.

Introductory Points (2)

- Expectation damages look to the future, attempting to place the injured party in the position that the party would have been in had the contract been fully performed.
  - Why doesn't the law simply compensate for the harm done, returning the nonbreaching party to the position the party was in before the contract was formed? See Lecture 9.

Formulas for expectation damages

- General formula applicable to all contracts

  Loss in value + other loss

  – cost avoided – loss avoided

Restatement (2d) of Contracts §347.

Formulas for expectation damages (2)

- Formulas used for specific contracts:
  - Construction contract (breach by owner)

    Contractor's expected net profit + unreimbursed expenses
  - Employment contract (breach by employer)

    Unpaid wages for remaining term of contract – wages that employee could have earned from comparable employment

An example

- Owner hires builder to construct a building for a total price of $200,000.
- Estimated total cost of construction is $180,000.
- Owner breaches.
- Owner has paid builder $70,000 for work done.
- Builder has spent a total of $95,000 for labor and materials (some of which are incorporated in the partially completed building).
- After breach the builder resells $10,000 of materials purchased for the project.

Computation of expectation recovery

- Loss in value:

  $200,000 expected - $70,000 received= **$130,000.**
- Other loss=**0**
- -Cost avoided

  $180,000 estimated cost - $95,000=

  -$85,000 cost to complete
- Loss avoided

  -$10,000 resold materials

Total expectation damages = $35,000.

Explanation of result

- Award of $35,000 puts builder in position he would have been in had contract been fully performed on both sides.
- Builder expected net profit on contract of **$20,000**.
- Builder has **$15,000** in unreimbursed expenses ($95,000 - $70,000 - $10,000).

Leading Case

American Standard, Inc. v. Schectman (New York 1981)

Facts

- Plaintiffs operated a plant that manufactured iron bars ("pig iron") until 1972.
- Plaintiffs decided to close the plant.
- They agreed to sell the equipment and structures on the land to defendant for
  - $275,000 +
  - Defendant's promise to remove all equipment and structures and grade the land to one foot below the surface.

Facts (2)

- Defendant breached his promise to grade the property to one foot below the surface and the plaintiffs sued for damages.
- In the meantime the plaintiffs had sold the property for $183,000, which was $3,000 less than market value of the property.
- The cost to complete the grading work was $110,500.

Facts (3)

- The defendant argued that plaintiffs' loss in value should be limited to the difference in market value resulting from his breach or $3,000.
- The plaintiffs argued that the loss in value should be the cost to complete the work or $110,500.

Decision

- The jury awarded the plaintiffs $90,000.
- The New York Supreme Court affirmed the award.

Reasoning

- When breach of contract involves failure to pay a sum of money, as in the example given earlier, computation of expectation damages is mathematical.
- When the breach involves a failure to perform a service or deliver property, questions of valuation arise.

Reasoning (2)

- The court held that the normal measure of expectation damages for failure to complete a construction contract is the cost to complete the performance minus the unpaid contract price.
  - This measure places the injured party in the position the party would have been in if the contract had been performed.

Reasoning (3)

- The court also held, however, that there are two exceptions to this general rule:
- If the breaching party has substantially performed in good faith and completion would involve economic waste in the sense of destruction of completed work, then the proper measure of damages is the decline in the market value of the property.

Reasoning (4)

- The economic waste exception did not apply because defendant had not substantially performed in good faith and completion would not require destruction of completed work.
- Recall the *Jacob & Youngs* case from last class where the court did apply the economic waste exception.

Reasoning (5)

- The second exception involves breach of an incidental covenant rather than a central provision of the contract where cost of completion would be disproportionately costly.
  - Here the provision to grade the property was specifically bargained for and was not incidental to the contract.

Comments on *American Standard*

- Since the plaintiffs had already sold the land, it was clear that they would not use the damage award to complete the grading.
  - Did the award of cost to complete therefore overcompensate the plaintiffs?

Expectation Damages under the UCC

- UCC adopts the expectation damage principle:
  - "The remedies provided by [the Uniform Commercial Code] must be liberally administered to the end that the aggrieved party may be put in as good a position as if the other party had fully performed . . . ."

UCC Damage Remedies for Sellers

- 2-706 Resale
- 2-708 Non-Acceptance or Repudiation
- 2-709 Price
- 2-710 Incidental and Consequential Damages
- 2-718 Liquidated Damages

UCC Damage Remedies for Buyers

- 2-712 Cover
- 2-713 Damages for Non-Delivery or Repudiation
- 2-714 Damages for Accepted Goods
- 2-718 Liquidated Damages

International and European Law

- As we will see in the next lecture, the basic remedy for breach of contract under International and European Law is specific performance.
- Damages are the secondary remedy if specific performance is not available or if the contract has been avoided.
- CISG Arts. 74, 75, 76
- UNIDROIT Principles Arts. 7.4.2, 7.4.5, 7.4.6, 7.4.10
- European Principles Art. 9:502, 9:506, 9:507

CISG Art. 74

Damages for breach of contract by one party consist of a sum equal to the loss, including loss of profit, suffered by the other party as a consequence of the breach. . . .

CISG Art. 75

If the contract is avoided and if, in a reasonable manner and within a reasonable time after avoidance, the buyer has bought goods in replacement or the seller has resold the goods, the party claiming damages may recover the difference between the contract price and the price in the substitute transaction as well as any further damages recoverable under article 74.

CISG Art. 76

(1) If the contract is avoided and there is a current price for the goods, the party claiming damages may, if he has not made a purchase or resale under article 75, recover the difference between the price fixed by the contract and the current price at the time of avoidance as well as any further damages recoverable under article 74. . . .

UNIDROIT Principles Art. 7.4.2

Full compensation

(1) The aggrieved party is entitled to full compensation for harm sustained as a result of the non-performance. Such harm includes both any loss which it suffered and any gain of which it was deprived, taking into account any gain to the aggrieved party resulting from its avoidance of cost or harm.

(2) Such harm may be non-pecuniary and includes, for instance, physical suffering or emotional distress.

UNIDROIT Principles Art. 7.4.5

Proof of harm in case of replacement transaction

Where the aggrieved party has terminated the contract and has made a replacement transaction within a reasonable time and in a reasonable manner it may recover the difference between the contract price and the price of the replacement transaction as well as damages for any further harm.

UNIDROIT Principles Art. 7.4.6

Proof of Harm by Current Price

(1) Where the aggrieved party has terminated the contract and has not made a replacement transaction but there is a current price for the performance contracted for, it may recover the difference between the contract price and the price current at the time the contract is terminated as well as damages for any further harm.

