CONCEPTS AND INSIGHTS SERIES

Concepts and Case Analysis in the Law of Contracts

Sixth Edition

Marvin A. Chirelstein

Foundation Press

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CONTRACTS

SIXTH EDITION

By

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To Ellen

PREFACE

My purpose in writing a brief Contracts primer is to offer first-year law students a reliable overview of the major themes and leading cases in the field. As the modest size of this book must suggest, I have made no effort to be comprehensive or to prepare a work that could possibly or even remotely qualify as a treatise. Very much more of the law of Contracts is omitted than included, and indeed two major topics—the Statute of Frauds and Assignment and Delegation—are touched upon only in passing. Some will feel that too much has been left out, but my own view is that omitting things is a good way to learn this or any other legal subject. At all events, my hope (and my hunch) is that less will actually turn out to be, if not more, then at least quite sufficient from the standpoint of a student reader.

* * *

New editions of many of the Contracts casebooks have recently appeared in student bookstores, most of them a good deal thicker than their predecessors. In an effort to keep up, I have added more cases and more discussion to this Sixth Edition. My aim, however, as in earlier editions, is to stress conceptual elements and case analysis rather than legal detail.

I am grateful to Barbara Aaronstein Black for comments and advice.

MARVIN A. CHIRELSTEIN

Columbia University
June, 2010

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Chapter 1

BACKGROUND ELEMENTS: THE CONTRACT CURVE AND EXPECTATION DAMAGES

Exchanging one thing for another—money for goods and services, typically—is a major preoccupation for most of us and for better or worse absorbs the greater part of our active lives. This being so, it is not surprising that Contracts—which is essentially the law of exchange—should have the status of a foundation course in law school. Any exchange relationship, even the simplest transaction at retail, is based on an agreement between the parties, and we naturally expect—though without thinking about it unless we have to—that legal rules in some way provide assurance that the agreement will be honored. Contract law is supposed to implement that expectation. In the process it chiefly asks and answers the following questions: first, whether the parties have behaved in such a way as to create legally recognizable expectations in one another; second, if they have, how those expectations should be characterized and understood; third, whether the understanding thus arrived at was faithfully carried out by the parties or somehow thwarted; and finally, if thwarted, what if anything the law should do about it. These questions can, of course, be presented in a fairly subtle way and they may prove irritatingly difficult to answer. They are not very numerous, however, and quite often the difficulty arises less from the need to solve a complex legal issue than from uncertainty about what the parties really *did* expect and understand in the particular case under consideration. Judicial opinions, even the "great" opinions that have been chewed over for generations, are sometimes rather dream-like and opaque when it comes to explaining why the parties acted or expressed themselves as they did, and it is that "opacity," I believe, not the legal rules as such, that creates problems in many instances.

But before approaching the cases themselves, it may be worthwhile to say something about the economic framework in which contract law arises, admitting in advance that "economics," here, pretty well reduces to a set of truisms that are largely obvious to begin with. One such truism is that people enter into exchange relationships with one another—trading this for that—for the sole and sufficient reason that it makes them feel better off to do so. Thus, imagine a world consisting of only two commodities—apples and oranges—and only two consumers—A and B—each with different preferences but each wanting to consume *some* quantity of both commodities. We can be quite sure that, unless already satisfied with the allocation of those commodities, A and B will at once commence to negotiate a trade, with A giving up some of his apples, say, in exchange for some of B's oranges and B doing the opposite. The effect, it is important to note, should be to make *both* parties feel richer than previously—not just A, not just B, but both. The trading process is not a poker game in which one player wins what another loses; rather, it is a kind of joint undertaking which increases the wealth of both parties and from which both emerge with a measure of enhanced utility. This is true, moreover, even though A and B are essentially in conflict, each seeking to drive the hardest bargain he can against the other and each having and cherishing the mentality of a shark. The act of making an exchange will (in the generality of cases) lead not only to individual but to mutual advantage despite a thoroughly self-centered outlook on the part of the traders. That being so, it would be unfortunate, even wasteful in economic terms, if the exchange did not take place.

