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CONTRACTS: NOTES ON THE EXAM

General Comments

Read the question carefully. If it says TT is the only manufacturer of mold resistant tile in Arcadia do not assume that it is the only seller of mold resistant tile in Arcadia, or the only producer which is able to supply mold resistant tile in Arcadia.

Think. Just because there is a shopping center in the question does not necessarily mean you should discuss a case we read involving a shopping center (Chung v Kaonohi Center). Or at least you should only discuss that case if it deals with an issue raised by the facts of the question. Context matters but doctrine matters too.

Do not make assumptions. The exam instructions expressly stated that you should not make assumptions. A number of the answers did in fact make assumptions, even using the word "assume" as if assuming were appropriate. Often where answers used "assume" it would have been better to use the word "if."

Have the courage of your convictions. If you think tile is a movable good then say so. If you say it is "likely" a movable good this suggests you are not sure and I will grade your answer as if you are not sure. Tile is a movable good (the question did not say the tile was fixed to a building, and the question describes a contract for the sale of tile which is capable of being delivered). Rather than trying to modify your answer by using a word like "likely" you might explain what would make a difference to the analysis.

Answer the question asked. Answering a different question you like better isn't really the point of an exam.

SECTION A (60% of the exam grade or 60 points)

1. What contract remedies does Cosmo have against Total Tile for its failure to deliver the mold resistant tile on time? Would you need to know any additional facts to answer this question? (15 points)

The tile is a movable good under UCC § 2-105,[1] thus UCC Article 2 applies. A

[1] " "Goods" means all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities (chapter 678) and things in action. "Goods" also includes the unborn young of animals and growing crops and other identified things attached to realty as described in the section on goods to be severed from realty."

number of answers discussed this situation as if it involved a mixed goods/services contract either on the basis of the delivery (which is clearly a feature of many sale of goods contracts and referred to as such in many of the UCC provisions we have read (consider e.g. UCC § 2-711)) or on the basis that the contract might involve installation (something which is not referred to as a possibility in the question). If a question does not in fact raise an issue it doesn't really make sense to discuss it as if it did.

But if you conclude that the UCC applies to the facts of a problem then you should apply the UCC. Don't say the UCC applies and then discuss expectation, reliance and restitution damages; instead you should discuss the relevant rules in the UCC. And discuss them and how they apply to the facts of the problem, don't just copy them into your answer. Where more than one remedy might be available tell me whether they are cumulative or alternative, don't make me guess whether you understand the relationship between the different remedial possibilities.

CC could accept the tile late and seek damages with respect to the delay under UCC § 2-714 (which could include incidental and consequential damages),[2] or could seek a remedy with respect to TT's breach of its obligations under the contract. Under UCC § 2-711 CC would recover its deposit and then could claim a remedy based on either a cover price (UCC § 2-712) or market price (UCC § 2-713) (with incidental and consequential damages as appropriate). Some answers suggested that CC should try to cover (in which case it would get a remedy based on the difference between the cover price and contract price) and if unable to do so then would be able to go for a remedy based on market price. But UCC §2-711 allows the buyer to choose which remedy to seek. CC could decide to claim a remedy based on market price.

The question does not give any information as to the likely possibilities of cover. We know TT is the only manufacturer of the mold resistant tile in Arcadia but Arcadia is a state in the US and tile manufacturers based in other states or even outside the US may sell mold resistant tile in Arcadia or at least agree to ship the tile to CC. A number of answers interpreted the question to say that TT was the only supplier of mold resistant tile in the state. In fact the question states that TT is the only <u>manufacturer</u>, which is different.

CC could claim costs associated with dealing with the breach, such as search costs with respect to the replacement tile, and additional delivery charges, as incidental damages. The question does not specify any such costs.