UNIDROIT Principles Art. 7.4.10

Interest on Damages

Unless otherwise agreed, interest on damages for non-performance of non-monetary obligations accrues as from the time of non-performance.

See also Art. 7.4.9 (Interest for Failure to Pay Money)

European Principles Art. 9:502

General Measure of Damages

The general measure of damages is such sum as will put the aggrieved party as nearly as possible into the position in which it would have been if the contract had been duly performed. Such damages cover the loss which the aggrieved party has suffered and the gain of which it has been deprived.

European Principles Art. 9:506

Substitute Transaction

Where the aggrieved party has terminated the contract and has made a substitute transaction within a reasonable time and in a reasonable manner, it may recover the difference between the contract price and the price of the substitute transaction as well as damages for any further loss so far as these are recoverable under this Section.

European Principles Art. 9:507

Current Price

Where the aggrieved party has terminated the contract and has not made a substitute transaction but there is a current price for the performance contracted for, it may recover the difference between the contract price and the price current at the time the contract is terminated as well as damages for any further loss so far as these are recoverable under this Section.

II. Limitations on Recovery of Expectation Damages

Leading Case

Hadley v. Baxendale (English Court of Exchequer 1854)

Facts

- Plaintiffs were in the milling business.
- On May 11 the mill was shut down.
- On May 12 plaintiffs discovered that the problem was caused by a crack in a crank shaft.
- The manufacturer was in Greenwich.
- On May 13, plaintiffs sent their servant to defendant's office to inquire about shipping the broken shaft to Greenwich. Defendant was a commercial carrier.

Facts (2)

- In the reported decision, the court states that the servant said that the mill was stopped and the shaft must be sent immediately.
  - A later English case states that the reported decision was incorrect and that the servant did not give this information to the defendant.
- Defendant's clerk said that if the shaft was presented for shipment by 12:00 any day it would be delivered in Greenwich the next day.

Facts (3)

- On the following day the shaft was taken to defendant's office before noon.
  - Defendant's clerk was told that if a special entry was necessary to speed up delivery, it should be made.
- The delivery was delayed due to defendant's neglect and plaintiff did not receive the new shaft for several days.

Facts (4)

- During this time, the mill was shut down resulting in lost profits.
- Plaintiffs paid a little more than 2 pounds to have the shaft delivered. They suffered lost profits of more than 25 pounds.

Decision

- The jury awarded the plaintiffs 25 pounds.
- The appellate court ordered a new trial finding error in the method of determining damages.

Reasoning

- The court drew a distinction between two types of damages that result from breach of contract:
  - Damages that arise naturally in the ordinary course of events (what we call today "general damages")
  - Damages based on special circumstances ("special damages")

Reasoning (2)

- To recover special damages, the injured party must communicate the special circumstances to the other party.
  - The other party is then given the opportunity either to refuse to accept the contract or to increase the price or to disclaim liability for these special damages.

Reasoning (3)

"Now, in the present case, if we are to apply the principles above laid down, we find that the only circumstances here communicated by the plaintiffs to the defendants at the time the contract was made, were, that the article to be carried was the broken shaft of a mill, and that the plaintiffs were the millers of that mill."

Reasoning (4)

"Suppose the plaintiffs had another shaft in their possession put up or putting up at the time, and that they only wished to send back the broken shaft to the engineer who made it; it is clear that this would be quite consistent with the above circumstances, and yet the unreasonable delay in the delivery would have no effect upon the intermediate profits of the mill."

Reasoning (5)

- Based on these facts, the court ruled that the jury should have been told that they could not award lost profits.

Current US Law

- Restatement (2d) of Contracts §351
- UCC §2-715

Restatement (2d) of Contracts §351(1)

Unforeseeability And Related Limitations On Damages

(1) Damages are not recoverable for loss that the party in breach did not have reason to foresee as a probable result of the breach when the contract was made.

Restatement (2d) of Contracts §351(2)

(2) Loss may be foreseeable as a probable result of a breach because it follows from the breach

(a) in the ordinary course of events, or

(b) as a result of special circumstances, beyond the ordinary course of events, that the party in breach had reason to know.

Restatement (2d) of Contracts §351(3)

(3) A court may limit damages for foreseeable loss by excluding recovery for loss of profits, by allowing recovery only for loss incurred in reliance, or otherwise if it concludes that in the circumstances justice so requires in order to avoid disproportionate compensation.

UCC §2-715(1)

Buyer's Incidental and Consequential Damages

(1) Incidental damages resulting from the seller's breach include expenses reasonably incurred in inspection, receipt, transportation and care and custody of goods rightfully rejected, any commercially reasonable charges, expenses or commissions in connection with effecting cover and any other reasonable expense incident to the delay or other breach.

UCC §2-715(2)

(2) Consequential damages resulting from the seller's breach include

(a) any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which could not reasonably be prevented by cover or otherwise; and

(b) injury to person or property proximately resulting from any breach of warranty.

- UCC §2-710 for sellers is similar.

International and European Law

- CISG Art. 74
- UNIDROIT Principles Art. 7.4.4
- European Principles, Art. 9:503

CISG Art. 74

. . . Such damages may not exceed the loss which the party in breach foresaw or ought to have foreseen at the time of the conclusion of the contract, in the light of the facts and matters of which he then knew or ought to have known, as a possible consequence of the breach of contract.

UNIDROIT Principles Art. 7.4.4

Foreseeability of harm

The non-performing party is liable only for harm which it foresaw or could reasonably have foreseen at the time of the conclusion of the contract as being likely to result from its non-performance.

European Principles Art. 9:503

Foreseeability

The non-performing party is liable only for loss which it foresaw or could reasonably have foreseen at the time of conclusion of the contract as a likely result of its non-performance, unless the non-performance was intentional or grossly negligent.

Leading case

Rockingham County v. Luten Bridge Co.

(United States Court of Appeals, 4th Cir. 1929)

Facts

- Plaintiff entered into contract with the defendant county to construct a bridge.
- The contract was originally authorized by a 3-2 vote of the county commission.
- One of the proponents resigned and a reconstituted commission then rescinded its approval and directed the plaintiff to stop work.
- Nonetheless, the plaintiff proceeded to complete the bridge and sued for the full purchase price.

Decision

- The court held that the plaintiff could not recover the full purchase price.
- When the defendant breached the contract, the plaintiff had a duty not to increase the damages to the defendant.