All this is slightly banal, I admit, but it does describe the formal setting in which contracts calling for the exchange of one thing for another are made. A and B *both* trade up, so to speak, until one or the other feels that no further trading will lead to his advantage. They are not of course unique. The same formulation can be extended to a society more nearly resembling the real world—that is, a society in which there are many commodities and many consumers, including, I should add, not only consumers of outputs—households that eat up the apples and oranges—but consumers of inputs—business firms that buy and use labor and raw materials in producing goods and services. Once more, all of these individuals and entities will "naturally" engage in trading one thing for another—buying and selling, getting and spending—up to the point where such activity produces no further *mutual* advantage and the allocation of available resources—people as well as things—is classically "efficient."

Stressing economic efficiency leads to yet another important question (though, again, pretty easily answered). Thus, why should the law—as of course it does—go to the trouble of enforcing contract obligations between private parties? Why should our costly legal apparatus be used (in some way not yet specified) to *compel* people to keep their promises? As already noted, A and B are *both* presumed to be made better off by trading goods and services. If that is so, why shouldn't they be expected to keep their promises voluntarily—why add the element of legal compulsion to an arrangement which the parties entered into *without* compulsion and which each evidently regards as being in his own best interest?

The answer, of course, is that if all transactions took place instantaneously, as in the case of an everyday retail purchase, the need for enforcement rules would be slight. If you buy a book at the bookstore, the transaction is complete once the cashier has counted your money and you put the book under your arm. But retail sales are really the exception, although of course not without their own special problems. In most other situations, including almost all commercial dealings, the agreed-upon exchange is noninstantaneous; rather, it is intended to occur at some date in the future or is expected to take considerable time to carry out. An example of the former would be an agreement to pay $X for Y tons of steel to be delivered in ninety days. An example of the latter would be an agreement to build a factory for a stated price, construction to be completed in two years. In both cases vital terms are agreed to by the parties today, while performance—full payment on the buyer's side perhaps, and certainly delivery or construction on the seller's—is necessarily deferred.

Given a lapse of time between agreement and performance, it is possible that one of the two parties will come to regret the deal. Their agreement represents the parties' best estimates of future market conditions, but those estimates will almost never be perfectly accurate and it is easy to imagine that buyer or seller, owner or builder, will subsequently find that actual market prices have moved in a direction that makes performance in accordance with the terms originally agreed upon unprofitable. Considerations of reputation and standing might even then deter the disadvantaged party from breaking his promise, but if the financial loss that he confronts becomes substantial he might well prefer to tolerate the other party's hard feelings and back out of the deal altogether. Clearly, however, both parties *intended* to be bound by their agreement and would have found it difficult or impossible to carry on business in the first place without being able to count on the enforcement of their claims to performance. The steel buyer, for example, might have made an agreement to resupply the steel (perhaps after further processing) at a fixed price to a customer of his own; the builder would surely have made fixed-price agreements with various material suppliers and sub-contractors when calculating his costs for the factory building. Planning at all stages will have been carried forward on the assumption that the promises made by other actors will be kept or (if not) enforced. Unless that assumption *can* be made the process of exchange will obviously be discouraged or greatly complicated. While the legal system could leave each party to protect himself against breach by the other through the medium of insurance, bonding, hedging or the like, it is not easy to think of any self-protective device (other than violence or taking human hostages) that does not itself entail a contractual commitment by which the affected parties expect to be bound.

Accepting that legal enforcement is desirable, the next and in a sense the last really important question is what form such enforcement should take. One possibility would be physical compulsion: a person committing breach of contract would be ordered to perform and would be *made* to do so by threat of fine or imprisonment. Actually, the law does compel performance in certain situations, but these are isolated and relatively few in number. More generally, the common law deals and has always dealt with contract breach not by forced compliance but by compensating the injured party for his loss through an award of money damages. Our rule, briefly stated, is that the injured party may recover from the party in breach a dollar sum sufficient to put him in as good a position as he would have occupied had the contract been performed in full. This principle—easily the most important single idea in the whole contracts field—is referred to by convention as the "expectation damage" rule, and of course it is the injured party's "expectations" that are being compensated.