With respect to either option (accept the tile late or seek damages for breach)

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[2] " Buyer's Damages for Breach in Regard to Accepted Goods. (1) Where the buyer has accepted goods and given notification (subsection (3) of Section 2-607) he may recover as damages for any non-conformity of tender the loss resulting in the ordinary course of events from the seller's breach as determined in any manner which is reasonable...")

there could be an issue with respect to consequential damages. We have discussed the idea of lost profits as a possible item of consequential damages. Here the question states that CC stands to make a loss on its contract with PG (suggesting no basis for lost profits fdamages). However, the contract between PG and CC provides that in the event of any delay in completing the construction project CC will pay damages to PG at an amount determined by a formula. The question does not tell us whether the 3 month tile delay would be significant with respect to CC's ability to complete the construction on time. We would need additional facts here.

UCC §2-715(2) states that consequential damages include damages for losses "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." If the delay would result in CC being liable for damages to PG with respect to the construction, there are some issues we do not have information about. The question does not say whether CC informed TT of likely costs associated with delay, or anything to allow us to know whether cover would have been possible. If TT had reason to know of the possible consequential damages and cover was not possible there would be an issue as to the amount CC could claim. The formula may be able to be challenged as a penalty rather than as a reasonable liquidated damages provision. If this is so then CC's ability to reduce the amount payable by making the penalty argument probably should be seen as being dealt with by the "which could not reasonably be prevented by cover or otherwise" language.

A number of answers argued for specific performance based on the "uniqueness" of the tile. It is not clear from the question whether the tile in fact would be appropriate for a specific performance remedy or whether in fact TT has any tile to supply (the question does not say). So there are additional facts we would need to know here. Some answers raised the issue of the statute of frauds. The question says the contract was "signed" which suggests writing. If the question describes the tile as "mold resistant" it doesn't really make sense to describe it as "waterproof" in your answer.

2. Gigi Grocery is concerned that the profitability of its store in PGAC will be very much reduced by the proximity of a competing store. What arguments can Gigi Grocery make that PG is in breach of contract in these circumstances? (15 points)

Answers to this question shared an intuition that there was something wrong here but offered some different suggestions about how GGG should argue its case. GGG would likely want either to get out of its contract with PG (i.e. find grounds for invalidating/avoiding the contract) or to be able to reduce its lease payments on the basis of the lower profitability (a remedy based on the difference between what GGG was promised and what it got). Had GGG known all the facts it would likely have

negotiated lower lease payments.

The question asks what arguments GGG can make that PG is in breach of contract. Answers which focused on remedies were not really addressing the question asked.

GGG might want to argue that PG was in breach of the contract because GGG was not in fact getting what it was promised (the exclusive right to operate the organic grocery store) in the contract. GGG could argue that although the two shopping centers have different names they are really part of one large shopping center. The similar design would help with this argument. But PG can argue that as a matter of form the shopping centers were separate. GGG was in fact the only organic grocery store in PGAC.

A better argument would be that PG breached its duty of good faith in depriving GGG of the benefit of the contract. *Market Street Associates v Frey* was the case we read about the duty of good faith (good faith was also discussed in Wagenseller). In Market Street Associates Posner says that the duty of good faith during the course of a contractual relationship is more demanding than when the parties are negotiating. Restatement § 205 deals with the duty of good faith and fair dealing and states that every contract imposes upon each party a duty of good faith and fair dealing in performance and enforcement. One of the restatement examples of the duty of good faith is where the owner of a shopping center grants exclusive rights to run a supermarket where the rent is to be a percentage of gross receipts and during the term of the lease acquires adjoining land and leases part to another for a competing supermarket.

A different argument that GGG might make here would focus not so much on breach but on PG's behavior in inducing GGG to enter into the contract. GGG could argue fraud: that PG promised an exclusive right but intended to undermine the right by setting up a new shopping center next door (*cf. Obde v Schlemeyer*). But it's not entirely clear that at the time PG and GGG entered into their contract PG in fact misled GGG.

Some answers referred to this situation as a non compete situation. And this makes sense because the exclusivity GGG thinks it has contracted for is to protect it from competition in the same sort of way non-compete clauses do. But when we discussed non-compete clauses (*e.g. Fullerton Lumber*) we were really thinking about challenges to their validity, and the hypothetical doesn't seem to raise the sort of concerns addressed in *Fullerton Lumber*. However, it does provide some support for the idea that reasonable restraints on competition are valid.