Example to illustrate duty not to increase damages

- Suppose contract price for bridge was $100,000.
- Total construction cost is estimated to be $80,000, leaving a profit to the plaintiff of $20,000.
- Suppose the defendant breaches the contract and orders the plaintiff to stop work before the plaintiff has done any work on the bridge.

Example (2)

- Plaintiff does not comply and proceeds to complete the bridge.
- If the court awards plaintiff $100,000, plaintiff will obtain a profit of $20,000 at a cost of $100,000 to the defendant.
- If, of the other hand, the plaintiff had not completed the contract, the plaintiff could still have recovered $20,000 in lost profits as expectation damages, but at a cost of only $20,000 to the defendant.

The principle and the doctrine

- Thus, the principle behind the decision in the *Rockingham County* case is that the duty to avoid increasing the damages does no harm to the injured party while avoiding increasing the cost to the breaching party.
- Economists would refer to this as a Pareto Optimal situation—the duty improves the position of one of the parties without harming any of the parties.

Current US Law

- Principle of the *Rockingham County* case is recognized under current US law.
- The principle goes by various names
  - Most commonly the duty to mitigate damages
  - The Restatement refers to the principle as the doctrine of avoidable consequences

Restatement (2d) of Contracts §350

Avoidability As A Limitation On Damages

(1) Except as stated in Subsection (2), damages are not recoverable for loss that the injured party could have avoided without undue risk, burden or humiliation.

(2) The injured party is not precluded from recovery by the rule stated in Subsection (1) to the extent that he has made reasonable but unsuccessful efforts to avoid loss.

UCC

- Recognizes the doctrine of avoidable consequences by incorporating general contract law to the extent not displaced by particular provisions of the Code. UCC §1-103(b) (revised).
- See also UCC §§2-710, 2-715 (sellers and buyers may recover incidental and consequential damages "which could not reasonably be prevented").

International and European Law

- CISG Art. 77
- UNIDROIT Principles Art. 7.4.8
- European Principles Art. 9:505

CISG Art. 77

A party who relies on a breach of contract must take such measures as are reasonable in the circumstances to mitigate the loss, including loss of profit, resulting from the breach. If he fails to take such measures, the party in breach may claim a reduction in the damages in the amount by which the loss should have been mitigated.

UNIDROIT Principles Art. 7.4.8

Mitigation of Harm

(1) The non-performing party is not liable for harm suffered by the aggrieved party to the extent that the harm could have been reduced by the latter party's taking reasonable steps.

(2) The aggrieved party is entitled to recover any expenses reasonably incurred in attempting to reduce the harm.

European Principles Art. 9:505

Reduction of Loss

(1) The non-performing party is not liable for loss suffered by the aggrieved party to the extent that the aggrieved party could have reduced the loss by taking reasonable steps.

(2) The aggrieved party is entitled to recover any expenses reasonably incurred in attempting to reduce the loss.

Concluding Comments

- US and International and European law seem quite similar on the concept of expectation damages and limitations on damages such as foreseeability and mitigation.
- As we will see next time, however, specific performance is more available internationally than in the US.

Alternatives to Expectation Damages

I. Specific Performance

II. Reliance, Restitutionary, and Contractually Agreed Upon Damages

I. Specific Performance

Leading Case

City Stores Co. v. Ammerman (US District Court, District of Columbia 1967)

Facts

- Defendants wanted to construct a shopping mall on a tract of land in Virginia, near Washington, DC.
- In order to get a building permit, they had to persuade the county to rezone the property.
- Defendants' situation was difficult because the planning commission had voted against their proposal.

Facts (2)

- A strong competitor had proposed another shopping mall close by.
- The hearing on the defendants' application before the zoning board was scheduled for May 31, 1962.
- In order to bolster their application, defendants asked for letters of support from several major department stores, including one owned by plaintiff.

Facts (3)

- Other stores had been unwilling to express a preference for defendants' application over its competitor.
- Normally, plaintiff would have also been unwilling to express a preference, but plaintiff had a very strong interest in opening stores in the area.

Facts (4)

- Plaintiff wrote a letter to the zoning board stating that the site proposed by defendants was preferable to any other in the area and expressing a strong desire to become a major tenant in the center.
- The court found that the plaintiff wrote this letter in exchange for and in consideration of defendants' promise that it would be given the opportunity to become a major tenant in defendants' center on the same terms granted to other major tenants.

Facts (5)

"You have our assurance that in the event we are successful with our application, that we will give you the opportunity to become one of our contemplated center's major tenants with rental and terms at least equal to that of any other major department store in the center."

Facts (6)

- Defendants did succeed in obtaining zoning approval.
- They entered into leases with two other major department stores for the center, but refused to give plaintiff a lease.
- Plaintiff brought suit for specific performance of defendants' promise.

Decision

- In considering plaintiff's request for specific performance, the court had to analyze the major limitations on the award of specific performance in the US:

Decision (2)

- (1) To obtain specific performance, the remedy at law of damages must be inadequate. Restatement (2d) of Contracts §360:
  - Uniqueness of subject of contract, e.g. land
  - Lack of substitute on market
  - Difficulty of proving damages
  - Difficult of collecting damages

Decision (3)

- The court found that damages were inadequate because it would be difficult to prove with any degree of certainty the profits that plaintiff would lose if it did not receive a lease.

Decision (4)

- (2) Specific performance must not be impractical.
  - The contract must be sufficiently definite to be enforced,
  - performance must not be inherently personal, and
  - the difficulties of supervision must not outweigh the potential benefits.

Decision (5)

- The court found that the parties could be ordered to negotiate a lease and if they failed to reach agreement, the terms of the other leases signed by defendants would provide sufficient definiteness to enforce the contract.
- The court noted the modern trend to enforce contracts even when some degree of supervision is required.

Decision (6)

- (3) Specific performance is discretionary and can be denied if the contract is unfair or if the party seeking relief has acted inequitably or if it would involve undue hardship to the defendant or third parties. Restatement (2d) of Contracts §364.

Decision (7)

- Defendants contended that an award of specific performance would be harsh because defendants would then be unable to enter into a lease with Sears.
- They also argued that plaintiff was guilty of laches (delay) in seeking specific performance.

Decision (8)

- The court rejected these claims:
  - Loss of a lease with Sears would only mean that defendants would make less money.
  - Plaintiff did not unreasonably delay and had informed defendants at every opportunity that they would seek enforcement.

UCC Specific Performance

- UCC §2-716
  - Specific performance may be ordered when the goods are "unique" or in "other proper circumstances".
- The comments state that the goal of the section is to continue traditional rules, with perhaps some liberalization in the award of specific performance.
- Under the Code courts are almost certain to deny specific performance when goods are available on the market.