To illustrate the rule as simply as possible, assume that Buyer and Seller contract for the sale of 1,000 barrels of oil (carefully specified as to grade or whatever) at a price of $50 a barrel, payment and delivery in 90 days. On the payment/delivery date, as it happens, oil is selling at only $44 a barrel and Buyer refuses to go through with the transaction. How much can Seller, the injured party, recover? A possible answer—but wrong—is $50,000. To be sure, $50,000 is the aggregate purchase price due under the contract, and clearly Buyer has breached. If, however, we give appropriate recognition to the fact that there is an active market for oil, Seller would obviously be over-compensated if we awarded him an amount equal to the full purchase price. Having learned from Buyer that the agreement is being dishonored, Seller is free, if he chooses, to sell his 1,000 barrels on the market to any buyer at the prevailing $44 price. Assume he does. If he were *also* entitled to recover $50,000 from Buyer, Seller's total receipts would be $94,000 and the breach of contract would have been a piece of rare good fortune from his standpoint. Aimed at compensating, but not over-compensating Seller for Buyer's breach, the expectation damage rule limits Seller's claim to the difference between the contract price—$50—and the market value of the goods at the contract date—$44—or $6 a barrel. In effect, Seller is required to "mitigate" damages by accepting the best price then available in the market. Whether or not he really sells the oil doesn't matter for this purpose: since he could if he wished, he is presumed to have done so. The proceeds of such sale, actual or presumed, are then applied to Buyer's account, that is, are treated as if received by Seller from Buyer himself. It follows that Seller's claim against Buyer under the prevailing common law damage rule is limited to $6,000, the sum "needed" to satisfy Seller's original expectation. That expectation, of course, was to receive $50 a barrel for 1,000 barrels of oil.

The concept just described is a simple one, I know, but to make sure of it I might ask the following: In applying the expectation damage rule, should it matter whether Seller *later* disposes of his oil for more or less than its market value at the contract date? Suppose after shrewd calculation he decides to retain the oil in the hope that the market, which is apparently volatile, will go back up to $50 in the near future? And suppose it quickly does, so that Seller actually *gets* his $50 a barrel, say two weeks afterwards. Or suppose it drops still further and the oil is finally sold by Seller for only $40. Should either of these events make a difference in computing Seller's damage claim? The answer is no. Seller is not required to dispose of his oil at $44, but if he doesn't he is on his own both legally and in economic terms. The entitlements and obligations of the parties—and in particular Seller's rights against Buyer—are cut off and determined at the date set by the contract. The reason is plain. Market forecasts made by the parties when the contract was entered into were keyed to a date exactly 90 days forward, no later. Seller proved to be the better forecaster (this time). But Seller's decision to hold his oil off the market *after* that date—to retain his long position hoping for a price jump—is obviously a decision made solely for his own interest; the consequences, good or bad, are his alone. Hence, Buyer's breach gives Seller a claim to $6,000 in damages—no more, no less—without regard to subsequent events.

This very brief description of the expectation damage rule has focused on proper compensation to Seller, the injured party, but the implications for Buyer are equally notable. Given the rule, Buyer's act in breaching the contract gains him nothing in my illustrative case. From Buyer's standpoint the obligation to pay Seller $6,000 in damages leaves Buyer no better off than he would be if he completed the contract by paying Seller $50,000 as promised, took delivery, and then simply sold the oil in the market for $44,000. Whatever he does, whether he fulfills the contract or breaches, Buyer is poorer by $6,000. Accordingly, unless he thinks he has some legal defense to offer, Buyer might as well grit his teeth and carry out his obligations in accordance with the contract.