Some answers cited *Hoffmann v Red Owl* and argued that a promissory estoppel argument might help GGG. Given that there is in fact a concluded contract between GGG and PG it is not at all clear that promissory estoppel could be used to extend the

obligations of PG.

If the question asks what arguments GGG can make it does not really make sense to begin the answer with the arguments PG might make.

3. PG tells Cosmo that Cosmo is in breach of the contract for the construction of PGAC because of the delay. PG says that it will not pay Cosmo for the construction work that Cosmo has done because Cosmo has used undocumented workers, which is illegal. In addition PG says that Cosmo must pay damages for the delay under the contractual formula. PG states that it would be willing to pay Cosmo 40% of the value of the work Cosmo has done in full and final settlement. Cosmo is in financial difficulties and agrees. Cosmo thinks that it can get away with paying its undocumented workers less than it had originally agreed to pay them because they are unlikely to sue. Discuss. (30 points)

PG says that CC is in breach of contract because of the delay in construction and that it does not want to pay for the work because of the illegality involved in CC's hiring of undocumented workers. The question states that a "large proportion of construction workers in Arcadia are undocumented." The question does not state this but the reference to the delay suggests that CC has not completed the work at the time PG claims that CC is in breach of contract.

Some answers wanted to treat this situation as being governed by the UCC, and usually by assertion rather than making an argument as to why this was the case. It is pretty clearly a construction contract although some of the components seem to be provided by CC. Some answers looked at the situation as a mix of goods and services, but tended to conclude that the services element would predominate.

The situation invites a discussion of the illegality issue. We encountered illegality as an argument with respect to hiring of undocumented workers in the *Coma Corporation* case. Here the illegality issue arises in the context of PG's suggestion it does not need to pay CC and CC's idea that it may be able to get away with not paying the workers. In *Coma Corporation* the court held that IRCA did not preclude workers claiming payment for work that had actually been done. The court said that allowing such claims was consistent with the policy of IRCA because it would reduce incentives for employers to hire undocumented workers. This is clearly relevant to the issue of whether CC can avoid paying the workers. It is less directly relevant to the PG-CC issue, but given the cases we have read it is not clear that a court would be comfortable with allowing PG a windfall based on these facts (*cf. Carroll v Beardon*). In addition, although PG is arguing it does not have to pay CC it also argues that CC should compensate it for the delay. If the contract is void for illegality there should not be a basis for enforcing the liquidated damages provision.

We are not told whether the contract specifies particular payments at particular stages of completing the work. If there is no such specification in the contract CC could claim a remedy based on the contract price less what it would cost PG to have someone else complete the work, or based on reliance or on a restitution theory. A reliance based remedy would allow CC to claim back expenses it has incurred in doing the construction work. This contract was a loss-making contract for CC however so it is open to PG to argue that the amount owed to CC should be reduced by reference to the loss CC would have made on the contract (*e.g. Armstrong Rubber*). Alternatively CC could claim a remedy based on restitution with respect to the value of the work it has done. This could be by reference to the value of the work to PG (value added to the property) or by reference to what PG would have had to pay another firm to do the work. The Restatement suggests that the builder in breach gets the lower amount (Restatement §371, comment b).

PG would be entitled to some damages with respect to the delay. The question states:

> "in the event of any delay in completing the construction project Cosmo will pay damages to PG at an amount determined by a formula. The contract states that the parties recognize that in the event of any delay in completing the construction it will be difficult to quantify PG's damages and that the formula is based on the average profits PG makes from its shopping centers throughout the US. Tom knows that PG's new shopping centers, especially new shopping centers based in areas where PG does not have an established presence, are less profitable than established shopping centers. Cosmo agreed to the formula because its management was confident of completing the work on time."

We are not given any details of the formula, although we are told that it is based on average profits in PG shopping centers rather than in new shopping centers even though new shopping centers where PG does not have an established presence are less profitable than established shopping centers. Thus the formula would tend to generate a liquidated damages amount higher than actual damages PG would suffer due to the delay. The contract seems to state that it would be difficult to quantify damages in the event of delay, and we saw the issue with respect to proof of lost profits in a new business in *Evergreen* and *Chung*. A liquidated damages clause makes sense in this context. But if the amount of damages is unreasonably high as a result of the application of the formula a court may decline to apply the formula. This would mean that PG would need to prove its lost profits.