International and European Law

- CISG Arts. 28, 46, 62
- UNIDROIT Principles Arts. 7.2.1, 7.2.2, 7.2.3
- European Principles Arts. 9:101, 9:102

CISG 28

If, in accordance with the provisions of this Convention, one party is entitled to require performance of any obligation by the other party, a court is not bound to enter a judgment for specific performance unless the court would do so under its own law in respect of similar contracts of sale not governed by this Convention.

CISG Art. 46(1), (2)

(1) The buyer may require performance by the seller of his obligations unless the buyer has resorted to a remedy which is inconsistent with this requirement.

(2) If the goods do not conform with the contract, the buyer may require delivery of substitute goods only if the lack of conformity constitutes a fundamental breach of contract and a request for substitute goods is made either in conjunction with notice given under article 39 or within a reasonable time thereafter.

CISG Art. 46(3)

(3) If the goods do not conform with the contract, the buyer may require the seller to remedy the lack of conformity by repair, unless this is unreasonable having regard to all the circumstances. A request for repair must be made either in conjunction with notice given under article 39 or within a reasonable time thereafter.

CISG Art. 62

The seller may require the buyer to pay the price, take delivery or perform his other obligations, unless the seller has resorted to a remedy which is inconsistent with this requirement.

UNIDROIT Principles Art. 7.2.1

Performance of Monetary Obligation

Where a party who is obliged to pay money does not do so, the other party may require payment.

UNIDROIT Principles Art. 7.2.2 (a), (b)

Performance of Non-monetary Obligation

Where a party who owes an obligation other than one to pay money does not perform, the other party may require performance, unless

(a) performance is impossible in law or in fact;

(b) performance or, where relevant, enforcement is unreasonably burdensome or expensive; >>>

UNIDROIT Principles Art. 7.2.2 (c), (d), (e)

(c) the party entitled to performance may reasonably obtain performance from another source;

(d) performance is of an exclusively personal character; or

(e) the party entitled to performance does not require performance within a reasonable time after it has, or ought to have, become aware of the non-performance.

UNIDROIT Principles Art. 7.2.3

Repair and Replacement of Defective Performance

The right to performance includes in appropriate cases the right to require repair, replacement, or other cure of defective performance. The provisions of Articles 7.2.1 and 7.2.2 apply accordingly.

European Principles Art. 9:101

Monetary Obligations

(1) The creditor is entitled to recover money which is due.

(2) Where the creditor has not yet performed its obligation and it is clear that the debtor will be unwilling to receive performance, the creditor may nonetheless proceed with its performance and may recover any sum due under the contract unless:

European Principles Art. 9:101 (2)(a), (b)

(a) it could have made a reasonable substitute transaction without significant effort or expense; or

(b) performance would be unreasonable in the circumstances.

European Principles Art. 9:102

Non-Monetary Obligations

(1) The aggrieved party is entitled to specific performance of an obligation other than one to pay money, including the remedying of a defective performance.

(2) Specific performance cannot, however, be obtained where: >>>

European Principles Art. 9:102 (2)(a)-(d)

(a) performance would be unlawful or impossible; or

(b) performance would cause the debtor unreasonable effort or expense; or

(c) the performance consists in the provision of services or work of a personal character or depends upon a personal relationship, or

(d) the aggrieved party may reasonably obtain performance from another source.

European Principles Art. 9:102 (3)

(3) The aggrieved party will lose the right to specific performance if it fails to seek it within a reasonable time after it has or ought to have become aware of the non-performance.

Comments on US and European Law

- CISG provides for specific performance unless precluded by local law of court hearing matter, Art. 28
- UNIDROIT and European Principles provide for specific performance but with some limitations, for example, when performance is impossible, harsh, or substitute contracts are available.

Comments (2)

- US law has many of same limitations as under International Principles, but also imposes requirement that damages be inadequate.
- Thus, specific performance less readily available in US.

Why doesn't US law allow specific performance more easily?

- History:
  - Law courts traditionally awarded damages.
  - Equity courts provided in personam relief.
  - Inadequacy of damages was jurisdictional pre-requisite for equity courts to act.
  - No longer makes sense because we no longer have separate courts of law and equity.

Why not?

- Economic analysis
  - Substantial body of literature in US applying principles of economic analysis to contract issues
  - Scholars divided on issue. Some have argued that traditional rules make sense economically because routine award of specific performance would increase bargaining costs.
  - Others disagree.
  - Compelling case for changing rules has not been made.

Comment on Personal Service Contracts

- Under US law contracts for personal services will not be specifically enforced. Restatement (2d) of Contracts §367.
- International and European Law are similar but perhaps somewhat less restrictive:
  - UNIDROIT Principles, Art. 7.2.2(d) ("exclusively personal character")
  - European Principles Art. 9:102(2)(c) ("personal character or depends upon a personal relationship")

Comment on personal service contracts (2)

- However, going back to English case of Lumley v. Wagner (1853), English and American courts will issue an injunction to prevent someone who has unique services (actors, singers, athletes) from breaching a contract to work for a competitor.
- US courts today will order employees reinstated to their jobs when they have been fired in violation of statutory protections, such as discrimination.

II. Reliance, Restitutionary, and Contractually Agreed Upon Damages

Introduction to other remedies

- As we have seen, in the US expectation damages are the normal remedy for breach of contract.
- Specific performance is available but requires plaintiff to show that an award of damages would be inadequate, along with other requirements.

Introduction to other remedies (2)

- US law recognizes a number of other damage remedies, when expectation damages not available.

A. Reliance Damages

Leading case

Wartzman v. Hightower Productions, Ltd.
(Maryland 1983)

Facts

- Three promoters came up with a weird idea.
- They would employ a singer-entertainer who would sit on a perch on top of a flag pole in Times Square in New York from April 1, 1975 until New Year's Eve.
- He would then descend having set a world record for flag pole sitting.

Facts (2)

- They hired a law firm to do the legal work to raise capital to finance the venture.
- The firm did not do the work properly.
- Because of the firm's mistakes, the promoters were forced to abandon the venture.

Facts (3)

- Plaintiffs were unable to show that the venture would have been profitable.
  - Loss profits were uncertain or speculative
- Plaintiffs did show that they made various expenditures totaling more than $155,000.