And very probably he would, which may suggest to the reader that the principal impact of the expectation damage rule is *prospective* rather than backward-looking and remedial. Viewed from the beginning rather than the end of the contracting process, it is obvious that both parties then considered themselves better off by (a) agreeing to exchange cash for oil and (b) fixing the price at $50 a barrel. Each party undoubtedly felt that the agreement was to his advantage despite an awareness that his market prediction might turn out badly. Why or how the two parties reached their respective conclusions about the future price of oil we don't know, but for our purposes it is enough to state that each of them must have regarded the promised exchange as advantageous from the standpoint of his own wealth position. Buyer evidently feared that oil prices would be higher in 90 days, maybe a lot higher, Seller just the opposite. Apparently, each party thought it desirable to avoid or at least minimize his risk by substituting a single known quantity and price figure—1,000 barrels of oil at $50 a barrel—for the range of possible market prices 90 days in the future. Plainly, however, the expected benefit could be realized by the parties only if their agreement was seen to be fully reciprocal, that is, only if it was evident to both—at the outset—that neither could lose through one-sided compliance. If the legal rules permitted either party to breach without compensation to the other, then, probably, the best course to follow would be to avoid agreement altogether—regretfully, to be sure, because, as noted, the proposed exchange, including the fixed-price feature, was otherwise thought by each to be to his advantage.

But, of course, contracts calling for a forward exchange are entered into every day, and most are routinely performed, even though as to any single transaction one party is likely to prove a better forecaster of future market developments than the other. The reason for this is that the expectation damage rule operates to deprive the "loser"—Buyer on this occasion—of any benefit from indulging in non-cooperative conduct and, reciprocally, gives the "winner" his due. The gamble is fair to both parties; neither can renege after the cards are dealt. In this respect the rule has a consistent and important role in making cooperative relations feasible[1] and in promoting what was described above as "efficient" resource allocation.

1. Birmingham, *Legal and Moral Duty in Game Theory: Common Law Contract and Chinese Analogies,* 18 Buffalo L.Rev. 99, 105 (1969).

The foregoing, I hope, adequately explains the expectation damage rule in its simplest and most fundamental aspect, but I should caution that the subject of contract remedies is far more complex and extensive than my simple illustration suggests. If, for example, the transaction between a buyer and seller involved some product or service for which no active trading market existed, measuring damages by reference to daily price quotations would not be possible. In some situations, also, buyer and seller might have different expectations of benefit, so that the convenient element of symmetry would be lacking. Finally, my illustration entirely neglects the possibility that the parties may have incurred out-of-pocket costs in *reliance* on the contract—again, perhaps, in differing amounts—for which the injured party would presumably seek recovery as well. How should all or any of these circumstances be handled in fashioning a well-calibrated damage rule? These and other detailed remedy problems are examined in Chapter 8.

Calculation of damages is the final and culminating event in any contract litigation. Before reaching the damage question, as noted earlier, one needs first to determine whether a "contract" actually exists between the parties, one that the law recognizes and will enforce, then what the contract means, then whether the acts or omissions complained of by the plaintiff constitute a breach. Issues of this sort make up the bulk (the word is used advisedly) of most Contracts courses and are taken up at appropriate points in the Chapters that follow. Probably, though, the student's perspective will be clearer at each of these stages if he or she has some idea in advance of what is ultimately at stake for the parties, and this suggests that an overview of damages and remedies may be a suitable starting point in this field.

Having praised the expectation damage rule as instrumental to the welfare-maximizing function of exchange, I should add, or concede, that in general contract law has nothing much to do with the larger question of who gets what in this world. The economist's model of efficiency is one in which all mutually beneficial trades have been carried out and executed, with the happy consequence that further changes that would benefit *all* individuals are impossible, at least until circumstances change. But beware the syllogism: the fact that no further changes can be made that will make everybody happy does not mean that everybody *is* happy. A given society's resources may, for example, be allocated in such a way that 10% of the population owns 90% of all the apples and oranges and everything else, while 90% of the population must live on the 10% that is left. This seems inequitable, to put it mildly, but resource allocation is "efficient" in economic terms if there are no further opportunities to exchange goods and services in a way that will make someone better off without making someone else worse off (if, in effect, no further gains from trade can be achieved). By contrast, a redistributive measure that produced a greater degree of equality in the ownership of resources would neither be compelled nor justified under a pure efficiency standard. Those made worse off would obviously suffer a loss of well-being unless they are altruists, and would therefore be unlikely to regard such a measure as anything but a forced exaction (otherwise known as a tax). Shifting wealth from one person (or group of people) to another—making the latter better off but the former worse off—lacks the element of *mutual* benefit with which the efficiency standard is usually identified.