We have no way of knowing whether the amount owing to CC for its work less the damages it owes to PG with respect to the delay is more or less than 40% of the value of the work CC has done. We do know that the question states that CC agreed to accept this amount because of its financial difficulties. In the *Selmer Company* case where there was no acknowledgment with respect to the amount owed and the

settlement was for over 50% of Selmer's demand and Selmer accepted it because of its own financial difficulties the court upheld the settlement. *Mitchell* is a contrasting case where the court found duress. Most answers concluded that this case is more like the *Selmer Company* case. I am not so sure. It seems to me that PG's aggressive stance with respect to what it is prepared to pay CC is rather different from the situation in that case. The arguments PG wants to make to limit its obligation to pay CC for CC's work are based on trying to take advantage of an illegality that seems to be endemic in construction in Arcadia, and of a clause that may be held to be invalid as a penalty - this behavior may be significant in making CC accept the settlement. It's perhaps not enough to constitute a threat, but PG is clearly a large sophisticated business. If CC is smaller and less sophisticated then that might make a difference.

SECTION B (40% of the exam grade)

These comments reflect much of what turned up in the answers, although with my own perspective. Arguments which don't coincide directly with my own views get credit if they are supported by material from the course.

I intended the first question to be about whether courts should always enforce things that are as a formal matter binding contracts and the second question to be about the distinction between promises that are enforced and promises that are not enforced (whether or not they are in fact formally contracts). This second question asks about the enforcement of promises rather than about the enforcement of agreements or contracts. But I accepted answers to the second question which focused on unenforceable contracts. The answers were pretty evenly divided between the two questions. But some answers to the second question could have been answers to the first question — generally there was some overlap in the materials cited in response to the two questions. Although the exam stated quite clearly that only one of the section B question should be answered 3 people decided to attempt both questions.

1. Do courts rewrite contracts? Should they do so?

A number of answers responded to this question by using the efficiency/fairness distinction. Some answers used this distinction in the context of this question effectively whereas others were less effective. Writing about cases where the courts intervene to do justice (or don't) versus cases where the courts emphasize upholding bargains does have a relationship to the question but answers which made an effort to explain the relationship obtained higher marks than answers which told me about the fairness/ efficiency distinction without linking it to the question. The clear links between the rewriting issue and the fairness/efficiency distinction relates to situations of unequal bargaining power. Standard form contracts or contract terms imposed by a contracting party on another do raise some issues with respect to fairness and also with respect to whether the terms will be enforced as written or not. Seeing some liquidated damages

provisions as unenforceable penalties and some non-compete clauses as too restrictive to enforce is often seen as based on a concern about inequality of bargaining position.

I think it makes sense to reflect a bit on what the question is asking. It is asking about the role of courts rather than about contract law. Therefore I think that implied warranties under the UCC are not the best example of what the question is asking about. Implied warranties do change the terms of a contract but they do so as a result of the decision of a legislature rather than a court. And because they are implied through legislation they are probably more transparent than if they were imposed only through court decisions. However it is possible to interpret the question to be asking whether if rewriting is to be done courts are the bodies to do it. One answer argued pretty effectively that legislatures should be responsible for making this sort of decision (*cf.* Leff).

The question also asks about rewriting contracts which seems to have to do with written contracts (texts) rather than oral contracts, and contracts rather than situations where no contract in fact exists (although one could argue a bit over this second item). The "rewriting contracts" terminology does not apply very well to the cases we read about contracts in the family setting where the courts are deciding when they should give remedies based on promises which were not reduced into formal written binding contracts. Promissory estoppel isn't about rewriting contracts but about finding a remedy where formal contract law did not traditionally provide for one.