Decision

- The court found that even if a plaintiff is unable to prove expectation damages with reasonable certainty, the plaintiff may still recover damages based on its reliance interest. Restatement (2d) of Contracts §349.
- The reliance interest seeks to place the injured party in the position the party was in before the contract was formed. Restatement (2d) of Contracts §344.

Decision (2)

- The rationale for recovery of reliance damages is that the defendant's breach made those expenditures worthless.
- If the breaching party can prove that the contract would have been a losing one, the amount of the loss is deducted from the award, but in these cases defendants can rarely if ever prove such damage because profit or loss is uncertain.

International and European Principles

- CISG (no specific sections on reliance damages), Art. 74
- UNIDROIT Principles Arts. 3.18, 7.4.2
- European Principles Arts. 4:117, 9:502

CISG Art. 74

Damages for breach of contract by one party consist of a sum equal to the loss, including loss of profit, suffered by the other party as a consequence of the breach. . . .

UNIDROIT Principles Art. 3.18

Damages

Irrespective of whether or not the contract has been avoided, the party who knew or ought to have known of the ground for avoidance is liable for damages so as to put the other party in the same position in which it would have been if it had not concluded the contract.

UNIDROIT Principles Art. 7.4.2

Full Compensation

(1) The aggrieved party is entitled to full compensation for harm sustained as a result of the non-performance. Such harm includes both any loss which it suffered and any gain of which it was deprived, taking into account any gain to the aggrieved party resulting from its avoidance of cost or harm.

(2) Such harm may be non-pecuniary and includes, for instance, physical suffering or emotional distress.

European Principles Art. 4:117

(1) A party who avoids a contract under this Chapter may recover from the other party damages so as to put the avoiding party as nearly as possible into the same position as if it had not concluded the contract, provided that the other party knew or ought to have known of the mistake, fraud, threat or taking of excessive benefit or unfair advantage.

European Principles Art. 9:502

General Measure of Damages

The general measure of damages is such sum as will put the aggrieved party as nearly as possible into the position in which it would have been if the contract had been duly performed. Such damages cover the loss which the aggrieved party has suffered and the gain of which it has been deprived.

Comments on Reliance Damages under US and International Law

- International Law does not specifically recognize recovery of reliance damages when the injured party is unable to prove expectation damages with reasonable certainty, but such recovery is probably implicit in the general measure of damages.

Why doesn't US law limit damages to reliance?

- The classic justification, Fuller & Perdue, The Reliance Interest in Contract Damages, 46 Yale L.J. 52, 57-62 (1936) (Part I), two reasons:

Justifications for expectation rather than reliance

- “[F]oregoing of other opportunities is involved to some extent in entering most contracts, and the impossibility of subjecting this type of reliance to any kind of measurement may justify a categorical rule granting the value of the expectancy as the most effective way of compensating for such losses.”

Justification for expectation rather than reliance (3)

- There is "a policy in favor of promoting and facilitating reliance on business agreements. . . . When business agreements are not only made but are also acted on, the division of labor is facilitated, goods find their way to the places where they are most needed, and economic activity is generally stimulated. These advantages would be threatened by any rule which limited legal protection to the reliance interest. Such a rule would in practice tend to discourage reliance."

B. Restitutionary Damages

Leading Case

Lancellotti v. Thomas (Pennsylvania 1985)

Facts

- The case involved a contract to sell a restaurant.
- Defendant agreed to sell the equipment, name, and good will of the restaurant to plaintiff for:

Facts (2)

- $25,000 in cash,
- Plaintiff's promise to rent the property on which the restaurant was located for 5 years at an annual rental of $8,000, and
- Plaintiff's promise to build an addition to the restaurant for $15,000 completed by May 1, 1973.

Facts (3)

- Plaintiff did not complete the addition as promised and failed to pay the first annual rent.
- Defendant reclaimed possession of the property and equipment.
- Plaintiff then sued to recover all or a portion of its $25,000 deposit. Defendant counterclaimed for damages for breach of contract.

Decision

- At common law a breaching party was not entitled to any relief.
  - Rationale: A party should not benefit from its own wrong.

Decision (2)

- However, the court adopts the modern view, set forth in Restatement of Contracts §374, which allows a breaching party to recover in restitution the benefit conferred on the other party, less the damages that party can establish.
  - Rationale: The nonbreaching party should not obtain a windfall and breaches often occurred without a bad intention.

UCC

- With minor differences, UCC Section 2-718 adopts a similar rule allowing the breaching party to recover in restitution.

International and European Law

- Unlike US law, International and European Law do not provide for restitution on behalf of the breaching party.
- Restitution appears to be limited to situations of contract avoidance or termination.

CISG Art. 81(2)

(2) A party who has performed the contract either wholly or in part may claim restitution from the other party of whatever the first party has supplied or paid under the contract. If both parties are bound to make restitution, they must do so concurrently.

UNIDROIT Principles Art. 7.3.6 (1)

Restitution

(1) On termination of the contract either party may claim restitution of whatever it has supplied, provided that such party concurrently makes restitution of whatever it has received. If restitution in kind is not possible or appropriate allowance should be made in money whenever reasonable.

UNIDROIT Principles Art. 7.3.6 (2)

(2) However, if performance of the contract has extended over a period of time and the contract is divisible, such restitution can only be claimed for the period after termination has taken effect.

European Principles Art. 4:115

Effect of Avoidance

On avoidance either party may claim restitution of whatever it has supplied under the contract, provided it makes concurrent restitution of whatever it has received. If restitution cannot be made in kind for any reason, a reasonable sum must be paid for what has been received.

See also article 9:307, 308, and 309 on recovery of money or property on termination of contract and 15:104 on restitution when contract is ineffective for violation of mandatory rules.

C. Agreed Remedies

Comments on Agreed Remedies

- Advantages of agreed remedies, sometimes called liquidated damages:
  - Damages, particularly expectation damages, are sometimes difficult to prove. Provisions for agreed remedies eliminate this problem.
  - Agreed remedies can promote settlement and avoid litigation by reducing differences in assessment by the parties of their liability or recovery.

Comments (2)

- Disadvantages:
  - Can overcompensate depending on formula
  - Could be inefficient by deterring breaches that are economically desirable, sometimes called "efficient" breaches.

US Law on Agreed Remedies

- Restatement (2d) of Contracts §356(1).
- UCC §2-718(1).

Restatement (2d) of Contracts §356(1)

Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty.

UCC §2-718(1)

(1) Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy.

International and European Law

- CISG Art. 6
- UNIDROIT Principles Art. 7.4.13
- European Principles Art. 9:509

CISG Art. 6

The parties may exclude the application of this Convention or, subject to article 12, derogate from or vary the effect of any of its provisions.