We might, nevertheless, and probably would conclude that the distribution of resources in the society just described was inhumane and unfair and decide that something should be done about it. Plainly, however, the process of trading one thing for another, which assumes the pursuit of purely selfish motives, will not serve well as an instrument of "reform" unless we are sure that the people in the rich minority will be consistently wrong in their predictions about the economic future, like Buyer in my illustration. But that is implausible. It follows, I think, that Contracts, the law of *voluntary* exchange, has relatively little to say about equity and fairness in the large. Rather, its focus is on that multitude of commonplace, small-scale transactions by means of which private individuals seek to advance their personal well-being, each individual acting strictly in his own interest.

All this is pretty cold-blooded. Not liking it very much, some writers argue that contract law, with its emphasis on enforcement, is essentially a reactionary force, one that operates to preserve the status quo by treating the act of voluntary exchange as sacrosanct and inviolable, even though in some cases the parties to a contract may be unequal in bargaining power and education. Where such inequality exists (it is said) enforcement on the usual basis is unjustified and rules of amelioration should be developed. From the other end, some assert that strict enforcement of contracts is really a way of showing respect for the dignity and freedom of other individuals by taking them at their word. Hence, arguably, judicial or legislative interventions in the name of fairness—for example, excusing certain people from performance when it appears that the obligations they have assumed are especially harsh—amounts to creating one class of caretakers and another class of sheep. These viewpoints, which inevitably involve the proponent's ethical values, are brought into sharper focus in connection with the subject of unconscionability, which is taken up in Chapter 4.

One further (and concluding) set of observations should be made concerning the purpose and function of legal rules in the Contracts field. As has been seen, contracts are voluntary arrangements created by the parties themselves to carry out their own particular aims. People exchange things with one another because they want to not because they have to, and in fashioning the terms of exchange—who is obliged to do what for whom—they are likewise free, within broad limits, to invent their own rules of conduct and to structure their relationship in the way that best suits their personal interests. As usual, the structure finally adopted will be the product of negotiation—sometimes protracted, sometimes instantaneous—with each party seeking his own advantage but with both parties, presumably, feeling better off as a result of the exchange.

The role of legal rules in this setting—whether we speak of statutory rules, as in the case of the Uniform Commercial Code, or of common law rules—is important but, in a sense, subordinate. If the parties to a contract had the time and the vision to negotiate and articulate every element that could conceivably bear upon their relationship, weighing every contingency and imagining all possible future states of the world, there would be little need for contract rules as such. The resulting agreement, under these idealized circumstances, would be complete and self-contained; there would be no gaps of meaning and no ambiguity of language or expression, and hence nothing would be left for judicial interpolation or surmise. The courts, then, would function solely as an enforcement mechanism, automatically converting known obligations and entitlements into legal judgments.

The difficulty, of course, is that no contract, however detailed, can or will be wholly comprehensive. Apart from limitations on human foresight, the cost in time and money of sorting out all possible contingencies and then drafting the relevant contract provisions would be prohibitive even for large transactions, and the resulting contract would be as thick as the proverbial phone-book (actually, some are). For the smaller, routine transactions of daily business or personal life, anything more complex and time-consuming than a one- or two-page purchase order is obviously impractical.

Having this circumstance in mind, the primary function of legal rules becomes apparent. Thus, the presence of standing rules on which the parties can rely in the absence of a fully articulated agreement makes it unnecessary to burden every contractual un-