Rewriting contracts suggests a change in the terms of a contract rather than every case in which a court might make a decision about validity or might grant a remedy even though no contract exists. Situations in which a court eliminates a provision from a contract (*e.g.* liquidated damages: *Lake River*; exculpatory clauses: *Yauger*) or where a court modifies a particular provision (*e.g.* non-compete clauses: *Fullerton Lumber*) or where a court implies terms from other documents (*e.g.* implied in fact terms in employment contracts: *Wagenseller*) are better examples for this question than cases where courts find contracts to be invalid (*e.g.* duress, lack of capacity). In the cases where a court eliminates a term of a contract the court is keeping a set of obligations in place but changing the characteristics of those obligations, rather than allowing for an unwinding of a relationship. Rewriting has implications for the pricing of the bargain. Here I think Easterbrook's arguments in *Pro-CD* are relevant - he wants to uphold the actual bargain that was intended even if there are some problems of formal contract doctrine in doing so.

At the same time, sophisticated parties are knowingly bargaining in the shadow of the law and know to contract in ways that take account of the risks that courts will rewrite their agreements. Franchisors take account of the risks that a liquidated damages clause will be treated as a penalty in drafting, as do employers drafting non-compete clauses. And sometimes parties will take account of the risks of rewriting in pricing their contracts. So in these types of situation, where the risk that courts will rewrite or write out contract provisions is well known, informed parties can address the

risks.

However we read other cases where the court's decision was arguably less predictable such as *Peevyhouse* and *Market Street Associates.* In *Peevyhouse* the court refuses to enforce the contract and in *Market Street Associates* the question is about what restrictions are imposed by virtue of the good faith requirement on a party's ability to enforce its contract rights. Market Street Associates arguably raises the question of interpretation of the contractual language (and also the hypothetical bargain idea which relates to the rewriting question). The meaning of a contract is often uncertain, and the distinction between interpretation and rewriting may not always be clear.

2. "Should the courts, as the arm of the state, enforce every statement made in the form of a promise? The courts have never thought so. But as soon as we accept the need to divide the enforceable from the unenforceable, we encounter the difficult task of articulating the criteria for deciding which is which" (from the casebook, in the introduction to contract in the family setting).

Discuss, either with respect to the domestic context or more generally.

The question asks about the distinction between enforceable and unenforceable promises and about the difficulties of drawing the line between these. And it begins by referring to courts "as the arm of the state" thus inviting some discussion of the proper role of the courts.

From the material we read this semester we know that distinguishing between unenforceable and enforceable promises may be based on: issues of capacity, formalities (consideration, Statute of Frauds, intention to create legal relations (*Balfour v Balfour*)) , and a range of issues with respect to public policy as defined by courts and legislatures (*e.g.*, statute regulates the issue/up to the legislature to decide policy, illegality/public policy, duress/unconscionability). Agreements which are intended by the parties to be binding may not be treated as binding because of a failure of formalities or because the subject matter of the agreement or the circumstances in which it is concluded conflict with public policy articulated in statutes or court decisions. A discussion of the various ways in which we saw that contracts could be treated as unenforceable would be appropriate here (note there is some possibility for overlap with the hypothetical).

But the question also raises the issue of whether there may be promises which may not really even be intended to be binding by the maker of the promise but which are treated by the courts as being binding because of the circumstances. One could say that the sort of promises which meet the criteria for contracts (supported by consideration, compliant with formalities, not contravening public policy etc) are an example of enforceable promises. But there are other promises which are treated as

enforceable even though they don't seem to meet the criteria for contracts. This invites some discussion of cases where people made promises but did not take care to ensure that the promises were legally effective and despite this failure to effectively formalize the contract the court provides a remedy as if there had been an effective contract. Examples of such cases in the domestic setting would be *Hamer v Sidway*, *Davis v Jacoby* and *Ricketts v Scothorn* (to which *Kirksey v Kirksey* provides a contrast). *Marvin v Marvin* and *Balfour v Balfour* might also be useful examples of cases where courts consider under what circumstances promises may be treated as being binding. In the commercial context we read *Hoffmann v Red Owl*. In some of these cases the courts seem to manipulate doctrine to provide a remedy. Other cases focus explicitly on reliance as the basis for the remedy: the promissor is liable for creating a situation in which the promissee suffers detriment through reliance.