UNIDROIT Principles Art. 7.4.13(1)

Agreed Payment for Non-performance

(1) Where the contract provides that a party who does not perform is to pay a specified sum to the aggrieved party for such non-performance, the aggrieved party is entitled to that sum irrespective of its actual harm.

UNIDROIT Principles Art. 7.4.13(2)

(2) However, notwithstanding any agreement to the contrary the specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the harm resulting from the non-performance and to the other circumstances.

European Principles Art. 9:509

Identical to UNIDROIT Principles.

Comments on US and International Law

- International and European Law appear to be more receptive to provisions for agreed remedies:
  - Such provisions are enforceable regardless of the party's actual loss.
  - Only in the case of gross excessiveness will the clause be unenforceable.

Comments on US and International Law (2)

- US law is more receptive to agreed remedies than in the past, but they are still evaluated under a reasonableness standard, which is more demanding than the international standard.
- One reason for greater US scrutiny of these clauses is historical, the penal bond at common law.
- Scholarly commentary in the US is divided but generally favors more liberal treatment of such clauses.

Thinking about Contract Doctrine and the Reality of Contract Making

Traditional Model of Contract

The traditional model of contract formation is based on a number of assumptions:

- First, the parties have relatively equal bargaining power and have the opportunity to negotiate the terms of the contract.
- Second, negotiations do in fact take place.

Traditional Model (2)

- Third, if negotiations are successful, the parties reach an agreement, usually reduced to writing.
- Fourth, the agreement contains few if any provisions that the parties have not discussed.

Modern contracts

- Some modern contracts follow the traditional model. Oddly, contracts that follow this model tend to be either the most simple or the most complex.
  - A sale of goods between neighbors.
  - A merger of two major corporations.

Modern contracts (2)

- Most modern contracts, however, do not follow the traditional model.
  - The parties lack equality of bargaining power.
  - Few if any contractual terms are negotiated.
  - Contracts do not result from a bargaining process but are presented on a take-it-or-leave-it basis by the seller.
  - Contracts are standard form with many provisions that have not been discussed.

Regulation of Traditional Contracts

- State regulation of the substantive fairness of traditional contracts was unnecessary because the self interest of the parties generally assured that the bargain was fair.
- Because fairness depended on the bargaining process, state regulation focused on assuring that the process of contract formation was not defective.

Regulation of Modern Contracts

- Self interest cannot assure the fairness of modern contracts because the bargaining process does not encompass most of the terms of the contract.
- In fact, self interest works against fairness because most people are unwilling to spend the time to read the fine print associated with modern contracts.

Regulatory Issues

- As a result, modern contracts require some degree of regulation of the fairness of their terms.
- The need for regulation poses both substantive and procedural issues:
  - What is the definition of an unfair term and what specific terms are unfair?
  - What are the procedures for prevention of unfair terms?

Overview

- Consider three US cases and one federal regulation that illustrate US approach to defining and preventing unfair terms.
- Then compare to EU approach.

Leading Case

C & J Fertilizer v. Allied Mutual Insurance Co. (Iowa 1975)

Facts

- Plaintiff C&J owned a fertilizer manufacturing plant.
- Defendant had issued an insurance policy covering the plant and its contents.

Facts (2)

The insurance policy defined "burglary" to mean an entry by actual force or violence of which

> "there are visible marks made by tools, explosives, electricity or chemicals upon, or physical damage to, the exterior of the premises at the place of such entry."

Facts (3)

- On Saturday, April 18, 1970, all of the exterior doors of the plant were locked when the employees left for the day.
- On Sunday, one of C&J's employees was at the plant and found all doors locked and secure.

Facts (4)

- On Monday, when employees reported for work, the exterior doors were still locked.
- However, it was found that entrance could be gained to the warehouse through a plexiglass door that could be forced open without making any marks.

Facts (5)

- In the driveway leading to the plexiglas door, there were tread marks in the mud of the tires of a truck.
- There were no visible marks on the exterior of the building showing forcible entry.

Facts (6)

- Chemicals had been stored in an interior room in the warehouse.
- The door to this room, which had been locked, showed visible marks of being forced open.
- Chemicals and equipment valued at $10,000 were taken from the building.

Facts (7)

- When the policy was issued, defendant's agent informed plaintiff that the policy required visible evidence of burglary, however, the agent did not specifically say that the evidence had to be on the exterior of the building.
- The agent expressed surprise when defendant denied coverage.

Facts (8)

- The president of C&J was a 37 year old farmer with a high school education.
- When he received the policy, he reviewed the provisions on coverage (including burglary), the amounts of insurance, and the location and description.
- He did not recall reading the fine print defining burglary.

Decision

- The trial court ruled that the policy was unambiguous and held for the defendant.
- The Supreme Court of Iowa reversed and ordered judgment for the plaintiff.

Reasoning

- The court first described the revolution in formation of contractual relationships:

  "Many of our principles for resolving conflicts relating to written contracts were formulated at an early time when parties of equal strength negotiated in the historical sequence of offer, acceptance, and reduction to writing. The concept that both parties assented to the resulting document had solid footing in fact."

Reasoning (2)

- Instead, today almost all contractual relations involve standard forms:

  "Standard form contracts probably account for more than ninety-nine percent of all contracts now made. Most persons have difficulty remembering the last time they contracted other than by standard form; except for casual oral agreements, they probably never have. But if they are active, they contract by standard form several times a day. Parking lot and theater tickets, package receipts, department store charge slips, and gas station credit card purchase slips are all standard form contracts. . . ."

Reasoning (3)

- With respect to insurance, the court observed that the ability of the potential purchaser to negotiate was practically zero.
  - Insurance contracts are typically offered on a take-it-or-leave-it basis.
- In addition, it is commonly understood that the insured rarely reads the detailed provisions of the policy.

Reasoning (4)

- The court then compared determination of the terms of a contract to law-making:

  "The concept that persons must obey public laws enacted by their own representatives does not offend a fundamental sense of justice: an inherent element of assent pervades the process."

Reasoning (5)

- Allowing the dominant party to a contractual relationship to dictate many of the terms is fundamentally different:

  "But the inevitable result of enforcing all provisions of the adhesion contract, frequently, as here, delivered subsequent to the transaction and containing provisions never assented to, would be an abdication of judicial responsibility in face of basic unfairness and a recognition that persons' rights shall be controlled by private lawmakers without the consent, express or implied, of those affected."

Reasoning (6)

- The court noted that the form of policy used in the case had been approved by the state insurance commission but

  "Regulation is relatively weak in most instances, and even the provisions prescribed or approved by legislative or administrative action ordinarily are in essence adoptions, outright or slightly modified, of proposals made by insurers' draftsmen."

Reasoning (7)

- As a result, the court concluded that some form of judicial review of the enforceability of the terms of the policy was appropriate.
- The method of review the court chose was the doctrine of reasonable expectations.

The Doctrine of Reasonable Expectations

- The court gave the following definition of the doctrine:

  "The objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations."

Court's Analysis of Reasonable Expectations

- The court found that the plaintiff's reasonable expectations based on discussions with the agent were that the policy did not cover burglary that was an "inside" job.
- An exclusion from coverage based solely on the lack of external evidence no matter how extensive the proof that the burglary was not an inside job violated plaintiff's reasonable expectations.

Dissent

- Four justices dissented.
- They argued that the role of the courts was not to rewrite policies but to decide cases based on the record.
- This policy was not ambiguous and the definition of burglary served a legitimate purpose of excluding inside jobs.

Current US Law

- The doctrine of reasonable expectations has been recognized by more than one-half of the states, but with substantial variations, principally with regard to insurance contracts.
- Restatement (2d) of Contracts §211 provides for application of the doctrine to other contracts.

Restatement (2d) of Contracts §211

Standardized Agreements

(1) Except as stated in Subsection (3), where a party to an agreement signs or otherwise manifests assent to a writing and has reason to believe that like writings are regularly used to embody terms of agreements of the same type, he adopts the writing as an integrated agreement with respect to the terms included in the writing.

Restatement (2d) §211(2)

(2) Such a writing is interpreted wherever reasonable as treating alike all those similarly situated, without regard to their knowledge or understanding of the standard terms of the writing.

Restatement (2d) §211(3)

(3) Where the other party has reason to believe that the party manifesting such assent would not do so if he knew that the writing contained a particular term, the term is not part of the agreement.

Leading case

Carnival Cruise Lines, Inc. v. Shute (United States Supreme Court 1991)

Facts

- The Shutes lived in Washington state.
- They purchased tickets for a seven-day cruise on one of defendant's ships from a travel agent in Washington.
- Defendant is a Florida-based cruise line.

Facts (2)

- The agent forwarded payment to Carnival, which mailed the tickets to the Shutes.
- On the face of each ticket was following statement:

SUBJECT TO CONDITIONS OF CONTRACT ON LAST PAGES **IMPORTANT!**

PLEASE READ

CONTRACT--ON LAST PAGES 1, 2, 3"

Facts (3)

On the last pages were the following clauses:

3. (a) The acceptance of this ticket by the person or persons named hereon as passengers shall be deemed to be an acceptance and agreement by each of them of all of the terms and conditions of this Passage Contract Ticket.

Facts (4)

"8. It is agreed by and between the passenger and the Carrier that all disputes and matters whatsoever arising under, in connection with or incident to this Contract shall be litigated, if at all, in and before a Court located in the State of Florida, U.S.A., to the exclusion of the Courts of any other state or country." (emphasis added).

Facts (5)

- The Shutes boarded the ship in Los Angeles.
- While off the coast of Mexico, Mrs. Shute suffered personal injuries when she slipped on a deck mat on ship.
- The Shutes filed suit in Washington.

Decision

- The district court dismissed on jurisdictional grounds.
- The court of appeals reversed. After finding that the district court had jurisdiction, it held that the forum selection clause was invalid because
  - it was not "freely bargained for" and
  - Evidence showed that application of the clause would deprive the Shutes of their day in court because they were not physically or financially able to sue in Florida.

Decision (2)

- The Supreme Court reversed the court of appeals, upheld the clause, and ordered the case dismissed.

Reasoning

- The Shutes conceded that they had received notice of the clause. The Court did not indicate how it would have decided the case if they had not received sufficient notice.

Reasoning (2)

- The Court then considered the Shutes' argument that the clause was not enforceable because it was not freely bargained for.
- The Court rejected this argument and held that a forum selection clause could be valid even if not bargained for.
- Including a reasonable forum selection clause may be permissible for several reasons:>>>>

Reasoning (3)

- “First, a cruise line has a special interest in limiting the fora in which it potentially could be subject to suit. Because a cruise ship typically carries passengers from many locales, it is not unlikely that a mishap on a cruise could subject the cruise line to litigation in several different fora.”

Reasoning (4)

- "Additionally, a clause establishing *ex ante* the forum for dispute resolution has the salutary effect of dispelling any confusion about where suits arising from the contract must be brought and defended, sparing litigants the time and expense of pretrial motions to determine the correct forum and conserving judicial resources that otherwise would be devoted to deciding those motions."

Reasoning (5)

- "Finally, it stands to reason that passengers who purchase tickets containing a forum clause like that at issue in this case benefit in the form of reduced fares reflecting the savings that the cruise line enjoys by limiting the fora in which it may be sued."

Reasoning (6)

- The Supreme Court also rejected the holding by the court of appeals that the Shutes were physically and financially unable to sue in Florida.
  - The Court stated that the evidence in the record did not support this conclusion.
  - Florida was not a “remote alien forum.”
  - A heavy burden of proof to set aside a clause on grounds of inconvenience exists.

Reasoning (7)

- Finally, the Court held that forum selection clauses were subject to judicial scrutiny for "fundamental fairness".

Reasoning (8)

- However, there was no evidence that the cruise line included the clause to discourage passengers from pursuing legitimate claims.
  - Florida was a reasonable forum because the cruise line was located there.
  - There was no evidence of fraud or overreaching.
  - The Shutes had ample notice of the clause and could have rejected the contract.

Leading case

Hill v. Gateway 2000, Inc. (United States Court of Appeals, 7th Cir. 1997)

Facts

- The Hills ordered a computer from defendant by telephone giving a credit card to make the purchase.
- Aside from price and delivery date, the parties did not discuss any of the terms of the purchase.
- A short time later the computer arrived.

Facts (2)

- In the box containing the computer were a list of terms prepared by Gateway.
- The terms stated that they governed the transaction unless the purchaser returned the computer within 30 days.
- The Hills kept the computer for more than 30 days, but then complained about its components and performance.

Facts (3)

- One of the terms contained in the box was a provision in which the purchaser agreed to submit all claims to arbitration.
- The Hills filed suit in federal court against Gateway.
- Gateway moved to dismiss and to have the case sent to arbitration.

Decision

- The trial court refused to send the case to arbitration:

  "[t]he present record is insufficient to support a finding of a valid arbitration agreement between the parties or that the plaintiffs were given adequate notice of the arbitration clause."

Decision (2)

- The Court of Appeals reversed and ordered the case sent to arbitration.
- The district court held that the contract was formed when the Hills made the purchase over the phone. Because the arbitration clause was not mentioned at that time, the clause was not part of the contract.

Decision (3)

- The 7th Circuit disagreed. It held that Gateway, as "master of the offer" could condition its offer on certain conduct by the Hills.
- The Hills accepted the terms of Gateway's offer by opening the box and keeping the computer for 30 days. Thus, a contract was formed which included the arbitration clause.

Comments on *Hill*

- In *Hill*, unlike *C&J* and *Carnival Cruise Lines,* the court did not consider the fairness or reasonableness of the arbitration provision.
- This is because Congress has determined that arbitration is fair and reasonable by enacting the Federal Arbitration Act.

Administrative Regulation

Federal Trade Commission, Credit Practices Rule, 49 Fed. Reg. 7740 (1984) (codified in 16 C.F.R. pt. 444.

Federal Trade Commission Credit Practices Rule

- The US Federal Trade Commission (FTC) has jurisdiction to regulate unfair and deceptive acts or practices in commerce.
- Effective March 1, 1985, the FTC adopted a "Credit Practices Rule" that outlawed certain contractual provisions that the FTC found unfair to consumers.

FTC Rule (2)

- The Rule applies to consumer credit contracts offered by finance companies, retailers (such as auto dealers and furniture and department stores), and credit unions for any personal purpose except to buy real estate.
- Banks and Savings and Loans are subject to to similar rules issued by their regulatory agencies.

FTC Rule (3)
Prohibited Contractual Provisions

- *Confession of Judgment or Cognovit clauses*. The rule prohibits contractual provisions that require consumers to give up their right to notice of a lawsuit, to present their case in court, or to hire an attorney.
- *Waivers of Exemptions*. Many states exempt personal belongings up to a certain dollar amount from execution of judgment. The rule generally prohibits contractual provisions that waive such exemptions.

FTC Rule (4)
Prohibited Contractual Provisions

- *Wage Assignments*. The rule prohibits contractual provisions in which the consumer agrees in advance to wage deductions if the consumer defaults on the debt, unless the consumer can cancel the agreement at any time.

FTC Rule (5)
Prohibited Contractual Provisions

- *Household goods security*. The rule prohibits creditors from using household goods as security unless the consumer borrowed money to purchase such an item.
- *Required notices to cosigners*. The rule requires specific notices be given to cosigners.

FTC Rule (6)
Prohibited Contractual Provisions

- *Limitations on assessment of late charges.* Creditors are permitted to assess late charges but they may not assess late charges on late charges (pyramiding).

FTC Rule (7)

- The rule may be enforced directly by the FTC. Courts may impose fines of up to $10,000 for each violation and enjoin the unlawful practice.
- In addition, most states have “little” FTC acts, which allow consumers to bring suit for treble damages plus attorney fees.
- http://www.ftc.gov/bcp/conline/pubs/buspubs/complcred.htm

Comments on the US Model for Defining Unfair Terms

I. Using principles of contract formation, was the provision in question part of the contract?

- A provision can be part of the contract even if contained in standard form language and not bargained for.
- Standard form terms have important economic advantages.

Comments on US Model (2)

II. Is the clause invalid because it violates a statutory or regulatory requirement?

- FTC Credit Practices Rules
- State Lemon Laws.

Comments on US Model (3)

III. Does the clause violate one of the modern limitations on freedom of contract?

- Unconscionability
- Lack of Good Faith
- Reasonable Expectations Doctrine
- Fundamental fairness

These doctrines have developed somewhat independently of one another. The scope and relationship of these doctrines has not been fully developed.

Comments on US Procedure

- There is some degree of governmental enforcement of unfair terms, such as by the FTC or by state attorneys general.
- On the whole, however, enforcement occurs through claims and defenses in private litigation. See the three cases discussed above.
- Suits by consumer groups in the US are rare and would face procedural problems.

European Approach

- Council Directive 93/13/EEC of 5 April 1993 on unfair terms in consumer contracts

Article 3

1. A contractual term which has not been individually negotiated shall be regarded as unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer.

European Approach (2)

2. A term shall always be regarded as not individually negotiated where it has been drafted in advance and the consumer has therefore not been able to influence the substance of the term, particularly in the context of a pre-formulated standard contract.

European Approach (3)

- The fact that certain aspects of a term or one specific term have been individually negotiated shall not exclude the application of this Article to the rest of a contract if an overall assessment of the contract indicates that it is nevertheless a pre-formulated standard contract.
- Where any seller or supplier claims that a standard term has been individually negotiated, the burden of proof in this respect shall be incumbent on him.

European Approach (4)

3. The Annex shall contain an indicative and non-exhaustive list of the terms which may be regarded as unfair.

The annex lists 17 types of clauses that may be considered to be unfair.

European Approach (5)

(i) irrevocably binding the consumer to terms with which he had no real opportunity of becoming acquainted before the conclusion of the contract; .

European Approach (6)

(q) excluding or hindering the consumer's right to take legal action or exercise any other legal remedy, particularly by requiring the consumer to take disputes exclusively to arbitration not covered by legal provisions, unduly restricting the evidence available to him or imposing on him a burden of proof which, according to the applicable law, should lie with another party to the contract.

European Approach (7)

Whereas, for the purposes of this Directive, assessment of unfair character shall not be made of terms which describe the main subject matter of the contract nor the quality/price ratio of the goods or services supplied; whereas the main subject matter of the contract and the price/quality ratio may nevertheless be taken into account in assessing the fairness of other terms; >>>

European Approach (8)

whereas it follows, inter alia, that in insurance contracts, the terms which clearly define or circumscribe the insured risk and the insurer's liability shall not be subject to such assessment since these restrictions are taken into account in calculating the premium paid by the consumer;

Comments on the European Approach

- The EU uses more of a regulatory than judicial approach to defining unfair terms than is the case in the US.
  - EU Directive
  - National legislation on Unfair terms
- EU places much more weight on individual negotiation than does the US.
- EU uses the concept of imbalance as a broad definition of unfairness. US tends to focus more on commercial reasonableness.

Comments on EU Approach (2)

- Enforcement procedures in EU seem more diverse than in US, particularly development of representative consumer organizations that are authorized to bring suit seeking a declaration that unfair terms are unenforceable.